February 13, 2012

By Electronic Submission

Office of the Comptroller of the Currency
250 E Street, S.W.
Mail Stop 1-5
Washington, D.C. 20219
Docket ID OCC-2011-14

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Ave., N.W.
Washington, D.C. 20551
Docket No. R-14[•] and RIN 7100 AD[•]

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN number 3064-AD85

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090
File Number S7–41–11

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

The Loan Syndications and Trading Association (“**LSTA**”)[1] appreciates the opportunity to provide comments to the Agencies concerning the potential impact on the loan markets of their Notice of Proposed Rulemaking on Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds,[2] which will implement Section 619 of the Dodd-Frank Act.[3] Section 619 added new Section 13 (the “**Volcker Rule**”) to the Bank Holding Company Act of 1956 (“**BHCA**”).

[1] The LSTA is a not-for-profit trade association that is made up of a broad and diverse membership involved in the origination, syndication, and trading of commercial loans. The 321 members of the LSTA include commercial banks, investment banks, broker-dealers, hedge funds, mutual funds, insurance companies, fund managers, and other institutional lenders, as well as service providers and vendors. The LSTA undertakes a wide variety of activities to foster the development of policies and market practices designed to promote just and equitable marketplace principles and to encourage cooperation and coordination with firms facilitating transactions in loans. Since 1995, the LSTA has developed standardized practices, procedures, and documentation to enhance market efficiency, transparency, and certainty.

[2] Notice of Proposed Rulemaking, Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011). We refer to the “Supplementary Information” section of the notice, beginning at 76 Fed. Reg. 68847, as the “**Proposing Release**” and the “Text of the Proposed Common Rules,” beginning at 76 Fed. Reg. 68944, as the “**Proposed Rule.**”

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203 (“**Dodd-Frank Act**”).

366 Madison Avenue, 15th Floor, New York, NY 10017
Tel: 212.880.3000 Fax. 212.880.3040 www.lsta.org.

The LSTA membership is comprised of banking entities and others who are involved with syndicated corporate loans and loan securitizations. Syndicated loans in the United States provide about $2.5 trillion of financing to U.S. companies. Borrowers range from large blue-chip companies like IBM to industrial companies like U.S. Steel to middle market companies like Sizzling Platter (which owns Little Caesars and Sizzler). The size of syndicated loans generally ranges from $20 million to $2 billion and beyond. Loans of this size are often too large to be held by one single lender, and they are thus syndicated among a lender group, which may include loan securitization vehicles, also known as collateralized loan obligations ("**CLOs**").[4] CLOs are a type of asset-backed security ("**ABS**"). There are more than $1.1 trillion of outstanding funded corporate loans in the U.S.[5] Existing CLOs hold roughly 25% of these loans.[6] The participation of CLOs in the syndicated loan market allows many businesses to obtain syndicated loans. Without their participation, the syndicated loan market would be far smaller, and access to capital would be far more difficult for U.S. companies. In addition, bridge loans and bridge loan commitments (collectively "**Bridge Loan Facilities**") are a longstanding and important form of capital-raising for businesses. They are typically obtained by companies seeking short-term and/or backstop financing and are intended to be a "bridge" to a more permanent financing structure. Like CLOs, Bridge Loan Facilities are a critical part of the corporate loan market.

While we recognize the enormity of the task confronting the Agencies as they seek to implement the Volcker Rule and appreciate their efforts, we nevertheless believe that the Proposed Rule is fundamentally flawed and runs a significant risk of harming rather than helping the financial markets and U.S. financial stability. In this regard, we agree with the Securities Industry and Financial Markets Association ("**SIFMA**") that the potential costs to the financial markets, investors and corporate issuers from incorrectly implementing the Volcker Rule are enormous, and we support the comments of SIFMA, as well as the American Securitization Forum ("**ASF**") and the American Bar Association ("**ABA**"), in their letters to the Agencies in response to the Proposed Rule.[7]

In particular, we fully endorse the comments as they relate to the overly broad definition of "covered funds" and the proposed inclusion by the Agencies of securitization vehicles in that definition. We believe that the Agencies have misconstrued a provision that manifestly intends to capture only hedge funds, private equity funds, and funds with similar characteristics, and not

[4] In this letter, we distinguish between those CLOs in existence at the time that the final rule implementing the Volcker Rule goes into effect ("**Existing CLOs**"), and CLOs created on or after that date ("**New CLOs**").

[5]Shared National Credit Review, 2011, available at: http://www.fdic.gov/news/news/press/2011/pr11142b.pdf.

[6] According to Wells Fargo Research, as of January 2012, there were $227 billion of outstanding CLOs collateralized by large corporate syndicated loans and $23 billion of outstanding CLOs collateralized by middle market syndicated loans. *See* Wells Fargo Securities, "CLO Market Overview" (Jan. 27, 2012), at 3 and 65, available at: http://www.lsta.org/WorkArea/showcontent.aspx?id=14972.

