

March 31, 2020

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Re: Comments on proposed "credit fund" exemption in *Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds*, Federal Reserve Docket No. R-1694, RIN 7100-AF70; OCC Docket ID-2020-0002; FDIC 3064-AF17; CFTC RIN 3038-AE93; SEC File No. S7-02-20

Dear Sir or Madam,

We are writing in support of the agencies' proposal to create a new exemption for "credit funds" from the definition of "covered funds" in the Volcker Implementing Rules.¹ With

¹ OCC, Federal Reserve, FDIC, CFTC, SEC, Proposed Rulemaking: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 12120 (Feb. 28, 2020). The proposed credit fund exemption would be codified at

March 31, 2020

Page 2

a few modest clarifications discussed below, the proposed new exemption can become a useful structure not only for fostering economic growth and stability, but also to work out troubled credits in the event of an economic downturn.

Set forth immediately below are suggested clarifications to the new exemptions that will improve the effectiveness of the proposal and reduce the need for future guidance. Some of the clarifications can be made in the adopting release accompanying the final rule, while others can be included in the text of the final rule. We also address these items for clarification in responses to questions 27-38 from the proposing release. Those questions, and our responses, are set forth below.

Clarify that “asset backed securities” requires issuance of tranches of debt securities

The existing “loan securitization” exemption of section __.10(c)(8) of the Volcker implementing rules requires that the loan pool be an issuer of “asset backed securities” as defined in Section 3(a)(79) of the Securities Exchange Act of 1934 (the “1934 Act”). The proposed “credit fund” exemption requires that the pool *not* be an issuer of “asset backed securities.” The meaning of “asset backed securities” is crucial to understanding which of these exemptions a loan pool can rely on. As currently drafted, the proposed exemption for “credit funds” has different substantive requirements for the permitted assets of the pool (conformance with safety and soundness standards applicable to the banking entity), imposes additional substantive restrictions on the operation of the pool (no proprietary trading allowed), and additional affiliate transaction restrictions on the relationship between the banking entity and the credit fund that do not apply to “loan securitizations” under the existing exception.² Both “loan securitization” pools and “credit funds” are pools of loans and some other fixed income assets, but one must issue “asset backed securities” and the other is prohibited from doing so. If the agencies adopt different exemptions for “loan securitizations” and “credit funds” with different requirements, the crucial term “asset backed security” needs to be more clearly defined.

The market understands the terms “asset backed securities” and “securitization” to mean the shifting of credit risk of financial assets to a pool that uses leverage in the form of multiple tranches of debt securities of different seniorities where payments on the debt securities are dependent on the cash flow from the pool of financial assets. This

subsection __.10(c)(15) of the interagency rules that implement the Volcker Rule (“Volcker Implementing Rules”), 12 C.F.R. §§ 44, 248, 351, 17 C.F.R. §§ 75, 255.

² Pools exempt from the covered fund definition as either “loan securitizations” or “credit funds” would be subject to Regulation W and Sections 23A and 23B of the Federal Reserve Act in their relations with an insured depository institution or its subsidiary that is or is affiliated with the sponsor or adviser to the pool, while pools exempted as “credit funds” would in addition be subject to the Volcker Rule’s “Super 23A” restrictions as modified by the amended Volcker Implementing Rules.

March 31, 2020

Page 3

understanding that leverage using tranches of debt securities of different seniorities distinguishes a “securitization” from a fund is clearly documented in the federal banking agencies’ capital rules, but is only hinted at and not clearly specified in Section 3(a)(79) of the 1934 Act and the SEC rules implemented thereunder Section 3(a)(79) of the 1934 Act.³ Section 3(a)(79) defines the term “asset backed security” by reference to a list of types of fixed income securities that fit the market understanding but the statutory definition leaves some uncertainty because it uses the phrase “fixed income or other security” and provides leeway to the SEC to add other categories to the definition by rulemaking.

Section 3(a)(79) specifies that:

The term “asset-backed security”—

(A) means a fixed-income or other security collateralized by any type of self-liquidating financial asset (including a loan, a lease, a mortgage, or a secured or unsecured receivable) that allows the holder of the security to receive payments that depend primarily on cash flow from the asset, including—

- (i) a collateralized mortgage obligation;
- (ii) a collateralized debt obligation;
- (iii) a collateralized bond obligation;
- (iv) a collateralized debt obligation of asset-backed securities;
- (v) a collateralized debt obligation of collateralized debt obligations; and
- (vi) a security that the Commission, by rule, determines to be an asset-backed security for purposes of this section; and

(B) does not include a security issued by a finance subsidiary held by the parent company or a company controlled by the parent company, if none of the securities issued by the finance subsidiary are held by an entity that is not controlled by the parent company.

³ See Regulation AB, 17 C.F.R. § 229.1101(c)(1) (definition of “asset backed security” in rules governing disclosure requirements for publicly traded asset-backed securities specifically excludes investment companies), Credit Risk Retention, 17 CFR § 246.2 (defining “ABS interest” to exclude common or preferred stock, limited liability interests, partnership interests, trust certificates or similar are issued primarily to evidence ownership of the issuing entity and are not primarily dependent on the cash flows of the collateral held by the issuing entity, as well as a right to receive payment for services provided).

March 31, 2020

Page 4

Section 3(a)(79) obviously requires that an “asset backed security” be a “security” as that term is defined for 1934 Act purposes.

Traditional bank loans⁴ to a loan pool, commercial paper,⁵ and active equity ownership interests such as a general partner interest in a partnership or a membership interest in a limited liability company (“LLC”) through which the member is actively involved in the operations and governance of the LLC⁶ are not “securities” for 1934 Act purposes. Loan pools financed solely by equity, “3(a)(10)” commercial paper, and bank loans are not issuers of “asset-backed securities.”

