INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

October 17, 2018

Office of the Comptroller of the Currency
Legislative and Regulatory Activities Division
400 7th Street, SW, Suite 3E-218
Washington, DC 20219
Docket ID OCC–2018–0010

Securities and Exchange Commission
Brent J. Fields, Secretary
100 F Street, NE
Washington, DC 20549-1090
File No. S7–14–18

Board of Governors of the Federal Reserve System
Ann E. Misback, Secretary
20th Street and Constitution Avenue, NW
Washington, DC 20551
Docket No. R–1608; RIN 7100–AF 06

Commodity Futures Trading Commission
Christopher Kirkpatrick, Secretary
1155 21st Street, NW
Washington, DC 20581
RIN: 3038–AE72

Federal Deposit Insurance Corporation
Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
550 17th Street, NW
Washington, DC 20429
RIN: 3064–AE67

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

Dear Sirs and Mesdames:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposal

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[1] The Investment Company Institute (ICI) is the leading association representing regulated funds globally, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US$22.7 trillion in the United States, serving more than 100 million US shareholders, and US$7.3 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

("Proposal") issued by the above-listed agencies ("Agencies") to amend the regulations ("2013 Final Rule") implementing Section 13 of the Bank Holding Company Act ("BHC Act"), commonly known as the Volcker Rule.[2]

ICI's longstanding interest in the Volcker Rule and its implementing regulations stems, in part, from our members' role as major "buy side" participants in US and international financial markets on behalf of millions of fund investors. From this perspective, we have stressed the critical importance of resilient markets and have been sensitive to concerns about the impact of the Volcker Rule and 2013 Final Rule on market making-related activities. In congressional testimony last year, ICI observed:

> Many variables affect capital markets activity and the liquidity in those markets. Clearly, however, friction created by regulatory requirements that are overbroad or insufficiently tailored to achieve the desired objective is one such variable that can and does influence the ways in which various entities—including dealers and their trading partners such as funds—participate in the capital markets.[3]

In our view, it is entirely appropriate for the Agencies to consider how the 2013 Final Rule[4] could be revised to achieve the congressional objectives underlying the Volcker Rule without creating unnecessary "friction." Indeed, the 2013 Final Rule has been the subject of widespread criticism owing to, among other things, its breadth (including extraterritorial effects), complexity,[5] and

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[2] Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 83 Fed. Reg. 33432 (July 17, 2018).

[3] Testimony of David W. Blass, General Counsel, Investment Company Institute, before the US House of Representatives Committee on Financial Services, Subcommittee on Capital Markets, Securities and Investment, on Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation (March 29, 2017), available at https://www.ici.org/pdf/17_house_fsc_volcker.pdf, at 11 (footnote omitted).

[4] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5536 (Jan. 31, 2014).

[5] *See*, *e.g.*, Daniel K. Tarullo, Governor of the Federal Reserve System, Departing Thoughts at the Woodrow Wilson School, Princeton University (April 4, 2017) ("several years of experience have convinced me that there is merit in the contention of many firms that, as it has been drafted and implemented, the Volcker rule is too complicated. Achieving compliance under the current approach would consume too many supervisory, as well as bank, resources relative to the implementation and oversight of other prudential standards.").

ambiguity.[6] As the preamble to the Proposal notes, stakeholders have cited these characteristics of the rule as raising significant compliance challenges and concerns about unintended consequences.

ICI therefore commends the Agencies for publicly acknowledging concerns that "parts of the 2013 final rule may be unclear and potentially difficult to implement in practice" and for undertaking jointly this effort to improve it.[7] We support the broad objectives of the Proposal, including to simplify and tailor the 2013 Final Rule to allow banking entities to provide services to clients more efficiently. We urge the Agencies to evaluate carefully input from commenters to ensure that any final rule revisions—including changes affecting how banking entities demonstrate compliance with restrictions on proprietary trading—result in requirements that are appropriately targeted and workable.

In the remainder of this letter, we focus on issues that are of greatest concern to our membership and on which we have significant expertise—namely, issues involving US registered investment companies ("RICs") and similar funds organized outside the United States (which we refer to collectively as "regulated funds"). The preamble to the Proposal discusses a broad range of regulated fund issues under the 2013 Final Rule that ICI and other stakeholders have identified and poses numerous, detailed questions about how regulated funds and their sponsors/advisers have been affected and inquiries about possible solutions. We hope this thorough vetting evidences a willingness on the part of the Agencies to move forward with appropriate regulatory action that comprehensively addresses these issues.

We provide an executive summary of our comments below. In Section I of the letter, we describe five ways in which the 2013 Final Rule and related guidance (or lack thereof) impede the activities and investments of regulated funds. We then discuss our proposed solution for these issues and discuss the Agencies' legal authority to adopt the proposed solution. In Section II, we explain how certain aspects of the current "foreign public fund" exclusion from the definition of "covered fund" unduly constrain banking entities' ability to offer regulated funds in jurisdictions outside the United States, and we propose targeted revisions to address these concerns. Appendices A and B to the letter provide proposed rule text to implement our recommendations.

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[6] *See, e.g.*, Michael Bright, Jackson Mueller and Phillip Swagel, FinReg21: Modernizing Financial Regulation for the 21st Century, Milken Institute Center for Financial Markets (March 24, 2017) at 3, available at http://www.milkeninstitute.org/publications/view/853 ("For example, if a trader buys a 10-year corporate bond from a client, but cannot easily re-sell that bond and instead sells a 10-year Treasury—meaning the trader is long a corporate note and short the 10-year Treasury note. Is this a 'prop trade,' or is it simply appropriate risk management in a rapidly moving market? How long can the trader hold this position before it becomes a 'prop trade?' This is a simple trade but not a simple question in the context of the Volcker Rule. And yet it seems obvious that this series of events should constitute allowable market-making—the normal activity of a broker-dealer in carrying out trades for customers and offsetting the resulting risks on its own books—in today's financial markets.").

[7] 83 Fed Reg. at 33434.

Executive Summary

Congress enacted the Volcker Rule to restrict banks from using their own resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain transactions or relationships. To accomplish these goals, the Volcker Rule prohibits banks and their affiliates (referred to as "banking entities") from engaging in "proprietary trading." The Volcker Rule also generally prohibits banking entities from sponsoring or investing in hedge funds, private equity funds, or other similar funds (referred to as "covered funds"), vehicles that, unlike RICs, are excluded from SEC regulation as investment companies. In the 2013 Final Rule, the Agencies appropriately excluded RICs from the definition of covered fund. They also sought to provide a corresponding exclusion for similar funds organized outside the United States.

Unfortunately, the 2013 Final Rule nonetheless gives rise to several issues for the global regulated fund industry, including that some regulated funds became subject to the restrictions of the Volcker Rule. Some (but not all) of the issues are the subject of guidance in the preamble to the 2013 Final Rule, Agency staff responses to frequently asked questions ("FAQs"),[8] and the preamble to the Proposal. To alleviate these concerns in a more effective and complete manner than current interpretive relief—while also fully effectuating Congress's intent—we strongly encourage the Agencies to revise the 2013 Final Rule. Our recommendations would help fulfill the Agencies' stated desire, through this rulemaking, "to provide banking entities with greater clarity and certainty about what activities are permitted."[9]

The rule changes we propose would:

- *Avoid impeding the activities and investments of regulated funds.* The current lack of sufficient exclusions for regulated funds and their activities leaves open the possibility that such a fund could be deemed to be a "banking entity" and thus subject to the full panoply of trading and investment restrictions in the Volcker Rule. This is an untenable result, and one that is directly at odds with the intent of Congress.

- *Eliminate unnecessary constraints on banking entities' ability to offer regulated funds in jurisdictions outside the United States.* In contrast to the exclusion for RICs, the "foreign public fund" exclusion from the definition of "covered fund" is available only to regulated non-US funds that adhere to certain additional conditions, including regarding their distribution. These conditions are at odds with the Agencies' intent to treat regulated non-US funds in a manner similar to RICs and to limit the extraterritorial application of the Volcker Rule.

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[8] The FAQs are available at https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

[9] 83 Fed. Reg. at 33434.

