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February 13, 2012

Via Electronic Mail

Office of the Comptroller of the Currency
250 E Street, SW., Mail Stop 2-3
Washington, DC 20219
Docket ID OCC-2011-14

Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NE.
Washington, DC 20549-1090
File No. S7-41-11

Jennifer J. Johnson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW.
Washington, DC 20551
Docket No. R-1432
RIN: 7100 AD 82

David A. Stawick, Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre, 1155 21st Street, NW.
Washington, DC 20581
RIN: 3038-AD05

Robert E. Feldman, Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW.
Washington, DC 20429
RIN: 3064-AD85

Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Goldman Sachs Group, Inc. ("Goldman Sachs" or "we") appreciates the opportunity to comment on the proposed rule (the "Proposed Rule") in the notice of proposed rulemaking issued by the Office of the Comptroller of the Currency (the "OCC"), the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC") and the Securities and

Exchange Commission (the "SEC") and the notice of proposed rulemaking issued by the Commodity Futures Trading Commission (the "CFTC" and, together with the OCC, the Federal Reserve, the FDIC and the SEC, the "Agencies") to implement the restrictions on proprietary trading and certain interests in, and relationships with, hedge funds and private equity funds contained in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank").[1] These restrictions are referred to as the "Volcker Rule."[2]

This letter focuses on the restrictions in the Proposed Rule relating to certain interests in, and relationships with, hedge funds and private equity funds (the "Fund Restrictions"). We are submitting a separate letter on the proprietary trading provisions of the Proposed Rule.

INTRODUCTION

We understand that the Agencies faced a challenging task in designing the Proposed Rule. However, we do not believe that they have struck the appropriate balance between achieving the statute's goals, on the one hand, and avoiding unnecessary encroachment on traditional banking and asset management activities on the other. It is clear that the aim of the statute is to prevent banking entities from engaging in proprietary trading and to limit their relationships with hedge funds and private equity funds. It is equally clear, however, that Congress did not intend the Volcker Rule to inhibit banking entities from lending, undermine their asset management businesses or disrupt their ordinary-course operations.[3] Yet, we believe that certain aspects of the Proposed Rule do adversely affect these core activities without generating any appreciable benefits to the safety and soundness of the financial system.

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1 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (proposed Nov. 7, 2011) (OCC, Federal Reserve, FDIC and SEC) and Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, ● Fed. Reg. ● (proposed ●, 2012) (CFTC). We refer to both the joint notice of proposed rulemaking, 76 Fed. Reg. 68846 (proposed Nov. 7, 2011) and the CFTC notice of proposed rulemaking as the "Proposed Rule," but we cite to pages of the Federal Register version of the joint notice of proposed rulemaking (the "NPR"). We also refer to the text of the proposed common rules (including the appendixes) as the "Proposed Rule" and the text preceding the proposed common rules as the "Preamble."

2 The Volcker Rule is codified as Section 13 of the Bank Holding Company Act of 1956, as amended (the "BHC Act").

3 *See* Section 13(g)(2) of the BHC Act ("Nothing in this section shall … restrict the ability of a banking entity … to sell or securitize loans in a manner otherwise permitted by law."); The Financial Stability Oversight Council (the "FSOC"), Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (Jan. 2011), at 47 (referred to herein as the "FSOC Study") ("[T]his inviolable rule of construction [Section 13(g)(2) of the BHC Act] ensures that the economically essential activity of loan creation is not infringed upon by the Volcker Rule."); 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan) ("[T]he Volcker language was modified to permit a banking entity to engage in a certain level of traditional asset management business, including the ability to sponsor and offer hedge and private equity funds."); 156 Cong. Rec. H5226 (daily ed. June 30, 2010) (statement of Rep. Himes) (confirming that the Volcker Rule will not "disrupt the way the firms structure their normal investment holdings").

The problems with the Proposed Rule are specific and technical. Our recommended changes are technical as well.[4] But the issues are important, with serious real-world consequences. Consider three particularly salient examples.

The first relates to ***lending and credit extension***. The statutory language, legislative history and FSOC Study make clear that Congress did not intend the Volcker Rule to limit banking entities' ability to extend credit.[5] The Proposed Rule, however, does just that, most notably by limiting banking entities' ability to lend through partnership structures and similarly structured credit funds. Lending is a fundamental banking activity, whether accomplished through direct loans or through a fund structure. Credit funds, in particular, offer many benefits that help to secure the supply of credit during periods of market distress and to reduce the concentration of risk for both individual banking entities and the banking system as a whole. The Proposed Rule is likely to reduce the supply of credit on which our economy depends, while also potentially reducing safety and soundness.

The second relates to ***asset management***. To provide asset management services to clients, we routinely sponsor entities that are not included within, or are exempt from, the definition of "covered fund." These entities would become "banking entities" under the Proposed Rule, making it difficult or impractical for us and other banking entities to provide client services through these funds. In addition, by extending the Volcker Rule's extraterritorial reach too broadly, and capturing an inappropriately wide range of foreign client funds, the Proposed Rule disadvantages U.S. banking entities relative to their international peers. The broad designation of foreign funds subject to the Fund Restrictions captures funds that are not at all "similar" to U.S. hedge funds and private equity funds, including regulated funds established outside the United States, among them foreign mutual fund equivalents, such as UCITS. As written, the Proposed Rule would cause U.S. banking entities to incur substantial expense in rebranding and restructuring these public foreign funds, while foreign competitors would face no such costs or restrictions. Aside from the expense, these actions would also harm existing franchise value for no public benefit.

The third relates to ***organizational structure***. Banking entities, like other corporate entities, seek to organize themselves efficiently across different business lines, jurisdictions and legal, tax and regulatory regimes. This often requires the use of wholly-owned subsidiaries and controlled joint ventures. As a global financial institution, Goldman Sachs has thousands of these entities that bear no resemblance to traditional hedge funds or private equity funds. These types of entities are "banking entities" under the statute and thus are already subject to the Volcker Rule. Yet the Proposed Rule goes a step further by also categorizing them as "covered funds," subjecting them to severe restrictions on inter-company transactions and, in some cases, preventing us from owning them entirely. The Proposed Rule will create extensive compliance costs and operational burdens, and is likely to restrict institutions from structuring themselves effectively, without enhancing the safety of banking entities or the financial system.

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[4] This letter is not intended as a comprehensive response to all of the Agencies' requests for comments. We endorse the comment letter on the Fund Restrictions submitted by the Securities Industry and Financial Markets Association (SIFMA), the American Bankers Association, the Financial Services Roundtable and The Clearing House Association, which addresses many other important issues that could also have significant effects on our asset management businesses. These issues include the way in which the 3% per-fund and aggregate *de minimis* limits are calculated, the capital treatment for *de minimis* investments, the definition of "carried interest" and the ability to engage in risk-mitigating hedging.

[5] *See supra* note 3.

