ANNEXURE B
SUGGGESTED CHANGES TO REGULATION

This Appendix summarizes our suggestions for changes to the regulatory language of the Proposed Common Rules. Italics denote suggested additions, while strikethroughs denote suggested deletions.

1. Definition of Loan

a. Preferred approach:

We propose that the definition of loan at § _.2(q) be modified to read as follows:

(q) Loan means any loan, lease, extension of credit, or secured or unsecured receivable. *A loan shall not mean a position:*

1. *having the expectation of profits arising from a common enterprise which depends solely on the efforts of a promoter or third party,#*
2. *in which there is common trading for speculation or investment,#*
3. *that materially has the characteristics of a commodity, security, or derivative, or*
4. *that falls within within the scope of § .3(b)(3)(ii)*

2. Eliminate Category from the "Rebuttable Presumption" under Trading Account

a. Preferred approach:

Modify § _.3(b)(2)(ii)'s rebuttable presumption for certain positions as follows:

(ii) Rebuttable presumption for certain positions. An account shall be presumed to be a trading account if it is used to acquire or take a covered financial position, other than a covered financial position described in paragraph (b)(2)(i)(B) or (C) of this section, that the covered banking entity holds for a period of ~~sixty~~ one hundred eighty days or less, unless the covered banking entity can demonstrate, based on all the facts and circumstances, that the covered financial position, ~~either individually or as a category~~, was not acquired or taken principally for any of the purposes described in paragraph (b)(2)(i)(A) of this section.

3. Removal of Repo and Reverse Repo Accounts as Exclusions to the Definition of Trading Account

a. Preferred approach:

Remove §_.3(b)(2)(iii)(A) entirely.

b. Alternative approach:

Remove §_.3(b)(2)(iii)(A) entirely in favor of a new entry in §_.6, §_.6(e), that defines repurchase and reverse repurchase agreements as a permitted activity:

§_.6(e) Permitted trading in repurchase and reverse repurchase agreements.
(1) The prohibition on proprietary trading contained in §l.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that is:
(i) A repurchase or reverse repurchase agreement pursuant to which the covered banking entity has simultaneously agreed, in writing, to both purchase and sell a stated asset, at stated prices, and on stated dates or on demand with the same counterparty;
(ii) That the agreement defined in (i) of this part adhere to a publicly-available, industry standardized master agreement; and
(iii) That the stated assets in the agreement defined in (i) of this part consist only of high-quality liquid assets.

4. Securities Lending

a. Preferred approach:

Remove §_.3(b)(2)(iii)(B) entirely.

b. Alternative approach:

Modify §_.3(b)(2)(iii)(B) entirely in favor of a new entry in §_.6, §_.6(f), that defines securities lending as a permitted activity:

§_.6(f) Permitted trading in securities lending agreements.
(1) The prohibition on proprietary trading contained in §l.3(a) does not apply to the purchase or sale by a covered banking entity of a covered financial position that:
(i) Arise under a transaction in which the covered banking entity lends or borrows a security temporarily to or from another party pursuant to a written securities lending agreement under which the lender retains the economic interests of an owner of such security, and has the right to terminate the transaction and to recall the loaned security on terms agreed by the parties; *and*
(ii) The assets that the covered banking entity invests in using the proceeds of the securities lending transaction, in order to minimize risk to their clients, be restricted to high-quality liquid assets.

5. Liquidity Management

a. Preferred approach:

Modify §_.3(b)(2)(iii)(C)(2) as follows:

> (2) Requires that any transaction ~~contemplated and authorized by the plan~~ be ~~principally~~ *solely* for ~~the purpose of managing the~~ *management of* liquidity of the covered banking entity, and not for the purpose of short-term resale, benefitting from actual or expected short-term price movements, realizing short-term arbitrage profits, or hedging a position taken for such short-term purposes;

Also, modify § .3(b)(2)(iii)(C)(3) to require that liquidity management positions "**consist only of high-quality liquid assets,**" and also to add the word "**reasonably**":

> (3) Requires that any position taken for liquidity management purposes be ~~highly liquid~~ *high-quality liquid assets,* and limited to financial instruments the market, credit and other risks of which the covered banking entity does not *reasonably* expect to give rise to appreciable profits or losses as a result of short-term price movements;