The understanding among industry participants is that an “asset backed security” is the product of a “securitization” in which financial assets are pooled and the pool entity issues debt securities in multiple tranches with different seniorities. The definitions in the federal banking agencies’ risk-based capital rules are consistent with this understanding.⁷ That capital rule defines “securitization” to mean a transaction in which the credit risk of one or more underlying financial exposures (such as loans, receivables, asset-backed securities, mortgage-backed securities, and other debt or equity securities) is transferred to third parties, and is separated into at least two tranches that reflect different levels of seniority, where payments depend upon the performance of the underlying financial exposures. The risk-based capital rules further distinguish a “securitization” from an

⁴ See 15 U.S.C. § 78c(a)(10); see also *Banco Espanol de Credito v. Security Pacific National Bank*, 973 F.2d 51 (2d Cir. 1992), cert. denied 509 U.S. 903 (1993).

⁵ 1934 Act Section 3(a)(10). Exempt commercial paper has an initial term to maturity of 270 days or less, is not subject to automatic renewal, is investment quality, is issued in large minimum denominations in institutional markets, and the issuer has more current assets than current liabilities.

⁶ See, e.g., *SEC v Howey*, 328 U.S. 293 (1946); *Ave. Capital Mgmt. II LP v. Schaden*, 843 F.3d 876,882 (10th Cir. 2016); *Rossi v. Quarmley*, 604 F. App’x 171 (3d Cir. 2015); *Robinson v. Glynn*, 349 F.3d 727 (4th Cir. 2003); *Great Lakes Chem. Corp. v. Monsanto Co.* 96 F. Supp. 2d 376 (D. Del. 2000); *Keith v. Black Diamond Advisors, Inc.* 48 F. Supp. 2d 326 (S.D.N.Y. 1999).

⁷ See 12 C.F.R. §§ 3.2, 3.202, 217.2, 217.202, 324.2, 324.202 (defining “securitization” to mean a transaction in which the credit risk of one or more underlying financial exposures (such as loans, commitments, credit derivatives, guarantees, receivables, asset-backed securities, mortgage-backed securities, other debt securities, or equity securities) is transferred to third parties, and has been separated into at least two tranches that reflect different levels of seniority, where performance depends upon the performance of the underlying exposures, but excluding operating companies, SBICs, SEC-registered investment companies and investment funds, and defining “investment fund” to mean a company that has no material liabilities and substantially all of the assets of the company are financial assets); 12 C.F.R. § 225, Appendix A at III(A), 34 (establishing look-through capital treatment for investment funds), and III(B)(3)(a)(xv) (creating more elaborate capital treatment for securitizations and defining “securitization” to mean “the pooling and repackaging by a special purpose entity of assets or other credit exposures into securities that can be sold to investors. Securitization includes transactions that create stratified credit risk positions whose performance is dependent upon an underlying pool of credit exposures, including loans and commitments.”).

March 31, 2020

Page 5

“investment fund,” which is defined to mean a company that has no material liabilities and substantially all of the assets of the company are financial assets, and from various other types of pooled investment vehicles such as registered investment companies, SBICs, community development investments, employee benefit plans, bank collective funds, and in most instances from operating companies.⁸

The SEC rules that implement the definition of “asset-backed securities” in Section 3(a)(79) of the 1934 Act are suggestive of the same result, but do not as clearly specify that an “asset backed” security requires the tranching of cash flows through the issuance of multiple classes of debt securities of different seniorities. In adopting Regulation AB, which specifies the registration process for public securitizations, the SEC acknowledged that while some ABS transactions involve simple pass through certificates of the cash flow of a pool, more often ABS transactions

involve multiple classes of securities, or tranches, with complex formulas for the calculation and distribution of the cash flows. In addition to creating internal credit enhancement or support for more senior classes, these structures allow the cash flows from the asset pool to be packaged into securities designed to provide returns with specific risk and timing characteristics.⁹

Rather than define the term “asset-backed securities” narrowly to this most common context for asset backed securities, the SEC chose to retain some flexibility in Regulation AB to allow a range of structures in order to address future developments. Retaining that flexibility is entirely appropriate in the context of defining disclosure requirements for public securitization transactions, but poses a problem when that flexibility creates ambiguity as to which of two different Volcker Rule covered fund exemptions applies to a particular structure.

We therefore respectfully suggest that either the text of the final rule or of the release accompanying the new exemption clarify the issue by including language to the effect of: “for purposes of §__.10 of the Volcker Implementing Rules, a pool must issue more than one tranche of debt securities with different seniorities whose payment streams are primarily dependent upon the financial assets held by the pool in order to qualify as an issuer of ‘asset-backed securities.’”

⁸ *Id.*

⁹ *Asset-Backed Securities*, SEC Rel. 33-8518 (Mar. 8, 2005).

March 31, 2020

Page 6

Allow BHC credit funds to own loans that do not meet bank credit quality standards

The existing loan securitization exemption does not set requirements for the credit quality of the loans that may be included in the assets of the pool.¹⁰ In contrast, the “safety and soundness” component of the proposed “credit fund” exemption would require, in essence, that the loans be limited to loans that the sponsoring or advising banking entity would be permitted to make and own¹¹, and a banking entity cannot rely upon the credit fund exemption to “invest” in a credit fund unless the portfolio loans, debt securities and cash investments of the credit fund meet the safety and soundness/credit quality standards and eligible investment requirements of the investing banking entity.

The “credit fund” proposal specifies that “the activities of the issuer are consistent with safety and soundness standards that are substantially similar to those that would apply if the banking entity engaged in the activities directly.” The federal banking agencies use “safety and soundness” requirements to impose relatively high credit quality requirements on insured depository institutions.¹²

The banking agencies require that loans made or acquired by a bank meet relatively high credit quality standards.¹³ A bank may continue to own, restructure, and work out loans that decline in credit quality or default after the bank makes or acquires the loan, although they are subject to regulatory criticism and in sufficient volume can negatively impact a bank’s CAMELS rating.¹⁴ In contrast, bank holding companies are permitted to make,

¹⁰ Volcker Implementing Rules §§ __.2(s), __.10(c)(8)(i)(A). Public asset securitizations that rely on Form S-3 under Regulation AB generally cannot include at the time of issuance of the asset backed securities any defaulted or non-performing loans, and no more than 20% with delinquent payments. Securitizations that use Form S-1, and private securitizations, are not subject to these credit quality requirements. *Asset-Backed Securities*, SEC Rel. 33-8518 (Mar. 8, 2005); *Bond Market Ass’n* (SEC Staff No-Action Letter Oct. 8, 1997).