[7] *See* SIFMA Volcker Rule Securitization Letter (Feb. 13, 2012): SIFMA Volcker Rule Covered Funds Letter (Feb. 13, 2012); SIFMA Volcker Rule Market Making Letter (Feb. 13, 2012); ABA Volcker Rule Letter (Feb. 13, 2012); and ASF Volcker Rule Letter (Feb. 13, 2012).

structures that bear no resemblance to these funds, such as ABS. Moreover, we agree that the Agencies have been given the flexibility to tailor the "covered fund" definition to implement the unambiguous intent of Congress in this regard and that the Proposed Rule, as currently drafted, is fundamentally flawed. Should the Agencies nonetheless disregard what Congress has made clear and what logic requires, at the very least, and as we discuss more fully below, we urge the Agencies to ensure that ***all*** forms of loan securitizations are expressly excluded from the "covered fund" definition.

I. The Statutory Rule of Construction on Loans and Loan Securitizations Prohibits the Agencies from Limiting or Restricting Banking Entities' Otherwise Permitted Loan and Loan Securitization Activities

The Volcker Rule generally prohibits any "banking entity" from (i) engaging in "proprietary trading," and (ii) acquiring or retaining any "ownership interest" in or acting as a "sponsor" to a "hedge fund" or "private equity fund."[8] Where the Volcker Rule permits a banking entity to engage in such activity with a "covered fund," it nevertheless imposes restrictions on a banking entity's ability to do so and also prohibits a banking entity from entering into a "covered transaction" under Section 23A of the Federal Reserve Act with a covered fund under certain circumstances and from entering into transactions with an affiliated covered fund other than on arms' length terms (together, the "**Section 23A/23B Restrictions**").[9]

To ensure that the Volcker Rule does not inadvertently restrict the ability of banking entities to continue to engage in lending and loan securitization activities, Congress included a "rule of construction" in the Volcker Rule to protect the loan markets that expressly prohibits the Agencies from using the Volcker Rule to limit or restrict the ability of a banking entity to sell or securitize loans if otherwise permitted by law.[10]

Congress also instructed the Financial Stability Oversight Council ("**FSOC**") to study and issue recommendations on implementation of the Volcker Rule,[11] and requires the Agencies to "consider the findings of the study" and "adopt rules to carry out" the Volcker Rule.[12] In its

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[8] BHCA § 13(a)(1).

[9] *Id.* § 13(f).

[10] Section 13(g)(2) provides:

> SALE OR SECURITIZATION OF LOANS.—Nothing in this section shall be construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans in a manner otherwise permitted by law.

[11] *Id*. § 13(b)(1). The FSOC issued its study and recommendations in January 2011. Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds, at 17 (Jan. 18, 2011) ("**FSOC Study**"), available at: http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[12] BHCA § 13(b)(2).

study, the FSOC noted that in promulgating the Volcker Rule, Congress "recognize[d] the critical function that loan creation plays in the nation's economy."[13] In particular, the FSOC Study observed that:

> this inviolable rule of construction ensures that the economically essential activity of loan creation is not infringed upon by the Volcker Rule. The creation and securitization of loans is a basic and critical mechanism for capital formation and distribution of risk in the banking system. While these activities involve the assumption of principal risk, the broader benefits to the economy reflect the intent of federal borrowing subsidies and protections. Accordingly, Congress determined that none of the restrictions of the Volcker Rule, nor the "backstop" restrictions on permitted activities, will apply to the sale or securitization of loans.[14]

We appreciate the Agencies' efforts to follow the statutory rule of construction, but, for the reasons discussed more fully below, we believe that these efforts do not go far enough and that the Proposed Rule, as drafted, will have a significant (albeit, we believe, unintended) harmful impact on CLOs and Bridge Loan Facilities and consequently on the loan markets.

Our comments in this letter are focused on the potential effects of the Proposed Rule on the U.S. loan markets, and are specifically directed to the potential impact of: (1) the proposed covered fund prohibition on CLOs; and (2) the proposed proprietary trading prohibition on the ability of banking entities (a) to continue to make bridge commitments and loans; and (b) to hold or sell instruments received from a borrower in satisfaction of a debt previously contracted.

Specifically, we request that the Agencies:

1. Define "loan securitization" to include all types of "securitization of loans,"[15] including, without limitation, Existing and New CLOs.

2. Exclude all loan securitizations (including CLOs) from the definition of "covered fund" in the Proposed Rule.

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[13] FSOC Study at 17.

