

## Compliance for Market Making and the Identification of Covered Funds

17. 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?

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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.<sup>1</sup> For purposes of meeting the final rule's exemption for market-making,<sup>2</sup> a reasonably designed compliance program for a trading desk engaged in market making-related activity may include objective factors on which 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.<sup>3</sup> As an example, an objective factor would include whether the securities of the issuer were offered in transactions registered under the Securities Act.<sup>4</sup> 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.<sup>5</sup>

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.<sup>6</sup> 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 § 351.21 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.<sup>7</sup>

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<sup>1</sup> See § 351.4(b)(2)(iii) of the final rule. See also § 351.20(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]”).

<sup>2</sup> § 351.11(c).

<sup>3</sup> 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.

<sup>4</sup> See 79 FR at 5674 n.1717, 5687 n.1861.

<sup>5</sup> 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 §§ 351.11(a)-(b).

<sup>6</sup> See § 351.20(b)(4), Appendix B.

<sup>7</sup> While market making-related activity in covered funds is permitted under § 351.11(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.