

MEMORANDUM

TO: Public File – Notice of Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (RIN 3064-AD85)

FROM: Gregory S. Feder, Counsel, FDIC Legal Division

DATE: April 11, 2012

SUBJECT: Meeting with Securities Industry and Financial Markets Association (SIFMA)

On April 10, 2012, representatives from the FDIC's Division of Risk Management Supervision (George French, Deputy Director; Bobby Bean, Associate Director; John Feid, Senior Capital Markets Specialist; Karl Reitz, Senior Policy Analyst; and Michael Spencer, Senior Policy Analyst), Division of Insurance and Research (Jack Reidhill, Chief, Special Studies Section), and Legal Division (Michael Krimminger, General Counsel; Michael Phillips, Counsel; Thomas Hearn, Counsel; and Greg Feder, Counsel) met with John Clements (Citigroup), Tejal Wadhvani (RBS Global Banking and Markets), Christopher Haas (Bank of America), Salvatore Palazzolo (Deutsche Bank), Daniel Rossner (Sidley Austin) and several representatives from SIFMA (Ken Bentsen, Chris Killian, Richard Dorfman, Randy Snook, and Matt McGinley).

The agenda for the meeting involved certain provisions of the interagency notice of proposed rulemaking ("NPR") on section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. This NPR was published in the Federal Register of November 7, 2011 (76 FR 68846). The primary topic for this meeting, as requested by SIFMA and shown in the attached presentation, was the impact of the NPR on the securitization markets.

THE VOLCKER RULE AND SECURITIZATION

APRIL 10, 2012

Agenda

1. Introductions
2. Discussion of the impact the Proposed Rule
3. Discussion of proposed amendments to the Proposed Rule
4. Conclusion

ABS and ILS are Neither Private Equity Nor Hedge Funds

- The Volcker Rule was intended to apply to, and restrict, the interactions of banking entities with hedge funds and private equity funds.
- It was not intended to apply to asset-backed securities or insurance-linked securities; rather, Dodd-Frank contains a separate regulatory regime for asset-backed securities.
- Such regime is set forth in sections 621, 932, 939, 941, 942, 943, 944, & 945. Other sections, such as section 1412, address securitization indirectly.
- Additionally, the SEC implemented, and is in the process of revising, its Regulation AB regulatory regime for ABS.

ABS and ILS are Neither Private Equity Nor Hedge Funds

- The definition of private equity and hedge funds in the Proposed Rule focuses on form over substance:
 - New Section 13 defines “hedge fund” and “private equity fund” as any “*issuer that would be an investment company under the Investment Company Act of 1940 ... but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds*” as the appropriate federal agencies may by rule determine.
- The application of the Volcker Rule should focus on substance of a fund, not securities law structure. Issuers may choose one exemption over another for technical reasons, such as inability to comply with one of the requirements of Investment Company Act Rule 3a-7. This does not make those issuers hedge funds or private equity funds.
- Congress recognized this, and included an exclusion for securitization in the Volcker Rule.

Congress Did Not Intend for the Rule to Impact ABS or ILS

- Congress sought to avoid disrupting securitization markets by specifying in Section 13(g)(2) of the Volcker Rule that the rule is not to be “construed to limit or restrict the ability of a banking entity or nonbank financial company ... to sell or securitize loans...” (the “Securitization Exclusion”).
 - ...not just that it not be construed to “prohibit” or “unduly” limit or restrict such activities.
- The FSOC study described the Securitization Exclusion as an “inviolable rule of construction [designed to ensure] that the economically essential activity of loan creation is not infringed upon by the Volcker Rule” and recommends that the Agencies be guided by the exclusion in crafting the Proposed Rules.



The Securitization Exemption is Drafted too Narrowly...

- The proposed “loan” definition:
 - would not encompass an asset-backed security that is issued in connection with a loan securitization or is otherwise backed by loans
 - does not make clear that other types of securities (such as ordinary debt securities) that the Agencies have traditionally viewed as “extensions of credit” fall within the “loan” definition
 - Limits derivatives to those whose notional amount is tied to the principal balance of loans backing the security that includes the derivative, and those derivatives may only be used for hedging purposes
- These conditions are unduly restrictive and will prevent the exemption from serving its intended purpose.



