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Financing America's Economy

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June 14, 2011

Submitted via e-mail

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The Honorable Timothy F. Geithner
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Three Lafayette Centre
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Re: Pre-Proposal Comment Letter on the Volcker Rule

Ladies and Gentlemen:

The Financial Services Roundtable (the "Roundtable"[1]) appreciates the opportunity to provide the regulatory agencies (the "Agencies") that are charged with implementing the new section 13 of the Bank Holding Company Act (the "Volcker Rule") with additional comments in advance of the issuance of a proposed rulemaking. This letter supplements the Roundtable's previously submitted comment letters on the Volcker Rule.[2]

1 The Financial Services Roundtable represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs.

2 *See* Letter from The Financial Services Roundtable, to the Board of Governors of the Federal Reserve System, Jan. 10, 2011, *available at* http://www.fsround.org/fsr/policy_issues/regulatory/pdfs/pdfs11/RoundtableVolckerConformancePeriodFRBFinalLetterAsSubmitted.pdf; Letter from The Financial Services Roundtable, to the Financial Stability Oversight Council, Nov. 5, 2010,

Executive Summary

In this letter, we offer the Agencies additional comments on (i) the authority of the Agencies to define "hedge fund" and "private equity fund" and the authority of Securities and Exchange Commission (the "SEC") under the Investment Company Act of 1940 to define "investment companies" for purposes of the Volcker Rule, (ii) the definition of "banking entity" with respect to employee pension funds, (iii) the critical importance of implementing the Volcker Rule so as to preserve the ability of banking entities to offer asset management services to customers, (iv) the Volcker Rule's restrictions on transactions between a banking entity and certain third-party hedge funds and private equity funds, (v) directed trustee arrangements, (vi) calculation of the *de minimis* limits on permitted investments in hedge funds and private equity funds, (vii) bank-owned and corporate-owned life insurance (collectively, "BOLI"), (viii) seed accounts created and used for purposes of marketing investment advisory services to unaffiliated investors, and (ix) the Federal Reserve Board's (the "Board's") conformance period rulemaking.

The Agencies Have Authority to Narrow the Definitions of "Hedge Fund" and "Private Equity Fund"

As the Financial Stability Oversight Council ("FSOC") has acknowledged, and as we discussed in detail in our prior letter to the FSOC, an implementation of the Volcker Rule's definition of "hedge fund" and "private equity fund" to include any and all entities relying on either Section 3(c)(1) or Section 3(c)(7) of the Investment Company Act of 1940 (the "Investment Company Act") would be over-broad and extend far beyond what Congress intended. FSOC recognized this concern and noted that these two provisions of the Investment Company Act "are used by a wide variety of funds and other legal entities … including special purpose acquisition vehicles and certain ERISA qualified employee pension funds."[3] For this reason, FSOC recommended the "Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in Section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases."[4]

We believe that there is ample support in the Act and authority available for the Agencies to effect the FSOC's recommendation to the Agencies.

- The FSOC's recommendations are themselves a source of authority under Section (b)(2)(A) of the Volcker Rule. Section (b)(2)(A) required the FSOC to conduct a Study and develop recommendations based on broadly-worded purposes behind the Volcker Rule, and required the Agencies to consider those recommendations in promulgating regulations. Congress normally acts on the understanding that agencies implementing a statute through rulemaking authority will receive judicial deference in interpreting complex and ambiguous provisions. *Chevron v. N.R.D.C.*, 467 U.S. 837 (1984). Section (b)(2)(A) goes beyond a grant of simple rulemaking authority and is a specific congressional direction that further deliberation and exercise of interpretation by the Agencies is necessary to properly implement the Volcker Rule. Thus, Congress did not intend for the Agencies to implement the definitions or other statutory language as if

available at http://www.fsround.org/fsr/policy_issues/regulatory/pdfs/pdfs10/FSOCLetter-VolckerStudyNovember52010.pdf.

3 Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds and Private Equity Funds 61-62 (January 18, 2011) (the " FSOC Study").

4 *Id.* at 62.

these provisions were self-executing, but expressly required the Agencies to consider the FSOC's recommendations when implementing those definitions.

- In addition to the Study requirements, there are other indications in the text of the Act, as discussed in our prior comments, that the congressional decision to use the terms "hedge fund" and "private equity fund" (and not the alternative, "private fund" used elsewhere in the Act) should be given meaning. An interpretation that any issuer that relies on either 3(c)(1) or 3(c)(7) is deemed to be both a hedge fund and a private equity fund is not consistent with the plain meaning of those terms.

- Standard canons of statutory construction require interpretation of the Volcker Rule so as to avoid unintended consequences and absurd results; this is nowhere more true than in an area as technically complicated and where agency expertise is particularly important, as here. To implement the Act without consideration of its practical consequences will subject a wide variety of entities to the Rule that no one considers to be hedge funds or private equity funds, and that present none of the concerns the Volcker Rule is aimed at addressing, including subsidiaries, joint ventures, financing and acquisition vehicles, and others, as discussed in our prior comments.

- This view is confirmed by the numerous statements by legislators made as part of the legislative history, as discussed in detail in our prior comments. In particular, statements by then-chairmen Dodd and Frank are particularly persuasive as explanations of the legislation by its two principal sponsors made prior to a final vote.

- In addition, Congress provided a critical safety valve to ensure that the Volcker Rule is properly implemented by providing the Agencies with broad, express authority under Section (d)(1)(J) to promulgate necessary exceptions as appropriate. Chairman Dodd's statement[5] explained the use of this exemptive authority in the context of venture capital funds, demonstrating that Section (d)(1)(J) is intended to be used broadly. A wide variety of structures, including those identified in our prior comments as clearly outside any reasonable definition of "hedge fund" or "private equity fund," serve a variety of legitimate business purposes - including promoting innovation, commerce, and capital formation, and facilitating the efficient and appropriate management of banking entities' assets and ordinary business operations. Where such entities are used to accomplish these goals, without presenting any of the risks the Volcker Rule is intended to address, we believe they clearly qualify under Section (d)(1)(J) as promoting banking entities' safe and sound operations and contributing to the larger U.S. economy and financial stability.[6]

Another approach, which we have not discussed in our previous comments, is for the SEC to use its rulemaking authority under Section 6(c) of the Investment Company Act to provide a limited

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5 156 Cong. Rec. S5904-5905 (daily ed. July 15, 2010).

