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February 13, 2012

By Electronic Mail

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20520

Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219

Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20551

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Re: Covered Funds Issues in the Volcker Rule Proposal (Federal Reserve Docket No. R-1432 and RIN 7100 AD 82; FDIC RIN 3064-AD85; OCC Docket ID OCC-2011-14; SEC File Number S7-41-11; CFTC RIN 3038–AC____)

Ladies and Gentlemen:

We appreciate the opportunity to provide our comments on the funds provisions of the proposed rule (the "Proposed Rule")[1] implementing Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank"),[2] commonly known as the "Volcker Rule." This letter highlights the key issues in the Proposed Rule. This letter is followed by an appendix which provides more detailed commentary about those issues in

1 Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011); 77 Fed. Reg. ______ (Feb. __, 2012). The proposed rule has been published by the Board of Governors of the Federal Reserve System the "Federal Reserve"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC"), the Commodity Futures Trading Commission (the "CFTC"), and the Securities and Exchange Commission (the "SEC" and, together with the Federal Reserve, the OCC, the FDIC and the CFTC, the "Agencies"). Given the distinct nature of the issues, Credit Suisse is also filing a separate comment letter on the proprietary trading provisions of the proposed Volcker Rule (the "CS Trading Letter").

2 Codified as new Section 13 of the Bank Holding Company Act of 1956 (the "BHCA").

response to the questions the Agencies have raised in the Proposed Rule and further to the Agencies' request in our discussions with them.

We believe that the Proposed Rule goes significantly beyond the text of the Volcker Rule and the intent of Congress, and could have adverse effects on the U.S. economy, U.S. investors, and banking organizations operating in the United States. At the same time, many fundamental questions about the Proposed Rule remain unanswered.

In light of the many open questions in the Proposed Rule, the important changes that will need to be made, and the potentially broad impact of the Rule on markets and financial institutions, we urge the Agencies to consider significantly modifying the Proposed Rule after consideration of the comments on the current proposal. Implementing the Volcker Rule presents numerous challenges for the Agencies. We are hopeful that the Proposed Rule can be recrafted in a manner that minimizes unintended consequences and adequately deals with the complexities presented by the statutory text of the Volcker Rule. We also hope that the uncertainties in the Volcker Rule can be clarified as soon as possible through appropriate revisions to the Proposed Rule.

We recognize the purposes of the Volcker Rule—to limit risks associated with certain dedicated proprietary activities while at the same time preserving banks' ability to provide their clients with asset management, investment and other banking services and limiting the Volcker Rule's extraterritorial effects. In our view, however, the Proposed Rule does not strike the right balance between these goals. We urge the Agencies to interpret and implement the Volcker Rule as Congress intended—in a manner that preserves important client-facing asset management, investment services and other core banking functions, while restricting specific activities that Congress believed create inappropriate risks. Conducted properly, with appropriate limits and internal controls, client-driven asset management-related activities, investment services and other core banking functions do not expose banking organizations to undue risk, and they provide valuable diversification to institutional investors and capital and liquidity to the U.S. economy.

In revising the Proposed Rule, the Agencies should consider the following key issues.

<u>Extraterritorial Application</u>

- The Agencies have not adequately addressed the potential unintended consequences of the Proposed Rule for entities and transactions outside the United States.

- In implementing the statutory exemption for foreign funds, the Proposed Rule would add a limitation that a banking organization's U.S. personnel cannot be involved in marketing the foreign fund. This limitation is not required by the statute and is not justified by the underlying purposes of the Volcker Rule. The limitation would not protect the safety and soundness of U.S. banking organizations or U.S. financial stability and is likely to result in more jobs being relocated overseas.

- The Agencies should clarify that foreign banks will be able to invest in foreign funds that have U.S. investors, and in derivatives linked to such funds, so long as the bank itself does not market the fund to U.S. investors. If this is not clarified, many foreign fund managers will exclude U.S. investors from their funds, which will limit the investment options available to U.S. investors.

- The Agencies did not clearly limit the extraterritorial application of the so-called "Super 23A" prohibition by interpreting its scope in a manner consistent with other U.S. banking laws (including Section 23A itself), the Volcker Rule's policy objectives, and longstanding principles regarding limits on the extraterritorial application of U.S. law. Congress cannot have intended the Super 23A prohibition to limit transactions outside the United States by a foreign bank with a foreign fund that has no U.S. investors.

Timing and Conformance Period Issues

- The Proposed Rule lacks clarity as to the date when conformance is required, which creates uncertainty that could result in unintended distressed sales of assets. Distressed sales, whether the result of uncertainty or of unduly short deadlines in the final rule, would artificially depress the value of investors' interests in funds. These losses would be immediately realized by investors that sell into the secondary market at the same time as banks are selling down their interests, and investors that stay in the fund will see the market value of their interests decline. In some cases, investors may be subject to drag-along rights, leading to further distressed selling and further price declines. The Agencies should seek to minimize the losses that would accrue to banking entities and investors—including pension funds and other institutional investors—from such distressed sales.

- The Federal Reserve should revisit the approach to the conformance period set forth in the Proposed Rule and in the conformance rules proposed in February, and should clarify that banking entities will have the full two-year statutory conformance period to bring their fund activities into compliance with the final rule. The statute authorizes the Federal Reserve to determine how banks bring their activities into compliance during the conformance period, so there is no need (and it would be wholly unrealistic) to require compliance immediately after the effective date in July, given the complexity of the Proposed Rule and the number of questions, issues and concerns it has raised.

- The Federal Reserve has the statutory authority to grant extensions to the conformance period, and should affirm in the final rule that it will presumptively grant extensions so as to minimize the adverse impact of sell downs on banks and investors.

- When determining conformance requirements and extensions, the Agencies should take into account a host of factors including market conditions, the financial impact on a banking entity, a bank's fiduciary duty to investors and the impact on, and bank's duties to, unaffiliated clients, customers and counterparties. As a matter of contractual obligation or in disclosures to investors, many banking entities have committed to maintain interests in their sponsored funds at a certain minimum value or percentage of the fund. Forcing banking entities to seek to escape those obligations would inflict hardships on the other investors in such funds, depriving them of their original understanding of the terms of their investments and likely depressing the value of their investments.

Extensions to Generally Permit a 3-Year Seeding Period for Sponsored Funds

- Current market practice for funds is that it generally takes at least two to three years to establish the track record necessary to attract significant support from third-party investors (e.g., pension funds, endowments and other institutional investors). Most major institutional investors will not consider investing in a new fund without such a track record.

- Under the statute and the Proposed Rule, funds are permitted an initial seeding period of one year and the Federal Reserve has authority to extend the seeding period for two additional years. If investors have no guarantee that the seeding entity will be permitted to remain in a fund for more than one year, they will be less likely to invest in new funds.

- In light of this grant of authority and the express purpose of the seeding period, we believe that the Federal Reserve should affirm that it will presumptively grant banking entities the extension provided for in the statute for all of a banking entity's covered funds, so long as there is a bona fide effort to build a track record and attract third-party investors.

Compliance Program and Reporting Requirements

- We believe it is essential for the Agencies to clarify when banking entities will be expected to have compliance programs in place, as it would be a practical impossibility to implement compliance systems by the effective date given the likely timing of the final rule and the fact that many fundamental issues remain unresolved.

- In our view, Congress intended the conformance period to give banks time to address compliance issues, decide what restructuring is required and put policies and systems in place. The Agencies should clarify in the final rule that banking entities will not be required to have compliance systems fully implemented and operating until the end of the conformance period.

- The Proposed Rule itself recognizes that most banking organizations will need to introduce and test extensive new policies and procedures, internal controls and reporting systems in order to comply with the Volcker Rule. Banks, particularly foreign banks, are limited in their ability to plan reorganizations and build compliance systems in the absence of greater clarity regarding these requirements.

Exclusion of Controlled Funds from the Definition of "Banking Entity"

- The Agencies acknowledge that the Volcker Rule was not intended to prohibit ownership or control of funds-of-funds, and excluded controlled covered funds organized under the asset management exemption from the banking entity definition. The Agencies did not, however, similarly exclude other funds that a banking entity might control, such as a fund sponsored under the foreign funds exemption, a foreign mutual fund, or a fund that a banking entity might control pursuant to the "DPC", hedging or market-making exemptions.

- As a result, such funds would be banking entities. This would effectively preclude organizing a fund-of-funds under the foreign funds exemption and require foreign funds-of-funds to comply with the exemption designed for U.S. sponsored funds. It would apply the Rule's proprietary trading restrictions to a banking entity's foreign hedge funds. It could also limit a banking entity's ability to foreclose on funds-of-funds collateral or invest in funds-of-funds in connection with risk-mitigating hedging.

- These are unintended consequence of the Proposed Rule that would have especially serious adverse effects on foreign banking organizations and the markets in which they operate.

<u>Employee Investments</u>

- Employee investments in bank-affiliated products should be encouraged to the fullest extent permissible under the statute, in order to create alignment with bank clients who invest in those products, whether or not a covered fund or a foreign fund.

- This is consistent with other Dodd-Frank provisions that encourage banks to have more "skin in the game" in investment vehicles they sponsor, and is consistent with fiduciary duties to fund investors.

- Dodd-Frank's specific authorization for employees who provide "other services" to invest in covered funds indicates that Congress did not intend to limit investment to employees providing investment advisory and management services—sales and marketing, administration, investor relations, deal sourcing and origination, deal evaluation and diligence, and operational support services should be included.

- Employees should not be required to divest existing investments in covered funds (including those acquired through leverage arrangements with their employer) during or after the conformance period, as this would unduly harm both the employees and the other investors in the funds in which employees have invested.

<u>Permitted Activities: Hedging, Market Making and Customer Trading</u>

- The Agencies should extend the hedging exemption in the proprietary trading provisions of the Proposed Rule to the covered fund provisions and should eliminate any additional requirements under the hedging exemption for covered funds activities. Similarly, the Agencies should properly interpret the scope of the market making and transactions on behalf of customers exemptions to apply to covered funds as well as proprietary trading activities. We believe the statute is unambiguous on these points.

- The policy rationales supporting the application of the hedging exemption to proprietary trading apply equally to covered funds. The additional requirements under the proposed hedging exemption for covered funds would, among other things, limit the ability of banking entities to engage in dynamic hedging or portfolio hedging, or to hedge exposures resulting from transactions linked to fund indices or transactions with other banking entities. These limitations could prevent banking entities from effectively managing risk arising from the facilitation of customer exposure. The additional requirements could also prevent banking entities from creating new products tailored to customer needs.

- Unless the market making and customer trading exemptions apply to covered fund activities, foreign banks may not be able to continue to (i) make markets in U.S. funds or structured products linked to U.S. funds or (ii) sell fund interests or fund-linked structured products to U.S. persons. These limitations would not protect the safety and soundness of foreign banks, and would encourage covered fund managers to discriminate against U.S. investors, thereby limiting the investment options available to U.S. investors.

Implications for Securitization Activities

- Congress did not intend for the Volcker Rule to have a negative effect on the securitization activities of banking organizations. While other provisions of Dodd-Frank specifically focused on reform of securitization, Congress included a specific direction in the Volcker Rule to preserve the ability of banking entities to sell or securitize loans. However, the Proposed Rule could significantly harm the securitization activities of banking entities, mainly because many common forms of securitization vehicles would be captured by the overbroad definition of covered fund. We do not believe the Agencies' currently proposed exemptions for securitization are sufficient to avoid these effects, and we urge the Agencies to exclude securitizations from the prohibitions imposed by the Volcker Rule.

- The Proposed Rule could seriously interfere with many commonplace securitization activities, including the sponsorship and support of asset-backed commercial paper conduits, the structuring and offering of collateralized loan obligations, and a number of other securitization activities and transactions. As a result, it could force banks to end or curtail many of their securitization activities, which would decrease the availability of credit and increase its cost to consumers and businesses. Especially at a time of persistent uncertainty in the international economy, imposing broad limitations on an activity that supports the provision of credit to consumers and businesses risks undermining financial stability.

There are many more specific issues related to the application of the Proposed Rule to banking entities and funds that should be addressed in a final rule to avoid significant negative consequences. We urge the Agencies to address these issues in a manner that avoids such unintended consequences and related negative effects on U.S. jobs, investment opportunities for U.S. investors, and international comity.

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We appreciate your consideration of our comments on the Proposed Rule and our suggestions on how to implement the Volcker Rule in a manner that appropriately limits the extraterritorial application of the Volcker Rule and preserves important client-facing asset management, investment services and other core banking functions. For any additional information, please do not hesitate to contact Michael W. Williams at (202) 626-3316 or Joseph L. Seidel at (202) 626-3302.

Sincerely,

Michael W. Williams
Managing Director
Credit Suisse Securities (USA) LLC

## APPENDIX

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APPENDIX

## I. Introduction

The Volcker Rule's stated policy objectives are to reduce risks to the U.S. banking system and to limit certain activities—"speculative" proprietary trading—conducted by banking entities that have implicit U.S. government and taxpayer support. The Volcker Rule attempts to accomplish these goals by prohibiting "banking entities" from (a) engaging in proprietary trading or (b) sponsoring, or acquiring or retaining an ownership interest in, a "private equity fund" or a "hedge fund" (a "covered fund"), in each case subject to certain exemptions.[3] The Volcker Rule was specifically designed to preserve the ability of banking organizations to engage in traditional customer-serving activities such as asset management, finance, securitization, market making, and the risk management functions related to these activities.

The Volcker Rule's restrictions on sponsoring and investing in covered funds are mainly intended to prevent banking entities from evading the limits on proprietary trading through their sponsorship of, and investment in, covered funds.[4] In addition, the Volcker Rule seeks to limit banking entities' covered fund activities to customer-related services and to eliminate incentives to "bail out" such funds.[5] The Volcker Rule has specific exemptions intended to preserve traditional asset management, lending, market making and other client-oriented financial services and to limit the extraterritorial reach of the Rule.[6] The preamble to the Proposed Rule acknowledges that traditional asset management and market making are among the client-oriented financial services that the Volcker Rule expressly aims to protect and permit.[7]

In our view, it is critical that the Agencies' implementation of the Volcker Rule give meaning to both of these objectives: first, preserving traditional asset management, lending, market making and other client-oriented financial services provided by banking organizations, and second, limiting the extraterritorial effects of the Volcker Rule. We believe that the core policy objective of the Volcker Rule (limiting risky speculative activities) can be addressed in a manner consistent with these other Congressional objectives.

Most of our comments in this letter focus on this central issue—achieving an appropriate balance between implementing the Volcker Rule's restrictions on targeted activities and ensuring that implementation of the Volcker Rule does not create unintended and unwarranted adverse effects on the ability of banking organizations to serve their clients, and, ultimately, on the U.S. economy.

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3 BHCA § 13(a)(1).

4 See Financial Stability Oversight Council (the "FSOC") Study and Recommendations on Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (Jan. 18, 2011) (the "FSOC Study") at 56.

5 Id.

6 Id. at 16-17, 47, 57-58.

7 Proposed Rule, 76 Fed. Reg. at 68,849.

In addition, we concur with the comment letters submitted by the Securities Industry and Financial Markets Association ("SIFMA" and the "SIFMA Letter") and the Institute of International Bankers (the "IIB") addressing, respectively, the issues raised by the Proposed Rule that are of particular interest to the securities and banking industry and to internationally headquartered banks with U.S. banking operations. We support the recommendations of SIFMA and the IIB regarding implementing the Volcker Rule in a manner consistent with Congressional intent, the Volcker Rule's underlying policies and past banking and securities law precedents.

## II. Background Regarding Credit Suisse

The Credit Suisse Group AG (together with all our affiliates and subsidiaries, "CS") is a leading global financial services company, based in Switzerland, that advises clients in all aspects of finance. CS's operations are globally integrated, and we have a presence in more than 50 countries. Under the Proposed Rule, CS, as a foreign bank with a New York state-licensed branch, would be deemed a banking entity subject to the Volcker Rule when it comes into effect.

Our asset management arm, Credit Suisse Asset Management ("CSAM"), offers investment solutions and services globally to a wide range of clients, including institutional investors, governments, foundations and endowments, corporations and individuals. CSAM provides its clients with access to a broad range of asset classes, with a focus on alternative investment strategies, emerging markets, asset allocation and traditional investment strategies. CSAM's main business centers include New York, London, Zurich, Hong Kong and Sao Paulo.

Our fund-linked products business ("FLP") provides its clients with access to a broad array of investment opportunities in covered funds and in covered fund-linked products, including operating a covered-fund market-making business and offering structured products linked to the performance of one or more covered funds or fund indices. FLP also provides different forms of financings to funds-of-funds, typically secured by fund interests. FLP's main business centers include New York, London and Zurich.

In addition to CSAM and FLP, other areas of CS's business are implicated by the covered funds provisions of the Proposed Rule. For example, CS is an active participant in the collateralized loan obligation ("CLO") market, including acting as investment advisor to CLO issuers, and underwriting and making a market in CLO securities. Similarly, CS manages a substantial asset-backed commercial paper ("ABCP") conduit. ABCP conduits are an important source of liquidity in U.S. credit markets, and CS is concerned that the Proposed Rule could have unintended adverse consequences for this method of financing.

For CS, providing clients with asset management and investment services through CSAM, FLP and other business units is a strategically important global line of business. Being able to offer clients a full range of asset management and investment products and solutions is important to the users of those services—our clients. We are therefore especially concerned that the Agencies' implementation of the Volcker Rule not create unintended and unjustified impediments to our ability to serve clients in the United States or abroad. We are also concerned about the potential follow-on effects that could arise from the Proposed Rule, which could harm U.S. and foreign investors and the broader global economy.

## III. Extraterritorial Application and Permitted Foreign Fund Activities

A key area of concern is the Agencies' implementation of the Volcker Rule's exemption related to foreign funds, which Congress specifically intended to limit the extraterritorial reach of the Volcker Rule. Not only could an unduly extraterritorial approach to the Volcker Rule limit foreign banks' ability to use their U.S. operations to serve clients outside the United States, it could also impair—in ways not contemplated by Congress or supported by any sound policy rationale—the ability of these banks' foreign operations to conduct business outside the United States.

### A. Foreign Funds That Could Be Deemed "Covered Funds"

Both publicly and privately offered funds organized and sponsored outside of the United States frequently rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (the "'40 Act") to address limited offerings or sales of fund interests to U.S. persons, even when a fund is not initially offered to such persons. Under the statute and the Proposed Rule, these funds would appear to be "covered funds" subject to the Volcker Rule's restrictions, even if they are broadly offered to the public outside the United States and therefore resemble U.S. mutual funds (which are exempt from the Volcker Rule), not private equity or hedge funds.

The Proposed Rule also proposes to expand the reach of the statutory text, deeming any foreign fund to be a "foreign equivalent" covered fund if such fund would rely on Section 3(c)(1) or 3(c)(7) of the '40 Act if it were organized or offered under U.S. law or offered or sold to a U.S. resident.[8] As a consequence, the Proposed Rule could have broad extraterritorial effects on funds with little or no U.S. nexus. Nothing in the legislative history indicates that Congress intended the definition of hedge fund and private equity fund, or the reference to "such similar funds", to be interpreted to capture such a broad range of foreign funds, many of which do not resemble traditional hedge funds and private equity funds.

