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250 E Street, S.W., Mail Stop 2-3
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Ann E. Misback
Secretary
Board of Governors of the Federal Reserve System 20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS,
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20551

Vanessa Countryman
Acting Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships with, Hedge Funds and Private Equity Funds, 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-AM10; CFTC; 17 C.F.R. Part 75 RIN: 3038-AE72

Ladies and Gentlemen:

We appreciate the opportunity to submit these comments in response to the request for public comments on the joint rulemaking of the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Commodity Futures Trading Commission and the U.S.

Securities and Exchange Commission[1] (collectively, the "Agencies") to revise the rules that implement the "Volcker Rule" restrictions on proprietary trading by banking entities and certain relationships between banking entities and hedge funds and private equity funds (the "Volcker Implementing Rules"). We understand from recent public statements from agency leadership that the proposed rulemaking will be reopened soon.

Summary

This comment letter makes two narrow suggestions for amendment of the Volcker Implementing Rules:

- Specify that the holding period for equity securities obtained through exercise of warrants or options that were granted to the banking entity in connection with a loan to the issuer begins when the loan was originally made, not when the warrant or option is exercised; and

- Exclude small business investment companies ("SBICs") licensed by the Small Business Administration (the "SBA"), low income housing tax credit partnerships ("LIHTC funds"), and other funds that qualify as "public welfare investments" from the definition of "banking entity" in subsection __.2(c)(2) of the Volcker Implementing Rules.

Both amendments would clarify and simplify the process for Volcker Rule compliance by banking entities making portfolio investments that have long been specifically authorized for national banks, state member banks and FDIC-insured nonmember banks. Neither change poses an increased risk to the investor bank or to the banking system as a whole.

Holding Period for Equities Acquired Through Exercise of Warrants or Options in Connection With Loans to Issuer

National banks (and, pursuant to 12 C.F.R. Part 362, FDIC-insured state banks) are authorized to hold warrants and options to acquire equity securities as additional compensation for loans to the issuer of the securities.[2] If the borrower is successful, and

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[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. 33,432 (July 17, 2018) (the "Release"). The statutory Volcker Rule is codified as Section 13 of the Bank Holding Company Act ("BHC Act"), 12 U.S.C. § 1851, and the Volcker Implementing Rules are codified at 12 C.F.R. §§ 44, 248 and 351 and 17 C.F.R. §§ 75 and 255. We cite to the uniform interagency subsections of the Volcker Implementing Rules preceded by an underscore mark for the relevant Agency's C.F.R. part.

[2] 12 C.F.R. § 7.1006; OCC Interpretive Letters No. 517 (Aug. 16, 1990), 992 (May 10, 2004). For the sake of simplicity, we use the term "warrant" to include both options and warrants.

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its equity securities increase in value above the strike price on the warrant, the bank can seek to monetize this additional compensation by selling the warrant back to the issuer or to a third party for cash or by exercising the warrant and selling the underlying equity security immediately thereafter in a "riskless principal" transaction.[3] National banks, however, generally cannot continue to own the equity securities after exercise of the warrant because the equity securities generally are not eligible assets for national bank ownership.[4]

The "proprietary trading" prohibition in the Volcker Rule[5] and the presumption in the Volcker Implementing Rules that the sale of securities within 60 days of acquisition constitutes proprietary trading unless established otherwise by the banking entity[6] creates an uncertainty around the use of a riskless principal sale of the equity securities immediately upon exercise of the warrant to acquire them. The issue is whether the 60-day short-term trading clock starts when the warrant is exercised, or instead many months or years earlier at the time the warrant was originally granted by the issuer/borrower when the loan was made by the banking entity. The Volcker Implementing Rules, the Agencies' responses to frequently asked questions regarding the Volcker Rule, and the adopting release for the Volcker Implementing Rules do not address this question.[7] Logically, the clock should start when the warrant was granted, back when the loan was made, because that is the moment when the banking entity obtained the contractual right to the equity upside as additional compensation for the loan.