6 In addition, any issuer exempt from registration as an investment company under the Investment Company Act of 1940 pursuant to an exemption other than Section 3(c)(1) or 3(c)(7), even if the issuer also qualifies for those exemptions, should be exempt from treatment as "hedge fund" or "private equity fund" for purposes of the Volcker Rule, unless the Agencies determine that it should be covered as an "other similar fund" due to the nature of its investments or other characteristics that it shares with traditional hedge funds or private equity funds. Also, any fund involved in the sale or securitization of extensions of credit is clearly intended to be broadly exempted under Section (g)(2).

exemption from the definition of "investment company" for entities that are clearly not hedge funds or private equity funds and whose activities are not of the type the Volcker Rule is concerned with curbing. Because Congress chose to incorporate into the Volcker Rule the definitional framework of the Investment Company Act, under which the SEC has broad exemptive and regulatory authority, Congress also understood that the SEC retained authority with respect to the definitional underpinnings of Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

This approach could be implemented in at least two different ways. In one approach, the SEC could adopt a regulation, which would be incorporated by reference in the Agencies' regulations under the Volcker Rule, to generally state that issuers that rely on either Section 3(c)(1) or 3(c)(7) of the Investment Company Act would not be considered "investment companies" solely for purposes of the Volcker Rule, <u>unless</u> they are either "hedge funds" or "private equity funds" (as defined by the new rule based on their structure, third-party investors, distribution characteristics, underlying investments and other relevant characteristics). Alternatively, a new SEC regulation under the Investment Company Act could provide exemptions for specified categories of legal entities that are not hedge funds or private equity funds (*e.g.*, Employee Retirement Income Security Act ("<u>ERISA</u>") – qualified employee pension funds) or entities with specific non-hedge fund/non-private equity fund characteristics (*e.g.*, wholly-owned, non-operating company subsidiaries utilized solely to manage an entity's ordinary course business affairs).

Such a rule would not have any other effect on the regulatory structure of the Investment Company Act but would have the effect intended by Congress and recommended by FSOC of limiting the definition of "hedge fund" and "private equity fund" under the Volcker Rule to actual hedge funds and private equity funds – the pooled investment vehicles that Congress sought to regulate under the Volcker Rule.[7]

The SEC clearly has authority, in our view, to issue such a rule. Under Section 6(c), the SEC has authority to provide exemptions with respect to any provision of the Investment Company Act "if and to the extent … necessary or appropriate in the public interest and consistent with the protection of investors and the purposes fairly intended by the policy and provisions of [the Investment Company Act]." We believe that issuing a rule as described above would satisfy the statutory tests since, (i) as evidenced by the findings in the FSOC Study, it is in the public interest to limit the impact of the Volcker Rule exclusively to pooled investment vehicles that are, in fact, hedge funds and private equity funds and (ii) the limited scope of the proposed rule would not have any impact on (and, therefore, would be consistent with) the protection of investors and the purposes of the Investment Company Act.

<u>Employee Pension Funds Affiliated with a Banking Entity Should Not Be Deemed "Banking Entities"; Investments by Affiliated Employee Pension Funds in Hedge Funds and Private Equity Funds Should Not Be Attributed to the Banking Entity</u>

The definition of "banking entity" should not include pension funds that are affiliated with a banking entity, and investments in hedge funds or private equity funds by employee pension funds should not be attributed to a banking entity for purposes of the Volcker Rule.[8] Section (h)(1) of the

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7 Such a rule would also not limit the rulemaking authority of the Agencies to include "other funds" under the definitions of "hedge fund" and "private equity fund" for purposes of the Volcker Rule.

8 As discussed in our prior comments, we urge the Agencies generally to interpret the definition of "banking entity" so as to advance the purposes of the Volcker Rule, rather than simply incorporating wholesale the concepts regarding affiliates, subsidiaries, and control developed under the Bank Holding Company Act, including with respect to the employee pension funds discussed in the text and in other contexts, such as minority investments.

Volcker Rule includes within the definition of "banking entity," "any affiliate or subsidiary" of such an entity. Section 2(g)(2) of the Bank Holding Company Act provides that unless the Board determines otherwise, any shares held or controlled directly or indirectly by trustees for the benefit of a company's employees are deemed to be controlled by the company. If one were to align Section (h)(1) of the Volcker Rule with Section 2(g)(2) of the Bank Holding Company Act, or if one were to otherwise view a banking entity's employee pension fund as controlled by the banking entity, that employee pension fund could be considered an "affiliate or subsidiary" of the bank holding company for purposes of the Volcker Rule. The terms of Section 2(g)(2), however, plainly authorize the Board to determine that such shares should not be viewed as controlled by a banking organization. Just as the SEC has authority to provide exemptions under the Investment Company Act for Volcker Rule purposes, the Board may determine that pension funds should not be viewed as affiliates for Volcker Rule purposes. A contrary interpretation, in our view, would unduly burden the employee pension funds of banking entities by making it much more difficult for such banking entities to offer competitive retirement plans to their employees. By making it more difficult for banking entities to attract and retain scarce talent, such an interpretation could detrimentally impact the safety and soundness of banking entities. We strongly urge the Agencies to clarify that employee pension funds are not subsidiaries or affiliates of a banking entity for purposes of the Volcker Rule.