To address the negative impact on banking entities' lending activities, we believe that the Agencies should:

a) confirm that credit funds are not subject to the Funds Restrictions by creating a new exclusion from the definition of "covered funds"; and

b) omit the provisions that would effectively prevent banking entities from foreclosing on collateral, by excluding entities acquired in satisfaction of debts previously contracted from the definition of "banking entity."

To avoid causing harm to banking entities' asset management businesses, we recommend that the Agencies:

a) limit the scope of "covered funds" to include only foreign funds that resemble hedge funds or private equity funds and that would be subject to the Volcker Rule if they were offered in the United States;

b) limit the scope of "covered funds" to include only commodity pools that are primarily engaged in trading commodity interests. Capturing all "commodity pools" as "covered funds" could subject registered mutual funds and a variety of U.S. businesses (even non-financial firms) seeking to hedge the risks arising from their day-to-day operations to the Volcker Rule and all of its compliance and other burdens;

c) define "banking entity" to exclude those funds that banking entities are allowed to invest in either because (i) they operate under exceptions under the Investment Company Act of 1940 (the "1940 Act") other than Section 3(c)(1) or 3(c)(7)[6] or (ii) investment and sponsorship of those funds is permitted under the Proposed Rule.[7] These entities are not a means for evasion from the Volcker Rule, yet, if they are not excluded from the definition of "banking entity," banking entities may not be able to continue to invest in, acquire or operate such entities; and

d) exempt permissible covered funds from application of the restrictions commonly referred to as "Super 23A."[8]

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[6] For example, this includes funds operating under Section 3(c)(5)(C) of the 1940 Act, which must primarily hold mortgages or interests in real estate, or issuers of asset-backed securities under Rule 3a-7 of the 1940 Act, whose payments must depend primarily on the cash flow from underlying assets and not from trading in the underlying assets. We refer to these entities as "non-covered funds."

[7] *See* Section __.13 and Section __.14 of the Proposed Rule. We refer to these entities as "permissible covered funds."

[8] Section __.16(a) of the Proposed Rule, referred to as "Super 23A," prohibits a banking entity (and its affiliates) that serves as the investment manager, investment adviser, commodity trading advisor, or sponsor of, or that organizes and offers, a covered fund, from entering into transactions with such covered fund that would be "covered transactions" as defined in Section 23A of the Federal Reserve Act (12 U.S.C. § 371c). This includes loans or extension of credit to the covered fund; purchases of or an investment in securities of the covered fund; purchases of assets of the covered fund; the acceptance of securities issued by the covered fund as collateral security for a loan or extension of credit to any person or company; or the issuance of a guarantee, acceptance or letter of credit, including an endorsement or standby letter of credit, on behalf of the covered fund. As such, "Super 23A"

(footnote continued)

To preserve banking entities' ordinary operations and organizational structure, we recommend that the Agencies:

a) exclude wholly owned subsidiaries and controlled joint ventures from the definition of "covered funds" because they have nothing in common with traditional hedge funds and private equity funds and pose little risk of evasion as they are "banking entities" subject to the Volcker Rule. The application of "Super 23A" to these entities as "covered funds" would make their operations unworkable;

b) replace the requirement that joint ventures be "operating companies" with a test that more accurately distinguishes joint ventures from the hedge funds or private equity funds that the Volcker Rule intends to capture;

c) exclude merchant banking portfolio companies from the definition of "banking entity," because designating them as such would expand the scope of the Volcker Rule beyond the financial sector and would be inconsistent with current Federal Reserve practice; and

d) exclude non-covered funds and permissible covered funds from the definition of "banking entity" so as not to impose illogical restrictions on their activities, and exclude permissible covered funds from "Super 23A."

We believe the Agencies have statutory authority to implement these recommendations. With respect to the definition of "banking entity," the FSOC Study recommended that the Agencies "carefully consider the impact of BHC Act definitions [of affiliate and subsidiary] on the Volcker Rule's definition of "banking entity" and *implement the term in a way that avoids results that Congress clearly did not intend in enacting the Volcker Rule.*"[9] The Agencies acted on this recommendation by stating in the Preamble that all covered funds that are affiliates or subsidiaries of banking entities are excluded from the definition of "banking entity." However, in the text of the Proposed Rule, the Agencies only exclude funds organized and offered under Section __.11.[10] We believe that the Agencies can and should use their authority to further refine the definition of "banking entity" to clarify such issues.

We also believe the Agencies have the authority to exclude entities from the definition of "covered fund" entirely, so as to avoid expanding the Volcker Rule beyond its intended objectives. In fact, the FSOC Study, citing the exemptive authority under Section 13(d)(1)(J) of the BHC Act, recommended that 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*."[11] As the FSOC recognized, Congress afforded the Agencies rulemaking

(*footnote continued*)

imposes a blanket prohibition on a variety of ordinary course transactions between a banking entity and any covered fund that it manages, advises, sponsors, or organizes and offers under Section __.11.

9 FSOC Study, at 68–69 (emphasis added).

10 "[I]n order to avoid application of section 13 of the BHC Act in a way that appears unintended by the statute and would create internal inconsistencies in the statutory scheme, the proposed rule also clarifies that the term 'banking entity' does not include any affiliate or subsidiary of a banking entity, if that affiliate or subsidiary is (i) a covered fund, or (ii) any entity controlled by such a covered fund." NPR at 68855.

11 FSOC Study, at 62 (emphasis added).

authority to clarify the definition and exclude certain entities in order to avoid expanding the Volcker Rule beyond its intended objectives.[12]

In the case of "Super 23A," we believe that the Agencies should read the exemptions in Section 13(d)(1) not only to permit investments in and sponsorship of certain covered funds, but also to grant the Agencies authority to exempt them from "Super 23A." The application of "Super 23A" could render the exemptions provided in Section 13(d)(1) meaningless.

In addition, we believe that Section 13(d)(1)(J) of the BHC Act, read with the statute as a whole,[13] applies to all activities that are prohibited by the Volcker Rule, including covered transactions under "Super 23A." As a matter of statutory structure, unlike most of the exemptions under Section 13(d)(1) of the BHC Act that specify what kinds of activities are permitted, Section 13(d)(1)(J) of the BHC Act is drafted more broadly and permits the Agencies to exempt "*such other activity*" as the Agencies determine "*would promote and protect safety and soundness of the banking entity and the financial stability of the United States*."[14] Section 13(d)(1)(J) of the BHC Act therefore should be read as going beyond merely permitting certain activities or investments, and as applying to all activities that are prohibited by the Volcker Rule, including covered transactions.

In the case of lending activities, we believe the statute mandates that the Agencies exclude activities that promote lending from the Fund Restrictions under the rule of construction in Section 13(g)(2) of the BHC Act.[15] Lending activities promote safety and soundness and financial stability; therefore, we believe

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[12] In the colloquy between Representative Barney Frank, the co-sponsor of Dodd-Frank, and Representative Jim Himes (referred to herein as the "Himes-Frank colloquy"), Representative Himes asked for confirmation that the Volcker Rule is not intended to disrupt firms' ownership or control of "subsidiaries or joint ventures that are used to hold other investments, [and] that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings." Representative Frank confirmed this point as "absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do." 156 Cong. Rec. H5226 (daily ed. June 30, 2010).