The exercise of the warrant and immediate sale of the equity in a riskless principal transaction is not a short-term arbitrage. It is simply a mechanism for the banking entity to monetize its contractual right to a portion of the long-term run up in value of the equity of the issuer whose operations the banking entity helped finance with the loan. It is an alternative to selling the warrant back to the issuer in a cash-out exercise or a sale of the

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Warrants generally are contractual obligations of the company that issues the underlying equity securities, while options may be issued the issuer of the underlying equity, or by the parent company or a third party.

[3] *See* OCC, Activities Permissible for National Banks and Savings Associations, Cumulative at 39 (Oct. 2017); OCC Interpretive Letter No. 992 (May 10, 2004).

[4] *See* 12 U.S.C. § 24(Seventh), 12 C.F.R. Part 1; *accord*, 12 U.S.C. § 335, 12 C.F.R. § 208.21(b); 12 U.S.C. § 1831a; 12 C.F.R. § 362.3(a).

[5] 12 U.S.C. §§ 1851(a)(1)(A), 1851(h)(4).

[6] Volcker Implementing Rules __.3(b)(2).

[7] *See* Agencies, *Volcker Rule: Frequently Asked Questions* (last updated Mar. 4, 2016); *see also Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds; Final Rule*, 79 Fed. Reg. 5,536 (Jan. 31, 2014).

unexercised warrant to a third party (who then exercises the warrant to obtain the equity security). But because there are more potential buyers of the equity in the public trading markets and it is less complicated to sell the equity than to negotiate a sale of the warrant back to the issuer or to an individual private buyer, the riskless principal exercise of the warrant and immediate sale of the underlying equity received on the warrant is a simpler, more certain and more efficient way for the bank to monetize the warrants.

We respectfully suggest that the Volcker Implementing Rules be clarified to specify that the holding period for ownership of equity securities acquired through exercise of warrants received as additional compensation for a loan is when the loan was made and the warrant granted, rather than when the warrant is exercised. Subpart __.3 of the Volcker Implementing Rules would be the appropriate place to include the amendment. In the alternative, the clarification could also be included in the adopting release accompanying the amended rule.

Exclude SBICs, LIHTC funds and Other Public Welfare Investments from Definition of "Banking Entity"

National banks,[8] state member banks of the Federal Reserve System,[9] and FDIC-insured state nonmember banks[10] are expressly authorized by Section 302(b) of the Small Business Investment Act of 1958[11] (the "SBIA Act") to invest in SBICs in an aggregate amount not to exceed 5% of the investor bank's capital, and by the National Bank Act, Federal Reserve Act and the Federal Deposit Insurance Act to invest in community and public welfare investments, including LIHTC Funds, Community Reinvestment Act ("CRA") funds and other public welfare investments in similarly limited aggregate amounts based on a small percentage of the capital or assets of the bank.[12]

In recognition of the importance of these types of investments to our economy, the Volcker Rule[13] and Volcker Implementing Rules[14] specifically allow these private fund investments by excluding them from the definition of "covered fund." As a consequence, however, these funds do not benefit from the exclusion available to

[8] 12 C.F.R. § 7.1015.

[9] *See* 12 C.F.R. §§ 225.107, 225.112.

[10] *See* 12 C.F.R. § 362.3(a).

[11] 15 U.S.C. § 682(b).

[12] 12 U.S.C. § 24(Eleventh); 12 C.F.R. §§ 24, 208.22, 362.3(a)(2)(i).

[13] 12 U.S.C. § 1851(d)(1)(e).

[14] Volcker Implementing Rules __.10(c)(11).

"covered funds" from the definition of "banking entity" in subpart __.2(c)(2)(i) of the Volcker Implementing Rules. Therefore SBICs, LIHTC funds and other public welfare investment funds are themselves "banking entities" that are required to have Volcker Rule compliance programs, recordkeeping systems, governance processes and conform to the other requirements of the Volcker Rule, if they are controlled by a banking entity, such as through a 25% or higher limited partnership ("LP") or limited liability company ("LLC") investment in the fund.

SBICs, LIHTC funds, CRA funds and other public welfare investments by their nature invest their portfolios only in specific narrow categories of investments using long-term hold strategies that are not of the sorts that the Volcker Rule was intended to restrict.