To the extent that the objective of the Volcker Rule is to reduce certain forms of risk-taking by banking entities, we note that employee pension funds already exist separate and apart from the banking entities with which they are affiliated. In addition, employee pension funds operate in the context of a separate and comprehensive regulatory regime based on ERISA which operates to protect plans and beneficiaries. Under ERISA, trustees of employee pension funds have fiduciary duties which they must discharge "solely in the interest of the participants and beneficiaries and for the *exclusive* purpose of providing benefits to participants and their beneficiaries."[9] This statutory mandate places extensive constraints on the overall discretion of trustees of employee pension funds and, thus, minimizes the risk of unsound investment activity. In light of this pre-existing regulatory framework administered by the Department of Labor, Congress did not intend for further restrictions on banking organization pension plan investments under the Volcker Rule.

ERISA trustees of employee pension funds often allocate a portion of the pension plan's assets to alternative investments in hedge funds and private equity funds with the objective of furthering the best interests of company employees. Attributing these investments to a "banking entity" for purposes of the Volcker Rule would impose new restrictions having nothing to do with proper management of pension fund assets and would prevent trustees from acting in the best interests of their beneficiaries. Allocating an investment portfolio among diversified asset classes is a fundamental tenet of portfolio management, and thus pension funds for employees of both banking and non-banking entities regularly invest a portion of portfolio assets in alternative investments, such as hedge funds or private equity funds. In keeping with their fiduciary obligations, trustees of pension funds select these investments in order to advance the best interests of employees, and they should be permitted to continue to do so. The Volcker Rule is intended to prohibit banking entities from taking on certain perceived risks, and interpreting the Volcker Rule to prevent asset diversification and risk reduction by pension plans for employees of a banking entity does not further this objective.

<u>The SEC's "Substantive Pre-existing Relationship" Standard is the Appropriate Standard for "Customer" Relationships under the Asset Management Exemption</u>

9 29 U.S.C. § 1104(a)(1) (2006) (emphasis added).

For many banking entities, providing asset management and investment advisory services to customers represents a core business. Congress recognized this fact when it exempted asset management services from the general prohibition on banking entities' investment in and sponsorship of private equity and hedge funds. Section (d)(1)(G) is intended to protect banking entities that are engaged in providing *bona fide* trust, fiduciary or investment advisory services and enable them to continue to organize and offer hedge funds and private equity funds to customers of such services.

The asset management exemption preserves the right of banking entities to sponsor private equity and hedge funds as a component of their asset management services. As noted in the FSOC Study, the Volcker Rule "reflects the basic principle that hedge funds and private equity funds sponsored by a banking entity should be aligned with and supportive of customer-focused advisory services."[10] Rules issued to effectuate the asset management exemption should emphasize that the asset management exemption permits, rather than disrupts, a banking entity's ability to provide traditional asset management services. Investors looking to access hedge fund and private equity fund investment strategies do so by investing in funds. Unless banking entities can offer hedge funds and private equity funds to customers, they will effectively be eliminated as providers of those investment strategies.

The clear inference from the Study and the plain language of the Volcker Rule's asset management exemption is that Congress intended the exemption to allow banking entities to provide the same asset management services to customers as do competitors that are not subject to the Volcker Rule. To do so, a banking entity must be able to offer a diversified array of investment opportunities. Investors that look to a banking entity for such asset management services expect to be able to invest in both hedge funds and private equity funds in the same fashion as they would in funds managed by non-bank affiliated competitors. Creating an asset management exemption that prevents banking entities from attracting customers would be at cross-purposes with the intent of the exemption, render it ineffective, and prevent banking entities from competing in the market for asset management services.

We agree with the Study that it is necessary to clarify and define the meaning of "customer" in the context of the asset management exemption.[11] The Agencies should look to securities law precedent for guidance in determining who are the "customers" for whom banking entities may organize and to whom they may offer hedge funds and private equity funds. Specifically, we recommend that the Agencies refer to the SEC's "substantive pre-existing relationship" ("SPR") standard in defining the scope of the customer requirement for purposes of the Volcker Rule.

Under the Securities Act, unless it is intended that a fund register with the SEC like any public company, an offering in a hedge fund or private equity fund must be done in such a way that ensures that there is no public offering of fund interests. The difference between a private, rather than a public, offering of securities involves adherence to standards developed by the courts and the SEC, including not engaging in any general solicitation or advertisement to investors. Specifically, Regulation D was adopted by the SEC as a safe harbor from registration under the Securities Act, and one of the key conditions to be met under this safe harbor is that securities be offered only to investors with which there is a substantive pre-existing relationship. The two elements required to meet this standard are evident from its name; a relationship must be both substantive and pre-existing.

For a relationship to be substantive, the issuer or a person acting on the issuer's behalf must be "aware of the financial circumstances or sophistication of the persons with whom the relationship

10 FSOC Study at 57.
11 FSOC Study at 64.

exists."[12] For a relationship to be pre-existing, there must be sufficient time between the establishment of a relationship and an offer of securities. The amount of time that is sufficient is not defined, but the SEC has approved a 45-day waiting period between initial contact and solicitation for investment in a particular offering.[13] Under certain circumstances, the SEC has found a 30-day period between the time an investor was qualified to invest in private placements and the investor was offered specific investment opportunities to be sufficient.[14]

In a public offering of securities, an issuer (itself or with the assistance of an underwriter) offers securities to anyone who wishes to purchase them, and need have no relationship with any investor since the Securities Act approach to investor protection depends mainly on adequate disclosure of material information about the issuer, *e.g.* through a prospectus or other public disclosures. In contrast, a key consideration in a private offering or private placement is that securities are not offered to all comers, but only to a limited number of investors with which the issuer or its agent can form a relationship sufficient in order to assure itself that the conditions for a private offering are met. Under Regulation D, which requires less extensive disclosures than a registered public offering, the issuer must make available to each investor at a reasonable time prior to investing the opportunity to ask questions and receive answers concerning the terms of the offering and to obtain additional information concerning matters disclosed by the issuer. Sales may be made under Rule 506 of Regulation D only to 35 offerees other than accredited investors; and each non-accredited investor must have knowledge or experience in financial and business matters so as to be able to evaluate the merits and risks of the investment, or the issuer must reasonably believe he or she does. In order to satisfy these conditions, the issuer must develop a relationship with the investor sufficient to permit a reciprocal exchange of information.

