Occupy the SEC

http://www.occupythesec.org

Volcker Rule Report Card:
Occupy the SEC (OSEC) Gives the Volcker Rule a Grade of "C-"

PART I: Final Rule Follows OSEC's Markups of Regulatory Language in Certain Areas, While Ignoring Many Key Recommendations

On December 10, 2013, the Federal Reserve, the Office of the Comptroller of the Currency ("OCC"), Federal Deposit Insurance Corp. ("FDIC"), The Commodity Futures Trading Commission ("CFTC") and the Securities and Exchange Commission ("SEC") ("Agencies") approved a final version of regulations implementing Section 619 of the Dodd-Frank Act, better known as the "Volcker Rule."

The Volcker Rule was passed in order to help avert another financial crisis similar to the Great Recession of 2008. That crisis was caused in large part by excessive bank speculation in global financial markets, and the Volcker Rule seeks to reduce the risk associated with these activities by prohibiting proprietary trading by government-backstopped banks.

In February 2012, Occupy the SEC ("OSEC") issued a 325-page comment letter to the banking regulators urging vigorous and robust implementation of Section 619. In an Appendix to that letter, OSEC issued 30 separate recommendations on specific markups to be made by the Agencies to strengthen the Rule.

The following table contains an analysis of each of OSEC's specific recommendations to refine language within the Proposed Volcker Rule, and highlights the Agencies' final disposition on each corresponding issue in the Final Volcker Rule. We have assigned a rating to the Agencies' response to each of our specific proposals based on whether it provides adequate consumer protections (favorable) or weakens the regulations (unfavorable).

This document compares OSEC's suggested regulatory markup with the Final Volcker Rule. It does not contain a complete analysis of all of OSEC's proposed recommendations, which were referenced in the Final Volcker Rule on 284 separate occasions. We continue to evaluate the Final Rule and are in the process of producing a detailed report card that provides a further assessment of the Rule, which we have graded a "C-" overall.

This grade reflects the fact that in certain areas the Agencies modified the Volcker regulations to reduce the risk of rule evasion by banks, which warrants a passing grade. For instance, they revised provisions for liquidity management, enhanced reporting and documentation

requirements, and made it more difficult for large banks to trade with each other by simply calling each other "customers."

However, the Agencies missed the mark in several key areas. Notably, they failed to properly define the scope of "covered funds," which creates avenues for rule evasion through usage of alternative fund structures like "business development companies." The Agencies also failed to restrict the underwriting exemption to registered securities, or limit the ability of banks to "make markets" in non-existent markets. They also failed to properly define the limitations to permitted exemptions under the Volcker Rule (i.e., transactions involving conflicts of interest, high risk assets or high risk trading activities).

This document is the first in a multi-part document that analyzes key components of the Final Volcker Rule. In future installations in this series, OSEC will analyze particular provisions in the Final Rule and assess what impact they could have on the economy, from the perspective of the average person.

Occupy the SEC **December 20, 2013**
Eric Taylor
AkshatTewary
George Bailey
et al.

TABLE: Comparison of Suggested Markups in Occupy the SEC's Comment Letter Responding to the Proposed Volcker Rule with the Corresponding Language Contained in the Final Version of the Volcker Rule

OSEC's Suggested Markups for Proposed Volcker Rule *(suggested additions in italics and suggested deletions in strikethrough)*	Corresponding Language in the Final Volcker Rule	Comments
1. Definition of Loan § _.2(q):Loan means any loan, lease, extension of credit, or secured or unsecured receivable. *A loan shall not mean a position:* *1. having the expectation of profits arising from a common enterprise which depends solely on the efforts of a promoter or third party,* *2. in which there is common trading for speculation or investment,* *3. that materially has the characteristics of a commodity, security, or derivative, or* *4. that falls within the scope of § _.3(b)(3)(ii)*	§ _.2(q):Loan means any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative.	The Agencies tightened up the language by making sure that a derivative or security is not confused as a secured or unsecured receivable. (Favorable)
2. Eliminate "Category" from the "Rebuttable Presumption" Definition of Trading Account § _.3(b)(2)(ii):Rebuttable presumption for certain positions. An account shall be presumed to be a trading account if it is used to acquire or take a covered financial position, other than a covered financial position described in paragraph (b)(2)(i)(B) or (C) of this section, that the covered banking entity holds for a period of ~~sixty~~*one hundred eighty days* or less, unless the covered banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, either ~~individually or as a category~~, was not acquired or taken principally for any of the purposes described in paragraph (b)(2)(i)(A) of this section.	§ _.3(b)(2)(ii):Rebuttable presumption for certain purchases and sales. The purchase (or sale) of a financial instrument by a banking entity shall be presumed to be for the trading account of the banking entity under paragraph (b)(1)(i) of this section if the banking entity holds the financial instrument for fewer than sixty days or substantially transfers the risk of the financial instrument within sixty days of the purchase (or sale), unless the banking entity can demonstrate, based on all relevant facts and circumstances, that the banking entity did not purchase (or sell) the financial instrument principally for any of the purposes described in paragraph (b)(1)(i) of this section.	The Agencies did not adopt OSEC's recommendation, allowing medium term positions to escape the Volcker Rule's prohibitions. (Unfavorable)
3. Removal of Repo and Reverse Repo Accounts as Exclusions to the Definition of Trading Account <u>a. Preferred markup:</u> Remove §_.3(b)(2)(iii)(A) entirely. <u>b. Alternative markup:</u> Remove §_.3(b)(2)(iii)(A) entirely in favor of a new entry in §_.6, §_.6(e),	The Agencies removed the repo exclusion from the "trading account" definition and added the following text: §_.3(d): <u>Proprietary trading does not include:</u> (1) Any purchase or sale of one or more	The Agencies adopted OSEC's alternative markup of making repos a permitted activity as opposed to excluding such transactions from the definition of trading account (OSEC's preferred approach). The Agencies' approach should add some additional scrutiny to these transactions. The Preamble suggests that shorting