We strongly urge the Agencies to resolve regulated fund issues through formal rule changes, which provide greater certainty and permanence than Agency or staff guidance. Recent Agency statements highlighting the differences between supervisory guidance and rules reinforce our strong preference for rule changes.[10]

Discussion

I. Avoid Impeding the Activities and Investments of Regulated Funds

The Volcker Rule's prohibition on proprietary trading and restrictions on activities involving hedge funds and private equity funds apply to "banking entities." A regulated fund would fall within the definition of "banking entity" if it were deemed an affiliate of a banking entity. In that event, the fund itself would be subject to the trading and investment restrictions in the Volcker Rule.

Treatment as a banking entity is entirely unworkable because a regulated fund's normal business activities (purchasing and selling securities for the fund's portfolio) could be deemed to fall within the broad definition of prohibited "proprietary trading."[11] In addition, some regulated funds—pursuant to their stated investment objectives and policies and in accordance with applicable regulation—invest in covered funds.

From the outset, ICI has urged the Agencies to ensure that the regulations implementing the Volcker Rule avoid this result—a result that is clearly at odds with congressional intent. We have consistently advocated for express exclusions for RICs and for regulated funds organized outside the United States (referred to in the 2013 Final Rule and preamble to the Proposal as "foreign public funds," or FPFs) from the definition of banking entity.[12] We continue to believe that such

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[10] *See* Interagency Statement Clarifying the Role of Supervisory Guidance (Sept. 11, 2018), available at https://www.federalreserve.gov/supervisionreg/srletters/sr1805a1.pdf (noting that "[u]nlike a law or regulation, supervisory guidance does not have the force and effect of law" but rather "outlines the agencies' supervisory expectations or priorities and articulates the agencies' general views regarding appropriate practices for a given subject area").

[11] The preamble to the Proposal asserts that "[t]hese disruptions would arise *because many funds' investment strategies involve proprietary trading prohibited by the 2013 final rule*." 83 Fed. Reg. at 33443 (emphasis added). We disagree with this characterization because, as discussed below, we do not believe that the normal business activities of regulated funds should be deemed to constitute "proprietary trading" as envisioned by either the statute or the 2013 Final Rule.

[12] *See* Letters to the Agencies from ICI and ICI Global, dated Feb. 13, 2012. The ICI Letter is available at https://www.ici.org/pdf/25909.pdf and the ICI Global Letter is available at https://www.iciglobal.org/pdf/12_icig_volcker.pdf. *See also* Letter to the OCC from ICI, dated September 21, 2017 (responding to the OCC's request for public input on how the 2013 Final Rule and its administration may be improved), available at https://www.ici.org/pdf/30882a.pdf ("2017 ICI Letter to OCC").

exclusions are the most straightforward and comprehensive solution, and correspond most closely to congressional intent. Nonetheless, we recognize that there may be other paths to avoid inappropriate application of the Volcker Rule to a regulated fund conducting its business in the ordinary course.

This rulemaking provides an excellent opportunity for the Agencies to resolve these issues. In the sections that follow, we outline why this is necessary and how it can be achieved. In Section A, we describe the ways in which regulated funds have been negatively impacted by the lack of an express exclusion for their activities and investments from the Volcker Rule. Section B discusses our recommended solutions. Section C discusses the Agencies' legal authority to adopt such solutions.

A. How Lack of a Permanent Solution to the "Banking Entity" Issue Negatively Affects Regulated Funds[13]

Regulated funds are negatively affected in at least five ways, only two of which are addressed by the staff FAQs. The five are: fund seeding; fund terminations; sponsor investment after the initial seeding period; investments in covered funds; and the corporate governance structures of FPFs. We discuss each in turn.

1. Fund seeding

During a seeding period when a banking entity sponsor is attempting to launch a new regulated fund, the sponsor could be considered to control the fund if its seed investment gives the sponsor a 25 percent or greater ownership position in the fund. In this event, the fund itself would come within the Volcker Rule definition of a banking entity.[14] Since development of the 2013 Final

[13] The discussion in this section responds to Questions 13-15 in the preamble to the Proposal.

[14] The preamble to the 2013 Final Rule discusses Federal Reserve precedent indicating that a bank holding company will not be considered to control a mutual fund solely by virtue of organizing, sponsoring, and managing the fund. *See* 79 Fed. Reg. at 5676. It also cites precedent allowing bank holding companies and financial holding companies to hold 25 percent or more of a RIC's voting shares for a limited period (six months for bank holding companies and one year for financial companies), subject to additional conditions, without being deemed to control the fund. *See id*. at 5676 nn. 1736, 1739.

Rule, the Agencies have been aware of the Volcker Rule uncertainties that regulated funds face during their initial seeding periods, which have been well documented by ICI and others.[15]

FAQ 16 provided much needed relief for regulated fund seeding—just before the compliance date for the 2013 Final Rule. Nevertheless, the phrasing of the FAQ sparked some uncertainty because it could be read to suggest that, in the ordinary course, a three-year seeding period may be the maximum allowed.[16] As a result, some industry participants were uncertain about longer seeding strategies, which may be necessary and common for certain types of regulated funds. Based on our members' experience, the length of fund seeding periods can vary significantly due to various factors, including many that are beyond their control (*e.g.*, customer demand, market conditions, investment strategies falling in or out of favor). For this reason, it is important to provide flexibility and not advisable to prescribe a maximum length of time for seeding.

In the preamble to the Proposal, the Agencies clarify that FAQ 16 was not intended to establish three years as the maximum permissible seeding period for a regulated fund.[17] We appreciate this clarification and welcome the Agencies' broader endorsement of the relief provided in this and other FAQs pertaining to regulated funds. But the upshot is that those wishing to determine how the Volcker Rule applies to seeding of regulated funds now must consult at least three sources: the preamble to the 2013 Final Rule; FAQ 16; and the preamble to the Proposal. The preamble language would be of little use in the event of a future decision to withdraw the FAQs because it does not stand on its own. And, as the Agencies recently have reminded us, none of these expressions of Agency or staff views has the force and effect of law.[18] Thus, the status quo leaves regulated funds with an imperfect solution to their concerns and continues to underscore the necessity of a comprehensive solution.

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[15] *See, e.g.*, Letter to The Honorable Janet Yellen, Chair, The Federal Reserve System, from Paul Schott Stevens, President & CEO, ICI, dated June 1, 2015 ("2015 ICI Letter to FRB Chair"); 2017 ICI Letter to OCC, *supra* note 12; Letter to the Agencies from the European Fund and Asset Management Association (EFAMA), dated October 16, 2014; Letter to Anna Harrington, Senior Supervisory Financial Analyst, Board of Governors of the Federal Reserve System, from George C.W. Gatch, Managing Director, CEO – Global Funds Management & Institutional, J.P. Morgan Asset Management, dated April 6, 2018 ("JPMAM letter"), available at https://www.federalreserve.gov/SECRS/2018/August/20180810/R-1608/R-1608_072518_132550_454131919446_1.pdf.

[16] It states, in relevant part, that "the staffs of the Agencies understand that the seeding period for an entity that is a RIC or FPF may take some time, for example, three years, the maximum period expressly permitted for seeding a covered fund under the implementing rules."

[17] *Id.* at 33443 (stating that "[t]he FAQ recognizes that the length of a seeding period can vary and therefore provides an example of 3 years…without setting any maximum prescribed period for a [regulated fund] seeding period").

[18] *See supra* note 11.

2. *Fund terminations*

Just as fund sponsors routinely seek to launch new regulated funds to meet investor needs and preferences, so too do fund sponsors routinely close or reorganize RICs or FPFs. This can occur for a variety of legitimate business reasons (*e.g.*, inability to attract or maintain sufficient assets, departure of a key portfolio manager, merger with or acquisition of a fund adviser offering similar funds, poor investment performance).