[14] *Id.* at 47. In fact, lending and loan securitization have long been considered core banking activities. *See, e.g.,* 12 C.F.R. 1.3(g) ("A national bank may securitize and sell assets that it holds, as a part of its banking business. The amount of securitized loans and obligations that a bank may sell is not limited to a specified percentage of the bank's capital and surplus."). 12 U.S.C. § 24(Seventh) has consistently been interpreted to permit loan securitization as central to the business of banking. *See, e.g.,* Testimony of John C. Dugan, Comptroller of the Currency, before the Financial Crisis Inquiry Comm'n (Apr. 8, 2010), Appendix D, at 4-7, available at: http://www.occ.gov/news-issuances/news-releases/2010/nr-occ-2010-39f.pdf.

[15] As discussed below, the Volcker Rule excludes from its reach the "sale or securitization of loans." BHCA § 13(g)(2). It does not define these terms.

3. Confirm that if the Proposed Rule nonetheless continues to treat loan securitizations as "covered funds," compliance by banking entities with the Securities and Exchange Commission's ("**SEC's**") final Rule 127B on material conflicts of interest relating to ABS ("**ABS Conflicts Rule**"), which include loan securitizations such as CLOs, will be deemed compliance with the Volcker Rule's material conflicts rules relating to covered funds.

4. Expressly permit banking entities to acquire and resell securities received in lieu of or to refinance Bridge Loan Facilities.

5. Extend the exemption for debt previously contracted proposed for covered fund activities in §__.14(b)(i) to proprietary trading in such assets.

II. Covered Funds and Covered Fund Activities – Potential Impact on CLOs

The Volcker Rule generally bars banking entities from acquiring or obtaining an ownership interest in or sponsoring a "hedge fund" or "private equity fund." The Volcker Rule defines a "hedge fund" or "private equity fund" as "an issuer that would be an investment company, as defined in the Investment Company Act of 1940 ["Investment Company Act"]. . ., but for section 3(c)(1) or 3(c)(7) of that Act," and gives the Agencies the authority to make rules relating to that definition.[16] The Proposed Rule includes all issuers that would be investment companies but for the enumerated provisions, as well as certain other "similar funds," in its definition of "covered funds."[17]

While CLOs do not "engage in the activities or have the characteristics of a traditional private equity fund or hedge fund,"[18] virtually all CLOs rely on either the Section 3(c)(1) or 3(c)(7) exemption from the Investment Company Act and, accordingly, absent an exclusion, would fall within the "covered fund" definition. However, in order to give full effect to the statutory rule of construction regarding loans and loan securitization, the Agencies should define "loan securitization" in a way that captures all loan securitization vehicles, including Existing CLOs and New CLOs, and should then exclude "loan securitizations," as adequately and appropriately defined, from the definition of "covered fund," pursuant to the rule of construction and their rulemaking authority under Section 13(h)(2) of the Volcker Rule.

A. Loan securitizations should be defined to include all Existing CLOs and New CLOs.

The Volcker Rule's rule of construction is prefaced: "Sale and Securitization of Loans," and it prohibits the Agencies from construing anything therein to limit or restrict the ability of a

[16] BHCA § 13(h)(2).

[17] Proposed Rule § __.10(b)(1).

[18] FSOC Study at 64.

banking entity "to sell or securitize loans" if otherwise permitted by law. The rule of construction thus embodies the policy imperative to protect the U.S. loan markets. The Volcker Rule does not define or in any way circumscribe the terms "loans," "securitize," or "securitization." When a term is not defined in a statute, it must be interpreted consistently with what it meant at the time of the statute's enactment, *i.e.,* it must be given its "ordinary, contemporary, common meaning."[19] We are concerned that the way the Agencies describe "loan securitizations" in the Proposed Rule is inappropriately narrow and excludes such traditional loan securitization vehicles as CLOs.

The Proposed Rule describes a "loan securitization" as "a covered fund that is an issuer of asset-backed securities, the assets or holdings of which are solely comprised of: (1) Loans; (2) Contractual rights or assets directly arising from those loans supporting the asset-backed securities; and (3) Interest rate or foreign exchange derivatives that: (A) Materially relate to the terms of such loans or contractual rights or assets; and (B) Are used for hedging purposes with respect to the securitization structure."[20] While we appreciate the Agencies' efforts to identify those loan securitization activities that the rule of construction protects, the proposed definition of "loan securitization" is overly narrow and would, we believe unintentionally, leave out CLOs. We ask that the Agencies define loan securitization to include all CLOs to ensure that they are accorded the same treatment under the Volcker Rule as other loan securitization vehicles.[21]

While CLOs are comprised primarily of loans, they necessarily also hold cash and short-term highly liquid investments in order to be able to invest and reinvest in loans. As currently structured, CLOs typically also hold a small amount of corporate securities and derivatives. Because the Proposed Rule uses the word "solely" and narrowly limits the types of assets permitted for investment, however, these traditional loan securitization vehicles would not be considered "loan securitizations" under the proposed definition. Defining loan securitizations to cover only those securitizations limited "solely" to the instruments described in the Proposed Rule would have a profound negative impact on the CLO market as well as on the syndicated corporate loan market more broadly. We do not believe this is the Agencies' intent. Accordingly, we urge the Agencies to define "loan securitization" in the Proposed Rule to reflect more accurately how loans are in fact securitized and to preserve the ability of banking entities to engage in CLO activities.