¹¹ Proposed new § __.10(c)(15)(iii)(B).

¹² See, e.g., 12 C.F.R. §§ 1.5, 30, Appendix A, 364, Appendix A; Federal Reserve Board, Division of Supervision, *Commercial Bank Examination Manual*, sections 2040-2060 (2019).

¹³ *Id.*

¹⁴ The proposal allows a credit fund to own non-conforming assets acquired “DPC” (in connection with foreclosing on or restructuring debts previously contracted). We understand this DPC provision would allow a credit fund to continue to own, work out, restructure and foreclose on loans that decline in credit quality after acquisition by the credit fund. We assume this provision would also allow a bank to sell or transfer to a credit fund as a capital contribution troubled loans and DPC assets previously acquired by the banking entity provided sufficient conflicts disclosures and valuation provisions are in place. This would allow the credit fund exemption to be used by banking entities as part of a good bank/bad bank strategy to transfer to third party investors a portion of the risk and potential return on portfolios of troubled loans, which could be useful to economic stability in a downturn.

March 31, 2020

Page 7

acquire and hold loans of lesser credit quality.¹⁵ Based upon the structure of proposed new subsection __.10(c)(15)(iii)(B) and (iv), we understand the intent of the proposed exemption is not to apply the tighter credit standards that apply to a bank to a credit fund in which the bank is not an investor but its parent bank holding company or nonbank subsidiary of the holding company has an ownership interest or is the sponsor. Further, for banks as investors in credit funds, based upon the structure of proposed new subsection __.10(c)(15)(iii)(B) and (iv), we understand that the ability of an investor bank to invest in that credit fund is conditioned upon the loan portfolio assets of that credit fund being eligible loans and assets for the bank to make and own directly, but if a bank were to invest in a credit fund that included loans that are not eligible investments for that investor bank, the credit fund would not lose its subsection __.10(c)(15) exemption as an investment for other banking entities that are authorized to invest in the types of portfolio loans and other assets that the credit fund invests in. More specifically, we understand that a bank holding company or its nonbank subsidiary would be permitted by proposed subsection __.10(c)(15) as currently drafted to sponsor and/or advise a covered fund that makes or acquires troubled or defaulted loans, and that banking entities that are bank holding companies or their nonbank subsidiaries would be allowed to invest in “ownership interests” in such a credit fund.

Similarly, the credit fund proposal requires that debt securities and other non-loan assets held by a credit fund are limited to assets that the banking entity could acquire and hold directly.¹⁶ The permissible investments of insured depository institutions and their operating subsidiaries¹⁷ are more limited than the permitted investments of bank holding companies.¹⁸ We assume the intent is not to apply the tighter permissible non-loan investment standards that apply to the bank to a credit fund in which the bank is not an investor but its parent bank holding company or nonbank subsidiary of the holding company has an ownership interest or is the sponsor.

Although the language of the proposed rule already so specifies, we believe it is important to further clarify the issue by including in the adopting release words to the effect of: “For the avoidance of doubt, the portfolio quality and investment standards to be applied to a credit fund are those applicable to the banking entity that is the sponsor of or that owns an “ownership interest” in the credit fund, and should not be interpreted to mean that the standards applicable to an affiliated bank that is neither a sponsor of or investor in the credit fund apply to a credit fund in which the bank holding company or its nonbank subsidiary is the sponsor and/or investor in ‘ownership interests’.”

¹⁵ 12 C.F.R. §§ 225.28(b)(1) &(2)(vii).

¹⁶ Proposed § __.10(c)(15)(iv)(B).

¹⁷ 12 C.F.R. §§ 1, 362.

¹⁸ 12 C.F.R. §§ 225.22(d)(4), (5), (6), (8), 225.28(b)(1)&(2).

March 31, 2020

Page 8

There are a few additional technical issues with the details of this part of the exemption as proposed. The Volcker Rule does not restrict a banking entity from serving as an investment adviser to a covered fund. A banking entity does not need to rely on a “covered fund” exemption of any sort to serve as investment adviser to a covered fund. Nor does the Volcker Rule prohibit a banking entity from lending to a covered fund or owning a carried interest for providing services or a debt security of a covered fund that is not an “ownership interest” (except where the banking entity or its affiliate serves as sponsor or investment adviser to the covered fund). It is not clear, either as a statutory construction matter or as a risk management matter, why the safety and soundness standards (which we read to include credit quality standards) applicable to a banking entity that is investment adviser to a credit fund should apply to the portfolio of a credit fund if the banking entity does not own an ownership interest in the credit fund. This would have the effect of imposing higher credit quality standards on the loan portfolio of a credit fund advised by a bank or its subsidiary investment adviser than a credit fund advised by a nonbank investment adviser subsidiary of the bank holding company, even if the investment adviser bank or its subsidiary does not invest in the credit fund.

In our view it would therefore be appropriate to strike the words “investment adviser” from the heading of proposed subsection __.10(c)(15)(iii). Moreover, a “commodity trading advisor” to a covered fund is deemed to be a “sponsor” of that covered fund. Thus, the inclusion of the term “, or commodity trading advisor” in the heading and first sentence of proposed §__.10(c)(15)(iii) is redundant and should be deleted. As revised, our suggested opening of (iii) would read: “(iii) Requirements for a sponsor. A banking entity that acts as a sponsor to an issuer that....”