that defines repurchase and reverse repurchase agreements as a permitted activity: *§_.6(e) Permitted trading in repurchase and reverse repurchase agreements. (1) The prohibition on proprietary trading contained in §l.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that is:* *(i) A repurchase or reverse repurchase agreement pursuant to which the covered banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;* *(ii) That the agreement defined in (i) of this part adhere to a publicly-available, industry standardized master agreement; and* *(iii) That the stated assets in the agreement defined in (i) of this part consist only of high-quality liquid asset.*	financial instruments by a banking entity that arises under a repurchase or reverse repurchase agreement pursuant to which the banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;	transactions disguised as repo agreements would be proprietary trading but the regulatory language does not convey that idea. The Agencies should have clarified the Rule to synchronize the Preamble's language on this point with the Rule actual language. (Slightly unfavorable)
4. Securities Lending <u>a. Preferred approach:</u> Remove §_.3(b)(2)(iii)(B) entirely. <u>b. Alternative approach:</u> Modify §_.3(b)(2)(iii)(B) entirely in favor of a new entry in §_.6, §_.6(f), that defines securities lending as a permitted activity: *§_.6(f) Permitted trading in securities lending agreements.* *(1)The prohibition on proprietary trading contained in §l.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that:* (i)Arise under a transaction in which the covered banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties; and *(ii) The assets that the covered banking entity invests in using the proceeds of the securities lending transaction, in order to minimize risk to their clients, be restricted to high- quality liquid assets.*	The Agencies removed the securities lending exclusion from the "trading account" definition and moved it to the list of permitted activities. §_.3(d): <u>Proprietary trading does not include:</u> … (2) Any purchase or sale of one or more financial instruments by a banking entity that arises under a transaction in which the banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties;	The Agencies did not include language regarding the quality of assets. (Slightly unfavorable)

5. Liquidity Management Modify §_.3(b)(2)(iii)(C)(2) as follows: (2) Requires that any transaction contemplated and authorized by the plan be ~~principally~~*solely* for ~~the purpose of managing the~~*management of* liquidity of the covered banking entity, and not for the purpose of short-term resale, benefiting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes; Also, modify §_.3(b)(2)(iii)(C)(3) to require that liquidity management positions "**consist only of high-quality liquid assets**," and also to add the word "**reasonably**": (3) Requires that any position taken for liquidity management purposes be ~~highly liquid~~ *high-quality liquid assets*, and limited to financial instruments the market, credit and other risks of which the covered banking entity does not *reasonably* expect to give rise to appreciable profits or losses as a result of short-term price movements;	§_.3(d): Proprietary trading does not include: … (3) Any purchase or sale of a security by a banking entity for the purpose of liquidity management in accordance with a documented liquidity management plan of the banking entity that: i. Specifically contemplates and authorizes the particular securities to be used for liquidity management purposes, the amount, types, and risks of these securities that are consistent with liquidity management, and the liquidity circumstances in which the particular securities may or must be used; ii. Requires that any purchase or sale of securities contemplated and authorized by the plan be principally for the purpose of managing the liquidity of the banking entity, and not for the purpose of short-term resale, benefiting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes; iii. Requires that any securities purchased or sold for liquidity management purposes be highly liquid and limited to securities the market, credit, and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short- term price movements; iv. Limits any securities purchased or sold for liquidity management purposes, together with any other instruments purchased or sold for such purposes, to an amount that is consistent with the banking entity's near-term funding needs, including deviations from normal operations of the banking entity or any affiliate thereof, as estimated and documented pursuant to methods specified in the plan; v. Includes written policies and procedures, internal controls, analysis, and independent testing to ensure that the purchase and sale of securities that are not permitted under §§ __.6(a) or (b) of this subpart are for the purpose of liquidity management and in accordance with the liquidity management plan described in paragraph (d)(3) of this section; and vi. Is consistent with [Agency]'s supervisory requirements, guidance, and expectations regarding liquidity management;	The language is mostly unchanged but the Agencies adopted one addition that OSEC suggested: the addition of the word "reasonably." This shifts the inquiry away from bankers' subjective expectations to a higher standard of objective reasonableness of those expectations, which can be more effectively evaluated by the Agencies and watchdogs. (Slightly favorable)