6. Clarification of Exemption for Clearing Organizations

a. Preferred approach:

Modify § _.3(b)(2)(iii)(D) to add "**clearing**" before "securities transactions"**:**

> (D) That are acquired or taken by a covered banking entity that is a derivatives clearing organization registered under section 5b of the Commodity Exchange Act (7 U.S.C. 7a–1) or a clearing agency registered with the SEC under section 17A of the Exchange Act (15 U.S.C. 78q–1) in connection with clearing derivatives or *clearing* securities transactions.

7. Exemption for Underwriting

a. Preferred approach:

Modify § _.4(a) to require exempted underwriting to occur only for registered securities:

> § _.4(a)(2)(ii): The covered financial position is a *registered* security;
>
> § _.4(a)(3): Definition of distribution. For purposes of paragraph (a) of this section, a distribution of securities means an offering of securities~~, whether or not subject to registration under the Securities Act,~~ that is distinguished from ordinary trading transactions by the magnitude of the offering and the presence of special selling efforts and selling methods.

§ _.4(a)(4): Definition of underwriter. For purposes of paragraph (a) of this section, underwriter means:

(ii) A person who has agreed with an issuer of securities or selling security holder:
(A) To purchase *registered* securities for distribution;
(B) To engage in a distribution of *registered* securities for or on behalf of such issuer or selling security holder; or
(C) To manage a distribution of *registered* securities for or on behalf of such issuer or selling security holder; and

(ii) A person who has an agreement with another person described in paragraph (a)(4)(i) of this section to engage in a distribution of such *registered* securities for or on behalf of the issuer or selling security holder.

Also, modify §_.4 (a) to remove weak language consider a banking entity's intent.

§ _.4(a)(vi) The underwriting activities of the covered banking entity ~~are designed to~~ generate revenues ~~primarily~~ *solely* from fees, commissions, underwriting spreads or other income not attributable to:

(A) Appreciation in the value of covered financial positions related to such activities; or
(B) The hedging of covered financial positions related to such activities; and

§ _.4(a)(vii) The compensation arrangements of persons performing underwriting activities *do* ~~are designed~~ not ~~to~~ reward proprietary risk-taking.

8. Disgorgement of Proprietary Gains Made by Underwriting

a. Preferred approach:

Add a new criteria to the underwriting exemption, §_.4(a)(2)(viii):

§ .4(a)(2)(viii): The covered banking entity disgorges any proprietary gains, as defined in § _.4(a)(2)(vi)(A) and § _.4(a)(2)(vi)(B), to the banking entity's depositors, on a pro-rated basis according to the amount on deposit, or to another party that is not affiliated with the banking entity, as determined by [Agency].

9. Definition of Permitted Market Making-Related Activities in §_.4(b)(1)

a. Preferred approach:

We propose the inclusion of the following language into _4(b)(1):

(1) Permitted market making-related activities. The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity that is made in connection with the covered banking entity's market making-related activities, *provided such activities do not include or incorporate:*

- *(i) Assets whose changes in values cannot be adequately mitigated by effective hedging;*
- *(ii) New products with rapid growth, including those that do not have a market history;*
- *(iii) Assets or strategies that include significant embedded leverage;*
- *(iv) Assets or strategies that have demonstrated significant historical volatility;*
- *(v) Assets or strategies for which the application of capital and liquidity standards would not adequately account for the risk; and*
- *(vi) Assets or strategies that result in large and significant concentrations to sectors, risk factors, or counterparties;*

10. Definition of Market Maker in §_.4(b)(2)(ii)

a. Preferred approach:

Here we propose an alternative definition of market maker:

> § _.4(b)(2)(ii) The trading desk or other organizational unit that conducts the purchase or sale holds itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular ~~or~~ *and* continuous basis;

11. Compensation Arrangements:

a. Preferred approach:

We propose the following change to the language of Section § __.4(b)(2)(vii) of the proposed rule:

> § _.4(b)(2)(vii) The compensation arrangements of persons performing the market making-related activities ~~are designed~~ *do* not to reward proprietary risk-taking