[13] *See Gonzales* v. *Oregon*, 546 U.S. 243, 273 (2006) ("[S]tatutes should not be read as a series of unrelated and isolated provisions.") (internal quotation marks and citation omitted); *Conroy* v. *Aniskoff*, 507 U.S. 511, 515 (1993) (it is a "cardinal rule that a statute is to be read as a whole…since the meaning of statutory language, plain or not, depends on context.") (internal quotation marks and citation omitted); *U.S. Nat. Bank of Oregon* v. *Independent Ins. Agents of America*, *Inc*. 508 U.S. 439, 455 (1993) ("In expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law.") (internal quotation marks and citation omitted); *K Mart Corp.* v. *Cartier, Inc.*, 486 U.S. 281, 291 (1988) ("[I]n ascertaining the plain meaning of the statute, the court must look to the particular statutory language at issue, as well as the language and design of the statute as a whole."); *United Savings Ass'n of Texas* v. *Timbers of Inwood Forest Assocs. Ltd.*, 484 U.S. 365, 371 (1988); Antonin Scalia, A Matter of Interpretation: Federal Courts and the Law 17 (1997) (courts should construe congressional statutes to mean what "a reasonable person would gather from the text of the law, placed alongside the remainder of the corpus juris").

[14] Section 13(d)(1)(J) of the BHC Act (emphasis added).

[15] Section 13(g)(2) of the BHC Act provides that "[n]othing in [the Volcker Rule] shall … restrict the ability of a banking entity … to sell or securitize loans in a manner otherwise permitted by law."

that it is also within the scope of the Agencies' authority under Section 13(d)(1)(J) of the BHC Act to exclude those activities from the Fund Restrictions.[16]

LENDING AND CREDIT EXTENSION

The Proposed Rule addresses lending by exempting from the Fund Restrictions funds that are issuers of asset-backed securities whose assets are solely comprised of loans and related assets.[17] In doing so, the Agencies have paid heed to the statutory language, legislative history and FSOC Study, which acknowledge the importance of allowing banking entities to maintain their lending activities.[18] However, we believe that the Agencies have carved out a narrow exemption that does not go far enough. The Proposed Rule's definition of "covered fund" should be modified to provide an appropriate and unambiguous exclusion for "loan funds"[19] that invest predominantly in loans with a long-term investment objective (which we refer to as "credit funds"). If the Agencies fail to do so, they risk shutting down a valuable source of stable credit to the economy.

Restricting banking entities' ability to use credit funds would arbitrarily limit lending activities on the basis of structure rather than function. Credit funds are simply vehicles that provide the same type of credit that banking entities are already authorized to extend from their own balance sheets. They serve as a stabilizing force in the credit markets, in part due to their structure as partnerships that are not susceptible to bank runs. In fact, the structure of credit funds promotes the safety and soundness of individual banking entities and the broader financial sector, in ways that traditional lending cannot.

Credit funds:

a) can tap into a broader and deeper pool of funding for lending, including institutional investors and foreign capital that would not otherwise be available in the U.S. lending market;

b) can reduce overall risk by allowing banking entities to pre-syndicate lending exposures *before* loans are made, rather than after, as in the case of balance sheet lending. Like securitizations, credit funds reduce the concentration of risk and spread risk outside the regulated banking sector. Unlike securitizations, credit funds do not require a continual source of third-party funding and are thus a more stable source of credit;

c) promote and protect the safety and soundness of the banking system and the financial stability of the United States, as well as bring financing to the U.S. economy. Because they have long-term

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[16] We note that the Agencies stated in the Preamble that loan securitizations will "promote and protect the safety and soundness of a banking entity, and would also promote and protect the financial stability of the United States." NPR at 68914.

[17] This includes contractual rights or assets directly arising from those loans, and interest rate or foreign exchange derivatives materially related to the terms of such loans, rights or assets that are used to hedge the securitization structure itself. Section __.13(d); Section __.14(a)(2)(v) of the Proposed Rule.

[18] *See supra* note 3.

[19] In Question No. 312, the Agencies specifically asked whether "loan funds" should be excluded from the definition of "covered fund." NPR at 68915.

investment objectives and significant committed capital to build their portfolios, they have the ability to continue to extend credit during times of distress and volatility. Credit funds increase liquidity and stability in the financial markets when other financing and syndication markets are not available or functioning properly.[20] By their very nature, credit funds are counter-cyclical and are not susceptible to a run on banks; and

d) are professionally managed and adhere to strong underwriting standards. As a result, credit funds tend to be selective when acquiring assets and aim to hold them to maturity. Credit fund managers have "skin in the game," aligning the sponsoring banking entity's interests with those of the fund's investors.[21]

We propose that the Agencies exclude credit funds that meet the criteria described in Annex A, or substantively similar criteria, from the definition of "covered fund."[22] The criteria we propose are intended to ensure that credit funds engage in traditional lending activity, do not employ excessive leverage and promote the safety and soundness of the sponsoring bank. Annex A discusses how our proposed criteria are designed to meet these goals.

We also recommend that the Agencies clarify that the term "loan," for purposes of credit funds, encompasses all types of extensions of credit that banks have traditionally been able to undertake under their lending authority, including notes and bonds, and not merely the leases, receivables and extensions of credit that are specifically mentioned.[23]

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[20] For example, when global leveraged lending and high yield issuance declined by 71% in 2008, credit funds sponsored by Goldman Sachs increased their lending by 49%. Since the credit crisis began, credit funds sponsored by Goldman Sachs have extended over $16 billion in credit. This funding provided alternative sources of credit when traditional securitizations were not available and traditional balance sheet lending was dislocated, and it allowed U.S. businesses to tap into meaningful financing from foreign investors.

[21] As a general matter, institutional investors will not make a meaningful investment in a credit fund unless the sponsor also has a meaningful investment in the fund.

[22] Given the rule of construction in Section 13(g)(2) of the BHC Act, we believe that the statute *mandates* that the Agencies use their exemptive authority under Section 13(d)(1)(J) of the BHC Act to exclude credit funds from the definition of "covered fund." If the Agencies choose not to exclude credit funds from the definition of "covered fund," we recommend that the Agencies confirm explicitly that credit funds fall under the exemption for issuers of asset-backed securities. Additionally, we encourage the Agencies to state in the adopting release that the way credit funds are typically structured is consistent with the definition of "asset-backed security" in Section 3(a)(77) of the Securities Exchange Act of 1934. Any other interpretation would raise significant issues with respect to activities that the SEC has already said fit squarely within the "asset-backed security" definition (for example, automobile loan and credit card vehicles that issue trust certificates).

In addition, if the Agencies do not exclude credit funds from the definition of "covered fund," we also believe that the Agencies have the authority to (and should) exempt credit funds from the application of "Super 23A."