6. Clarification of Exemption for Clearing Organizations Modify § _.3(b)(2)(iii)(D) to add "**clearing**" before "securities transactions": (D) That are acquired or taken by a covered banking entity that is a derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1) or a clearing agency registered with the SEC under section 17A of the Exchange Act (15 U.S.C. 78q–1) in connection with clearing derivatives or *clearing* securities transactions.	§_.3(d): Proprietary trading does not include: … (4) Any purchase or sale of one or more financial instruments by a banking entity that is a derivatives clearing organization or a clearing agency in connection with clearing financial instruments; (5) Any excluded clearing activities by a banking entity that is a member of a clearing agency, a member of a derivatives clearing organization, or a member of a designated financial market utility;	The Agencies clarified that the clearing requirement would apply to both derivatives and securities transactions. (Favorable)
7. Exemption of Underwriting Modify § _.4(a) to require exempted underwriting to occur only for *registered* securities: § _.4(a)(2)(ii): The covered financial position is a *registered* security; § _.4(a)(3): Definition of distribution. For purposes of paragraph (a) of this section, a distribution of securities means an offering of securities, ~~whether or not subject to registration under the Securities Act~~, that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods. § _.4(a)(4): Definition of underwriter. For purposes of paragraph (a) of this section, underwriter means: i. A person who has agreed with an issuer of securities or selling security holder: (A) To purchase *registered* securities for distribution;(B) To engage in a distribution of *registered* securities for or on behalf of such issuer or selling security holder; or (C) To manage a distribution of *registered* securities for or on behalf of such issuer or selling security holder; and ii. A person who has an agreement with another person described in paragraph (a)(4)(i) of this section to engage in a distribution of such *registered* securities for or on behalf of the issuer or selling security holder. Also, modify §_.4 (a) to remove weak language considering a banking entity's intent: § _.4(a)(vi) The underwriting activities of the covered banking entity ~~are designed~~ to generate revenues ~~primarily~~*solely* from fees, commissions, underwriting spreads or other income not attributable to:	§ _.4(a)(2)(ii):The amount and type of the securities in the trading desk's underwriting position are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties, and reasonable efforts are made to sell or otherwise reduce the underwriting position within a reasonable period, taking into account the liquidity, maturity, and depth of the market for the relevant type of security; § _.4(a)(3) and § _.4(a)(4): (3) Definition of distribution. For purposes of paragraph (a) of this section, a distribution of securities means: (i) An offering of securities, whether or not subject to registration under the Securities Act of 1933, that is distinguished from ordinary trading transactions by the presence of special selling efforts and selling methods; or (ii) An offering of securities made pursuant to an effective registration statement under the Securities Act of 1933. (4) Definition of underwriter. For purposes of paragraph (a) of this section, underwriter means: (i) A person who has agreed with an issuer or selling security holder to: (A) Purchase securities from the issuer or selling security holder for distribution; (B) Engage in a distribution of securities for or on behalf of the issuer or selling security holder; or (C) Manage a distribution of securities for or on behalf of the issuer or selling security holder; or (ii) A person who has agreed to participate or is participating in a distribution of such securities for or on behalf of the issuer or selling security holder.	The Agencies completely removed § _.4(a)(vi), which vaguely premised eligibility as an underwriter on the "intended" sources of revenue. This change went beyond OSEC's proposal to remove intentionality from the requirement. However, the Agencies did not require that underwritten securities be "registered," which raises some questions about the riskiness, quality and liquidity of the securities that the banks can lawfully underwrite. (Slightly unfavorable)

(A) Appreciation in the value of covered financial positions related to such activities; or(B) The hedging of covered financial positions related to such activities; and § _.4(a)(vii) The compensation arrangements of persons performing underwriting activities *do* ~~are designed~~ not to reward proprietary risk-taking.		
8. Disgorgement of Proprietary Gains Made Through Underwriting Add a new criteria to the underwriting exemption, §_.4(a)(2)(viii): *§ _.4(a)(2)(viii): The covered banking entity disgorges any proprietary gains, as defined in § _.4(a)(2)(vi)(A) and § _.4(a)(2)(vi)(B), to the banking entity's depositors, on a pro-rated basis according to the amount on deposit, or to another party that is not affiliated with the banking entity, as determined by [Agency].*	N/A	OSEC's suggestion was not adopted. Disgorgement would have been a clear-cut and efficient penalty for violation of the Volcker Rule. (Very Unfavorable) The lack of penalties for violations of the Volcker Rule is a significant shortcoming of the rulemaking.
9. Definition of Permitted Market Making-Related Activities in §_.4(b)(1) We proposed the inclusion of the following language into §_4(b)(1): (1) Permitted market making-related activities. The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity's market making-related activities, *provided such activities do not include or incorporate*: *(i) Assets whose changes in values cannot be adequately mitigated by effective hedging;* *(ii) New products with rapid growth, including those that do not have a market history;* *(iii) Assets or strategies that include significant embedded leverage;* *(iv) Assets or strategies that have demonstrated significant historical volatility;* *(v) Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and* *(vi) Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;*	§_4(b): (1) Permitted market making-related activities. The prohibition contained in§ __.3(a) does not apply to a banking entity's market making-related activities conducted in accordance with paragraph (b) of this section. (2) Requirements. The market making-related activities of a banking entity are permitted under paragraph (b)(1) of this section only if: (i) The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments; (ii) The amount, types, and risks of the financial instruments in the trading desk's market-maker inventory are designed not to exceed, on an ongoing basis, the reasonably expected near term demands of clients, customers, or counterparties, based on: (A) The liquidity, maturity, and depth of the market for the relevant types of financial instrument(s); and (B) Demonstrable analysis of historical customer demand, current inventory of financial instruments, and market and	In the Final Rule the Agencies defined additional factors that would connote permissible market-making. The Agencies failed to explicitly acknowledge that risky or highly illiquid markets are inappropriate for the market-making exemption. Further, it is questionable whether the Final Rule will markedly alter the current customer-serving business of banking entities in a material way. (Slightly unfavorable)