It is against this background that the SEC's articulation of the need for an SPR should be understood. The rationale for the SPR aligns well with the purposes behind the Volcker Rule's preservation of banking entity asset management activities involving the organization and offering of hedge fund and private equity fund interests to customers of banking entity investment advisory services.

We respectfully submit that the SPR standard is the appropriate standard for a customer relationship under the Volcker Rule. The SPR standard creates a balance that allows funds and their agents to develop significant new customer relationships prior to a sale of fund interests, yet still requires an appropriate amount of time accompanied by meaningful contacts and other steps for the relationship to develop. The SPR standard imposes sufficient restrictions on banking entities that provide asset management services, while providing flexibility for them to establish new customer relationships and not be limited to a static pool of customers who invested prior to the effectiveness of Volcker Rule. The SPR standard is also one that is familiar to all parties engaged in the asset management business, as offerors of ownership interests in private equity and hedge funds must comply with this standard to qualify for a private placement exemption. This familiarity with the standard will reduce overall implementation costs for banking entities and supervisory burdens for the Agencies.

We also believe the definition of "customer" for these purposes should not focus on which party initiates a customer relationship. The SPR standard is also appropriate in this regard. For example, the standard should apply in situations where banking entities seek out sophisticated investors for their asset management services by offering investments in funds they sponsor, as well as in situations where

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12 *See Mineral Lands Research & Marketing Corp*, SEC No-Action Letter (Dec. 4, 1985).
13 *Bateman Eichler, Hill Richards, Inc.*, SEC No-Action Letter (Dec. 3, 1985).
14 *Lamp Technologies , Inc.*, SEC No-Action Letter (May 29, 1997).

sophisticated investors seek out qualified managers. A standard that policed which party initiated contact would be burdensome and result in higher overall costs, as well as place anti-competitive limitations on asset managers affiliated with banks and thrifts.

We believe that an approach that allows banking entities to offer customers an array of investment opportunities to meet their needs and desires for investment strategies intended to generate competitive returns is a system that will be most consistent with the purposes of the asset management exemption. The SPR standard allows asset managers affiliated with banks and thrifts to compete effectively for investors and also allows investors to be discerning about where and with whom to invest their money. Because the SPR standard is most consistent with the objectives underlying the asset management exemption, we urge the Agencies to adopt this standard when determining whether the requisite customer relationship exists for purposes of this exemption.

Super 23A Should Not Apply to Business Relationships Between Banking Entities and Third-Party Funds

The Volcker Rule permits banking entities to provide customers with access to third-party hedge funds and private equity funds by sponsoring funds-of funds that invest in third-party hedge funds and private equity funds. The sponsorship of funds-of-funds is subject to, *inter alia*, Section (f)(1) of the Volcker Rule, which subjects transactions between a banking entity and any hedge fund or private equity fund sponsored by the banking entity to the restrictions on covered transactions in Section 23A of the Federal Reserve Act, as if the banking entity were a bank and the sponsored fund were an affiliate under Section 23A ("Super 23A"). In a discussion of the application of Super 23A to funds-of-funds sponsored by a banking entity, the Study noted that "conflicts of interest [could] arise where a banking entity directs a . . . fund of funds investment to a third-party hedge fund or private equity fund with which the banking entity has other business relationships."[15] The Study recommended that when evaluating such business relationships, the Agencies consider:

- the extent to which business relationships between the banking entity and a third party fund could incentivize the banking entity to protect the hedge fund or private equity fund from loss or incentivize the banking entity to take on outsize risk; and

- whether to subject the banking entity's business relationships with the third party fund to the restrictions of Super 23A.[16]

For two reasons, we believe that Super 23A should not be expanded to cover business relationships between a banking entity and a third-party fund. First, such an expansion is not authorized by the plain language of the Volcker Rule. Section (f)(1) clearly provides that the restrictions of Super 23A only apply to an enumerated list of relationships between a banking entity and a hedge fund or private equity fund. Section (f)(1) clearly restricts this list of possible relationships to where the banking entity (i) serves directly or indirectly as investment adviser of the fund, (ii) sponsors the fund, (iii) organizes and offers the fund pursuant to Section (d)(1)(G), or (iv) otherwise controls the fund. To expand Super 23A to cover third-party funds with which banking entities have arms-length business relationships would be to significantly expand the Volcker Rule prohibitions beyond the funds covered by the statute. Moreover, Congress considered and decided against expanding the coverage of Super 23A in this manner. Early versions of legislation would have included within the 23A prohibitions

15 FSOC Study at 65.

16 *Id.*

certain unaffiliated private equity and hedge funds in which a sponsored fund invests, but this approach was rejected in the law as enacted.

Second, even if such an expansion were consistent with the plain language and history of Section (f)(1) (and we believe it is not), placing restrictions on arms-length transactions between banking entities and third-party funds would add no incremental protection of the safety and soundness of any banking entity or to the financial stability of the U.S. With respect to protecting a banking entity from loss, any possibility that a banking entity would in fact provide assistance to the third-party fund is already addressed by Section (d)(1)(G)(V), which unequivocally prohibits a banking entity from "bailing out" a fund that a banking entity-sponsored fund-of-funds invests in. No banking entity could extend assistance to a third-party fund because of this provision of the Volcker Rule.

For these reasons, we believe that Super 23A should not be expanded beyond the enumerated list of relationships in Section (f)(1) of the Volcker Rule.[17]

<u>Directed Trustee Arrangements Should Not Be Deemed "Sponsorships"</u>

For some banking entities, providing trust and custodial services to funds constitutes a significant portion of the bank's overall revenue mix. There is a concern that certain trust and custodial arrangements, specifically arrangements where a banking entity acts as custodian or administrator for a fund and yet exercises no actual investment authority or discretion over fund assets ("<u>directed trustee arrangements</u>") could be deemed "sponsorships" of funds under Section (h)(5) of the Volcker Rule.[18] Were directed trustee arrangements deemed impermissible sponsorships, the ordinary course business activities of banking entities would be seriously disrupted, detrimentally impacting both the banking entities that provide trust and custodial services to funds and the vast array of customers that rely on these services.[19] In order to avoid detrimental impacts on a traditional custodial service that presents none of the concerns the Volcker Rule is intended to address, we request that the Agencies clarify that directed trustee arrangements between a banking entities and funds are not "sponsorships" of funds by banking entities for purposes of the Volcker Rule.

