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Board of Governors of the Federal Reserve System
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Securities and Exchange Commission
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Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
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Christopher Kirkpatrick
Secretary
Commodity Futures Trading Commission
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Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E–218
Washington, DC 20219

Re: <u>**Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds**</u>

OCC: 12 C.F.R. Part 44, Docket No. OCC-2018-0010, RIN: 1557-AE27;
Federal Reserve: 12 C.F.R. Part 248, Docket No. R-1608, RIN: 7100-AF 06;
FDIC: 12 C.F.R. Part 351, RIN 3064-AE67; SEC: 17 C.F.R. Part 255 Release
No. BHCA-3, File No. S7-14-18 RIN: 3235-AMIO; CFTC: 17 C.F.R. Part 75
RJN: 3038-AE72

<u>**Definitions of "Banking Entity" and "Insured Depository Institution" with Respect to Industrial Loan Companies**</u>

Ladies and Gentlemen:

The National Association of Industrial Bankers (NAIB) appreciates this opportunity to submit a comment letter in response to the request for public comments[1] on the joint rulemaking of the Board of Governors of the Federal Reserve System ("<u>Federal Reserve</u>"), Commodity Futures Trading Commission, Federal Deposit Insurance Corporation ("<u>FDIC</u>"), Office of the Comptroller of the Currency, and

[1] *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) (the "<u>Release</u>").

Securities and Exchange Commission (together, the "Agencies") to revise the rules that implement section 13 of the Bank Holding Company Act of 1956 (such statute, the "BHCA",[2] and section 13 thereof, the "Volcker Rule", or "Rule").[3] The Rule establishes restrictions on proprietary trading by "banking entities" and certain relationships between banking entities and hedge funds and private equity funds. The implementing regulations for the Rule are codified at 12 C.F.R. §§ 44, 248, 351 and 17 C.F.R. §§ 75, 255.

NAIB is the association of industrial banks (IBs). Industrial banks, first chartered in 1910, operate under a number of titles; industrial loan banks, industrial loan corporations, or thrift and loan companies. These banks engage in consumer and commercial lending on both a secured and unsecured basis. They do not offer demand checking accounts but do accept time-deposits, savings deposit money market accounts and NOW accounts. Industrial banks provide a broad array of products and services to customers and small businesses nationwide, including in some of the most underserved segments of the US economy. These same institutions are also commonly referred to as Industrial Loan Companies (ILCs).

NAIB appreciates the difficult task facing the Agencies in implementing the Rule. We agree with the Agencies' efforts to tailor the Rule's application, by providing greater clarity and certainty about prohibited activities, and seeking to improve the effective allocation of compliance resources. One way in which the Agencies could tailor the Rule's application to serve these goals is by adopting a more tailored approach to defining the types of entities covered by the Rule. In particular, for reasons described in more detail below, our members believe that an exemption should be provided for industrial banks ("IBs") and the parent companies that control them, so that they and their affiliates are not deemed to be "banking entities" within the meaning of the Volcker Rule, as long as the IB itself remains under the community bank thresholds recently established by the Economic Growth, Regulatory Reform, and Consumer Protection Act ("EGRRCPA"). Our members also believe that shareholders of a bank's parent company should not be subject to the Volcker Rule if they own less than 25% of the voting shares and meet certain conditions that would automatically qualify their investment as passive. As explained in more detail below, this approach would better reflect the Volcker Rule's place in the broader scheme of the financial services markets, encourage the efficient formation and deployment of capital in and by companies that control IBs and IBs themselves, and ensure the availability of responsible sources of credit to American consumers.

Background

With certain exceptions not relevant here, the Volcker Rule currently applies to all banks, including IBs. It also applies to any parent company that controls a bank or IB (whether they are commercial companies or financial services companies), and to any other subsidiary of such parent company, if the group on a consolidated basis exceeds $10 billion in total consolidated assets, or exceeds certain trading thresholds.[4]

[2] 12 U.S.C. § 1841 *et. seq.*

[3] 12 U.S.C. § 1851.