When a RIC does need to liquidate, it adheres to requirements in the Investment Company Act of 1940 (the "Investment Company Act") and other relevant laws, including approval by the RIC's board of directors and board oversight of the liquidation process.[19] Regulated funds in non-US jurisdictions similarly conduct liquidations (or mergers) under an established and orderly process.[20]

As unaffiliated investors redeem their shares (as may occur after the announcement of a plan to liquidate the fund), a regulated fund's sponsor or adviser may find itself holding a greater than 25 percent ownership interest in the fund. In that event, forcing the sponsor or adviser to reduce or withdraw its investment—to avoid having the fund become subject to the Volcker Rule as a "banking entity"—could harm the interests of remaining unaffiliated investors. For example, it could necessitate sales of fund portfolio securities at inopportune times and sub-optimal prices and increase expenses for the remaining investors. Further, in the case of a RIC, sales of portfolio securities to redeem the sponsor or adviser could result in increased taxable capital gain distributions to the remaining investors, as the tax law would require the fund to distribute any capital gains realized inside the portfolio.

Permitting a regulated fund's sponsor or adviser to maintain its investment would allow for a more orderly process to dispose of the fund's assets for the benefit of remaining unaffiliated investors and would benefit remaining unaffiliated investors further by spreading fixed fund

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[19] *See* ICI paper, *"Orderly Resolution" of Mutual Funds and Their Managers* (July 2014), available at https://www.ici.org/pdf/14_ici_orderly_resolution.pdf.

[20] For a description of the orderly liquidation procedures of UCITS, for example, *see* ICI Letter to the Secretariat of the Financial Stability Board, dated May 29, 2015, available at https://www.ici.org/pdf/15_ici_fsb_comment.pdf, at 31-32. *See also* Board of the International Organization of Securities Commissions, *IOSCO Report on Good Practices for the Termination of Investment Funds, Final Report* (November 2017), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD588.pdf (stating that "IOSCO recognises the importance for investment funds to have termination procedures in place from an investor protection perspective. For this reason, IOSCO's Committee on Investment Management…has developed a set of good practices for the termination of investment funds which take into account investors' interests during this process."). These IOSCO "good practices" are part of the body of detailed policy work that informs IOSCO's common principles for public investment funds discussed further below. *See infra* notes 69 through 71 and accompanying text.

expenses over a larger base. This temporary elevated ownership interest in a regulated fund during its termination period should not raise any concerns under the Volcker Rule. Yet, unlike in case of fund seeding, the Agencies (or their staffs) have not addressed this issue, even through FAQs.

3. Sponsor investment after the initial seeding period

As investment products designed to help investors meet a broad range of financial goals, regulated funds come in many different flavors. What is common to all such funds is that their ability to thrive is closely tied to the movements of the markets in which they invest, the level of customer demand for the fund's investment strategy, and sufficient access to channels for distributing the fund to unaffiliated investors.

Consequently, at times after its initial seeding period, a regulated fund might experience a reduction in its assets under management ("AUM") for a variety of reasons. For example, changes in the market value of the fund's portfolio holdings or a large individual redemption or series of smaller redemptions by fund investors might cause a decrease in AUM. Or, a trading or distribution platform could decide to drop a fund from its featured offerings, which likewise could cause the fund to shrink (or vice versa). In addition, markets ordinarily go in cycles during which some types of investments or strategies may fall in or out of favor, leading to fluctuations in fund AUM.

Redemptions by fund investors or other situations involving a decrease in AUM could cause a regulated fund's AUM to fall below a minimum threshold, *e.g.*, for investment by institutional investors under their own investment criteria or for the fund to qualify for inclusion on a given trading or distribution platform. Even in the absence of fund investor redemptions, a fund may find that it is too small to qualify for inclusion on a particular distribution platform—which inclusion would allow the fund to attract additional investors.

These circumstances often will prompt a banking entity sponsor to reevaluate the long-term prospects for the fund—such as whether the fund's investment strategy is still worthwhile even if out of favor for the moment—and possibly weigh whether it should take steps toward closing (*i.e.,* liquidating or merging) the fund. After conducting such an evaluation, the sponsor might reasonably conclude that it is appropriate temporarily to (1) maintain an ownership interest of 25 percent or more of a regulated fund's voting shares due to actions by others, or (2) increase its investment in a regulated fund to 25 percent or more of the fund's voting shares.

A decision to commit resources in this manner would not be made lightly. Rather, the sponsor would reach its decision based on fiduciary, business, and other considerations, including, for example, that its ownership interest in the fund is appropriate:

- to mitigate potential negative effects of significant redemptions on remaining unaffiliated investors, such as: reduced diversification of assets due to sales of portfolio securities; a higher and potentially uncompetitive expense ratio; or undue concentration of remaining investors (which could disqualify the fund for investment by institutional investors);

- to seek to avoid disqualification of, or re-qualify, the fund for inclusion on trading or distribution platforms (disqualification would significantly reduce the ability to maintain and grow fund assets going forward); or

- to maintain fund AUM at or above the level needed to qualify for investment by institutional investors or other clients that have minimum fund AUM requirements.

The sponsor's investment in these circumstances is not unlike an initial seed investment in the fund, in that it signifies a degree of confidence in the long-term potential of the fund to be commercially viable, based on numerous factors such as demand from unaffiliated investors, market conditions, and access to distribution channels. It is *not* a "bailout" intended to support the fund's net asset value.[21]

In short, maintaining or increasing the sponsor's investment on a temporary basis can make sense as a business matter. It also can benefit existing unaffiliated investors, including by helping assure that the fund remains viable while the sponsor seeks to attract new unaffiliated investors. As in the case of fund seeding, this can take some time. Yet, unlike in the case of initial seeding, the Agencies have not addressed this issue.

4. *Investments in covered funds*

As the Agencies recognized in the preamble to the 2013 Final Rule, some RICs invest in derivatives through a wholly-owned subsidiary (commonly referred to as a controlled foreign corporation, or "CFC"). A CFC typically is organized in the Cayman Islands and may be structured as an investment company exempt from registration in reliance on section 3(c)(1) or 3(c)(7) of the Investment Company Act—making it a covered fund. The use of this structure benefits RIC shareholders by allowing the RIC to qualify for favorable tax treatment for income earned through derivatives trading.

[21] For a detailed discussion of why regulated funds do not pose significant "step-in risk," *see* ICI Global Letters to the Basel Committee on Banking Supervision ("BCBS"), dated March 17, 2016 (available at https://www.iciglobal.org/pdf/29778.pdf) and May 15, 2017 (available at https://www.iciglobal.org/pdf/30705a.pdf)(responding to BCBS consultations on the identification and measurement of step-in risk).

5. *FPF corporate governance structures*

In addition to facing the seeding and other situations described above that can raise "banking entity" issues for all regulated funds, many FPFs face additional "banking entity" concerns due to their corporate governance structures. FPFs often have corporate governance structures or relationships with their sponsor that the BHC Act would view as involving control of a fund by its banking entity sponsor, which would make the fund a banking entity.[22] As with fund seeding, the Agencies have been aware of these concerns since the development of the 2013 Final Rule[23] and—just before the July 2015 compliance date for the 2013 Final Rule—the Agency staffs issued FAQ 14 to provide relief.

In the preamble to the Proposal, the Agencies indicate that "nothing in the [Proposal] would modify the application of the staff FAQs discussed above [which include FAQ 14], and the agencies will not treat…FPFs that meet the conditions included in the applicable staff FAQs as banking entities or attribute their activities and investments to the banking entity that sponsors the fund or that otherwise may control the fund under the circumstances set forth in the FAQs."[24] We regard this clarification as helpful, but we believe this language is emblematic of the need for the Agencies to adopt a permanent solution to avoid future uncertainty. Once again, regulated funds and their banking entity sponsors will need to rely on relief spread among multiple sources and of a less authoritative nature than formal rules. In the context of FPFs, a rule-based solution is all the more desirable, as it would give greater assurances to foreign regulators, and greater clarity and certainty to foreign banking entities, as to the extraterritorial reach of the Volcker Rule.

B. Proposed Solution to the "Banking Entity" Issue for Regulated Funds[25]

Although greatly welcomed, the FAQs are an imperfect and incomplete solution. They interpret but do not alter the legal requirements of the 2013 Final Rule—an approach that can cause

[22] For example, the sponsor might select a majority of the fund's directors or trustees. Unlike for RICs, the preamble to the 2013 Final Rule gives no assurances that an FPF generally will not be considered an affiliate of its banking entity sponsor. Nor does the 2013 Final Rule address the issue of seeding FPFs.