Of primary importance to any analysis of directed trustee arrangements is the fact that directed trustees exercise no investment discretion over fund assets. In contrast to trust arrangements where trustees influence or direct how fund assets are invested, a directed trustee's service to a fund is limited

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17 We also urge the Agencies to clarify that sponsored or otherwise controlled private equity and hedge funds are not within the meaning of the term "banking entity" in order to avoid the anomalous result that such a controlled fund would then be prohibited, *e.g.*, from making controlling investments in other private equity and hedge funds. This would create an internal contradiction within Super 23A, which explicitly contemplates such investments by a sponsored fund of funds. Similarly, asset management affiliates should not be viewed as within the meaning of the term "banking entity" for purposes of the name-sharing prohibition in subsection (d)(1)(G)(vi), so long as the asset management affiliate does not share a variant of the name of any affiliated bank, thrift, or bank/thrift holding company. This interpretation would provide meaningful information for investors in funds sponsored by the asset management affiliate while avoiding any confusion with respect to the related depository institutions. A contrary interpretation would again have the anomalous result of requiring each sponsored private equity and hedge fund to have a unique name.

18 Subsection (h)(5) of the Volcker Rule defines "sponsoring" a fund to include serving as a general partner, managing member, or "trustee" of a fund.

19 We note that if directed trustee arrangements were deemed impermissible sponsorships, a banking entity's reliance on the asset management exemption under Section (d)(1)(G) would likely be insufficient to prevent significant harm to directed trustee arrangements. This is because directed trustees often provide short-term credit to funds as part of their traditional custody services. Even if the directed trustee arrangement relied on the asset management exemption, an extension of credit from the banking entity to the fund would be prohibited by Super 23A's prohibition on "covered transactions" between the banking entity and the fund for which it was acting as directed trustee.

to traditional trust and custodial services, none of which implicate the type of risk-taking the Volcker Rule is addressed to. By definition, the incentive structures that could lead to the banking entity taking on excess risk are not present in the context of a directed trustee arrangement. The SEC and the Board seemed to have recognized the lower risk associated with directed trustee arrangements: when implementing exceptions to the definition of "broker" under Section 201 of the Gramm-Leach-Bliley Act ("Regulation R"), both the SEC and the Board deemed arrangements where a trustee "did not exercise investment discretion with respect to the account" to be custodial, rather than trust accounts. We believe that the designation of directed trustee arrangements as custodial accounts under Regulation R stands as an explicit regulatory recognition that directed trustees arrangements are distinguishable from other trust arrangements. Consistent with this precedent, we request that the Agencies recognize that a directed trustee's lack of investment discretion over fund assets places the arrangement outside the scope of a "sponsored" fund for purposes of the Volcker Rule.

It is also important to note that directed trustee arrangements arise in a variety of different contexts. In addition to being used to satisfy the "trust requirement" under section 403(a) of ERISA, directed trustee arrangements also arise, *inter alia*, (i) in the context of common law trusts, wherever they may be established, (ii) when institutional investors establish business trusts under state law (as in the case of a Delaware statutory trust), or (iii) when a Unit Trust is organized overseas under the UCITS rules or similar regulations and seeks U.S. investors. Instead of being restricted to a specific economic, legal or regulatory context, directed trustee arrangements are best understood as trust relationships with specific economic characteristics (the trustee's lack of investment discretion over fund assets) that arise in a variety of functional contexts (*e.g.*, ERISA, business trust, UCITS). When analyzing directed trustee arrangements, the Agencies should not look to the specific economic, legal or regulatory regime governing the trustee relationship, but rather should look to whether or not the banking entity has investment discretion over fund assets. We respectfully request that the Agencies use this analysis to determine these types of directed trustee arrangements are not sponsorships for purposes of the Volcker Rule.

Permitted Employee Investments Should Not Count Towards the *De Minimis* Limits

Section (d)(4) of the Volcker Rule permits banking entities to make *de minimis* investments in hedge funds and private equity funds that a banking entity organizes in conjunction with its asset management services. These *de minimis* investments cannot constitute more than three percent of the total ownership interests of the fund one year after the date of the fund's establishment, nor may the aggregate of all the *de minimis* interests of the banking entity in hedge funds and private equity funds exceed three percent of the Tier 1 capital of the banking entity (the "*de minimis* limits"). In its discussion of *de minimis* investments, the Study recommended that the Agencies consider whether investments by directors and employees engaged in providing services to a hedge fund or private equity fund should be included in the calculation of the percentage of the banking entity's investment in a private equity fund or hedge fund for purposes of the *de minimis* limits.[20]

We note that as a matter of statutory construction, subsection (d)(1)(G)(vii) does not limit the amount of permissible investments by employees and directors in a hedge fund or private equity fund. We believe that the lack of a stated limit is a strong signal of Congress's intent not to impose numerical

20 FSOC Study at 67.

limits on permissible investments by employees and directors; indeed, when read together with subsection (d)(1)(G)(vii)'s restriction of permissible investors to only directors or employees that "directly engage" in providing investment advisory or other services to a fund (a functional, rather than a numerical restriction), this interpretation of congressional intent is strengthened. It would be inconsistent with such an expression of intent to impose a numerical limit on permitted employee and director investments, and thus it seems inconsistent with congressional intent to impose a numerical limit on permitted employee and director investments by counting these investments towards the *de minimis* limits that apply to the banking entity.