[4] The Volcker Rule was originally enacted as part of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank") and applies to any "banking entity." A banking entity is defined by statute to include an "insured depository institution (as defined in section 1813 of this title)" or "any company that controls an insured depository institution." Congress recently amended the law to exclude from the statutory definition of "insured depository institution" certain community banks "that [do] not have and [are] not controlled by a company that has—(i) more than $10,000,000,000 in total consolidated assets; and (ii) total trading assets and trading liabilities, as reported on the most recent applicable regulatory filing filed by the institution, that are more than 5 percent of total consolidated assets."

Generally speaking, the Rule has had significant effects on holding companies and affiliates of banks. The Rule has had somewhat less of an impact on the banks themselves because, putting aside the Rule, banks have historically been subject to more restrictive limitations on their investing and trading activities than have holding companies and their nonbank subsidiaries. [5] Those restrictions can be more stringent than the provisions of the Rule. Thus, arguably the most significant impact of the Rule has been on the parent companies and affiliates of depository institutions.

IBs are state-chartered banking institutions that offer a broad array of financial products and services. Legally they differ from other banks by not offering demand deposit checking accounts.[6] IB charters are available in a limited number of states, and most recent applicants have sought charters from Utah or Nevada.[7] IBs that offer deposit products have been eligible to apply for FDIC insurance since 1982. The more important difference relates to the companies that control IBs, which are exempt from regulation by the Federal Reserve[8] under either the BHCA or the Home Owners Loan Act ("HOLA"),[9] but instead are regulated in a more limited way by the IB's regulators.[10]

The first IBs, called "Morris Plan banks," were founded in 1910 to extend credit to industrial workers.[11] Prior to the 1980s, these entities were authorized in several states and generally referred to as industrial loan corporations ("ILCs"). In keeping with that initial purpose, ILCs historically operated as small consumer finance companies authorized in some states to take uninsured or privately insured deposits.

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[5] *See* 12 C.F.R. Part 1 (describing investment securities permitted for national banks). Many states, such as Utah, allow state chartered banks to engage in any activity and enjoy all rights and privileges permitted for national banks.

[6] *See* National Association of Industrial Bankers, *et.al.*, Comment Letter on Proposed Rule Implementing Prohibition on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds, n.1 (Feb. 13, 2012), *available at* https://www.regulations.gov/document?D=OCC-2011-0014-0301.

[7] *See* JAMES R. BARTH AND TONG LI, INDUSTRIAL LOAN COMPANIES: SUPPORTING AMERICA'S FINANCIAL SYSTEM, 2 (2011).

[8] The core restrictions in the BHCA apply to a company that controls or seeks to control a "bank." However, the definition of "bank" excludes an IB, so long as such IB either (i) has total assets of less than $100,000,000, or (ii) does not accept demand deposits that the depository could withdraw by check or similar means for payment to third parties. 12 U.S.C. § 1841(c)(2)(H). This provision also grandfathers in certain IBs that do not meet either of these tests, but which either (i) do not engage in any activities that such IBs were not lawfully engaged in as of March 5, 1987, or (ii) which have not been acquired after August 10, 1987.

[9] The core restrictions in the HOLA apply to any company that "directly or indirectly controls a savings association" or a savings and loan holding company. 12 U.S.C. § 1467a(a)(1)(D)(i). The definition of a savings association does not include an IB. 12 U.S.C. § 1467a(a)(1)(A). For ease of reference, and because the Volcker Rule is codified as part of the BHCA, our letter usually refers only to the BHCA when discussing holding company regulation. However, the holding companies of savings associations or savings banks are subject to regulation under Section 10 of the HOLA rather than the BHCA. Although there are some differences between the BHCA and Section 10 of the HOLA, at a high level they are similar in that they both impose requirements on the direct and indirect holding companies (as well as the nonbank subsidiaries of such holding companies) of the banks that are respectively covered by those statutes, including requirements such as supervision and regulation by the Federal Reserve, prudential regulations such as consolidated regulatory capital requirements at the holding company level, and legal restrictions on the conduct of business activities.