...and is Rendered Ineffective by Super 23A

- Super 23A will render securitizations impossible in many cases, even if the securitization otherwise meets the criteria for the securitization exemption, because it will prohibit:
 - repurchase of assets from the ABS Issuer for breaches of representations or warranties;
 - servicing advances;
 - liquidity facilities, lines of credit, or guarantees;
 - ...all of which are customary, and in most cases necessary, for securitization markets to function.
- In other words, it will preclude the operation of securitization markets.
- It will also not carry out Congressional intent. Rulemaking that renders securitization impractical, despite the plain language of the Securitization Exclusion, fails the clear requirement of the Securitization Exclusion.

What Happens on July 21?

- The law becomes effective, but there may not be implementing rules to guide compliance. Banking entities need to plan now, and guidance from regulators is needed.
 - *Can a bank sponsor an ABCP conduit? Can it provide liquidity facilities? May loans be repurchased?*
- Banks should be able to enter in to new securitization transactions and relationships after July 21 but prior to the release of the final rules, and existing and new pre-final rule securitizations should be permanently grandfathered from the ownership, sponsorship, and relationship prohibitions of the final rule.
- At a minimum, SIFMA believes that the agencies should issue guidance to the effect that banking entities should have the full 2 year conformance period after release of a final rule to conform their activities.
- At a minimum, the full statutory conformance period should be available for banking entities to bring activities into compliance with the Volcker Rule.

Impact

- If there are no changes to the proposal, sponsors will have a choice to do one of two things with respect to their existing securitizations:
 - (1) Break contractual commitments and face litigation, or (2) Violate the Rule
- Divestment would further disrupt already damaged markets;
- The securitization investor base will shrink further (as banks will be unable to participate), compounding divestment concerns noted above;
- ABS issuers that are banking entities would be required to comply with the extensive compliance regime, which doesn't reasonably apply to ABS issuers in the first place, and will place further cost burdens on securitizations;
- Foreign firms with a U.S. presence will be required to engage in a complex analysis of their global securitization activities in the context of the proposed securitization exemption;
- Securitization will be pushed outside of the regulated banking system.



Solution: Amend the Covered Funds Definition

- As discussed, the Proposed Rule focuses on the form of transactions, not the substance of the transactions. Securitization issuers are not hedge funds, nor are they private equity funds.
- We believe that excluding ABS Issuers and ILS Issuers from the definition of "covered funds" is the appropriate approach, and is required to ensure the practical viability of banking entity securitization and insurance-linked securities transactions, and to carry out the intent of Congress.
- This request is supported by necessity as well as history:
 - *Even under Glass-Steagall the Agencies and the courts deemed sponsorship of ABS Issuers and ownership of interests therein to be a permissible banking activity.*
 - *The Agencies have treated asset-backed securities differently in their regulations from securities of hedge funds and private equity funds.*
 - *Congress expressly included in the Dodd-Frank Act a broad new regulatory framework governing asset-backed securities that is separate from the Volcker Rule and not applicable to hedge funds or private equity funds.*
 - *Reg AB and other rules apply specifically to securitizations, and not hedge funds or private equity funds.*
 - *The SEC excluded "securitized asset funds" from implementing regulations requiring advisor reporting of 3(c)(7) funds.*



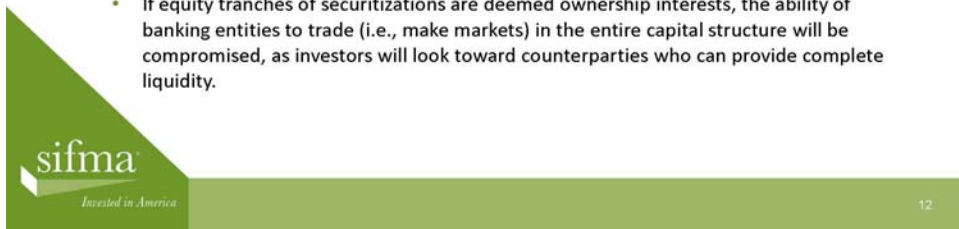
Solution: Amend the Covered Funds Definition (con't)