[23] *See, e.g.,* 2015 ICI Letter to FRB Chair, *supra* note 15.

[24] 83 Fed. Reg. at 33444. The preamble makes the same point about the FAQs for RICs and the relief extended to foreign excluded funds. *See id*. (stating that "to accommodate the pendency of the proposal, for an additional period of one year until July 21, 2019, the Agencies will not treat qualifying foreign excluded funds…as banking entities or attribute their activities and investments to the banking entity that sponsors the fund or otherwise may control the fund under the circumstances set forth in the policy statement" released by the FRB, FDIC and OCC on July 21, 2017). We note that the appropriate treatment under the Volcker Rule for foreign excluded funds is beyond the scope of this letter.

[25] The discussion in this section responds to Question 17 in the preamble to the Proposal.

needless confusion and is subject to change without the procedural protections that formal rulemaking provides.[26]

As already noted, ICI continues to believe that expressly excluding RICs and FPFs from the definition of banking entity is the most straightforward and comprehensive path for the Agencies to follow in addressing the concerns outlined above. Such exclusions best effectuate the intent of Congress that the Volcker Rule should not apply to regulated funds. Moreover, such exclusions are consistent with Agency positions as reflected in the preamble to the 2013 Final Rule, the staff FAQs, and statements in the preamble to the Proposal.

Nevertheless, we are aware that the Agencies may have reservations about following such a path. For that reason, there could be an alternative—one that would exclude activities of RICs and FPFs during certain timeframes, and subject to appropriate conditions, from the definition of "proprietary trading" and the restrictions that apply to banking entities' investments in "covered funds." The exclusions generally would cover:

- *A seeding period.* The proposed exclusions would require that the fund be operated pursuant to a written plan to test the fund's investment strategy, establish a track record of the fund's performance for marketing purposes, and attempt to distribute the fund's shares.

- *A termination period*. The proposed exclusions would require that the fund be operated pursuant to a written plan to dispose of the fund's assets in an orderly manner.

- *Other temporary instances in which a banking entity sponsor might own 25 percent or more of a regulated fund's voting shares.* The proposed exclusions would require the fund's banking entity sponsor to: (1) determine that maintaining such an ownership interest is necessary to permit the fund to continue to attract unaffiliated investors; (2) reduce its ownership below 25 percent within a reasonable period, not to exceed two years; and (3) maintain supporting documentation.

Further, to address the additional "banking entity" concerns that arise for many FPFs because of their corporate governance structures, the proposed exclusions would cover FPFs that meet specified conditions based on FAQ 14.

[26] As noted above, the Agencies recently released statements highlighting that guidance and staff statements do not have the force and effect of law. *See supra* note 4.

In Appendix A, we provide proposed rule text to accomplish these purposes. We believe our recommendations, if implemented, would be helpful in several respects.

First, there would be greater certainty regarding seeding practices. To launch new regulated funds, bank-affiliated advisers require certainty that they will be able to avail these funds of a sufficient seeding period. The formal rule changes we propose would provide the clarity and certainty regarding regulated fund seeding that piecemeal guidance lacks. Our approach also is consistent with a goal of the Proposal described in the preamble, which is "to codify or otherwise address matters currently addressed by staff responses to [FAQs]."[27] Our proposed rule language tracks the description of a seeding period in FAQ 16 and would permit the multi-year seeding periods the Agencies have confirmed FAQ 16 was intended to accommodate.[28]

We note that, to allow fund seeding, the Agencies also will need to modify or abandon the proposed new accounting prong in the definition of "trading account" (a key element of the definition of proprietary trading). The proposed accounting prong would capture seed investments in regulated funds, as such investments typically are recorded at fair value under applicable accounting standards.[29] The proposal does not include an exemption or exclusion from the proprietary trading prohibition for such seed investments; accordingly, the proposal effectively would prohibit seed investments in regulated funds. Such a result would directly conflict with the determination by the Agencies to permit and accommodate such seed investments, as reflected by the language in the 2013 preamble, FAQs issued by the Agencies, and the statements made by the Agencies in the preamble to the Proposal.[30]

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[27] 83 Fed. Reg. at 33436.

[28] *See supra* note 18.

[29] Even if a banking entity does not record seed investments at fair value, we believe the proposed accounting prong still presents issues. For example, if banking entities apply different accounting treatment to seed investments, different Volcker Rule outcomes may result for the same investing activity. Further, if a banking entity is able to choose whether to record a seed investment at fair value, we believe the proposed accounting prong would discourage the discipline and prudent risk management associated with recording the investment at fair value, because such a decision would subject their seed investment to the proprietary trading prohibition (assuming some type of exclusion or exemption is available).

[30] *See, e.g.*, 79 Fed. Reg. at 5676 (describing relevant Federal Reserve Board precedent); FAQ 14 (acknowledging that a banking entity may own, control or hold the power to vote more than 25% of the voting shares of a foreign public fund during a seeding period); FAQ 16 ("staff of the Agencies would not advise the Agencies to treat a RIC or FPF as a banking entity solely on the basis of the level of ownership of the RIC or FPF by a banking entity during a seeding period or expect an application to be submitted to the Board to determine the length of the seeding period"); 83 Fed. Reg. at 33443-44 (noting that the staffs did not set "any maximum prescribed period for a RIC or FPF seeding period" in the FAQs and indicating that "nothing in the [Proposal] would modify the application of the staff FAQs").

Second, our proposals address other temporary situations that should not raise Volcker Rule concerns. As noted above, the guidance in FAQ 16 is limited to regulated fund seeding. Our proposal would extend to other instances during a regulated fund's life cycle when a banking entity sponsor may own a substantial portion of the fund for a temporary period. These instances would include a termination period, so that the sponsor can unwind the fund in an orderly manner. In addition, the exclusion would be available in the event of a decrease in AUM of a fund that, in the sponsor's judgment, nevertheless has promising long-term prospects.

Finally, our proposals would facilitate regulatory oversight. We are unaware of any evidence of banking entities using regulated funds to evade the restrictions of the Volcker Rule. Moreover, applicable legal and regulatory requirements make this a remote risk. In any event, the Agencies have ample tools to address any individual cases of evasion, including under other provisions of the BHC Act, which would remain in place. Still, to provide additional assurances to the Agencies and facilitate regulatory oversight, the conditions of our proposed exclusions from the "proprietary trading" definition and "covered fund" restrictions would include documentation requirements.[31] This documentation would be available for inspection/examination by the relevant Agency.

C. Legal Authority for the Proposed Solution

We begin from the well-established premise that the Volcker Rule was not intended to apply to regulated funds in the first instance.[32] The Volcker Rule therefore should not impede the normal business activities of regulated funds. These activities include investing in securities and other financial instruments in accordance with stated investment policies to pursue stated investment objectives on behalf of fund investors—all subject to comprehensive investor protection regulation.

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[31] To be eligible for the exclusions during a fund seeding period, the fund would have to be "operated pursuant to a written plan to test the fund's investment strategy, establish a track record of the fund's performance for marketing purposes, and attempt to distribute the fund's shares." Similarly, in the context of a fund termination, the fund would have to be "operated pursuant to a written plan to dispose of the fund's assets in an orderly manner." In other temporary situations, a fund's sponsor or adviser would have to maintain documentation describing (1) the basis for its determination that its maintaining its 25 percent or greater ownership position is necessary to permit the fund to continue to attract unaffiliated investors, and (2) how it expects to reduce its level of ownership below 25 percent within a reasonable period, not to exceed two years. *See* Appendix A. We suggest that the documentation should not have to follow any prescribed format; it can consist of any written evidence that supports the sponsor's determination and need not require the creation of a new document just for this purpose.

[32] In the preamble to the 2013 Final Rule, the Agencies recognized that Congress was "concerned about banking entities' exposure to and relationships with funds that explicitly are *excluded* from SEC regulation as investment companies." 79 Fed. Reg. at 5698-99.