[10] Companies that control IBs are required by law to serve as a source of financial strength for those IBs. 12 U.S.C. § 1831o-1.

[11] *See* BARTH AND LI, *supra* note 7, at 11.

Beginning in the 1970s, a newer form of ILC developed as "branchless" banks that used technology to offer specialized products and services to a customer group not defined by geography. This contrasted with the traditional model of a bank that offered a full array of services to residents of a delineated community through branches. Some of the first of these branchless banks offered credit cards (American Express, Discover, AT&T (in conjunction with a long distance calling card)), consumer loans (Citicorp Person-to-Person), and mortgages (Merrill Lynch, Franklin Templeton). Some of these operated as stand-alone operations while others offered complementary financial products and services to customers of affiliates.[12] A good example of a complementary service is the owner of a large chain of truck stops that organized an IB to provide specialized financial services to truckers at the truck stops, such as factoring bills of lading.

States, including Utah, renamed federally insured ILCs as "industrial banks" when they became eligible for federal deposit insurance. In the Competitive Equality Banking Act of 1987 ("CEBA"), Congress enacted an express exemption from the BHCA for IB parents. Since the activities of a company that controls a CEBA-exempted IB are not subject to the restrictions on business activities that apply to bank holding companies under the BHCA, this permitted both financial and commercial companies to pursue opportunities to develop financial services businesses requiring a bank – for example, providing credit to consumers. Several IBs were formed after that, mostly based in Utah. All of those banks were branchless and specialized. So long as these types of companies do not own another type of bank as well, the other financial and commercial activities of the holding company and its nonbanking affiliates are not subject to regulation under the BHCA.

Another important feature of IBs is that most are a small part of a larger diversified group of companies. Some IBs, such as those owned by Toyota and BMW, constitute less than 1% of the affiliate group's total consolidated assets. In contrast, a bank owned by a parent subject to the BHCA is often the primary asset of the group. That is important because the parent of an IB is typically able to provide any support the IB may need, such as additional capital. The small size of an IB, as compared with the total consolidated assets of the parent company, also makes the potential impact of banking laws and regulations that extend to the affiliates more important when evaluating whether the costs of owning an IB outweigh the benefits. A burden like complex recordkeeping, required of every entity in a corporate group many times larger than the IB, has resulted in the parent deciding to not pursue plans to organize an IB or to close otherwise healthy and profitable IBs.

The exemption for IB owners from the BHCA is also significant because it imposes no restriction on other business activities of the parent company and affiliates. Many IB affiliates engage in a broad array of other businesses, including systems and technology development, manufacturing, and retailing, and those businesses frequently utilize investment strategies that are important to them and otherwise are independent of the IB. For example, an affiliate involved in developing new technologies may invest in other companies developing similar technologies, especially startups. That may be a way to keep abreast of new developments and be a first step in eventually acquiring the company, or it might just be a way to utilize the company's expertise to invest in promising new companies as a means to generate additional profits for the corporate group. In some cases, the Volcker Rule would prohibit those investments even though they are unlikely to pose any risk to the IB. This is clearly another unintended consequence of the Rule.

In our members' experience, another noteworthy unintended impact of the Volcker Rule has been blocking investments by institutional investors in the parent companies of IBs. Institutional

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[12] *Id.* at 1-2.

investors such as retirement funds, mutual funds, insurance companies, and other private investors cannot pursue many investment strategies and otherwise do their jobs if they are subject to the Volcker Rule. Beginning at very low investment thresholds, including ownership of a class of voting securities as low as five or ten percent of the class, investors may either become subject to the Rule, or lack sufficient clarity as to whether they are subject to the Rule due to the complex analysis of what "control" means under applicable banking laws, including the BHCA. If such an investor potentially could be deemed to control an IB or a bank, then it would be subject to the Rule.