### B. The Foreign Funds Exemption

Recognizing the broad extraterritorial reach of the covered funds definition, Congress deliberately and appropriately limited the extraterritorial effects of the Volcker Rule by permitting foreign banks to sponsor and invest in covered funds pursuant to Sections 4(c)(9) and

[8] We understand this provision to mean that foreign funds that would rely on 3(c)(1) or 3(c)(7) if they were located in the U.S. or if their securities were offered in the U.S. in the same manner that they are offered overseas would be treated as covered funds. We assume that the Agencies did not mean to require that every foreign fund be treated as if it were only offered in the U.S. in a manner consistent with Section 3(c)(1) or 3(c)(7), as that approach would by definition sweep in almost every foreign fund, regardless of whether it was a "foreign equivalent" of a U.S. private equity or hedge fund or a U.S. fund that relies on Section 3(c)(1) or 3(c)(7). See 76 Fed. Reg. at 68,897 ("The Agencies have proposed to include as 'similar funds' . . . the foreign equivalent of any entity identified as a 'covered fund'. These entities have been included in the proposed rule as 'similar funds' given that they are generally managed and structured similar to a covered fund . . .").

4(c)(13) of the BHCA solely outside of the United States (the "Foreign Funds Exemption").[9] Exempting the foreign fund activities of foreign banking organizations is consistent with the policy objectives of the Volcker Rule, which generally focus on protecting U.S. banks, U.S. financial stability and U.S. taxpayer funds from what Congress deemed to be inappropriate risks. It is also consistent with longstanding principles of international bank supervision, reflected in U.S. federal banking laws and federal banking agencies' regulations and interpretations, which limit unwarranted extraterritorial application of U.S. banking laws and accord appropriate deference to home country bank supervision. The scope of the exemption in the statutory text focuses on the location of the activities a bank engages in as principal that would incur risk—i.e., investing in or sponsoring a covered fund. It is those, and only those, activities that must occur "solely" outside the United States, except where the statute includes other separate limitations. The statute's plain language should not be expanded, and there is no statutory basis, to prohibit other activities such as sales by U.S.-based personnel.

Under the Proposed Rule, a foreign banking organization would be permitted to sponsor and invest in foreign funds pursuant to Section 4(c)(9) of the BHCA solely outside the United States. As explained in the preamble to the Proposed Rule, a foreign banking organization would be considered to sponsor and invest in foreign funds "pursuant to Section 4(c)(9) of the [BHCA]" so long as it meets the asset and revenue tests required to remain a "qualifying foreign banking organization" ("QFBO") under the Federal Reserve's Regulation K.[10] We support this aspect of the Proposed Rule's approach.

However, in defining what it means to sponsor and invest in a foreign fund "solely outside of the United States," the Proposed Rule (Section __.13(c)) would narrow the scope of the Foreign Funds Exemption by adding new limitations beyond what was required or contemplated by the statute.[11] In particular, the Proposed Rule would require that no subsidiary, affiliate, or employee of the banking entity that is involved in the offer or sale of an ownership interest in the covered fund be incorporated or physically located in the United States.

We urge the Agencies to remove from the final rule the new limitation that the Agencies have proposed that would prohibit U.S.-based personnel from offering or selling ownership interests in foreign funds to foreign investors. This limitation was not included in the statutory Foreign Funds Exemption, and there is no policy basis for its insertion.

1. The Plain Language and Legislative History of the Volcker Rule Requires Only That Specified Activities Occur Solely Outside the United States

The Agencies appear to have taken the view that Congress' use of "solely" in the Foreign Funds Exemption requires restrictions on activities conducted in the United States that could be viewed as related to sponsorship of a covered fund. This approach is not supported by

9 See BHCA § 13(d)(1)(I) and Proposed Rule § __.13(c).

10 If an organization were not a "foreign banking organization" under Regulation K but were otherwise a "banking entity" for Volcker Rule purposes (e.g., through control of a U.S. thrift or industrial loan company), it would be required to meet a comparable assets and revenues-based test in order to be considered to sponsor and invest in foreign funds pursuant to BHCA Section 4(c)(9).

11 Compare Proposed Rule § __.13(c)(1) and BHCA § 13(d)(1)(I).

the plain language of the statute, where "solely" specifically modifies the acquisition and retention of ownerships interests in, and sponsorship of, a covered fund. The statutory text of the Foreign Funds Exemption does not refer to the location of marketing or other related activities; it only—in a separate provision—forbids sales to U.S. residents.[12]

The location of sales personnel does not relate to the question of whether a foreign banking organization "sponsors" or "invests in" a foreign fund solely outside the United States. Indeed, the fact that Congress included a separate prohibition on offers and sales to U.S. investors as a supplement to the "solely outside of the United States" restriction confirms that a foreign banking organization could otherwise have sold interests in covered funds it sponsors to U.S. investors consistent with the requirement that it sponsor a foreign fund solely outside the United States (and such sales to U.S. investors would most naturally have involved U.S. sales personnel). In other words, the location of sales activities does not determine whether a banking entity has sponsored (or invested in) a covered fund solely outside the United States.

When the actual sponsorship, trading and/or investment in a foreign covered fund takes place outside of the United States, by a foreign banking entity controlled only by foreign banking entities that satisfy the QFBO test (or its parallel, for banking entities not subject to the BHCA), and no interest is offered or sold to U.S. residents by that banking entity, the physical location of entities and personnel providing marketing and other services to the fund is irrelevant to the location of the risk from the activity. Instead, the analysis of whether sponsorship or investment in a fund pursuant to BHCA Section 4(c)(9) or 4(c)(13) occurs "solely outside of the United States" for purposes of the Foreign Funds Exemption should focus on the location of the activities a banking entity engages in as principal that would incur risk for the bank.

Revisions to the statutory text of the Volcker Rule made during the legislative process illustrate that the Proposed Rule's approach is not consistent with the plain meaning of the statutory text. Early drafts of the Volcker Rule would have required an "investment or activity" relying on the exemption for foreign activities to be conducted "solely outside of the United States".[13] In the final statutory text, however, the Foreign Funds Exemption focuses on specifically identified actions taken as principal that could create risk for a banking entity—i.e., the "acquisition or retention . . . or the sponsorship of, a [covered fund] . . . solely outside of the United States".[14] The Proposed Rule would appropriately interpret the general prohibition on ownership and sponsorship to apply only when a banking entity is acting "as principal".[15] The narrowing of the limitations on this exemption from "activities" to specifically identified actions taken as principal (investment or sponsorship) illustrates the plain meaning of the language and Congress's intent to focus on the location of the principal risk-generating activity, and not on other activities unrelated to the location of principal risk.

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12 BHCA § 13(d)(1)(H) and (I).

13 See, e.g., The Restoring American Financial Stability Act of 2010, S. 3217, 111th Congress § 619 (as reported by the S. Comm. on Banking, Apr. 29, 2010) (emphasis added).

14 BHCA § 13 (d)(1)(I) (emphasis added).

15 Proposed Rule § __.10(a)

2. Prohibiting Related U.S. Activities Would Be Inconsistent with the Volcker Rule's Objectives and Congressional Intent

The scope of the Foreign Funds Exemption should be interpreted in light of the original purpose of the Volcker Rule—limiting risks to financial stability and to institutions that benefit from the federal safety net. The statutory mandate for the FSOC Study as well as the Study itself emphasize these underlying purposes of the Volcker Rule.[16] When interpreting the application of the Volcker Rule, including the Foreign Funds Exemption, to foreign banks the Agencies should use these objectives as guiding principles, as they will appropriately focus the Rule on the location of the risk-taking activity (and not, except as may be specifically required by the Volcker Rule itself, on the location of other activities).

The purpose, and statutory basis, of the Proposed Rule's new restriction on sales by U.S.-based personnel is unclear, especially in light of the specific limitation in the Foreign Funds Exemption that already prohibits a foreign bank from offering or selling a fund interest to U.S. residents. To the extent that the new limitation is designed to prohibit a foreign bank from using U.S. personnel to sell interests in funds that it sponsors or invests in outside the United States to foreign investors, there is no apparent policy rationale for this limitation in the underlying objectives of the Volcker Rule.

The Foreign Funds Exemption should be implemented in accordance with its plain meaning to focus solely on investing in and sponsoring a covered fund, and not be expanded to prohibit other factors irrelevant to the location of principal risk and with no basis in the statutory text.[17] This interpretive approach would be consistent with the Volcker Rule's stated policy objectives—reducing risks to the U.S. banking system and limiting certain activities conducted by banking entities that have implicit U.S. government (and U.S. taxpayer) support.[18]

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[16] See BHCA §§ 13(b)(1)(B) and (C) (instructing the FSOC to conduct a study on how to implement the Volcker Rule so as to, among other things, protect taxpayers and limit the transfer of federal subsidies from banks to their unregulated affiliates); FSOC Study at 1 ("The Volcker Rule prohibits banking entities, which benefit from federal insurance on customer deposits or access to the discount window, from engaging in proprietary trading and [covered fund activities], subject to certain exceptions.") (emphases added).

See also FSOC Study at 9 (proposed framework intended to "limit the transfer of subsidies from the federal support provided to depository institutions to speculative activities"); id. at 15-16 ("Congress intended to strictly restrain speculative risk taking in the form of proprietary trading by banking entities, which benefit from the support of federal deposit insurance and access to discount window borrowing" and "permitted activities are limited to important forms of financial intermediation that Congress concluded are permissible in the context of entities that have the support of federal deposit insurance and discount window access").

[17] BHCA Section 13(d)(1)(I) refers to the "acquisition or retention . . . or the sponsorship of, a [covered fund] . . . solely outside of the United States" (emphasis added). This contrasts with earlier drafts of the Volcker Rule, in which "solely outside of the United States" modified an "investment or activity". See, e.g., The Restoring American Financial Stability Act of 2010, S. 3217, 111th Congress § 619 (as reported by the S. Comm. on Banking, Apr. 29, 2010) (emphasis added). This narrowing of the limitations from "activities" to specifically identified actions (investment or sponsorship) illustrates Congress's intent to focus on the location of actions taken as principal that create risk.

[18] See BHCA § 13(b)(1) (requiring the FSOC to conduct a study and make recommendations on how the Volcker Rule's implementation could promote safety and soundness, enhance financial stability, protect

The risk for activities conducted pursuant to Foreign Funds Exemption would be borne by a foreign bank outside of the United States, and would be subject to the supervision and risk management requirements of the bank's home country regulators. The foreign operations of foreign banks are not eligible for U.S. federal deposit insurance or other relevant forms of federal support, such as borrowing from the Federal Reserve discount window, thus addressing the risk that the Foreign Funds Exemption would result in an inappropriate use of U.S. taxpayer subsidies to support these activities.[19]

Foreign banks, including CS, often locate marketing and sales personnel for their foreign funds in the United States in order to serve customers in the Americas (other than the U.S.), who may prefer to discuss investment options outside of customary working hours in Europe or Asia. The additional limitation proposed by the Agencies regarding the involvement of U.S. sales personnel would likely force significant fund-related activities to shift outside of the United States, moving financial services jobs overseas without any benefit to U.S. financial stability or the safety and soundness of U.S. banks.

Deferring to home country regulation of the foreign fund activities of foreign banks is also consistent with the intent of Congress to adhere to longstanding principles of international comity and to avoid unwarranted extraterritorial application of the Volcker Rule.[20] Governments and supervisors in other countries may make different judgments about which types of fund activities banks may conduct and, in the Volcker Rule, Congress appropriately deferred to home country regulators with respect to activities located outside the United States.[21]

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taxpayers and consumers from unsafe and unsound practices, limit the inappropriate transfer of federal subsidies, reduce conflicts of interest, and limit activities that create, or could create, undue risk of loss). See also 156 Cong. Rec. S5894 (daily ed. July 15, 5010) (Colloquy between Sen. Merkley and Sen. Levin) (the "Merkley-Levin Colloquy") ("Properly implemented, section 619's limits will tamp down on the risk to the system"); the FSOC Study at 15, 56 ("[One] purpose of the Volcker Rule is . . . [to] [s]eparate federal support for the banking system from speculative trading activity with the banking entity's own capital.")

[19] See, e.g., FSOC Study at 46 ("[B]ecause of U.S. extra-territorial regulatory constraints, the statute does not restrict proprietary trading conducted by non-U.S. entities outside the United States. These entities are not eligible for discount window loans or federal depository insurance.").

[20] See, e.g., Merkley-Levin Colloquy at S5897 ("[Sections 13(d)(1)(H) and 13(d)(1)(I)] recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law."). See also 156 Cong. Rec. S5889-S5890 (daily ed. July 15, 2010) (Statement of Sen. Hagan) ("For consistency's sake, I would expect that, apart from the U.S. marketing restrictions, [Section 13(d)(1)(I)] will be applied by the regulators in conformity with and incorporating the Federal Reserve's current precedents, rulings, positions, and practices under sections 4(c)(9) and 4(c)(13) of the Bank Holding Company Act so as to provide greater certainty and utilize the established legal framework for funds operated by bank holding companies outside of the United States.").

[21] Other G-20 countries are actively debating the appropriate regulatory treatment of institutions that combine proprietary/investment banking activities and retail banking. If the Volcker Rule were applied—beyond its plain meaning—to reach foreign banks' foreign fund activities, it could result in the imposition of overlapping and inconsistent regulatory regimes on these institutions' non-U.S. operations. See, e.g., Letter from Chancellor of the Exchequer George Osborne to Chairman of the Federal Reserve Ben Bernanke, January 23, 2012 (expressing concerns about the Volcker Rule's extraterritorial effects and requesting a dialogue between U.S. and U.K. regulators on their respective reform efforts).

If "solely outside of the United States" were interpreted to be more limiting than its plain meaning and context in the Volcker Rule suggest, it could have significant adverse and unintended consequences for the U.S. economy and financial services sector. In the context of fund sponsorship, trading and investment, a narrow implementation of the Foreign Funds Exemption in Section 13(d)(1)(I) will force fund trading and sales activities to shift outside of the United States, moving financial services jobs overseas without any benefit to U.S. financial stability or the safety and soundness of U.S. banks.

For these reasons, we urge the Agencies to delete from the final rule the proposed restriction on sales activities of U.S.-based personnel.

3. The U.S. Marketing Restriction

The Foreign Funds Exemption permits foreign banks to acquire, retain, sponsor and/or invest in foreign covered funds, provided that, among other conditions, "[n]o ownership interest in such covered fund is offered for sale or sold to a resident of the United States" (the "U.S. Marketing Restriction").[22] The U.S. Marketing Restriction is a specific requirement that Congress added as a supplement to the requirement that any sponsorship and investment by a foreign bank in a foreign covered fund be solely outside the United States. This restriction is designed to prevent foreign banks from using the Foreign Funds Exemption, which Congress intended to limit the extraterritorial effects of the Volcker Rule, to market and sell ownership interests in covered funds in the United States.

Consistent with this purpose, the Agencies should interpret the U.S. Marketing Restriction in a manner that avoids unwarranted and unintended effects on foreign banks' ability to operate their own funds and invest in and trade ownership interests in third-party funds outside of the United States. The Agencies should also exercise caution to limit the incentives for foreign fund managers and fund sponsors to discriminate against U.S. residents. The following proposed approaches are designed to implement the plain language of the U.S. Marketing Restriction and avoid the severe disruptions in such foreign activities that could result from an expansion of the U.S. Marketing Restriction beyond its plain language or intended effects.

(a) The U.S. Marketing Restriction should not apply to third-party funds or to secondary sales

In order to avoid unintended restrictions on a foreign bank's foreign funds business and investments, the Agencies should clarify that a banking entity may rely on the Foreign Funds Exemption so long as no ownership interest in the relevant covered fund is offered for sale or sold to U.S. residents by the covered banking entity. The Volcker Rule should not impair a banking entity's ability to sponsor, invest in or trade a foreign covered fund solely due to the actions of third parties outside the control (or even knowledge) of the banking entity, such as sales conducted by third-party funds in which a foreign bank has invested or secondary market sales by investors in a foreign bank's fund.[23] Any other interpretation would severely

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22 See Proposed Rule §§ __.13(c)(1)(iii) and (3)(iii).

23 The Agencies should also clarify that non-U.S. investors in foreign covered funds should not be deemed to become U.S. residents for purposes of the U.S. Marketing Restriction if, after purchasing their interests in

and unreasonably restrict the non-U.S. investments and operations of foreign banks. For example:

- A foreign bank would be prevented from investing in or trading (including making a market or hedging with interests in) a third-party covered fund outside the United States unless the bank could obtain adequate assurances that no investments from U.S. residents have been, or would be, solicited or accepted by the fund, and no transfers to U.S. persons have been, or would be, permitted in the future. In many cases, fund managers would be unwilling to provide such assurances, and it would effectively become impossible for a foreign bank to make any secondary market purchases of securities that did not originally contain such restrictions. Furthermore, such an interpretation would force fund sponsors and distributors unaffiliated with any banking entities to choose between precluding either foreign banking entities or U.S. residents from investing in their funds, which would likely restrict investment options for U.S. institutional investors without serving any policy purpose.

  As described below, these challenges would be even greater if fund-linked products were treated as ownership interests in a third-party fund, as there may be no relationship between the entity that structures and sells such a fund-linked product and the sponsor and distributor of its reference fund, and thus little or no ability to determine if the reference fund has been or could be sold to U.S. investors.

- A foreign bank that sponsors and sells ownership interests in foreign covered funds to investors outside the United States would be forced to restrict and monitor any secondary sales to prevent sales by investors to U.S. residents. Prohibiting sales to U.S. residents is currently not a common market practice. Even if it were possible to implement such restrictions, the challenges of monitoring and enforcing such restrictions would be significant, both for the sponsoring foreign banks and the Agencies that supervise them.

  Preventing an investor that wishes to dispose of its interest in a bank-sponsored foreign covered fund from independently identifying and sourcing a U.S. resident as a potential buyer for its interest would not serve the purpose of the U.S. Marketing Restriction, but could decrease the value of such fund interest by limiting resale options and would limit investment opportunities for U.S. investors.

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the covered fund, they relocate to the United States. The SEC has applied this principle when measuring the number of U.S. persons who are beneficial owners of a foreign fund relying on the Touche Remnant doctrine, which generally requires a foreign fund that wishes to make a private offering of securities in the United States to comply with either Section 3(c)(1) or 3(c)(7) of the ’40 Act. See Touche Remnant & Co. (avail. Aug. 27, 1984). In Investment Funds Institute of Canada, the SEC concluded that a foreign fund would not violate the 100 persons beneficial ownership limit if non-U.S. investors in the fund subsequently relocated to the United States and became U.S. persons, subject to certain conditions to prevent abuse of the exemption. See Investment Funds Institute of Canada (avail. Mar. 4, 1996).

Applying the restriction on offers or sales to U.S. residents to sales by the foreign bank and not to sales by independent third parties would be wholly consistent with the plain language of BHCA Section 13(d)(1)(I), which focuses on the activities and status of the banking entity relying on the exemption. It would also be consistent with the underlying policy objectives of the Volcker Rule and Congressional intent.[24] The Volcker Rule restricts a foreign bank (and its agents) from marketing its foreign covered funds to U.S. investors, but it should not prohibit the bank from investing in or trading interests in any foreign third-party funds that have one or more U.S. investors.[25] Such a prohibition would not advance the Volcker Rule's policy objectives and would represent an unnecessary and unreasonable extraterritorial application of the Volcker Rule. It would also present significant compliance challenges, since the activities of third parties outside the control and perhaps knowledge of the banking entity would alter the permissibility of the banking entity's activities or investments.