A second set of technical issues involves the investment restrictions imposed by proposed subsections __.10(c)(15)(iv)(B) and (v)(B). As regards proposed subsection __.10(c)(15)(iv)(B), where the investor in ownership interests is a bank or operating subsidiary of a bank, OCC and FDIC regulations and interpretations would impose this requirement even without this clause.¹⁹ Where the investor is a bank holding company or its nonbank subsidiary is an investor in ownership interests representing “control” of the fund or aggregating to more than 5% of a class of the voting securities of the fund if the banking entity is investment adviser to the fund, the Bank Holding Company Act and Regulation Y would impose a similar requirement.²⁰ We suggest adding to the end of proposed subsection __.10(c)(15)(iv)(B) the words: “under applicable federal banking laws and regulations” to avoid the need for the credit fund to seek to verify portfolio

¹⁹ 12 C.F.R. §§ 1.3(e), (f), (h), 362 (limits on investments of banks).

²⁰ 12 C.F.R. §§ 225.22(d)(4), (5), (6), (8), 225.28(b)(1)&(2).

March 31, 2020

Page 9

compliance with state or foreign banking laws and limit the complexity of determining compliance with the “credit fund” exemption.

Further, as regards proposed subsection __.10(c)(15)(v)(B), applicable banking laws and regulations apply of their own force. That is why they are called “applicable” banking laws and regulations. They do not need to be incorporated into this exemption as a condition to the exemption. Therefore we suggest that proposed subsection __.10(c)(15)(v)(B) be omitted from the final rule as unnecessary.

We further suggest that it be made clear in the adopting release that the investment limits and safety and soundness standards applicable to otherwise unaffiliated banking entities that invest in the credit fund do not determine compliance of the fund with the “credit fund exemption.” As regards any third-party U.S. banking entities that wish to invest in an exempt “credit fund,” other applicable federal banking laws separately impose portfolio limits and requirements,²¹ so including limits in the credit fund exemption are not needed to police the credit quality and asset permissibility for third-party investor banking entities. In other words, if a bank that is not the sponsor in a credit fund decides to invest inappropriately in a fund designed for investment by bank holding companies it should not cause the credit fund to lose its exemption and become an impermissible “covered fund” investment under the Volcker Rule for bank holding companies that have invested in the credit fund.

Allow banks to retain interests in work-out credit funds in connection with contributing substandard, distressed and defaulted loans

A useful strategy to banks in disposing of portfolios of troubled loans is to pool the loans and sell interests in the pool to third party investors that are interested in financing and taking on the credit risk of the loan pool. Generally speaking, a bank is able to get a better price for the pool if it retains a portion of the equity of the pool – the so-called “skin in the game” that signals to other investors that the bank has confidence in the downside valuation placed on the pool of loans and the ability of management to realize value for all investors in working out the loans. It also allows the bank to recapture some of the upside value of the pool if the loan workouts are successful. Retaining an equity interest in the troubled loan pool is allowed, and in many contexts may be required, by the credit risk retention rule.²²

²¹ 12 C.F.R. §§ 1.3(e), (f), (h), 362 (limits on investments of banks), 12 C.F.R. §§ 225.22(d)(4), (5), (6), (8) (limits on investments of bank holding companies and their nonbank subsidiaries).

²² 12 C.F.R. §§ 43, 244, 373, 1234; 17 C.F.R. § 246, 24 C.F.R. § 267.

March 31, 2020

Page 10

These pools may be created for an individual bank to dispose of its troubled loans or, to achieve a larger and more diversified pool and achieve scale efficiencies, created along with other banks that contribute their own troubled loans and also retain interests in the collective troubled loan pool.

This arrangement is permitted under the existing “loan securitization” exemption, provided that the pool is an issuer of “asset-backed securities.” But under the proposed new “credit fund” exemption, banks and their operating subsidiaries would apparently not be allowed to retain ownership interests in pools of loans that, at the moment the bank invests, contain loans that are not up to the credit quality required of loans held in portfolio by the bank. This is particularly true in the context of pools of troubled loans contributed by more than one bank.

In order to allow a bank or its operating subsidiary to use the credit fund exemption to the Volcker Rule as part of a troubled loan portfolio disposition strategy, we suggest that the rule be clarified to allow a bank or its operating subsidiary to sponsor and/or retain an ownership interest in a pool containing substandard, distressed and/or defaulted loans contributed by that bank alone or along with other banks, in connection with their exercise of DPC and workout authority.

We do not suggest that a bank or its operating subsidiary be allowed to invest in pools of troubled debt other than in this limited context. We note, however, that under existing Regulation Y and under the credit fund exemption as proposed, a bank holding company or its non-bank subsidiary would be allowed to sponsor and invest in ownership interests in a pool of troubled loans regardless of whether the bank holding company has contributed loans to the pool.

We therefore suggest adding a new subsection __.10(c)(15)(vi) that specifies that “Notwithstanding any other provision of this subsection __.10(c)(15), an insured depository institution or its operating subsidiary shall be allowed to acquire and retain an interest in a credit fund through a contribution of troubled loans and DPC assets from the portfolio of the insured depository institution or its operating subsidiary, notwithstanding that the portfolio of that credit fund includes loans and DPC assets contributed by that depository institution or its operating subsidiary or other insured depository institutions and their operating subsidiaries also in exchange for interests in the credit fund that would not otherwise meet the credit quality standards of an insured depository institution in other contexts.”

March 31, 2020

Page 11

Clarify holding periods for DPC assets of a credit fund

The proposed new credit fund exemption allows a credit fund to hold assets acquired in a work out or foreclosure of portfolio loans of the credit fund (*i.e.* DPC assets) but does not specify the holding period for the DPC assets. National banks, state banks, and bank holding companies are subject to similar but subtly different DPC holding periods, and bank holding companies that acquire debt that is in default at the time of acquisition have a shorter DPC holding period that starts when the defaulted debt is acquired, rather than the later date that the DPC assets are acquired in foreclosure or in a work-out or restructuring of the credit.²³ In addition, these DPC holding periods of banks and bank holding companies can be extended upon the approval of the bank's or bank holding company's regulators. Would a credit fund be eligible to seek an extension from a bank regulator, and if so, which one? Would all of the state and federal bank regulators whose banking entities are invested in the credit fund need to approve the extension? If the credit fund is not sponsored or advised by a banking entity but has banking entities among its investors, would the federal banking agencies still be willing to entertain requests for extensions from the credit fund or its nonbank manager?