Many institutional investors have internal guidelines setting minimum investments in any company, and if that minimum is close to or over the control threshold for a bank or IB's parent, those investors will often decide not to invest. It can be challenging and time consuming for an investor to obtain definitive comfort that significant minority investments would not result in the investor being subject to the Volcker Rule. Seeking such comfort from the Agencies may not be a feasible approach for institutional investors seeking to act quickly. However, this is less of an issue for the smallest de novo banks, which mostly rely on individuals for their initial capital, and for the largest banks, because an investor can invest billions of dollars and still be below the relevant control threshold. The greatest impact is on mid-size holding companies that are too large to rely on small individual investments and must look to institutional investors for new capital. Companies of that size have reported many instances where potential investors said they would buy new stock of the parent if they would not become subject to the Volcker Rule, but otherwise would not. For example, one IB is owned by a regulated gas and electric utility that has encountered this problem multiple times when raising capital for new power plants, upgrading existing plants, and developing new energy programs. In a capital-intensive industry, this is a serious drawback that our members believe is not offset by any corresponding benefits.

The two requests we describe below are intended to help alleviate these problems within the authority of the regulators to prescribe standards for implementation of the Rule. Our members are seeking implementation of both of these solutions, as each addresses different aspects of the foregoing issues.

Discussion

Question 22 of the Release asks: "Are there any other investment vehicles or entities that are treated as banking entities and for which commenters believe relief, consistent with the statute, would be appropriate? Which ones and why? What form of relief could be provided in a way consistent with the statute?"[13]

NAIB believes that the uniform application of the Volcker Rule to IBs, their controlling companies, and their investors has resulted in deleterious and potentially unintended consequences. Consistent with the other questions posed in the release regarding tailoring of the Rule to different size institutions,[14] we believe that the Agencies should offer relief to certain IBs and their controlling companies when an IB does not exceed a specified size (namely, the same size thresholds as apply under the EGRRCPA, at the bank level). As described further in Section C, below, we believe that this relief may be offered in a manner consistent with the Rule and broader BHCA.

[13] Release at 33445-46.

[14] *See, e.g.*, Release at 33441-42 (discussing tailoring of the compliance requirements to different size banking entities).

In addition, to help remedy the unintended and significant impact the Volcker Rule has had on limiting the ability of mid-size holding companies to raise new capital, it would also be helpful for the regulators to set specific standards that would automatically classify any entity holding or committing to buy shares of a bank's ultimate parent (or intermediate holding company not wholly owned) as passive for purposes of applying the Volcker Rule. For example, the Federal Reserve has agreed with certain investors that they would be considered passive and so able to hold up to 25% of a bank parent if the investor only has a certain number of representatives on the parent company's board of directors and does not attempt to put forth resolutions for a vote or otherwise exercise a controlling influence over the holding company or bank. Our proposal would simply set similar standards across the board instead of on a case-by-case basis, but would still allow regulators to act if they determined that a party was exercising control by indirect means.

A. Proposed Regulatory Amendments

1. Exemption for Parents and Affiliates of an IB Below the EGRRCPA Community Bank Thresholds

There are two main reasons why offering this form of relief would be appropriate. First, the current approach to implementation of the Volcker Rule expands the application of the BHCA to a class of entities not historically subject to that statute. While the BHCA definition of a bank does not include IBs, IBs are included in the definition of an insured depository institution for the purposes of the Federal Deposit Insurance Act.[15] This results in IBs and companies that control IBs being considered banking entities for purposes of the Volcker Rule, unlike under the balance of the BHCA, which is much broader than the Volcker Rule. Second, subjecting entities not otherwise subject to the BHCA to the Volcker Rule impedes capital formation and investment, and indirectly upsets the carefully drawn distinction between banking and commerce. The Agencies can avoid these anomalous results, which subject multi-billion dollar worldwide enterprises to the Volcker Rule merely because a small IB is part of the group, by amending the definition of an insured depository institution, as used in the Volcker Rule, in a manner consistent with the EGRRCPA's amendment, to exclude IBs that would qualify on their own as community banks and also to exclude their holding companies regardless of size (which traditionally are not regulated under the BHCA).