(b) The U.S. Marketing Restriction should not apply to derivatives and structured products linked to third-party funds

To the extent that the final rule treats derivatives and structured products linked to covered funds as ownership interests, the Agencies should clarify that such fund-linked products should not be treated as ownership interests for purposes of the U.S. Marketing Restriction if such products are linked to a third-party fund. When a fund-linked product is created and sold by a party that is not affiliated with a foreign covered fund, neither the sponsor or adviser of such fund, nor any person interested in investing in such fund, would have any knowledge, control or assurance that such fund-linked products were not sold to U.S. residents. It would be impossible for a foreign bank seeking to invest in a foreign fund to be certain that some third-party had not created and sold an "ownership interest" in the fund to a U.S. investor in the form of a fund-linked product referencing the fund. Even if a third-party did sell a fund-linked product to a U.S. investor, and even if a foreign bank became aware of such sale, the general rule should not be interpreted to apply to such sales for the reasons set out in Part III.B.3.a above.

Furthermore, the Agencies should also clarify that, in the case of fund-linked products, a foreign bank should be permitted both to invest in a third-party foreign fund pursuant to the Foreign Funds Exemption, and also to sell fund-linked products referencing that fund to U.S. residents, so long as the foreign bank otherwise complies with the Volcker Rule's trading restrictions with respect to its sales of fund-linked products. Foreign banks are separately permitted to sell fund-linked products in compliance with the Volcker Rule's proprietary trading restrictions, and to invest in third-party foreign covered funds in compliance with the Foreign Funds Exemption. There is no reason that conducting one activity should foreclose the other—indeed, generally banks that sell fund-linked products attempt to invest in the reference fund to hedge their synthetic exposure from selling the fund-linked products, so permitting the

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24 See Merkley-Levin Colloquy at S5897 ("[The exemption] prohibit[s] a foreign bank from improperly offering its hedge fund and private equity fund services to U.S. persons when such offering could not be made in the United States.") (emphasis added).

25 Such third-party funds are subject to a separate regulatory scheme governing when, and to what extent, they can be offered or sold to U.S. investors, and there is no policy justification for changing that scheme solely due to a passive investment by a foreign bank. See '40 Act §§ 3(c)(1), (7) and 7(d).

combination would preserve the ability of foreign banks to manage their risks in an efficient manner.

(c) Timing and conformance considerations

The Agencies should confirm that compliance with the U.S. Marketing Restriction will be required only as of the Volcker Rule's July 21, 2012, effective date (the "Effective Date") or, as applicable, after the July 2014 conformance date. We and other market participants have been and continue to rely on the plain language of the statute to conclude that banking entities may continue to sponsor, invest in and trade funds that comply with the Foreign Funds Exemption so long as: (a) for new foreign covered funds that the banking entity sponsors, invests in or trades after the Effective Date, the banking entity does not offer or sell interests in that fund to U.S. investors after the Effective Date, and (b) for existing funds, the banking entity terminates any offers or sales to U.S. investors by the end of the relevant conformance period. We believe that this understanding is consistent with the wording of the Proposed Rule, which repeats the language of the Volcker Rule's U.S. Marketing Restriction without elaboration. The plain language of the U.S. Marketing Restriction and the Proposed Rule's implementing language preclude a fund that "is" offered or sold to U.S. residents from relying on Section __.13(c) of the Proposed Rule, not a fund that was or ever has been offered or sold to, or is held by, U.S. residents.

The restriction in the statutory text was designed to prevent foreign banks from gaining an inappropriate competitive advantage over U.S. institutions by selling their foreign covered funds to U.S. residents after compliance with the Volcker Rule is required. Interpreting the U.S. Marketing Restriction to apply retroactively to sales that were made prior to the Effective Date or conformance date would be unreasonable and inconsistent with the restriction's objective. It is also not clear how such an approach could reasonably be implemented. Foreign banks would be required either to divest their interests in funds with any U.S. investors or somehow force redemptions by U.S. investors as a result of sales that occurred before the compliance deadline for the Volcker Rule or even before the Effective Date or the passage of the Volcker Rule. Forcing a foreign bank sponsor to divest its interests could violate the bank's commitment to investors to invest with the fund in order to support the fund's growth and/or align the interests of the bank and the investors by keeping "skin in the game." It could also harm the fund's performance—and thus its investors—by reducing available capital or forcing asset sales at unfavorable times and prices.

Requiring U.S. investor redemptions would also be a complex and contentious process likely to harm the fund's investors. U.S. investors that wish to remain in high-performing funds would likely object, and setting a redemption price that would be perceived to be fair by both the redeemed U.S. investors and the remaining foreign investors would be fraught with difficulty. Extensive redemptions could also harm the fund's performance (and thus its investors) through reduced capital and/or untimely asset sales.

(d) The definition of "U.S. resident" should be revised to match the definition of "U.S. person" under Regulation S

While we generally agree with the Agencies' proposal to rely on the definition of "U.S. person" in the SEC's Regulation S ("Reg S")[26] to define "U.S. resident" in the Proposed Rule, we strongly disagree with the Agencies' proposed expansions of the Reg S definition, which would create significant uncertainty regarding the status of many persons and funds and cause significant confusion and compliance difficulties in the market. Without explanation, the Proposed Rule's definition of "U.S. resident" does not include the exclusions in Section 902(k)(2) of Reg S that carve out certain persons and entities that should not be treated as U.S. persons. These include carve-outs for certain U.S. persons who are not U.S. residents (e.g., foreign branches of U.S. entities), certain U.S. residents (e.g., dealers and fiduciaries) acting on behalf of non-U.S. resident customers, employee benefit plans organized outside of the United States in accordance with local laws, and multinational organizations such as the International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the African Development Bank, and the United Nations.[27]

The Proposed Rule also makes several small but significant changes to the Reg S definition that cast the status of certain foreign fund structures into doubt by including in the definition of U.S. person "[a]ny trust of which any . . . beneficiary . . . is a resident of the United States" and "[a]ny discretionary . . . account . . . held by a dealer or fiduciary for the benefit or account of a resident of the United States".[28] Adding trusts with U.S. beneficiaries and discretionary accounts held for the benefit or account of a U.S. resident could capture foreign fund structures outside the United States that are organized as trusts or as separate account structures in accordance with local laws if they have any U.S. investors, even though such structures would not be captured under Reg S. In the case of foreign funds-of-funds, this could lead to their exclusion from other foreign funds that are structured to preclude sales to U.S. investors in order to qualify for the Foreign Funds Exemption.

Although these expansions of the Reg S definition were apparently intentional, the Agencies give no indication of the rationale for proposing them.[29] Nothing in the Volcker Rule's statutory text or in the policy underlying the U.S. Marketing Restriction support the expansions and in some cases they are inconsistent with the plain meaning of the term "U.S. resident". The SEC has a long history of applying and interpreting Reg S to offerings and sales that occur outside of the United States and its application is well understood by both regulators and market participants alike. Applying a different standard for testing a person's U.S. status under Reg S and under the Volcker Rule will create significant market uncertainty and complicate compliance efforts under both regimes. Consequently, we believe that the final rule

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26 See 76 Fed. Reg. at 68,881-2.

27 See 17 C.F.R. § 230.902(k)(2).

28 See Proposed Rule § __.2(t)(4), (6).

29 In the preamble of the Proposed Rule, the Agencies "note that the proposed definition is similar but not identical to the definition of 'U.S. person' for purposes of the SEC's Regulation S" without further explanation. See 76 Fed. Reg. at 68,881.

should incorporate the Reg S definition of U.S. person without modification, including the tailored exemptions to the definition provided in Section 902(k)(2) of Reg S.[30]

(e) The U.S. Marketing Restriction should not apply to the U.S. employees of a banking entity who invest pursuant to bona fide employee investment, retirement or compensation programs

We urge the Agencies to clarify that the U.S. employees of a banking entity or its affiliates would not be considered U.S. residents for purposes of the U.S. Marketing Restriction if they invest in a foreign covered fund pursuant to bona fide employee investment, retirement or compensation programs. The U.S. Marketing Restriction is designed to address competitive concerns, which are not implicated by bona fide employee investment, retirement or compensation programs that provide opportunities for employees to invest in foreign covered funds. The Foreign Funds Exemption appropriately does not limit employee investments, and there is no policy rationale for excluding U.S. employees from the employee retirement or compensation programs offered to non-U.S. employees.

## IV. Providing Adequate Conformance Periods

Subpart E of the Federal Reserve's Proposed Rule incorporates provisions relating to the Volcker Rule's conformance provisions, including the two-year conformance period and extended transition periods, which the Federal Reserve had previously adopted in February 2011 as a final rule (the "Conformance Rule").[31] In the preamble to the Proposed Rule, the Federal Reserve asks whether, in light of the interplay between the substantive provisions of the Proposed Rule and the related conformance periods, any changes should be made to Subpart E.

In our view, the scope and breadth of the Agencies' proposed implementation of the Volcker Rule in the substantive provisions of the Proposed Rule underscore the critical importance of revising the conformance period provisions of Subpart E. These revisions and related clarifications are necessary to ensure that banking organizations will have what Congress intended to be a reasonable period of time to bring activities into conformance with the Volcker Rule and to avoid unnecessary disruptions to financial markets, client service and safe and sound banking operations. In the context of funds, adequate transition periods are especially important to protect the interests of investors in funds, who invested at a time when they had no reason to expect that something like the Volcker Rule could require banking organizations to wind up sponsored funds or divest from their own or third-party funds prematurely. Adequate transition periods are also necessary to ensure that banks can unwind their investments in an orderly fashion and avoid the fire sales, downward pressure on asset prices, and liquidity crises that could otherwise arise.

[30] See 17 C.F.R. § 230.902(k)(2).

[31] 76 Fed. Reg. 8265 (Feb. 14, 2011).

## A. Revisions to Conformance Rule to Give Statutory Conformance Period Full Effect

We urge the Federal Reserve to revise its Conformance Rule to permit banks to continue to sponsor and invest in covered funds during the conformance period, so long as all activities are brought into compliance by the end of the conformance period.[32] When the Federal Reserve adopted the final Conformance Rule in February 2011, it still appeared possible that the Agencies could issue the final rule by the October 2011 statutory deadline. It is now clear that the final rule will not be released until very shortly before the Volcker Rule's Effective Date (at the earliest). Given the complexity of the Proposed Rule, the uncertainty regarding the outcome of many fundamental questions, and the compressed schedule between the release of the final rule and the Effective Date, there are compelling reasons for the Federal Reserve to revisit the Conformance Rule.

The Federal Reserve stated in the Conformance Rule release that the statutory conformance period is intended to allow banking entities to bring into conformance the "activities, investments, and relationships of the banking entity or company that were commenced, acquired, or entered into before the Volcker Rule's effective date".[33] However, nothing in the statutory text limits the applicability of the conformance period to activities and investments pre-existing as of the Effective Date. Section 13(c)(2) of the BHCA provides that banking entities and other companies subject to the Volcker Rule "shall bring [their] activities and investments into compliance with [the Volcker Rule] not later than 2 years after the [Effective Date]"—it places no conditions on when those activities and investments were originally initiated. Accordingly, what steps towards conformance the Agencies require during that conformance period are clearly within their discretion.[34]

While requiring full compliance for new activities as of the Effective Date might have appeared reasonable when the Conformance Rule was issued last February, that approach would no longer be feasible and would create significant disruptions within financial institutions and the markets. The Federal Reserve should give full effect to the statutory conformance period in a revised Conformance Rule in order to provide for the orderly conformance of activities and investments that Congress intended. In addition, the Agencies should clarify as soon as is possible that all banking entities will have the full two-year conformance period before any requirement to comply with the funds provisions of the Proposed Rule comes into effect.

## B. Clarity Regarding Conformance Timing for Existing Activities

In our view, two years is unlikely to be sufficient time to restructure and unwind existing fund activities, since final rules are not likely to be released until immediately prior to the Effective Date (if not later). As a result, we urge the Federal Reserve to extend the conformance period by rule for all banking entities subject to the Volcker Rule. Congress

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32 The Agencies specifically requested comment in the preamble to the Proposed Rule on whether any portion of the Federal Reserve's Conformance Rule should be revised in light of the Proposed Rule. See 76 Fed. Reg. at 68,923 (Question 347).

33 76 Fed. Reg. 8265 (Feb. 14, 2011).

34 See BHCA § 13(c)(2).

explicitly provided for the possibility of such a blanket extension in recognition of the difficulties in rapidly achieving compliance and the significant downside risks to the U.S. economy if restructuring activities are pressed too quickly, before the markets have time to adapt. If the Federal Reserve is unwilling to grant such an extension by rule, then it should clarify, as soon as possible, that there will be a general presumption to grant extensions of the conformance period, and that banking entities would be able to apply for extensions for multiple funds, or their entire fund business, in one application, rather than on an individual, fund-by-fund basis.

Clarity regarding when conformance with the Volcker Rule will be required is important to avoid unnecessary distressed sales of assets. Distressed sales, whether the result of uncertainty or of unduly short deadlines in the final rule, would artificially depress the value of investors' interests in funds. Investors that sell into the secondary market around the same time as banks are selling down their interests would realize immediate losses as a result of the bank sales, as the market for the particular fund interest, and fund interests as a whole, would be flooded by banks trying to sell down to permitted levels. Investors that stay in such funds will see the market value and liquidity of their interests decline. In some cases, investors may be subject to drag-along rights, leading to further distressed selling by investors in funds that banks are forced to exit and leading to further price declines. These are exactly the type of negative impacts on markets and investors that Congress sought to avoid by providing for an extended conformance period.

When determining conformance requirements and extensions, the Agencies should take into account a host of factors, including market conditions, the financial impact on a banking entity, a bank's fiduciary duty to investors, and the impact on, and bank's duties to, unaffiliated clients, customers and counterparties. Many banking entities have committed to maintain interests in their sponsored or advised funds at a certain minimum value or percentage of the fund. The commitments arise in fund disclosure documents and also in explicit contractual obligations. Investors clearly value these commitments, believing that they align the banking entity's interests with their own. Forcing banking entities to seek to escape these obligations would inflict hardships on other investors, depriving them of their original understanding of the terms of their investments and depressing their value. It could also undermine relationships between banks and their customers.

C. <u>Specific Issues Concerning Illiquid Funds</u>

Under the Volcker Rule, a banking organization may apply to the Federal Reserve for an extended transition period of five years to retain sponsorship of, or an investment in, a fund that qualifies as an illiquid fund. Under the Conformance Rule and Subpart E, the illiquid fund extension would be in addition to any one-year extensions (up to three) of the general conformance period available to any type of fund—whether or not an illiquid fund.

1. Definition of Illiquid Funds

In the Conformance Rule, the Federal Reserve defined the term "illiquid fund" and related terms narrowly, relying significantly on the legal terms of the banking organization's relationship with the fund and legal ability to exit the relationship. In our view, Congress intended illiquid funds eligible for the extended transition period to be defined in a manner that takes into account market considerations, including the financial impact on a banking organization and its fiduciary duties to investors. Consequently, we would suggest the following changes:[35]

- The extended transition period for illiquid funds should apply not only if the retention of an interest in the fund is contractually required, but also if divestiture of the fund interest would result in a loss or cost to the banking entity—e.g., because the illiquidity of the fund's assets means that the proceeds to be received from such divestiture would be less than the fair value of such interest (assuming that such assets were held until their maturity or until the termination of the fund in accordance with its otherwise applicable term). Without such a clarification, the purpose of the extended transition period for illiquid funds—avoiding forced premature divestitures that could create unnecessary losses—would not be realized.

- In order to be considered to have a contractual obligation to retain a fund interest, a banking entity should not be required affirmatively to seek the consent of third parties (and for such consent to be withheld). For many large banking organizations, the burden associated with seeking consents from the managers of third-party funds, or from investors in our own sponsored funds, potentially would be enormous. We do not believe that such a requirement is implied by the Volcker Rule's approach to transition periods, and it is unnecessary to ensure an orderly process of bringing fund activities into compliance with the Volcker Rule. It would also seem unfair to penalize banking entities that negotiated contractual rights to exit if required to do so for regulatory reasons, while effectively rewarding those who took no precautions to address potential regulatory concerns that could arise. If necessary, the Federal Reserve can take into consideration the practical effect of consent requirements as a discretionary factor among others in evaluating whether to grant an extension, but unsuccessful attempts to obtain consent to transfer, terminate, etc. should not be a prerequisite for a fund to qualify as an "illiquid fund".

- In order to be considered "principally invested" in illiquid assets, it should be sufficient if at least 50% of the fund's total consolidated assets are illiquid assets or risk-mitigating hedges, not the 75% requirement included in the Conformance Rule and Subpart E. We believe that there is ample statutory discretion and strong policy support for measuring "principally invested" at 50% rather than 75%.

2. Procedure for Applying for Extensions

Although not entirely clear from the Conformance Rule (or Subpart E), it appears that the Federal Reserve anticipates that a banking organization would need to exhaust its three possible one-year extensions (which are available to all types of funds) before applying for a

[35] See also the discussion of timing and conformance issues related to the U.S. Marketing Restriction in Part III.B.3(c) above.

five-year extension for an illiquid fund. As noted above, we urge the Federal Reserve to act to extend the general conformance period by rule for all banking entities and funds. If the Federal Reserve chooses not to grant such an extension, it should permit a banking organization that had sponsored or invested in an illiquid fund to apply for both the general one-year extensions and the five year extension at the same time, and to file a single application for multiple funds—or all of its funds—at the same time. Such an approach would mitigate any risk of market disruptions as the sponsors and investors in illiquid funds seek to exit their funds in a hasty manner, and would be significantly more efficient for both the banking organization and the Federal Reserve, whose application processing resources will inevitably be strained by Volcker Rule extension requests.

3. Duration of Extensions

Under the Conformance Rules, an illiquid fund extension automatically terminates on the date on which the banking entity is no longer under a contractual obligation to retain an interest in the fund. The Federal Reserve rejected requests for a grace period or other period of time following the triggering event in order to divest or otherwise conform the investment or activity. We continue to believe that a grace period is required in order to facilitate orderly compliance with the Volcker Rule and to avoid unintentional violations of the Volcker Rule. We respectfully request that the Federal Reserve reconsider this issue in connection with the pending rulemaking and adopt a six-month grace period following the end of a contractual obligation before a banking entity is required to bring the relevant investment or activity into conformance with the Volcker Rule's requirements.

D. Criteria for Extensions

The criteria that the Federal Reserve would apply in evaluating an extension request do not give adequate consideration to the effects of a premature divestiture or termination of a fund on investors, most of whom will have invested in the relevant fund without any reason to expect that the restrictions of the Volcker Rule would affect their investment. Although the listed criteria include a reference to potential conflicts of interest,[36] that criterion as written is too narrow and does not give full weight to legitimate investor protection concerns. To the extent that the Federal Reserve does not grant a blanket extension as discussed above, we would suggest revising the relevant criterion to require that the Federal Reserve consider "duties that the banking entity owes to unaffiliated clients, customers or counterparties, including investors in a fund that the banking entity sponsors, and the impact to such clients, customers and counterparties if the banking entity were to divest or dispose of the activity or investment within the applicable period."

E. Other Significant Timing Issues Related to the Conformance Requirements

Neither the Conformance Rule nor the Proposed Rule has addressed a number of significant questions relating to the requirements for conforming activities and investments that pre-date the Effective Date. For example, there are a number of pre-existing activities that we assume will be permitted to continue not only during the conformance period but indefinitely, in

36 See 76 Fed. Reg. at 68,970.

light of the relevant policy considerations, the obstacles to (or impossibility of) conforming these activities, and the regulatory approaches to conformance in other contexts. For example, in connection with compliance with the Asset Management Exemption[37] and the 23A Prohibition:[38]

- A covered fund that shares a name with a banking entity should not be required to change its name during the conformance period, since changing the name of the fund after it had been marketed and sold to investors would appear unnecessary and an unreasonable burden on the fund's sponsor.