1. *Existing CLOs should be included in the definition of "loan securitization."*

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[19] *Perrin v. United States,* 444 U.S. 37, 42 (1979) ("[U]nless otherwise defined, words will be interpreted as taking their ordinary, contemporary, common meaning" at the time Congress enacted the statute). *See also FCC v. AT&T, Inc.* 131 S.Ct. 1177, 1182 (2011) ("When a statute does not define a term, we typically 'give the phrase its ordinary meaning.'" (quoting *Johnson v. United States,* 559 U.S. ----, ----, 130 S.Ct. 1265, 1267, 176 L.Ed.2d 1 (2010)).

[20] Proposed Rule §__.13(d).

[21] In addition to CLOs, loan securitizations include securitization vehicles backed by assets such as mortgage and auto loans.

It is critical that the Agencies fully implement the Congressional mandate to protect the loan markets and, accordingly, that they do not hamstring the corporate loan market by restricting existing loan securitization vehicles, including Existing CLOs. If Existing CLOs are not captured by the definition of "loan securitization," they would be subject to numerous Volcker Rule restrictions that would hamper the ability of banking entities to continue to support the secondary CLO market and to make new loans. These restrictions would severely impair liquidity in the corporate loan market, resulting in significant disruptions to bank lending activity more generally. The Agencies should thus define "loan securitization" to include all Existing CLOs. In addition, for the reasons discussed below, loan securitizations (including Existing CLOs) should be carved out of the definition of "covered fund."

2. *The definition of "loan securitization" should also include New CLOs.*

The statutory rule of construction compels the Agencies to protect all loan securitizations from the effects of the Volcker Rule. As noted above, this includes CLOs, as they are currently typically structured. If, however, the Agencies determine that a balance needs to be struck between ensuring that CLOs are comprised primarily of loans while at the same allowing for the continuation of a robust corporate loan market, we would propose a set of characteristics (set forth below) that New CLOs must have in order to be considered a loan securitization for purposes of the Volcker Rule.

As the Agencies know, the LSTA has been actively engaged in the Agencies' credit risk retention proposal.[22] As we have made clear in that context, we do not believe that CLO managers are generally subject to the risk retention requirements under the Dodd-Frank Act. However, as is the case here, we appreciate the Agencies' need to ensure that excluded instruments are defined in a way that limits the potential for abuse. To strike an appropriate balance between the Agencies' concerns and the continued health of the corporate loan market, we suggest the following characteristics that would ensure that New CLOs continue to be predominantly comprised of loans and highly liquid temporary investments:

> Holdings of New CLOs must be comprised of at least 90 percent of senior, secured syndicated loans and temporary investments. All holdings must be limited to senior, secured syndicated loans, other corporate credit obligations, temporary investments, government obligations used to credit enhance ABS interests issued by a New CLO, hedge transactions, and workout interests.

While we recommended these investment characteristics for certain actively managed CLOs in

[22] *See* LSTA Comment Letter on Notice of Proposed Rulemaking, Credit Risk Retention (Aug. 1, 2011) ("**LSTA Risk Retention Letter**"), available at: http://www.lsta.org/WorkArea/showcontent.aspx?id=13958; *See* LSTA Comment Letter on Notice of Proposed Rulemaking, Credit Risk Retention (Sep. 2, 2011), and Appendix A ("**LSTA Supplemental Risk Retention Submission**"), available at: http://www.sec.gov/comments/s7-14-11/s71411-309.pdf, as revised by: http://www.lsta.org/WorkArea/showcontent.aspx?id=14988 (Feb. 10, 2012) ("**LSTA Revised Supplemental Risk Retention Submission**").

the context of risk retention, we believe they present a workable framework for all New CLOs for Volcker Rule purposes as well, including non-managed or other CLOs as to which the risk retention rules may have a different application.[23]

Defining "loan securitization" as suggested is crucial to ensuring that New CLOs are treated the same for Volcker Rule purposes as are other types of loan securitization. This would allow these loan securitization vehicles to continue to play their critical role in corporate financing in the U.S.

B. To comport with the statutory rule of construction and Congressional intent with respect to "hedge funds" and "private equity funds," loan securitizations (including CLOs) must be excluded from the "covered fund" definition.

