



# The “Volcker Rule”: Proposals to Limit “Speculative” Proprietary Trading by Banks

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June 30, 2010

Congressional Research Service

7-5700

[www.crs.gov](http://www.crs.gov)

R41298

## Summary

In 1933, during the first 100 days of President Franklin D. Roosevelt’s New Deal, the Securities Act of 1933 and the Glass-Steagall Act (GSA) were enacted, setting up a pervasive regulatory scheme for the public offering of securities and generally prohibiting commercial banks from underwriting and dealing in those securities. Banks are subject to heavy, expensive prudential regulation, while the regulation of securities firms is predominately built around registration, disclosure of risk, and the prevention and prosecution of insider trading and other forms of fraud.

While there are two distinct regulatory systems, the distinguishing lines between the traditional activities engaged in by commercial and investment banks became increasingly difficult to discern as a result of competition, financial innovation, and technological advances in combination with permissive agency and judicial interpretation.

One of the benefits of being a bank, and thus being subject to more extensive regulation, is access to what is referred to as the “federal safety net,” which includes the Federal Deposit Insurance Corporation’s (FDIC’s) deposit insurance, the Federal Reserve’s discount window lending facility, and the Federal Reserve’s payment system.

In the wake of the Great Recession of 2008, there have been calls to reexamine the activities that should be permissible for commercial banks in light of the fact that they receive governmental benefits through access to the federal safety net. Some have called for the reenactment of the provisions of the GSA that imposed affiliation restrictions between banks and securities firms, which were repealed by the Gramm-Leach-Bliley Act (GLBA) in 1999.

While neither the House- nor the Senate-passed version of H.R. 4173, the comprehensive financial regulatory reform proposals of the 111<sup>th</sup> Congress, includes provisions that would reenact the GSA, both bills do propose curbs on “proprietary trading” by banking institutions. H.R. 4173, newly titled the Dodd-Frank Wall Street Reform and Consumer Protection Act, which is modeled on the Senate version, would limit the ability of commercial banking institutions and their affiliated companies and subsidiaries to engage in trading unrelated to customer needs and investing in and sponsoring hedge funds or private equity funds. Such an approach has been referred to as the “Volcker Rule,” having been urged upon Congress by Paul Volcker, former Chairman of the Board of Governors for the Federal Reserve System and current Chairman of the President’s Economic Recovery Advisory Board.

This report briefly discusses the permissible proprietary trading activities of commercial banks and their subsidiaries under current law. It then analyzes the Volcker Rule proposals under the House- and Senate-passed financial reform bills and under the Conference Report. **Appendix A**, **Appendix B**, and **Appendix C** of the report provide the full legislative language in each.

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## Introduction

In 1933, during the first 100 days of President Franklin D. Roosevelt’s New Deal, the Securities Act of 1933<sup>1</sup> and the Glass-Steagall Act (GSA)<sup>2</sup> were enacted, setting up a pervasive regulatory scheme for the public offering of securities and generally prohibiting commercial banks from underwriting and dealing in those securities.<sup>3</sup> GSA prohibited affiliations between banks (which, for the purposes of this report, means bank-chartered depository institutions, that is, financial institutions that hold federally insured consumer deposits) and securities firms (which are commonly referred to as “investment banks” even though they are not technically banks and do not hold federally insured consumer deposits);<sup>4</sup> further restrictions on bank affiliations with non-banking firms were enacted in Bank Holding Company Act of 1956 (BHCA)<sup>5</sup> and its subsequent amendments, eliminating the possibility that companies owning banks would be permitted to take ownership or controlling interest in insurance companies, manufacturing companies, real estate companies, securities firms, or any other non-banking company. As a result, distinct regulatory systems developed in the United States for regulating banks, on the one hand, and securities firms on the other.

Banks are institutions of limited power; they may only engage in the activities permissible pursuant to their charter, which generally limits them to the “business of banking” and all powers incidental to the business of banking.<sup>6</sup> Included in these activities restrictions are certain

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<sup>1</sup> 48 Stat. 74, codified at 15 U.S.C. §§ 77a *et seq.*

<sup>2</sup> Technically, the GSA is the same as the Banking Act of 1933; however, the GSA has come to refer to only four sections (§§ 16, 20, 21, and 32) of that piece of legislation, 48 Stat. 162. GSA §§ 20 and 32, which pertained to affiliation restrictions between banks and securities firms, were repealed by the GLBA. Section 16, which delineates the express powers of banks, and § 21, which makes it illegal for any securities company to engage in deposit taking and preserves the authority of commercial banks to engage in the limited securities activities authorized under the GSA § 16, were not repealed by the GLBA and are still good law. For more detailed information on the GSA, see CRS Report R41181, *Permissible Securities Activities of Commercial Banks Under the Glass-Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)*, by David H. Carpenter and M. Maureen Murphy.

<sup>3</sup> Another important bar to banks’ dealing in securities is the BHCA, administered by the Board of Governors of the Federal Reserve System (FRB). Prior to enactment of the GLBA, the BHCA prohibited companies owning or controlling banks (i.e., bank holding companies (BHCs)), from acquiring “ownership or control ... of any company which is not a bank or ... any company the activities of which had been determined by the ... [FRB] to be so closely related to banking as to be a proper incident thereto.” 12 U.S.C. § 1843.

<sup>4</sup> The use of the term “bank” to describe both commercial banks and investment banks can be confusing. The term “investment bank” generally is used to describe financial institutions that are primarily involved in the securities business that are not depository institutions because they do not hold federally insured consumer deposits, and therefore are not technically banks. Bear Stearns, before its acquisition by JP Morgan Chase, and Lehman Brothers, before its failure, were examples of investment banks. The term “commercial bank,” on the other hand, usually refers to depository institutions, generally, or specifically to a depository institution with a bank charter. There are three primary types of federal depository charters: bank, thrift (a.k.a., savings and loan association), and credit union. Thrifts, like banks, offer federally insured consumer deposits, but thrifts, unlike banks, historically have been mission-oriented through a required focus on residential mortgages and related assets. In order to maintain this concentration, thrifts have been subject to limitations on the types of assets in which they can invest. Credit unions engage in activities similar to those of banks and thrifts, but usually on a more limited basis. Credit unions, unlike most banks and thrifts, are owned by their depositors and are tax-exempt. *The Department of the Treasury Blueprint for a Modernized Financial Regulatory Structure*, Dept. of Treasury, pp. 38-39, Mar. 2008, available at <http://ustreas.gov/press/releases/reports/Blueprint.pdf>. This report focuses on banks, not other forms of depository institutions.

<sup>5</sup> 70 Stat. 133; 12 U.S.C. §§ 1841-1850.

<sup>6</sup> 12 U.S.C. § 24(Seventh) (stating, in part: “To exercise ... all such incidental powers as shall be necessary to carry on the business of banking; by discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt; by receiving deposits; by buying and selling exchange, coin, and bullion; by loaning money on personal (continued...)”).

limitations on their ability to engage in proprietary trading, that is, investing as principal, rather than at the behest or for the benefit of customers, for the bank’s own account. In addition to activity restrictions, banks are subject to capital standards, affiliation restrictions, management interlocking restrictions, and many other standards;<sup>7</sup> they are subject to regular examinations to ensure they are being well-managed, conducting business in a safe and sound fashion, and complying with numerous consumer protection and other laws;<sup>8</sup> and federal banking regulators have a full range of strong and flexible enforcement tools, such as prompt corrective action powers, to rectify problems that are found during examinations.<sup>9</sup>

One of the benefits of being a bank, and thus being subjected to heavy, expensive regulation, is access to what is referred to as the “federal safety net,” which includes the Federal Deposit Insurance Corporation’s (FDIC’s) deposit insurance, the Federal Reserve’s discount window lending facility,<sup>10</sup> and the Federal Reserve’s payment system.

The regulation and oversight of securities firms are very different from that of banks. Securities firms may be primarily regulated by the Securities and Exchange Commission (SEC) at the federal level, or they may not be regulated directly at the federal level at all, which often is the case for hedge funds, private equity firms, and special purpose vehicles (SPVs).<sup>11</sup> Rather than regulating for safety and soundness, the SEC’s regulatory regime is predominately built around registration, disclosure of risk, and the prevention and prosecution of insider trading and other forms of fraud. SEC-regulated firms generally are not subject to capital and liquidity standards or to regular safety and soundness examinations.<sup>12</sup> And aside from a general prohibition on accepting federally insured consumer deposits, securities firms generally are not subject to activity restrictions, as are banks.<sup>13</sup> As a result, these institutions generally do not have access to the federal safety net.<sup>14</sup>

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(...continued)

security; and by obtaining, issuing, and circulating notes according to the provisions of title 62 of the Revised Statutes.”).

<sup>7</sup> See, e.g., 12 U.S.C. § 1828.

<sup>8</sup> See, e.g., 12 U.S.C. § 1820(d).

<sup>9</sup> 12 U.S.C. § 1831o; 12 U.S.C. § 1818.

<sup>10</sup> The discount window is the Federal Reserve’s authority to lend directly to depository institutions and U.S. branches of foreign banks, generally where the depository is unable to acquire funding in the private market. Loans made through the discount window must be sufficiently collateralized and are subject to a interest rate above the federal funds rate. 12 U.S.C. § 343. For more information on the discount window, see *Federal Reserve Discount Window*, Federal Reserve System, available at <http://www.frbdiscountwindow.org/discountwindowbook.cfm?hdrID=14&dtIID=43>.

<sup>11</sup> See, generally, CRS Report R40783, *Hedge Funds: Legal Status and Proposals for Regulation*, by Kathleen Ann Ruane and Michael V. Seitzinger.

<sup>12</sup> CRS Report RS22581, *Overview of Major Federal Securities Laws*, by Michael V. Seitzinger.

<sup>13</sup> See, David M. Eaton, *The Commercial Banking-Related Activities of Investment Banks and Other Nonbanks*, 44 Emory L. J. 1187 (1995).

<sup>14</sup> However, in emergency situations, there are two possible ways investment banks may secure credit from the Federal Reserve banks. If they are able to offer U.S. government issued or guaranteed obligations as collateral for their own promissory notes and the Federal Reserve bank, in consultation with the FRB, judges that credit is unavailable elsewhere and that failure to secure credit would have an adverse effect on the U.S. economy, advances may be granted to such individuals, partnerships, or corporations. If they lack adequate eligible security for advances, Section 13(3) of the Federal Reserve Act (FRA) provides a mechanism by which a discount may be secured upon the vote of five or more Members of the FRB. 12 U.S.C. § 343. The applicable Board Regulation, 12 C.F.R. § 201.4(d) reads:

*Emergency credit for others.* In unusual and exigent circumstances and after consultation with the  
(continued...)

While there are two distinct regulatory systems, the distinguishing lines between the traditional activities engaged in by commercial and investment banks became increasingly difficult to discern as a result of competition, financial innovation, and technological advances in combination with permissive agency and judicial interpretation. Beginning in the late 1970s, the Board of Governors of the Federal Reserve System (FRB), as the primary regulator for bank holding companies (BHCs),<sup>15</sup> and the Office of the Comptroller of the Currency (OCC), as the primary regulator for national banks, issued a series of regulations and orders, liberally interpreting the limitations imposed on the activities of commercial banks through laws such as the GSA and the BHCA. The result was the incremental expansion of the types and levels of securities activities permissible for BHCs and financial subsidiaries of banks. The Gramm-Leach-Bliley Act of 1999 (GLBA)<sup>16</sup> continued this trend by repealing two of the four sections of the GSA and the BHCA and by establishing the financial holding company (FHC) structure, which permits commercial banks and full-service investment banks (as well as insurance companies) to coexist under common control.

In the wake of the Great Recession of 2008, there have been calls to reexamine the activities that should be permissible for commercial banks in light of the fact that they receive governmental benefits through access to the federal safety net. Some have called for the reenactment of the repealed provisions of the GSA, which is discussed in greater detail in another CRS report.<sup>17</sup>

While neither the House- nor the Senate-passed version of H.R. 4173, the comprehensive financial regulatory reform proposals of the 111<sup>th</sup> Congress, includes provisions that would reenact the GSA, both bills do propose curbs on “proprietary trading” by banking institutions. The bills would limit the ability of commercial banking institutions and their affiliated companies and subsidiaries to engage in trading unrelated to customer needs and investing in and sponsoring hedge funds or private equity funds. Such an approach has been referred to as the “Volcker Rule,” having been urged upon Congress by Paul Volcker, former Chairman of the FRB and current Chairman of the President’s Economic Recovery Advisory Board.

This report briefly discusses the permissible proprietary trading activities of commercial banks and their subsidiaries under current law. It then analyzes the Volcker Rule proposals under both the House- and Senate-passed financial reform bills. **Appendix A**, **Appendix B**, and **Appendix C** of the report provide the full legislative language from both bills.

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Board of Governors, a Federal Reserve Bank may extend credit to an individual, partnership, or corporation that is not a depository institution if, in the judgment of the Federal Reserve Bank, credit is not available from other sources and failure to obtain such credit would adversely affect the economy. If the collateral used to secure emergency credit consists of assets other than obligations of, or fully guaranteed as to principal and interest by, the United States or an agency thereof, credit must be in the form of a discount and five or more members of the Board of Governors must affirmatively vote to authorize the discount prior to the extension of credit. Emergency credit will be extended at a rate above the highest rate in effect for advances to depository institutions.

<sup>15</sup> BHCs are companies owning or controlling at least one bank.

<sup>16</sup> P.L. 106-102.

<sup>17</sup> CRS Report R41181, *Permissible Securities Activities of Commercial Banks Under the Glass-Steagall Act (GSA) and the Gramm-Leach-Bliley Act (GLBA)*, by David H. Carpenter and M. Maureen Murphy.