- Consistent with current approaches to pre-existing extensions of credit under Section 23A of the FRA and the Federal Reserve's Regulation W ("Regulation W"), any extension of credit that pre-dates the Effective Date should not need to be terminated in order to comply with the Asset Management Exemption.[39] The Volcker Rule's 23A Prohibition prohibits a banking entity from "entering into" covered transactions (not maintaining pre-existing covered transactions), and thus should only prohibit entering into such transactions after the Effective Date. Requiring a banking entity to terminate a pre-existing extension of credit would in some cases require it to violate the terms of its contractual obligations. To the extent a banking entity is contractually obligated, prior to the Effective Date, to modify the terms of a pre-existing covered transaction in a specific manner, such modifications should be considered part of the pre-existing transaction.

- Pre-existing investments and leverage arrangements in sponsored funds by employees who are not engaged in providing services to the funds should not be required to be divested or unwound during or following the conformance period. Banking entities may not have the authority to require such divestitures, and such a requirement would be unfairly burdensome and potentially costly for employees of the banking entity if divestitures would result in losses. The employee investment restriction should apply only to investments and leverage arrangements entered into after the Effective Date.

## V. Seeding Period for Covered Funds

The Agencies should exercise their statutory authority to provide a seeding period for funds that reflects the reality of the funds markets. The one-year period in the Proposed Rule is insufficient to attract institutional investors in some instances, and would place banks at a competitive disadvantage. Congress intended to preserve the important asset management services that bank-organized funds provide and the final rule should reflect this intent.

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[37] See BHCA § 13(d)(1)(G), implemented by Proposed Rule § __.11.

[38] See BHCA § 13(f).

[39] See 12 C.F.R. § 223.21(b)(2) (covered transactions with nonaffiliates that later become affiliates are generally not required to be unwound under Regulation W unless they were entered into in contemplation of the nonaffiliate becoming an affiliate).

A. A Generally Applicable Three-Year Period is Appropriate and Additional Case-By-Case Extensions Should Be Available

Under the statute and the Proposed Rule, a banking entity has one year to bring its investment in a covered fund organized and offered under the Asset Management Exemption down to 3% of the covered fund's total interests, with the possibility of an extension for up to two years upon application to the Federal Reserve. Current market practices in the hedge fund space in particular are such that in many cases, a fund needs at least two to three years to establish the track record necessary to attract significant support from third-party investors (e.g., pension funds, endowments and other institutional investors). We therefore urge the Federal Reserve to permit banking entities to apply for one two-year extension for all of a banking entity's covered funds organized under the Asset Management Exemption, and then simply require notice when a particular fund is going to cross the one-year mark without reducing the banking entity's interest below 3%. The text of the statute does not require a banking entity to apply on a fund-by-fund basis, and permitting such a blanket extension would reflect the realities of the marketplace.[40] The Agencies would be able to monitor a banking entity's fund activities during the extended seeding period to ensure that the banking entity is operating in a manner consistent with safety and soundness.

Most major institutional investors, such as pension funds and endowments, will not invest in a new fund until it has established a multi-year track record. The one-year period in the Proposed Rule would therefore place banks at a significant competitive disadvantage to non-bank fund sponsors. In today's market, hedge funds are facing increasing compliance costs that create significant barriers to entry and make smaller funds uneconomical. A one-year seeding period would not give a bank sufficient time to attract institutional investors, resulting in smaller funds that would not benefit from the economies of scale and additional investment opportunities available to larger funds (i.e., because the fund does not have sufficient capital for larger investments or because a larger investment would be too great a concentration of a fund's available capital). These disadvantages would, in turn, push institutional investors, particularly those seeking investment strategies that require larger amounts of capital, to less regulated or unregulated non-bank fund sponsors. These effects are neither required by the statutory text of the Volcker Rule, nor necessary to achieve the Volcker Rule's purpose of reducing bank exposure to private equity and hedge fund activities. Additionally, the lack of a guaranteed multi-year seeding period will make it harder to attract investors to a fund, given the risk that a seeding banking entity sponsor could be forced to sell down and potentially close the fund after one year if an extension cannot be acquired.

Additional extensions beyond the three-year mark should be available under the Agencies' BHCA Section 13(d)(1)(J) exemptive authority, so long as the banking entity can demonstrate a bona fide effort to build a track record and attract third-party investors. Forcing a banking entity fund sponsor to abandon its fundraising efforts mid-stream could force the banking entity to absorb significant fund start-up costs, harming safety and soundness.

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[40] See BHCA § 13(d)(4)(C) ("Upon an application by a banking entity, the Board may extent the period of time to meet the requirements under [the Asset Management Exemption] for 2 additional years, if the Board finds that an extension would be consistent with safety and soundness and in the public interest.").

B. Calculation of the Seeding Period

The Proposed Rule does not indicate when a fund will be considered "established" for purposes of determining when the seeding period begins to run. In our view, a fund should not be considered to have been established until the first capital contributions are made to the fund. Before then, the fund is only in an early stage of formation, and fund raising and documentation often continue until the last minute before the first capital is contributed. Using an alternative moment—for example, when the fund limited partnership or LLC vehicle legally comes into existence—would be a matter of form over substance, as establishing legal existence has little bearing on the actual progress the fund is making towards beginning operations.

## VI. Compliance Program Requirements

The timing and scope of the complex and extensive compliance program requirements set forth in Section __.20 and Appendix C of the Proposed Rule present special concerns for foreign banks, especially if applied to the activities and operations of foreign banks outside of the United States.[41]

A. Timing of Implementation

It is essential that the Agencies clarify as soon as possible (i.e., prior to issuance of a final rule) the extent to which banking entities will be expected to implement the compliance program requirements by the Effective Date.

The preamble to the Proposed Rule appears to suggest that compliance systems should be in place and operating on the Effective Date, a goal that is impossible to achieve from a practical perspective given the likely timing for the release of final implementing regulations and the continued uncertainty about final requirements.[42] This is especially true for foreign banks with extensive operations outside the United States, where the application of the compliance program requirements is not clear and was not addressed in the Proposed Rule or accompanying preamble. We believe that it is imperative that the Agencies provide more broadly for the conformance period to serve as a transition period for implementation, during which time the Agencies and their regulated institutions can work collaboratively to put in place appropriate programs, metrics and reporting capabilities. It seems clear that this was Congress' intent when it adopted the two-year conformance period and, since it is simply not feasible for institutions to have compliance programs and reporting procedures in place by the Effective Date, the Agencies should adopt a uniform approach to the conformance period rather than subject institutions to an unrealistic deadline and then grant supervisory relief on a case-by-case basis.

In order to properly assess the new requirements and develop a comprehensive program to ensure compliance with the funds provisions of the Volcker Rule, we expect banks

[41] Similar concerns arise with respect to the application of compliance program, recordkeeping and reporting requirements to trading activities. See CS Trading Letter.

[42] See 76 Fed. Reg. at 68,855.

will need to do the following: (1) modify their IT systems; (2) review and potentially modify record-keeping procedures to meet the new data requirements; (3) assess internal controls; (4) develop appropriate policies and procedures; (5) provide training to key employees; (6) update their managerial/supervisory frameworks to ensure proper oversight and accountability for compliance with the new rules; (7) identify appropriate surveillance and testing tasks; (8) hire additional senior compliance personnel and their staff; and (9) engage third-party service providers such as consultants and law firms to assist with interpreting rules and developing short-term and long-term solutions to meet the new challenges, including the overall infrastructure needed to create a comprehensive and sustainable compliance program.

B. Cost-Benefit Analysis Regarding Compliance Program Requirements

The compliance program requirements contemplated for larger banking organizations are extensive and highly prescriptive. We urge the Agencies to consider not only the marginal benefits of the proposed controls and reporting requirements but also the very significant costs of implementing them.[43] In addition, we urge the Agencies to clarify that full implementation of Appendix C should apply only to those banking entities and business lines within a banking group that have significant covered funds or trading activities. While the Proposed Rule provides some relief for institutions with small trading and/or covered funds operations, once it is triggered, it appears that every banking entity in the corporate group is required to comply with Appendix C if it engages in any covered fund (or proprietary trading) activities.[44]

The Agencies should clarify in the final rule that compliance programs will focus on the real centers of risk and activity in a consolidated banking group and be tailored to the scope of their particular activities, rather than imposing expensive compliance obligations on large swaths of the firm not engaged in significant covered activities.

C. Compliance Program Requirements Should Not Apply Outside the United States

Section __.20 requires each banking entity to establish a compliance program "appropriate for the size, scope and complexity of activities and business structure of the covered banking entity."[45] The Proposed Rule does not indicate how such requirements are to be applied to foreign banks, and could be read to suggest that U.S. regulators will impose detailed requirements on the internal operations and management of foreign banks outside of the United States—including home offices—and even where such entities have little to no direct U.S.-facing activities. This would represent an unprecedented expansion of U.S. regulators' supervisory powers into the home country operations of foreign banks.

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43 The U.S. Court of Appeals for the District of Columbia Circuit vacated the SEC's proxy access rule, Rule 14a-11, for failing to adequately consider the costs of the rule. See Business Roundtable v. SEC, 647 F.3d 1144 (D.C. Cir. 2011).

44 A banking entity that engages in any covered funds activity restricted by the Volcker Rule must comply with Appendix C if the banking entity's consolidated group, as a whole, has over $1 billion in worldwide investments in covered funds and/or over $1 billion in assets under management in their sponsored or advised covered funds worldwide. See Proposed Rule § __.20(c).

45 See Proposed Rule § __.20(a).

With respect to covered funds activities, we urge the Agencies to clarify that only entities engaged in covered funds activities in the United States—i.e., sponsoring or investing in covered funds in the United States pursuant to the Asset Management Exemption or other exemptions—must institute the compliance programs required by the Proposed Rule. All other group affiliates would only be required to comply with Section __.20(d), which would require compliance policies and procedures designed to prevent the entity from engaging in U.S. covered fund activities. Such policies and procedures could be adopted on an enterprise-wide basis, as contemplated by the Proposed Rule.

## VII. Excluding Controlled Funds from the Definition of Banking Entity

Under the statutory text of the Volcker Rule, it was unclear whether a covered fund controlled by a banking entity would itself be deemed a banking entity subject to the Volcker Rule, leading to a variety of anomalous results, as recognized by the FSOC Study and the preamble to the Proposed Rule. For example, treating controlled covered funds as banking entities would effectively prohibit bank-sponsored fund-of-funds structures (i.e., because the fund-of-funds would be prohibited as a banking entity from investing in third-party funds), notwithstanding the fact that Congress clearly contemplated that banks should be able to continue to sponsor and invest in funds-of-funds.

The preamble describes the Proposed Rule as addressing this issue by excluding from the term "banking entity" an affiliate or subsidiary that is a covered fund or an entity controlled by such a covered fund. However, the exclusion in the Proposed Rule itself is far more narrow, and would exclude only covered funds organized, offered and held pursuant to Section __.11 (i.e., in connection with the so-called Asset Management Exemption), as well as any other entity controlled by such a fund.

The Proposed Rule does not similarly exclude other covered funds that a banking entity is permitted to sponsor under other authorities, including (i) foreign covered funds sponsored and controlled pursuant to the Foreign Funds Exemption, (ii) covered funds acquired pursuant to the Proposed Rule's DPC authority,[46] or (iii) covered funds that are acquired in connection with bona fide risk-mitigating hedging activities.[47] As a result, such funds would apparently be treated as "banking entities" subject to the Volcker Rule's proprietary trading and funds prohibitions. The exclusion from the definition of banking entity also does not address U.S. or foreign publicly traded mutual funds or other investment vehicles controlled by a banking entity, which apparently would also become restricted as "banking entities" under the Volcker Rule.

In our view, this result could not possibly have been intended, and the Agencies should provide an exclusion from the definition of "banking entity" for any covered fund that a

46 See Proposed Rule § __.14(b)(1).

47 See BHCA § 13(d)(1)(C); Proposed Rule § __.13(b). Part XIII of this letter address similar issues that arise in the context of securitization structures under the Proposed Rule.

banking entity sponsors and invests in under any applicable exemption.[48] More particularly, to fully address the issue created by the statutory language, the final rule should exclude from the definition of "banking entity":

- Any covered fund that is permissibly sponsored or controlled under the Volcker Rule, including pursuant to the Foreign Fund Exemption, DPC, or the Hedging or Trading Exemptions (as defined below);

- Any registered investment company or regulated investment fund controlled by a banking entity; and

- Any entity that would be an investment company under the '40 Act but that relies on one of a number of other applicable '40 Act exemptions for fund entities—e.g., Section 3(c)(5) (real-estate, mortgages and receivables finance), Rule 3a-7 (issuers of asset-backed securities) and Section 6(b) (employees securities companies) of the '40 Act.

A. Foreign Covered Funds

Congress clearly intended to limit the extraterritorial impact of the Volcker Rule. Without an exclusion from the banking entity definition, foreign covered funds that do not conform to the requirements of Section __.11 (e.g., because, consistent with local law, the banking entity serves as general partner and shares a name with the fund) would not be permitted to engage in proprietary trading or invest in covered funds without complying with the Volcker Rule's exemptions. These restrictions would severely curtail foreign banks' ability to freely operate their funds businesses, especially hedge funds and funds-of-funds, outside the United States. The potential overbroad application of the covered funds definition to foreign funds could exacerbate these issues.[49]

If the Proposed Rule were to be implemented as currently drafted, it could effectively preclude foreign banks from organizing many funds-of-funds and hedge funds outside of the United States, because the Volcker Rule would impose strict limits on such funds' core functions (e.g., investing in other funds, or engaging in proprietary trading, on behalf of the funds' investors). Because of differences in U.S. and foreign markets and investment company/securities law requirements, many of these client-oriented foreign funds do not conform to the specific requirements of Section __.11. A narrow interpretation of the Foreign Funds Exemption and the exemption for proprietary trading "solely outside of the United States" would severely restrict the range of permissible activities for foreign funds, reducing client-facing investment alternatives.

Specifically, if the Proposed Rule were interpreted so as to (i) prevent a foreign bank's foreign funds-of-funds from investing in any covered fund that is sold to U.S. investors,

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[48] There should be no question that the Agencies have the authority to interpret the statute in this way, just as they interpreted the statute in the Proposed Rule to exclude covered funds organized, offered and held pursuant to the Asset Management Exemption from the definition of banking entity.

[49] See Part III.A above.

or (ii) prevent a foreign bank's controlled foreign hedge funds from engaging in any trading with U.S. counterparties or on U.S. exchanges or having any trading personnel in the United States, it would unreasonably limit foreign fund operations and would prohibit funds, organized and offered outside of the United States, and without U.S. investors, from continuing to pursue their current investment strategies. Failing to exclude such funds from the definition of banking entity would cause severe and unwarranted disruptions to the current and future business of foreign banks outside of the United States, harming investors, customers and the banks themselves.

B. Other Controlled Funds

Similar problems would arise if a banking entity, in the ordinary course of conducting its permitted banking activities, acquires control of a covered fund that is a fund-of-funds or hedge fund (pursuant to exemptions such as DPC or the Hedging or Trading Exemptions), a registered investment company or similar regulated investment fund, or an entity that relied on another applicable '40 Act exemption. If such funds were held to fall within the definition of banking entity, a bank could be prevented from fully foreclosing on collateral in the form of fund interests, from underwriting or making markets in such fund interests, or from fully hedging derivatives or other structured products sold to customers that reference such a fund, because the fund would technically become subject to the Volcker Rule's proprietary trading and fund provisions once the bank's interest in the fund crossed BHCA control thresholds. For all practical purposes, such a reading would undermine the Congressional mandate that the Volcker Rule not prohibit any of these bona fide banking activities.

## VIII. Treatment of Employee Investments

Banks have traditionally provided many of their employees with the opportunity to participate in both bank-sponsored funds and in third-party funds as a component of their employees' compensation and as an alternative investment strategy for retirement or otherwise. Employee investments in sponsored funds align the interests of bank employees with those of their clients and is common market practice. We understand the concern that, if employees hold significant investments in a banking entity's sponsored fund, it could create additional incentives to bail out the fund (although we believe this risk is definitively mitigated by the 23A Prohibition and the prohibition on guaranteeing a fund's obligations under the Asset Management Exemption). We also understand the concern that banking entities not be permitted to evade the Asset Management Exemption's investment limits by funneling proprietary funds though employees via leverage provided to individuals or vehicles.

On the other hand, the Volcker Rule does not overrule the principle that employees of a banking entity should be free to make independent investment decisions with their own funds and that banking entities should be permitted to provide bona fide compensation arrangements and investment opportunities to their employees.[50]

[50] Accordingly, the Proposed Rule properly would not prevent employees of a banking entity from acquiring or retaining investments, in their personal capacity, in third-party funds, or prevent a banking entity from facilitating such investments through the organization of feeder vehicles or from providing financing for such investments pursuant to bona fide compensation arrangements or ordinary course extensions of credit.

A. Employee Investment Vehicles

To facilitate employee participation in investments in third-party funds and sponsored funds, foreign banks rely on a range of pooled investment vehicles. These vehicles provide our employees with exposure to funds through the purchase of fund interests by the pool or synthetic exposure based on the performance of one or more designated funds through deferred compensation arrangements. Many of these investment vehicles could qualify for the exemption for "employee security companies" in Section 6(b) of the '40 Act, but opt to rely on Section 3(c)(1) or 3(c)(7) instead because the Section 6(b) exemption is available only upon application to the SEC.[51] If these vehicles or deferred compensation arrangements were deemed covered funds, they would become subject to the Volcker Rule's limitations on employee investments and covered transactions, severely limiting our ability to design competitive employee compensation arrangements.

The preamble to the Proposed Rule helpfully confirmed that if an issuer may rely on an exclusion or exemption from the definition of investment company other than Section 3(c)(1) or 3(c)(7) of the '40 Act, it would not be considered a covered fund as long as it can satisfy all of the conditions of such alternative exclusion or exemption. We request that the Agencies confirm that any investment vehicle that satisfies the definition of an employees' security company under Section 2(a)(13) of the '40 Act would not be deemed a covered fund, regardless of whether such company has applied for or been granted an exemption from the '40 Act.

Further, we appreciate the Agencies' clarification in the Proposed Rule that qualified plans under ERISA would not be treated as investments by a banking entity "as principal", even if the banking entity controls the plan. We assume that this same principle would extend to comparable non-U.S. pension plans, and it would be helpful if the Agencies could confirm this point in the final rule.

B. Employee Investments under the Asset Management Exemption

The Volcker Rule's statutory text prohibits directors and employees of a banking entity from investing in funds organized and offered under the Asset Management Exemption unless the director or employee is "directly engaged in providing investment advisory or other services to" the covered fund.[52] Although the Proposed Rule provides some helpful explanation of how such employee investments will be treated, several issues would benefit from additional clarification.

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[51] Section 2(a)(13) of the '40 Act defines an employees' securities company to be "any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned (A) by the employees or persons on retainer of a single employer or of two or more employers each of which is an affiliated company of the other, (B) by former employees of such employer or employers, (C) by members of the immediate family of such employees, persons on retainer, or former employees, (D) by any two or more of the foregoing classes of persons, or (E) by such employer or employers together with any one or more of the foregoing classes of persons."

[52] BHCA § 13(d)(1)(G)(vii).

1. Scope of "Other Services"

The reference to "other services" in BHCA Section 13(d)(1)(G)(vii) indicates that Congress did not intend to limit employee and director investments only to those professionals providing investment advisory or management services to a covered fund. Certainly, the supervisors of a fund's portfolio managers or investment advisers should be permitted to invest. In addition, deal sourcing and origination, deal evaluation and diligence, administrative, regulatory, oversight, product structuring, investor relations, sales and marketing, tax, accounting and other operational support personnel all provide services to the funds that a bank organizes and offers. We believe that the Asset Management Exemption should be interpreted to give banking entities the flexibility to permit employees who provide such services (and their supervisors) to participate in bank-sponsored investment products. This approach would be consistent with the statutory language, align the interests of bank employees with clients who invest in bank-sponsored funds, help banks attract and retain top-quality employees, give our employees a personal stake in the performance of our business, and support a culture of responsibility and commitment to the products and services we offer.