The ways in which our members have been affected by the Volcker Rule are unintended consequences of the 2013 Final Rule and, therefore, the Agencies can and should resolve regulated fund issues by modifying the 2013 Final Rule. While we continue to believe that excluding such funds from the definition of "banking entity" would be the best and most expedient way to proceed, we have developed the approach set forth in Appendix A as a more narrowly targeted alternative. The proposed approach is consistent with the policy judgments the Agencies have expressed in FAQs 14 and 16, and reaffirmed in the preamble to the Proposal, indicating that the Agencies will not treat RICs and FPFs that meet certain conditions as banking entities or attribute their activities and investments to the banking entity that sponsors or may otherwise control the fund under the circumstances set forth in the FAQs.

Proposed Exclusion from "Proprietary Trading" Definition. We recommend that the Agencies adopt a provision that would, in the prescribed circumstances described above, exclude purchases and sales of any financial instrument by a regulated fund from the definition of proprietary trading.

In crafting our recommendation, we look to the 2013 Final Rule, which contains nine separate exclusions for various types of trading activities that the Agencies have concluded do not constitute "proprietary trading" as defined by the statute. Four of these provisions were first proposed by the Agencies in 2011, and the other five were added to the 2013 Final Rule in response to public comments.

The preamble to the 2013 Final Rule explains each of these exclusions, offering various policy rationales to support the various exclusions. For example, the Agencies explain that the exclusion in Section 3(d)(1) for repurchase and reverse repurchase arrangements and securities lending reflects the fact that these agreements "operate in economic substance as secured loans and do not in normal practice represent proprietary trading."[33] The exclusion for liquidity management activities in Section 3(d)(3) permits positions taken "for the purpose of *bona fide* liquidity management, subject to certain requirements"[34] and the preamble description cites the "important prudential purpose"[35] of liquidity management activity. And, the exclusion for transactions by derivatives clearing organizations and clearing agencies is justified in part by the fact that it prevents the rule from "inadvertently hindering the Dodd-Frank Act's goal of promoting central clearing of financial transactions."[36] This demonstrates that the Agencies have

[33] *Id*. at 5552.

[34] *Id*. at 5554.

[35] *Id*. at 5555.

[36] *Id*. at 5556.

flexibility to interpret "proprietary trading" as appropriate to permit transactions that do not raise the concerns that the Volcker Rule seeks to address.

The exclusion in Section 3(d)(8) for purchases or sales through a deferred compensation or similar plan may be instructive. The preamble to the 2013 Final Rule explains that the lack of such an exclusion "would have restricted a banking entity's ability to engage in principal-based trading as an asset manager that serves the needs of the institutional investors, such as through ERISA pension and 401(k) plans."[37] It further notes that "the Agencies believe that purchases and sales by a banking entity when acting through pension and deferred compensation plans generally occur on behalf of beneficiaries of the plan and consequently do not constitute the type of principal trading that is covered by the statute."[38]

We believe a similar rationale should extend to purchases and sales of any financial instrument by regulated funds, in the circumstances and subject to the conditions in our proposed exclusion. Like deferred compensation plans, regulated funds are "established and administered in accordance with the laws of the United States or a foreign sovereign."[39] And, as with deferred compensation plans, the purpose of a regulated fund's portfolio trading activity—including during the periods specified in our proposed exclusion—is to support a customer-facing asset management business (such as establishing a track record for the fund to attract unaffiliated investors).

The Agencies have signaled their willingness to consider additional exclusions from the definition of proprietary trading. We note that the Proposal would add a further exclusion for trades to correct errors, such as when an erroneous execution occurs on behalf of a client. The Agencies explain in the preamble to the Proposal that such error trade transactions "do not appear to be the type of transaction the statutory definition of 'proprietary trading' was intended to cover. In particular, these transactions generally lack the intent described in the statutory definition of 'trading account' to profit from short-term price movements."[40]

For all of these reasons, the Agencies can and should exercise their authority to determine that the activities of regulated funds, under the prescribed conditions of our proposed exclusion

[37] *Id*. at 5558.

[38] *Id*.

[39] *Id*.

[40] 83 Fed. Reg. at 33452.

described above, do not involve proprietary trading as defined by the statute or the 2013 Final Rule.[41]

Proposed Exclusion from "Covered Fund" Restrictions. Similarly, the Agencies should exercise their authority to determine that the regulated fund activities encompassed by our proposed exclusion would not involve the type of investing that the Volcker Rule was intended to prohibit. As with proprietary trading, the Agencies already have identified four exclusions from the covered funds prohibitions, including a corresponding exclusion for deferred compensation and similar plans. The Agencies explained that these exclusions were appropriate because the activities that they encompass do not involve banking entities engaging in the type of covered fund activities that the Volcker Rule was designed to address.[42] We respectfully submit that the same rationale applies to the purchase of covered fund interests by regulated funds.

If the Agencies proceed in the manner we recommend above, it will not be necessary to use the Agencies' authority in section 13(d)(1)(J) of the BHC Act to deem the regulated fund activities at issue to be "permitted activities."[43]

II. Eliminate Unnecessary Constraints on Banking Entities' Ability to Offer Regulated Funds in Jurisdictions Outside the United States

As originally proposed, the definition of "covered fund" was exceedingly broad. The Agencies recognized this potential overreach and sought to adopt "a tailored definition" that would focus on "vehicles used for the investment purposes that were the target of [BHC Act Section 13]"—namely, hedge funds and private equity funds.[44] The 2013 Final Rule includes several express exclusions from the definition of covered fund, which "are designed to provide certainty, mitigate compliance costs and other burdens, and address the potential over-breadth of the covered fund

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[41] *See* 79 Fed. Reg. at 5546 (noting that "to respond to concerns raised by commenters while remaining consistent with Congressional intent," the Agencies provided in the 2013 Final Rule "that certain purchases and sales are not proprietary trading").

[42] *Id*. at 5668 ("Because these activities do not involve the banking entity engaging in an activity intended or designed to take ownership interests in a covered fund as principal, they do not appear to be the types of activities that section 13 of the BHC Act was designed to address.").

[43] *Id.* at 5553 (discussing exclusions from the definition of proprietary trading and stating that "[b]ecause the Agencies do not believe these excluded activities involve proprietary trading, as defined by the statute and final rule, the Agencies do not believe it is necessary to use our exemptive authority in section 13(d)(1)(J) of the BHC Act to deem these activities a form of permitted proprietary trading.").

[44] *Id*. at 5671.

definition and related requirements ...."[45] Responding to comments from ICI[46] and other stakeholders, the Agencies provided one such exclusion for non-US funds publicly offered to retail investors outside the United States.

The preamble to the Proposal cites the Agencies' statement that the "foreign public fund" exclusion "is designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of [the Volcker Rule], including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States."[47] The preamble also notes the Agencies' view at the time that it was appropriate to exclude foreign funds meeting the requirements of the exclusion "because they are sufficiently similar to U.S. RICs."[48]

The Agencies currently request comment on whether the existing exclusion for foreign public funds "is effective in identifying foreign funds that may be sufficiently similar to RICs and permitting U.S. banking entities and their foreign affiliates to carry on traditional asset management businesses outside of the United States...."[49] We believe that the Agencies crafted the existing exclusion more narrowly than necessary to achieve these goals by requiring that:

> (1) a non-US fund be authorized to offer and sell ownership interests to retail investors in its home jurisdiction;
>
> (2) ownership interests in the fund be sold predominantly through one or more public offerings outside of the United States; and
>
> (3) ownership interests in a non-US fund sponsored by a US banking entity be sold predominantly to unaffiliated parties.

These three conditions of the exclusion make it more difficult for the asset management affiliates of US banking entities to offer retail investment vehicles in the same manner and to the same extent as their peers in foreign banking organizations and firms that are not affiliated with banks. Creating such competitive imbalances clearly was not a result that Congress intended when it enacted the Volcker Rule. In addition, in contrast to the intent expressed in the Preamble, some non-US funds that closely resemble US RICs may not be able to rely on the exclusion.

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[45] *Id*. at 5677.

[46] ICI Global Letter, *supra* note 12, at 5-7.

[47] 83 Fed. Reg. at 33473 n.159; *see also* 79 Fed. Reg. at 5678.

[48] 83 Fed. Reg. at 33473; *see also* 79 Fed. Reg. at 5678.

[49] 83 Fed. Reg. at 33473.