Additionally, the explanation of this sixth criterion in the supplementary information should be changed to the following:

> Under § __.4(b)(2)(vii) of the proposed rule, the compensation arrangements of persons performing market making-related activities at the banking entity ~~must be designed~~ not ~~to~~ encourage or reward proprietary risk-taking. Activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position held in inventory, rather than success in providing effective and timely intermediation and liquidity services to customers, are inconsistent with permitted market making-related activities. ~~Although a banking entity relying on the market-making exemption may appropriately take into account revenues resulting from movements in the price of principal positions to the extent that such revenues reflect the effectiveness with which personnel have managed principal risk retained, a banking entity relying on the market-making exemption should provide compensation incentives that primarily reward customer revenues and effective customer service, not proprietary risk-taking~~.

Furthermore, the same change should be made to the language regarding the Risk-Mitigating Hedging exemption.

> Seventh, § _.5(b)(2)(vi) of the proposed rule requires that the compensation arrangements of persons performing the risk-mitigating hedging activities ~~are designed~~ *do* not ~~to~~ reward proprietary risk-taking. Hedging activities for which a banking entity has established a compensation incentive structure that rewards speculation in, and appreciation of, the market value of a covered financial position, rather than success in reducing risk, are inconsistent with permitted risk-mitigating hedging activities.

12. Disgorgement of Proprietary Gains Made by Market Making

a. Preferred approach:

Add a new criteria to the market making exemption, § _.4(b)(2)(viii):

> *§_.4(b)(2)(viii): The covered banking entity disgorges any proprietary gains, as defined in § _.4(b)(2)(v)(A) and § _.4(b)(2)(v)(B), to the banking entity's depositors, on a pro-rated basis according to the amount on deposit, or to another party that is not affiliated with the banking entity, as determined by [Agency].*

13. Hedging Documentation

a. Preferred approach:

We propose the amendment of the wording of § _.5(c) to the following:

(c) Documentation. With respect to any purchase, sale, or series of purchases or sales conducted by a covered banking entity pursuant to this Sec. --.5 for risk-mitigating hedging purposes ~~that is established at a level of organization that is different than the level of organization establishing or responsible for the positions, contracts, or other holdings the risks of which the purchase, sale, or series of purchases or sales are designed to reduce~~, the covered banking entity must, at a minimum, document, *with particularity,* at the time the purchase, sale, or series of purchases or sales are conducted risk-mitigating purpose of the transaction and identify the risks of the individual or aggregated positions, contracts, or other holdings of a banking entity that the transaction is designed to reduce.

14. Permitted Trading on Behalf of Customers

a. Preferred approach:

Remove "investment adviser, commodity trading advisor" from §_.6(b)(2)(i)(A):

(A) Is conducted by a covered banking entity acting as ~~investment adviser, commodity trading advisor,~~ trustee, or in a similar fiduciary capacity for a customer;

15. Riskless Principal Transaction

a. Preferred approach:

We suggest the following alternative definition of riskless principal transaction at § _.6(b)(2)(ii):

(ii) The covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account, to offset a ~~contemporaneous~~ *simultaneous* sale to (or purchase from) the customer, *where the purchase price and offsetting sale price are identical, exclusive of any explicitly disclosed markup or markdown, commission equivalent, or other fee*;

16. Client, Customer Counterparty

a. Preferred approach:

We propose that the phrase, client, customer, or counterparty, which is referenced throughout the Proposed Rule yet is undefined be defined as follows::

> *A customer is a counterparty that is NOT itself a covered banking entity, and with which a banking entity has a direct and substantive relationship, which was initiated by the client prior to the transaction.*

We further propose that the term "customer" be defined as follows:

> *Customer means an investor engaged in a continuing, direct, and pre-existing relationship with a banking entity where a banking entity provides one or more financial products or services to the investor.*

17. Definition of Material Conflict of Interest

a. Preferred approach

Remove ", or substantially mitigate," from §_.8(b)(1)(ii).