With respect to directors, we understand that directors of banking entities who provide services to a sponsored fund through their oversight of a fund's operations and investments should be permitted to invest in the fund. At a minimum, we presume this would include any individual serving on the board or investment committee of a fund or its manager.

Institutional investors expect portfolio managers, senior management and the sponsoring/advising firm to have "skin in the game", a requirement consistent with other provisions of Dodd-Frank and the banking entity's fiduciary duties to fund investors. Defining the scope of permitted employee investments too narrowly would make it difficult for asset managers affiliated with bank to compete with other non-bank-affiliated managers. To address potential concerns that employee investments will create incentives to bail out a fund (again, a risk we believe to be definitively mitigated by the 23A Prohibition and the prohibition on guaranteeing a fund's obligations under the Asset Management Exemption), non-investment professionals could have limitations imposed on the amount of their investments.

2. Notional or Synthetic Employee Exposure to Bank Funds

Notional or synthetic employee compensation arrangements tied to the performance of sponsored funds should not be treated as if they constituted employee investments in the underlying sponsored fund. Although there may be reasons to treat a derivative or synthetic exposure as an ownership interest in a fund in certain circumstances, there are important distinctions in the context of employee compensation arrangements. Such programs are usually hedged through an investment in the underlying fund or funds, so that the banking entity would be essentially neutral as to whether the fund performed better or worse than expected, as the hedge would offset the deferred compensation liability associated with the program. In particular, notional plans with returns linked to the performance of a basket of a bank's funds should not be deemed to create any kind of pro rata ownership interests in these funds (and thus prohibited where participating employees are not directly engaged in providing services to each of the underlying funds) but rather should be viewed as bona fide compensation arrangements further aligning the interests of employees with those of clients.

## IX. Permitted Activities: Hedging, Market Making and Customer Trading

Many major banking organizations operate significant customer-facing fund-linked structured product businesses that offer investors tailored exposures to the performance of one or more covered funds or fund indices based on the investors' investment and risk management needs ("Structured Products Businesses"). For example, certain fund-linked structured products may offer full or partial downside protection, allowing customers to gain exposure to fund performance while limiting their potential losses; others may allow customers to gain exposure to a diversified basket of covered funds that may be otherwise unavailable due to minimum investment requirements. Banking organizations hedge such exposures through investments in the covered funds referenced in the fund-linked structured products or in synthetic products linked to such funds.

Many major banking organizations also operate significant customer-facing businesses that make markets in covered fund interests and in structured products linked to covered funds (a "Market-Making Business"). A Market-Making Business provides customers with access to a broad array of investment opportunities and liquidity in covered funds and in covered fund-linked products, such as structured notes and derivatives.

We are concerned that these customer-facing intermediation activities will be severely limited due to the potential application of the Volcker Rule, which could be read to prevent a Structured Products Business from effectively and efficiently hedging its risks and a Market-Making Business from making markets in U.S. funds or structured products linked to U.S. funds or selling fund interests or fund-linked structured products to U.S. persons.

### A. Application of the Hedging Exemption to the Covered Funds Provisions of the Volcker Rule

Banking entities that have a Structured Products Business regularly hold ownership interests in covered funds to hedge their exposure as the short counterparty to the customers of their synthetic products. We support the Agencies' interpretation of the hedging exemption in BHCA Section 13(d)(1)(C) (the "Hedging Exemption") to apply to hedging with ownership interests in covered funds in connection with such intermediation activities. If implemented as it is currently drafted, however, this limited Hedging Exemption would make it difficult for a Structured Products Business to effectively and efficiently hedge its risks. In fact, it may have the perverse effect of prohibiting banking entities from partially or dynamically hedging the exposures that arise from a Structured Products Business, potentially pushing banks out of the business and depriving investors of the opportunity to invest in fund-linked structured products altogether.[53]

Properly conducted hedging activities are an essential component of a banking entity's risk management. The FSOC Study notes that "hedging activity serves a critical role by

[53] We believe it is unlikely that other less-regulated entities could move into the Structured Products Business, because most investors in structured products demand that they be backed by an institution with a high credit rating. To the extent Structured Products Businesses were to migrate to other entities, however, they would no longer be housed in institutions subject to wide-ranging and comprehensive supervisory, conflict of interest and capital frameworks.

allowing banking entities to manage their risk exposures while they engage in a variety of market making and banking activities."[54] We believe that the limits in the Hedging Exemption will in fact "unduly constrain[] the important risk management function" served by a banking entity's hedging activities, despite the Agencies' (and Congress') express contrary intent.[55]

1. The Final Rule Should Contain a Single Hedging Exception for Both Proprietary Trading and Covered Funds

The plain language of the Hedging Exemption in BHCA Section 13(d)(1)(C) makes no distinction between proprietary trading and covered fund activities. The Proposed Rule, however, would impose significant additional conditions on permitted hedging with covered fund interests. We do not believe there is any reasonable justification for imposing additional limits on the Hedging Exemption for purposes of covered fund activities. Indeed, the policy rationale for permitting hedging as an exemption to the proprietary trading restrictions—permitting banks to effectively manage risks arising from their customer-facing intermediation activities—applies equally in the context of covered funds.

We recommend that the Agencies permit hedging of market making and other customer facing activities using ownership interests in covered funds pursuant to the risk-mitigating hedging requirements in Section __.5, as modified in the final rule, and without the additional limitations imposed by Section __.13(b). The documentation and compliance requirements imposed under Section __.5 are more than sufficient to confirm that a business is engaged in bona fide risk-mitigating hedging, rather than taking speculative proprietary positions or maintaining unjustified, unhedged exposures to covered funds. The additional requirements imposed by Section __.13(b) are unnecessary and impractical in light of the range of hedging approaches required in order to appropriately and effectively hedge risks. They would also lead to increased compliance costs and less efficient hedging strategies because a banking entity would be required to comply with two different regulatory regimes limiting hedging transactions.

2. The Final Rule Should Permit Dynamic Hedging and Portfolio Hedging Using Fund Interests

A Structured Product Business often relies on portfolio and dynamic hedging to manage its exposure to counterparties. Hedge fund interests are relatively illiquid—e.g., they generally can only be bought and sold at certain times and in large, indivisible interests.[56] One of the benefits that the Structured Product Business provides to customers is increased liquidity in terms of timing and more options in terms of the size of interests and exposures available. It is not always possible or desirable to find a perfectly matching fund interest for every customer

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54 See FSOC Study at 21. See also Merkley-Levin Colloquy at S5896 (indicating that the risk-mitigating hedging exemption was included because "its sole purpose is to lower risk").

55 See 76 Fed. Reg. at 68,909 (explaining that Section __.13(b) is intended to limit "potential abuse of the hedging exception while not unduly constraining the important risk management function that is served by a banking entity's hedging activities.").

56 Funds are commonly subject to liquidity restrictions such as limited redemption windows, extended notice periods, lock-up periods, gates and suspensions and typically have high minimum investment amounts.

transaction (in terms of size or even in terms of the fund itself).[57] Instead, such businesses may hedge on an aggregate basis by making a single investment in the reference fund or invest in one or more highly correlated fund interests to perform the same risk-mitigating hedging purpose.[58] Dynamic portfolio hedging has proven a more effective method to control the risks associated with this business.

Banking regulators have long acknowledged in the analogous area of equity derivative hedging that portfolio hedging using otherwise impermissible investments is both bona fide and appropriate.[59] And yet, as implemented in Proposed Rule Section __.13(b), the Hedging Exemption appears not to permit the kind of dynamic portfolio hedging banking entities rely on to control the risks of their Market-Making and Structured Products Businesses. Instead, it would require every hedge intended to offset an exposure to a covered fund to be an offsetting hedge in the same covered fund, and in the same amount, which appears to preclude hedging using highly correlated, but different, fund interests, hedging aggregated exposures to different customers in different funds using portfolio hedges, or hedging a fund index-linked exposure with a covered fund which replicates the fund index. It also does not take into account the illiquid nature of covered funds[60] or provide for hedging risks other than simple "delta one" risks arising from changes in price. For example, it is unclear how to apply the Hedging Exemption to risks arising from volatility that are typically addressed through "vega" hedging.[61]

3. The Agencies Should Eliminate the Limitation on Hedging Exposures Arising from Customer Transactions with a Banking Entity

We recommend that the Agencies remove the limitation in the Hedging Exemption that covered fund exposures arising from customer transactions can be hedged only when the customer is not a banking entity.

This limitation is not required by the statutory text, and it is unnecessary to achieve the Agencies' expressed purpose to prevent a banking entity from avoiding the 3% de

57 For example, when a bank sells a customer synthetic exposure to an emerging market equity fund, it may not be able to buy the corresponding fund interest directly—the fund could be closed, or could only offer interests a few times per year, or for some other reason.

58 For example, where the underlying may be a hedge fund index, a bank will hedge by attempting to replicate the hedge fund index through purchasing the hedge funds comprising of the hedge fund index. The replication may not be perfect, and could result in residual exposures to covered funds.

59 See, e.g., OCC Interpretive Letter No. 1090 (Oct. 25, 2007); OCC Interpretive Letter No. 1033 (June 14, 2005); OCC Interpretive Letter No. 892 (Sept. 13, 2000) ("Letter 892"); Federal Reserve Board Statement Concerning the Acquisition of Stock by State Member Banks to Hedge Equity Derivative Transactions (Feb. 21, 2002).

60 For example, a bank may be required to repurchase fund-linked notes at a customer's request. It may take an extended period for the bank to unwind its correlated hedge investment in one or more covered funds, however, because of liquidity restrictions on covered funds (e.g., due to notice periods, less frequent redemption windows, lock ups), which may result in residual exposure to the underlying covered funds for such period.

61 For example, certain structured products have non-standard payouts (e.g., leverage, principal protection, optionality) which require dynamic hedging strategies to manage the risk incurred.

minimis investment limit in U.S. covered funds a bank organizes and offers.[62] With the expanded (indeed, as described above, overbroad) definition of ownership interest in the Proposed Rule, each banking entity must justify each actual or synthetic exposure it holds to a covered fund under one of the permitted activities provided by statute or regulation under the Volcker Rule. It is unnecessary to place limits on one banking entity legitimately providing services to another due to the concern that the customer banking entity might be evading the Volcker Rule.

Requiring banking entities to independently determine whether each customer is itself a banking entity would impose a substantial and needless compliance burden on banking entities providing fund-linked products to the market. Because the definition of banking entity is so broad, encompassing all the affiliates and subsidiaries of a U.S. or foreign bank, some potential counterparties may not be readily identified as banking entities.

In practice, it is not uncommon for a banking entity to acquire a synthetic exposure to a fund from another banking entity. For example, the fund-linked products desk of a banking entity may occasionally hedge covered fund exposures arising from customer-driven transactions by entering into a risk mitigating derivatives transaction with the fund-linked products desk of a different banking organization, rather than investing in the reference fund itself.

4. The Agencies Should Clarify the Specific Customer Requirement Does Not Impose a Reverse Inquiry Requirement

As we understand the Hedging Exemption, the requirement that a hedging transaction arise out of a transaction "conducted solely to accommodate a specific customer request" does not impose a reverse inquiry requirement on hedging with covered fund interests, but rather merely requires that hedging using covered fund interests must be directly linked to risks that arise from customer-facing transactions (i.e., that arise from a customer's independent and valid business purpose) and not risks that arise more generally from a banking entity's business activities.[63] We understand, however, that some parties have expressed concerns that this provision could be read to impose a reverse inquiry requirement. Nothing in the statute suggests there should be a reverse inquiry requirement for hedging, and the Agencies did not create one in the hedging exemption under Section __.5 of the Proposed Rule. Limiting hedging only to those transactions where a banking entity passively waits for a customer to come with a specific request for a product ignores the reality of the market place and would severely curtail innovation, preventing banking entities from proactively anticipating customer needs and creating new products tailored to those needs. Such a requirement could effectively render it impossible to operate a Structured Products Business, and the final rule should impose no such requirement.

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62 See 76 Fed. Reg. 68,908 n.298.

63 See Proposed Rule § __.13(b)(2)(ii)(B)(1). See also note 59, above, and note 68, below.

B. Application of the "Trading Exemptions" to the Covered Funds Provisions of the Volcker Rule

1. The Plain Language of the Volcker Rule Permits the Purchase and Sale of Fund Interests as Part of Legitimate Underwriting and Market-Making-Related Activities and Transactions on Behalf of Customers

BHCA Section 13(d)(1)(B) permits banking entities to purchase and sell securities and other financial instruments in connection with underwriting and market-making-related activities (the "Market-Making Exemption"). BHCA Section 13(d)(1)(D) permits banking entities to purchase and sell securities and other instruments "on behalf of customers" (the "Customer Trading Exemption" and, together with the Market-Making Exemption, the "Trading Exemptions").

We think it is clear from the plain language of Section 13 and the absence of any legislative history to the contrary that the scope of the permitted activities of underwriting and market making and transactions on behalf of customers includes all activities otherwise prohibited under BHCA Section 13(a). The Proposed Rule, however, applies these exemptions only to the proprietary trading prohibition in Section __.3(a), and not to the fund sponsorship and investment prohibition in Section __.10(a). We believe that this would be an unjustified narrowing of the scope of the Trading Exemptions.

Nothing in the statutory text limits the applicability of the Trading Exemptions to the proprietary trading prohibition or precludes reliance on these exemptions to permit the purchase and sale of limited partnership and other ownership interests in covered funds (which are generally treated as securities under the securities laws) pursuant to the Trading Exemptions' terms (e.g., not as investments, but as an intermediary facilitating customer demand). The introductory subsection of 13(d)(1), titled "In General", does not distinguish between the proprietary trading prohibition in subsection 13(a)(1)(A) and the restrictions related to covered funds in subsection 13(a)(1)(B); instead it explains that the list of activities in 13(d)(1) are permitted "[n]otwithstanding the restrictions under subsection (a),"[64] making clear that, to the extent 13(d)(1) contains no further textual direction, a permitted activity will apply to both the proprietary trading prohibition in 13(a)(1)(A) and the restrictions related to covered funds in 13(a)(1)(B).

Each of subsections 13(d)(1)(B) and (D) refers to "[t]he purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4)."[65] This cross-reference to subsection 13(h)(4), which in its totality is the definition of the core defined term "proprietary trading," is used to incorporate only the list of "securities and other instruments" in that subsection into the permitted activities exemptions, as neither Section 13 nor any other section of the BHCA defines "securities and other instruments."[66] If Congress had

64 BHCA § 13(d)(1) (emphasis added).

65 BHCA §§ 13(d)(1)(B), (D) (emphasis added).

66 See BHCA § 13(h)(4) ("The term 'proprietary trading' . . . means engaging as a principal for the trading account of the banking entity . . . in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any

intended to limit these exemptions to proprietary trading, it could have simply said that "proprietary trading" as defined in BHCA Section 13(h)(4) would be permitted subject to the relevant conditions.[67]

We urge the Agencies to interpret the Trading Exemptions according to their plain statutory language, to allow trading in any security, derivative or other instrument—including interests in covered funds and fund-linked products—pursuant to an underwriting or market making-related activity or on behalf of customers.

### 2. Effects on the Market Making and Structured Products Businesses of Banking Entities

If the Trading Exemptions are not applied to covered fund ownership interests, banking entities may no longer be permitted to make markets in U.S. hedge funds or to sell ownership interests in foreign hedge funds to U.S. persons once the Volcker Rule becomes effective and the conformance period ends. If the scope of the U.S. Marketing Restriction is not clarified as described in Part III.B.3 above, foreign banks may also not be permitted to make markets outside the United States in foreign hedge funds, since many of those funds could be sold by third parties to U.S. investors. These limitations would not protect the safety and soundness of the bank, and would encourage covered fund managers to discriminate against U.S. investors, thereby limiting the investment options available to U.S. investors.

In addition, it is critical for banking entities with Structured Product Businesses that the scope of the Customer Trading Exemption be expanded to include the structuring and execution of one-off bespoke trades in which a banking entity acts as principal, as many of its activities may not fit into the Market-Making Exemption.[68] Providing customers with such services permits banking entities to meet customer demands for such products and to fulfill the function of financial intermediary while avoiding the speculative proprietary activities that are the underlying concern of the Volcker Rule.

## X. The Scope of "Covered Funds"

Congress intended the Volcker Rule to apply only to traditional private equity and hedge funds. Both the preamble to the Proposed Rule and the FSOC Study acknowledge that the baseline statutory definition of "covered funds" sweeps much more broadly and requires adaptation in the Agencies' implementing rules to achieve Congress' intended scope.[69]

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such security, derivative, or contract, or any other security or financial instrument that the [Agencies] may, by rule as provided in subsection (b)(2), determine.") (emphasis added).

[67] See, e.g., BHCA § 13(d)(1)(H) (permitting "[p]roprietary trading conducted by a banking entity . . . provided that the trading occurs solely outside of the United States").

[68] The statutory text of the Customer Trading Exemption should accommodate a wide range of transactions entered into as principal to effect a customer's valid and independent business purpose. Banking regulators have routinely recognized the authority of banking entities to engage in such "customer-driven" transactions. See, e.g., OCC Interpretive Letter No. 1039 (Sept. 13, 2005); Letter 892.

[69] The preamble notes that the statutory definition "could potentially include within its scope many entities and corporate structures that would not usually be thought of as a 'hedge fund' or 'private equity fund.'

Many entities that do not resemble a private equity or hedge fund—including many common corporate entities with large banking groups—are caught up in the definition because they rely on the Section 3(c)(1) or 3(c)(7) exemption from the '40 Act. We appreciate the Agencies' acknowledgement of this issue and the effort to address some of the overbreadth by providing carve-outs permitting banking entities to sponsor and invest in certain types of "covered funds". However, additional refinements are required to address the very significant issues raised by the statutory definition.

The entities that the Agencies have attempted to carve out from the Volcker Rule's sponsorship and investment prohibitions include only a subset of the carve-outs that would be required to address most of the entities that would be inadvertently covered, and the wording of several of the carve-outs creates questions about whether they will achieve their intended purpose. In addition, the Proposed Rule does not exclude the carved-out entities from the definition of covered funds, but instead only exempts those entities from the Section __.10(a) prohibition on sponsorship and investment. As a result, such entities are still "covered funds" subject to the 23A Prohibition, creating significant limitations that have no policy justification and were not intended by Congress.

A. Defining Covered Funds Based on Private Equity and Hedge Fund Characteristics

We recommend that the Agencies reconsider the approach taken in the Proposed Rule, and instead take the approach suggested in one of the questions posed in the preamble to the Proposed Rule—namely, defining a covered fund by reference to the typical characteristics of a hedge fund or private equity fund.[70]

The preamble to the Proposed Rule provides a list of potential characteristics (also referenced in the FSOC Study) of a hedge fund or a private equity fund, such as compensation structure, trading/investment strategy, use of leverage and investor composition, among others.[71] An approach focused on characteristics rather than reliance on Section 3(c)(1) or 3(c)(7) would likely result in a definition that more accurately reflects the result intended by Congress, and in our view—for the reasons described in other comment letters—the Agencies have ample discretion under the Volcker Rule to take this approach.