The Proposed Rule treats loan securitizations as covered funds, but provides an explicit

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[23] *See* LSTA Revised Supplemental Risk Retention Submission. In the context of risk retention, we have recommended the following in connection with "open market CLOs," *i.e.,* those actively managed CLOs that we believe are not subject to risk retention under the Dodd-Frank Act:

> An open market CLO [must] operate in accordance with transaction documents pursuant to which it issues ABS interests in a securitization transaction that require it to hold at least 90 percent of the aggregate outstanding principal amount of its assets in senior, secured syndicated loans and temporary investments (all such assets to be valued at par, and excluding from such calculation government obligations used to credit enhance ABS interests issued by an open market CLO, hedge transactions and workout interests); provided, that if at any time it is not in compliance with this requirement, an open market CLO may not purchase any assets other than senior, secured syndicated loans, temporary investments, government obligations used to credit enhance ABS interests issued by an open market CLO and hedge transactions.
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> An open market CLO shall operate in accordance with transaction documents pursuant to which it issues ABS interests in a securitization transaction that require that it hold not more than 10 percent of the aggregate outstanding principal amount of its assets in corporate credit obligations other than senior, secured syndicated loans and temporary investments (all such assets to be valued at par, and excluding from such calculation government obligations used to credit enhance ABS interests issued by an open market CLO, hedge transactions and workout interests); provided, that if at any time it is not in compliance with this requirement, an open market CLO may not purchase any assets other than senior, secured syndicated loans, temporary investments, government obligations used to credit enhance ABS interests issued by an open market CLO and hedge transactions.

In addition:

> An open market CLO may not invest in ABS interests or in derivatives, provided that this shall not prohibit an open market CLO from acquiring loan participations or any interest in or relating to a letter of credit or entering into hedge transactions.

We believe that these same requirements could appropriately be applied to New CLOs for purposes of the Volcker Rule. All relevant terms, such as "temporary investments," "hedge transactions," and "workout interests" are defined in the LSTA Revised Supplemental Risk Retention Submission and we suggest that the Agencies look to those same definitions for purposes of describing the investment characteristics for New CLOs.

exemption from the covered fund activities restrictions for loan securitizations that meet the conditions set forth in the Proposed Rule. While we appreciate the Agencies' efforts to follow the statutory instruction not to apply the Volcker Rule to loan and loan securitization activities, we believe that the Agencies have not gone far enough and that loan securitizations (including CLOs) must be explicitly excluded from the definition of "covered funds."

First, as discussed above, the statutory rule of construction mandates that loan securitization activities by banking entities may not in any way be limited or restricted by the Volcker Rule. The only way to implement this mandate fully is to exclude loan securitizations (including CLOs) from the definition of "covered funds." A failure to do so would leave all loan securitizations, including CLOs, vulnerable to intended and unintended effects of the Volcker Rule and would essentially vitiate Congress' explicit instruction to the Agencies.

Second, even aside from this statutory mandate, the Agencies should carve out loan securitizations (including CLOs) from the definition of "covered fund" because they do not engage in the activities or have the characteristics of a traditional private equity fund or hedge fund. In that regard, the FSOC Study recognized that there are many types of vehicles relying on exemptions under Sections 3(c)(1) or 3(c)(7) of the Investment Company Act that do not pursue similar investment strategies to hedge funds or private equity funds and do not raise the concerns the Volcker Rule was designed to address.[24] The legislative history of the Dodd-Frank Act underscores that Congress intended for the Agencies to define "hedge funds" and "private equity funds" more narrowly to capture "traditional" hedge funds and private equity funds and not all structures that rely on the enumerated Investment Company Act exemptions.[25] In fact, the

[24] FSOC Study at 64.

[25] *See, e.g.,* Himes-Frank Colloquy, 156 Cong. Rec. H5223, H5226 (Jun. 30, 2010):

> Mr. HIMES. Madam Speaker, I rise to enter into a colloquy with Chairman Frank. I want to clarify a couple of important issues under section 619 of the bill, the Volcker Rule. The bill would prohibit firms from investing in traditional private equity funds and hedge funds. Because the bill uses the very broad Investment Company Act approach to define private equity and hedge funds, it could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds. I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings.
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> Mr. FRANK of Massachusetts. If the gentleman would yield, let me say, first, you know, there has been some mockery because this bill has a large number of pages, although our bills are smaller, especially on the page. We do that--by the way, there are also other people who complain sometimes that we've left too much discretion to the regulators. It's a complex bill dealing with a lot of subjects, and we want to make sure we get it right, and we want to make sure it's interpreted correctly. The point the gentleman makes is absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do.
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> Mr. HIMES. Thank you, Mr. Chairman.