The Agencies may accomplish this by defining insured depository institution as follows:

(r) Insured depository institution has the same meaning as in section 3(c) of the Federal Deposit Insurance Act (12 U.S.C. 1813(c)), but does not include:

(1) an insured depository institution that is described in section 2(c)(2)(D) of the BHC Act (12 U.S.C. 1841(c)(2)(D));

(2) an insured depository institution that does not have, and is not controlled by a depository institution holding company (as defined in 12 U.S.C. § 1813(w)(1)) that has:

(A) more than $10,000,000,000 in total consolidated assets; and

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[15] *See* 12 U.S.C. §§ 1813(c)(2) (defining "insured depository institution" to include "any bank"), 1813(a)(1)(A) (defining "bank to include any "State bank"), 1813(a)(2) (defining a "State bank" to include an "industrial bank (or similar depository institution which the Board of Directors finds to be operating substantially in the same manner as an industrial bank)").

(B) total trading assets and trading liabilities, as reported on the most recent applicable regulatory filing filed by the institution, that are more than 5 percent of total consolidated assets;

This suggested definition mirrors the existing definition of insured depository institution in the final rule, as it would be amended by the EGRRCPA, with one change. Instead of applying the $10 billion and 5% trading assets and liabilities thresholds to any IDI and any "company" that controls an IDI, it would apply those thresholds only to any IDI and any "depository institution holding company" that controls an IDI. Depository institution holding company is defined in the Federal Deposit Insurance Act to include bank holding companies and savings and loan holding companies. These are the holding companies that, together with their affiliates, traditionally are subject to regulation under the BHCA (or HOLA) because of the types of bank subsidiaries they own or control.

The suggested change would exclude IBs that satisfy the community bank size threshold established by the EGRRCPA, as well as their parent companies regardless of consolidated size, from the definition of banking entity and therefore from the scope of the Volcker Rule. It would not affect parent companies that also control a bank or savings association other than an IB, as the definition of insured depository institution proposed above would not exclude companies regulated under the BHCA and the HOLA from the scope of the Volcker Rule.[16] In practical terms, our suggested interpretive change means automotive manufacturers, energy companies, and other types of companies that own IB subsidiaries would not be subject to the Volcker Rule if their respective IB subsidiaries satisfy the community bank thresholds. This is justified because investment activities in such companies typically play a vital role for other parts of the company and occur on a scale much larger than the IB, and consequently have less of a relationship to the IB. There is no compelling reason to restrict those investment activities – the risk they pose to the IB is minimal.

2. Adoption of Objective Standards to Facilitate Non-Controlling Investments

Another anomalous result can be avoided by adopting specific, objective standards to qualify investments as passive in order to permit investments up to 25% of a parent company's voting shares when the investor merely holds the stock as an investment and does not exercise any control over the bank. This should apply to all investments in all companies that control a bank regardless of the type of bank involved.

As mentioned above, mid-size companies that control a bank are unnecessarily constrained in raising capital because they must usually rely on institutional investors, and those investors will not make investments that subject them to the Volcker Rule. This is less of a problem if the threshold for becoming subject to the Rule is 25% of a class of the parent company's or bank's voting shares. The problem lies in the investment thresholds for a class of voting securities. At an investment size of as low as five or ten percent, and up to 25% of a class of voting securities, investors may either become subject to the Rule, or lack sufficient clarity as to whether they are subject to the Rule. Such investors often cannot obtain certainty that they are not subject to the Rule from the relevant Agency either at all or in a timely way. Investors must act quickly when deciding whether to buy or subscribe to shares, based upon whether market conditions are favorable, or when a subscription fills or expires.