As we and other banking entities have reviewed the potential impact of the Proposed Rule on our operations, the magnitude of the potential unintended consequences of using the 3(c)(1)/3(c)(7) exemptions as a baseline have become even more apparent. It increasingly appears impractical to anticipate and provide a carve-out for every type of corporate vehicle that relies on one of these exemptions. Inevitably, there will be a multitude of corporate entities that are clearly not traditional private equity or hedge funds, but fail to fit within one of the enumerated exemptions. Unless the definition is narrowed to focus on an entity's

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For instance, joint ventures, acquisition vehicles, certain wholly-owned subsidiaries, and other widely-utilized corporate structures typically rely on the exclusion contained in section 3(c)(1) or 3(c)(7) of the Investment Company Act. . . . certain securitization vehicles may [also] be included in this definition." 76 Fed. Reg. at 68,897. See also FSOC Study at 7, 62.

70 76 Fed. Reg. at 68,898 (Question 221).

71 See 76 Fed. Reg. at 68,898-99 (Question 223), FSOC Study at 62.

characteristics, we expect every large banking entity to have multiple entities that are inadvertently caught up in the definition and for which supervisory relief would be sought.

If the Agencies nevertheless do not adopt a characteristics-based narrowing of the definition or a pure characteristics-based approach, we urge them to revisit the specific exemptions proposed to broaden them appropriately and add additional exemptions. In this regard, we specifically note and support the recommendations for exemptions proposed in the SIFMA Letter.

B. The Proposed Exemptions Are Too Narrow to Achieve Their Intended Purpose

1. Joint Ventures

The Proposed Rule proposes to exempt from the Section __.10(a) prohibition on ownership and sponsorship joint ventures between the banking entity and any other person. Although a helpful concept, this and other exemptions for certain corporate structures are overly narrow. For example, the requirement that a joint venture be an operating company is unclear and unnecessary to prevent evasion of prohibitions on fund activities through joint venture arrangements. We believe the Agencies should define the term "joint venture" as any company with (i) a limited number of participating investors and (ii) management pursuant to a shareholders' agreement among the participating investors, rather than management by a general partner or similar entity, and that the Agencies should remove the requirement that a joint venture be an operating company (which in any event is undefined in the Proposed Rule), as recommended in the SIFMA Letter.

2. Acquisition Vehicles

It is not clear to us what entities the acquisition vehicle carve-out is intended to reach, but as drafted it could be read to cover only temporary special-purpose corporate entities formed to facilitate a merger or acquisition, such as a merger subsidiary in a triangular merger. We do not see a policy rationale for such a limited exclusion, and as written it is far too narrow to address industry concerns with respect to acquisition vehicles. The Agencies should exclude from the Volcker Rule acquisition vehicles formed for a banking entity (alone or with other investors) to invest in or acquire a single company. It is common for investors to structure an investment in a company through one or more intermediate holding companies. Sometimes such holding companies rely on Section 3(c)(1) or 3(c)(7) of the '40 Act. Such structures do not resemble fund structures, where multiple investors make commitments that are subsequently invested in multiple portfolio companies identified by a manager.

3. Wholly-owned Subsidiaries and Liquidity Management

The Proposed Rule provides a carve-out for consolidated, wholly-owned subsidiaries engaged principally in liquidity management activities. We do not see a policy rationale for only exempting those wholly-owned subsidiaries that are engaged in liquidity management, or for requiring companies engaged in bona fide banking activities to be wholly-owned (especially if employees of the relevant banking group are the other equity holders). A wholly-owned subsidiary (which would itself be a "banking entity" under the Volcker Rule, subject to the proprietary trading and funds restrictions) does not resemble a private equity or hedge fund or present the policy concerns underlying the Volcker Rule's funds provisions. Due to the technicalities of the '40 Act definition of an investment company, however, a wholly-owned subsidiary of a banking entity could be required to rely on the Section 3(c)(1) or 3(c)(7) exemptions with respect to its offer and sale of debt securities, and thus be caught up in the covered funds definition. We urge the Agencies to exclude from the definition of covered fund any subsidiary of which a banking entity owns at least 90% of total ownership interests, and of which employees of the relevant banking group would be permitted to own up to 10% of total ownership interests.[72]

Likewise, a banking entity may have reasons to use liquidity management vehicles whose ownership interests are not wholly owned by the banking entity. For example, it may be more efficient—for tax, creditor protection or other reasons—for certain vehicles used to raise secured debt financing for a banking group to be owned and "controlled" by an independent general partner or holding company, even though the debt will be secured by assets of the banking group and the benefits of the financing will inure to the banking group itself. Vehicles engaged in bona fide liquidity management pursuant to a documented liquidity management plan required by Section __.3(b)(ii)(3)(C) should be excluded from the definition of covered fund, whether or not they are wholly owned.

4. Securitization Vehicles

We appreciate the Agencies' attempts to prevent the Volcker Rule from having unintended effects on the securitization market, because many loan securitization vehicles have traditionally relied on Section 3(c)(1) or 3(c)(7) and thus would be covered funds under the proposal.

However, the scope of the loan securitization exemption as proposed appears to be too narrow to achieve its intended purpose. Similarly, the carve-out for investments in securitizations that are made by a banking entity "in compliance with the minimum requirements" of Dodd-Frank's risk retention rules raises many questions that are not addressed in the Proposed Rule or its preamble. We do not believe that the Volcker Rule was intended to regulate the securitization market (unlike other provisions of Dodd-Frank expressly targeted at securitization), but it could have many unintended consequences for securitizations.

We discuss issues relating to securitizations in detail in Part XIII below.

C. Entities Should Be Exempted from the Definition of Covered Funds Rather Than the Section __.10(a) Prohibition

As discussed above, and in Part XII with respect to the 23A Prohibition, the Proposed Rule does not exclude exempted entities from the covered funds definition, but instead exempts them from the Section __.10(a) prohibition on sponsoring or investing in covered funds. While we understand that the Agencies have adopted this approach because they believe it

[72] The SEC has taken the position in several no-action letters that exemptions from the registration requirements of the '40 Act for wholly-owned subsidiaries are available to subsidiaries that issue securities to a limited number of employees. See Continental Illinois (Delaware) Limited (avail. Apr. 1, 1973); Public Services Resources Corp. (avail. Nov. 22, 1988); National Medical Enterprises (avail. Jan. 8, 1990).

reflects the statutory structure of the Volcker Rule, such an approach creates results that cannot have been intended by Congress and that justify a different regulatory approach. For example, a banking entity could be prohibited from entering into covered transactions with a wholly-owned subsidiary, a funding vehicle used for liquidity management, or a joint venture that relied on Section 3(c)(1) of the '40 Act and thus was technically a "covered fund". As discussed in Part XII, under the Proposed Rule, a foreign bank could be prohibited from entering into covered transactions with a sponsored foreign fund with no U.S. investors or any U.S. nexus. This is an extremely significant flaw in the structure of the Proposed Rule that must be addressed to achieve a reasonable interpretation of Congressional intent and to prevent expansive and unjustifiable extraterritorial application of the Volcker Rule to a foreign bank's activities outside the United States.

### D. Entities Not Addressed in the Proposed Rule for Which Exemptions from the Definition of Covered Funds Are Needed

#### 1. Regulated Foreign Investment Companies

While U.S. mutual funds and other registered investment companies generally fall outside the scope of the Volcker Rule,[73] comparable regulated foreign investment companies that engage in public offerings outside the United States may be covered as a result of relying on Sections 3(c)(1) and/or 3(c)(7) for limited sales in the United States. The Proposed Rule did not adopt the industry suggestion that such regulated foreign investment companies and mutual funds (such as UCITS)—especially those publicly sold or traded on exchanges—should be exempt.[74]

We do not believe that Congress intended to permit banking entities freely to sponsor and invest in a U.S. mutual fund while prohibiting banking entities from sponsoring and investing in a comparable fund outside the United States. Particularly in light of the Agencies' approach to "foreign equivalent" funds, it would be illogical to prohibit an investment in a foreign mutual fund that would be permissible if the fund were organized in the United States. We urge the Agencies to exempt regulated foreign investment companies from the definition of "covered funds".

The Agencies should make clear that a foreign fund that, if organized in the United States or offered to U.S. residents, would be required to register as an investment company under the '40 Act, or that could rely on an exemption other than Section 3(c)(1) or 3(c)(7) of the '40 Act, would not be deemed to be a "covered fund" for purposes of the Volcker Rule. Such an interpretation would be logically consistent with the Agencies' expansion of the

[73] The Proposed Rule's inclusion of commodity pools adds a complication to this general understanding, as discussed below.

[74] See, e.g., Letter of Bank of Montreal et al. to FSOC, Nov. 5, 2010 (explaining that many public funds in Canada could technically be considered "hedge funds" or "private equity funds" under the Volcker Rule, because the SEC has concluded that they must rely on Section 3(c)(1) and/or 3(c)(7) of the '40 Act to permit a limited number of U.S. residents to hold interests in such funds without causing such funds to violate the '40 Act).

definition of covered fund to include "foreign-equivalent funds" and with the plain language of the statute, which only applies to funds that rely on Section 3(c)(1) or 3(c)(7).

Alternatively, we suggest that, because a definition based on Sections 3(c)(1) and 3(c)(7) of the '40 Act would not sensibly apply outside of the United States, foreign covered funds should be identified based on specified characteristics typical of U.S. private equity or hedge funds. Even if the Agencies decide not to pursue the characteristics-based approach more generally to define all covered funds, such an approach would be especially appropriate in the context of foreign funds, because it would permit the Agencies to restrict the universe of foreign covered funds to those funds that in practice resemble hedge funds and private equity funds. One characteristic identifying a foreign "covered fund" should be that the fund is partly or wholly exempted from substantive regulation due to its limited distribution (just as hedge funds and private equity funds that rely on 3(c)(1) or 3(c)(7) are exempted due to their limited distribution). Conversely, a fund that is subject to substantive regulation comparable to that of a U.S. mutual fund or other investment company registered under the '40 Act should be categorically excluded from the covered fund definition.

The Agencies could utilize their exemptive authority under Section 13(d)(1)(J) to implement such an approach, just as the Agencies provided carve-outs for other entities that may inadvertently be caught by the definition of "covered fund", on the grounds that forcing banking entities to restructure operations outside the United States would impose unnecessary costs and expenses on banking entities without improving the safety and soundness of their U.S. operations or U.S. financial stability and would raise serious issues of international comity.

2. Venture Capital and Infrastructure Funds

The Proposed Rule does not contain an express carve-out for venture capital or infrastructure funds, despite explicit Congressional support for excluding such entities from the Volcker Rule and numerous industry comments supporting an exemption.[75]

Venture capital funds serve an important public policy purpose, providing capital for start-up ventures, small businesses and innovation in U.S. markets. Similar policy considerations would support an exclusion for infrastructure funds, which was also recommended by the industry in comments prior to the release of the Proposed Rule. Infrastructure funds invest in instruments that finance public works projects, such as roads, bridges and other public infrastructure, and they serve a variety of public purposes, including job creation and infrastructure maintenance and improvement, which provide direct and tangible benefits to the economies of the countries in which they invest.

The preamble to the Proposed Rule poses a question regarding the possibility of exempting venture capital funds, and asks if the definition used by the SEC in its recent rulemaking under the Investment Advisers Act of 1940 (the "Advisers Act") would be an

[75] See, e.g., 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (Colloquy between Sen. Boxer and Sen. Dodd) ("[P]roperly conducted venture capital investment will not cause the harms at which the Volcker Rule is directed. In the event that properly conducted venture capital investment is excessively restricted by the provisions of section 619, I would expect the appropriate Federal regulators to exempt it using their authority under section 619[(d)(1)](J).").

appropriate definition.[76] We urge the Agencies to exclude both venture capital funds and infrastructure funds from the definition of covered fund, and agree that the definition in the Venture Capital Rule is a helpful starting point. Because application of the Volcker Rule prohibitions to venture capital funds would potentially have much harsher consequences than would a requirement to register under the Advisers Act, the Agencies should consider using a broader formulation than the definition in the Venture Capital Rule. For example, the Venture Capital Rule contains specific limits on leverage, purchases of securities from secondary sources (including angel investors and company founders that may need liquidity), and investments in debt securities of a portfolio company, in the securities of a reporting portfolio company, or in other venture capital funds (e.g., in a fund of venture capital funds complex). As explained in numerous comment letters to the SEC during its rulemaking process for the Venture Capital Rule, each of these restrictions places limits on legitimate venture capital fund activities, and prohibiting banking entities from investing in (rather than merely requiring registration for advisers to) such venture capital funds may have a significant negative impact on the industry.

The final rule should provide an exemption for venture capital funds for purposes of the Volcker Rule which retains some level of flexibility to accommodate investment fund structures and strategies that may not fit into the Venture Capital Rule definition, but still serve the same important public policies of providing capital for start-up ventures, small businesses and innovation in the United States. Likewise, the final rule should provide an exemption for infrastructure funds, which again serve important public policy purposes by financing new and existing public infrastructure through public-private partnerships.

3. Credit Funds

In addition to typical securitization vehicles, banking entities sometimes use other corporate structures to raise third-party funding for traditional lending activities, including through funds organized as partnerships or LLCs. These “credit funds” primarily engage in core banking activities, such as providing loans and other financing directly to borrowers and/or purchasing loans and other extensions of credit in the secondary market. Such lending activities are expressly protected from the reach of the Volcker Rule in BHCA Section 13(g)(2), and should not be inhibited solely because a banking entity chose a particular corporate form in which to conduct the activities. These credit funds provide important financing and liquidity to the commercial lending market, and are an important part of the U.S. economy.

It is unclear whether credit funds would be eligible for the loan securitization exemption currently provided in the Proposed Rule because they do not issue “asset-backed securities” in the usual sense of the term. We urge the Agencies to exclude such funds from the definition of covered fund. Credit funds are inherently engaged in a core banking activity, and can be operated in a safe, risk controlled manner in compliance with federal banking laws designed to protect the safety and soundness of banking institutions. There is no reason to prohibit a banking entity from engaging in lending activity through a credit fund that it could just as easily conduct through a securitization or as principal on its own balance sheet. We would

[76] See Advisers Act Rule 203(l)-1, 76 Fed. Reg. 39,646 (July 6, 2011) (to be codified at 17 C.F.R. § 275.203(l)-1) (the “Venture Capital Rule”) (exempting certain investment advisers to venture capital funds from registration requirements under the Advisers Act).

propose that the Agencies exempt any entity that would otherwise be a covered fund if its assets consist predominantly (e.g., more than 50%) of loans, as defined in Section __.2(q) of the Proposed Rule.

4. Financial Market Utilities

We recommend that the Agencies also exclude financial market utilities (“FMUs”) from the proposed definition of the term “covered funds.” Banking entities are both majority and minority investors in U.S. and foreign FMUs, which include securities clearing agencies, derivatives clearing organizations, securities exchanges, derivatives boards of trade and alternative trading systems. Many privately held FMUs rely on Sections 3(c)(1) or 3(c)(7) for an exemption from the ’40 Act and may not qualify for an alternative exemption. Unless FMUs are expressly excluded from the definition of “covered fund,” the Volcker Rule could severely disrupt the operations of bank-affiliated U.S. and foreign FMUs, with the potential for devastating effects on the safety, soundness, efficiency and stability of the U.S. and global financial systems.

E. Process for Case-by-Case Exemptions

As discussed above, the carve-outs in the Proposed Rule would address only a fraction of the wide range of entities that do not resemble private equity or hedge funds but are swept up by the definition of “covered fund”. If the Agencies rely on a series of specific exemptions to address the overbreadth of a definition based on Sections 3(c)(1) and 3(c)(7) of the ’40 Act, it is unlikely that a final rule, even with the benefit of public comment, will be able to refine this approach in a manner that addresses the multitude of entities whose individual facts do not fit within an exemption. As a practical matter, it will be critical that banking entities be able to obtain relief from the relevant Agency with respect to specific cases, whether such relief is formal or informal, and in the form of legal opinions, no-action letters, or case-by-case exemptions. Given the number of unpredictable and unintended consequences that may arise as the Agencies and banking entities begin applying the Volcker Rule to their operations, we believe this type of relief should be available for all of the Volcker Rule’s definitions and substantive requirements. We urge the Agencies to consider including a formal procedure for this type of guidance or relief.

F. “Similar Funds”: Commodity Pools and Foreign Equivalent Funds

1. Commodity Pools

As suggested by the FSOC Study, the proposal expands the scope of covered funds to include “commodity pools” as defined in the Commodity Exchange Act (the “CEA”).[77] We understand that the Agencies and the FSOC were concerned with commodity pools that act as hedge funds, making leveraged speculative investments in commodities. Although it is true that certain hedge funds are “commodity pools”, not all commodity pools are hedge funds. The commodity pool definition is substantially broader than the preamble to the Proposed Rule

[77] See CEA § 1a(10).

suggests, and the inclusion of commodity pools as similar funds would have significant unintended consequences.[78]

Nearly every fund that makes even incidental investments in futures, options on futures, commodity options, swaps and certain other instruments subject to CFTC regulation, even for hedging purposes, is a "commodity pool" as defined in the CEA—regardless of the nature of its investors.[79] Indeed, even feeder funds that invest more than 5% of their assets in a commodity pool may be regarded as commodity pools, which captures, among other entities, funds-of-funds that invest in underlying funds that trade commodities.[80] As a result, the proposed inclusion of commodity pools could prohibit banking entity investments in many public funds such as mutual funds and exchange-traded funds.

A potentially more viable approach to including those commodity pools that are commonly understood as "hedge funds" would look instead to the registration exemptions for CPOs. For example, CFTC Rule 4.13(a)(4) exempts from registration certain CPOs that operate commodity pools whose participants are limited to "qualified eligible person[s]".[81] This definition would more closely parallel the scope of Section 3(c)(7) of the '40 Act, although it would suffer from the same problems of overbreadth as would reliance on '40 Act exemptions. Again, an approach based on the characteristics of the fund would likely be the most workable way to achieve the statute's intent.

2. Foreign Equivalent Funds as "Similar Funds"

The Proposed Rule would also expand the scope of covered funds to include any foreign fund that "would be a covered fund" if it were organized or offered under U.S. law or to U.S. residents.[82] We understand this provision to mean that foreign funds that would rely on Section 3(c)(1) or 3(c)(7) if they were located in the United States or if their securities were offered in the United States in the same manner that they are offered overseas would be treated as covered funds.[83] We assume that the intended focus of this expansion was to prevent U.S.

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78 The term "commodity pool" means any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in "commodity interests," which, following Dodd-Frank, includes swaps and certain other instruments in addition to futures. Id. See also Edward F. Greene et al., U.S. Regulation of the International Securities and Derivatives Market, §§ 18.13 – 18.16 (2012) (discussing definition of commodity pool and commodity pool operator ("CPO") and certain exemptions from regulation for CPOs).

79 Similar to the '40 Act's definition of investment company, the CEA defines commodity pool very broadly and relies on exemptions to limit its impact. However, in the case of commodity pools, exemptions are generally granted to the operator of the pool, i.e., the person or entity with the authority to control the day-to-day operations of the pool. Exemptions are rarely granted to the pools themselves. The CFTC and its staff have issued "not a pool" interpretations only in the limited cases of certain ERISA plans and funds held solely by employees, family members and other close associates of a fund's manager.

80 See CFTC Interpretive Letter No. 86-22 (Sept. 19, 1986).

81 See 17 C.F.R. § 4.13(a)(4). The CFTC does not have an exemption from the definition of CPO that parallels Section 3(c)(1) of the '40 Act. In addition, the CFTC has proposed rescinding the Rule 4.13(a)(4) exemption. See 76 Fed. Reg. 7976 (Feb. 11, 2011).