	other factors regarding the amount, types, and risks, of or associated with financial instruments in which the trading desk makes a market, including through block trades; (iii) The banking entity has established and implements, maintains, and enforces an internal compliance program required by subpart D that is reasonably designed to ensure the banking entity's compliance with the requirements of paragraph (b) of this section, including reasonably designed written policies and procedures, internal controls, analysis and independent testing identifying and addressing: (A) The financial instruments each trading desk stands ready to purchase and sell in accordance with paragraph (b)(2)(i) of this section; (B) The actions the trading desk will take to demonstrably reduce or otherwise significantly mitigate promptly the risks of its financial exposure consistent with the limits required under paragraph (b)(2)(iii)(C) of this section; the products, instruments, and exposures each trading desk may use for risk management purposes; the techniques and strategies each trading desk may use to manage the risks of its market making-related activities and inventory; and the process, strategies, and personnel responsible for ensuring that the actions taken by the trading desk to mitigate these risks are and continue to be effective; (C) Limits for each trading desk, based on the nature and amount of the trading desk's market making-related activities, that address the factors prescribed by paragraph (b)(2)(ii) of this section, on: (1) The amount, types, and risks of its market-maker inventory; (2) The amount, types, and risks of the products, instruments, and exposures the trading desk may use for risk management purposes; (3) The level of exposures to relevant risk factors arising from its financial exposure; and (4) The period of time a financial instrument may be held; (D) Internal controls and ongoing monitoring and analysis of each trading desk's compliance with its limits; and (E) Authorization procedures, including escalation procedures that require review and approval of any trade that would exceed a trading desk's limit(s), demonstrable analysis that the basis for any temporary or permanent increase to a trading desk's limit(s) is consistent with the requirements of paragraph (b) of this section, and independent review of such demonstrable analysis and approval; (iv) To the extent that any limit identified pursuant to paragraph (b)(2)(iii)(C) of this section is exceeded, the trading desk takes action to bring the trading desk into compliance with the limits as promptly as possible after the limit is exceeded;	

	(v) The compensation arrangements of persons performing the activities described in paragraph (b) of this section are designed not to reward or incentivize prohibited proprietary trading; and (vi) The banking entity is licensed or registered to engage in activity described in paragraph (b) of this section in accordance with applicable law.	
10. Definition of Market Maker in §_.4(b)(2)(ii) § _.4(b)(2)(ii) The trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular ~~or~~ *and* continuous basis;	§ _.4(b)(2)(i): The trading desk that establishes and manages the financial exposure routinely stands ready to purchase and sell one or more types of financial instruments related to its financial exposure and is willing and available to quote, purchase and sell, or otherwise enter into long and short positions in those types of financial instruments for its own account, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the relevant types of financial instruments;	The phrase "routinely stands ready" raises the bar slightly for a desk to qualify as a market maker. The Agencies failed to explicitly acknowledge that risky or highly illiquid markets are inappropriate for the market-making exemption. (Neutral)
11. Compensation Arrangements We propose the following change to the language of Section § __.4(b)(2)(vii) of the proposed rule: § _.4(b)(2)(vii) The compensation arrangements of persons performing the market making-related activities ~~are designed~~*do*not to reward proprietary risk-taking Additionally, the explanation of this sixth criterion in the supplementary information should be changed to the following: Under § __.4(b)(2)(vii) of the proposed rule, the compensation arrangements of persons performing market making-related activities at the banking entity must be designed not to encourage or reward proprietary risk-taking. Activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. ~~Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with~~	§ __.4(b)(2)(v): (Market-making) The compensation arrangements of persons performing the activities described in paragraph (b) of this section are designed not to reward or incentivize prohibited proprietary trading; and § __.5(b)(3)(Hedging) The compensation arrangements of persons performing risk-mitigating hedging activities are designed not to reward or incentivize prohibited proprietary trading.	The Agencies failed to make the proposed changes, allowing bank employees to be rewarded for taking proprietary risks so long as their compensation arrangements were not directly "designed" to achieve that result. A stricter and more robust restriction would have required banks to actually withhold compensation from bank employees where such compensation derived from proprietary trading (and was not designed to achieve that result). (Unfavorable)