To resolve this problem, the Agencies should consider adopting provisions that would automatically clarify that an investor would not be deemed to control the bank or IB, or holding

[16] This means that large bank holding companies or savings and loan holding companies would be unable to rely upon the proposed IB exclusion, as they have bank or savings association subsidiaries.

company of the bank or IB, if certain objective conditions are satisfied. The Federal Reserve has taken this kind of action on a case-by-case basis in connection with certain mutual funds and possibly other institutional investors so this is clearly something the Agencies can do with their existing authority. The following more objectively measurable standards would give investors that own less than 25% of a bank, IB, or holding company thereof definitive comfort that they are not subject to the Volcker Rule, and therefore the freedom to invest on a timeframe that is reasonable for the market. We believe the Agencies have the authority to determine if control exists when ownership of a company remains below 25% of a class of voting securities without requiring any statutory changes. We therefore recommend that the Agencies adopt provisions along the lines of the following, and make clear that these provisions supersede existing regulatory definitions of "affiliate" and "subsidiary".

(*) (1) Control has the same meaning as Section 2(a)(2) of the Bank Holding Company Act, 12 U.S.C. 1841(a)(2) except as noted in clause (2) below.

(2) For purposes of the Section 13 of the BHCA, an investor that owns less than 25% of a class of voting securities of a company shall not be deemed to control the company if—

(A) no more than two directors or 10% of the total number of authorized directors, whichever is less, of a company that controls a bank are nominees of, employed by or otherwise related to the investor; and

(B) no directors of the bank are nominees of, employed by or otherwise related to the investor; and

(C) the investor is not the largest single investor if its stock holdings would otherwise be presumed to control; and

(D) the investor is not acting in concert with other investors that in the aggregate hold more than 24.9% of the outstanding voting shares of the entity; and

(E) the investor does not otherwise exercise, attempt to exercise or have the ability to exercise control over the management and policies of the bank or any entity that directly or indirectly controls the bank.

This would allow an institutional investor to acquire up to 24.9% of a class of voting shares of a company that controls a bank without being deemed a control party provided it is a truly passive investment, which would significantly increase access of mid-size companies to investments by institutional investors.

B. Policy Considerations

1. Consistency with the Purposes of the Law

While the Volcker Rule is codified as part of the BHCA, the statutory definitions used in the Volcker Rule do not always align with those employed in the broader statute. When presented with a comprehensive statutory scheme, under which different classes of entities are subject to different forms of regulation, we believe that legislative changes are best interpreted in a manner that gives effect to that larger scheme. We do not believe that Congress intended for the Volcker Rule, or the broader BHCA, to apply to commercial firms that own IBs. Therefore, to the extent possible, the Agencies should adopt regulatory definitions of the terms banking entity and insured depository institution that incorporate the IB exemption from the BHCA.

Interpreting the Rule in this manner permits different types of entities to provide the services that the broader statute contemplates them providing. In the case of IBs, these are services that directly complement the other financial and non-financial lines of business in which their holding companies and investors engage – such as providing credit or deposit products to a company's wider customer base. Using the Volcker Rule to impose restrictions on such companies and the IBs they control would undercut the statutory purpose of providing these exclusions in the BHCA.

Many would agree that one of the primary goals of Dodd-Frank was to reduce systemic risk in the U.S. financial system, including the potential for contagious runs and potential bank failures. An institution must be large enough to affect the market's perceptions of the banking industry in order to be capable of setting off such a run. In enacting the EGRRCPA, Congress has made a determination as to what size such institutions must be, codifying the idea that institutions below a certain size do not pose a level of risk meriting regulation under the Rule. Therefore, if an IB itself remains below the relevant thresholds, it would be an odd result – and one we do not believe was intended by Congress – to suggest that its larger parent company operating outside the traditional banking system (in some cases, outside the financial services sector entirely) poses such a risk.