## Current Restrictions on Proprietary Trading

### Pre-GLBA

The OCC and the FRB are empowered to implement, enforce, and, by extension, interpret (by regulation, guidance, or order) the subtleties and ambiguities of the GSA and the BHCA. For several decades after the enactment of the GSA, banks did not attempt to expand beyond traditional banking activities to a significant degree. This trend began to change in the 1970s. High inflation, coupled with a consumer movement to interest-bearing accounts and investment products, such as money market funds offered by securities firms, reduced the profitability of traditional bank products.<sup>18</sup> Corporate consumers also began moving to securities firms for short-term lending (e.g., through the commercial paper market), which, for some, was less expensive than borrowing directly from banks. Facing lower profits and stiffer competition from securities firms, banks began seeking approval from regulators to engage in a greater universe of securities activities.<sup>19</sup> Additionally, regulators may have become less cautious as time passed after the Great Depression.<sup>20</sup>

Beginning in the 1970s and 1980s, requests for approval to engage in a greater universe of securities activities were largely granted by the OCC and the FRB, and, in most cases, have been approved by courts. By the time that the GLBA was enacted in 1999, the FRB had authorized certain BHCs and their subsidiaries to underwrite and deal in an array of bank-ineligible securities, including municipal bonds, commercial paper, mortgage-backed securities and other consumer-related securities, corporate debt securities, and corporate equity securities.<sup>21</sup> In addition to underwriting and dealing activities, the FRB also approved other securities activities such as the provision of investment advice,<sup>22</sup> the brokering of securities,<sup>23</sup> and others. The FRB promulgated the list of permissible nonbanking activities at 12 C.F.R. § 225.28(b).<sup>24</sup> With respect to securities-related activities, the regulation includes two distinct categories: (1) agency functions for customers and (2) transactions as principal (i.e., for the company's own account,

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<sup>18</sup> Jerry W. Markham, *Banking Regulation: Its History and Future*, 4 N.C. Banking Inst. 221, 240-44 (2000).

<sup>19</sup> Alan E. Sorcher and Satish M. Kini, *Does the Term "Bank Broker-Dealer" Still Have Meaning?*, 6 N.C. Banking Inst. 227, 233-34 (2002). See, also, Charles K. Whitehead, *Reframing Financial Regulation*, 90 B.U. L. Rev. 1, 17-18 (2010).

<sup>20</sup> *Securities Industry Assoc. v. Comptroller of the Currency*, 577 F.Supp. 252, 255 (D.C. Cir. 1985) (internal citations omitted) (quoting Letter from James E. Smith, Comptroller of the Currency, to G. Duane Vieth (June 10, 1974), reprinted in [1973-78] Fed. Banking L. Rep. (CCH ¶ 96,272)).

<sup>21</sup> 61 Fed. Reg. 68,750-51 (Dec. 30, 1996), citing Citicorp, J.P. Morgan & Co., and Bankers Trust New York Corp., 73 Fed. Res. Bull. 473 (1987), aff'd, *Securities Industry Ass'n v. Board of Governors*, 839 F.2d 47, 66 (2d Cir.), cert. denied, 486 U.S. 1059 (1988); *Chemical New York Corp., Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, Manufacturers Hanover Corp., and Security Pacific Corp.*, 73 Federal Reserve Bulletin 731 (1987); *J.P. Morgan & Co., The Chase Manhattan Corp., Bankers Trust New York Corp., Citicorp, and Security Pacific Corp.*, 75 Federal Reserve Bulletin 192 (1989), aff'd, *Securities Industries Ass'n v. Board of Governors*, 900 F.2d 360 (D.C. Cir. 1990).

<sup>22</sup> *Bd. of Governors for the Federal Reserve System v. Investment Company Institute*, 450 U.S. 46 (1981).

<sup>23</sup> *Securities Industry Assoc. v. Bd. of Governors for the Federal Reserve System*, 468 U.S. 207 (1984).

<sup>24</sup> It includes activities related to extending credit; real estate appraising; check-guaranty services; collection agency services; credit bureau services; asset management; real estate settlement services; operating industrial loan companies and savings associations; management consulting; employee benefits consulting; career counseling; courier services; various limited insurance services; community development activities; money orders; and data processing.

often referred to as “proprietary trading”). In the latter category are the following: (1) “[u]nderwriting and dealing in government obligations and money market instruments”; (2) “[i]nvesting and trading activities” in certain swaps, futures, options, foreign exchange, and other derivative contracts; and (3) “buying and selling bullion and related activities.” The FRB requires banks to adhere to a number of limitations and conditions, largely spelled out in regulation, in order to engage as principal in each of these three categories.

## **Post-GLBA**

After GLBA, commercial banks were provided the authority to make proprietary investments in a broader array of securities, but to do so, they generally must either be organized as an FHC or the bank itself must establish a financial subsidiary. The permissible proprietary activities vary for FHCs and financial subsidiaries, so they are addressed in turn.

## **Financial Holding Companies**

The GLBA introduced the FHC, a separate form of BHC for companies wishing to expand beyond the business of banking and closely related activities to a broader array of financial services. The GLBA permits FHCs to engage in and own companies engaging in (1) activities that are “financial in nature or incidental to such financial activity” or (2) activities that are “complementary to a financial activity” and do “not pose a substantial risk to the safety and soundness of the depository.”<sup>25</sup> The GLBA listed certain activities as “financial in nature,”<sup>26</sup> including all the nonbanking activities which had already been authorized for BHCs.<sup>27</sup> The GLBA empowered the FRB, in coordination with the Secretary of the Treasury, to issue orders or regulations supplementing that list.<sup>28</sup>

**Merchant Banking Investments.** Under the GLBA<sup>29</sup> and rules promulgated jointly by the Secretary of the Treasury and the FRB,<sup>30</sup> FHCs with a securities affiliate or an insurance affiliate with an investment adviser affiliate<sup>31</sup> may engage in what is referred to as merchant banking activities, under certain conditions. Merchant banking means to “directly or indirectly and as principal or on behalf of one or more persons, ... acquire or control any amount of shares, assets or ownership interests of a company or other entity that is engaged in any activity not otherwise authorized for the financial holding company.”<sup>32</sup> FHC merchant banking investments must be “part of a bona fide underwriting or merchant or investment banking activity.”<sup>33</sup> Additionally, the

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<sup>25</sup> 12 U.S.C. § 1843(k)(1).

<sup>26</sup> 12 U.S.C. § 1843(k)(4).

<sup>27</sup> 12 C.F.R. § 225.28.

<sup>28</sup> 12 U.S.C. §§ 1843(k)(1) – (3). The GLBA established conditions which must be fulfilled before a BHC may become an FHC: all of the company’s depository institution subsidiaries must be well managed and well capitalized, and the company must file a notice with the FRB of its intention to become an FHC, certifying that its depository institution subsidiaries meet those capital and management standards. 12 U.S.C. § 1843(l)(1). There is also an additional requirement applicable to any expansion of activities—that all insured depository affiliates have received a satisfactory rating under the most recent Community Reinvestment Act examination. 12 U.S.C. § 1843(l)(2).

<sup>29</sup> 12 U.S.C. § 1843(k)(4)(H).

<sup>30</sup> 12 C.F.R. §§ 225.170 – 225.177, promulgated in 66 Fed. Reg. 8466, 8484 (January 31, 2001).

<sup>31</sup> 12 C.F.R. § 225.170(f).

<sup>32</sup> 12 C.F.R. § 225.170(a).

<sup>33</sup> 12 C.F.R. § 225.170(b).



interests must only be held on a temporary basis<sup>34</sup> and, in general, no longer than 10 years.<sup>35</sup> Under the regulation, the shares in such investments may be acquired by any subsidiary of the FHC other than a depository institution subsidiary.<sup>36</sup> If assets other than debt or equity securities are involved, they must be “held or promptly transferred to a portfolio company.”<sup>37</sup> “Portfolio company,” in this context, is merely the term used for the company to which these assets must be transferred.<sup>38</sup> Depository institution subsidiaries of the FHC may not routinely manage the portfolio company.<sup>39</sup> There also are restrictions designed to prevent the FHC from routinely managing or operating the portfolio company.<sup>40</sup> For example, executive officers of the holding company and of certain subsidiaries of the holding company, including its securities broker and depository institution subsidiaries, may not serve as executive officers of the portfolio company.<sup>41</sup> Despite these restrictions, however, there is a provision which permits an FHC to routinely, but on a temporary basis,<sup>42</sup> manage a portfolio company; this may occur “only when intervention by the financial holding company is necessary or required to obtain a reasonable return on the financial holding company’s investment in the portfolio company upon resale or other disposition of the investment, such as to avoid or address a significant operation loss or in connection with a loss of senior management at the portfolio company.”<sup>43</sup> The FRB’s prior approval is not generally required for an FHC to engage in merchant banking activities unless the proposed investment will result in the aggregate carrying value of all merchant banking investments to exceed a certain level.<sup>44</sup>

***Merchant Banking Investments Through a Private Equity Fund.*** An FHC also may make merchant banking investments through a private equity fund that makes investments in nonfinancial companies, provided the private equity fund meets certain qualifications and the FHC’s investments comply with requirements for merchant banking. “Private equity fund” is defined, for this purpose, as a company “formed for the purpose of and exclusively engaged in the business of investing in shares, assets, and ownership interests of financial and nonfinancial companies for resale or other disposition.”<sup>45</sup> The private equity company must not be an operating company; no more than 25% of its equity may be held by the FHC or any of its officers, directors,

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<sup>34</sup> The regulation states that “[a] financial holding company may own or control shares, assets and ownership interests pursuant to this subpart only for a period of time to enable the sale or disposition thereof on a reasonable basis consistent with the financial viability of the financial holding company’s merchant banking investment.” 12 C.F.R. § 225.172(a).

<sup>35</sup> 12 C.F.R. § 225.172(b)(1).

<sup>36</sup> 12 C.F.R. § 225.170(d).

<sup>37</sup> 12 C.F.R. § 225.170(e)(1). In addition, there are requirements applicable to the books and records and separate management of the portfolio company. 12 C.F.R. §§ 225.170(e)(2) and (3).

<sup>38</sup> Federal Reserve System Bank Holding Company Supervision Manual § 3907.0.2.3.2, available at <http://www.federalreserve.gov/boarddocs/supmanual/bhc/bhc.pdf> (stating: “‘portfolio company’ means any company or entity that is directly or indirectly held, owned, or controlled by an FHC that is using the merchant banking authority, and the company or entity is engaged in an activity that is not authorized for the FHC under section 4 of the BHC Act.”).

<sup>39</sup> 12 C.F.R. § 225.171(b)(f).

<sup>40</sup> 12 C.F.R. § 225.171.

<sup>41</sup> 12 C.F.R. §§ 225.171(b)(i) and (ii).

<sup>42</sup> 12 C.F.R. § 225.171(b)(e)(2).

<sup>43</sup> 12 C.F.R. § 225.171(b)(e)(1).

<sup>44</sup> 12 C.F.R. 225.174(a) sets this level at the lesser of 30% of Tier 1 capital of the FHC or 20% of Tier 1 after investments in private equity funds are excluded.

<sup>45</sup> 12 C.F.R. § 225.173(a).

employees or principal shareholders; its term must be no longer than 15 years; and it must not have been formed to evade the merchant banking restrictions on FHCs.<sup>46</sup> If an FHC makes investments through a private equity fund, the investments will generally be subject to a 15-year limitation rather than the 10-year limit that would apply if the FHC were to make direct investments.<sup>47</sup> If an FHC controls a private equity fund, the FHC may not routinely operate the private equity fund.<sup>48</sup>

Federal Reserve Act (FRA) §§ 23A, which imposes limitations on “covered transactions”<sup>49</sup> between a bank and its affiliates, and 23B,<sup>50</sup> which requires certain transactions to be on market terms, apply to transactions between an FHC and its subsidiaries and the private equity fund only if control exists.<sup>51</sup>

The regulations presume control for applicability of sections 23A and 23B if the FHC controls more than 15% of the private equity firm’s total equity.<sup>52</sup> This presumption may be rebutted with contrary evidence presented to the FRB or by showing the existence of any one of the following presumptions against control: (1) none of the FHC’s officers, directors, or employees serves as a director or trustee of the firm; (2) another person or entity holds more of the total equity of the firm than does the FHC and no more than one of the FHC’s officers, directors, or employees serves as a director or trustee of the firm; (3) another person or entity controls more than 50% of the voting shares of the firm and the officers, directors, or employees of the FHC do not constitute a majority of the directors or trustees of the firm.<sup>53</sup>

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<sup>46</sup> 12 C.F.R. §§ 225.173(a)(2) – (5).

<sup>47</sup> 12 C.F.R. § 225.173(c).

<sup>48</sup> 12 C.F.R. § 225.173(d)(4). “Control” is determined based on such factors as serving in certain capacities in managing the fund; owning or controlling 25% of a class of voting shares of the fund; or selecting or controlling a majority of the directors of the private equity fund. 12 C.F.R. § 225.173(a)(4).

<sup>49</sup> The transactions covered by sections 23A and 23B include extending credit to an affiliate; purchasing or investing in the securities of an affiliate; accepting the affiliate’s securities as collateral for any extension of credit; and guaranteeing obligations of the affiliate. 12 U.S.C. § 371c(b)(7); 12 C.F.R. § 223.3(h).

<sup>50</sup> 12 U.S.C. § 371c-1. The statute requires that such transactions must be “on terms and under circumstances, including credit standards, that ... are at least as favorable to such bank ... as those prevailing at the time for comparable with or involving other nonaffiliated companies, or ... in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply, to nonaffiliated companies.” 12 U.S.C. § 371c-1(a) (1). It applies to all insured banks. 12 U.S.C. § 371c(e).