Below, we explain why each of these conditions is unduly restrictive. We then propose targeted revisions to the foreign public fund exclusion that are designed to achieve the Agencies' regulatory goals without placing unnecessary constraints on the ability of banking entities to offer regulated funds in jurisdictions outside the United States.

A. Why Certain Conditions of the Existing Foreign Public Fund Exclusion Are Unduly Restrictive

a. "Home Jurisdiction" Requirement

Under the current exclusion, a "foreign public fund" must be "authorized to offer and sell ownership interests to retail investors in the [fund's] home jurisdiction."[50] There are, however, many valid business reasons for organizing a fund in one jurisdiction and then selling its shares primarily, or even exclusively, in other jurisdictions—for example, more favorable tax treatment, or flexibility to distribute a single fund into multiple markets. In fact, organizing and distributing regulated funds in this manner is common practice in many markets.

As noted in Question 145 in the preamble to the Proposal, for example, a fund established pursuant to the Undertakings for Collective Investment in Transferable Securities ("UCITS") Directive may be organized in one jurisdiction in the European Union, such as Ireland or Luxembourg, but offered and sold in one or more other EU member states.[51] UCITS are widely recognized as the European counterpart to RICs. The UCITS regime, which has been in place for three decades, provides "a harmonised retail fund regime suitable for sale to the retail market within the EU on a cross-border basis."[52] This is facilitated by the "product passport," which enables fund sponsors to create a single product for the entire EU rather than having to establish an investment fund product on a jurisdiction-specific basis.[53]

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[50] 2013 Final Rule § _.10(c)(1)(C). The preamble to the Proposal notes the Agencies' understanding that banking entities generally interpret the reference to the issuer's home jurisdiction to mean the jurisdiction in which the fund is organized. *See* 83 Fed. Reg. at 33474.

[51] 83 Fed. Reg. at 33474.

[52] A brief guide to marketing investment funds in the EU, by Derbhil O'Riordan, *Dillon Eustace*, 1 May 2017, at https://uk.practicallaw.thomsonreuters.com/6-577-8426?transitionType=Default&contextData=(sc.Default)&firstPage=true&comp=pluk&bhcp=1.

[53] *Id.*

In some cases, a UCITS may not be actively marketed in the jurisdiction in which it is organized. Ireland and Luxembourg are popular hubs for UCITS creation,[54] but each local market is not large enough to support the offer and sale of all UCITS organized there. Or, a UCITS may be organized in one of those jurisdictions but designed for offer and sale through a particular retail channel (*e.g.*, Germany, France, United Kingdom).[55]

UCITS are an attractive investment vehicle not only in the European Union but across the globe. For more than two decades, fund sponsors have actively promoted UCITS outside of the European Union. As of June 2017, roughly 47% of assets under management in UCITS are denominated in a currency other than Euros, indicating that UCITS are widely distributed beyond the Eurozone.[56] Also as of June 2017, an estimated €3.3 trillion in assets (equivalent to US$3.8 trillion, and representing about 36 percent of total UCITS assets) are managed by UCITS that are authorized by at least one regulator outside the European Economic Area for distribution outside the European Union.

Issues with the "home jurisdiction" requirement also arise outside Europe. It is common to organize funds in the Cayman Islands for distribution to retail investors in various jurisdictions in Asia.[57] For example, a significant number of Cayman unit trusts are publicly offered and sold to retail investors in Japan. These funds are registered as "exempt trusts" under Cayman law for tax purposes, and that status is conditioned on a declaration from the trustee that there will be no unitholders resident or domiciled in the Cayman Islands (except in certain limited circumstances). Instead, the Cayman-registered trust is authorized for public offer and sale in

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[54] *See* L. Christopher Plantier, Globalisation and the Global Growth of Long-Term Mutual Funds, ICI Global Perspective (March 2014) at 10, available at https://www.iciglobal.org/pdf/icig_per01-01.pdf (explaining that "[c]ross-border funds tend to be domiciled in countries with the most favourable business environments for establishing, servicing, and distributing funds throughout the world. These environments can include certain legal or tax withholding advantages available in a given country. The quality of a country's workforce and the efficiency and legal expertise embedded in the regulatory approval process for cross-border funds also have been cited as key factors influencing the choice of cross-border funds domiciliation (Lang and Schafer 2013). Ireland and Luxembourg are the two most prominent domiciles for cross-border funds."). In 2012, the two jurisdictions accounted for 86 percent of cross-border fund registrations worldwide. *Id.* at 11.

[55] For example, a banking entity may organize UCITS in Luxembourg for one or more other EU banks to distribute publicly to that bank's client base in the bank's home jurisdiction.

[56] Source: Investment Company Institute tabulations of Morningstar Direct data.

[57] *See, e.g.*, JPMAM letter, supra note 15, at 9 (citing the example of a fund domiciled in the Cayman Islands for offer and sale to retail investors in both Hong Kong and Singapore). Such a fund would be authorized in each jurisdiction, subject to the obligations imposed by the regulator in that regime. The regulations imposed will be similar, but not identical, to those of locally domiciled funds.

Japan, and Japanese investors will be entitled to the protections afforded by the laws and regulations of Japan.[58]

b. *"Predominantly Through One or More Public Offerings Outside of the United States" Requirement*

To qualify as a "foreign public fund" under the current exclusion, the fund's ownership interests must be sold predominantly through one or more public offerings outside of the United States.[59] By this, the Agencies "generally expect that an offering is made predominantly outside of the United States if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States."[60] This requirement is contrary to the Agencies' stated objective of "treat[ing] foreign public funds consistent with similar U.S. funds" because the exclusion for RICs places no conditions on their distribution.[61] Indeed, as ICI and others have noted, a RIC is free to sell its shares primarily, or even exclusively, through non-public offerings.[62]

The "predominance" requirement also presents considerable compliance challenges. Distribution of retail fund products often depends on intermediaries or other third parties. For this reason, as the Agencies note, fund sponsors often find it difficult if not impossible to identify a fund's underlying investors—much less determine, with any degree of certainty, the residency status of most of a fund's investors.

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[58] It is our understanding that Japanese law requires these trusts to be registered under the Investment Trust & Investment Company Act as "foreign investment trusts," and the securities offered by the trusts are filed in accordance with the Financial Instruments & Exchange Act. This is similar to the process for US RICs (*i.e.*, registration of the fund under the Investment Company Act and the securities the fund issues under the Securities Act of 1933).

[59] 2013 Final Rule § _.10(c)(1).

[60] 79 Fed. Reg. at 5678.

[61] In Question 141 in the preamble to the Proposal, the Agencies ask whether it is appropriate to exclude RICs from the definition of "covered fund" regardless of how their ownership interests are sold. *See* 83 Fed. Reg. at 33473. The answer is yes, and the reason why should be clear—Congress intended the Volcker Rule to apply to investment funds that are explicitly excluded from regulation under the Investment Company Act

[62] The preamble to the 2013 Final Rule asserted that a fund that "purports to publicly offer its shares but in fact offers on a more limited basis may be less likely to resemble a RIC." 79 Fed. Reg. at 5678. This misperception may have contributed to the overly narrow approach in the current FPF exclusion.

c. "Predominantly to Persons Other Than" Affiliated Parties Requirement

If the fund's sponsor is a US banking entity, the fund can qualify for the foreign public fund exclusion only if its ownership interests are sold "predominantly" to unaffiliated parties.[63] This would require the fund sponsor, for example, to track—and possibly limit—investments in the fund by its directors and employees. The Agencies adopted this restriction on the theory that foreign public funds sponsored by US banking entities "may present heightened risks of evasion."[64] The preamble to the 2013 Final Rule presented no compelling rationale, however, for why potential sales of a comprehensively regulated non-US fund to affiliated persons raises such strong evasion concerns. The predominance restriction, moreover, strikes us as inconsistent with the regulation of RICs in the United States, where the SEC views the ownership of fund shares by the portfolio manager, for example, in positive terms.[65]

In the preamble to the Proposal, the Agencies inquire whether this "predominance" restriction has resulted in the same types of compliance challenges as the "sold predominantly in one or more public offerings outside of the United States" requirement discussed above. Our members indicate that it has. Indeed, in some cases, fund sponsors have adopted restrictions prohibiting directors and employees from investing in regulated non-US funds because it is not possible to get accurate information on director and employee holdings from intermediaries in a timely manner. Such restrictions are at odds with a general expectation at some firms and in some markets that if a fund is established for retail distribution, employee investments should be encouraged.[66]

B. Targeted Revisions to the Foreign Public Fund Exclusion Are Warranted

In the subsections below, we explain how targeted revisions to the current exclusion would more accurately identify the types of non-US funds that should be considered "sufficiently similar" to RICs and thus appropriately excluded from the definition of "covered fund" under the Volcker Rule. A markup showing our suggested revisions to the current exclusion is provided in Appendix B.