82 See Proposed Rule § __.10(b)(3).

83 See note 8, above.

banking entities from investing through their foreign affiliates in private equity or hedge funds outside of the United States. Because a foreign investment fund with no U.S. investors or sales activities does not rely on Section 3(c)(1) or 3(c)(7) of the '40 Act, such funds could have been viewed as outside the scope of the Volcker Rule, and the foreign affiliates of domestic banks could have invested in such funds freely.

Such an expansion of the covered fund definition is not necessary to achieve its intended purpose, and it creates potentially unintended consequences for foreign banks. If the Agencies retain the expansion, it will be critical to tailor it so as not to interfere with the non-U.S. operations of foreign banking organizations. The main practical (and we assume unintended) significance for foreign banking organizations of the foreign equivalent funds provision is that the 23A Prohibition and the Volcker Rule's limitations on activities that create material conflicts of interest, involve exposure to high risk assets or trading strategies, or create risks to safety and soundness or U.S. financial stability (the "Prudential Backstops") would apparently apply to a foreign bank's sponsorship or management of, or investments in, foreign covered funds with no U.S. investors or other U.S. nexus. This would be an extraordinary and unjustifiable extraterritorial expansion of U.S. regulation of foreign banking activities outside of the United States. If the Agencies retain the foreign equivalent funds provision in the final rule, we urge them to clarify that the Prudential Backstops would only apply to activities in the United States, as they address matters of prudential regulation traditionally left to the discretion of home country regulators.

## XI. The Scope of "Ownership Interests" Attributed to a Banking Entity

### A. Preserving Legitimate Business Relationships with Third-Party Funds

As part of an asset management business, banks often develop business relationships with independent investment managers operating a variety of investment funds and strategies, including managers of private equity funds, hedge funds, and funds-of-funds. Some of these managers are established operators in the alternative investments space, while others are new entrants just launching their businesses. Banks will enter into mutually beneficial relationships with many such managers, where, for example, a bank may provide placement and distribution or other services to the managers in return for the opportunity to offer the managers' funds to the bank's customers. We do not believe the Volcker Rule was intended to implicate these types of business relationships, but we are concerned that the wording of parts of the Proposed Rule could inadvertently create doubt regarding their continued viability.

The Proposed Rule defines an ownership interest as "any equity, partnership, or other similar interest (including, without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar instrument) in a covered fund, whether voting or nonvoting, or any derivative of such interest."[84] The preamble to the Proposed Rule notes that this definition is meant to focus "on the attributes of the interest and whether it provides a banking entity with economic exposure to the profits and losses of the covered fund."[85] The preamble adds that debt securities

[84] Section __.10(b)(3).

[85] 76 Fed. Reg. at 68,897.

could be considered ownership interests if they exhibit "substantially the same characteristics as an equity or other ownership interest" by, for example, providing voting rights, "the ability to share in the covered fund's profits or losses, or the ability . . . to earn a return based on the performance of the fund's underlying holdings or investments."[86]

The addition of derivatives and other instruments that provide economic exposure to a fund would be an expansion of the plain language of the statute, which applies only to "equity, partnership, or other ownership interests[s]". While we understand the Agencies' objective of ensuring that banking entities cannot evade Asset Management Exemption investment limits in covered funds, we urge that any expansion of the ownership interest concept be implemented in a targeted manner focused on evasion, so as not to preclude banking entities' legitimate business relationships with covered funds and fund managers.

To this end, we ask that the Agencies clarify that bona fide lending arrangements with covered funds and/or their managers would not be deemed to create an impermissible "ownership interest". A bona fide lending arrangement with a covered fund (to the extent permitted under the 23A Prohibition) with legitimate and customary protective covenants should not be deemed an ownership interest in such covered fund, even if, for example, the interest rate on the loan is based on the performance or revenue of the fund.[87] Lending to all manner of entities is a fundamental part of the business of banking, and Congress intentionally limited the scope of the 23A Prohibition to prohibit covered transactions only with covered funds sponsored, managed or advised by the banking entity. In the course of a bank's asset management business, as it develops relationships with trusted independent fund managers, the bank will often extend credit to third-party funds—for example, to fund temporary shortfalls in capital calls or to provide working capital in the form of revolving credit facilities. It would be an unwarranted expansion of the statutory language prohibiting ownership interests and the 23A Prohibition to transform a bona fide loan into an "ownership interest" simply because the interest rate is tied to the profits or revenues of the borrower. In this respect, it is well understood that bona fide bank loans can include loans with a performance-linked return.[88]

## B. Clarifying the Carried Interest Exemption

We support the Agencies' confirmation in Section __.10(b)(3)(ii)(A) that carried interest arrangements should not be deemed ownership interests. Excluding carried interest is especially appropriate because it does not expose a banking entity to a fund's losses, but only a portion of its profits. However, we believe that the limitations that the Agencies have imposed on the exclusion have made it too narrow in certain respects and that certain technical clarifications should be made to achieve its intended purpose.

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86 Id.

87 The Agencies helpfully acknowledged the permissibility of using ownership interests in covered funds to collateralize bona fide loans by permitting banking entities to acquire and retain such interests acquired "DPC" in Section __.14(b)(1) of the Proposed Rule, a clarification we support.

88 See, e.g., 12 C.F.R. §7.1006 (permitting a national bank to take a share in profit, income or earnings of a borrower, or a stock warrant of such borrower, as consideration for a loan, so long as the obligation to repay principal is not conditioned on the value of the profit, income, earnings or stock warrant so received).

- First, restricting the carried interest exclusion only to those funds for which a banking entity or its affiliate serves as investment adviser or manager discounts the possibility that funds or their managers may provide a banking entity with a share of a fund's carried interest in return for other services, such as lending, placement or distribution, or debt or equity financing provided to a fund's adviser or manager. In addition, due to the typical structure of fund groups, banking entities that hold minority investments in investment managers could be prevented from receiving their share of the manager's profit that is received in the form of carried interest. Carried interest typically is not received by the management company itself, but by a special purpose vehicle (e.g., for tax or regulatory reasons, or to maintain corporate separateness and limited liability in the case of clawback). The special purpose vehicle in turn distributes the carry directly to the investment professionals and equity holders of the management company. A banking entity that, e.g., holds equity in (or has provided profit-participating financing to) an investment manager should not be precluded from receiving its share of the manager's profits if the carried interest is structured for legitimate reasons not to run through the management entity itself.[89]

- Second, the Proposed Rule's requirement that carried interest received by a banking entity not be transferrable by the banking entity would unnecessarily limit the value of the interest, which a banking entity could otherwise decide to sell if it needed liquidity or was ending its relationship with the fund (voluntarily or for regulatory reasons). We fail to see how this restriction would advance the policy objectives of the Volcker Rule or serve to prevent evasion.

- Third, we suggest that the Agencies confirm three technical points related to the carried interest exclusion:

  - The Proposed Rule would require that the person or entity receiving the carried interest has not provided funds to the covered fund in connection with the interest.[90] We presume this would not prevent the general partner (or special limited partner) and "sponsor" of a covered fund from paying a nominal amount to the fund in order to obtain a general partner or special limited partnership interest that serves as the vehicle to deliver the carry, as is generally the practice in such arrangements. In order for the carried interest clarification to have meaning, this capital commitment should not be viewed as funds provided in connection with the carried interest.

  - The Proposed Rule would require that profits, once allocated and if not promptly distributed, do not share in the subsequent profits and losses of the covered fund.[91] The Proposed Rule makes clear that this requirement

89 Similar issues arise with respect to the requirement that the "sole purpose and effect" of a carried interest held by a banking entity must be to provide compensation for services provided to the covered fund by the banking entity (or its affiliates).

90 See Proposed Rule § __.10(b)(3)(ii)(A)(3).

91 See Proposed Rule § __.10(b)(3)(ii)(A)(2).

should not impair typical carried interest clawback structures, as it acknowledges that recipients of carried interests may be obligated to return profits previously received. However, it would be helpful if the Agencies also confirmed that this requirement should not affect the practice common in many U.S. fund structures where a "reserve" portion of the carried interest is formally allocated for tax reasons, but continues to be invested in or alongside the fund, and is not finally allocated until a later date. Nor should it affect the common European structure in which allocated carried interest shares in the subsequent losses, but not profits, of the fund.[92]

- Fund managers or organizers may occasionally structure special purpose vehicles to serve as "carry vehicles" that initially receive payments of carry and then distribute the carry to the appropriate parties. Such "special limited partners" and other carry vehicles could be considered funds and subject to the Section __.10(a) prohibition on sponsoring or investing in covered funds under the Proposed Rule, even though they are essentially static pass-through entities the main purpose of which is administrative convenience. To give effect to the carried interest exclusion, we request that the Agencies confirm that such vehicles would not be considered covered funds under the Proposed Rule.

C. Excluding Derivatives from Ownership Interests

The treatment of derivatives and other instruments that provide economic exposure to the profits and losses of a covered fund as "ownership interests" could have significant ramifications for the fund-linked structured products business lines of major banking organizations. These business lines are client-facing, and provide customers with synthetic and other structured products that are linked to the performance of sponsored and third-party covered funds. If, notwithstanding the fact that the text of the Volcker Rule requires no such reading, these products were deemed to be ownership interests in a covered fund, the application of the Foreign Funds, Trading and Hedging Exemptions in the Volcker Rule to trading in such synthetic and structured products will be a critical issue for banking entities engaged in this line of business, as well as their international supervisors. We address the application of these exemptions to banking entities engaged in the fund-linked structured products business in more depth in Part III.B.3.b above and Part IX below.

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92 This requirement also should not prevent banking entities from paying carry as a bonus in a notional deferred compensation plan, rather than as a partnership allocation. Section 409A of the Internal Revenue Code requires nonqualified deferred compensation to be distributed on a specified date or dates or a specified event established at the time compensation is deferred, in which case profit cannot be allocated to the recipient at the time underlying investments are realized, because it may not be paid to the recipient until several years later. See 26 U.S.C. § 409A.

## XII. The Appropriate Interpretation of the Prohibition on "Covered Transactions" with Covered Funds

The 23A Prohibition prohibiting "covered transactions" (as defined in Section 23A of the FRA) between banking entities and the covered funds they sponsor, advise, manage or organize and offer[93] presents a number of important interpretive questions for the Agencies as they develop regulations implementing the Volcker Rule.

The Proposed Rule addresses a number of these interpretive issues, but does not address several issues important to foreign banks. For example, the Proposed Rule reasonably interprets the 23A Prohibition to permit investments in covered funds that a banking entity sponsors and invests in under the Proposed Rule, notwithstanding the fact that acquisitions of shares in an advised covered fund would be "covered transactions". The Agencies did not exercise any exemptive authority under the Volcker Rule to exclude investments in covered funds from the 23A Prohibition; instead, the Agencies used their discretion to interpret the statute to avoid what otherwise would have been a clearly unintended result. Exercising such interpretive authority is especially important in the context of the 23A Prohibition, which includes numerous ambiguities and interpretive questions. We strongly urge the Agencies to address in a similar manner several of the other ambiguities and interpretive issues that relate to the 23A Prohibition, including its geographic scope.

As the Agencies are aware, foreign banks with significant asset management and fund-linked product operations regularly enter into covered transactions with the covered funds they organize, sponsor or advise. For example, a foreign bank might provide a line of credit to enable a fund to meet redemption requests or cover capital shortfalls if investors fail to timely meet their contribution obligations when called, enter into an interest rate or foreign exchange swap with a fund, guarantee the obligations of a fund to another lender or a swap counterparty, or even create a principal protected structured product in the form of a covered fund where the bank guarantees the return of principal (or perhaps even a certain rate of return) and separately hedges the risks of such guarantee. The 23A Prohibition will likely be extremely disruptive to all such arrangements, as funds will be forced to seek out substitute third-party providers. In some cases, the arm's-length terms available from the bank for such transactions may be better than those available from other lenders or counterparties, because the bank will be able to rely on its familiarity with the sponsored or advised fund when underwriting the credit risk of the fund.[94]

Because of the highly disruptive consequences of applying the 23A Prohibition to typical market practices—consequences made worse by the overly broad definition of covered fund in the Proposed Rule—we urge the Agencies to interpret its scope narrowly, and not to apply it to the activities of foreign banking entities acting from outside of the United States.

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93 See BHCA § 13(f). The 23A Prohibition also applies to the covered funds controlled by a covered fund a banking entity sponsors, advises, manages or organizes and offers, and would require all transactions between a banking entity and such funds other than prohibited covered transactions to comply with Section 23B of the FRA.

94 Benefits from such cost savings would inure to the benefit of the fund's investors, not directly to CS itself. CS's benefit is in the ability to offer funds with attractive cost structures to our customers.

A. The Prohibition Should Not Apply to Covered Transactions by Non-U.S. Entities

The Agencies have proposed to implement the 23A Prohibition in a manner that could be understood to prohibit all extensions of credit and other covered transactions by a foreign bank with all of its advised or sponsored covered funds, inside or outside of the United States. This overbroad global reach, which we do not believe could have been intended by Congress or the Agencies, would be exacerbated by the inclusion of commodity pools and "foreign equivalent" funds in the definition of covered funds.[95] The Proposed Rule could thus be read to prohibit loans and other extensions of credit, purchases of assets or securities, guarantees, derivatives transactions, and securities lending and borrowing between the head office of a foreign bank and:

- A privately offered investment fund that it operates and advises wholly outside of the United States,
- A publicly offered non-U.S. investment company that relies on Section 3(c)(1) or 3(c)(7) of the '40 Act, or
- Any public or private foreign investment vehicle that falls within the expansive scope of the commodity pool definition under the CEA.

These results could not have been intended, and we believe that such interpretations would represent unjustifiable extraterritorial expansions of the Volcker Rule's intended scope.

The Agencies' interpretation of the 23A Prohibition should, consistent with the policy objectives of the Volcker Rule, focus on the activities of banking entities inside the United States and not apply to the activities of foreign banks acting outside of the United States. The 23A Prohibition should not apply to covered transactions between a foreign bank, acting from outside of the United States, and a foreign covered fund in which the foreign bank holds a permissible interest. Principles of statutory interpretation, traditional deference to home country bank regulation in this area, and policy considerations each support this conclusion:

- First, the Agencies' interpretation of the 23A Prohibition must take into account the presumption against extraterritorial application of U.S. law.[96] Congress must clearly and affirmatively express an intent to apply U.S. law abroad, and it did not do so in the context of the 23A Prohibition. Nothing in the statutory text of the Volcker Rule suggests that relationships between a foreign bank and foreign covered funds (which foreign banks are expressly permitted to invest in and sponsor as part of the Foreign Funds Exemption) should be limited by the 23A Prohibition. To the contrary, whereas the statutory text of the Asset Management

[95] We discuss issues surrounding the scope of the covered fund definition more generally below.

[96] The Supreme Court recently reaffirmed this principle in Morrison v. National Australia Bank, 130 S. Ct. 2869 (2010).

Exemption cross-references and specifically requires compliance with the 23A Prohibition, the Foreign Funds Exemption does not.[97]

- Second, Congress has historically and consistently adhered to the principle of deference to home country regulation for the foreign operations of foreign banks that involve credit extensions and other "covered transactions", which are traditionally matters subject to home country risk management standards and requirements. For instance, neither Section 23A itself, nor U.S. lending limits, apply to a foreign bank's non-U.S. branches.[98]

- Third, there is no policy rationale for prohibiting a foreign bank from lending to (or entering into other covered transactions with) a foreign covered fund in which the bank could invest freely pursuant to the Foreign Funds Exemption.

Just as the Agencies concluded in the Proposed Rule that the 23A Prohibition could not have been intended to prohibit investments in covered funds sponsored pursuant to the Proposed Rule, they should also conclude that Congress did not intend to interfere with the relationships between foreign banks and their foreign covered funds outside of the United States. The fact that the Agencies have proposed to expand the scope of the definition of covered funds outside of the United States heightens the importance of this interpretation.

For similar reasons, transactions between a foreign bank, acting from outside the United States, and a U.S. covered fund that the foreign bank sponsors, advises or organizes and offers should fall outside the scope of the 23A Prohibition. If the Agencies were to extend the 23A Prohibition to lending by foreign banks' head offices and non-U.S. branches, such an approach would represent a drastic departure from the policy objective of Section 23A of the FRA itself and, in our view, the 23A Prohibition in the Volcker Rule—i.e., protecting the bank (not the affiliate or covered fund) from risks presented by extensions of credit or other covered transactions to a covered fund. As noted above, transactions between banks and their affiliates are traditionally matters left to the bank's home country regulators. Section 23A itself and Regulation W provide a clear example of a statutory and regulatory structure, consistent with our understanding of the intent of Volcker Rule, where the U.S. branches, agencies and bank subsidiaries of a foreign bank are subject to U.S. rules limiting lending to certain designated affiliates, but the lending of the bank's non-U.S. branches and agencies is not limited by U.S. law.[99] The 23A Prohibition should be interpreted to apply in the same manner, only to transactions between a foreign bank's U.S. branches, agencies and affiliates and the covered funds that the foreign bank sponsors or advises.

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97 See BHCA §§ 13(d)(1)(G)(iv), (D)(1)(I).

98 See, e.g., 12 C.F.R. § 223.61 (limiting the application of Section 23A and 23B with respect to foreign banks to transactions between their U.S. branches and agencies and certain affiliates).

99 See id.

B. Transactions with "Covered Funds" in Which a Banking Entity May Permissibly Hold an Ownership Interest

The Proposed Rule attempts to address certain unintended consequences of the Volcker Rule's overbroad definition of covered fund by allowing banking entities to own or sponsor certain entities that inadvertently fall into the definition of covered funds, such as joint ventures, acquisition vehicles, wholly-owned liquidity management vehicles and certain securitization structures.[100] However, because the Agencies exempted such entities from the Section __.10(a) prohibition on sponsorship and investments and did not exclude them from the definition of "covered fund", the Proposed Rule could be read to apply the 23A Prohibition to covered transactions between a banking entity and these specialized entities.[101] This result is clearly not intended by Congress nor justified by the Volcker Rule's underlying policies, and applying the 23A Prohibition to these entities would frustrate the purpose of excluding them in the first place. The same policies and interpretive analysis employed by the Agencies to create the exemptions in Sections __.13 and __.14 also justify interpreting the 23A Prohibition in a manner that excludes such entities from its scope. The Agencies should clarify that the 23A Prohibition does not apply to any covered fund that is exempt from Section __.10 (a) pursuant to Section __.13 or __.14 of the Proposed Rule (or, alternatively, interpret the definition of "covered fund" not to include such entities).

C. Prime Brokerage Attestation

Section __.16 of the Proposed Rule requires that the Chief Executive Officer of the top-tier entity of a banking entity that avails itself of the exemption to the 23A Prohibition available for prime brokerage transactions with certain covered funds certify annually that the banking entity does not, directly or indirectly, guarantee, assume or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests. The Proposed Rule does not address how the proposed CEO attestation requirement would be applied to foreign banking organizations or their U.S. operations.

We believe the most reasonable approach to adapting the U.S. governance and certification requirements to banks headquartered outside the United States would be to permit a senior officer with authority for the U.S. operations of a foreign banking organization to make the attestation.

D. Other Interpretive Issues

The 23A Prohibition relies on a reference to Section 23A to define the scope of a "covered transaction", but does not expressly reference any of the exemptions or mitigating factors present in Section 23A or the Federal Reserve's implementing rules in Regulation W. Because of the broad scope of the 23A Prohibition, and the fact that it is a flat prohibition on covered transactions, whereas Section 23A and Regulation W target similar concerns through prudential requirements of collateral, quantitative exposure limits and limits on poor quality

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100 See Proposed Rule §§ __.13 and __.14.