Further, counting permitted employee investments towards the *de minimis* limits would significantly undercut the intended policy benefits of subsection (d)(1)(G)(vii). Because subsection (d)(1)(G)(vii) is designed to ensure that the incentives of the banking entity's employees are aligned with the incentives of investors in funds sponsored by the banking entity, counting permitted employee investments towards the *de minimis* limits would limit the Agencies' ability to achieve an important policy goal. When analyzed in light of the fact that investors in bank-sponsored funds usually demand significant co-investments from the banking entity itself, the important policy goal of subsection (d)(1)(G)(vii) could be undermined, because the required co-investments by the banking entity would "crowd out" permitted employee and director investments in sponsored funds.

Given that the *de minimis* limits and subsection (d)(1)(G)(vii) are both intended to ensure that a banking entity's incentives are aligned with the incentives of investors in funds sponsored by the banking entity, we believe that "other services" in subsection (d)(1)(G)(vii) should be interpreted to allow for investments in hedge funds and private equity funds by employees of the banking entity that provide support services to the fund. Support services should be interpreted to include administrative, oversight and risk management, legal, compliance, regulatory, investor relations, sales and marketing, tax, accounting, valuation and other operational support services. Specifically, we request that the Agencies confirm that senior management and directors of a banking entity's asset management division will be eligible to invest in hedge funds and private equity funds consistent with subsection (d)(1)(G)(vii) of the Volcker Rule. The managers and directors of a banking entity's asset management division provide support through substantive supervision of investment advisors, portfolio mangers, and other service providers, and therefore have a direct impact on the fund's investment advisory services. Accordingly, these individuals should be eligible to invest in hedge funds and private equity funds under subsection (d)(1)(G)(vii) of the Volcker Rule.

Because the provision of support services is integral to the successful operation of a hedge fund or private equity fund, aligning the incentives of the employees that provide support services to a fund with the incentives of the fund's investors themselves would expand the benefits that (d)(1)(G)(vii) and the *de minimis* limits were intended to promote. Indeed, the fact that financial institutions regularly issue stock options to their operational employees illustrates that incentivizing providers of support services is an important and desirable operational objective, an objective best understood in light of the fiercely competitive markets for human capital in the financial services industry. We ask the Agencies to recognize the substantial competition for talent in the financial services industry, and the benefits of incentivizing employees that provide support services.

<u>Bank-Owned and Corporate-Owned Life Insurance Should Not Be Subject to the Volcker Rule</u>

We believe that Congress did <u>not</u> intend BOLI contracts to be subject to the restrictions and prohibitions of the Volcker Rule. While this exclusion of BOLI contracts from the reach of the Volcker Rule is clear for BOLI contracts supported by an insurer's general account or by a separate account of the insurer that is registered with the SEC, the analysis with respect to other BOLI (*e.g.*, private placement separate account BOLI products) may be less clear. With respect to such products, we believe that any similarity between BOLI and traditional hedge funds and private equity funds is largely restricted to the fact that both rely on the exemptions under 3(c)(1) or 3(c)(7) of the Investment Company Act. Banking entities purchase BOLI insurance policies as a tax effective means to manage the risks associated with employee benefit obligations. Applicable banking supervisory guidance prohibits the purchase of BOLI for speculative purposes[21] and establishes a number of requirements that must be fulfilled by the purchasing bank entity, including rigorous, continual oversight of such policies by the banking entity's senior management. The guidance also requires that the assets in a BOLI separate account be invested in bank-eligible securities, with an exception for certain non-bank-eligible investments that act as a hedge against existing obligations of the banking entity. Insurance and tax laws also dictate requirements affecting this product. Further, the insurance and tax law requirements applicable to a BOLI separate account mean that a banking entity does not, and cannot, own or control the assets in the separate account and cannot make investment decisions regarding the individual assets in a separate account.

The BOLI insurance structure is dependent upon an insurance company establishing a "separate account" on its books to support each BOLI policy. Insurance company separate accounts are used to hold portfolios of securities that are dedicated to supporting specific variable insurance contracts (while all other insurance company assets not held in such separate accounts are held in the "general account" and support the insurance company's general insurance and other liabilities). The separate account structure is attractive because assets held in a separate account are not available to satisfy the general creditors of the insurance company. In the event of an insurance company failure, any assets in a separate account supporting a BOLI policy cannot be used to satisfy general creditors' claims against the insurance company. To achieve the tax deferral benefit for the increase in value of the assets in a separate account supporting a BOLI policy, the purchasing banking entity may not exercise investment control over the assets in the separate account, and the variable insurance policies are structured to prevent investment control by the policyholder. The courts however, have determined that the separate account itself is an "investment company" and therefore the separate account either must be registered as such with the SEC or rely on an exemption from registration under the Investment Company Act. The separate account that supports a BOLI policy will generally rely on either the 3(c)(1) or 3(c)(7) exemption under the Investment Company Act, and hence the separate account technically meets the definition of a hedge fund or private equity fund for purposes of the Volcker Rule.

Beyond the separate account's reliance on the 3(c)(1) or 3(c)(7) exemptions, however, BOLI bears no resemblance to the traditional hedge funds or private equity funds that the Volcker Rule is intended to police.

First, as noted, existing bank regulatory guidance prohibits the purchase of BOLI policies for speculative purposes.[22] It also prohibits depository institutions from holding life insurance in excess of their risk of loss or cost to be recovered, requires investments in separate accounts to comply with the limits on bank eligible investments (with the minor exception for certain equity investments reflecting a

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21 Interagency Statement on the Purchase and Risk Management of Life Insurance (2004) (the "Interagency Guidance") (generally imposing restrictions on banks and savings associations with respect to the purchase and use of life insurance; specifically requiring, *inter alia*, that banks and savings associations not purchase life insurance for speculation and that banks and savings associations have a comprehensive risk management process for purchasing and holding life insurance).

22 Interagency Guidance at 2.

very high degree of correlation used to hedge specific equity-linked obligations under an employee benefit plan), and limits the cash surrender value of BOLI to be 25% or less of capital.[23] Management must approve the purchase of BOLI policies and exercise regular oversight over their operation, performance and fulfillment of bank regulatory requirements.[24]

Insurance law provides that a banking entity purchasing an insurance policy supported by a separate account does not have a legal ownership interest in the separate account; rather the assets of the separate account are considered assets of the insurance company (and, as noted above, the assets are insulated from claims of the insurance company's general creditors).