<sup>51</sup> Sections 23A and 23B cover certain transactions involving a bank and its “affiliates” and define “affiliates” to include both holding company nonbank affiliates and financial subsidiaries of banks. 12 U.S.C. §§ 371c(b) and 371c-1(d)(1). It places an overall limit of 20% of a bank’s capital and surplus on the amount of credit a bank may extend to affiliates<sup>51</sup> and a 10% limit on credit to any single affiliate, with exceptions to these percentages for financial subsidiaries of banks. 12 U.S.C. § 371c(e)(3). Under 12 U.S.C. § 24a(a)(1) there is no limit on the interest that a national bank may hold in a financial subsidiary. This applies to state-chartered banks, as well. 12 U.S.C. § 1828(j)(1) (state-chartered, FDIC-insured banks); 12 U.S.C. § 1468(a) (insured savings banks). Section 23A also prohibits banks from purchasing “low quality assets” from an affiliate. 12 U.S.C. § 371c(a)(3). Section 23B also imposes an arms length requirement on securities sales by a bank to an affiliate, including securities sales that are subject to repurchase agreements, and on other types of transactions including payment of money or services to an affiliate; transactions for which the affiliate is paid for its services to the bank; and, any transactions between the bank and a third party in which the affiliate participates or has a financial interest. 12 U.S.C. § 371c-1(a)(2). The statute provides the FRB with broad authority to “exempt transactions or relationships from the requirements of ... [§ 23A] if it finds such exemptions to be in the public interest ....” 12 U.S.C. §§ 371c(f)(2), 371c-1(2)(B). Under § 23B, the FRB also has authority to exclude a BHC subsidiary from the definition of “affiliate,” and, therefore, from coverage under the section.

<sup>52</sup> 12 C.F.R. § 225.176(b).

<sup>53</sup> 12 C.F.R. § 225.176(b)(3).

On June 22, 2000, the FRB issued guidance on FHCs’ equity investments and merchant banking activities.<sup>54</sup> This guidance focuses on sound policies and practices, including board of directors oversight; limits on and controls with respect to types and amounts of investments; periodic reviews of investments and of the component elements of the investment process; assessment of possible investment performance under various circumstances; internal controls adopted to types of investments; exit strategies; and capital allocation based on risk. There are also guidelines on transactions involving the portfolio company which are not subject to the FRA §§ 23A and 23B.<sup>55</sup> FHCs are urged to

have systems and policies in place to monitor transactions between the holding company, or a non-depository institution subsidiary of the holding company, and a portfolio company ... [to] assure that the risks of these transactions, including exposures of the holding company on a consolidated basis to a single portfolio company, are reasonably limited and that all transactions are on reasonable terms, with special attention paid to transactions that are not on market terms.<sup>56</sup>

### **Financial Subsidiaries of State- and Federally Chartered Banks**

Since the GLBA, not only may banks affiliate with securities firms within the FHC structure, national banks and state-chartered banks also may, subject to certain conditions, own or control financial subsidiaries that may engage in many of the same securities activities permissible for FHCs. Specifically, the GLBA authorized national banks to control or hold an interest in financial subsidiaries which could engage in “activities that are financial in nature or incidental to financial activity,” as well as “activities that are permitted for national banks to engage in directly (subject to the same terms and conditions that govern the conduct of the activities by a national bank).”<sup>57</sup> It also provided authorization for state-chartered banks to control or hold interests in subsidiaries engaging “in activities as principal that would only be permissible for a national bank to conduct through a financial subsidiary.”<sup>58</sup>

In general, financial subsidiaries may conduct any other activities authorized for FHCs with exceptions<sup>59</sup> for (1) underwriting insurance or annuities, except for certain grandfathered

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<sup>54</sup> Fed. Reserve Bd., Supervisory Guidance on Equity Investment and Merchant Banking Activities of Financial Holding Companies, and Other Banking Organizations Supervised by the Federal Reserve (June 22, 2000), available at <http://www.federalreserve.gov/boarddocs/SRLetters/2000/sr0009a1.pdf>.

<sup>55</sup> *Id.* at 13. These are described as

risk management issues [which] may arise when a banking institution or an affiliate lends to or has other business relationships with: ... a portfolio company; ... the general partner or manager of a private equity fund that has also invested in a portfolio company; or ... a private equity-financed company in which the banking institution does not hold a direct or indirect ownership interest but is an investment or portfolio company of a general partner or fund manager with which the banking organization has other investments.

<sup>56</sup> *Id.* at 13.

<sup>57</sup> 12 U.S.C. § 24a (a)(2)(A).

<sup>58</sup> 12 U.S.C. § 1831w. Essentially, the same conditions apply to state banks as are applicable to national banks with respect to controlling a financial subsidiary. State-chartered banks may conduct “activities that are financial in nature” only if the bank and each of its insured depository affiliates are well capitalized after making the capital deductions dictated for national banks under 12 U.S.C. § 24a(c); the bank complies with the financial and operating standards set for the national banks under 12 U.S.C. § 24a(d); and there is compliance with the restrictions on transactions with affiliates found in §§ 23A and 23B of the Federal Reserve Act, 12 U.S.C. §§ 371c and 371c-1.

<sup>59</sup> 12 U.S.C. § 24a(a)(2)(B).

activities primarily related to credit insurance; (2) developing or investing in real estate; and (3) merchant banking<sup>60</sup> or insurance portfolio investing. There is also a provision permitting the Secretary of the Treasury to designate additional activities as financial in nature, in coordination with the FRB, based on the same standards as are applicable to the FRB when adding to the list of financial activities under the BHCA.<sup>61</sup>

For a national bank to hold a financial subsidiary that is engaging in proprietary financial activities as principal, rather than in an agency capacity, the bank and all of its depository institution affiliates must be well capitalized; there must be OCC approval; the bank must have a satisfactory rating under the Community Reinvestment Act;<sup>62</sup> the assets of all financial subsidiaries of the bank must not exceed the lesser of \$50 billion or 45% of the assets of the bank; and the largest banks must adhere to additional requirements.<sup>63</sup> State-chartered, federally insured

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<sup>60</sup> The GLBA prohibition on merchant banking activities by financial subsidiaries of banks was absolute for the first five years after the GLBA’s enactment; thereafter, the FRB and the Secretary of the Treasury have the power jointly to issue rules to permit merchant banking. 12 U.S.C. § 1843 note. To date, no such rules have been issued.

<sup>61</sup> The factors include marketplace and technology changes, and competitive considerations. 12 U.S.C. §§ 1843(k)(3) and (3) and 24a(b), as added by P.L. 106-102, § 103 and 121, 113 Stat. 1338, 1343 and 1374.

<sup>62</sup> 12 U.S.C. §§ 2901 *et seq.*

<sup>63</sup> 12 U.S.C. §§ 24a(a)(2) and (3). The statute provides:

(2) Conditions and requirements. A national bank may control a financial subsidiary, or hold an interest in a financial subsidiary, only if—

(B) the activities engaged in by the financial subsidiary as a principal do not include—

(i) insuring, guaranteeing, or indemnifying against loss, harm, damage, illness, disability, or death (except to the extent permitted under section 302 or 303(c) of the Gramm-Leach-Bliley Act [15 USCS § 6712 or § 6713(c)]) or providing or issuing annuities the income of which is subject to tax treatment under section 72 of the Internal Revenue Code of 1986 [26 USCS § 72];

(ii) real estate development or real estate investment activities, unless otherwise expressly authorized by law; or

(iii) any activity permitted in ... [12 USCS § 1843(k)(4)] [expanded activities available to FHCs], except activities described in section ... [12 USCS § 1843(k)(4)(H)] [merchant banking activities] that may be permitted in accordance with ... [12 USCS § 1843 note] ....

(C) the national bank and each depository institution affiliate of the national bank are well capitalized and well managed;

(D) the aggregate consolidated total assets of all financial subsidiaries of the national bank do not exceed the lesser of—

(i) 45 percent of the consolidated total assets of the parent bank; or

(ii) \$ 50,000,000,000;

(E) except as provided in paragraph (4), the national bank meets any applicable rating or other requirement set forth in paragraph (3); and

(F) the national bank has received the approval of the Comptroller of the Currency for the financial subsidiary to engage in such activities, which approval shall be based solely upon the factors set forth in this section.

(3) Rating or comparable requirement.

(A) In general. A national bank meets the requirements of this paragraph if—

(i) the bank is 1 of the 50 largest insured banks and has not fewer than 1 issue of outstanding eligible debt that is currently rated within the 3 highest investment grade rating categories by a nationally recognized statistical rating organization; or

(ii) the bank is 1 of the second 50 largest insured banks and meets the criteria set forth in clause (i) or such other criteria as the Secretary of the Treasury and the Board of Governors of the Federal Reserve System may jointly establish by regulation and determine to be comparable to and consistent with the purposes of the rating required in clause (i).

(continued...)

banks have similar authority, provided that the bank and all of its insured depository institution affiliates are well capitalized and well managed.<sup>64</sup>

## Financial Regulatory Reform: How House and Senate Versions of H.R. 4173 Treat the “Volcker Rule”

### Volcker Testimony

Testifying before the Senate Committee on Banking, Housing, and Urban Affairs on February 2, 2010, Chairman Paul Volcker urged the committee to prevent commercial banking institutions, beneficiaries of taxpayer-subsidized deposit insurance and emergency liquidity, from continuing to engage in sponsoring and investing in hedge funds and private equity funds and “trading unrelated to customer needs and continuing banking relationships.”<sup>65</sup> These activities he identified as “essentially proprietary and speculative activities.”<sup>66</sup> Although he provided no definitions in his testimony, he made it clear that he believed that any definitional problems could be overcome by providing regulators “broad” and “specific” authority to define “hedge fund” and “private equity fund” and that regulators could use it to prevent the emergence of “a new breed of bank-based funds that in all but name would function as hedge or equity funds.” He was equally optimistic about the ability of Congress and the regulators to deal with the dangers of “proprietary trading.” He indicated that he thought that there are means available by which regulators could identify, and eliminate, speculative proprietary trading by bank fund managers not only because of the potential risks for the institutions but also because of possible conflicts with the interests of their customers. He described “proprietary trading,” at least in terms of any sizeable volume, as being conducted by only “a handful of large commercial banks”—“maybe four or five in the United States and perhaps a couple of dozen worldwide.”<sup>67</sup>

### House Provision

H.R. 4173, as passed by the House of Representatives, addresses proprietary trading only in the context of certain companies—financial holding companies that have been determined to be systemically significant by the Financial Services Oversight Council<sup>68</sup> and, therefore, subjected to

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(...continued)

(B) Consolidated total assets. For purposes of this paragraph, the size of an insured bank shall be determined on the basis of the consolidated total assets of the bank as of the end of each calendar year.

<sup>64</sup> 12 U.S.C. § 1832w.

<sup>65</sup> Statement of Paul A. Volcker Before the Comm. On Banking, Housing, and urban Affairs of the U.S. Senate 1 (February 2, 2010). [http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore\\_id=ec787c56-dbd2-4498-bbbd-ddd23b58c1c4](http://banking.senate.gov/public/index.cfm?FuseAction=Files.View&FileStore_id=ec787c56-dbd2-4498-bbbd-ddd23b58c1c4).

<sup>66</sup> *Id.* at 1.

<sup>67</sup> *Id.* at 3.

<sup>68</sup> The underlying legislation would effectuate a comprehensive realignment of responsibilities of regulating banks and thrifts, bank and financial holding companies, and subsidiaries thereof. For further information, see CRS Report (continued...)



stricter prudential standards. Section 1117(a) of the measure provides authority for the Board of Governors of the Federal Reserve System (FRB) to ban proprietary trading by financial holding companies that have been subjected to stricter standards upon determining that such trading “poses an existing or foreseeable threat to the safety and soundness of such company or to the financial stability of the United States.” The bill defines “proprietary trading” as “the trading of stocks, bonds, options, commodities, derivatives, or other financial instruments with the company’s own money and for the company’s own account.”<sup>69</sup> The bill allows the FRB broad power to make exemptions to the ban. Not only may the FRB exempt proprietary trading determined to be “ancillary to other operations,” such as making a market in securities, hedging risk, and determining the market value of the company’s assets, the FRB may, through regulation, exempt any other type of proprietary trading.

## Senate Provision

Section 619 of the Senate-passed version of H.R. 4173, which is included in the Conference Base Text of H.R. 4173,<sup>70</sup> requires the federal banking agencies to engage in a joint rulemaking to prohibit “proprietary trading” and investing in hedge funds or private equity funds by covered entities, that is, federally insured depository institutions, bank holding companies, companies treated as bank holding companies,<sup>71</sup> and their subsidiaries. Before the banking agencies conduct the rulemaking to prohibit proprietary trading and investment in hedge funds, however, the Financial Stability Oversight Council, which is substantively similar to the House bill’s Financial Services Oversight Council, must conduct a study. The Council consists of nine presidentially appointed voting members;<sup>72</sup> it is chaired by the Secretary of the Treasury; and, pursuant to other sections of the legislation, it possesses substantive powers relating to systemic risk and regulation of financial companies. The study must be completed within six months of enactment of this legislation and is to be geared to assessing the potential implications and effect of the specifications of section 619 with respect to a list of factors, including taxpayer costs; household and business burdens; spread of the federal safety net to non-depository institutions; risk to the financial system; and safety and soundness of the institutions. On the basis of that study, the Council is required to “make recommendations” regarding the substantive prohibitions and

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(...continued)

R40975, *Financial Regulatory Reform and the 111<sup>th</sup> Congress*, coordinated by Baird Webel.

<sup>69</sup> H.R. 4173, as passed by the House, § 1117(c).

<sup>70</sup> The Conference Base Text is available at the Senate Committee on Banking, Housing and Urban Affairs website, [http://banking.senate.gov/public/\\_files/ChairmansMarkofHR4173forConference.pdf](http://banking.senate.gov/public/_files/ChairmansMarkofHR4173forConference.pdf).

<sup>71</sup> The reference to “companies treated as bank holding companies” may include (1) companies subjected to supervision by the Board of Governors of the Federal Reserve System (FRB) by a Council determination that material distress at the company could pose a threat to financial stability; (2) intermediate holding companies, which section 167(b) of the bill authorizes the FRB to require nonbank financial companies supervised by the FRB to form in order to segregate their financial activities from commercial or other activities not permissible under the Bank Holding Company Act (BHCA); and (3) supervised securities holding companies, supervised by the FRB and subjected to the requirements of the BHCA under section 618(e)(2) of the bill.