> (ii) Makes such disclosure explicitly and effectively, and in a manner that provides the client, customer, or counterparty the opportunity to negate~~, or substantially mitigate,~~ any materially adverse effect on the client, customer, or counterparty created by the conflict of interest; or

18. Definition of Covered Fund

a. Preferred approach:

Modify § _.10(b)(1) to add the elements 10(b)(1)(v) and (vi):

> *(v) An issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a 1 et seq.), but for Section 3(c)(2) of that Act, or Rule 3a-1 or Rule 3a-6 of the Rules and Regulations promulgated under that Act, and*
>
> *(vi) Any issuer that the Commission deems to be a covered fund, should the Commission deem that said issuer exhibit the characteristics of a fund that takes on proprietary trading activities;*

19. Definition of Ownership Interest

a. Preferred approach:

Remove § _.10(b)(3)(ii)(A), which exempts carried interest from the definition of ownership interest.

Revise § _.10(b)(3)(i) as follows:

> (i) Ownership interest means any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest~~,~~ *or any interest that derives its value from the performance or value of the covered fund*.

20. Definition of Prime Brokerage Transaction

a. Preferred approach:

The Agencies should **remove** "financing" and "securities borrowing or lending services" from the definition of prime brokerage in § _.10(b)(4):

> (4) Prime brokerage transaction means one or more products or services provided by a covered banking entity to a covered fund, such as custody, clearance, ~~securities borrowing or lending services,~~ trade execution, or ~~financing,~~ data, operational, and portfolio management support.

21. Permitted Employee Investments

a. Preferred approach:

Modify § _.11(g) to remove "or other services":

> (g) No director or employee of the covered banking entity takes or retains an ownership interest in the covered fund, except for any director or employee of the covered banking entity who is directly engaged in providing investment advisory ~~or other services~~ to the covered fund;

22. Ownership limits in Covered Funds

a. Preferred approach:

Redefine § _.12(a)(2)(i) by adding a new entry, § _.12(a)(2)(i)(C):

(C) May at no time during the initial 1 year following the establishment of the fund (or such longer period as may be provided by the Board pursuant to paragraph (e) of this section) exceed $10 million, or 3% of Tier 1 capital, whichever is less.

23. Include Committed Funds in Ownership Interest

a. Preferred approach:

Amend §§ _.12(b)(2)(i) and _.12(b)(2)(i)(A) as follows:

§ _12(b)(2)(i): The aggregate amount of all ownership interests of the covered banking entity shall be the greater of (without regard to committed funds not yet called for investment):

§ _.12(b)(2)(i)(A): The value of any investment or capital contribution made with respect to all ownership interests held under § _.12 by the covered banking entity in the covered fund, *including committed funds not yet called for investment*, divided by the value of all investments or capital contributions, respectively, made by all persons in that covered fund, *including committed funds not yet called for investment*;

24. Valuing Investments in Covered Funds

a. Preferred approach:

Amend § _.12(b)(4) as follows:

§ _12(b)(4): Methodology and standards for calculation. For purposes of determining the amount or value of its investment in a covered fund under this paragraph (b), a covered banking entity must calculate its investment in the same manner and according to the same standards utilized by the covered fund for determining the aggregate value of the fund's assets and ownership interests, *except that committed funds not yet called for investment shall be counted toward the value of the total investment in the covered fund regardless of the standards used by the covered fund.*

25. Compensation "Hedging"

a. Preferred approach:

We suggest that the Agencies **remove the permitted "hedging" of compensation arrangements** through an ownership interest in a covered fund provided by § _.13(b)(1)(i)(B).

b. Alternative Approach:

Add the following **new criteria** be to § _.13(b)(2)(ii)(B)(2) in order to prevent rule evasion (additions in italics):

> § _.13(b)(2)(ii)(B)(2) Is directly connected to its compensation arrangement with an employee that directly provides investment advisory or other services to, that covered fund, *provided that*:
>
> *(i) No "hedge" is permitted during the one year following the establishment of the fund.*
>
> *(ii) All proceeds from the "hedge" must be paid entirely to the investment advisor, and*
>
> *(iii) The "hedge" in the covered fund that does not exceed 3 percent of the total outstanding ownership interests in the fund;*

26. Remove Bank Owned Life Insurance as a Covered fund activities determined to be permissible.

a. Preferred approach:

Remove § _.14(a)(1), Bank owned life insurance.