- At a minimum, the definition of “loan” must be broadened, and a variety of other changes made (as discussed in our comment letter) to carry out the intent of Congress and to not undermine the critical role securitization plays in ensuring the availability of credit and non-governmental funding in the real economy and the global efforts of regulators to restore the securitization markets.



Other Considerations: Defining Ownership Interests

- We see no justification for classifying debt asset-backed securities as “ownership interests” for purposes of the Volcker Rule. Nor do we believe that many equity asset-backed securities should be viewed as “ownership interests” under the rule.
 - While an interest in a securitization issuer might take the form of equity for state law, accounting or tax purposes, the Agencies have not generally regarded such interests as an equity interests for banking law purposes. The Agencies have long taken the position that banks may invest in equity securities with debt-like characteristics as debt securities.
 - Many equity securities of securitization issuers (such as owner trust certificates and pass-through securities) have such characteristics.
 - Banks currently hold billions of dollars of these interests in asset-backed securities; mandated divestiture would be extremely problematic.
 - If equity tranches of securitizations are deemed ownership interests, the ability of banking entities to trade (i.e., make markets) in the entire capital structure will be compromised, as investors will look toward counterparties who can provide complete liquidity.



Other Considerations: Market Making and Underwriting Under Covered Funds/Super 23A Provisions

- Broker-dealer and other affiliates of banks are significant underwriters of asset-backed securities and insurance-linked securities and frequently act as market makers in connection with such securities.
- Read strictly, the ownership restrictions of the Proposed Rules and Super 23A may, in certain cases, be construed to prohibit such activities, a result we do not believe was intended.
- The Agencies have included underwriting and market-making exemptions to the Proposed Rules' prohibition on proprietary trading, but have not included similar exemptions from the ownership or Super 23A restrictions under the Proposed Rules.
- The absence of such exemptions would significantly limit and restrict loan securitizations.
- The Agencies should clarify that the ownership and Super 23A restrictions under the Proposed Rules do not prohibit ownership or retention of ABS or ILS in connection with underwriting or market-making activities.

Other Considerations: Expanding the Risk Retention Exemption

- The risk retention exemption permits a banking entity to retain an amount or value of ownership interests in an issuer of "asset-backed securities" in order to comply with the "minimum" risk retention requirements of new Section 15G of the Exchange Act;
- We believe sponsors should be able to retain more than just the legally mandated minimum amount of risk under Section 15G of the Exchange Act, as the market or other regulatory requirements may demand such higher level for certain products or asset classes.
- Limiting the amount of risk retention is inconsistent with the policy behind the risk retention requirements.
 - E.g., investors may demand greater than 5% for certain asset classes.
 - E.g., Article 122a in Europe may require different, or higher, levels of risk retention.

Annex: ABS That Commonly Rely on 3(c)(1) or 3(c)(7)

- The following is a non-exhaustive, short list of asset-backed securities (“ABS”) transactions that commonly rely on the Section 3(c)(1) or Section 3(c)(7) exemptions from the Investment Company Act of 1940:
 - Certain lease receivables-backed (e.g. auto, equipment, airplane) securitizations (e.g., those that rely on residual values)
 - Certain asset-backed commercial paper conduits
 - Insurance-linked securities
 - Some tender offer bond (municipal bond) securitizations
 - Certain foreign ABS that do not use U.S. trustees
 - Certain ABS backed by non-performing assets
 - Most portfolio-managed ABS (e.g., most CLOs and loan securitizations)
 - Synthetic ABS
 - ABS whose underlying assets are equity or equity-linked
 - “Repack” vehicles collateralized by a mix of commercial real estate, corporate loan and corporate debt assets and nonfinancial assets