~~which personnel have managed principal risk retained, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking.~~ Furthermore, the same change should be made to the language regarding the Risk-Mitigating Hedging exemption: Seventh, § _.5(b)(2)(vi) of the proposed rule requires that the compensation arrangements of persons performing the risk-mitigating hedging activities ~~are designed~~*do* not ~~to~~ reward proprietary risk-taking. Hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing risk, are inconsistent with permitted risk- mitigating hedging activities.		
12. Disgorgement of Proprietary Gains Made by Market Making Add a new criteria to the market making exemption, § _.4(b)(2)(viii): §_.4(b)(2)(viii): The covered banking entity disgorges any proprietary gains, as defined in § _.4(b)(2)(v)(A) and § _.4(b)(2)(v)(B), to the banking entity's depositors, on a pro-rated basis according to the amount on deposit, or to another party that is not affiliated with the banking entity, as determined by [Agency].		OSEC's suggestion was not adopted. Disgorgement would have been a clear-cut and efficient penalty for violation of the Volcker Rule. (Very unfavorable)
13. Hedging Documentation We propose the amendment of the wording of § _.5(c) to the following: (c) Documentation. With respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to this Sec. --.5 for risk-mitigating hedging ~~purposes that is established at a level of organization that is different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce,~~ the covered banking entity must, at a minimum, document, *with particularity,* at the time the purchase, sale, or series of purchases or sales are conducted: (1)The risk-mitigating	§ _.5(c) Documentation requirement. (1) A banking entity must comply with the requirements of paragraphs (c)(2) and (c)(3) of this section with respect to any purchase or sale of financial instruments made in reliance on this section for risk-mitigating hedging purposes that is:(i) Not established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the hedging activity is designed to reduce;(ii) Established by the specific trading desk establishing or responsible for the underlying positions, contracts, or other holdings the risks of which the purchases or sales are designed to reduce, but that is effected through a financial instrument, exposure, technique, or strategy that is not specifically identified in the trading desk's	The Agencies eliminated language relating to organizational levels, as requested, and added new terms that are more precise than the Proposed Rule in defining what documentation is required to support exempted hedging. However, the hedging of "aggregated" risk, which is permitted by statute, still presents itself as labyrinthine in scope, and remains a potential avenue for evasive proprietary trading schemes. The Final Rule's requirement that banks produce granular documentation supporting trades could serve a strong deterrent to evasive schemes. (Favorable)

purpose of the purchase, sale, or series of purchases or sales; (2) The risks of the individual or aggregated positions, contracts, or other holdings of a covered banking entity that the purchase, sale, or series of purchases or sales are designed to reduce; and (3) The level of organization that is establishing the hedge.	written policies and procedures established under paragraph (b)(1) of this section or under § __.4(b)(2)(iii)(B) of this subpart as a product, instrument, exposure, technique, or strategy such trading desk may use for hedging; or (iii) Established to hedge aggregated positions across two or more trading desks. (2) In connection with any purchase or sale identified in paragraph (c)(1) of this section, a banking entity must, at a minimum, and contemporaneously with the purchase or sale, document: (i) The specific, identifiable risk(s) of the identified positions, contracts, or other holdings of the banking entity that the purchase or sale is designed to reduce; (ii) The specific risk-mitigating strategy that the purchase or sale is designed to fulfill; and(iii) The trading desk or other business unit that is establishing and responsible for the hedge. (3) A banking entity must create and retain records sufficient to demonstrate compliance with the requirements of paragraph (c) of this section for a period that is no less than five years in a form that allows the banking entity to promptly produce such records to [Agency] on request, or such longer period as required under other law or this part.	
14. Permitted Trading on Behalf of Customers Remove "investment adviser, commodity trading advisor" from §_.6(b)(2)(i)(A): (A) Is conducted by a covered banking entity acting as ~~investment adviser, commodity trading advisor,~~ trustee, or in a similar fiduciary capacity for a customer;	§ __.6(c)(1): The prohibition contained in § __.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as trustee or in a similar fiduciary capacity, so long as:	The Agencies adopted OSEC's markup. This revised language more specifically defines the roles of banks as market-making intermediaries. (Favorable)
15. Riskless Principal Transaction We suggest the following alternative definition of riskless principal transaction at § _.6(b)(2)(ii): (ii) The covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account, to offset a ~~contemporaneous~~*simultaneous* sale to (or purchase from) the customer, *where the purchase price and offsetting sale price are identical, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee*;	§ __.6(c)(2): Riskless principal transactions. The prohibition contained in § __.3(a) does not apply to the purchase or sale of financial instruments by a banking entity acting as riskless principal in a transaction in which the banking entity, after receiving an order to purchase (or sell) a financial instrument from a customer, purchases (or sells) the financial instrument for its own account to offset a contemporaneous sale to (or purchase from) the customer.	The Agencies failed to make the proposed changes. The "contemporaneous sale" language only requires that exempt transactions occur within the same general time period (and not simultaneously). Thus, there is room for market makers to conduct trading that would profit off of price fluctuations occurring over small time-scales. (Unfavorable)