27. Limitations on Prime Brokerage with a Covered Fund: Third-party Funds Only

a. Preferred approach:

Modify § _.16(a)(2)(ii) to include the phrase "third party":

> (ii) Enter into any prime brokerage transaction with any *third party* covered fund in which a covered fund managed, sponsored, or advised by such covered banking entity (or an affiliate or subsidiary thereof) has taken an ownership interest, if:

28. Limitations on Prime Brokerage with a Covered Fund: Investment Limits

a. Preferred approach:

Add a new entry to § _.16(a)(2)(ii), § _.16(a)(2)(ii)(D):

> *(D) The covered banking entity has divested from the covered fund such that its their ownership interest in the covered fund is no more than the 3% de minimis investment limitation set forth in § _.12(a)(1)(ii);*

29. Extension of Required Time to Make and Keep Records

a. Preferred approach:

Amend § _.20(b)(6) to read 6 years instead of 5:

> (6) Making and keeping records sufficient to demonstrate compliance with section 13 of the BHC Act and this part, which a covered banking entity must promptly provide to [Agency] upon request and retain for a period of no less than *6* years.

30. Change "Timely Notification" to "Immediate Notification" in Appendix C

a. Preferred approach:

Modify Appendix C, III(A), "Analysis and quantitative measurements" in the bullet that begins "Immediate review and compliance investigation . . . " as follows:

> Immediate review and compliance investigation of the trading unit's activities, escalation to senior management with oversight responsibilities for the applicable trading unit, *immediate* notification to [Agency] *(where 'immediate' shall mean no later than one day following the time when the concern was raised internally)*, appropriate remedial action (e.g., divesting of impermissible positions, cessation of impermissible activity, disciplinary actions), and documentation of the investigation findings and remedial action taken when the quantitative measurement, considered together with the facts and circumstances, suggests a reasonable likelihood that the trading unit has violated any part of section 13 of the BHC Act and this part.

ANNEXURE C
SUGGGESTED CHANGES TO THE PROPROSED RULE'S MARKET-MAKING COMMENTARY

III. Commentary

A. Overview of Market Making-Related Activities

In the context of trading activities in which a covered banking entity acts as principal, market making-related activities generally involve the covered banking entity either (i) in the case of market making in a security that is executed on an organized trading facility or exchange, passively providing liquidity by submitting resting orders that interact with the orders of others on an organized trading facility or exchange and acting as a registered market maker[1], where such exchange or organized trading facility provides the ability to register as a market maker, or (ii) in other cases, providing an intermediation service to its customers by assuming the role of a counterparty that stands ready to buy or sell a position that the customer wishes to sell or buy. A market maker's "customers" generally vary depending on the asset class and market in which the market maker is providing intermediation services. In the context of market making in a security that is executed on an organized trading facility or an exchange, a ``customer'' is any person on behalf of whom a buy or sell order has been submitted by a broker-dealer or any other market participant. In the context of market making in a covered financial position in an over-the-counter market, a "customer" generally would be a market participant, *that is not itself a covered banking entity*, that makes use of the market maker's intermediation services, ~~either~~ by requesting such services ~~or entering into a continuing relationship with the market maker with respect to such services.~~

The primary purpose of market making-related activities is to intermediate between buyers and sellers of similar positions, for which service market makers are compensated, resulting in more liquid markets and less volatile prices. The purpose of such activities is not to earn profits as a result of movements in the price of positions and risks acquired or retained; rather, a market maker generally manages and limits the extent to which it is exposed to movements in the price of principal positions and risks that it acquires or retains, or in the price of one or more material elements of those positions. ~~To the extent that it can,~~ a market maker will eliminate some or all of the price risks to which it is exposed. ~~However, in some cases, the risks posed by one or more positions may be sufficiently complex or specific that the risk cannot be fully hedged. In other cases, although it may be possible to hedge the risks posed by one or more positions, the cost of~~

---

[1] The status of being a registered market maker is not, on its own, a sufficient basis for relying on the exemption for market making-related activity contained in Sec. _.4(b). Registration as a market maker generally involves filing a prescribed form with an exchange or organized trading facility, in accordance with its rules and procedures, and complying with the applicable requirements for market makers set forth in the rules of that exchange or organized trading facility. See, e.g., Nasdaq Rule 4612, New York Stock Exchange Rule 104, CBOE Futures Exchange Rule 515, BATS Exchange Rule 11.5.