These are not academic questions, but important practical issues that would need to be worked out before the new credit fund exemption can be used effectively. The ability to delay the sale of DPC assets is especially important in times of market illiquidity, economic stress and financial crisis, to avoid forcing their disposal at "fire sale" prices.

Moreover, the current short time DPC asset holding period that applies under the BHC Act and Regulation Y to debts that were in default at the time of acquisition, and the early trigger to that holding period as of the date the debt was acquired (if already in default at time of acquisition) puts a very short and imprudent clock on the disposition of DPC assets related to those defaulted loans if they are not otherwise eligible for long-term ownership by the bank holding company. For example, if a bank holding company acquires a loan that is in default at the time of acquisition, and seeks to work with the borrower through forbearance and loan modification over the course of two years, but ultimately needs to foreclose on collateral or otherwise acquires DPC assets that are not otherwise eligible for ownership by a bank holding company (such as more than 5% of a class of voting securities of a company), the DPC holding period clock has run and the

²³ Compare 12 U.S.C. § 1843(c)(2); 12 C.F.R. §§ 225.22(d)(1), 225.140 (holding period for DPC assets acquired for non-defaulted loans), *with* 12 C.F.R. § 225.28(b)(2)(vii) and 12 C.F.R. § 225.12(b)(2) (shorter holding period and earlier start to holding period for loans that are already in default at time acquired).

March 31, 2020

Page 12

bank holding company must immediately dispose of the otherwise ineligible asset at whatever price is available.²⁴ That benefits no one and does not serve the public interest.

A simple way to resolve this issue would be to clarify in the text of the new exemption or in the adopting release accompanying the rule, words to the effect of: “The maximum holding period for DPC assets owned by a credit fund shall be five years, with the holding period commencing on the date that the DPC assets are acquired by the credit fund (not the date that the loan is acquired even if in default at the time of acquisition), but can be extended for up to five additional years in periods of market stress and illiquidity by order of [the Federal Reserve].”

Benefits to allowing bank holding companies to sponsor and invest in troubled loan funds

There is a public benefit to allowing bank holding companies and their nonbank subsidiaries to sponsor and invest in credit funds that own troubled loans. Banking organizations have special expertise in managing portfolios of distressed debt. Many loans currently are held in pools managed by nonbank investment managers with limited or no experience in working out troubled loans. In the current environment, allowing banking entities to apply their special expertise in restructuring and working out troubled loans through a private fund structure would be particularly helpful. The Volcker Rule should not stand in the way of bank loan workout expertise being brought to bear now, when it is needed most.

The Federal Reserve Board has long recognized that “[b]anks and bank holding companies have significant expertise in identifying, holding, valuing, and working out defaulted debt; in determining the value of collateral for loans; and in participating in the financial restructuring of companies whose debt obligations are impaired.” Given this belief, the Federal Reserve Board allows bank holding companies to directly and indirectly acquire distressed debt, including debt in default, under the general lending authority of a banking organization and as authorized related activity, both of which are identified as “closely related to banking.”²⁵ In orders authorizing bank holding companies to acquire distressed debt or debt in default, the Federal Reserve Board has stated that “[l]ending is a core banking activity, and banks and bank holding companies

²⁴ See 12 C.F.R. § 225.28(b)(2)(vii) (referencing shorter DPC holding period of 12 C.F.R. § 225.12(b) for assets acquired in satisfaction of debts that were in default at the time acquired).

²⁵ 12 C.F.R. § 225.28(b)(1) and (2). See also, Bank Holding Companies and Change in Bank Control (Regulation Y), 62 Fed. Reg. 9305 (February 28, 1997) (The Federal Reserve noted that “making, acquiring, brokering and servicing all types of loans or extensions of credit are considered permissible lending activities,” and certain activities like “acquiring debt in default” are “usual in connection with making, acquiring, brokering or servicing loans or other extensions of credit.”)

March 31, 2020

Page 13

routinely make and purchase debt; collect, work out, and restructure debt; and participate on creditors' committees for companies in default on debt in connection with the bank's or the holding company's direct lending activities."²⁶ Furthermore, the Federal Reserve Board has stated that the public benefits from banking organizations engaging in the acquisition of distressed debt, including debt in default, in accordance with the limitations set forth in the Federal Reserve Board's regulations and interpretations, can reasonably be expected to produce public benefits, such as increases in resources and funding available for loan workouts and remediations.²⁷ Allowing a bank holding company or its nonbank subsidiary greater freedom to do so through a "credit fund" would serve the public interest and would be consistent with the Federal Reserve Board's recognition of the public benefits of allowing bank holding companies and nonbank subsidiaries to acquire distressed debt, including debt in default, as an activity "closely related to banking."

We note that a banking entity can also choose to sponsor, advise and provide other services to a loan fund, and own a "carried interest" and a *de minimis* amount of other equity "ownership interests" in a loan fund subject to a capital haircut pursuant to the existing exemptions provided by the Volcker Implementing Rules, including subsections __.11(a) (fiduciary fund exemption, subject to the 3%/3% investment limit) and __.11(b) (asset securitization exemption, subject to a 5%/3% investment limit). What the proposed "credit fund" exemption allows, however, is the ability of third-party banking entities to invest in "ownership interests" in a credit fund, and allows an uncapped investment in a credit fund. Given the statutory directive in the Volcker Rule not to limit or restrict the sale or securitization of loans by a banking entity,²⁸ we believe the additional flexibility provided by the proposed credit fund exemption is an appropriate implementation of the statutory intent.

²⁶ Norwest Corporation Board Order ("Norwest Order"), 81 Fed. Res. Bull. 1128 (F.R.B.), 1995 WL 736778 (December 1995).