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[63] *See id*. (explaining that "the Agencies generally expect that a foreign public fund will satisfy this additional condition if 85 percent or more of the fund's interests are sold to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity").

[64] *Id*. at 5679.

[65] *See* SEC, Disclosure Regarding Portfolio Managers of Registered Management Investment Companies, 69 Fed. Reg. 52788, 52792 (Aug. 27, 2004) (observing that disclosure of a portfolio manager's ownership provides "a direct indication of his or her alignment with the interests of shareholders in that fund.").

[66] Employee investments, similar to portfolio manager investments favored by the SEC, constitute a direct indication of alignment with the interests of unaffiliated fund shareholders.

In developing our recommendations, we considered carefully our members' experience with the current exclusion, as discussed above. We also have endeavored to be responsive to questions and concerns raised in our interactions with staffs of the Agencies, including concerns about the potential for evasion.

a. *Removal of the "Home Jurisdiction" Requirement*

We agree with the Agencies that a "foreign public fund" needs to be one that is "authorized to offer and sell ownership interests to retail investors," as the current exclusion requires. Instead of requiring such authorization to be in the fund's "home jurisdiction," however, the Agencies should permit the fund to be so authorized in "one or more jurisdictions outside the United States."[67]

If a jurisdiction authorizes a fund for offer and sale to retail investors, those choosing to invest in the fund will be entitled to the protections of the securities laws in that jurisdiction. In other words, the local regulator determines the scope of regulation that is appropriate to impose on a fund that is publicly offered and sold to the general investing public in that jurisdiction. Returning to an earlier example, in the case of a Cayman-registered trust authorized in Japan for sale to Japanese retail investors, the protections afforded by the Japanese securities laws will apply.[68]

Although the precise governing rules for funds that are "authorized to offer and sell ownership interests to retail investors" will vary across jurisdictions, they are guided by common principles for public investment funds that have been developed by the International Organization of Securities Commissions ("IOSCO").[69] The 127 jurisdictions that are IOSCO members—including the United States—commit to regulate according to these principles and the more detailed IOSCO policy work that informs those principles,[70] and their level of adherence to the IOSCO principles is evaluated periodically through the IMF/World Bank Financial Sector

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[67] This can be accomplished by revising (i)(B) to refer to an issuer that "[i]s authorized to offer and sell ownership interests to retail investors in the issuer's home one or more jurisdictions outside of the United States." For the reasons we describe, it likewise would be inappropriate to tie the authorization requirement to a fund's "primary" jurisdiction.

[68] *See supra* note 58 and accompanying text.

[69] *See* IOSCO, Objectives and Principles of Securities Regulation (May 2017), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD561.pdf at 10. Principles 24 through 27 apply to collective investment schemes and cover the same broad regulatory provisions as apply to RICs, including custody, disclosure, marketing, valuation and conflicts of interest.

[70] *See, e.g.*, IOSCO Fact Sheet (Feb. 2018) (noting that the IOSCO membership regulates more than 95% of the world's securities markets and includes all the major emerging markets). The fact sheet is available at https://www.iosco.org/about/pdf/IOSCO-Fact-Sheet.pdf.

Assessment Program ("FSAP").[71] As a result, the Agencies can be assured that any such fund, regardless of where it is organized, should be "of a type that is more similar to a U.S. registered investment company rather than to a U.S. covered fund."[72]

Our recommended revision would allow all regulated non-US funds offered on a cross-border basis to qualify for the foreign public fund exclusion. Given their operational advantages and popularity among investors, the number of cross-border mutual funds outside the United States grew by 150 percent from 2002 to 2012.[73] Continued growth may occur as demand for diversified and highly regulated investment products increases, particularly among investors in emerging economies. And, several jurisdictions (Japan, Korea, Australia, New Zealand, and Thailand) are working toward the launch of an "Asia region funds passport," similar to the product passport for UCITS, that would allow for cross-border distribution of regulated funds among these jurisdictions.[74]

b. *Revisions to the "Sale of Ownership Interests" Provision*

As noted above, the current FPF exclusion requires that the fund's ownership interests must be sold predominantly through one or more public offerings outside of the United States. The preamble to the 2013 Final Rule explains that this requirement was included "in order to help maintain [the] distinction" between funds authorized to sell ownership interests to retail investors (and thus more similar to US RICs) and those that are not (and thus more similar to a US covered fund). Another aim of this requirement was to "avoid circumstances that could result in an evasion of section 13 and the final rule."[75]

We understand the Agencies' desire for assurance that the exclusion will apply only to funds that are similar to US RICs. As explained above, however, the current "belt and suspenders" approach

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[71] Jurisdictions not reviewed through FSAP are evaluated by IOSCO Assessment Committee. Whether conducted through the FSAP or the Committee, IOSCO's detailed assessment methodology will guide the review. *See* IOSCO, Methodology for Assessing Implementation of the IOSCO Objectives and Principles of Securities Regulation (May 2017), available at https://www.iosco.org/library/pubdocs/pdf/IOSCOPD562.pdf at 8-19 (introduction) and 150-175 (principles relating to collective investment schemes).

[72] 79 Fed. Reg. at 5678.

[73] Plantier, *supra* note 54, at 11 (providing data on the growth of cross-border mutual funds from 2001-2012 and on the number of cross-border mutual fund registrations in 2012 by fund domicile and market region.)

[74] *See, e.g.,* Asia region funds passport (press release), Ministry of Business, Innovation & Employment, Government of New Zealand, dated Sept. 19, 2018, available at https://www.mbie.govt.nz/info-services/business/business-law/asia-region-funds-passport ("Once it is implemented, a funds passport will allow a managed fund based in one jurisdiction to be offered more easily to investors in other participating jurisdictions. A similar passport initiative in Europe, known as Undertakings for Collective Investment in Transferable Securities or 'UCITS', has been successful.").

[75] 79 Fed. Reg. at 5678.

has proven to be too restrictive. With two modifications, we believe the "sale of ownership interests" provision can give appropriate assurances to the Agencies without unduly restricting the ability of banking entity sponsors to offer regulated non-US funds—for example, as part of an array of products and services to serve the investment needs of their clients outside the United States.[76]

First, if a fund is offered and sold publicly in one or more jurisdictions outside the United States, that fact alone should provide sufficient assurance that the fund is adhering to the regulatory requirements necessary to offer and sell its shares to the general investing public, as determined by the local regulator in such jurisdiction(s). Accordingly, in these circumstances, it is not necessary to track actual sales to establish that a fund is subject to regulation that makes it more similar to a RIC than to a hedge fund.

Second, it is also the case that a fund adhering to the regulatory requirements necessary to offer and sell its shares to the general investing public may not actually sell its shares in that manner. For example, our members sometimes will use such funds (*e.g.*, UCITS) for specific purposes, such as to form part of a larger portfolio for certain clients who want the protections afforded by a regulated fund (*e.g.*, clients of the firm's wealth management or asset management business). The Agencies acknowledge as much, noting that "[s]ome foreign funds, like some RICs, may be authorized for sale to retail investors but may choose to offer ownership interests to high-net worth individuals or institutions in non-public offerings."[77]

Such a fund deserves to be eligible for the FPF exclusion. We recognize, however, that it could be difficult for the Agencies to distinguish between a regulated non-US fund sold only in non-public offerings and a hedge fund (for which the exclusion is not available). Therefore, to provide further assurance in cases where a regulated non-US fund is sold only in non-public offerings, our proposed revisions affirmatively require that (1) the fund comply with the regulatory requirements necessary to offer and sell its shares publicly in one or more jurisdictions, and (2) the banking entity sponsor for such fund maintain documentation sufficient to demonstrate such compliance. These added requirements will ensure that such a fund is adhering to the regulatory requirements applicable to "public" funds.