<sup>72</sup> The other members are the Chairman of the Board of Governors of the Federal Reserve System, the Comptroller of the Currency, the Chairman of the Securities and Exchange Commission, the Chairperson of the Federal Deposit Insurance Corporation, the Chairperson of the Commodities Futures Trading Corporation, the Director of the Federal Housing Finance Agency, the Director of the Bureau of Consumer Financial Protection (to be established under this legislation), and a presidentially appointed independent member with expertise in the insurance industry.



definitions of section 619. The joint rulemaking by the banking regulators is required to "reflect any recommendations or modifications made by the Council."<sup>73</sup>

Subsection 619(b) of the bill requires the federal banking agencies to prohibit proprietary trading by insured depository institutions, companies directly or indirectly controlling insured depository institutions, companies treated as bank holding companies, and any of their subsidiaries (covered entities). Subsection 619(a) defines "proprietary trading" as follows:

... purchasing or selling, or otherwise acquiring and disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments ... for the trading book (or such other portfolio as the Federal banking agencies may determine) of such institution, company, or subsidiary ... and ... subject to such restrictions as the Federal banking agencies may determine, does not include purchasing or selling or otherwise acquiring and disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of customer relationships, including risk-mitigating hedging activities related to such a purchase, sale, acquisition, or disposal. § 619(a)(2)

Subsection 619(b)(2) provides exceptions for the following types of obligations, provided the "investment ... is otherwise authorized by Federal law," and subject to any conditions imposed "on the conduct of investments" by the appropriate federal banking agency:

- (i) obligations of the United States or any agency of the United States, including obligations fully guaranteed as to principal and interest by the United States or an agency of the United States;
- (ii) obligations, participations, or other instruments of, or insured by, the Government National Mortgage Association, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, including obligations fully guaranteed as to principal and interest by such entities; and
- (iii) obligations of any State or any political subdivision of a State.

Subsection 619(c)(1) requires the federal banking agencies to engage in a joint rulemaking procedure to prohibit the covered entities "from sponsoring or investing in a hedge fund or a private equity fund." Subsection 619(a)(1) defines "hedge fund" and "private equity fund" as "a company or other entity that is exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 50a-3(c)(1) or 80a-3(c)(7)), or a similar fund, as jointly determined by the appropriate Federal banking agencies."

Under subsection 619(a)(3), "sponsoring" a hedge fund or a private equity fund includes "serving as a general partner, managing member, or trustee," "selecting ... a majority of the directors," or "sharing ... the same name or a variation of the same name" as the fund. Subsection 619(d)(1) provides exceptions from the prohibition on sponsoring or investing in a hedge fund or private equity fund for any "investment otherwise authorized under Federal law that is ... an investment in a small business investment company ... or designed primarily to promote the public welfare,

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<sup>73</sup> The assignment of authority between the Council and the banking regulators is in some sense novel in terms of current law. This arrangement, coupled with the lack of specific language delineating standards by which the regulators would be able to alter or disregard recommendations of the Council may, however the regulators deal with Council recommendations, result in litigation yielding consequences unforeseen by the drafters of section 619.

as provided in” 12 U.S.C. § 24(Eleventh).<sup>74</sup> There are also exceptions for investments permitted under sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act,<sup>75</sup> provided they are conducted solely outside the United States by a company not controlled directly or indirectly by a company organized under the laws of the United States or of a state.

Subsection 619(e) prohibits covered entities that serve as investment managers or advisers to hedge funds or private equity funds from engaging in certain transactions with those funds and requires other specified transactions with them to be on market terms.<sup>76</sup>

Subsection 619(f) requires the FRB to “adopt rules imposing additional capital requirements and specifying additional quantitative limits for nonbank financial companies supervised by the ... [FRB] under section 113 [of the Senate legislation] that engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds.”<sup>77</sup> Excepted from these rules is a list of investments that includes U.S. obligations, obligations issued by the federal housing government-sponsored enterprises (housing GSEs), obligations of small business investment companies; state and local obligations; and obligations designed to promote the public welfare.

All of the requirements for rulemaking, regarding both proprietary trading and investments in hedge and private equity funds, are specifically subjected “to the recommendations and modifications” of the Council under subsection 619(g). Subsection (g) requires the Council to complete a study of the foregoing provisions assessing a number of factors.<sup>78</sup> On the basis of that study, the Council is authorized to

make recommendations regarding the definitions ... and the implementation of [the] provisions ... including any modifications to the definitions, prohibitions, requirements, and limitations contained therein that the Council determines would more effectively implement the purposes of this section and ... make recommendations for prohibiting the conduct of the activities described ... above a specific threshold amount and imposing additional capital requirements on activities conducted below such threshold amount.

Although there are certain express exceptions to section 619’s prohibitions, unlike other banking laws, section 619 does not contain a specific provision delegating broad exemptive power to the regulators.<sup>79</sup> It appears that, in lieu of delegating such authority to the regulators, section 619

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<sup>74</sup> Under 12 U.S.C. § 24(Eleventh), the conditions under which national banks are permitted to “make investments designed primarily to promote the public welfare” are specified.

<sup>75</sup> 12 U.S.C. §§ 1843(c)(3) and 1843(c)(9).

<sup>76</sup> Transactions covered in § 23A of the Federal Reserve Act, 12 U.S.C. § 371c, are prohibited; transactions covered in § 23 B, 12 U.S.C. § 371c-1, must be on market terms.

<sup>77</sup> Section 113 provides for subjecting companies to FRB supervision by a Council determination that material distress at the company could pose a threat to financial stability.

<sup>78</sup> Among the factors that the Council is to examine are the extent that the limitations would impact safety and soundness of the covered institutions and companies; protect taxpayers and minimize the risk of unsafe and unsound practices; limit inappropriate transfer to unregulated entities of the federal subsidy provided by deposit insurance and federal liquidity facilities; reduce inappropriate conflicts of interest between the self-interest of the covered companies and the interests of their customers; impose costs on U.S. households and businesses; limit risky activities in covered companies; and “appropriately accommodate the business of insurance within an insurance company in accordance with State insurance company investment laws.”

<sup>79</sup> See, e.g., 12 U.S.C. § 371c(f)(2) (authorizing the FRB “at its discretion, by regulation or order [to] exempt transactions or relationships from the requirements of [§ 23A of the Federal Reserve Act] ... if it finds such exemptions to be in the public interest and consistent with the purposes of this section”) and 12 U.S.C. § 371c-1(e)(2)(A) (authorizing the FRB to “exempt transactions or relationships from the requirements of” § 23B of the Federal Reserve (continued...))

provides the Council with some flexibility to modify the parameters of the law both by requiring the rulemaking to "reflect" Council recommendations and by including, in each of the substantive provisions defining prohibitions, language subjecting the prohibition "to the recommendations and modifications of the Council."<sup>80</sup> The Committee Report accompanying the bill takes a broad view of the dangers in permitting banking firms to engage in these risky activities and a narrow view of the authority of the Council to substantially alter the prohibitions of section 619.<sup>81</sup>

Subsections 619(g)(1)(A) and (h) present a timetable for implementation: (1) the Council is to complete its study no later than six months after the bill is enacted; (2) the regulators are to issue final rules no later than nine months after completion of the Council study; and (3) effective two years after these rules are promulgated, insured depository institutions, companies controlling depository institutions, companies treated as bank holding companies, and subsidiaries of these institutions may not retain investments or relationships prohibited under the regulations, unless a company applies for and receives an extension. Extensions may be given one year at a time for a maximum of three years for any one company.

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(...continued)

Act). FRA §§ 23A and 23B deal with restrictions on interaffiliate transactions within bank holding companies (BHCs). Under § 23B, the FRB also has authority to exclude a BHC subsidiary from the definition of "affiliate," and, therefore, from coverage under the section.

<sup>80</sup> Sections 619(b)(1) (prohibition on proprietary trading); (c)(1) (prohibition on sponsoring and investing in hedge funds and private equity funds); and (f)(1)(capital and quantitative limitations for certain nonbank financial companies).

<sup>81</sup> The Committee Report states:

The incentive for firms to engage in these activities is clear: when things go well, high-risk behavior can produce high returns...When losses from high-risk activities are significant, they can threaten the safety and soundness of individual firms and contribute to overall financial instability. Moreover, when the losses accrue to insured depositories or their holding companies, they can cause taxpayer losses. In addition, when banks engage in these activities for their own accounts, there is an increased likelihood that they will find that their interests conflict with those of their customers.

The Council recommendations and modifications will be included in a study to assess the extent to which the prohibitions, limitations and requirements of section 619 will promote several goals, including: the safety and soundness of depositories and their affiliates; protecting taxpayers from loss; limiting the inappropriate transfer of economic subsidies from institutions that benefit from deposit insurance and liquidity facilities of the Federal government to unregulated entities; reducing inappropriate conflicts of interest between depositories and their affiliates, or financial companies supervised by the Board of Governors, and their customers; affecting the cost of credit or other financial services, limiting undue risk or loss in financial institutions; and appropriately accommodating the business of insurance within insurance companies subject to State insurance company investment laws.

The Council study is included to assure that the prohibitions included in section 619 work effectively. It is not the intent of the section to interfere inadvertently with longstanding, traditional banking activities that do not produce high levels of risk or significant conflicts of interest. For that reason the Council is given some latitude to make needed modifications to definitions and provisions in order to prevent undesired outcomes. However, it is intended that the Council will determine how to effectively implement the prohibitions and restrictions of the section, and not to weaken them.

S.Rept. 111-\_\_\_\_, 111<sup>th</sup> Cong., 2d Sess. 7 and 74 (2010) to accompany S. 3217, April 30, 2010, available on the website of the Senate Committee on Banking, Housing, and Urban Affairs at [http://banking.senate.gov/public/\\_files/Committee\\_Report\\_S\\_Rept\\_111\\_176.pdf](http://banking.senate.gov/public/_files/Committee_Report_S_Rept_111_176.pdf).

In addition to the § 619 provisions, § 989 of the Senate-passed bill requires the Government Accountability Office to conduct a study and issue a report on “the risks and conflicts associated with proprietary trading” engaged in by banks, BHCs, FHCs, subsidiaries of BHCs and FHCs, and “any other entity, as the Comptroller General of the United States may determine.” This study and report requirement also was included as part of the Conference Base Text of H.R. 4173.

## **The Conference Report: Section 619**

***Banking Entities May Not Engage in Proprietary Trading or Hedge Fund Ownership or Sponsorship; Nonbanking Financial Companies Subject to FRB Supervision May Do So With Capital and Quantitative Limits.*** Subsection (a) of section 619 of the Conference Report contains an outright prohibition on proprietary trading by and ownership of interests in or sponsorship of hedge funds or private equity funds by a “banking entity.” Subsequent provisions of the bill, however, provide exceptions to this. “Banking entity” is defined in subsection (h) to mean any FDIC-insured depository institution, company controlling an insured depository institution, company treated as a bank holding company for purposes of the International Banking Act of 1978, and any affiliate or subsidiary of such entity.<sup>82</sup> The exact language provides a broad prohibition. It reads: “a banking entity shall not ... engage in proprietary trading, or ... acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund.” There are, however, certain exceptions, some transitional and others designated as permitted activities under subsection (d) of the legislation.

Rather than subjecting nonfinancial companies supervised by the FRB to a prohibition on proprietary trading and hedge fund ownership or sponsorship, the legislation authorizes the regulators to issue rules subjecting such companies to additional capital and quantitative limits on such activities unless the activity has been identified as a permitted activity under section (d) and has not been subjected to capital and quantitative requirements for safety and soundness purposes.

***Definitions.*** Subsection 619(h) sets forth definitions of various terms, in some cases providing a degree of discretion to the regulators to expand the reach of the prohibitions and limitations. For example:

A “hedge fund” or a “private equity fund” is defined as “an issuer that would be an investment company ... but for sections 3(c)(1) or 3(c)(7) of [the Investment Company Act of 1940] ..., or such similar funds as the ... [appropriate regulatory agencies] may by rule ... determine.”<sup>83</sup>

“Proprietary trading” is “engaging as principal for the trading account of the banking entity or nonbank financial company supervised by the Board 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 or any such security, derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or

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<sup>82</sup> Excluded from the definition of “banking entity” are institutions functioning solely in a trust capacity under specified conditions: substantially all the deposits must be in trust funds; none of its insured deposits are marketed through an affiliate; no demand deposits are accepted or commercial loans made; and the institution does not accept payment, discount, or borrowing services from the Federal Reserve banks.

<sup>83</sup> Emphasis supplied.

contract, or any other security or financial instrument that the appropriate ... agencies ... may, by rule ... determine.”<sup>84</sup>

Some definitions are substantially similar to those in the Senate bill (e.g., “nonbank financial company” and “sponsor”). In addition, there are two new definitions: “trading account” and “illiquid fund.” “Trading account” is defined to mean “any account used for acquiring or taking positions in the securities and instruments described [under 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 other accounts as the appropriate ... agencies ... may, by rule ... determine.” “Illiquid fund” is defined in subsection 619(h)(7) as a hedge fund or private equity fund that “as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets such as portfolio companies, real estate investments, and venture capital investments; and ... [which] makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets.”

**Council Study and Coordinated Joint Rulemaking.** Subsection (b) of section 619 requires the Financial Stability Oversight Council to complete a study not later than six months after enactment and make recommendations to the regulators on implementation. The Conference Report, thus, appears to provide the Council less power than the Senate-passed bill, because it limits the Council to recommending how implementation may be geared to (1) promote banking entity safety and soundness; (2) limit inappropriate transfers to “unregulated entities” of the federal subsidies embodied in FDIC deposit insurance and FRS liquidity programs; (3) “protect taxpayers and consumers and enhance financial stability” by minimizing risky activities by banking entities; (4) reduce conflicts of interest between customer interests and the self-interest of the covered entities; (5) limit unduly risky activities of the covered entities; (6) accommodate insurance company investment authority while safeguarding both affiliated banking entities and the financial stability of the United States;<sup>85</sup> and (7) devise appropriate timing for divestiture of illiquid assets affected by implementation of section 619.