[23] The Agencies state in the Preamble that "the proposed definition of loan is expansive, and includes a broad array of loans and similar credit transactions …" NPR at 68865. Historically, banking entities have had the authority to hold fixed-income notes or bonds pursuant to their general lending powers. *See e.g.*, OCC Interpretive Letter No. 930, at 4 (Mar. 11, 2002) ("[A] national bank may purchase and hold debt securities … as loans under its general lending powers."). Dodd-Frank does not disturb this power. Instead, Dodd-Frank confirms it. *See* Section 13(g)(2) of the BHC Act.

The Proposed Rule also impinges on banking entities' lending ability because of its over-broad definition of the term "banking entity." As written, any company in which a banking entity acquires a controlling interest in satisfaction of debts previously contracted ("DPC Companies")—that is, through the traditional practice of foreclosing on a defaulted secured loan—would itself become a "banking entity." To prevent the parent banking entity from violating the Volcker Rule, the DPC Company would need to bring its own operations into compliance. This could significantly impede lending by reducing the value of the collateral, potentially to zero. DPC Companies are not part of a banking entity's operational structure, and applying the Volcker Rule to them would disrupt the secured lending market without furthering the Volcker Rule's objectives.[24] We believe the Agencies should explicitly exclude DPC companies from the definition of "banking entity."[25]

ASSET MANAGEMENT

A. Foreign Funds

We are concerned that the Agencies have exceeded their statutory authority and competitively disadvantaged U.S. banking entities' asset management businesses through their overbroad definition of which foreign funds should be "covered funds." The Proposed Rule's definition of "covered fund" extends to "[a]ny issuer … that is organized or offered outside of the United States that would be a covered fund … were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States…."[26] This definition could capture many foreign funds that are not at all similar to traditional hedge funds and private equity funds, including mutual fund equivalents, such as UCITS,[27] and that do not pose the risks that the Volcker Rule is meant to address.[28]

Accordingly, we recommend that the Agencies narrow the scope of "covered funds" to include only those foreign funds that are truly similar to hedge funds and private equity funds and that have the essential statutory characteristics of funds offered and sold in the United States under Section 3(c)(1) or

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[24] Nothing in Dodd-Frank or its legislative history suggests that Congress intended to limit banking entities' ability to lend, to take collateral of any kind, or to realize on collateral by foreclosure. In fact, the numerous accommodations for lending in Section 13 of the BHC Act suggest that Congress intended the contrary.

[25] As discussed in the Introduction, we believe that the Agencies have the authority to exclude DPC Companies from the definition of "banking entity."

[26] Section __10(b)(1)(iii) of the Proposed Rule.

[27] Funds offered under the Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive are permitted to be marketed within all countries that are member states of the European Union.

[28] We believe that the Agencies have gone beyond the statute, which authorizes them to designate as covered funds only "similar funds" to U.S. hedge funds and private equity funds. Presumably, the Agencies mean "similar funds," as used in Section 13(h)(2) of the BHC Act, to include foreign funds that, if organized or offered under the laws, or offered to one or more residents, of the United States, would typically be organized and offered pursuant to the exceptions in Section 3(c)(1) or 3(c)(7) of the 1940 Act. As the Proposed Rule is drafted, however, it appears that it will apply to many other types of foreign funds that are subject to regulation in their home jurisdictions or, more generally, any foreign fund that, by its characteristics, would be an "investment company" but would not rely on the exceptions under Section 3(c)(1) or 3(c)(7).

3(c)(7) of the 1940 Act.[29] Specifically, a foreign fund would not be a covered fund if it: (i) has engaged, or commits to engage within a year from the date of establishment, in a public offering of its securities to investors; (ii) will redeem its investors' holdings at least monthly; and (iii) is regulated pursuant to the laws of an Organization for Economic Co-Operation and Development ("OECD") jurisdiction, a country where there is a "designated offshore securities market" or any other country designated by the Agencies. The final rule should also expressly state that foreign funds that are not covered funds under this standard should not become covered funds due to secondary sales or the relocation of any investor to the United States.

Without modification, the Proposed Rule could sweep in established and regulated funds in foreign jurisdictions, causing U.S. banking entities to incur unnecessary and substantial expense in restructuring these funds to bring them into conformance. For example, Goldman Sachs would need to rebrand our roughly 500 established funds so as not to "share a name," to reissue the funds' securities and to amend operational documents and contracts. Beyond being a significant expense for us and time-consuming for our clients, this would seriously harm existing franchise value for no discernible benefit. It would also place us and other U.S. banking entities at a competitive disadvantage relative to our foreign counterparts, which face no such regulations or restrictions.

B. Commodity Pools

Similarly, the Agencies have taken a far too expansive approach to commodity pools. The Proposed Rule's definition of "covered fund" extends to all "commodity pools" as they are defined in the Commodity Exchange Act (the "CEA"). While the Agencies may have intended to capture only funds that are principally invested in commodities and derivatives, they have gone farther and potentially subjected funds that make even incidental investments in such instruments—and even companies that fall outside the definition of "investment company"—to the Volcker Rule. Treating these companies as covered funds would also inappropriately extend the Volcker Rule beyond the financial sector without contributing in any meaningful way to its stability. We do not believe this is what Congress intended.

The issue lies in the sweeping definition of "commodity pools." The CEA defines this term to include any investment trust, syndicate or similar form of enterprise that is "operated for the purpose of trading in commodity interests," and the CFTC has at times interpreted the term "commodity interest" very expansively.[30] Thus, the Proposed Rule's scope could encompass registered mutual funds, exchange traded funds, banks and bank holding companies, investment companies that qualify for exemptions other than Section 3(c)(1) or 3(c)(7) of the 1940 Act, and even non-financial companies that fall outside the

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[29] If the Agencies determine to treat inappropriately captured foreign funds as permissible covered funds, they should also exempt such funds from application of "Super 23A." Foreign funds that do not have the essential characteristics listed above should also be excluded from the definition of "banking entity" to the extent they are "affiliates" of banking entities.

[30] *See, e.g.*, CFTC Interpretive Letter No. 98-68 (Sept. 18, 1998) ("[T]here is currently no exception to the obligation to register as a [commodity pool operator] based on the fact that a fund makes only *de minimis* investments in commodity interests, regardless of whether these investments are made for speculative or bona fide hedging purposes, are solely incidental to the securities trading of the fund or whether the general purpose and intent of the fund is to engage primarily in securities transactions."); CFTC Interpretive Letter No. 98-26 (Apr. 7, 1998).

definition of "investment company," if they trade in "commodity interests."[31] It is not apparent how a commodity pool, without further explanation, can be "similar" to an issuer that would be an investment company under the 1940 Act but for Section 3(c)(1) or 3(c)(7) of that Act, or to hedge funds or private equity funds.[32] Although some commodity pools may resemble hedge funds or private equity funds, it is not the case that *all* of them do.