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[76] We recommend that the agencies revise (i)(C) to refer to an issuer that "[s]ells ownership interests:

(1) ~~predominantly~~ through one or more public offerings in one or more jurisdictions outside of the United States; or

(2) in non-public offerings, but only if it complies with the regulatory requirements necessary to offer and sell its shares publicly in one or more jurisdictions, and its banking entity sponsor maintains documentation sufficient to demonstrate such compliance.

[77] Question 147 in the Proposal.

c. Ineligibility of Funds Formed for Investment by Affiliated Parties

Our proposal retains a separate "anti-evasion" provision, notwithstanding our skepticism about the Agencies' claim that foreign public funds sponsored by US banking entities "may present heightened risks of evasion."[78] We propose revising the current rule language to preclude a sponsor from relying on the FPF exclusion if the sponsored fund is formed for the purpose of investment by affiliates and the directors and employees of such entities.[79]

Reframing the existing provision in this manner would carry out the Agencies' regulatory intent without the compliance burdens or other problems associated with the current formulation. For example, it would relieve the operational challenges involved in tracking investments by directors and employees and obviate the possible need to prohibit such persons from investing in FPFs. At the same time, it squarely addresses the Agencies' concern that, "[a]bsent the additional condition, a U.S. banking entity could establish a foreign public fund *for the purpose* of itself investing substantially in that fund and, through the fund, making investments that the banking entity could not make directly under section 13."[80]

We note that revising the exclusion in the way we propose would not foreclose the Agencies from exercising their broad supervisory authority to address any particular instances of evasion. As we explained to the Agencies in 2012, if a foreign regulator authorizes a regulated non-US fund that US banking regulators believe poses significantly more risk to a banking entity than a RIC would pose, the Agencies have ample authority to step in and protect the banking entity.[81]

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[78] 79 Fed. Reg. at 5679.

[79] More specifically, we recommend revising (ii) as follows:

(ii) With respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor, the sponsoring banking entity may not rely on the exemption in paragraph (c)(1)(i) of this section for such issuer if the issuer was formed for the purpose of investing for the benefit of~~unless ownership interests in the issuer are sold predominantly to persons other than~~:

(A) Such sponsoring banking entity;

~~(B) Such issuer;~~

(~~C~~B) Affiliates of such sponsoring banking entity ~~or such issuer~~; ~~and~~or

(~~D~~C) Directors and employees of such entities.

[80] 79 Fed. Reg. at 5679 (emphasis added).

[81] ICI Global Letter, *supra* note 12, at 7.

We appreciate this opportunity to share our views regarding needed improvements to the 2013 Final Rule. We have focused in this letter on issues that are of greatest concern to our membership and on which we have significant expertise, and we think it is important for the Agencies to address these issues in any revisions to the 2013 Final Rule.

If you have any questions regarding our comments or would like additional information, please contact me at (202) 326-5813 or solson@ici.org; Rachel H. Graham, Associate General Counsel, at (202) 326-5819 or rgraham@ici.org; or Frances M. Stadler, Associate General Counsel and Corporate Secretary, at (202) 326-5822 or frances@ici.org.

Sincerely,

/s/ Susan M. Olson

Susan M. Olson
General Counsel
Investment Company Institute

Appendices (2)

Appendix A

Proposed revisions to ensure that regulated funds are not treated as "banking entities" for purposes of the Volcker Rule

Add new subsection (10) to __.3(d)

Proprietary trading does not include:

(10) Any purchase or sale of one or more financial instruments by a regulated fund that is not a banking entity itself under paragraphs (i), (ii), or (iii) of section _.2(c), but only during the following circumstances:

(i) In the case of a foreign public fund, when a banking entity (1) does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the foreign public fund (other than during the periods specified in (ii)), and (2) provides investment advisory, commodity trading advisory, administrative, and other services to, or maintains other relationships with, the fund in compliance with applicable limitations in the relevant foreign jurisdiction; or

(ii) In the case of any regulated fund, during each of the following periods:

(A) A seeding period during which a regulated fund is operated pursuant to a written plan to test the fund's investment strategy, establish a track record of the fund's performance for marketing purposes, and attempt to distribute the fund's shares;

(B) A termination period during which a regulated fund is operated pursuant to a written plan to dispose of the fund's assets in an orderly manner; or

(C) A temporary period during which the regulated fund's banking entity sponsor or adviser owns 25 percent or more of the fund's voting shares, provided that the banking entity sponsor or adviser:

(1) determines that maintaining such ownership interest is necessary to permit the fund to continue to attract unaffiliated investors;
(2) reduces its level of ownership below 25 percent within a reasonable period, not to exceed two years; and
(3) maintains documentation that describes the basis for its determination and how it expects to reduce its level of ownership below 25 percent.

Add new subsection (a)(3) to __.10(a)

Paragraph (a)(1) of this section does not include acquiring or retaining an ownership interest in a covered fund by a regulated fund that is not a banking entity itself under paragraphs (i), (ii), or (iii) of section _.2(c), but only during the following circumstances:

(i) In the case of a foreign public fund, when a banking entity (1) does not own, control, or hold with the power to vote 25 percent or more of the voting shares of the foreign public fund (other than during the periods specified in (ii)), and (2) provides investment advisory, commodity trading advisory, administrative, and other services to, or maintains other relationships with, the fund in compliance with applicable limitations in the relevant foreign jurisdiction; or

(ii) In the case of any regulated fund, during each of the following periods:

(A) A seeding period during which a regulated fund is operated pursuant to a written plan to test the fund's investment strategy, establish a track record of the fund's performance for marketing purposes, and attempt to distribute the fund's shares;

(B) A termination period during which a regulated fund is operated pursuant to a written plan to dispose of the fund's assets in an orderly manner; or

(C) A temporary period during which the regulated fund's banking entity sponsor or adviser owns 25 percent or more of the fund's voting shares, provided that the banking entity sponsor or adviser:

(1) determines that maintaining such ownership interest is necessary to permit the fund to continue to attract unaffiliated investors;
(2) reduces its level of ownership below 25 percent within a reasonable period, not to exceed two years; and
(3) maintains documentation that describes the basis for its determination and how it expects to reduce its level of ownership below 25 percent.

Definition to be added to section _.2:

Regulated fund means:

(A) Any investment company that is registered under section 8 of the Investment Company Act of 1940 (15 U.S.C. 80a–8); and

(B) Any foreign public fund as described in Section _.10(c)(1).

Appendix B: Recommended revisions to FPF Exclusion

As marked against the 2013 Final Rule:

Foreign public funds.

(i) Subject to paragraphs (ii) and (iii) below, an issuer that:

(A) Is organized or established outside of the United States;

(B) Is authorized to offer and sell ownership interests to retail investors in ~~the issuer's home~~ one or more jurisdictions outside of the United States; and

(C) Sells ownership interests:

(1) ~~predominantly~~ through one or more public offerings in one or more jurisdictions outside of the United States; or

(2) in non-public offerings, but only if it complies with the regulatory requirements necessary to offer and sell its shares publicly in one or more jurisdictions, and its banking entity sponsor maintains documentation sufficient to demonstrate such compliance.

(ii) With respect to a banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State and any issuer for which such banking entity acts as sponsor, the sponsoring banking entity may not rely on the exemption in paragraph (c)(1)(i) of this section for such issuer if the issuer was formed for the purpose of investing for the benefit of~~unless ownership interests in the issuer are sold predominantly to persons other than~~:

(A) Such sponsoring banking entity;

~~**(B)** Such issuer;~~

(~~C~~B) Affiliates of such sponsoring banking entity ~~or such issuer~~; ~~and~~or

(~~D~~C) Directors and employees of such entities.

(iii) For purposes of paragraph (c)(1)(i)(C) of this section, the term "public offering" means a distribution (as defined in § 248.4(a)(3) of subpart B) of securities in any jurisdiction outside the United States to investors, including retail investors, provided that:

(A) The distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made;

(B) The distribution does not restrict availability to investors having a minimum level of net worth or net investment assets; and

(C) The issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available.