Subsection (b) requires the federal banking regulators and the SEC and CFTC to conduct joint rulemaking and to adopt these rules no later than nine months after the Council completes its study. The regulators must coordinate the regulations for safety and soundness and elimination of the possibility of advantaging or disadvantaging some companies. Subsection (c) specifies that final rules are to become effective 12 months after they are issued or two years after enactment. In general, banking entities will be given two years to divest nonconforming activities.

**Divestiture of Nonconforming Activities.** Subsection (c) addresses divestiture of nonconforming activities. Divestiture of nonconforming activities is generally required within two years of enactment subject to certain exceptions. The FRB is to issue rules on the divestiture provisions within six months of enactment. Additional capital and other restrictions, including margin requirements, on ownership interests in or sponsorship of hedge funds or private equity funds by banking entities are to be implemented by rules promulgated within the context of the joint rulemaking. The two-year divestiture requirement may be extended under certain circumstances:

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<sup>84</sup> Emphasis supplied.

<sup>85</sup> The actual language reads: “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.”



(1) the FRB may approve extensions for one-year periods not to exceed three additional years, and (2) if a contractual obligation in effect on May 1, 2010, requires a banking entity to take or retain its ownership interest in, or provide additional capital to, an illiquid fund, the entity may apply to the FRB for an extension which may be granted for no more than five years; divestiture would be required at the end of the five years or on the contractual date—whichever is earlier.

**Permitted Activities.** Subsection (d) identifies exceptions to the blanket prohibitions of subsection 619(a) by listing permitted activities and setting conditions under which those activities may be conducted. It excludes from permitted activities any transaction or class of activities, otherwise permitted, that would involve or result in a material conflict of interest; a material exposure by the banking entity to “high-risk assets or high-risk trading strategies” as defined by the regulators; or a threat to safety and soundness of the banking entity or to the financial stability of the United States. It provides standards by which the regulators may set further limits or conditions on these activities and includes authority for the regulators to add to the list of permitted activities. The regulators may impose additional capital and quantitative limits as “appropriate to protect the safety and soundness of banking entities engaged in such activities.” Among the conditions specified for conducting these activities are that the activity must (1) be permitted under other federal or state law; (2) be subjected to restrictions as determined by the appropriate federal regulators; and (3) not involve or result in a material conflict of interest, expose the banking entity to “high-risk assets or high-risk trading strategies,” or threaten safety and soundness of the banking entity or the financial stability of the United States. Subject to those conditions, the exceptions or permitted activities are:

- **Organizing and Advising Hedge or Private Equity Funds in Connection with Fiduciary or Trust Services.** Subsection (d)(1)(G) authorizes banking entities to organize and offer private equity or hedge funds only if (1) the banking entity provides “bona fide trust, fiduciary, or investment advisory services”; (2) the fund is offered only in connection with trust, fiduciary, or investment advisory services to “persons that are customers of such services of the banking entity”; (3) the banking entity retains only a de minimis interest in the funds;<sup>86</sup> (4) the banking entity and its affiliates engage in no transaction with the fund that would be designated as a covered transaction under FRA section 23A and other transactions with the fund are conducted only on terms specified in FRA section 23B, as if the banking entity were a member bank, and the fund an affiliate of that bank; (5) the banking entity does not guaranty the obligations of the hedge fund or private equity fund; (6) the banking entity does not share a name with the hedge fund or private equity fund; (7) no director or employee of the banking entity, other than a director or employee directly engaged in providing investment advisory or other services to the hedge fund or private equity fund, takes or retains an interest in the fund; and (8) the banking entity takes certain steps to assure the investors in the hedge fund or private equity fund that losses of the fund will be borne solely by its investors.
- **Government and GSE Obligations.** Subsection (d)(1)(A) authorizes the purchase and sale of U.S. obligations; obligations of federal agencies; obligations of Ginnie Mae, Fannie Mae, Federal Home Loan Banks, Farmer Mac, and Farm

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<sup>86</sup> A de minimis investment, as defined in subsection (d)(4), is “not more than 3 percent of the total ownership interests of the fund,” and “immaterial to the banking entity, as defined by rule” but such that the aggregate investment of the banking entity in all such funds does not exceed 3 percent of its Tier 1 capital.



Credit System institutions; and obligations of any state or political subdivision of a state.

- **Market Making Activities.** Subsection (d)(1)(B) authorizes the “purchase, sale, acquisition, or disposition of securities and various instruments which the regulators have determined by rule to fall within the definition of “proprietary trading” under subsection (h)(4), provided the transactions are “in connection with underwriting or market-making related activities, to the extent that ... [such transactions] are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties.”
- **Risk Mitigating Hedging Activities.** Subsection (d)(1)(C) authorizes “risk-mitigating hedging activities” that are related to “positions, contracts, or other holdings of the banking entity and are designed to reduce specific risks in connection with and related to such holdings.
- **Small Business Investment Company Investments.** Subsection (d)(1)(E) authorizes specified small business investment company investments and investments qualified as rehabilitation expenditures with respect to qualified rehabilitated building or certified historic structure as defined in section 47 of the Internal Revenue Code or similar state historic tax credit program.
- **Insurance Company Portfolio Investments.** Subsection (d)(1)(F) authorizes the “purchase, sale, acquisition, or disposition of securities and other instruments” which the regulators have determined by rule to fall within the definition of “proprietary trading” under subsection (h)(4) if the transactions are “by a regulated insurance company directly engaged in the business of insurance for the general account of the company 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.” The transactions must also comply with applicable law, regulation, or guidance, and there must be no determination by the regulators that a relevant law, regulation, or guidance is insufficient to protect the safety and soundness of the banking entity or the financial stability of the United States.
- **Proprietary Trading by Foreign Companies Conducted Outside the United States.** Subsections (d)(1)(H) and (I) authorize investments permitted under sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act,<sup>87</sup> provided they are conducted solely outside the United States by a company not controlled directly or indirectly by a company organized under the laws of the United States or of a state.
- **Other Investments.** Subsection (d)(1)(J) provides the regulators with authority to permit “[s]uch other activity ... by rule, ... [as] would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.”
- **De Minimis Investments by Banking Entities in Hedge Funds and Private Equity Funds.** Subsection 619(d)(4) permits banking entities, subject to certain limitations, to make and retain a “de minimis investment” in a hedge fund or

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<sup>87</sup> 12 U.S.C. §§ 1843(c)(3) and 1843(c)(9).

private equity fund or to make an initial investment in a hedge fund or private equity fund that the banking entity organizes. Among the limitations is a requirement to seek unaffiliated investors to reduce, within one year (subject to a possible extension for two more years), the banking entity’s initial investment to the prescribed de minimis amount, as defined in subsection (d)(4). A de minimis investment must be (1) “not more than 3 percent of the total ownership interests of the fund,” (2) “immaterial to the banking entity, as defined by rule” and (3) such that the aggregate investment of the banking entity in all such funds does not exceed 3 percent of its Tier 1 capital. There is also a requirement that a banking entity’s aggregate outstanding de minimis or initial investments in hedge funds or private equity funds organized by the banking entity, including retained earnings, must be deducted from assets and tangible equity of the banking entity and the amount of the deduction to “increase commensurate with the leverage of the hedge fund or private equity fund.”

***Limitation on Relationships with Hedge Funds and Private Equity Funds.*** Under subsection 619(f), a banking entity serving as “an investment manager, investment advisor, or investment sponsor to a hedge fund or private equity fund” or a banking entity which organizes and offers a hedge fund or private equity fund in connection with fiduciary or trust services as specified in subsection (d)(1)(G) or any affiliates thereof may enter into a transaction with the fund which would be a covered transaction under FRA section 23A if the banking entity and affiliate were a member bank and the fund were an affiliate thereof. In addition, any transaction between the banking entity and the fund must comply with Section 23B of the FRA as if the banking entity were a member bank and the fund, an affiliate, thereof. The FRB may permit a banking entity to enter into a prime brokerage transaction with any hedge fund or private equity fund in which a hedge fund or private equity fund managed, sponsored, or advised by the banking entity or nonbank financial company has an ownership interest under certain conditions. The banking entity must be in compliance with all of the conditions under which a banking entity may organize and advise a hedge fund or private equity fund in connection with fiduciary or trust services under subsection (d)(1)(G). Moreover, the banking entity’s chief executive officer must provide an annual, and updated as necessary, written certification of compliance. The FRB must have determined that the primary brokerage agreement is consistent with the safe and sound operation of the banking entity; moreover, the prime brokerage transaction is subject to FRA section 23B as if the counterparty were an affiliate of the banking entity. Additional capital charges or other restrictions for nonbank financial companies are to be covered by rules issued by the appropriate regulators in the prescribed joint rulemaking proceedings.

***Anti-Evasion Provision.*** Subsection (e) authorizes the appropriate regulator, having reasonable cause to believe that a banking entity or a nonbank financial company supervised by the FRB, is engaged in activities functioning as an evasion of section 619, or in violation of section 619, to order, subject to notice and opportunity for a hearing, termination of the activity and disposition of the investment. This subsection also requires the regulators to issue internal control and recordkeeping rules to insure compliance with section 619.

***Rules of Construction.*** Subsection 619(g) provides three rules of statutory construction for interpreting section 619: (1) the prohibitions and restrictions of section 619 apply, except as provided in the section, notwithstanding the existence of other provisions of law authorizing such activities; (2) nothing in section 619 is to “be construed to limit the ability of a banking entity or nonbank financial company ... to sell or securitize loans in a manner otherwise permitted by

law”; and (3) nothing in section 619 is to “be construed to limit the inherent authority of any Federal agency or State regulatory authority under otherwise applicable provisions of law.”

## **Future Prospects: Rulemaking and Mandated Study**

While the Conference Committee was at work, there appeared to be some apprehension within the financial services industry about the reach of § 619, the imprecision of its definitions and prohibitions, and its implementation.<sup>88</sup> Some concerns may have been allayed by the Conference Report’s final version of section 619. For example, there are specific provisions providing for (1) distinct treatment for insurance company portfolio investments; (2) the ability of banking entities and non-financial companies determined to be systemically important to sponsor hedge fund and private equity funds that are limited to customer investments; (3) conditions under which bank investments in hedge funds and private equity funds may be permitted; and (4) phase-in periods. Although the outlines of a new regulatory framework for proprietary trading and hedge fund operations of banking entities and other systemically important companies are fully outlined in the legislation, the actual reach and practical effect of the provisions await the clarifying hand of the regulators. To illustrate, subsection (d)(1)(C) authorizes banking entities to engage in “risk-mitigating hedging activities” related to “positions, contracts, or other holdings of the banking entity that are designed to reduce specific risks to a banking entity in connection with and related to such positions, contracts or other holdings.” It delineates no parameters for these hedging activities. With this and other provisions of the bill, there is likely to be an intensive rulemaking process wherein virtually every possible interpretation of the statutory language will be subjected to a full airing.

It also might be noted that a related provision of the legislation provides clear indication that Congress will continue to monitor the scope of investment activities permitted to banking concerns. Section 620 of the Conference Report gives the federal banking agencies 20 months to study and report on investment and other activities that banking entities may conduct under federal and state law. The agencies are to evaluate and make recommendations on (1) types of activities or investments; (2) associated risks; (3) risk mitigation activities; (4) safety and soundness concerns; (5) potential negative effects of each activity with respect to banking entities and the U.S. financial system; (6) whether each activity or investment is appropriate for banking entities; and (7) any necessary additional restrictions.

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<sup>88</sup> Eric Dash and Nelson D. Swartz, “Bank Lobbyists Make a Final Run at Reform Bill,” *N.Y. Times* (June 20, 2010), available at <http://www.nytimes.com/2010/06/21/business/21volcker.html?scp=1&sq=volcker%20rule&st=cse>; S.Rept. 111-\_\_\_\_, 111<sup>th</sup> Cong., 2d Sess. 7 and 74 (2010) to accompany S. 3217, April 30, 2010, available on the website of the Senate Committee on Banking, Housing, and Urban Affairs at [http://banking.senate.gov/public/\\_files/Comittee\\_Report\\_S\\_Rept\\_111\\_176.pdf](http://banking.senate.gov/public/_files/Comittee_Report_S_Rept_111_176.pdf).

## **Appendix A. Text of H.R. 4173 § 1117, as Passed by the House**

### **SEC. 1117. RESTRICTION ON PROPRIETARY TRADING BY DESIGNATED FINANCIAL HOLDING COMPANIES.**

(a) In General- If the Board determines that propriety trading by a financial holding company subject to stricter standards poses an existing or foreseeable threat to the safety and soundness of such company or to the financial stability of the United States, the Board may prohibit such company from engaging in propriety trading.

(b) Exceptions Permitted- The Board may exempt from the prohibition of subsection (a) propriety trading that the Board determines to be ancillary to other operations of such company and not to pose a threat to the safety and soundness of such company or to the financial stability of the United States, including—

- (1) making a market in securities issued by such company;
- (2) hedging or managing risk;
- (3) determining the market value of assets of such company; and
- (4) propriety trading for such other purposes allowed by the Board by rule.

(c) Rulemaking Authority- The primary financial regulatory agencies of banks and bank holding companies shall jointly issue regulations to carry out this section. (d) Effective Date- The provisions of this section shall take effect after the end of the 180-day period beginning on the date of the enactment of this title. (e) Proprietary Trading Defined- For purposes of this section and with respect to a company, the term 'proprietary trading' means the trading of stocks, bonds, options, commodities, derivatives, or other financial instruments with the company's own money and for the company's own account

(d) Effective Date- The provisions of this section shall take effect after the end of the 180-day period beginning on the date of the enactment of this title.