See also January 13, 2012 Letter from Senator Kay R. Hagan to the Agencies and the Commodity Futures Trading Commission ("**CFTC**"), stating that "Congress made clear that the private funds provisions of Section 619 . . .

Agencies themselves generally treat loan securitizations differently from hedge funds and private equity funds.[26] The FSOC Study thus logically urges the Agencies to "consider criteria for providing exceptions with respect to certain funds that are technically within the scope of the 'hedge fund' and 'private equity fund' definition in the Volcker Rule but that Congress may not have intended to capture in enacting the statute."[27]

To do this, loan securitizations (including CLOs) must be excepted from the definition of "covered fund" rather than merely exempted from certain prohibitions because it would be virtually impossible to tailor an exemption from the prohibition on covered fund activities that would ensure compliance with the statutory rule of construction mandate. The complexity and opacity of the Volcker Rule make it almost certain that unintended consequences will attach to loan securitizations if they are exempted from the prohibition on covered fund activities, rather than excluded entirely from the definition of "covered fund." Indeed, one need look no further for evidence of this complexity than the over 1300 questions asked by the Agencies in their Proposing Release. We are concerned therefore, that restrictions would apply to exempted covered funds that could not apply to non-covered funds (*i.e.,* those excluded from the definition).

If loan securitizations are not excluded from the definition of "covered fund," the numerous "limit[ations] or restrict[ions] on the ability of a banking entity . . . to . . . securitize loans in a manner otherwise permitted by law" that could be imposed by the Proposed Rules include extensive new compliance obligations, restrictions on the ability of banking entities to underwrite or make markets in loan securitizations,[28] the "backstop" conflict of interest rules, and potentially new Section 23A/23B Restrictions where a banking entity sponsors a loan

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[were] not . . . intended to restrict or prohibit other legitimate structures-including foreign funds, joint ventures, venture capital funds, loan funds, securitization vehicles, and structured notes - that are not usually thought of as private equity or hedge funds and do not
relate to trading the firm's own capital."

[26] *See, e.g*., CFTC and SEC, Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 12 C.F.R. Parts 275 and 279, 76 Fed. Reg. 71128 (Nov. 16, 2011) ("Hedge funds may be "any private fund (*other than a securitized asset fund*)…"; similarly "private equity fund" excludes a securitized asset fund)(emphasis supplied).

[27] FSOC Study at 7. We also refer the Agencies to the comments in the SIFMA Volcker Rule Covered Funds Letter, The ABA Volcker Rule Letter, and the ASF Volcker Rule Letter with respect to the unworkable breadth of the definition of "covered fund" and the Agencies' responsibility to take into account the FSOC's recommendations to define covered funds appropriately.

[28] As currently drafted, the Proposed Rule would not permit banking entities to rely on the underwriting and market making exemptions in connection with their covered fund activities, even though Section 13(d)(1) of the Volcker Rule provides that, notwithstanding the prohibitions under Section 13(a) (on proprietary trading and covered fund activities), "the following activities … are permitted: … (B) The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making-related activities…," making clear that the underwriting and market making exemptions were intended to apply to covered fund activities as well as proprietary trading activities. The LSTA supports the SIFMA Volcker Rule Covered Funds Letter in this regard, as well as the letter of the Commenting Parties relating to underwriting and market making activities in connection with structured finance securities.

securitization vehicle.[29] This result would be inconsistent with the plain language of the statutory rule of construction and the FSOC Study.

The Agencies have clear authority not merely to exempt loan securitizations (including CLOs) from certain of the Volcker Rule prohibitions, but to exclude those loan securitizations from the "covered fund" definition altogether. First, the statutory rule of construction compels the exclusion. Second, Section 13(h)(2) of the Volcker Rule uses the terms "hedge fund" and "private equity fund." Those words cannot be superfluous but must inform what follows. Section 13(h)(2) goes on to give the Agencies rulemaking authority to define similar funds. Clearly Congress did not intend to capture all vehicles that rely on the enumerated Investment Company Act sections in their definition of "hedge fund" and "private equity fund," but instead gave the Agencies the authority to carve out from the definition those types of vehicles that were never meant to be included in the first place. For these reasons, we urge the Agencies to exclude loan securitizations (including CLOs) from the "covered fund" definition.[30]

III. Material Conflicts of Interest and Loan Securitizations

The Volcker Rule, at Section 13(d)(2)(A)(i), provides a "backstop" so that even if otherwise permitted, any covered fund activity that "would involve or result in a material conflict of interest," as defined by the Agencies, would be prohibited.[31] Proposed §__.17(a)(1) would implement this section. Even if loan securitizations (including CLOs) are considered "covered funds," the material conflicts of interest provisions in the Volcker Rule and the Proposed Rule should not apply to them.