2. Formation, Deployment, and Utilization of Capital

Application of the Volcker Rule to companies that control IBs impedes the efficient formation and deployment of capital, both for the benefit of the IB and for other purposes. Application of the Rule to entities that invest in IBs or the companies that control IBs prevents capital from being deployed to support an IB's lending and other activities, as well as the broader business of an IB's parent company. It also prevents those sources of capital from serving as a source of strength to IBs. Expanding the ability of nonbanking firms – whether they may be pension plans, charitable endowments, private equity firms, or other investors with significant capital to deploy – to invest in IBs, as well as the financial and non-financial companies that control IBs, would enhance the safety and soundness of IBs by making greater amounts of equity capital available to such institutions. IBs could then deploy such capital, in some cases serving as a stable source of credit for the larger banking population.[17]

Simultaneously, providing clarity to companies that control IBs regarding their obligations under the Rule will enable such companies to more efficiently deploy their internal resources, including those contributed by investors. Under the status quo, both financial and non-financial companies that may control IBs must implement extensive, costly Volcker Rule compliance regimes. In many cases, these regimes are ill-suited to the business activities that an IB's affiliates are engaged in, as the Volcker Rule was designed for the regulation of financial services entities, and thus are even more costly to implement and adhere to for commercial companies. By further defining the types of entities that are subject to the Rule, the Agencies can reduce the compliance burdens on entities that operate

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[17] It is also notable that lending occurring through an IB is regulated by the FDIC, and subject to safety and soundness requirements (including risk monitoring). This form of lending is therefore safer from a systemic perspective than alternatives that certain segments of the consumer population may use, as the overall size and risk level of consumer borrowings is comprehensively monitored by a federal regulator. Perversely, though, the current interpretation of the Volcker Rule penalizes firms that control IBs for seeking to bring a larger portion of their business under the purview of federal bank regulation by seeking an IB charter (insured IBs themselves are regulated by the FDIC in addition to the applicable state regulator).

independently of an IB, and which pose only minimal risk to the IB's operations, without increasing the overall risk to either any individual IB, or the banking system overall.

Moreover, it is worth noting that, while the Volcker Rule clearly was intended to prevent banks from investing in hedge funds or private equity funds, it is not clear that the Volcker Rule was ever intended to prevent the opposite: namely, preventing companies such as private equity firms from investing in banks. We already have an extensive set of laws, including the BHCA, that govern when and under what conditions such firms may invest in banks. Those statutes historically have not subjected such firms to regulation as a result of making investments in IBs, and it is an odd and perhaps unintended result that the Volcker Rule could be interpreted in a manner that circumvents that framework. Thus, these proposed amendments to the Rule would facilitate investors deploying capital to companies that control IBs, and empower those IBs to deploy that capital in optimal ways.

C. Legal Authority: General Rulemaking Authority Under Section 13(b)

We believe that the Agencies may exercise their general rulemaking authority under Section 13(b) of the Rule to implement the exclusions for IBs and their parent companies described above.[18] The Rule provides that the Agencies "shall . . . adopt rules to carry out this section."[19] In so doing, Congress empowered the Agencies to answer a number of interpretive questions, and rectify certain statutory ambiguities. We believe that further defining the meaning of an insured depository institution for purposes of the Volcker Rule falls within the scope of this power.