Finally, under applicable tax law, once a BOLI policy is established, a policyholder cannot exercise investment discretion over the assets in the separate account; if a bank entity policyholder did so, it would be subject to severe negative tax consequences (basically by forfeiting the economic benefit of the policy).[25] The fact that the BOLI policyholder does not exercise investment discretion over the underlying assets supporting the policy makes it difficult, if not impossible for the policyholder to take on excess risk through the policy itself, which stands as further evidence that BOLI lacks the attributes of a mechanism for evading the Volcker Rule.

In sum, because BOLI accounts do not have any of the attributes that give rise to the same concerns as the hedge funds and private equity funds that the Volcker Rule was meant to restrict, neither the insurance company separate accounts that support BOLI variable insurance contracts nor the insurance contracts themselves should be deemed hedge funds or private equity funds for purposes of the Volcker Rule.

For similar reasons, we also believe there is no reason to suggest that BOLI could potentially be used to conduct impermissible proprietary trading.[26] As described above, existing bank regulatory guidance flatly prohibits the purchase or use of BOLI for speculative purposes. Even if a banking entity attempted to use a BOLI account to conduct impermissible proprietary trading, it would be extremely difficult to do so, because a BOLI account can permissibly hold equity-linked obligations only as a hedge against a specific corresponding equity-linked obligation. Any changes in the equity-linked holdings of the BOLI account must be highly correlated to changes in value of the underlying obligation being hedged.[27]

We believe the Agencies have a variety of different options to clarify that BOLI policies and the separate accounts that support them are not to be considered hedge funds or private equity funds for the purposes of the Volcker Rule's prohibition against acquiring or retaining an equity, partnership, or other ownership interest in or sponsoring a hedge fund or private equity fund. For example, the Agencies could clarify that: (i) a banking entity's purchase of BOLI insurance policy does not give the banking entity an ownership interest in a hedge fund or private equity fund, but rather (as clearly understood in the Interagency Guidance) the banking entity owns an insurance policy; (ii) the separate account supporting such a policy, while technically treated as an investment company for purposes of the Investment Company Act, does not constitute a hedge fund or private equity fund for the purposes of the

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23 See generally Interagency Guidance.

24 *Id.*

25 *Id.* at 13.

26 *Cf.*, FSOC Study at 75 (discussing potential designation of certain financial instruments as "proprietary trading" as defined in subsection (h)(4) of the Volcker Rule).

27 Interagency Guidance at 3.

Volcker Rule because the separate account does not share any characteristics of a hedge fund or private equity fund and is simply a structure under insurance law for an insurance company to hold assets remote from the insurance company's creditors, and is subject to insurance regulation as well as extensive limitations under the terms of the insurance policy that it supports; (iii) assets held by insurance companies in separate accounts are held on behalf of customers for purposes of Section (d)(1)(D) of the Volcker Rule; (iv) insurance company BOLI activities – both issuance of BOLI variable insurance policies and establishment and maintenance of their supporting separate accounts -- do not involve "sponsoring" a hedge fund or private equity fund; and (v) such activities are inherent in the business of insurance and must be accommodated by the Volcker Rule.

We also believe that ownership by a banking entity of a BOLI policy and ownership by the insurance company of the separate account supporting such a policy should be permissible under Section (d)(1)(J) of the Volcker Rule as activities that promote and protect the safety and soundness of banking entities and the financial stability of the United States. The Interagency Guidance recognizes the importance of BOLI policies to the safety and soundness of banking entities, noting that "because the cash flows from a BOLI policy are generally income tax-free if the institution holds the policy for its full term, BOLI can provide attractive tax-equivalent yields to help offset the . . . cost of providing employee benefits."[28] These tax benefits clearly promote the safety and soundness of banking entities that purchase and use BOLI. Just as banks' use of BOLI provides important safety and soundness benefits, forced divestiture resulting from BOLI being deemed a hedge fund or private equity fund for purposes of the Volcker Rule would have significant detrimental effects on bank safety and soundness and the financial stability of the United States. Indeed, the Interagency Guidance notes that a bank's inability to hold a BOLI policy until maturity could "compromise the success of the BOLI plan."[29] A Michael White Associates LLC report issued at the end of the third quarter 2010 using information from bank call reports noted that BOLI totaling approximately $140 billion was held by 915 bank holding companies and 7,760 stand-alone banking entities. FDIC data indicates that depository institutions held more than $128 billion of life insurance assets as of March 2011,[30] which includes both general and separate account BOLI.[31] If banking entities were forced to divest themselves of such policies, they would be entitled only to the cash surrender value of the policies and would face tax liabilities for previously untaxed increases in the value of the policy's cash surrender value and potentially other tax penalties and surrender charges. Markets could be impacted by the sales that would be triggered by forced divestiture of such policies. We thus submit that because of the ongoing benefits to safety and soundness that BOLI provides to banking entities and the potential for detrimental impact on safety and soundness in the event of forced divestiture and on the stability of the U.S. financial system, the Agencies should at a minimum deem the purchase and use of BOLI to be permissible under Section (d)(1)(J) of the Volcker Rule.

Even if BOLI were not exempted under Section (d)(1)(J) of the Volcker Rule, the use of BOLI is a quintessential example of a risk-mitigating hedging activity permissible under Section (d)(1)(C) of the Volcker Rule. As noted, BOLI policies are not used for speculative purposes, but rather are purchased specifically to offset the liabilities associated with deferred employee compensation and retiree benefits obligations. Existing regulatory guidance on BOLI recognizes that "the purchase of BOLI can be an

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28 *Id*. at 1.

29 *Id*. at 11.

30 Federal Deposit Insurance Corporation, Statistics on Depository Institutions 2011 (Custom Report on Life Insurance Assets as of March 31, 2011).