## Appendix B. Text of H.R. 4173 § 619, as Passed by the Senate, and Which Is Included as Part of the Conference-Base Text of H.R. 4173

### SEC. 619. RESTRICTIONS ON CAPITAL MARKET ACTIVITY BY BANKS AND BANK HOLDING COMPANIES.

(a) *Definitions- In this section—*

(1) *the terms 'hedge fund' and 'private equity fund' mean a company or other entity that is exempt from registration as an investment company pursuant to section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (15 U.S.C. 80a-3(c)(1) or 80a-3(c)(7)), or a similar fund, as jointly determined by the appropriate Federal banking agencies;*

(2) *the term 'proprietary trading'—*

(A) *means purchasing or selling, or otherwise acquiring or disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments by an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), and any subsidiary of such institution or company, for the trading book (or such other portfolio as the Federal banking agencies may determine) of such institution, company, or subsidiary; and*

(B) *subject to such restrictions as the Federal banking agencies may determine, does not include purchasing or selling, or otherwise acquiring or disposing of, stocks, bonds, options, commodities, derivatives, or other financial instruments on behalf of a customer, as part of market making activities, or otherwise in connection with or in facilitation of customer relationships, including risk-mitigating hedging activities related to such a purchase, sale, acquisition, or disposal; and*

(3) *the term 'sponsoring', when used with respect to a hedge fund or private equity fund, means—*

(A) *serving as a general partner, managing member, or trustee of the fund;*

(B) *in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund; or*

*(C) sharing with the fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.*

*(b) Prohibition on Proprietary Trading-*

*(1) IN GENERAL- Subject to the recommendations and modifications of the Council under subsection (g), and except as provided in paragraph (2) or (3), the appropriate Federal banking agencies shall, through a rulemaking under subsection (g), jointly prohibit proprietary trading by an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), and any subsidiary of such institution or company.*

*(2) EXCEPTED OBLIGATIONS-*

*(A) IN GENERAL- The prohibition under this subsection shall not apply with respect to an investment that is otherwise authorized by Federal law in—*

*(i) obligations of the United States or any agency of the United States, including obligations fully guaranteed as to principal and interest by the United States or an agency of the United States;*

*(ii) obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, including obligations fully guaranteed as to principal and interest by such entities; and*

*(iii) obligations of any State or any political subdivision of a State.*

*(B) CONDITIONS- The appropriate Federal banking agencies may impose conditions on the conduct of investments described in subparagraph (A).*

*(C) RULE OF CONSTRUCTION- Nothing in subparagraph (A) may be construed to grant any authority to any person that is not otherwise provided in Federal law.*

*(3) FOREIGN ACTIVITIES- An investment or activity conducted by a company pursuant to paragraph (9) or (13) of section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) solely outside of the United States shall not be subject to the prohibition under paragraph (1), provided that the company is not directly or indirectly controlled by a company that is organized under the laws of the United States or of a State.*



*(c) Prohibition on Sponsoring and Investing in Hedge Funds and Private Equity Funds-*

*(1) IN GENERAL- Except as provided in paragraph (2), and subject to the recommendations and modifications of the Council under subsection (g), the appropriate Federal banking agencies shall, through a rulemaking under subsection (g), jointly prohibit an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), or any subsidiary of such institution or company, from sponsoring or investing in a hedge fund or a private equity fund.*

*(2) APPLICATION TO FOREIGN ACTIVITIES OF FOREIGN FIRMS- An investment or activity conducted by a company pursuant to paragraph (9) or (13) of section 4(c) of the Bank Holding Company Act of 1956 (12 U.S.C. 1843(c)) solely outside of the United States shall not be subject to the prohibitions and restrictions under paragraph (1), provided that the company is not directly or indirectly controlled by a company that is organized under the laws of the United States or of a State.*

*(d) Investments in Small Business Investment Companies and Investments Designed To Promote the Public Welfare-*

*(1) IN GENERAL- A prohibition imposed by the appropriate Federal banking agencies under subsection (c) shall not apply with respect an investment otherwise authorized under Federal law that is—*

*(A) an investment in a small business investment company, as that term is defined in section 103 of the Small Business Investment Act of 1958 (15 U.S.C. 662); or*

*(B) designed primarily to promote the public welfare, as provided in the 11<sup>th</sup> paragraph of section 5136 of the Revised Statutes (12 U.S.C. 24).*

*(2) RULE OF CONSTRUCTION- Nothing in paragraph (1) may be construed to grant any authority to any person that is not otherwise provided in Federal law.*

*(e) Limitations on Relationships With Hedge Funds and Private Equity Funds-*

*(1) COVERED TRANSACTIONS- An insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), and any subsidiary of such institution or company that serves, directly or indirectly, as the investment manager or investment adviser to a hedge fund or private equity fund may not enter into a covered transaction, as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c) with such hedge fund or private equity fund.*

(2) *AFFILIATION*- An insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), and any subsidiary of such institution or company that serves, directly or indirectly, as the investment manager or investment adviser to a hedge fund or private equity fund shall be subject to section 23B of the Federal Reserve Act (12 U.S.C. 371c-1) as if such institution, company, or subsidiary were a member bank and such hedge fund or private equity fund were an affiliate.

(f) *Capital and Quantitative Limitations for Certain Nonbank Financial Companies-*

(1) *IN GENERAL*- Except as provided in paragraph (2), and subject to the recommendations and modifications of the Council under subsection (g), the Board of Governors shall adopt rules imposing additional capital requirements and specifying additional quantitative limits for nonbank financial companies supervised by the Board of Governors under section 113 that engage in proprietary trading or sponsoring and investing in hedge funds and private equity funds.

(2) *EXCEPTIONS*- The rules under this subsection shall not apply with respect to the trading of an investment that is otherwise authorized by Federal law—

(A) *in obligations of the United States or any agency of the United States, including obligations fully guaranteed as to principal and interest by the United States or an agency of the United States;*

(B) *in obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, including obligations fully guaranteed as to principal and interest by such entities;*

(C) *in obligations of any State or any political subdivision of a State;*

(D) *in a small business investment company, as that term is defined in section 103 of the Small Business Investment Act of 1958 (15 U.S.C. 662); or*

(E) *that is designed primarily to promote the public welfare, as provided in the 11<sup>th</sup> paragraph of section 5136 of the Revised Statutes (12 U.S.C. 24).*

(g) *Council Study and Rulemaking-*

(1) *STUDY AND RECOMMENDATIONS*- Not later than 6 months after the date of enactment of this Act, the Council—

*(A) shall complete a study of the definitions under subsection (a) and the other provisions under subsections (b) through (f), to assess the extent to which the definitions under subsection (a) and the implementation of subsections (a) through (f) would—*

*(i) promote and enhance the safety and soundness of depository institutions and the affiliates of depository institutions;*

*(ii) protect taxpayers and enhance financial stability by minimizing the risk that depository institutions and the affiliates of 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 inappropriate conflicts of interest between the self-interest of depository institutions, affiliates of depository institutions, and financial companies supervised by the Board, and the interests of the customers of such institutions and companies;*

*(v) raise the cost of credit or other financial services, reduce the availability of credit or other financial services, or impose other costs on households and businesses in the United States;*

*(vi) limit activities that have caused undue risk or loss in depository institutions, affiliates of depository institutions, and financial companies supervised by the Board of Governors, or that might reasonably be expected to create undue risk or loss in such institutions, affiliates, and companies; and*

*(vii) appropriately accommodates the business of insurance within an insurance company subject to regulation in accordance with State insurance company investment laws;*

*(B) shall make recommendations regarding the definitions under subsection (a) and the implementation of other provisions under subsections (b) through (f), including any modifications to the definitions, prohibitions, requirements, and limitations contained therein that the Council determines would more effectively implement the purposes of this section; and*

*(C) may make recommendations for prohibiting the conduct of the activities described in subsections (b) and (c) above a specific threshold amount and imposing additional capital requirements on activities conducted below such threshold amount.*

(2) *RULEMAKING- Not earlier than the date of completion of the study required under paragraph (1), and not later than 9 months after the date of completion of such study—*

*(A) the appropriate Federal banking agencies shall jointly issue final regulations implementing subsections (b) through (e), which shall reflect any recommendations or modifications made by the Council pursuant to paragraph (1)(B); and*

*(B) the Board of Governors shall issue final regulations implementing subsection (f), which shall reflect any recommendations or modifications made by the Council pursuant to paragraph (1)(B).*

*(h) Transition-*

*(1) IN GENERAL- The final regulations issued by the appropriate Federal banking agencies and the Board of Governors under subsection (g)(2) shall provide that, effective 2 years after the date on which such final regulations are issued, no insured depository institution, company that controls, directly or indirectly, an insured depository institution, company that is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), or subsidiary of such institution or company, may retain any investment or relationship prohibited under such regulations.*

*(2) EXTENSION-*

*(A) IN GENERAL- The appropriate Federal banking agency for an insured depository institution or a company described in paragraph (1) may, upon the application of any such company, extend the 2-year period under paragraph (1) with respect to such company, if the appropriate Federal banking agency determines that an extension would not be detrimental to the public interest.*

*(B) TIME PERIOD FOR EXTENSION- An extension granted under subparagraph (A) may not exceed—*

*(i) 1 year for each determination made by the appropriate Federal banking agency under subparagraph (A); and*

*(ii) a total of 3 years with respect to any 1 company.*

## Appendix C. The Conference Report: Section 619

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1 SEC. 619. PROHIBITIONS ON PROPRIETARY TRADING AND  
2 CERTAIN RELATIONSHIPS WITH HEDGE  
3 FUNDS AND PRIVATE EQUITY FUNDS.

4 The Bank Holding Company Act of 1956 (12 U.S.C.  
5 1841 et seq.) is amended by adding at the end the fol-  
6 lowing:

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

10 “(a) IN GENERAL.—

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

13 “(A) engage in proprietary trading; or

14 “(B) acquire or retain any equity, partner-  
15 ship, or other ownership interest in or sponsor  
16 a hedge fund or a private equity fund.

17 “(2) NONBANK FINANCIAL COMPANIES SUPER-  
18 VISED BY THE BOARD.—Any nonbank financial com-  
19 pany supervised by the Board that engages in pro-  
20 prietary trading or takes or retains any equity, part-  
21 nership, or other ownership interest in or sponsors  
22 a hedge fund or a private equity fund shall be sub-  
23 ject, by rule, as provided in subsection (b)(2), to ad-  
24 ditional capital requirements for and additional  
25 quantitative limits with regards to such proprietary  
26 trading and taking or retaining any equity, partner-

1 ship, or other ownership interest in or sponsorship  
2 of a hedge fund or a private equity fund, except that  
3 permitted activities as described in subsection (d)  
4 shall not be subject to the additional capital and ad-  
5 ditional quantitative limits except as provided in  
6 subsection (d)(3), as if the nonbank financial com-  
7 pany supervised by the Board were a banking entity.

8 “(b) STUDY AND RULEMAKING.—

9 “(1) STUDY.—Not later than 6 months after  
10 the date of enactment of this section, the Financial  
11 Stability Oversight Council shall study and make  
12 recommendations on implementing the provisions of  
13 this section so as to—

14 “(A) promote and enhance the safety and  
15 soundness of banking entities;

16 “(B) protect taxpayers and consumers and  
17 enhance financial stability by minimizing the  
18 risk that insured depository institutions and the  
19 affiliates of insured depository institutions will  
20 engage in unsafe and unsound activities;

21 “(C) limit the inappropriate transfer of  
22 Federal subsidies from institutions that benefit  
23 from deposit insurance and liquidity facilities of  
24 the Federal Government to unregulated entities;



1           “(D) reduce conflicts of interest between  
2           the self-interest of banking entities and  
3           nonbank financial companies supervised by the  
4           Board, and the interests of the customers of  
5           such entities and companies;

6           “(E) limit activities that have caused  
7           undue risk or loss in banking entities and  
8           nonbank financial companies supervised by the  
9           Board, or that might reasonably be expected to  
10          create undue risk or loss in such banking enti-  
11          ties and nonbank financial companies super-  
12          vised by the Board;

13          “(F) appropriately accommodate the busi-  
14          ness of insurance within an insurance company,  
15          subject to regulation in accordance with the rel-  
16          evant insurance company investment laws, while  
17          protecting the safety and soundness of any  
18          banking entity with which such insurance com-  
19          pany is affiliated and of the United States fi-  
20          nancial system; and

21          “(G) appropriately time the divestiture of  
22          illiquid assets that are affected by the imple-  
23          mentation of the prohibitions under subsection  
24          (a).

25          “(2) RULEMAKING.—

1           “(A) IN GENERAL.—Unless otherwise pro-  
2           vided in this section, not later than 9 months  
3           after the completion of the study under para-  
4           graph (1), the appropriate Federal banking  
5           agencies, the Securities and Exchange Commis-  
6           sion, and the Commodity Futures Trading  
7           Commission, shall consider the findings of the  
8           study under paragraph (1) and adopt rules to  
9           carry out this section, as provided in subpara-  
10          graph (B).

11          “(B) COORDINATED RULEMAKING.—

12           “(i) REGULATORY AUTHORITY.—The  
13           regulations issued under this paragraph  
14           shall be issued by—

15                   “(I) the appropriate Federal  
16                   banking agencies, jointly, with respect  
17                   to insured depository institutions;

18                   “(II) the Board, with respect to  
19                   any company that controls an insured  
20                   depository institution, or that is treat-  
21                   ed as a bank holding company for  
22                   purposes of section 8 of the Inter-  
23                   national Banking Act, any nonbank fi-  
24                   nancial company supervised by the  
25                   Board, and any subsidiary of any of

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1 the foregoing (other than a subsidiary  
2 for which an agency described in sub-  
3 clause (I), (III), or (IV) is the pri-  
4 mary financial regulatory agency);

5 “(III) the Commodity Futures  
6 Trading Commission, with respect to  
7 any entity for which the Commodity  
8 Futures Trading Commission is the  
9 primary financial regulatory agency,  
10 as defined in section 2 of the Dodd-  
11 Frank Wall Street Reform and Con-  
12 sumer Protection Act; and

13 “(IV) the Securities and Ex-  
14 change Commission, with respect to  
15 any entity for which the Securities  
16 and Exchange Commission is the pri-  
17 mary financial regulatory agency, as  
18 defined in section 2 of the Dodd-  
19 Frank Wall Street Reform and Con-  
20 sumer Protection Act.