~~\2\ In certain cases, depending on the conventions of the relevant market (e.g., the over-the-counter derivatives market), such a "customer" may consider itself or refer to itself more generally as a "counterparty"~~

~~doing so may be so high as to effectively make market making in those positions uneconomic if complete hedges were acquired.~~ In ~~such~~ *some* cases, in order to provide effective intermediation services, market makers are required to retain ~~at least~~ some risk for ~~at least~~ some period of time with respect to price movements of retained principal positions and risks. The size and type of risk that must be retained in such cases may vary ~~widely~~ depending on the type and size of the positions, the liquidity of the specific market, and the market's structure, *but in all cases will be limited to a size that can be reasonably disposed of in the near term under normal market conditions and poses no significant risk in unexpected market moves or changes in liquidity.* As the liquidity of positions increases, *both* the frequency with which a market maker must take or retain risk in order to make a market in those positions, *as well as the reasonable size of those positions*, generally decreases.

The profitability of market making-related activities relies on forms of revenue that reflect the value of the intermediation services that are provided to the market maker's customers. These revenues typically take the form of explicit fees and commissions or, in markets where no such fees or commission are charged, a bid-ask ~~or similar~~ spread that is generated by charging higher prices to buyers than is paid to *contemporaneous* sellers of comparable instruments. In the case of a derivative contract, these revenues reflect the difference between the cost of entering into the derivative contract and the cost of hedging incremental, residual risks arising from the contract. These types of ``customer revenues" provide the primary source of a market maker's profitability. Typically, a market maker holds ~~at least~~ some risk with respect to price movements of retained principal positions and risks. As a result, the market maker also incurs losses or generates profits as price movements actually occur, but such losses or profits are incidental to customer revenues and *will always be* significantly limited by the banking entity's hedging activities. Customer revenues, not revenues from price movements, predominate. The appropriate proportion of ``customer revenues" to profit and losses resulting from price movements of retained principal positions and risks varies depending on the type of positions involved, the typical fees, commissions, and spreads payable for transactions in those positions, and the risks of those positions, *but in all cases this proportion will be very high.* ~~As a general matter, the proportion of ``customer revenues" generated when making a market in certain positions increases as the fees, commissions, or spreads payable for those positions increase, the volatility of those positions' prices decrease, and the prices for those positions are less transparent.~~ Because a market maker's business model entails managing and limiting the extent to which it is exposed to movements in the prices of retained principal positions and risks while generating customer revenues that are earned, regardless of movements in the price of retained principal positions and risks, a market maker *always* ~~typically~~ generates significant revenue relative to the risks that it retains. Accordingly, a market maker will typically demonstrate consistent profitability and low earnings volatility ~~under normal market conditions~~. The appropriate extent to which a market maker will demonstrate consistent profitability and low earnings volatility varies depending on the type of positions involved, the liquidity of the positions, the price transparency of the positions, and the volatility of the positions' prices, *but the extent will be significant in all cases.* As a general matter, consistent profitability will decrease and earnings volatility will increase as the liquidity of the positions decrease, the volatility of the positions' prices increase, and the prices for the positions are less transparent.

As the primary purpose of market making-related activities is to provide intermediation services to its customers, ~~market makers focus their activities on servicing customer demands and typically only engage in transactions with non-customers to the extent that these transactions directly facilitate or support customer transactions. In particular,~~ a market maker generally only transacts with non-customers to the extent necessary to hedge or otherwise manage the risks of its market making-related activities, including managing its risk with respect to movements of the price of retained principal positions and risks, ~~to acquire positions in amounts consistent with reasonably expected near term demand of its customers,~~ or to sell positions acquired from its customers. The appropriate proportion of a market maker's transactions that are with customers versus non-customers varies depending on the type of positions involved and the extent to which the positions are typically hedged in non-customer transactions, *but in all cases this proportion will be high*. ~~In the case of a derivatives market maker that engages in dynamic hedging, the number of non-customer transactions significantly outweighs the number of customer transactions, as the derivatives market maker must constantly enter into transactions to appropriately manage its retained principal positions and risks as market prices for the positions and risks move and additional transactions with customers change the risk profile of the market maker's retained principal positions.~~