As such, the Agencies should clarify that only commodity pools that are primarily engaged in trading commodity interests will be treated as similar funds.[33] Additionally, a commodity pool that is also an SEC-registered investment company should be expressly excluded from the definition of "covered fund."[34] At a minimum, the Agencies should clarify that engaging in incidental investments in futures, options on futures, commodity options, swaps and certain other instruments would not cause an entity to become a "covered fund."

C. Non-Covered Funds and Permissible Covered Funds

Under the Proposed Rule, banking entities may invest in both non-covered funds (entities that do not fall within the definition of "covered fund") and permissible covered funds (covered funds that the Proposed Rule exempts from the Fund Restrictions) without the restrictions that are applicable to covered funds organized and offered under Section __.11. As part of our asset management business, we routinely sponsor entities like these, such as bank collective trusts, real estate lending vehicles and credit funds. Clients rely on us to provide them with professional asset management services through these types of funds. The Proposed Rule will curtail our asset management business if non-covered funds and permissible covered funds are not excluded from the definition of "banking entity."[35]

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[31] For example, an energy company that has significant hedges against the risk of changes in oil prices could become a covered fund.

[32] Section 13(h)(2) of the BHC Act only permits the Agencies to designate as covered funds "similar funds" to hedge funds and private equity funds. Because the Agencies have the flexibility to designate the scope of this designation, we think it is important that they explain and justify the scope of their decision.

[33] We understand that other commenters, such as SIFMA, are proposing that the Agencies modify the scope of commodity pools that are designated as "similar funds" to include only those entities that are primarily engaged in trading commodity interests and meet several other conditions, and we support this proposal. In the alternative, we offer a proposal that is based only on whether the entity is primarily engaged in trading commodity interests.

As with foreign funds, if the Agencies determine to treat inappropriately captured commodity pools as permissible covered funds, they should also exempt such funds from application of "Super 23A."

[34] We believe this treatment is consistent with Rule 4.5 under the CEA, which excludes from the definition of the term "commodity pool operator" any person sponsoring a registered investment company. Such entities should also be excluded from the definition of "banking entity" to the extent they are "affiliates" of banking entities.

[35] We note that the definition of "banking entity" under the Proposed Rule expressly excludes covered funds permissibly organized, offered and held under Section __.11 of the Proposed Rule (or any entity controlled by such a covered fund). Section __.2(e)(4). This clarification of the statute was intended to avoid "internal inconsistencies in the statutory scheme" by subjecting these funds, established for client asset management purposes, to the Volcker Rule as banking entities. NPR at 68855. The same logic applies for non-covered funds and permissible covered funds that are established for asset management purposes. We also note that the Preamble (but not the Proposed Rule) states that these permissible covered funds are not included in the definition of "banking entity." *Id.*
(footnote continued)

Under the Proposed Rule, any non-covered fund or permissible covered fund that is an "affiliate" of a banking entity would become a banking entity, subject to the Volcker Rule.[36] Such treatment would subject these entities to the proprietary trading prohibition and prohibit these funds from investing in other funds and from conducting ordinary course operations, such as incidental short-term trading for risk management or funding purposes—both of which are critical for their safe operation. For example, under the Proposed Rule, bank collective trusts would be prohibited from buying and selling securities. As such, this treatment would undermine the exclusions or exemptions that have been provided by the Agencies or by statute.[37] Moreover, such a designation would add considerable compliance costs to their operations, for no obvious benefit. We believe that the Agencies should expressly exclude non-covered funds and permissible covered funds from the definition of "banking entity."

In the case of many non-covered funds, it is important to note that these are client investment vehicles in which the parent banking entity has made no or only a *de minimis* investment, and we do not believe that these entities are a means for evasion by the parent banking entity.[38] If particular concerns remain about evasion by non-covered funds in which a parent banking entity has made more than a *de minimis* investment, we propose that such non-covered funds be required to commit affirmatively not to engage in proprietary trading, other than as an incident to their core activities,[39] if they are to be excluded from the definition of "banking entity."[40] This would seem to be an effective and less costly way of ensuring

(*footnote continued*)

at 68855. We believe both the adopting release and the final rule text should be consistent and exclude non-covered funds and permissible covered funds from the definition of "banking entity."

As discussed in the Introduction, we believe that the Agencies have the authority to exclude non-covered funds and permissible covered funds from the definition of "banking entity."

36 For example, these entities would be "affiliates" if the general partner or managing member of the fund is a banking entity.

37 For example, the Proposed Rule expressly permits banking entities to sponsor and invest in funds for risk-mitigating hedging purposes, issuers of asset-backed securities, bank-owned life insurance investments and certain activities and investments solely outside the United States. *See* Sections __.13(a) –(d) and Section __.14(a) of the Proposed Rule. Given the Agencies' recognition of these entities' beneficial role and the desirability of permitting banking entities to invest in them, they should expressly exclude permissible covered funds from the definition of "banking entity."

38 Permissible covered funds are also not a means of evasion of the Volcker Rule, as the Agencies have already laid out conditions they deemed necessary to permit those activities.

39 If this condition is adopted, the Agencies must recognize that applying the Volcker Rule's proprietary trading restrictions to these non-covered funds requires additional guidance as to what would constitute prohibited proprietary trading.

40 The Agencies could go further by also requiring that (i) losses in non-covered funds are borne solely by fund investors and not by the banking entity (except to the extent of the banking entity's economic exposure to the fund), (ii) the banking entity does not guarantee the obligations of such funds, and (iii) transactions between a banking entity and a non-covered fund must be conducted on an arm's-length basis.

that entities that are legally and substantively distinct from hedge funds and private equity funds do not pose the concerns that the Volcker Rule is intended to address.[41]

In addition, because of the importance of permissible covered funds for client asset management services, the Agencies should use their authority to exempt these entities from "Super 23A," the application of which may otherwise render the exemptions from the Fund Restrictions meaningless.[42]

DISRUPTIONS TO THE STRUCTURE AND OPERATIONS OF BANKING ENTITIES

A. Wholly-Owned Subsidiaries and Joint Ventures

Under the Proposed Rule, banking entities' interactions with "covered funds" are severely restricted in terms of investment, sponsorship, and, in the case of sponsored or advised funds (along with funds controlled by such funds), the imposition of "Super 23A." Yet the statutory definition of "covered fund" is extremely broad and extends to banking entities' wholly-owned subsidiaries and joint ventures, which are not, in operation and form, like hedge funds or private equity funds.[43]

The Agencies recognized that the definition of "covered fund" would inappropriately capture common corporate structures and accordingly exempted a subset of wholly-owned subsidiaries from this definition.[44] They also created an exemption for joint ventures that are "operating company[ies]" and that do not engage in any activity or any investment prohibited under the Volcker Rule.[45]

However, both of these exemptions are drawn too narrowly. As a result, they impose restrictions that will undermine banking entities' organizational structure and operational flexibility, again with no incremental benefits to safety and soundness. As such, the Agencies should consider using their statutory authority to exclude all wholly-owned subsidiaries and controlled joint ventures from the definition of "covered funds," and modify the exemption for joint ventures in the manner we discuss below.[46]

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[41] We believe that Section 13(d)(1)(J) of the BHC Act provides ample authority to exclude non-covered funds from the definition of "banking entity" and that permitting banking entities to continue to operate entities that are not subjected to the Fund Restrictions will promote safety and soundness and financial stability.