16. Client, Customer Counterparty We propose that the phrase, client, customer, or counterparty, which is referenced throughout the Proposed Rule yet is undefined, be defined as follows: *A customer is a counterparty that is NOT itself a covered banking entity, and with which a banking entity has a direct and substantive relationship, which was initiated by the client prior to the transaction.* We further propose that the term "customer" be defined as follows: *Customer means an investor engaged in a continuing, direct, and pre-existing relationship with a banking entity where a banking entity provides one or more financial products or services to the investor.*	§ __.4(b)(3): Definition of client, customer, and counterparty. For purposes of paragraph (b) of this section, the terms client, customer, and counterparty, on a collective or individual basis refer to market participants that make use of the banking entity's market making-related services by obtaining such services, responding to quotations, or entering into a continuing relationship with respect to such services, provided that: (i) A trading desk or other organizational unit of another banking entity is not a client, customer, or counterparty of the trading desk if that other entity has trading assets and liabilities of $50 billion or more as measured in accordance with § __.20(d)(1) of subpart D, unless: (A) The trading desk documents how and why a particular trading desk or other organizational unit of the entity should be treated as a client, customer, or counterparty of the trading desk for purposes of paragraph (b)(2) of this section; or (B) The purchase or sale by the trading desk is conducted anonymously on an exchange or similar trading facility that permits trading on behalf of a broad range of market participants.	The regulators defined "client", "customer" and "counterparty" so as to exclude mega-banks from the Volcker Rule's client-facing exemption. However, the final language does not prohibit bank entities generally from being a customer, client or counterparty. This definition is consistent with the recent articulation of what constitutes a systemically importance financial institution (or SIFI). The Rule would have been stronger if it had applied to all bank holding companies, since the Volcker Rule was intended to apply to *all* BHCs, but the current definition is still favorable as it focuses on those banks that are most likely to engage in speculative trading. (Favorable)
17. Definition of Material Conflict of Interest Remove ", or substantially mitigate," from §_.8(b)(1)(ii): (ii) Makes such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate~~, or substantially mitigate,~~ any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or	§ __.7(b)(2)(i)(B): Such disclosure is made in a manner that provides the client, customer, or counterparty the opportunity to negate, or substantially mitigate, any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or	The Agencies failed to make the proposed changes. The "substantially mitigate" language undermines the vitality of the Conflict of Interest limitation on permitted proprietary trading activities. (Unfavorable)
18. Definition of Covered Fund Modify § _.10(b)(1) to add the elements 10(b)(1)(v) and (vi): *(v) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a—1 et seq.), but for Section 3(c)(2) of that Act, or Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under that Act, and* *(vi) Any issuer that the Commission deems to be a covered fund, should the Commission deem that said issuer exhibit the characteristics of a fund that takes on proprietary trading activities;*	§ __.10(b):Definition of covered fund. (1) Except as provided in paragraph (c) of this section, covered fund means: (i) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. 80a-3(c)(1) or (7)); (ii) Any commodity pool under section 1a(10) of the Commodity Exchange Act (7 U.S.C. 1a(10)) for which:	The Final Rule mirrors the statutory definition of covered funds. The Agencies failed to exercise their statutory authority to broaden the scope of the covered fund definition, paving the way for banking entities to skirt the covered fund restrictions by simply investing in funds that are not 3(c)(1), 3(c)(7) or commodity pool funds. (Very Unfavorable)

