January 23, 2012

Via Electronic Mail

MEMORANDUM TO: Scott G. Alvarez
Anna M. Harrington
Jeremy R. Newell
Christopher M. Paridon
(Board of Governors of the Federal Reserve System)

RE: Permitted Activities Exemptions under Section 13 of the Bank Holding Company Act of 1956

As a follow-up to our meeting with you on January 13, 2012, we write to set forth our analysis of Section 13[1] of the Bank Holding Company Act of 1956 (the "BHC Act"), commonly referred to as the "Volcker Rule," and why certain "permitted activities" in Section 13(d) apply to both proprietary trading and hedge fund and private equity fund activities.

We understand that many comment letters you will receive will cover the importance from a policy perspective of applying certain permitted activities exemptions to both covered funds and proprietary trading, as well as the anomalous results that would follow from a contrary reading. In this memorandum, we address only the legal question of the statute's meaning in light of its plain language and structure. In our view, the statute is unambiguous on this point, and nothing in the legislative history is inconsistent with our reading.

Section 13(a) is entitled "In General" and is followed by Section 13(a)(1), entitled "Prohibition," which contains the basic prohibition of the Volcker Rule. It reads:

> "Unless otherwise provided in this section, a banking entity shall not—
> (A) engage in proprietary trading; or
> (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."[2]

The prohibition on proprietary trading and the restrictions related to covered funds are thus both contained in Section 13(a).

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1 12 U.S.C. § 1851.

2 For purposes of this letter, we refer to hedge funds and private equity funds collectively as "covered funds," as in the notice of proposed rulemaking implementing Section 13 of the BHC Act. *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 76 Fed. Reg. 68,846 (proposed Nov. 7, 2011).

Section 13(d) is entitled "Permitted Activities," and its first subsection, 13(d)(1), is also entitled "In General." In this "In General" subsection, Congress sets out the language that will govern all permitted activities in the list that follows. Section 13(d)(1) reads:

> "*Notwithstanding the restrictions under subsection (a)*, to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, *the following activities (in this section referred to as 'permitted activities') are permitted*…"[3]

Because the "In General" subsection of (d)(1) does not distinguish between the proprietary trading prohibition in subsection (a)(1)(A) and the restrictions related to covered funds in subsection (a)(1)(B) and instead says "[n]otwithstanding the restrictions under *subsection (a),*" the general principle established by the language and structure of the statutory text is that each of the enumerated exceptions for permitted activities in subsection (d)(1) applies equally to *both* the proprietary trading *and* the restrictions related to covered funds within subsection (a). Structurally, each one of the permitted activities is listed in a subsection of, and hence governed by, the introductory language of the "In General" section of 13(d)(1). The language and structure of the general section make clear, therefore, that to the extent Section 13(d)(1) contains no further textual direction, a permitted activity will apply to both the proprietary trading prohibition in 13(a)(1)(A) and the restrictions related to covered funds in 13(a)(1)(B).[4]

Sections 13(d)(1)(B), (D) and (F) set forth, respectively, the permitted activities of underwriting and market-making-related activities, activities on behalf of customers, and activities by a regulated insurance company directly engaged in the business of insurance for the general account of the company and by any affiliate. Each of these sections refers

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[3] All emphasis on statutory text in this letter has been added.

[4] *See* SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 20:22 (7th ed., Norman J. Singer ed.) ("A proper application of the 'whole act interpretation' will ascribe to the exception equal power over all other provisions of the act unless it is specifically limited to particular sections."). *See also, Gonzales v. Oregon*, 546 U.S. 243, 273 (2006) ("statutes should not be read as a series of unrelated and isolated provisions.") (internal quotation marks and citation omitted); *Conroy v. Aniskoff*, 507 U.S. 511, 515 (1993) (it is a "cardinal rule that a statute is to be read as a whole…since the meaning of statutory language, plain or not, depends on context.") (internal quotation marks and citation omitted); *U.S. Nat. Bank of Oregon v. Independent Ins. Agents of America, Inc.* 508 U.S. 439, 455 (1993) ("[i]n expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law," and statutory construction "must account for a statute's full text, language as well as punctuation, structure, and subject matter.") (internal quotation marks and citation omitted); *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring) (The meaning of terms on the statute books ought to be determined by that which is most compatible with the surrounding body of law into which the provision must be integrated); *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988) (Scalia, J.); Antonin Scalia, A Matter of Interpretation: Federal Courts and the Law 17 (1997) (courts should construe congressional statutes to mean what "a reasonable person would gather from the text of the law, placed alongside the remainder of the *corpus juris.*")

to "the purchase, sale, acquisition, or disposition of *securities and other instruments described in subsection (h)(4)*."[5] The cross reference to subsection (h)(4), which in its totality is the definition of the core defined term "proprietary trading," is used to incorporate only the list of "securities and other instruments" in that subsection into the permitted activities exemptions,[6] as neither Section 13 nor any other section of the BHC Act defines "securities and other instruments."[7]

In contrast, when Congress wanted to use its core defined term "proprietary trading," it did so without hesitation. For example, Section 13(d)(1)(H) applies only to the proprietary trading restrictions and specifically exempts "*[p]roprietary trading* conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c), provided that the trading occurs solely outside of the United States." Section 13(d)(1)(G) and (I) apply only to the covered funds prohibitions and exempt "[o]rganizing and offering *a private equity or hedge fund*" and "[t]he acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a *hedge fund or a private equity fund* by a banking entity pursuant to paragraph (9) or (13) of section 4(c) solely outside of the United States." Thus, it is inescapable that Congress drafted language differently when it intended for a specific exemption to apply only to the proprietary trading prohibitions or only to the covered fund restrictions, and Congress quite plainly did not use such language in subsections (d)(1)(B), (D) and (F).[8]

In conclusion, we think it is clear in the plain language and structure of Section 13, and the absence of any legislative history to the contrary, that the scope of the permitted activities of underwriting and market-making, transactions on behalf of customers, and transactions by insurance companies and their affiliates for the general account of the insurance company includes *all* activities otherwise prohibited under

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[5] Section 13(h)(4) describes "…any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine." An "equity, partnership or other ownership interest" in a covered fund that is a security would clearly be included in this description, as evidenced by the proposed definition of the term "Ownership interest" in §__.10(b)(3) of the proposed rules. 76 Fed. Reg. 68846, 68950 (Nov. 7, 2011).

[6] Section 13 of the BHC Act frequently cites other statutes to incorporate definitions but not to incorporate operative provisions. For example, Section 13(d)(1)(E) cites the definition of "small business investment companies" in Section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662); Section 13(h)(1) cites the definition of "insured depository institution" in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); Section 13(h)(2) defines "hedge fund" and "private equity fund" by reference to 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.

[7] The text and structure of Section (h)(4) also support this reading since (h)(4) itself contains two parts: first a description of short-term principal trading and then, separated by a comma, a laundry list of the types of securities and other instruments covered.

[8] *See Keene Corp*. v. *United States*, 508 U.S. 200, 208 (1993) ("where Congress includes particular language in one section of a statute but omits it in another . . . , it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (internal quotations omitted).

subsection (a), whether those activities would involve proprietary trading or covered funds.

We hope that this analysis will prove helpful as the final rule is drafted.

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