21 “(ii) COORDINATION, CONSISTENCY,  
22 AND COMPARABILITY.—In developing and  
23 issuing regulations pursuant to this sec-  
24 tion, the appropriate Federal banking  
25 agencies, the Securities and Exchange

1                   Commission, and the Commodity Futures  
2                   Trading Commission shall consult and co-  
3                   ordinate with each other, as appropriate,  
4                   for the purposes of assuring, to the extent  
5                   possible, that such regulations are com-  
6                   parable and provide for consistent applica-  
7                   tion and implementation of the applicable  
8                   provisions of this section to avoid providing  
9                   advantages or imposing disadvantages to  
10                  the companies affected by this subsection  
11                  and to protect the safety and soundness of  
12                  banking entities and nonbank financial  
13                  companies supervised by the Board.

14                   “(iii) COUNCIL ROLE.—The Chair-  
15                   person of the Financial Stability Oversight  
16                   Council shall be responsible for coordina-  
17                   tion of the regulations issued under this  
18                   section.

19                   “(c) EFFECTIVE DATE.—

20                   “(1) IN GENERAL.—Except as provided in para-  
21                   graphs (2) and (3), this section shall take effect on  
22                   the earlier of—

23                   “(A) 12 months after the date of the  
24                   issuance of final rules under subsection (b); or

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1           “(B) 2 years after the date of enactment  
2           of this section.

3           “(2) CONFORMANCE PERIOD FOR DIVESTI-  
4           TURE.—A banking entity or nonbank financial com-  
5           pany supervised by the Board shall bring its activi-  
6           ties and investments into compliance with the re-  
7           quirements of this section not later than 2 years  
8           after the date on which the requirements become ef-  
9           fective pursuant to this section or 2 years after the  
10          date on which the entity or company becomes a  
11          nonbank financial company supervised by the Board.  
12          The Board may, by rule or order, extend this two-  
13          year period for not more than one year at a time,  
14          if, in the judgment of the Board, such an extension  
15          is consistent with the purposes of this section and  
16          would not be detrimental to the public interest. The  
17          extensions made by the Board under the preceding  
18          sentence may not exceed an aggregate of 3 years.

19          “(3) EXTENDED TRANSITION FOR ILLIQUID  
20          FUNDS.—

21                 “(A) APPLICATION.—The Board may,  
22                 upon the application of a banking entity, extend  
23                 the period during which the banking entity, to  
24                 the extent necessary to fulfill a contractual obli-  
25                 gation that was in effect on May 1, 2010, may

1 take or retain its equity, partnership, or other  
2 ownership interest in, or otherwise provide addi-  
3 tional capital to, an illiquid fund.

4 “(B) TIME LIMIT ON APPROVAL.—The  
5 Board may grant 1 extension under subpara-  
6 graph (A), which may not exceed 5 years.

7 “(4) DIVESTITURE REQUIRED.—Except as oth-  
8 erwise provided in subsection (d)(1)(G), a banking  
9 entity may not engage in any activity prohibited  
10 under subsection (a)(1)(B) after the earlier of—

11 “(A) the date on which the contractual ob-  
12 ligation to invest in the illiquid fund terminates;  
13 and

14 “(B) the date on which any extensions  
15 granted by the Board under paragraph (3) ex-  
16 pire.

17 “(5) ADDITIONAL CAPITAL DURING TRANSITION  
18 PERIOD.—Notwithstanding paragraph (2), on the  
19 date on which the rules are issued under subsection  
20 (b)(2), the appropriate Federal banking agencies,  
21 the Securities and Exchange Commission, and the  
22 Commodity Futures Trading Commission shall issue  
23 rules, as provided in subsection (b)(2), to impose ad-  
24 ditional capital requirements, and any other restric-  
25 tions, as appropriate, on any equity, partnership, or



1 ownership interest in or sponsorship of a hedge fund  
2 or private equity fund by a banking entity.

3 “(6) SPECIAL RULEMAKING.—Not later than 6  
4 months after the date of enactment of this section,  
5 the Board shall issues rules to implement para-  
6 graphs (2) and (3).

7 “(d) PERMITTED ACTIVITIES.—

8 “(1) IN GENERAL.—Notwithstanding the re-  
9 strictions under subsection (a), to the extent per-  
10 mitted by any other provision of Federal or State  
11 law, and subject to the limitations under paragraph  
12 (2) and any restrictions or limitations that the ap-  
13 propriate Federal banking agencies, the Securities  
14 and Exchange Commission, and the Commodity Fu-  
15 tures Trading Commission, may determine, the fol-  
16 lowing activities (in this section referred to as ‘per-  
17 mitted activities’) are permitted:

18 “(A) The purchase, sale, acquisition, or  
19 disposition of obligations of the United States  
20 or any agency thereof, obligations, participa-  
21 tions, or other instruments of or issued by the  
22 Government National Mortgage Association, the  
23 Federal National Mortgage Association, the  
24 Federal Home Loan Mortgage Corporation, a  
25 Federal Home Loan Bank, the Federal Agricul-

1 tural Mortgage Corporation, or a Farm Credit  
2 System institution chartered under and subject  
3 to the provisions of the Farm Credit Act of  
4 1971 (12 U.S.C. 2001 et seq.), and obligations  
5 of any State or of any political subdivision  
6 thereof.

7 “(B) The purchase, sale, acquisition, or  
8 disposition of securities and other instruments  
9 described in subsection (h)(4) in connection  
10 with underwriting or market-making-related ac-  
11 tivities, to the extent that any such activities  
12 permitted by this subparagraph are designed  
13 not to exceed the reasonably expected near term  
14 demands of clients, customers, or counterpar-  
15 ties.

16 “(C) Risk-mitigating hedging activities in  
17 connection with and related to individual or ag-  
18 gregated positions, contracts, or other holdings  
19 of a banking entity that are designed to reduce  
20 the specific risks to the banking entity in con-  
21 nection with and related to such positions, con-  
22 tracts, or other holdings.

23 “(D) The purchase, sale, acquisition, or  
24 disposition of securities and other instruments

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1 described in subsection (h)(4) on behalf of cus-  
2 tomers.

3 “(E) Investments in one or more small  
4 business investment companies, as defined in  
5 section 102 of the Small Business Investment  
6 Act of 1958 (15 U.S.C. 662), investments de-  
7 signed primarily to promote the public welfare,  
8 of the type permitted under paragraph (11) of  
9 section 5136 of the Revised Statutes of the  
10 United States (12 U.S.C. 24), or investments  
11 that are qualified rehabilitation expenditures  
12 with respect to a qualified rehabilitated building  
13 or certified historic structure, as such terms are  
14 defined in section 47 of the Internal Revenue  
15 Code of 1986 or a similar State historic tax  
16 credit program.

17 “(F) The purchase, sale, acquisition, or  
18 disposition of securities and other instruments  
19 described in subsection (h)(4) by a regulated in-  
20 surance company directly engaged in the busi-  
21 ness of insurance for the general account of the  
22 company and by any affiliate of such regulated  
23 insurance company, provided that such activi-  
24 ties by any affiliate are solely for the general

1 account of the regulated insurance company,  
2 if—

3 “(i) the purchase, sale, acquisition, or  
4 disposition is conducted in compliance  
5 with, and subject to, the insurance com-  
6 pany investment laws, regulations, and  
7 written guidance of the State or jurisdic-  
8 tion in which each such insurance company  
9 is domiciled; and

10 “(ii) the appropriate Federal banking  
11 agencies, after consultation with the Fi-  
12 nancial Stability Oversight Council and the  
13 relevant insurance commissioners of the  
14 States and territories of the United States,  
15 have not jointly determined, after notice  
16 and comment, that a particular law, regu-  
17 lation, or written guidance described in  
18 clause (i) is insufficient to protect the safe-  
19 ty and soundness of the banking entity, or  
20 of the financial stability of the United  
21 States.

22 “(G) Organizing and offering a private eq-  
23 uity or hedge fund, including serving as a gen-  
24 eral partner, managing member, or trustee of  
25 the fund and in any manner selecting or con-

1 trolling (or having employees, officers, directors,  
2 or agents who constitute) a majority of the di-  
3 rectors, trustees, or management of the fund,  
4 including any necessary expenses for the fore-  
5 going, only if—

6 “(i) the banking entity provides bona  
7 fide trust, fiduciary, or investment advisory  
8 services;

9 “(ii) the fund is organized and offered  
10 only in connection with the provision of  
11 bona fide trust, fiduciary, or investment  
12 advisory services and only to persons that  
13 are customers of such services of the bank-  
14 ing entity;

15 “(iii) the banking entity does not ac-  
16 quire or retain an equity interest, partner-  
17 ship interest, or other ownership interest  
18 in the funds except for a de minimis in-  
19 vestment subject to and in compliance with  
20 paragraph (4);

21 “(iv) the banking entity complies with  
22 the restrictions under paragraphs (1) and  
23 (2) of subparagraph (f);

24 “(v) the banking entity does not, di-  
25 rectly or indirectly, guarantee, assume, or

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1 otherwise insure the obligations or per-  
2 formance of the hedge fund or private eq-  
3 uity fund or of any hedge fund or private  
4 equity fund in which such hedge fund or  
5 private equity fund invests;

6 “(vi) the banking entity does not  
7 share with the hedge fund or private equity  
8 fund, for corporate, marketing, pro-  
9 motional, or other purposes, the same  
10 name or a variation of the same name;

11 “(vii) no director or employee of the  
12 banking entity takes or retains an equity  
13 interest, partnership interest, or other  
14 ownership interest in the hedge fund or  
15 private equity fund, except for any director  
16 or employee of the banking entity who is  
17 directly engaged in providing investment  
18 advisory or other services to the hedge  
19 fund or private equity fund; and

20 “(viii) the banking entity discloses to  
21 prospective and actual investors in the  
22 fund, in writing, that any losses in such  
23 hedge fund or private equity fund are  
24 borne solely by investors in the fund and  
25 not by the banking entity, and otherwise



1           complies with any additional rules of the  
2           appropriate Federal banking agencies, the  
3           Securities and Exchange Commission, or  
4           the Commodity Futures Trading Commis-  
5           sion, as provided in subsection (b)(2), de-  
6           signed to ensure that losses in such hedge  
7           fund or private equity fund are borne sole-  
8           ly by investors in the fund and not by the  
9           banking entity.

10           “(H) Proprietary trading conducted by a  
11           banking entity pursuant to paragraph (9) or  
12           (13) of section 4(e), provided that the trading  
13           occurs solely outside of the United States and  
14           that the banking entity is not directly or indi-  
15           rectly controlled by a banking entity that is or-  
16           ganized under the laws of the United States or  
17           of one or more States.

18           “(I) The acquisition or retention of any eq-  
19           uity, partnership, or other ownership interest  
20           in, or the sponsorship of, a hedge fund or a pri-  
21           vate equity fund by a banking entity pursuant  
22           to paragraph (9) or (13) of section 4(e) solely  
23           outside of the United States, provided that no  
24           ownership interest in such hedge fund or pri-  
25           vate equity fund is offered for sale or sold to a

1 resident of the United States and that the  
2 banking entity is not directly or indirectly con-  
3 trolled by a banking entity that is organized  
4 under the laws of the United States or of one  
5 or more States.

6 “(J) Such other activity as the appropriate  
7 Federal banking agencies, the Securities and  
8 Exchange Commission, and the Commodity Fu-  
9 tures Trading Commission determine, by rule,  
10 as provided in subsection (b)(2), would promote  
11 and protect the safety and soundness of the  
12 banking entity and the financial stability of the  
13 United States.

14 “(2) LIMITATION ON PERMITTED ACTIVITIES.—

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

19 “(i) would involve or result in a mate-  
20 rial conflict of interest (as such term shall  
21 be defined by rule as provided in sub-  
22 section (b)(2)) between the banking entity  
23 and its clients, customers, or counterpar-  
24 ties;

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1           “(ii) would result, directly or indi-  
2           rectly, in a material exposure by the bank-  
3           ing entity to high-risk assets or high-risk  
4           trading strategies (as such terms shall be  
5           defined by rule as provided in subsection  
6           (b)(2));

7           “(iii) would pose a threat to the safety  
8           and soundness of such banking entity; or

9           “(iv) would pose a threat to the finan-  
10          cial stability of the United States.

11          “(B) RULEMAKING.—The appropriate  
12          Federal banking agencies, the Securities and  
13          Exchange Commission, and the Commodity Fu-  
14          tures Trading Commission shall issue regula-  
15          tions to implement subparagraph (A), as part  
16          of the regulations issued under subsection  
17          (b)(2).

18          “(3) CAPITAL AND QUANTITATIVE LIMITA-  
19          TIONS.—The appropriate Federal banking agencies,  
20          the Securities and Exchange Commission, and the  
21          Commodity Futures Trading Commission shall, as  
22          provided in subsection (b)(2), adopt rules imposing  
23          additional capital requirements and quantitative lim-  
24          itations, including diversification requirements, re-  
25          garding the activities permitted under this section if

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1 the appropriate Federal banking agencies, the Secu-  
2 rities and Exchange Commission, and the Com-  
3 modity Futures Trading Commission determine that  
4 additional capital and quantitative limitations are  
5 appropriate to protect the safety and soundness of  
6 banking entities engaged in such activities.