[42] As discussed in the Introduction, we believe that the Agencies have the authority to exempt permissible covered funds from the application of "Super 23A."

[43] A global banking entity may have thousands of these entities (we alone have more than 3,000 wholly-owned subsidiaries), which help banking entities operate efficiently across different jurisdictions, and legal, tax and regulatory regimes.

[44] *See* NPR at 68913 ("[W]ithout this exemption, many entities would be forced to alter their corporate structure without achieving any reduction in risk.").

[45] Section __.14(a)(2)(i) of the Proposed Rule.

[46] As discussed in the Introduction, we believe that the Agencies have the authority to exclude wholly-owned subsidiaries and controlled joint ventures from the definition of "covered fund."

1. Wholly-owned subsidiaries

The exemption for wholly-owned subsidiaries is limited to those that are engaged principally in performing bona fide liquidity management activities and that are carried on the banking entity's balance sheet.[47] In reality, only a very small number of wholly-owned subsidiaries would satisfy this requirement. The vast majority, which have nothing in common with hedge funds or private equity funds, and which by definition have no unaffiliated investors, would be "covered funds" because they would be ineligible for this narrow exemption.

By carving the exemption so narrowly, the Proposed Rule would effectively prohibit banking entities from forming and owning wholly-owned subsidiaries. The Proposed Rule will require banking entities to engage in burdensome and costly ongoing reviews to determine which of their wholly-owned subsidiaries fall within the definition of "covered fund." This would require a determination of whether a wholly-owned subsidiary is an "investment company" and, if so, whether it would qualify for exceptions under the 1940 Act other than Section 3(c)(1) or 3(c)(7). Because the 1940 Act analysis is highly fact-intensive, this will require continual monitoring of each and every wholly-owned subsidiary,[48] without any benefits to safety and soundness.

The need to exclude the full range of wholly-owned subsidiaries from the definition of "covered fund" becomes all the more apparent when we consider the application of "Super 23A." Wholly-owned subsidiaries are also "banking entities" under the Proposed Rule, meaning that they pose no risk of evasion. Yet "Super 23A" could prohibit a banking entity from financially supporting its wholly-owned subsidiaries. It would even go as far as prohibiting two wholly-owned subsidiaries that are both "covered funds" from trading with or lending to each other. These illogical results undermine banking entities' organizational structure and ordinary operations without improving safety and soundness. Therefore, the Agencies should exclude all wholly-owned subsidiaries from the definition of "covered fund."[49]

2. Joint ventures

The Agencies should also exclude controlled joint ventures from the definition of "covered funds." Like wholly-owned subsidiaries, controlled joint ventures fall within the definition of "banking entity" under the Proposed Rule, and should pose no risk of evasion. Also like wholly-owned subsidiaries, they would suffer from the interplay between the definitions of "banking entity" and "covered fund" and the restrictions

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[47] Section __.14(a)(2)(iv) of the Proposed Rule. In addition, the Proposed Rule provides an exemption for acquisition vehicles whose sole purpose is to effectuate a transaction involving the acquisition or merger of one entity with or into the banking entity or its affiliate. Section __.14(a)(2)(ii) of the Proposed Rule. These exemptions will not be necessary if investments in wholly-owned subsidiaries are made generally permissible by excluding, as we suggest, all such entities from the definition of "covered fund."

[48] The banking entity would be required to monitor the percentage of investment securities held by each wholly-owned subsidiary, along with the principal activities of these subsidiaries.

[49] The Agencies should not limit the exclusion to those wholly-owned subsidiaries in which a banking entity holds all of the outstanding securities. Issuance of debt to third parties is a key component of the financing of many of these entities and should not preclude exclusion from the definition of "covered fund." If the Agencies were concerned that a wholly-owned subsidiary was being operated as a "covered fund" in violation of the Fund Restrictions, they could use their broad anti-evasion authority under Section 13(e)(2) of the BHC Act.

of "Super 23A." Once again, the limits on banking entities' structure and operational flexibility do not generate any commensurate public benefit.

In addition to exempting controlled joint ventures from the definition of "covered funds," the Agencies should revise the exemption for joint ventures in the Proposed Rule.[50] Currently, the exemption is limited to joint ventures that are "operating compan[ies]" and that do not engage in any activity or any investment prohibited by the Volcker Rule. We believe this exemption is too narrow, failing to give any meaningful effect to the legislative history that the Agencies specifically cited in the Preamble,[51] and failing to recognize how joint ventures operate.

The "operating company"[52] qualification is neither relevant nor helpful. Banking entities organize and invest in many joint ventures that may not be "operating companies," such as those that acquire non-performing loans, credit card receivables, consumer loans, commercial real estate loans or automobile loans. These joint ventures promote safety and soundness by allowing a banking entity to limit the size of its exposure to permissible investments or to transfer the risk of existing assets.

The operating company requirement should therefore be replaced[53] with a test that more accurately distinguishes a joint venture from a hedge fund or private equity fund. Such a test could include indicators such as whether: (i) there are a limited number of unaffiliated partners;[54] (ii) the parties operate the venture on a joint basis or in proportion to their relative ownership, including pursuant to a shareholders' agreement; (iii) material decisions are not made by one party (for example, a general partner); and (iv) the joint venture does not engage in any activity or investment not permitted under the Proposed Rule, other than activities or investments incidental to its permissible business.[55]

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[50] It would be contrary to Congressional intent for the Agencies to interpret and apply the joint venture exemption based on a narrow qualification and thus not apply it to all appropriate joint ventures, including those that make investments. *See* Himes-Frank colloquy *supra* note 12.

[51] *See* NPR at 68913 (citing Himes-Frank colloquy).

[52] We note that the term "operating company" is not defined in the Proposed Rule or in federal banking law or regulation. The concept does appear in the Federal Reserve's Regulation K, Regulation U and Regulation Y, but the term is not defined. *See* 12 C.F.R. § 211.23; 12 C.F.R. § 221.124; 12 C.F.R. § 225.173.

[53] If the operating company concept is to be kept at all, it should be clarified that the joint venture entity itself need not be an operating company if the operating company is held directly or indirectly by the joint venture entity. Otherwise, the exception would not allow intermediate entities formed for unrelated tax, regulatory, accounting or risk management purposes to qualify for the exemption.

[54] We do not think it is necessary to set a specific number in light of the suggested requirement that the parties operate the venture on a joint basis. This requirement distinguishes the joint venture partners from passive investors in a hedge fund or private equity fund.