19. Definition of Ownership Interest • Remove § _.10(b)(3)(ii)(A), which exempts carried interest from the definition of ownership interest. • Revise § _.10(b)(3)(i) as follows: (i) Ownership interest means any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest, *or any interest that derives its value from the performance or value of the covered fund*.	§ __.10(d)(6)(ii): Ownership interest does not include: Restricted profit interest. An interest held by an entity (or an employee or former employee thereof) in a covered fund for which the entity (or employee thereof) serves as investment manager, investment adviser, commodity trading advisor, or other service provider so long as: (A) The sole purpose and effect of the interest is to allow the entity (or employee or former employee thereof) to share in the profits of the covered fund as performance compensation for the investment management, investment advisory, commodity trading advisory, or other services provided to the covered fund by the entity (or employee or former employee thereof), provided that the entity (or employee or former employee thereof) may be obligated under the terms of such interest to return profits previously received; (B) All such profit, once allocated, is distributed to the entity (or employee or former employee thereof) promptly after being earned or, if not so distributed, is retained by the covered fund for the sole purpose of establishing a reserve amount to satisfy contractual obligations with respect to subsequent losses of the covered fund and such undistributed profit of the entity (or employee or former employee thereof) does not share in the subsequent investment gains of the covered fund; (C) Any amounts invested in the covered fund, including any amounts paid by the entity (or employee or former employee thereof) in connection with obtaining the restricted profit interest, are within the limits of § __.12 of this subpart; and (D) The interest is not transferable by the entity (or employee or former employee thereof) except to an affiliate thereof (or an employee of the banking entity or affiliate), to immediate family members, or through the intestacy, of the employee or former employee, or in connection with a sale of the business that gave rise to the restricted profit interest by the entity (or employee or former employee thereof) to an unaffiliated party that provides investment management, investment advisory, commodity trading advisory, or other services to the fund.	Despite OSEC's recommendation, the Final Rule retains the carried interest exemption to ownership of covered funds. Instead of using the term "carried interest" the Rule uses "Restricted Profit Interest." As a result, profit can still be tied to performance of the fund manager, which could produce deleterious incentives. (Unfavorable)
20. Definition of Prime Brokerage Transaction The Agencies should **remove** "financing" and "securities borrowing or lending services" from the definition of prime brokerage in § _.10(b)(4): (4) Prime brokerage transaction means one or more products or services	§ __.10(d)(7): Prime brokerage transaction means any transaction that would be a covered transaction, as defined in section 23A(b)(7) of the Federal Reserve Act (12 U.S.C. 371c(b)(7)), that is provided in connection with custody,	Despite OSEC's recommendation, the Final Rule allows financing and securities lending to occur as permitted prime brokerage activities, which creates opportunities for risky overleveraging.

provided by a covered banking entity to a covered fund, such as custody, clearance, ~~securities borrowing or lending services~~, trade execution, or ~~financing~~, data, operational, and portfolio management support.	clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support.	(Unfavorable)
21. Permitted Employee Investments Modify § _.11(g) to remove "or other services": (g) No director or employee of the covered banking entity takes or retains an ownership interest in the covered fund, except for any director or employee of the covered banking entity who is directly engaged in providing investment advisory ~~or other services~~ to the covered fund;	§ __.11(a)(7): No director or employee of the banking entity (or an affiliate thereof) takes or retains an ownership interest in the covered fund, except for any director or employee of the banking entity or such affiliate who is directly engaged in providing investment advisory, commodity trading advisory, or other services to the covered fund at the time the director or employee takes the ownership interest;	Despite OSEC's recommendation, the Final Rule allows bank personnel to engage in "other services" even though that term is not properly defined, thereby creating opportunities for rule evasion. (Unfavorable)
22. Ownership limits in Covered Funds Redefine § _.12(a)(2)(i) by adding a new entry, § _.12(a)(2)(i)(C): *(C) May at no time during the initial 1 year following the establishment of the fund (or such longer period as may be provided by the Board pursuant to paragraph (e) of this section) exceed $10 million, or 3% of Tier 1 capital, whichever is less.*	N/A	The Agencies did not adopt OSEC's markup, which would have made it impossible for a bank to seed a covered fund without acquiring external funding. Under the Final Rule, banks can take on significant exposure to covered funds within one year of such funds' their establishment, even though risk of loss in a fund can be highest during its first year of operations. (Unfavorable)
23. Include Committed Funds in Ownership Interest Amend §§ _.12(b)(2)(i) and _.12(b)(2)(i)(A) as follows: § _12(b)(2)(i): The aggregate amount of all ownership interests of the covered banking entity shall be the greater of ~~(without regard to committed funds not yet called for investment)~~: § _.12(b)(2)(i)(A): The value of any investment or capital contribution made with respect to all ownership interests held under § _.12 by the covered banking entity in the covered fund, *including committed funds not yet called for investment*, divided by the value of all investments or capital contributions, respectively, made by all persons in that covered fund*, including committed funds not yet called for investment*;	§ __.12(b)(2)(i): The aggregate number of the outstanding ownership interests held by the banking entity shall be the total number of ownership interests held under this section by the banking entity in a covered fund divided by the total number of ownership interests held by all entities in that covered fund, as of the last day of each calendar quarter (both measured without regard to committed funds not yet called for investment); (ii) The aggregate value of the outstanding ownership interests held by the banking entity shall be the aggregate fair market value of all investments in and capital contributions made to the covered fund by the banking entity, divided by the value of all investments in and capital contributions made to that covered fund by all entities, as of the last day of each calendar quarter (all measured without regard to committed funds not yet called for investment). If fair market value cannot be determined, then the value shall be the historical cost basis of all investments in and contributions made by the banking entity to the covered fund;	The Agencies did not adopt OSEC's markup, thereby expanding the scope of a bank's permissible ownership interests in a single covered fund. (Unfavorable)