²⁷ See e.g., Norwest Order (The Federal Reserve Board found that the Norwest's acquisition of an asset-based commercial lending company (which involved acquisition of debt in default) would produce increased economies of scale and gains in efficiency for Norwest and increase the funding available to lenders in connection with credit purchases by the lending company.); see also, Bank of America Corporation Order, 94 Fed. Res. Bull. C81 (F.R.B.), 2008 WL 7861866, pg. 14 (August 2008) (The Federal Reserve Board found that Bank of America Corporation's acquisition of Countrywide Financial Corporation (which involved the acquisition of debt in default) would result in public benefits include enhanced loan remediation processes.).

²⁸ 12 U.S.C. § 1851(g)(2).

March 31, 2020

Page 14

Specify that warrants associated with loans are not trading account assets

The proposed “credit fund” exemption would allow the credit fund to own equity warrants associated with portfolio loans on essentially the same terms as are permitted for banks.²⁹ Banks normally are not permitted to own the underlying equity securities after exercise, and thus either sell the warrant prior to exercise or sell the underlying equity securities immediately upon exercise. The proposed “credit fund” exemption prohibits the fund from engaging in “proprietary trading” in securities. In order to make clear that a credit fund may realize value on an equity warrant, we respectfully suggest that either the text of the rule or the adopting release that accompanies the final rule make clear that a credit fund is not deemed to be engaged in “proprietary trading” by exercising the warrant and simultaneously or promptly selling the underlying equity securities. This would align the treatment of warrants with that accorded to DPC securities under the exemption.

Responses to questions 27 through 38 on the proposed “credit fund” exemption

Set forth below are questions 27-38 from the proposing release (in bold) followed by our responses (indented, not in bold).

Question 27. Is the proposed rule’s approach to a credit fund exclusion appropriate and effective? Why or why not? Do the conditions imposed on the proposed exclusion effectively address the concerns about administrability and evasion that the agencies expressed in the preamble to the 2013 rule?

Yes, the proposed rule’s approach to a credit fund exclusion is appropriate and effective, but could be made more effective through small clarifications, including that:

- an issuer of “asset backed securities” means a pool of financial instruments that issues tranches of debt securities with different seniorities;
- in order to qualify for the new “credit fund” exemption, the loan portfolio of a credit fund in which a bank holding company or its non-bank subsidiary is the sponsor must meet the safety and soundness/loan credit quality requirements applicable under the Bank Holding Company Act and Regulation Y (including performing, non-performing and defaulted

²⁹ See 12 C.F.R. §§ 1.6, 7.1006 (national banks allowed to receive and own equity warrants as additional consideration on loans), 362 (FDIC-insured state member banks generally limited to engaging as principal in activities that are permissible for a national bank).

March 31, 2020

Page 15

loans and associated DPC assets), while that of a credit fund in which a bank or its operating subsidiary is the sponsor must meet the safety and soundness and investment requirements applicable to a national bank or FDIC-insured state bank;

- a bank or its operating subsidiary that invests in a credit fund cannot invest if the loan portfolio of the credit fund invests in loans or debt instruments that are not permissible assets of the bank (although this already applies under OCC and FDIC rules, so not clear why this has been added as a condition to the investor banking entity's reliance on the credit fund exemption to make the investment) but such an investment by a bank would not preclude banking entities that are bank holding companies or nonbank subsidiaries from investing where the portfolio loans or debt investments are permissible under Regulation Y;
- a banking entity (including a bank) should be allowed to transfer its own performing, non-performing, defaulted or otherwise distressed portfolio loans and associated DPC assets to a credit fund through a sale or capital contribution and receive back cash, debt obligations, or an ownership interest in the credit fund;
- Subsection __.14 and most of subsection __.15 of the Volcker Implementing Rules do not apply to the transactions and relationships between a banking entity that is an investor in a credit fund that is not sponsored, advised or "controlled" by the banking entity or any of its affiliates, and this should be made more clear in the final text of subsection __.10(c)(15)(iv)(A); and
- specify that warrants associated with loans, and the underlying securities received on exercise, are not "trading account" assets and can be sold before, at or promptly after exercise without triggering the prohibition on the proprietary fund engaging in proprietary trading.

***Question 28.* What types of loans and permissible debt instruments or some subset of those assets, if any, should a credit fund be able to hold? Are the definitions used in the proposed exclusion appropriate and clear?**

- The loan and investment portfolio of a credit fund in which a bank holding company or its non-bank subsidiary is the sponsor or is an investor in "ownership interests" should be required to meet the safety and soundness and investment requirements applicable under the Bank Holding Company Act and Regulation Y (including performing, non-performing and defaulted loans and associated DPC assets).

March 31, 2020

Page 16

- The loan and investment portfolio of a credit fund in which a bank or its operating subsidiary is the sponsor or is an investor in “ownership interests” should be required to meet the safety and soundness and investment requirements applicable to a national bank or FDIC-insured state bank.
- A new subsection __.10(c)(15)(vi) should be added to the exemption to specifically allow, insofar as the Volcker Rule is concerned, the use of credit funds in a good bank/bad bank transaction or other loan portfolio work-outs. Such a clause would permit one or more banking entities to use their DPC authority to transfer their own underperforming, non-performing, defaulted or otherwise distressed portfolio loans and associated DPC assets to a credit fund through a sale or capital contribution and hold debt or equity interests paid for by the contributed troubled loans and assets, notwithstanding the fact that the loan and DPC portfolio of the resulting credit fund might not otherwise be permitted assets of the banking entity.

Question 29. The agencies believe it could be appropriate to permit credit funds to hold a small amount of non-loan and non-debt assets, such as warrants or other equity-like interests directly related to the other permitted assets, subject to appropriate conditions. Should credit funds be able to hold small amounts of equity securities (or rights to acquire equity securities) received on customary terms in connection with the credit fund’s loans or debt instruments? If so, what should be the quantitative limit on permissible non-loan and non-debt assets? Should the limit be five or ten percent of assets, or some other amount? How should such quantitative limit be calculated? Does the holding of a certain amount of equity securities (or rights to acquire equity securities) raise concerns that banking entities may use credit funds to evade the limitations and prohibitions in section 13 of the BHC Act? Why or why not? For example, under the proposal, could the holdings of an excluded fund be predominantly equity securities (or rights to acquire equity securities) received on customary terms in connection with the credit fund’s loans or debt instruments? If so, how?