The Agencies have previously exercised their interpretive discretion to exclude certain additional entities from the definition of banking entity. For example, the only statutory exclusion from the definition of a banking entity is the exclusion from the definition of an insured depository institution for those banks functioning solely in a trust or fiduciary capacity. However, the implementing regulations also exclude covered funds that are not themselves banking entities, certain portfolio companies and small business investment companies, and the FDIC acting in its corporate capacity or as a conservator or receiver from the definition of a banking entity. These exclusions help implement the statute in a manner that does not unduly disrupt the functioning of existing markets, and prevents the statute from curtailing certain activities that Congress likely did not intend to prohibit.[20] In adopting the first of these exceptions, the Agencies noted that the exception was adopted to avoid application of the Rule "in a way that appears unintended by the statute and would create internal inconsistencies in the statutory scheme."[21] The other exceptions appear to have been adopted under similar circumstances.[22] The existence of these exceptions indicates that the Agencies recognize that they are empowered to interpret the statutory definitions in order to ensure the Rule's proper functioning within the statutory scheme. The change to the regulatory definition of insured depository institution described above would

[18] *See* 12 U.S.C. § 1851(b)(2).

[19] 12 U.S.C. § 1851(b)(2)(A).

[20] *See* FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROHIBITIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS, 68-69 (2011) (noting that applying the statutory definition as-written would result in, for example, a *de facto* ban on operation of certain fund-of-fund businesses and on hedge funds and private equity funds controlled by a banking entity making investments in other funds).

[21] *See* 76 Fed. Reg. 68856-57 (Nov. 7, 2011).

[22] *See* 79 Fed. Reg. 5640-41, 5734 (Jan. 31, 2014) (exempting certain obligations of the FDIC; removing proposed prohibition on parallel investments, which specifically references permissibility of using merchant banking authority).

do the same by ensuring the Volcker Rule functions properly within the general framework of the BHCA, of which it is a part.

The Agencies have also dealt with interpretive questions regarding the interaction between different parts of the banking statutes. These include situations where the text of the statute would appear to compel one result, but the Agencies developed an alternative interpretation to ensure the Rule did not inadvertently prohibit what other statutes expressly permit. An example of this is how the Rule applies to activities of foreign banking entities that control IBs.[23] The Rule exempts investments by such banking entities made solely outside of the United States, even though the statutory text does not appear, on its face, to permit such an exemption.[24]

This approach further demonstrates that the Agencies may act and have acted within the scope of their powers under the Volcker Rule in offering interpretations of the statutory text that enhance its consistency with other statutes and the general statutory framework for regulation of banking organizations more generally. NAIB believes that the Agencies should take the same approach with respect to the scope of the definitions of insured depository institution and control.

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We appreciate the willingness of the Agencies to consider this comment, and would be happy to discuss further at the request of the Agencies.

Thank you,

[redacted]

Frank Pignanelli
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[23] *See id.* at 5535, 5653, 5739-40.

[24] The Rule states that this exemption applies to investments in or sponsorships of a hedge fund or private equity fund by a banking entity "pursuant to paragraph (9) or (13) of section 1843(c) of [the BHCA]." 12 U.S.C. § 1851(d)(1)(I). Because IBs are not considered banks under the BHCA, foreign parent companies of ILCs or IBs generally would not be eligible to make investments pursuant to these authorities, even if the activity would otherwise satisfy all of the substantive conditions for that exemption. Recognizing that the statute did not properly account for the difference in regulation between the holding companies of ILCs and IBs, and those of banks, the Agencies interpreted the statute to include such authority. As adopted, the Rule included an alternative to the qualifying foreign banking organization test under section 4(c)(9) of the BHCA, under which a foreign entity was not required to demonstrate that more than half of its banking business is outside the United States. *See* §§ __.6(e)(2)(ii)(B), __.13(b)(2)(ii)(B). The Agencies noted that they omitted this requirement to reflect "the fact that foreign entities subject to section 13 of the BHC Act, but not the BHC Act generally, are likely to be, in many cases, predominantly commercial firms . . . [and that applying this requirement] would likely make the exemption unavailable to such firms." *See* 79 Fed. Reg. at 5653 & 5739-40.