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The "Volcker Rule": Proposals to Limit "Speculative" Proprietary Trading by Banks

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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of the provisions of the GSA that imposed affiliation restrictions between banks and securities firms, which were repealed by the Gramm-Leach-Bliley Act (GLBA) in 1999.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 111th 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 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 both the House- and Senate-passed financial reform bills. **Appendix A** and **Appendix B** of the report provide the full legislative language from both bills.

Contents

Appendixes

Contacts

Introduction

In 1933, during the first 100 days of President Franklin D. Roosevelt's New Deal, the Securities Act of 1933[1] and the Glass-Steagall Act (GSA)[2] 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.[3] 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);[4] further restrictions on bank affiliations with non-banking firms were enacted in Bank Holding Company Act of 1956 (BHCA)[5] 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.[6] Included in these activities restrictions are certain

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[1] 48 Stat. 74, codified at 15 U.S.C. §§ 77a *et seq*.

[2] 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.

[3] 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.

[4] 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 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.

[5] 70 Stat. 133; 12 U.S.C. §§ 1841-1850.

[6] 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;[7] 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;[8] 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.[9]

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,[10] 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).[11] 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.[12] And aside from a general prohibition on accepting federally insured consumer deposits, securities firms generally are not subject to activity restrictions, as are banks.[13] As a result, these institutions generally do not have access to the federal safety net.[14]

(...continued)

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

[7] See, e.g., 12 U.S.C. § 1828.

[8] See, e.g., 12 U.S.C. § 1820(d).

[9] 12 U.S.C. § 1831o; 12 U.S.C. § 1818.

[10] 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&dtlID=43.

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

[12] CRS Report RS22581, *Overview of Major Federal Securities Laws*, by Michael V. Seitzinger.

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

[14] 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),[15] 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)[16] 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.[17]

While neither the House- nor the Senate-passed version of H.R. 4173, the comprehensive financial regulatory reform proposals of the 111th 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.

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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.

[15] BHCs are companies owning or controlling at least one bank.

[16] P.L. 106-102.

[17] 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.[18] 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.[19] Additionally, regulators may have become less cautious as time passed after the Great Depression.[20]

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.[21] In addition to underwriting and dealing activities, the FRB also approved other securities activities such as the provision of investment advice,[22] the brokering of securities,[23] and others. The FRB promulgated the list of permissible nonbanking activities at 12 C.F.R. § 225.28(b).[24] 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,

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

[19] 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).

[20] 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)).

[21] 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).

[22] Bd. of Governors for the Federal Reserve System v. Investment Company Institute, 450 U.S. 46 (1981).

[23] Securities Industry Assoc. v. Bd. of Governors for the Federal Reserve System, 468 U.S. 207 (1984).

[24] 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."[25] The GLBA listed certain activities as "financial in nature,"[26] including all the nonbanking activities which had already been authorized for BHCs.[27] The GLBA empowered the FRB, in coordination with the Secretary of the Treasury, to issue orders or regulations supplementing that list.[28]

Merchant Banking Investments. Under the GLBA[29] and rules promulgated jointly by the Secretary of the Treasury and the FRB,[30] FHCs with a securities affiliate or an insurance affiliate with an investment adviser affiliate[31] 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."[32] FHC merchant banking investments must be "part of a bona fide underwriting or merchant or investment banking activity."[33] Additionally, the

[25] 12 U.S.C. § 1843(k)(1).

[26] 12 U.S.C. § 1843(k)(4).

[27] 12 C.F.R. § 225.28.

[28] 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).

[29] 12 U.S.C. § 1843(k)(4)(H).

[30] 12 C.F.R. §§ 225. 170 – 225.177, promulgated in 66 Fed. Reg. 8466, 8484 (January 31, 2001).

[31] 12 C.F.R. § 225.170(f).

[32] 12 C.F.R. § 225.170(a).