[55] To give meaning to this exemption, it is important that the Agencies allow a joint venture the flexibility to engage in incidental activities that might be prohibited under the Volcker Rule without requiring the joint venture to constantly review whether such activities comply with the technical requirements of the various permitted activities under the Volcker Rule. Such a requirement, or a requirement that a joint venture (that is not a banking entity) not engage in *any* activity or investment not permitted under the Proposed Rule, is not practical and may have adverse economic consequences. Non-banking entity investors in a joint venture would be less willing to accept partners that are banking entities, as this would effectively impose the Volcker Rule on the joint venture. If a banking entity does invest in a joint venture, both it and the joint venture company will face a significantly increased regulatory and

(footnote continued)

In summary, we believe that the Agencies should use their statutory authority to avoid significant disruptions to banking entities by expressly excluding both wholly-owned subsidiaries and controlled joint ventures from the definition of "covered fund"[56] and by modifying the "operating company" requirement as detailed above.

B. Merchant Banking Portfolio Companies

Banking entities are permitted to buy and sell portfolio companies under their merchant banking authority. These portfolio companies sit outside a banking entity's core businesses, and a banking entity is not permitted to manage them, even if the banking entity may "control" the company under the BHC Act.[57] Under the Proposed Rule, however, a merchant banking portfolio company that is controlled by a banking entity would itself be deemed a "banking entity." This is not consistent with Federal Reserve practice under the BHC Act.

Treating portfolio companies as banking entities would inappropriately extend the Volcker Rule beyond the financial sector and would impose a significant compliance regime on non-financial firms. It could also limit the ability of merchant banking portfolio companies to manage risk and obtain funding; in particular, it might deter them from accepting capital from or transacting with U.S. banking entities, which would restrict an important source of capital for U.S. businesses. We believe that this would harm safety and soundness and financial stability. Therefore, the Agencies should use their exemptive authority to exclude merchant banking portfolio companies from the definition of "banking entity."[58]

C. Non-Covered Funds and Permissible Covered Funds

As discussed above in the context of asset management, the considerable restrictions of the Volcker Rule could also make it difficult or impractical for banking entities to conduct their normal operations by investing in, acquiring or operating non-covered funds and permissible covered funds. These restrictions would apply to the activities of such operational entities as non-controlled joint ventures as well as small

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(*footnote continued*)

compliance burden. In addition, consistent with Section 13(g)(2) of the BHC Act, joint ventures that exclusively hold investments that would qualify under the exemption for issuers of asset-backed securities should expressly be exempted even if they do not meet all of the foregoing qualifications.

[56] *See* FSOC Study, at 62; *see also* Himes-Frank colloquy, *supra* note 12. As discussed in the Introduction, we believe the Agencies are authorized to exclude wholly-owned subsidiaries and controlled joint ventures from the definition of "covered fund."

[57] Section 4(k)(4)(H) of the BHC Act and the Federal Reserve's related merchant banking regulations authorize financial holding companies to engage in the activity of investing in shares of companies not engaged in activities permissible under Section 4(k) in order to realize capital appreciation upon disposition of the investment. 12 C.F.R. § 225.170 et seq. These regulations require that merchant banking portfolio company investments be bona fide. Section 4(k)(4)(H)(ii) of the BHC Act "prevents the merchant banking authority from being used to engage in nonfinancial activities." *See* Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. 16460, 16463 (March 28, 2000). Section 4(k)(4)(H)(iv) of the BHC Act; 12 C.F.R. § 225.171(a). The Federal Reserve traditionally has not viewed merchant banking portfolio companies as BHC "affiliates" for purposes of activities restrictions and compliance and supervision.

[58] As discussed in the Introduction, we believe that the Agencies have the authority to exclude merchant banking portfolio companies from the definition of "banking entity."

business investment companies and certain investments that are designed primarily to promote the public welfare, including the welfare of low- and moderate-income communities or families. Given the Agencies' recognition of these funds' beneficial role and the desirability of permitting banking entities to invest in them,[59] the Agencies should not impose the substantial restrictions that apply to "banking entities" to these funds.[60] Instead, the Agencies should expressly exclude non-covered funds and permissible covered funds from the definition of "banking entity."[61]

In addition, the Agencies should use their authority to exempt permissible covered funds from "Super 23A," the application of which would otherwise render the exemptions from the Fund Restrictions meaningless.[62]

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[59] *See, e.g.*, NPR at 68913 ("[I]nvestments in [joint ventures] would … appear to promote and protect the safety and soundness of banking entities and promote and protect the financial stability of the United States."); *id.* at 68908 ("In addition to the acquisition or retention of an ownership interest, permitting a banking entity to act as sponsor to these types of public interest investments will provide valuable expertise and services to these types of entities, as well as help enable banking entities to provide valuable funding and assistance to small business and low- and moderate-income communities.").

[60] As discussed above, the Agencies could address any concerns of evasion by requiring non-covered funds to commit affirmatively not to engage in proprietary trading, other than as an incident to their core activities, and by requiring that (i) losses in non-covered funds are borne solely by fund investors and not by the banking entity (except to the extent of the banking entity's economic exposure to the fund), (ii) the banking entity does not guarantee the obligations of such funds, and (iii) transactions between a banking entity and a non-covered fund must be conducted on an arm's-length basis.

[61] As discussed in the Introduction, we believe that the Agencies have the authority to exclude non-covered funds and permissible covered funds from the definition of "banking entity."

[62] As discussed in the Introduction, we believe that the Agencies have the authority to exempt permissible covered funds from the application of "Super 23A."

CONCLUSION

We appreciate your consideration of our comments and suggestions on the Proposed Rule. We would be happy to provide any additional information or to discuss any of our comments and suggestions with the Agencies in more detail.

Sincerely,

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CREDIT FUNDS

As discussed in our comment letter, it is important that the Agencies continue to allow banking entities to engage in traditional lending activities through credit funds, which promote safety and soundness and provide an important source of credit to the broader economy. We understand that credit funds may have varying characteristics. In order to distinguish credit funds from entities that are appropriately captured by the Volcker Rule, we propose a framework to define the credit funds that should be excluded from the definition of "covered fund." We expect that the Agencies would adopt definitive quantitative thresholds or guidance, as they deem necessary and appropriate, for each of the criteria set forth below. We later discuss the rationale for each criterion in more detail and provide examples of what we believe could be appropriate thresholds.

Under this framework, an entity would be an excluded credit fund if it:

1. is predominantly engaged in originating loans and other extensions of credit or participates in the origination of loans by purchasing loans and other extensions of credit in debt originations;

2. commits to hold such instruments for a length of time sufficient to establish long-term investment intent (although it should also retain the ability to protect the fund's interests by disposing of a problem credit during that period);

3. does not, except in the management of a problem credit, purchase or sell synthetic securities (including total rate of return swaps or credit default swaps), or hedge or otherwise transfer the borrower's credit risk;

4. has sufficient equity capital contributed by its sponsoring banking entity to align the banking entity's interest with the other investors in the fund; and

5. is limited in the amount of leverage it employs.

