



Commodity Futures Trading Commission

Office of Public Affairs

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CFTC Division of Swap Dealer and Intermediary Oversight Responds to Frequently Asked Questions Regarding Certain Requirements under Section 13 of the Bank Holding Company Act of 1956 and Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act added a new section 13 to the Bank Holding Company Act of 1956 ("BHC Act"), commonly referred to as the Volcker rule, that generally prohibits insured depository institutions and any company affiliated with an insured depository institution from engaging in proprietary trading and from acquiring or retaining ownership interests in, sponsoring, or having certain relationships with a hedge fund or private equity fund. These prohibitions are subject to a number of statutory exemptions, restrictions, and definitions.

The Commodity Futures Trading Commission ("CFTC") is working closely with the other agencies charged with implementing the requirements of section 13, including the Federal Reserve Board, Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission (each an "Agency" and collectively with the CFTC "the Agencies"). While these frequently asked questions ("FAQs") apply to banking entities for which the CFTC has jurisdiction under section 13 of the BHC Act, they have been developed by staffs of the Agencies and substantively identical versions will appear on the public websites of each Agency.

Compliance for Market Making and the Identification of Covered Funds

1. May a banking entity's compliance program for market making-related activities include objective factors on which a trading desk may reasonably rely to determine whether a security is issued by a covered fund? Furthermore, may a market maker meet its compliance program requirements by making use of a shared utility or third party service provider that utilizes objective factors if the market maker reasonably believes the system of the shared utility or third party service provider will identify whether a security is issued by a covered fund?

The final rule's exemption for market making-related activity requires a banking entity to establish, implement, maintain, and enforce a reasonably designed compliance program for a trading desk engaged in market making-related activity that includes, among other things, strong internal controls and independent testing.¹ For purposes of meeting the final rule's exemption for market-making,² a reasonably designed compliance program for a trading desk engaged in market making-related activity may include objective factors on which

¹ See § 75.4(b)(2)(iii) of the final rule. See also § 75.20(a) of the final rule (providing that "each banking entity shall develop and provide for the continued administration of a compliance program reasonably designed to ensure and monitor compliance with the prohibitions and restrictions on proprietary trading and covered fund activities and investments set forth in section 13 of the BHC Act and [the final rules]").

² § 75.11(c).

the trading desk may reasonably rely to determine whether a security is issued by a covered fund. Objective factors are factual criteria that can be used to reliably identify whether an issuer or a particular type of issuer is a covered fund.³ As an example, an objective factor would include whether the securities of the issuer were offered in transactions registered under the Securities Act.⁴ Objective factors would not be considered part of a reasonably designed compliance program if the banking entity designed or used such objective factors to evade section 13 and the final rule.

On the other hand, the Agencies' staffs do not believe it would be reasonable for a trading desk to rely solely on either or both the name of the issuer or the title of the issuer's securities; these factors alone would not convey sufficient information about the issuer for a trading desk reasonably to determine whether a security is issued by a covered fund.

A reasonably designed compliance program for a trading desk engaged in market making-related activity also may permit the trading desk to use a shared utility or third party service provider that utilizes objective factors if the banking entity reasonably believes the system of the shared utility or third party service provider will identify whether a security is issued by a covered fund and use of the shared utility or third party service provider is identified in the trading desk's compliance program. The use of objective factors by a shared utility or third party service provider should be evaluated by the banking entity in considering whether the banking entity reasonably believes that the shared utility or third party service provider has a system that will identify whether a security is issued by a covered fund.

Whether a compliance program is reasonably designed will depend on the facts and circumstances. A compliance program that is reasonably designed for a trading desk engaged in market making-related activities may not be reasonably designed for other activities conducted by a banking entity. This FAQ only addresses the compliance program for a trading desk engaged in market making-related activity.⁵

Importantly, the banking entity's reliance on objective factors, a shared utility, or a third party service provider must be subject to independent testing and audit requirements applicable to the banking entity's compliance program.⁶ If independent testing or other review of the banking entity's compliance program shows that the objective factors used by the banking entity, shared utility, or third party service provider are not effective in identifying whether a security is issued by a covered fund, then the banking entity must promptly update its compliance program to remedy such issues and, as necessary, take action under § 75.21 of the final rule implementing section 13 of the BHC Act. Further, if at any time the banking entity discovers it holds an ownership interest in a covered fund in violation of the final rule implementing section 13 of the BHC Act, it must promptly dispose of the interest or otherwise conform it to the requirements of the final rule.⁷

³ Notably, the reasonableness of a particular objective factor may vary based on the type of issuer, and relying on objective factors may not be reasonable for all types of issuers. This may be the case, for example, for potential covered fund issuers whose operations or structure are not consistent with market standards or practices for which objective factors could be tailored.