[33] 12 C.F.R. § 225.170(b).

interests must only be held on a temporary basis[34] and, in general, no longer than 10 years.[35] Under the regulation, the shares in such investments may be acquired by any subsidiary of the FHC other than a depository institution subsidiary.[36] If assets other than debt or equity securities are involved, they must be "held or promptly transferred to a portfolio company."[37] "Portfolio company," in this context, is merely the term used for the company to which these assets must be transferred.[38] Depository institution subsidiaries of the FHC may not routinely manage the portfolio company.[39] There also are restrictions designed to prevent the FHC from routinely managing or operating the portfolio company.[40] 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.[41] Despite these restrictions, however, there is a provision which permits an FHC to routinely, but on a temporary basis,[42] 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."[43] 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.[44]

Merchant Banking Investments Through a Private Equity Fund. An FHC also may make merchant banking investments though 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."[45] 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,

[34] 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).

[35] 12 C.F.R. § 225.172(b)(1).

[36] 12 C.F.R.§ 225.170(d).

[37] 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).

[38] 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.").

[39] 12 C.F.R. § 225.171(b)(f).

[40] 12 C.F.R. § 225.171.

[41] 12 C.F.R. §§ 225.171(b)(i) and (ii).

[42] 12 C.F.R. § 225.171(b)(e)(2).

[43] 12 C.F.R. § 225.171(b)(e)(1).

[44] 12 CC.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.

[45] 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.[46] 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.[47] If an FHC controls a private equity fund, the FHC may not routinely operate the private equity fund.[48]

Federal Reserve Act (FRA) §§ 23A, which imposes limitations on "covered transactions"[49] between a bank and its affiliates, and 23B,[50] 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.[51]

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.[52] 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.[53]

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[46] 12 C.F.R. §§ 225.173(a)(2) – (5).

[47] 12 C.F.R. § 225.173(c).

[48] 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).

[49] 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).

[50] 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).

[51] 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[51] 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.

[52] 12 C.F.R. § 225.176(b).

[53] 12 C.F.R. § 225.176(b)(3).

On June 22, 2000, the FRB issued guidance on FHCs' equity investments and merchant banking activities.[54] 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.[55] 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.[56]

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)."[57] 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."[58]

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

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[54] 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.

[55] *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.

[56] *Id.* at 13.

[57] 12 U.S.C. § 24a (a)(2)(A).

[58] 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.

[59] 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[60] 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.[61]

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;[62] 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.[63] State-chartered, federally insured

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[60] 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.

[61] 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.

[62] 12 U.S.C. §§ 2901 *et seq.*

[63] 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.[64]

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."[65] These activities he identified as "essentially proprietary and speculative activities."[66] 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."[67]

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[68] and, therefore, subjected to

(...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.

[64] 12 U.S.C. § 1832w.

[65] 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.

[66] *Id.* at 1.

[67] *Id.* at 3.

[68] 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."[69] 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,[70] 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, i.e., federally insured depository institutions, bank holding companies, companies treated as bank holding companies,[71] 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; [72] 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

(...continued)

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

[69] H.R. 4173, as passed by the House, § 1117(c).

[70] 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.

[71] 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.

[72] 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."[73]

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,

[73] 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).[74] There are also exceptions for investments permitted under sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act,[75] 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.[76]

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."[77] 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.[78] 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.[79] It appears that, in lieu of delegating such authority to the regulators, section 619

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[74] 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.

[75] 12 U.S.C. §§ 1843(c)(3) and 1843(c)(9).

[76] 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.

[77] 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.

[78] 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."

[79] 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."[80] 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.[81]

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.

(...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.

[80] 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).

[81] 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-___, 111th 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.

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.

Issues for the Conference Committee

There appears to be apprehension within the financial services industry about the reach of § 619, the imprecision of its definitions and prohibitions, and how it is to be implemented. Some media reports suggest that among the issues that the industry is hoping that the Conference Committee will address are (1) whether there should be broader exemptions for customer-driven investments; (2) whether insurance company portfolio investment warrants special treatment; (3) whether depository institutions, bank and financial holding companies, non-financial companies determined to be systemically important, and their subsidiaries may sponsor hedge fund and private equity funds that are limited to customer investments; (4) whether there are conditions under which bank investment in hedge funds and private equity funds could be permitted; and (5) how long a phase-in period should be permitted.[82]

[82] 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-___, 111th 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.

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) proprietary 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 11th 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 11th 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.

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