Our framework also applies additional safeguards, as a condition to the exclusion from the definition of "covered fund," requiring that:

6. a banking entity sponsoring a credit fund will not, and will disclose to investors (and, if required, commit to the appropriate banking regulator) that it will not, guarantee the obligations of the credit fund or otherwise provide financial support or assistance to either investors in connection with their investment in the fund or to the fund itself;

7. the credit fund must follow prudent credit underwriting standards, real estate appraisal standards and other credit standards, such as diversification requirements and/or concentration limits, reasonably designed to ensure that the fund is operated in a safe and sound manner, which may include syndication of loans or other extensions of credit pursuant to item (1) above; and

8. the governing documents of the credit fund will include appropriate terms and other required criteria set forth in this framework.

DISCUSSION OF CREDIT FUND CRITERIA

The above criteria, which we now discuss in more detail, are provided with the recognition that our framework is but one way for the Agencies to continue to permit these important lending vehicles to operate. In any event, we hope that the principles we outline below will be useful to the Agencies as they determine the appropriate conditions to exclude credit funds from the definition of "covered fund."

The first three conditions are designed to help ensure that credit funds engage in traditional bank lending activity, which focuses on origination and participation in primary extensions of credit rather than purchases of loans in the secondary market. Risk in traditional lending is assessed through underwriting, a relationship with the borrower and the exercise of management discretion, rather than through analysis driven by market prices or other trading-directed analysis.

1. The credit fund is predominantly engaged in originating loans and other extensions of credit or participates in the origination of loans by purchasing loans and other extensions of credit in debt originations.

Condition 1 requires that a credit fund be predominantly engaged in traditional bank lending activity. By "predominantly engaged," we mean that a sufficiently high percentage of the credit fund's assets (such as 85%) are attributable to traditional, primary lending activity to demonstrate that such activities are the genuine purpose of the fund. Credit funds should be allowed to engage in some lending-related activities that go beyond strictly originating and participating in loans, so long as those activities are permissible for banking entities. For example, in some sectors, it is customary for banking entities (at the request of the borrower) to acquire an equity-like component in connection with the origination of a loan as additional compensation for the risk of the loan or to keep interest payments at a viable rate for the borrower. Banking entities should not lose the ability to engage in these permissible activities simply because the loan is made through a credit fund.

2. The credit fund commits to hold such instruments for a length of time sufficient to establish long-term investment intent (although it should also retain the ability to protect the fund's interests by disposing of a problem credit during that period).

Credit funds' long-term objectives promote and protect the safety and soundness of the banking system as a whole and the financial stability of the United States. Condition 2 therefore requires that loans generally be held for a sufficient period to demonstrate a long-term investment intent (such as two to three years) and that the loans are not bought and sold to realize price appreciation. We recognize that a banking entity could otherwise operate a credit fund like a hedge fund. The condition does allow a banking entity to dispose of problem credits during that period in order to minimize potential losses to the credit fund and thus enhance safety and soundness.

3. The credit fund does not, except in the management of a problem credit, purchase or sell synthetic securities (including total rate of return swaps or credit default swaps), or hedge or otherwise transfer the borrower's credit risk.

Condition 3, while allowing a sponsoring bank to hedge interest rate risk and foreign exchange risk and thereby support safety and soundness, ensures that the banking entity retains the credit risk and earns returns in exchange for that risk, and that it cannot hedge away credit risk in a way that could undermine financial stability. In contrast to some securitizations, in which the entire credit risk can be passed on to third parties, credit funds retain all the credit risk of the funds' loans. Because credit funds retain this risk, credit funds must adhere to strong underwriting standards and rely on the expertise of professional managers to manage the risk. As a result, they are very selective when acquiring assets.

Conditions 4-6 are designed to protect the safety and soundness of credit funds' sponsoring banking entities and to protect financial stability by aligning interests and limiting risk and leverage.

4. The credit fund has sufficient equity capital contributed by its sponsoring banking entity to align the banking entity's interest with the other investors in the fund.

Condition 4 requires a sufficient investment (such as a minimum of 5% of the credit funds' equity capital) by the sponsoring banking entity in order to align its interests with other investors in the credit fund ("skin in the game"). This condition provides further assurance that a credit fund could not follow an "originate-to-distribute" model that provides little accountability for the quality of its underwriting. This requirement is important not only to protect the safety and soundness of the sponsoring banking entity, but also to enable the credit fund to attract third-party funding. As a general matter, institutional investors will not make a meaningful investment in a credit fund unless the sponsor also has a meaningful investment in the fund. These investors prefer to lend alongside a regulated institution that commits its own funds, is subject to federal banking standards and has a relationship lending model.

5. The credit fund is limited in the amount of leverage it employs.

In contrast to collateralized debt obligations ("CDOs") and some hedge funds, credit funds typically employ modest amounts of leverage. Condition 5 imposes a limit (such as a 5:1 maximum leverage ratio) on the credit fund's leverage in order to protect investors, including the sponsoring banking entity, and should prevent unsafe and unsound balance sheet growth while mandating a minimum level of capital to absorb portfolio losses. We believe that the limit should be set below the leverage ratio of banking entities themselves, which are typically leveraged between 12:1 and 18:1. This condition addresses concerns that credit funds could pose excessive risk to the safety and soundness of the sponsoring banking entity or to the financial system generally.

6. A banking entity sponsoring a credit fund will not, and will disclose to investors (and, if required, commit to the appropriate banking regulator) that it will not, guarantee the obligations of the credit fund or otherwise provide financial support or assistance to either investors in connection with their investment in the fund or to the fund itself.

Condition 6 applies the "no bailout" provisions that are applicable to organized and offered funds under Section __.11 of the Proposed Rule, which we believe would be properly applied to credit funds. This condition mitigates the risk that a credit fund could jeopardize the safety and soundness of its sponsoring banking entity by exposing the banking entity to the fund's losses beyond those sustained directly because of the banking entity's investment in the fund.

7. The credit fund must follow prudent credit underwriting standards, real estate appraisal standards and other credit standards, such as diversification requirements and/or concentration limits, reasonably designed to ensure that the fund is operated in a safe and sound manner, which may include syndication of loans or other extensions of credit pursuant to item (1) above.

Condition 7 requires that credit funds adhere to prudent underwriting standards that are typical of the standards required of banks to engage directly in lending. These could also include conditions relating to active monitoring of loans and relationships and limits on the total number of loans and loans to one borrower (which should be consistent with the requirements applicable to the sponsoring banking entities themselves). Without these standards, a credit fund might be able to make riskier loans than a bank could make directly, which is not their purpose. Because credit funds are actively managed, the fund managers have the discretion to modify the terms of the credit and work out problem credits, offering flexibility to borrowers in periods of economic stress.

8. The governing documents of the credit fund will include appropriate terms and other required criteria set forth in this framework.

Finally, Condition 8 requires that credit funds' governing documents include the appropriate terms and other required criteria we have outlined in this framework. By mandating that credit funds be contractually obligated to adhere to these criteria, the condition ensures that the sponsoring banking entity will be accountable to fund participants as well as to regulators.