Because a market maker generates revenues primarily by transacting with, and providing intermediation services to, customers, a market maker typically engages in transactions that earn fees, commissions, or spreads as payment for its services. Transactions in which the market maker pays fees, commissions, or spreads—i.e. where it pays another market maker for providing it with liquidity services—are much less frequent, although in some cases obtaining liquidity services from another market maker and paying fees, commissions, or spreads may be necessary to prudently manage its risk with respect to price movements of retained principal positions and risks. The appropriate proportion of a market maker's transactions that earn, rather than pay, fees, commissions or spreads varies depending on the type of positions involved, the liquidity of the positions, and the extent to which market trends increase the volatility of its risk with respect to price movements of retained principal positions and risks, *but in all cases this proportion should be high.* As a general matter, the proportion of a market maker's transactions that earn rather than pay fees, commissions or spreads decreases as the liquidity of the positions decreases, and the extent to which the price volatility of retained principal positions and risks increases.

Finally, because the primary purpose of market making-related activities is to provide intermediation services to its customers, a market maker does not provide compensation incentives to its personnel that ~~primarily~~ reward proprietary risk-taking. ~~Although a market maker may take into account revenues resulting from movements in the price of retained principal positions and risks to the extent that such revenues reflect the effectiveness with which personnel have effectively managed the risk of movements in the price of retained principal positions and risks,~~ a market maker that provides compensation incentives relating to revenues ~~generally~~ does so *exclusively* through incentives that ~~primarily~~ reward customer revenues and effective customer service.

B. Overview of Prohibited Proprietary Trading Activities

Like permitted market making-related activities, prohibited proprietary trading involves the taking of principal positions by a covered banking entity. Unlike permitted market making-related activities, the purpose of prohibited proprietary trading is to generate profits as a result of, or otherwise benefit from, changes in the price of positions and risks taken. Whereas a market maker attempts to eliminate some or all of the price risks inherent in its retained principal positions and risks by hedging or otherwise managing those risks in a reasonable period of time after positions are acquired or risks arise, a proprietary trader *may* seek~~s~~ to capitalize on those risks, and generally only hedges or manages a portion of those risks when doing so would improve the potential profitability of the risk it retains. *Despite these very different intentions, the component trades and resulting risk profiles may be identical.* A proprietary trader does not *consider his counterparties to be* ~~have~~ ``customers" because a proprietary trader simply seeks to obtain the best price and execution in purchasing or selling its proprietary positions. A proprietary trader generates few if any fees, commissions, or spreads from its trading activities because it is not providing an intermediation service to any customer or other third party. *In the process of trading, however, he may appear to be capturing bid/offer spreads as a result of buying low and selling higher as a proprietary strategy.* Instead, a proprietary trader is likely to pay fees, commissions, or spreads to other market makers when obtaining their liquidity services is beneficial to execution of its trading strategy. Because a proprietary trader seeks to generate profits from changes in the price of positions taken, a proprietary trader typically provides compensation incentives to its personnel that primarily reward successful proprietary risk taking.

C. Distinguishing Permitted Market Making-Related Activities From Prohibited Proprietary Trading

No changes in items 1-5.

6. Compensation Incentives

~~Absent explanatory facts and circumstances,~~ the trading activity of a trading unit that provides compensation incentives to employees that ~~primarily~~ reward proprietary risk taking will be considered to be prohibited proprietary trading, and not permitted market making-related activity.

~~[The Agency] will base such a determination on all available facts and circumstances, including, among other things, an evaluation of: the extent to which compensation incentives are provided to trading unit personnel that reward revenues from movements in the price of retained principal positions and risks; the extent to which compensation incentives are provided to trading unit personnel that reward customer revenues; and the compensation incentives provided by other covered banking entities to similarly-situated personnel.~~