7 “(4) DE MINIMIS INVESTMENT.—

8 “(A) IN GENERAL.—A banking entity may  
9 make and retain an investment in a hedge fund  
10 or private equity fund that the banking entity  
11 organizes and offers, subject to the limitations  
12 and restrictions in subparagraph (B) for the  
13 purposes of—

14 “(i) establishing the fund and pro-  
15 viding the fund with sufficient initial eq-  
16 uity for investment to permit the fund to  
17 attract unaffiliated investors; or

18 “(ii) making a de minimis investment.

19 “(B) LIMITATIONS AND RESTRICTIONS ON  
20 INVESTMENTS.—

21 “(i) REQUIREMENT TO SEEK OTHER  
22 INVESTORS.—A banking entity shall ac-  
23 tively seek unaffiliated investors to reduce  
24 or dilute the investment of the banking en-

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1           tity to the amount permitted under clause  
2           (ii).

3           “(ii) LIMITATIONS ON SIZE OF IN-  
4           VESTMENTS.—Notwithstanding any other  
5           provision of law, investments by a banking  
6           entity in a hedge fund or private equity  
7           fund shall—

8                   “(I) not later than 1 year after  
9                   the date of establishment of the fund,  
10                  be reduced through redemption, sale,  
11                  or dilution to an amount that is not  
12                  more than 3 percent of the total own-  
13                  ership interests of the fund;

14                  “(II) be immaterial to the bank-  
15                  ing entity, as defined, by rule, pursu-  
16                  ant to subsection (b)(2), but in no  
17                  case may the aggregate of all of the  
18                  interests of the banking entity in all  
19                  such funds exceed 3 percent of the  
20                  Tier 1 capital of the banking entity.

21                  “(iii) CAPITAL.—For purposes of de-  
22                  termining compliance with applicable cap-  
23                  ital standards under paragraph (3), the ag-  
24                  gregate amount of the outstanding invest-  
25                  ments by a banking entity under this para-

1 graph, including retained earnings, shall be  
2 deducted from the assets and tangible eq-  
3 uity of the banking entity, and the amount  
4 of the deduction shall increase commensu-  
5 rate with the leverage of the hedge fund or  
6 private equity fund.

7 “(C) EXTENSION.—Upon an application by  
8 a banking entity, the Board may extend the pe-  
9 riod of time to meet the requirements under  
10 subparagraph (B)(ii)(I) for 2 additional years,  
11 if the Board finds that an extension would be  
12 consistent with safety and soundness and in the  
13 public interest.

14 “(e) ANTI-EVASION.—

15 “(1) RULEMAKING.—The appropriate Federal  
16 banking agencies, the Securities and Exchange Com-  
17 mission, and the Commodity Futures Trading Com-  
18 mission shall issue regulations, as part of the rule-  
19 making provided for in subsection (b)(2), regarding  
20 internal controls and recordkeeping, in order to in-  
21 sure compliance with this section.

22 “(2) TERMINATION OF ACTIVITIES OR INVEST-  
23 MENT.—Notwithstanding any other provision of law,  
24 whenever an appropriate Federal banking agency,  
25 the Securities and Exchange Commission, or the



1 Commodity Futures Trading Commission, as appro-  
2 priate, has reasonable cause to believe that a bank-  
3 ing entity or nonbank financial company supervised  
4 by the Board under the respective agency’s jurisdic-  
5 tion has made an investment or engaged in an activ-  
6 ity in a manner that functions as an evasion of the  
7 requirements of this section (including through an  
8 abuse of any permitted activity) or otherwise violates  
9 the restrictions under this section, the appropriate  
10 Federal banking agency, the Securities and Ex-  
11 change Commission, or the Commodity Futures  
12 Trading Commission, as appropriate, shall order,  
13 after due notice and opportunity for hearing, the  
14 banking entity or nonbank financial company super-  
15 vised by the Board to terminate the activity and, as  
16 relevant, dispose of the investment. Nothing in this  
17 paragraph shall be construed to limit the inherent  
18 authority of any Federal agency or State regulatory  
19 authority to further restrict any investments or ac-  
20 tivities under otherwise applicable provisions of law.

21 “(f) LIMITATIONS ON RELATIONSHIPS WITH HEDGE  
22 FUNDS AND PRIVATE EQUITY FUNDS.—

23 “(1) IN GENERAL.—No banking entity that  
24 serves, directly or indirectly, as the investment man-  
25 ager, investment adviser, or sponsor to a hedge fund

1 or private equity fund, or that organizes and offers  
2 a hedge fund or private equity fund pursuant to  
3 paragraph (d)(1)(G), and no affiliate of such entity,  
4 may enter into a transaction with the fund, or with  
5 any other hedge fund or private equity fund that is  
6 controlled by such fund, that would be a covered  
7 transaction, as defined in section 23A of the Federal  
8 Reserve Act (12 U.S.C. 371e), with the hedge fund  
9 or private equity fund, as if such banking entity and  
10 the affiliate thereof were a member bank and the  
11 hedge fund or private equity fund were an affiliate  
12 thereof.

13 “(2) TREATMENT AS MEMBER BANK.—A bank-  
14 ing entity that serves, directly or indirectly, as the  
15 investment manager, investment adviser, or sponsor  
16 to a hedge fund or private equity fund, or that orga-  
17 nizes and offers a hedge fund or private equity fund  
18 pursuant to paragraph (d)(1)(G), shall be subject to  
19 section 23B of the Federal Reserve Act (12 U.S.C.  
20 371e-1), as if such banking entity were a member  
21 bank and such hedge fund or private equity fund  
22 were an affiliate thereof.

23 “(3) PERMITTED SERVICES.—

24 “(A) IN GENERAL.—Notwithstanding para-  
25 graph (1), the Board may permit a banking en-

1           tity to enter into any prime brokerage trans-  
2           action with any hedge fund or private equity  
3           fund in which a hedge fund or private equity  
4           fund managed, sponsored, or advised by such  
5           banking entity has taken an equity, partner-  
6           ship, or other ownership interest, if—

7                   “(i) the banking entity is in compli-  
8                   ance with each of the limitations set forth  
9                   in subsection (d)(1)(G) with regard to a  
10                  hedge fund or private equity fund orga-  
11                  nized and offered by such banking entity;

12                  “(ii) the chief executive officer (or  
13                  equivalent officer) of the banking entity  
14                  certifies in writing annually (with a duty to  
15                  update the certification if the information  
16                  in the certification materially changes) that  
17                  the conditions specified in subsection  
18                  (d)(1)(g)(v) are satisfied; and

19                  “(iii) the Board has determined that  
20                  such transaction is consistent with the safe  
21                  and sound operation and condition of the  
22                  banking entity.

23                  “(B) TREATMENT OF PRIME BROKERAGE  
24                  TRANSACTIONS.—For purposes of subparagraph  
25                  (A), a prime brokerage transaction described in

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1           subparagraph (A) shall be subject to section  
2           23B of the Federal Reserve Act (12 U.S.C.  
3           371e-1) as if the counterparty were an affiliate  
4           of the banking entity.

5           “(4) APPLICATION TO NONBANK FINANCIAL  
6           COMPANIES SUPERVISED BY THE BOARD.—The ap-  
7           propriate Federal banking agencies, the Securities  
8           and Exchange Commission, and the Commodity Fu-  
9           tures Trading Commission shall adopt rules, as pro-  
10          vided in subsection (b)(2), imposing additional cap-  
11          ital charges or other restrictions for nonbank finan-  
12          cial companies supervised by the Board to address  
13          the risks to and conflicts of interest of banking enti-  
14          ties described in paragraphs (1), (2), and (3) of this  
15          subsection.

16          “(g) RULES OF CONSTRUCTION.—

17          “(1) LIMITATION ON CONTRARY AUTHORITY.—  
18          Except as provided in this section, notwithstanding  
19          any other provision of law, the prohibitions and re-  
20          strictions under this section shall apply to activities  
21          of a banking entity or nonbank financial company  
22          supervised by the Board, even if such activities are  
23          authorized for a banking entity or nonbank financial  
24          company supervised by the Board.

1           “(2) SALE OR SECURITIZATION OF LOANS.—

2           Nothing in this section shall be construed to limit or  
3           restrict the ability of a banking entity or nonbank fi-  
4           nancial company supervised by the Board to sell or  
5           securitize loans in a manner otherwise permitted by  
6           law.

7           “(3) AUTHORITY OF FEDERAL AGENCIES AND

8           STATE REGULATORY AUTHORITIES.—Nothing in this  
9           section shall be construed to limit the inherent au-  
10          thority of any Federal agency or State regulatory  
11          authority under otherwise applicable provisions of  
12          law.

13          “(h) DEFINITIONS.—In this section, the following  
14          definitions shall apply:

15                 “(1) BANKING ENTITY.—The term ‘banking en-  
16                 tity’ means any insured depository institution (as de-  
17                 fined in section 3 of the Federal Deposit Insurance  
18                 Act (12 U.S.C. 1813)), any company that controls  
19                 an insured depository institution, or that is treated  
20                 as a bank holding company for purposes of section  
21                 8 of the International Banking Act of 1978, and any  
22                 affiliate or subsidiary of any such entity. For pur-  
23                 poses of this paragraph, the term ‘insured depository  
24                 institution’ does not include an institution that func-  
25                 tions solely in a trust or fiduciary capacity, if—

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1           “(A) all or substantially all of the deposits  
2           of such institution are in trust funds and are  
3           received in a bona fide fiduciary capacity;

4           “(B) no deposits of such institution which  
5           are insured by the Federal Deposit Insurance  
6           Corporation are offered or marketed by or  
7           through an affiliate of such institution;

8           “(C) such institution does not accept de-  
9           mand deposits or deposits that the depositor  
10          may withdraw by check or similar means for  
11          payment to third parties or others or make  
12          commercial loans; and

13          “(D) such institution does not—

14                 “(i) obtain payment or payment re-  
15                 lated services from any Federal Reserve  
16                 bank, including any service referred to in  
17                 section 11A of the Federal Reserve Act  
18                 (12 U.S.C. 248a); or

19                 “(ii) exercise discount or borrowing  
20                 privileges pursuant to section 19(b)(7) of  
21                 the Federal Reserve Act (12 U.S.C.  
22                 461(b)(7)).

23          “(2) HEDGE FUND; PRIVATE EQUITY FUND.—  
24          The terms ‘hedge fund’ and ‘private equity fund’  
25          mean an issuer that would be an investment com-



1       pany, as defined in the Investment Company Act of  
2       1940 (15 U.S.C. 80a-1 et seq.), but for section  
3       3(e)(1) or 3(e)(7) of that Act, or such similar funds  
4       as the appropriate Federal banking agencies, the Se-  
5       curities and Exchange Commission, and the Com-  
6       modity Futures Trading Commission may, by rule,  
7       as provided in subsection (b)(2), determine.

8           “(3) NONBANK FINANCIAL COMPANY SUPER-  
9       VISED BY THE BOARD.—The term ‘nonbank finan-  
10      cial company supervised by the Board’ means a  
11      nonbank financial company supervised by the Board  
12      of Governors, as defined in section 102 of the Fi-  
13      nancial Stability Act of 2010.

14          “(4) PROPRIETARY TRADING.—The term ‘pro-  
15      prietary trading’, when used with respect to a bank-  
16      ing entity or nonbank financial company supervised  
17      by the Board, means engaging as a principal for the  
18      trading account of the banking entity or nonbank fi-  
19      nancial company supervised by the Board in any  
20      transaction to purchase or sell, or otherwise acquire  
21      or dispose of, any security, any derivative, any con-  
22      tract of sale of a commodity for future delivery, any  
23      option on any such security, derivative, or contract,  
24      or any other security or financial instrument that  
25      the appropriate Federal banking agencies, the Secu-

1 securities and Exchange Commission, and the Com-  
2 modity Futures Trading Commission may, by rule  
3 as provided in subsection (b)(2), determine.

4 “(5) SPONSOR.—The term to ‘sponsor’ a fund  
5 means—

6 “(A) to serve as a general partner, man-  
7 aging member, or trustee of a fund;

8 “(B) in any manner to select or to control  
9 (or to have employees, officers, or directors, or  
10 agents who constitute) a majority of the direc-  
11 tors, trustees, or management of a fund; or

12 “(C) to share with a fund, for corporate,  
13 marketing, promotional, or other purposes, the  
14 same name or a variation of the same name.

15 “(6) TRADING ACCOUNT.—The term ‘trading  
16 account’ means any account used for acquiring or  
17 taking positions in the securities and instruments  
18 described in paragraph (4) principally for the pur-  
19 pose of selling in the near term (or otherwise with  
20 the intent to resell in order to profit from short-term  
21 price movements), and any such other accounts as  
22 the appropriate Federal banking agencies, the Secu-  
23 rities and Exchange Commission, and the Com-  
24 modity Futures Trading Commission may, by rule  
25 as provided in subsection (b)(2), determine.

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1           “(7) ILLIQUID FUND.—

2                   “(A) IN GENERAL.—The term ‘illiquid  
3 fund’ means a hedge fund or private equity  
4 fund that—

5                           “(i) as of May 1, 2010, was prin-  
6 cipally invested in, or was invested and  
7 contractually committed to principally in-  
8 vest in, illiquid assets, such as portfolio  
9 companies, real estate investments, and  
10 venture capital investments; and

11                           “(ii) makes all investments pursuant  
12 to, and consistent with, an investment  
13 strategy to principally invest in illiquid as-  
14 sets. In issuing rules regarding this sub-  
15 paragraph, the Board shall take into con-  
16 sideration the terms of investment for the  
17 hedge fund or private equity fund, includ-  
18 ing contractual obligations, the ability of  
19 the fund to divest of assets held by the  
20 fund, and any other factors that the Board  
21 determines are appropriate.

22                           “(B) HEDGE FUND.—For the purposes of  
23 this paragraph, the term ‘hedge fund’ means  
24 any fund identified under subsection (h)(2), and  
25 does not include a private equity fund, as such

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1 term is used in section 203(m) of the Invest-  
2 ment Advisers Act of 1940 (15 U.S.C. 80b-  
3 3(m)).”.

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