For example, under SBA regulations and model forms of fund operating agreements, SBICs generally invest their portfolios in loans and debt and equity securities of small, non-publicly traded companies, and short-term cash and liquid investments.[15] They are not short-term traders of portfolio assets. Similarly, LIHTC Funds invest in apartment complexes and other multi-family housing projects occupied primarily by low- and moderate- income tenants, in order to qualify for federal tax credits under chapter 42 of the Internal Revenue Code and CRA credit under state and federal banking laws. Other public-welfare investments authorized for banks by their nature do not involve actively traded portfolios of "financial instruments."[16]

In practice, many of these funds are sponsored and operated by specialty investment managers that are not themselves banking entities, and offered for investment to unaffiliated banks, which are essentially passive investors in LP interests or LLC interests issued by the funds. Commonly these investments by any one bank are below 10% of the equity interests in the fund, but there is no reason under the federal banking laws, the Internal Revenue Code or the SBIA Act that they need to be so limited. Due to the limited availability of quality public welfare investments in some market areas and the need under the CRA Act to get investment credits for a bank's branch "footprint" market areas, banks often wish to acquire a larger equity stake in the SBIC, LIHTC, CRA or other public welfare fund.

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[15] 13 C.F.R. §§ 107.530 (restrictions on investment of idle cash), 107.700 *et seq.* (restriction on investment to specified types of small businesses); *See also* powers limitations in Section 2 of SBA Model Forms of SBIC partnership agreements, *available at* https://www.sba.gov/partners/sbics/forms-guides.

[16] *See* 12 C.F.R. § 24.6 (list of types of permitted public welfare and CRA investments); *Community Reinvestment Act, Interagency Questions and Answers Regarding Community Reinvestment; Guidance*, 81 Fed. Reg. 48,506 (July 25, 2016) (discussing types of investments for which CRA investment credit is allowed).

However, as currently in effect, the Volcker Implementing Rules treat SBICs, LIHTC Funds and other CRA funds and public welfare investments as "banking entities" subject to the Volcker Rule if a banking entity owns 25% or more of any class of voting interest in the fund. As a practical matter this does not affect the portfolio investments or investment strategies of these public welfare investment fund. But it does impose Volcker Rule compliance program, governance and record keeping requirements not only on the fund, but also on its general partner, managing member or other controlling entity. This serves no real risk reduction purpose. It simply is an inefficient cost burden imposed on these fund managers, their funds, and ultimately on the investor banks. Forcing these funds to needlessly devote costly resources to Volcker Rule process and compliance program requirements diverts resources away from the important federally-mandated goals of the funds to foster small business and the jobs and economic growth they create, provide housing to low- and moderate-income persons, and provide financing and economic development to low- and moderate-income communities and neighborhoods.

In the July 2018 Release, the Agencies discuss this issue for foreign public funds, employee securities companies and registered investment companies.[17] And, as noted in the July 2018 Release, the final rule adopted in 2013 excludes portfolio companies owned by an SBIC from the definition of "banking entity."[18] The argument for excluding SBICs, LIHTC funds, and other CRA and public welfare investment funds from the definition of "banking entity" is not that it would substantively interfere with their investment strategies, but instead that treating them as "banking entities" needlessly imposes the expense and burden of a Volcker recordkeeping, compliance and governance program on these public welfare funds and their managers, and impedes the important public purposes for which Congress authorized these investments, without furthering the purposes for which the Volcker Rule was enacted.

We therefore respectfully request that the Volcker Implementing Rules be amended to exclude SBICs, LIHTC Funds and other CRA and public welfare funds from the definition of "banking entity."

[17] 83 Fed. Reg. at 33442-33446.

[18] *Id.* at 33,443, n. 42.

We appreciate the opportunity to submit this comment letters on the proposed amendments to the Volcker Implementing Rules and thank you for your consideration of our comments. If you have any questions or wish to discuss them further, please do not hesitate to contact me at (202) 942-5745.

Respectfully submitted,

[redacted]

David F. Freeman, Jr.