Yes, credit funds should be allowed to make or acquire loans with warrants and similar “equity kickers” on the same terms as is permitted for national banks pursuant to 12 C.F.R. §§ 1.6, 7.1006. That requires, among other things, that the warrants be in addition to, and not in lieu of, repayment of principal (and generally is in addition to interest payments as well), that they be exercisable at the option of the lender, not the issuer, and that the lending with warrants attached meet applicable safety and soundness requirements. If a bank or bank operating

March 31, 2020

Page 17

subsidiary is a sponsor or investor in “ownership interests” in the credit fund, then the credit fund should dispose of impermissible equity securities before, at, or promptly after exercise and that should not be viewed as short-term profit driven “proprietary trading” because the credit fund acquires the right to obtain the equity security when the loan is made or acquired not at the later date when the warrant is exercised. If a bank holding company is the sponsor or investor in “ownership interests” in the credit fund should conform its holdings of equity securities before, at, or promptly after exercise to the percentage limits of the Bank Holding Company Act and Regulation Y.

No, allowing lending with warrants attached does not raise concerns about evading Section 13 or other provisions of the Bank Holding Company Act. It is not a short-term strategy. There is a long time between when the loan is made (and the warrant acquired) and the exercise of the warrant and sale of the equity securities. Banks and bank holding companies have engaged in this activity for decades for their own accounts as principal under existing law. Lending with warrants as conducted by banking entities is not a strategy to build an equity portfolio, it is a way to get a little bit of extra compensation when a borrower is very successful. Banking entities that currently engage in lending with warrants attached expect that roughly 90% of the time the warrants will expire unexercised, because either the equity is not “in the money” at the exercise date, or the issuer has not gone public or merged with a public company by that date. Moreover, the most common form of exercise requires the issuer to redeem out the exercising lender in cash for the difference between market price and strike price, rather than be actually delivering equity securities. And for those few instances where the lender exercises and obtains equity securities, more often than not they are sold relatively quickly or transferred to the parent holding company and conformed to the Regulation Y cap on equity securities (5% of a class of voting securities of an issuer).

***Question 30.* The proposed credit fund exclusion would permit excluded credit funds to hold related rights and other assets that are related or incidental to acquiring, holding, servicing, or selling loans or debt instruments, provided that each right or asset that is a security meets certain requirements. Should credit funds be allowed to hold such related rights and other assets? Are these assets necessary for the proper functioning of a credit fund? Are the requirements regarding rights or assets that are securities applicable to the holdings of credit funds or otherwise appropriate?**

Yes, these rights and other assets should be permitted for a credit fund. They are useful or in some cases necessary to assure timely payment (and repayment of principal at maturity) and in obtaining investment quality ratings.

March 31, 2020

Page 18

Question 31. Is the list of permitted securities appropriately scoped, overbroad, or under-inclusive? Why or why not? Should the list of permitted securities be modified? If so, how and why?

The permitted securities list and requirements are appropriate if the words “investment adviser, or commodity trading advisor” are deleted from the heading and first sentence of subsection __.10(c)(15)(iii) (because those words are not needed to achieve the objective of the clause), and the following is the intended meaning of the clauses:

A bank holding company or its nonbank subsidiary cannot invest in “ownership interests” in a credit fund in reliance on the exemption unless the debt securities investment portfolio held pursuant to subsection __.10(c)(15)(i)(B) or (C) of the credit fund meet the investment requirements applicable under the Bank Holding Company Act and Regulation Y.

A bank or its operating subsidiary cannot invest in “ownership interests” in a credit fund in reliance on the exemption unless the debt securities investment portfolio held pursuant to subsection __.10(c)(15)(i)(B) or (C) of the credit fund meet the investment requirements applicable to a national bank or an FDIC-insured state bank under federal law.

We suggest the agencies make clear that if the governing documents of the credit fund include such a portfolio investment restriction, then the reasonable, good faith reliance of a banking entity on representations by a credit fund of its portfolio’s compliance with those requirements will provide a safe harbor for the investing banking entity.

Question 32. The proposal provides that any interest rate or foreign exchange derivatives held by the credit fund adhere to certain requirements. Should credit funds be allowed to hold these, or any other type of derivatives? Are the requirements that the written terms of the derivatives directly relate to assets held and that the derivatives reduce the interest rate and/or foreign exchange risks related to the assets held applicable to the holdings of credit funds generally? Are such requirements otherwise appropriate? Why or why not?

Any derivatives held in a credit fund’s fund portfolio should be limited to warrants to acquire equity securities associated with loans, interest rate and FX derivatives to hedge loans or convert them to the governing currency of the fund or its financing debt, and other bona fide risk-reducing hedging transactions. In

March 31, 2020

Page 19

some cases use of equity put options (whether documented as options or swaps) or forward sales contracts where the fund is the “seller” or owns the put right are useful in hedging troubled loans, DPC assets and equity warrants associated with loans, and should also be permitted in essentially the same way as permitted for a banking entity as principal. We therefore suggest adding a clause (E) to the end of subsection __.10(c)(15)(i) as follows:

“(D) Forward sales contracts for portfolio assets, or equity or index put or collar options (whether documented as an option or swap, or settled in cash or in kind), if the credit fund is the seller or holder of the right to exercise the put, and the contracts are used to dispose of a portfolio asset or hedge against a potential decline in value of portfolio assets.”

Question 33. Which safety and soundness standards, if any, should be referenced in the credit fund exclusion? Should the agencies reference the safety and soundness standards codified in the banking agencies’ regulations, e.g., 12 CFR part 30, 12 CFR part 364, or other safety and soundness standards? Safety and soundness standards can vary depending on the type of banking entity. Is there a universally applicable standard that would be more appropriate, such as standards applicable to insured depository institutions?

See response to question #28 above.