If, as we request, loan securitizations (including CLOs) are excluded from the definition of "covered fund," they would not be subject to Section 13(d) (or any other provisions of the Volcker Rule). As noted above, the FSOC itself has stated that "Congress determined that none of the restrictions of the Volcker Rule, nor the 'backstop' restrictions on permitted activities, will apply to the sale or securitization of loans."[32] However, even if the Agencies decline to exclude loan securitizations (including CLOs) from the "covered fund" definition, loan securitizations are ABS, and Congress has separately addressed conflicts of interest for ABS in the Dodd-Frank Act. Subjecting loan securitizations to §__.17(a)(1) would be unduly duplicative and potentially

[29] We agree with and refer the Agencies to the discussion in the SIFMA Volcker Rule Securitization Letter and the ASF Volcker Rule Letter describing the restrictions that would attach to a banking entity's ability to engage in a securitization if the 23A/23B Restrictions and other limitations in the Proposed Rule were to apply to securitization vehicles. We note that the 23A/23B Restrictions could apply to loan securitizations (including CLOs) only if they are "sponsored" by banking entities.

[30] For an extensive discussion of the legal basis for this authority, we refer you to the SIFMA Covered Funds Letter.

[31] Under the Volcker Rule, otherwise permitted activities are nevertheless subject to a "backstop" that prohibits these activities if they result in a material conflict of interest or a material exposure to high-risk assets or high-risk trading strategies, pose a threat to safety and soundness of the banking entity, or pose a threat to financial stability. BHCA § 13(d) (2).

[32] FSOC Study at 47.

inconsistent and confusing.

Section 621 of the Dodd-Frank Act added new Section 27B to the Securities Act of 1933 to prohibit material conflicts of interest in connection with offerings of ABS. Section 27B(a) provides:

> An underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security (as such term is defined in section 3 of the Securities and Exchange Act of 1934 (15 U.S.C. 78c), which for the purposes of this section shall include a synthetic asset-backed security), shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity.

Section 27B requires the SEC to promulgate rules to implement the statute's provisions. The SEC issued proposed Rule 127B in September ("**ABS Conflicts Proposal**").[33] It recently extended the comment deadline until February 13, 2012 to coincide with the comment deadline on the Proposed Rule and specifically to "provide the public with a better opportunity to consider any potential interplay between the ABS Conflicts and Volcker Rule Proposals."[34]

The ABS Conflicts Proposal is directly geared towards securitizations and material conflicts that could arise in the context of securitizations. As such, we expect that the final ABS Conflicts Rule, amended to take into account the LSTA's concerns,[35] will reflect a thorough understanding of and be tailored towards potential conflicts in securitizations, including loan securitizations.

To the extent that loan securitizations (including CLOs) are not excluded from the definition of "covered fund," we request that the Agencies expressly deem compliance with the SEC's final ABS Conflicts Rule to be compliance with the Volcker Rule material conflicts rules. Such confirmation will be consistent with the Congressional mandate to promulgate rules for potential ABS conflicts separately from the Volcker Rule rules and will also prevent unnecessary confusion and duplication.

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[33] Proposed Rule, Prohibition Against Conflicts of Interest in Certain Securitizations, 76 Fed. Reg. 60320 (Sep. 28, 2011).

[34] Proposed Rule; Extension of Comment Period, Prohibition against Conflicts of Interest in Certain Securitizations, 77 Fed. Reg. 24 (Jan. 3, 2012).

[35] *See* LSTA Comment Letter on Prohibition Against Conflicts of Interest in Certain Securitizations; Proposed Rule (Release No. 34-65355; File No. S7-38-11; RIN 3235-AL04), available at: http://sec.gov/comments/s7-38-11/s73811-24.pdf.

IV. Proprietary Trading Prohibition and Potential Impact on Bridge Loan Facilities

We appreciate the Agencies' confirmation that the Volcker Rule does not affect proprietary trading in loans,[36] but believe and are concerned that an unintended consequence of the proprietary trading provisions of the Proposed Rule will be to impair financing under Bridge Loan Facilities.

Bridge Loan Facilities are a time-honored, oft-used and important form of capital-raising for businesses. They are typically obtained by companies seeking short-term and/or backstop financing and are intended to be a "bridge" to a more permanent financing structure. Thus, when a Bridge Loan Facility is made, the lender almost always contemplates that the borrower will replace that Bridge Loan Facility with either permanent loan financing and/or securities provided or issued to financial institutions, which may include affiliates of a lender. In this regard, Bridge Loan Facilities typically provide the lender with the right to require that the borrower incur such permanent financings for such purpose, thereby enabling the lender to reduce its credit exposure to the borrower. This right is a longstanding market feature and is often central to the commercial terms and conditions upon which a lender may be willing to provide a Bridge Loan Facility. Any uncertainty around this issue will increase the credit risk associated with this legitimate and longstanding source of funding for borrowers worldwide and will unduly burden, or render impracticable, this method of capital formation. As Section 13(g)(2) of the Volcker Rule clearly evidences that the Rule was never intended by Congress to chill commercial lending or make it impractical or burdensome, it therefore flows from this statutory rule of construction that the acquisition and resale of securities in the context set forth above should not be captured by the Volcker Rule.