24. Valuing Investments in Covered Funds Amend § _.12(b)(4) as follows: § _12(b)(4): Methodology and standards for calculation. For purposes of determining the amount or value of its investment in a covered fund under this paragraph (b), a covered banking entity must calculate its investment in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests, *except that committed funds not yet called for investment shall be counted toward the value of the total investment in the covered fund regardless of the standards used by the covered fund.*	§ __.12 (b)(2)(iii): For purposes of the calculation under paragraph (b)(2)(ii), once a valuation methodology is chosen, the banking entity must calculate the value of its investment and the investments of all others in the covered fund in the same manner and according to the same standards.	The Agencies have left it up to banks to determine their own internal means of valuating their investments in Covered Funds, which creates opportunities for evasion, particularly with respect to committed-yet-uncalled funds. (Unfavorable)
25. Compensation "Hedging" <u>a. Preferred approach:</u> We suggest that the Agencies **remove the permitted "hedging" of compensation arrangements** through an ownership interest in a covered fund provided by § _.13(b)(1)(i)(B). <u>b. Alternative Approach:</u> Add the following **new criteria** be to § _.13(b)(2)(ii)(B)(2) in order to prevent rule evasion (additions in italics): § _.13(b)(2)(ii)(B)(2) Is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund, *provided that*: *(i) No "hedge" is permitted during the one year following the establishment of the fund.* *(ii) All proceeds from the "hedge" must be paid entirely to the investment advisor, and* *(iii) The "hedge" in the covered fund that does not exceed 3 percent of the total outstanding ownership interests in the fund;*	§ __.13(a): <u>Permitted Risk-Mitigating Hedging Activities.</u> (1) The prohibition contained in § _.10(a) of this subpart does not apply with respect to an ownership interest in a covered fund acquired or retained by a banking entity that is designed to demonstrably reduce or otherwise significantly mitigate the specific, identifiable risks to the banking entity in connection with a compensation arrangement with an employee of the banking entity or an affiliate thereof that directly provides investment advisory, commodity trading advisory or other services to the covered fund.	The Agencies did not adopt OSEC's markup, thereby permitting compensation arrangements to actually reward bank employees for proprietary risk-taking, provided that those arrangements were not "designed" to do so. (Unfavorable)
26. Remove Bank Owned Life Insurance as a Covered fund activities determined to be permissible. Remove § _.14(a)(1), Bank owned life insurance.	No change	The Agencies did not adopt OSEC's markup, thereby expanding the scope of permissible banking activities. (Unfavorable)

27. Limitations on Prime Brokerage with a Covered Fund: Third-party Funds Only Modify § _.16(a)(2)(ii) to include the phrase "third party": (ii) Enter into any prime brokerage transaction with any *third party* covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, if:	§ __.14(a)(2)(ii): Enter into any prime brokerage transaction with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or an affiliate thereof) has taken an ownership interest, if:	The Agencies did not adopt OSEC's markup. (Unfavorable)
28. Limitations on Prime Brokerage with a Covered Fund: Investment Limits Add a new entry to § _.16(a)(2)(ii), § _.16(a)(2)(ii)(D): *(D) The covered banking entity has divested from the covered fund such that its ownership interest in the covered fund is no more than the 3% de minimis investment limitation set forth in § _.12(a)(1)(ii);*	No change.	The Agencies did not adopt OSEC's markup. (Unfavorable)
29. Extension of Required Time to Make and Keep Records Amend § _.20(b)(6) to read 6 years instead of 5: (6) Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a covered banking entity must promptly provide to [Agency] upon request and retain for a period of no less than *6* years.	§ __.20(b) Contents of compliance program.. . . . (6)Records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a banking entity must promptly provide to [Agency] upon request and retain for a period of no less than 5 years or such longer period as required by [Agency].	The Agencies did not adopt OSEC's markup. This is an especially egregious shortcoming given the failure of the Agencies to take a sufficient number of enforcement actions relating to the 2008 crisis in a timely manner (for purposes of various statutes of limitations). (Unfavorable)
30. Change "Timely Notification" to "Immediate Notification" in Appendix C Modify Appendix C, III(A), "Analysis and quantitative measurements" in the bullet that begins 'Immediate review and compliance investigation . . ." as follows: Immediate review and compliance investigation of the trading unit's activities, escalation to senior management with oversight responsibilities for the applicable trading unit, *immediate* notification to [Agency] (*where 'immediate' shall mean no later than one day following the time when the concern was raised internally*), appropriate remedial action (e.g., divesting of impermissible positions, cessation of impermissible activity, disciplinary actions), and documentation of the investigation findings and remedial action taken when the quantitative measurement, considered together with	Appendix B, Part II.A: Immediate review and compliance investigation of the trading desk's activities, escalation to senior management with oversight responsibilities for the applicable trading desk, timely notification to [Agency], appropriate remedial action (e.g., divesting of impermissible positions, cessation of impermissible activity, disciplinary actions), and documentation of the investigation findings and remedial action taken when quantitative measurements or other information, considered together with the facts and circumstances, or findings of internal audit, independent testing or other review suggest a reasonable likelihood that the trading desk has violated any part of section 13 of the BHC Act or this part.	The Agencies did not adopt OSEC's markup and left the phrase "timely" undefined, which creates uncertainty. (Unfavorable)

the facts and circumstances, suggests a reasonable likelihood that the trading unit has violated any part of section 13 of the BHC Act and this part.		