Question 34. Is the application of sections __.14 and __.15 to the proposed credit fund exclusion appropriate? Why or why not? Should a banking entity that sponsors or serves as an investment adviser to a credit fund be required to comply with the limitations imposed by both sections __.14(a) and (b)? Why or why not?

The arrangement is subject to Sections 23A and 23B of the Federal Reserve Act and Regulation W if a bank or its operating subsidiary is involved in the transaction or series of transactions with the credit fund, and the credit fund is either a control affiliate of the bank or the fund’s investment adviser is the bank or a subsidiary or affiliate of the bank.

Section __.10(c)(15)(iv)(B) of the proposal would allow a banking entity to make an unlimited investment in “ownership interests” in the credit fund (*i.e.* not subject to the 3% investment cap that applies to covered funds sponsored or advised by the banking entity and operated pursuant to subsection __.11(a) of the Volcker Implementing Rules). But as currently drafted, proposed subsection __.10(c)(15)(v)(A) apparently would not allow investment by an affiliated or unaffiliated banking entity in the debt tranches of a credit fund. If the proposed

March 31, 2020

Page 20

new credit fund exemption allows a banking entity to invest to an unlimited degree in the equity, it is not clear how safety and soundness are furthered by prohibiting the banking entity from investing in the debt tranches. Moreover, for an unaffiliated banking entity, the senior debt tranches typically are not “ownership interests” in a covered fund, so neither Section 23A/B/Regulation W, not “Super 23A” would otherwise prohibit an otherwise unaffiliated banking entity from investing in senior debt tranches.

The exemptions in the “Super 23A” provisions of the Volcker Implementing Rules are being brought into closer conformity to Sections 23A and 23B of the Federal Reserve Act and Regulation W by other parts of the rulemaking proposal.

In view of the above, it is not clear what further safety and soundness benefits accrue from subjecting credit funds to sections __.14 and __.15 of the Volcker Implementing Rules. Therefore, we suggest deleting subsection __.10(c)(15)(v)(A) from the proposal so as not to subject banking entities already subject to Sections 23A, 23B and Regulation W to the additional “Super 23A” affiliate transaction restrictions that are statutorily designated for the sponsor and advisor banking entity.

For banking entities that are not the sponsor or investment adviser or lead equity investor, it is not clear how safety and soundness are furthered by prohibiting the banking entity from investing in the senior debt tranches but allowing it to invest in the equity tranches. Therefore, we suggest deleting subsection __.10(c)(15)(v)(A) from the proposal so as not to subject otherwise unaffiliated investors that are banking entities to the “Super 23A” affiliate transaction restrictions that are statutorily designated for the sponsor and advisor banking entity.

Question 35. Is it appropriate to require a banking entity that sponsors or serves as an investment adviser or commodity trading advisor to a credit fund, to comply with the disclosure requirements of § __.11(a)(8), as if the credit fund were a covered fund? Why or why not?

Yes. The requirements of __.11(a)(8) bring clarity to disclosure of conflicts and risks, things that may be required in any event by the federal securities laws’ anti-fraud requirements.

Question 36. Is the definition of proprietary trading in the credit fund exclusion appropriately scoped, overbroad, or under-inclusive? Why or why not? If the

March 31, 2020

Page 21

definition is not appropriately scoped, is there an alternative definition of proprietary trading? Should credit funds sponsored by, or that have as an investment adviser, a banking entity be able or be required to use the associated banking entity's definition of proprietary trading, for the purposes of this exclusion? Why or why not? Would such an approach impose undue compliance burdens? If so, what are such burdens?

See responses above to questions 29 and 32.

***Question 37.* Should the agencies establish additional provisions to prevent evasion of section 13 of the BHC Act? Why or why not? If so, what requirements would be appropriate and properly balance providing firms with flexibility to facilitate extensions of credit and ensuring compliance with section 13 of the BHC Act? For example, should the agencies impose quantitative limitations, additional capital charges, control restrictions, or other requirements on use of the credit fund exclusion?**

No. see responses above to questions 28, 29, 31 and 32. The proposed credit fund exemption would in essence allow banking entities to do indirectly through a credit fund what the banking entity could do directly on its own balance sheet. It is hard to view that as an evasion of the Volcker Rule.

***Question 38.* The proposed exclusion for credit funds is similar to the current exclusion for loan securitizations. Should the agencies combine the proposed credit fund exclusion with the current loan securitization exclusion? If so, how? What would be the benefits and drawbacks of combining the exclusions or maintaining separate exclusions for each type of activity? If the two exclusions remain separate, should the proposed credit fund exclusion contain a requirement that a credit fund not issue asset-backed securities? Why or why not?**

Combining the new credit fund exclusion with the existing loan securitization exemption would be simpler and avoid the need to further characterize or define "asset backed securities." It could be accomplished by simply deleting the words "for asset backed securities" from current subsection __.10(c)(8), and adding to that exemption the broader debt securities portfolio investment authority contained in the current set of proposed amendments to subsection __.10(c)(8) and the authority included in the proposed credit fund exemption at subsection __.10(c)(15) to own equity warrants associated with a portfolio loan, and make the other clarifications discussed above.

We anticipate, however, that if the existing "loan securitization" exemption is combined with the proposed new "credit fund" exemption there will be a push to

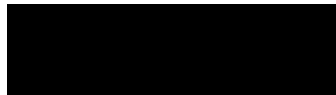
March 31, 2020

Page 22

restrict the credit quality of the exempted fund's portfolio and impose additional affiliate transaction restrictions similar to those proposed for the new type of "credit funds." In that event, it would be preferable to have two separate exemptions, one being the existing subsection .10(c)(8) loan securitization exemption and the other the proposed new credit fund exemption at subsection __.10(c)(15).

In summary, we support the proposed new "credit funds" exemption from the definition of "covered funds" and, with the clarifications discussed above, we urge the agencies to promptly adopt the new exemption, so that the new exemption can be used by banking entities as a new tool to address prudently the current economic situation.

Respectfully,

A solid black rectangular box redacting the signature of David F. Freeman, Jr.

David F. Freeman, Jr.