31 Federal Deposit Insurance Corporation, Statistics on Depository Institutions Help, http://www2.fdic.gov/sdi/definitions.asp?SystemForm=ID&HelpItem=OALIFINS.

effective way for institutions to manage exposures arising from commitments to provide employee compensation and pre- and post-retirement benefits."[32] Guidance also imposes limits on the amount of BOLI that can be purchased, restricts its use as a tool for managing the liabilities associated with deferred employee compensation and retiree benefits obligations, and requires regular reporting to and oversight by senior management. These restrictions constitute an explicit regulatory recognition that BOLI is meant as a risk mitigation tool to manage the liabilities associated with obligations owed by a banking entity to its employees; the purchase and use of BOLI is a permissible hedging activity under Section (d)(1)(C) of the Volcker Rule.

Seed Accounts Should Be Permissible Under the Volcker Rule

We request the Agencies to clarify that a seed account created and used for purposes of marketing the performance or track record of particular investment strategies to unaffiliated investors is not a "trading account" as defined in Section (h)(6) of the Volcker Rule. Managing portfolios for specific institutional and other clients (such portfolios often being referred to as "separate accounts," not to be confused with insurance company separate accounts discussed above) is fundamental to the asset management business and is a primary activity of many asset managers.

In order to obtain and maintain clients who directly receive investment advisory services from an asset manager, it is essential that asset managers provide a track record of actual trading results. As a result of market practice and SEC requirements, asset managers typically create these track records by establishing *de minimis* seed accounts and market the ensuing track record to existing and potential separate account clients. These seed accounts are not used "principally for the purpose of selling in the near term" or "with the intent to… profit from short-term price movements," as Section (h)(6) of the Volcker Rule defines "trading account." Instead, these seed accounts are established and used for the purpose of attracting and maintaining separate account clients of the asset manager.

This intent is clearly evidenced by the *de minimis* size of seed accounts and the use of their performance with existing and potential clients of the asset manager. Without the ability to advertise performance based on seed account track records, a banking entity would be at a distinct disadvantage in both obtaining and maintaining separate account clients. As the FSOC Study recognizes, the Volcker Rule is not designed to restrict core banking functions of banking entities, including asset management on behalf of customers. To that end, we request that the Agencies clarify the definition of "trading account" as described above in order to allow banking entities that engage in asset management activity to continue to be able to create and maintain seed accounts in connection with the development and offering of separate account management services to existing and potential clients.

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32 *Id*. at 21.

The Board Should Revisit its Final Rule on the Conformance Period

On February 14, 2011, the Board published its final rule implementing the conformance period provisions of the Volcker Rule.[33] As part of the provisions governing the conformance period, Section (c)(3)(A) of the Volcker Rule provides that, in addition to the initial two-year conformance period and three additional one-year discretionary extensions, a banking entity's investment in an "illiquid fund" is eligible for an extended transition period "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010." In the preamble to the final rule, the Board interprets this provision to permit it to grant an extended transition period to a banking entity only if the banking entity's contractual obligation in place on May 1, 2010 did not permit the banking entity to terminate its obligations to the fund.[34]

We believe that this interpretation is inconsistent with congressional intent, in that it may not give banking entities sufficient time to unwind or dispose of their sponsorships of and investments in private equity funds. Specifically, the Board's definition of the phrase "contractual obligation" may make it virtually impossible for any illiquid fund to qualify for the extended transition period. With respect to the rule's definition of "contractual obligation," because the terms governing almost every illiquid fund permit holders of an interest in the fund to transfer their interest with applicable consent or because of a change in law, the Board's interpretations could make every illiquid fund ineligible for the extended transition period. Such a result would be inconsistent with the intent of the conformance period provisions; we submit that Congress did not intend to create an extended transition period for illiquid funds that no funds would qualify for. In order to avoid this result, we respectfully request that the Board revisit the final rule's definition of "contractual obligation" such that a fund will not be deemed ineligible for the extended transition period simply because holders of interests in the fund can transfer their interests in the fund.

Investments in the types of funds intended to be eligible for this extended transition period are by their nature illiquid. There is no established secondary trading market for such limited partner interests. Sales are done on a one-on-one negotiated basis, and investors understand that if they buy a limited partner interest, they may need to hold such interests for the life of the fund. For example, the representations and warranties that limited partners make at the time they invest customarily recite the limited partner's understanding that there is no secondary market for such interest, that it is not anticipated such a market will ever develop, and that for these reasons the investor will be required to retain ownership of the interest and bear the economic risk of this investment for an indefinite period of time.

If it is virtually impossible for an illiquid fund to qualify for the extended transition period, the final rule has the potential to cause massive and simultaneous "fire sales" of fund interests by banking entities. Because numerous banking entities would simultaneously become ineligible to hold their illiquid fund interests, the entirety of the illiquid fund holdings of each banking entity would enter the market at nearly the same time, leading to a severe depression in prices. Banking entities would take significant losses on the sale of these interests, and these losses would force banking entities to reduce overall investment and retain additional capital. A fire sale of this nature would also have detrimental effects on unaffiliated investors in the illiquid funds.

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33 Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8265 (Feb. 14, 2011) (codified at 12 CFR Part 225).

34 *Id*. at 8267.

We believe that forced simultaneous divestiture of fund interests is contrary to the basic purpose of subsections (c)(2) and (c)(3) of the Volcker Rule and contrary to the public interest as a whole. Given that the illiquid fund extension was intended to reduce risk in the banking system, we do believe that an interpretation that increases the potential for systemic risk is undesirable. As currently drafted, the final rule creates significant potential for uncertainty and volatility in the market for fund interests and in the banking system; this uncertainty and volatility will only be compounded by the significant changes taking place throughout the financial services sector. Because the extended transition period was intended to allow sufficient time for banking entities to wind down investment portfolios not in compliance with the Volcker Rule, we believe that the Board should revisit its interpretation of the conformance period provisions to allow for meaningful application of the extended transition period for illiquid funds.

Sincerely,

Richard M. Whiting

Richard M. Whiting
Executive Director & General Counsel

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We thank the Agencies for the opportunity to provide our comments. If you have any questions, please feel free to contact me or Peter Freeman at (202) 289-4322.