Additionally, the acquisition and resale of the securities issued in lieu of or to refinance Bridge Loan Facilities is best viewed as a traditional underwriting activity that should qualify as permitted underwriting activity, without regard to when the securities are resold or whether the resale is pursuant to a particular manner of distribution. The context for the extension of a Bridge Loan Facility is capital-raising and the securities issued in lieu of or to refinance Bridge Loan Facilities are taken as a means of efficiently distributing risk. Yet, we note that in the case of these securities, there is often a period of time (typically ranging from three months to a year or more) between the date a bridge commitment is extended and when a bridge loan is required to be funded or such securities are required to be issued. During that time, market conditions and investor demand can and do change. Thus, we agree with the position articulated in SIFMA's Volcker Rule Market Making Letter that the underwriting exemption to the prohibition on

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[36] To "provide additional clarity" to the Volcker Rule, the Proposing Release notes that the exclusion of loans is "intended to eliminate potential confusion by making clear that the purchase and sale of loans . . . are outside the scope of transactions to which the proprietary trading restrictions apply." Proposing Release, at 42. Under the Proposing Release, therefore, the transfer of loans through assignment or participation, the primary means by which loans are transferred, is not within the scope of the Volcker Rule.

proprietary trading in the Proposed Rule has been drafted too narrowly.[37] Consequently, we request that the Agencies clarify that (i) permitted underwriting activity includes the acquisition and resale of securities issued in lieu of or to refinance Bridge Loan Facilities, irrespective of whether those activities fall within the definition of a "distribution" for purposes of Regulation M; and (ii) "near term demands of clients" in connection with permitted underwriting activity should be measured at the time of initial extension of the bridge commitment.

V. Debt Previously Contracted – Extension of Covered Fund Exemption to Proprietary Trading

To enable banking entities to manage their risk, the Proposed Rule allows them to acquire or retain an ownership interest in or sponsor a covered fund if done "in the ordinary course of collecting a debt previously contracted."[38] However, we believe that the Proposed Rule inadvertently fails to contain a similar exemption in the proprietary trading context for instruments received in connection with debt previously contracted. Where a banking entity receives securities as debt previously contracted assets that result from restructuring or foreclosure of loans or any of the other circumstance permitted to a bank to receive securities held in satisfaction of debts,[39] we would not expect that these assets would be subject to the prohibition on proprietary trading. Accordingly, we fully support the comments of SIFMA with respect to debt previously contracted and for the reasons set forth in the SIFMA Volcker Rule Market Making Letter, we request that the Agencies extend the exemption from covered fund restrictions in §__.14(b)(i) to proprietary trading in debt previously contracted instruments.[40]

VI. CONCLUSION

For all of the foregoing reasons, the LSTA respectfully urges the Agencies to revise and repropose the Proposed Rule and in that context, adhere to the statutory rule of construction by:

1. Defining "loan securitization" to include all types of securitizations of loans, including without limitation Existing CLOs and New CLOs.

2. Excluding loan securitizations (including CLOs) from the definition of "covered fund."

3. Confirming that to the extent the Proposed Rule continues to treat loan securitizations as "covered funds," compliance by banking entities with the SEC's

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[37] *See* SIFMA Volcker Rule Market Making Letter, Appendix A – Underwriting Permitted Activity.

[38] Proposed §__.14(b)(i).

[39] Banks are permitted to hold debt previously contracted assets pursuant to Section 4(c)(2) of the BHCA, 12 CFR 1.7, and 12 CFR 225.12(b).

[40] *See* SIFMA Volcker Rule Market Making Letter.

ABS Conflicts Rule will be deemed compliance with the Volcker Rule's material conflicts rules relating to covered funds.

4. Clarifying that banking entities may acquire and resell securities received in lieu of or to refinance Bridge Loan Facilities.

5. Extending the covered fund activities exemption for debt previously contracted to the proprietary trading of such assets.

We appreciate the enormity of the task the Agencies face in implementing the Volcker Rule and are grateful for the efforts the Agencies have already made to follow faithfully the statutory rule of construction with respect to loans and loan securitizations. We appreciate your consideration of our comments and concerns and stand ready to provide any additional information you believe might be useful.

Please feel free to contact Elliot Ganz at (212) 880-3003 if you have any questions regarding our comments.

Sincerely,

R. Bram Smith
Executive Director