⁴ See 79 FR at 5674 n.1717, 5687 n.1861.

⁵ In the context of market making-related activity, it generally would not be reasonable for the compliance program to permit the trading desk to rely on objective factors, shared utilities, or third party service providers in determining whether an issuer is a covered fund if the banking entity has already determined that the issuer is a covered fund in connection with sponsoring the issuer or acquiring an ownership interest in the issuer as an investment. Where a banking entity organizes and offers, including sponsors, an entity that may be a covered fund, the banking entity should know if the issuer is a covered fund and may not rely on objective factors. See § 75.11(a)-(b).

⁶ See § 75.20(b)(4), Appendix B.

⁷ While market making-related activity in covered funds is permitted under § 75.11(c) of the final rule, such activity is subject to certain limits on the amount of covered fund ownership interests the banking entity may hold.

CEO Certification for Prime Brokerage Transactions

2. When is a banking entity required to submit the annual CEO certification for prime brokerage transactions required by § 75.14(a)(2)(ii)(B) of the final rule? What about legacy covered funds?

Section 75.14(a)(1) of the final rule prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, commodity trading advisor, or sponsor to a covered fund, that organizes and offers a covered fund pursuant to § 75.11 of the final rule or that holds an ownership interest in accordance with § 75.11(b), and any affiliate of the banking entity, from entering into a covered transaction as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c(b)(7)) with the covered fund or with any other covered fund that is controlled by such covered fund. Notwithstanding this prohibition, § 75.14(a)(2) provides that a banking entity may enter into any prime brokerage transaction⁸ with any covered fund in which a covered fund managed, sponsored, or advised by such banking entity (or an affiliate) has taken an ownership interest, so long as the conditions enumerated in the final rule are satisfied.⁹ One of the conditions requires a written CEO certification annually.¹⁰

Staffs of the Agencies believe that banking entities that are required to provide the annual CEO certification for prime brokerage transactions as of the end of the conformance period should submit the first CEO certification required under § 75.14 after the end of the conformance period but no later than March 31, 2016.¹¹ A banking entity may provide the required annual certification in writing at any time prior to the March 31 deadline to the relevant Agency.

The conformance period for investments in and relationships with a legacy covered fund (i.e., a covered fund sponsored or owned by a banking entity prior to December 31, 2013) currently ends on July 21, 2016.¹² Banking entities that engage in prime brokerage transactions with legacy covered funds should submit their first CEO certification by March 31 following the end of the relevant conformance period.

In any case, a banking entity should provide the CEO certification annually within one year of its prior attestation. Moreover, under the final rule, the CEO has a duty to update the certification if the information in the certification materially changes at any time during the year when he or she becomes aware of the material change.

⁸ The final rule defines “prime brokerage transaction” to mean 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, clearance and settlement, securities borrowing or lending services, trade execution, financing, or data, operational, and administrative support. See § 75.10(d)(7).

⁹ See § 75.14(a)(2) & (c); see also 79 FR at 5747.

¹⁰ See § 75.14(a)(2)(ii)(B).

¹¹ See http://www.cftc.gov/ucm/groups/public/@externalaffairs/documents/file/volckerrule_faq091014.pdf (“The staffs of the Agencies believe that banking entities subject to Appendix B as of the end of the conformance period should submit the first CEO attestation required under Appendix B after the end of the conformance period but no later than March 31, 2016.”).

¹² The Board granted banking entities until July 21, 2016 to conform investments in and relationships with covered funds that were in place prior to December 31, 2013 and announced its intention to act next year to grant banking entities until July 21, 2017 to conform investments in and relationships with legacy covered funds. See Board Order Approving Extension of Conformance Period under Section 13 of the Bank Holding Company Act (December 18, 2014), available at <http://www.federalreserve.gov/newsevents/press/bcreg/20141218a.htm>. A banking entity would thus have until July 21, 2017 to conform its relationships with legacy covered funds.