101 We discuss the overbroad scope of the covered fund definition in more detail in Part X, above.

assets, the 23A Prohibition should be carefully defined in scope to avoid unintended results that would be inconsistent with the policy objectives underlying the Volcker Rule.

The intent behind the 23A Prohibition is to prevent U.S. banking entities from providing guarantees, funding and other support to the covered funds they sponsor and advise and to protect U.S. banking entities from overexposure to the risks taken by their covered funds. We believe that Congress intended the Agencies to interpret the 23A Prohibition in light of this intent, with the exemptions in Regulation W serving as examples of areas where such risks are mitigated or absent. Some interpretive guidelines that we believe should be clarified in the final rule are set forth below:

- We recommend that the Agencies interpret the 23A Prohibition to incorporate the prudential exemptions in Section 23A and Regulation W, including the exemptions for extensions of credit fully secured by cash or U.S. government or agency securities, for intraday extensions of credit, and for purchases of liquid assets and readily marketable securities at or below current market prices.[102] These exemptions have been carefully designed not to expose a bank (or banking entity) to inappropriate risks under Section 23A, and are just as appropriate (and necessary) to prevent unintended consequences in the case of the 23A Prohibition.

- A U.S. banking entity should be permitted to purchase securities as principal (including fixed income securities and OTC derivatives) from a U.S. covered fund it sponsors or advises if the banking entity can execute the transaction on a riskless principal basis.[103] Enabling such riskless principal transactions would preserve a key trading outlet for the fund, and preserving several well capitalized trading partners for a fund is crucial to enabling the fund to find the best possible prices when seeking to sell certain assets. Wholly eliminating the ability of a covered fund to make any trades with its sponsoring or advising banking entity could have a significant negative effect on the performance of the covered fund, which would directly impact the returns the fund provides to investors.

## XIII. Implications for Securitization Activities

### A. Excluding Securitizations from the Definition of Covered Fund

Although Congress did not intend for the Volcker Rule to have a negative effect on the securitization activities of banking organizations, the definitions and terminology in the Proposed Rule raise numerous issues for banks that perform various roles in the securitization markets. In the preamble to the Proposed Rule, the Agencies ask many of the key questions concerning the Proposed Rule's possible effects on the securitization market, recognizing some of the many complexities in this area.[104] While the interpretive questions raised by the Proposed

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102 These exemptions would, for example, permit a banking entity to continue to provide spot FX services to the covered funds it sponsors or advises.

103 E.g., if the banking entity has already arranged a buyer for the security or has entered into a back-to-back transaction for an OTC derivative transaction to eliminate the principal risk of the trade with the fund.

104 See, e.g. Proposed Rule Questions 217, 219, 220, 225, 227 – 240.

Rule are complex, the policy issues are simpler. Securitization plays a pivotal role in financing a broad range of economic activities in the United States. Especially at a time of persistent uncertainty in the international economy, imposing broad limitations on an activity that supports the provision of credit to consumers and businesses risks undermining rather than supporting financial stability.

In other provisions of Dodd-Frank, Congress took major, explicit steps to reform the securitization market, expressly mandating (i) risk retention by the originators and securitizers of asset-backed securities ("ABS"),[105] (ii) disclosure requirements for securitization issuers,[106] (iii) additional due diligence requirements for securitization issuers,[107] (iv) rules prohibiting material conflicts of interest between the underwriters and placement agents of a securitization and the investors in such securitization,[108] (v) removal of references to credit rating agency ratings in laws and regulations,[109] and (vi) further regulation of the credit rating agencies.[110] All of these provisions were intended entirely or in large part to strengthen the securitization market so that it could once again serve an integral and reliable role in financing economic activity.

As a consequence of the overbroad definition of "covered fund," however, the Volcker Rule as implemented by the Proposed Rule could have a profoundly negative effect on the securitization market. A large number of private securitization issuers currently rely on Section 3(c)(1) or 3(c)(7) of the '40 Act rather than more restrictive exemptions such as Rule 3a-7 (for securitizations with no, or more limited, permitted trading) or Section 3(c)(5) (for securitizations of accounts receivable, mortgages and certain other asset types).[111] Moreover, as explained above, the inclusion of commodity pools in the "covered fund" definition would significantly expand the Volcker Rule's reach to a wide range of otherwise exempt entities, including both public and private securitization issuers that fall under the broad definition of "commodity pool". The SEC's recent announcement that it is examining whether to further narrow the application of Section 3(c)(5) and Rule 3a-7 to exclude certain securitizations that currently rely on those provisions makes the breadth of the Proposed Rule an even greater concern as more issuers may be forced to look to Section 3(c)(1) or 3(c)(7) exemptions.[112]

Recognizing that reliance on '40 Act exemptions to define hedge funds and private equity funds could inadvertently impact securitizations, Congress late in the legislative

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105 See Dodd Frank § 941 (codified as new Section 15G of the Exchange Act).

106 See id. § 942.

107 See id § 945.

108 See id. § 621.

109 See id. §§ 939, 939A.

110 See id. Title IX, Subtitle C.

111 Such issuers would include any actively managed securitization (which generally have no viable alternative Investment Company Act exemptions other than Sections 3(c)(1) or 3(c)(7)), synthetic securitization, or securitization that holds assets other than mortgages or assets that are "eligible assets" as defined by Rule 3a-7 under the Investment Company Act.

112 SEC Release No. IC-29779, 76 Fed. Reg. 55,308.

process added a specific direction to the Agencies to use the rulemaking process to avoid impeding the securitization market, requiring that "[n]othing in [the Volcker Rule] 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" (the "Securitization Exclusion").[113] The Securitization Exclusion reflects Congress's well grounded recognition that securitization is an important source of credit and liquidity for the U.S. economy; securitization vehicles are fundamentally different from private equity and hedge funds; and banks' sponsorship and management of securitization issuers are consistent with banks' traditional lending business and are well outside the core policy objectives of the Volcker Rule.[114]

Securitization is a method of broadening the pool of lenders available to finance activity across a wide swath of the economy, including both consumer and corporate debt. Securitization increases the availability of credit and lowers its cost. As Comptroller of the Currency John Walsh recently commented at the Annual Conference of the American Securitization Forum, "[i]t is hard to imagine full recovery of the financial system without the liquidity and funding avenues provided by a well functioning securitization market."[115] The financing activity that is facilitated by securitization structures such as asset-backed commercial paper ("ABCP") conduits is precisely the type of activity that Congress and the executive branch have urged banks to expand in order to support economic growth and job creation.

Unfortunately, the Proposed Rule—if adopted as drafted—would seriously and unnecessarily restrict many commonplace securitization activities, including the sponsorship and support of ABCP conduits, CLOs, and a number of other securitization structures. This result would directly conflict with Congress's direction in the Securitization Exclusion, as well as other aspects of Dodd-Frank that specifically address securitization.

The Proposed Rule attempts to implement the Securitization Exclusion through narrow exemptions from the ownership and sponsorship prohibitions for (i) securitizations the assets of which are exclusively loans (the "Loan Securitization Exemption"), and (ii) investments required in order to comply with Dodd-Frank's risk retention requirements (the "Risk Retention Exemption"). As described below, the scope of the Loan Securitization Exemption is too narrow, both in the way it defines a securitization and in the relief that it grants from the Volcker Rule's restrictions, and neither exemption adequately protects securitization activity from significant and unintended limitations.

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[113] BHCA § 13(g)(2).

[114] See, e.g., 12 C.F.R. 1.3(g) (A national bank may securitize and sell assets that it holds, as part of its banking business); 12 C.F.R. 1.3(h) (permitting national banks to purchase and sell shares in pooled investment vehicles whose assets consist exclusively of assets that the bank may purchase and sell for its own account).

[115] Remarks by John Walsh, Acting Comptroller of the Currency, before the Annual Conference of the American Securitization Forum, Jan. 24, 2012.

If not significantly revised, the Proposed Rule's overly narrow approach to implementing the Securitization Exclusion could:

- Prohibit a banking entity from sponsoring many types of securitizations clearly intended to be excluded from the Volcker Rule by Congress.
- Prohibit common forms of warehouse financing for securitizations sponsored or advised by a banking entity.
- Prohibit banks from providing to issuers (including ABCP conduits) vital liquidity or credit support, such as revolving credit facilities, asset purchase commitments, guarantees, credit default swaps or term loans.
- Prohibit the purchase of debt securities issued by a securitization, including pursuant to a banking entity's underwriting and market-making functions.
- Prohibit a banking entity from entering into interest rate or foreign exchange hedge agreements with a securitization issuer it sponsors or advises.
- Impose compliance and reporting obligations on securitization issuers controlled by banking entities, with no corresponding benefits to safety and soundness of U.S. banks or U.S. financial stability.

The net impact of such results would be a significant curtailment of securitization activities by banks, which will decrease the availability of credit and increase its cost. Congress specifically directed the Agencies to avoid such a result, as securitization is clearly not the intended focus of the Volcker Rule.

The Proposed Rule's current approach, providing targeted securitization exemptions from the prohibitions in Section ___.10(a) of the Proposed Rule, would not effectively implement the Securitization Exclusion. Rather than providing discrete, narrow exemptions from certain aspects of the Volcker Rule, the Agencies should give effect to the Securitization Exclusion by providing an exclusion of securitizations from the definitions of covered fund and banking entity.[116] The currently proposed exemptions are too narrowly defined and would not provide an exemption from the 23A Prohibition. Their application would also require difficult judgments about how a term such as "ownership interest" should be adapted to securitization issuers, which have an entirely different corporate, capital and investment structure from private equity and hedge funds. In contrast, an exclusion of securitizations from the definitions of covered fund and banking entity will carry out the mandate of the Securitization Exclusion in a clear and complete manner.

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[116] We address in Part VII of this letter the issues presented by the possibility that certain covered funds associated with a banking entity may also be considered to be "banking entities." With respect to securitizations, there are additional issues, including the lack of any employees or infrastructure required to comply with the reporting and compliance obligations imposed on banking entities and the practical obstacles of obtaining the cooperation of unaffiliated third parties to implement the comprehensive tracking and reporting required by the rule. Excluding securitizations from the definition of banking entity would of course address these concerns.

Moreover, given that the regulation of securitizations has been separately and specifically addressed by Congress elsewhere, and in view of the fundamental differences between securitizations, on the one hand, and hedge funds and private equity funds, on the other hand, an exclusion of securitizations from the definitions of covered fund and banking entity is a sound interpretation of the Volcker Rule as part of the larger framework of the Dodd-Frank Act. A well-defined exclusion for what is, at heart, a lending activity, will offer clarity and simplicity for compliance and enforcement while avoiding unintended consequences for securitizations.

When one considers the structure and operation of common securitizations in the market today, it is difficult to see how a banking entity could use ownership or sponsorship of a securitization in order to avoid the Volcker Rule's core purpose—prohibiting banking entities from engaging in proprietary trading—as they are not set up to engage in the kind of proprietary trading about which Congress was concerned. For example, as described below, CLOs engage in purchases and sales of assets, but they do so subject to specific trading restrictions and covenants that are a part of the transaction documents, and generally with a focus on the cash flow that will be generated by holding those assets over a long period of time, not from short-term market appreciation. If the Agencies are concerned that these touchstone characteristics of securitizations could change in the future, the Volcker Rule gives the Agencies ample authority to monitor the development of the securitization market and either address the activities of particular institutions or modify their approach to securitizations generally if appropriate.

We believe a clear exclusion of securitization issuers from the definitions of covered fund and banking entity is the only way for the Agencies to give full effect to the Volcker Rule's plain language and congressional intent and to avoid damaging the securitization market. In the following sections, we provide additional information regarding the fundamental differences between securitization and private equity and hedge funds, and explain in detail many of the problems and uncertainties that would arise if the Proposed Rule were applied to securitizations without modification.

## B. Distinguishing Securitization Issuers from Private Equity and Hedge Funds

Securitizations are fundamentally different from hedge funds or private equity funds in that securitization investors are making a credit-based investment in fixed-income assets such as receivables or loans, while investors in hedge funds and private equity funds are seeking equity-like returns arising from the funds' general partner realizing trading profits from market movements in stock prices or enhancing the value of an equity stake in operating businesses by undertaking the active management and restructuring of those businesses. This fundamental difference is at the heart of the distinction Congress sought to draw between the type of credit-based activities that have traditionally been the core business of banks, on one hand, and exposure to the risks of trading activities and equity investments, on the other hand.

Securitizations generally attract investment capital by the issuance of debt, and thus their investors by and large are interested in fixed income exposure that is defined by the stated coupon payable on their notes or bonds, and is not defined by the profits generated by the securitization's investment strategy. Some securitization structures are static vehicles that provide credit exposure to preselected pools of assets in return for cash flows from those assets. Other securitization vehicles own actively managed asset pools with an investment adviser or administrator that is required to follow investment guidelines that are developed with input from the investors and credit rating agencies and that are specified in detail in the transaction agreements. In fact, to the extent a securitization is managed at all, it is subject to significant investment restrictions that are intended primarily to maintain a portfolio of credits that will yield sufficient cash to service the debt issued by the securitization, and to limit the issuer's ability to expose investors to higher levels of risk in pursuit of greater yield.

Investors make decisions as to whether to invest in a securitization based on the investment guidelines, their understanding of the credit risk of the underlying assets or types of assets (in reliance on their own assessments or the evaluations of their advisors), the expected yield of the securitization securities, and their assessment (in light of these factors) of the adequacy of the various types of credit support that are built into the securitization's structure. Although securitizations often issue one or more classes of securities that benefit from any excess cash flow generated by the assets beyond what is necessary to service the stated interest on the more senior securities, the risk and reward to investors in those securities are determined primarily by cash flow and credit on the underlying assets rather than by trading gains or equity market valuations.

Two areas of the asset-backed securities market that illustrate how banks provide liquidity to important sectors of the economy through their securitization activities are ABCP and CLO structures, each of which rely on Section 3(c)(1) or Section 3(c)(7) of the '40 Act.

1. Asset-Backed Commercial Paper Conduits

As the Agencies are aware, ABCP conduits fully supported by their bank sponsors have for decades been a reliable and important source of low-cost liquidity for companies in many sectors of the economy, ranging from companies that provide loans to consumers with respect to autos, credit cards and student loans to companies involved with providing funding for dealer inventories, the manufacturing or leasing of planes, industrial equipment and a large set of other miscellaneous businesses. ABCP conduits issue short term commercial paper and use the proceeds to provide financing to customers of the sponsoring bank either through repurchase agreements in respect of, or loans secured by, low-risk, highly rated financial assets. These assets take the form of loans, leases, receivables, notes, certificates and other instruments backed by loans, and they provide the current cash flow to the ABCP conduit necessary to make interest payments on the commercial paper. At maturity of the short-term commercial paper, the ABCP conduit typically issues new commercial paper and applies the proceeds to retire the outstanding issuance. ABCP conduits typically do not issue any class of securities that receive economic "upside" above their stated return, but instead the main objective is to effectively pass on the favorable rates at which the conduit can borrow in the ABCP market to the businesses being financed in the form of better financing terms.

The financing activity that is facilitated by the operation of fully-supported ABCP conduits is precisely the type of activity that Congress and the executive branch have urged banks to expand to support economic and job growth.[117] The availability of this type of funding

[117] The United States government has itself sought to avail itself of the market for ABCP to obtain funding for student loans originated through the Federal Family Education Loan Program ("FFELP"). When in late 2008 new funding for FFELP lenders through the asset-backed securities market evaporated, the

is tied to the continued ability of sponsoring banks to provide credit and liquidity support to the conduit. The forms of support can vary widely and include asset purchase agreements, commitments to lend, letters of credit, guarantees, loans and other forms of credit enhancement. This support enables the conduit to provide the customers of the sponsoring bank with a low-cost, alternate source of funding for their operations. Credit rating agencies rely on these support commitments to assign the bank's own short-term debt ratings to the commercial paper issued by the ABCP conduit, and investors look to this liquidity and credit support for assurance that, in the event that the current outstanding commercial paper cannot be paid at maturity by a new issuance of commercial paper (due to liquidity issues in the commercial paper market, for example), or there are significant losses on the assets owned by the conduit, the conduit has a source of funds available to make the required payments to investors. Without banking entities' providing credit and liquidity support sufficient to fully repay the commercial paper, the rating agencies would not be able to assign sufficiently high ratings to the commercial paper, investors would not have sufficient comfort to continue purchasing commercial paper from the conduits at such favorable rates, and the ABCP market would likely cease to exist.

The bank has full exposure to the assets acquired by or securing the amounts lent by the conduit, and it subjects those assets and the obligors to the same analysis in which it would engage if it were lending directly against those assets. The bank's ability to engage in this activity through the conduit simply expands the pool of potential lenders while maintaining a low cost of funding for the ultimate borrowers. Given the full support of their bank sponsors and the high quality of their assets, it is not surprising that fully-supported ABCP conduits performed well even during the stress of the financial crisis.

It is evident that ABCP conduits serve an entirely different aim from hedge funds and private equity funds; it is also true that their capital structures bear little resemblance to the types of funds that are the focus of the Volcker Rule. As noted, ABCP conduits typically issue highly-rated commercial paper. A typical fund, however, will issue only un-rated equity, often in the form of partnership or LLC interests. While it may issue both general and limited partnership interests, they will both represent interests in the total equity risk and reward arising

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Department of Education and the Department of Treasury jointly announced an ABCP conduit program, which came to be known as Straight-A Funding, to entice more private sector capital to the student loan market. Like private-sector ABCP conduits, Straight-A Funding benefited from several forms of liquidity and credit support (but in this case from the federal government) including a put agreement that obligated the Department of Education to purchase student loans from the conduit upon the occurrence of certain events, and a liquidity agreement with the Federal Financing Bank whereby it would make advances to Straight-A Funding as necessary to repay commercial paper obligations. When announced the program anticipated issuing up to $60 billion of commercial paper, and following its final student loan asset purchases in August 2010 had $39 billion of short-term notes outstanding.

The federal government's experience with Straight-A Funding reveals two key points. First, the federal government recognizes that ABCP conduits are an efficient and attractive way for banks to lend their own credit-worthiness to expand the pool of possible lenders willing to finance key economic activity. Second, the existence of a robust ABCP market at the time the program was initiated was key to its overall success. If the Proposed Rule is not modified to exclude ABCP conduits from the restrictions placed on covered funds, and banks are unable to continue to play the same role in establishing and providing liquidity to ABCP conduits, it would be an outcome directly at odds with the federal government's previous recognition of the importance and usefulness of ABCP.

from the fund's assets. In contrast to the securities issued by ABCP conduits, no class of the fund's securities will carry a debt-like principal amount or be promised a stated yield. The capital structures of ABCP conduits are entirely different and do not offer the same type of investment profile.

While recognizing the policy objectives of the Volcker Rule covered funds provisions, there can be little doubt that Congress, bank supervisors and other policymakers have sought to encourage banks to increase lending activity to all sectors of the economy. As described below, however, unless ABCP issuers are excluded from the definition of covered fund, the Proposed Rule may make it impossible for this particular lending activity to continue. The loss of low-cost funding secured by high quality, low-risk assets is not a result that was intended by Congress in adopting the Volcker Rule, and is not consistent with enhancing the financial stability of the United States.

2. Collateralized Loan Obligations

Banking organizations also play important roles in the market for CLOs, including acting as investment advisor to CLOs, and underwriting and making markets in CLO securities. CLOs issue securities to sophisticated institutional investors and use the proceeds to purchase various forms of corporate debt, which are pledged to secure the CLO's debt and provide the cash flow necessary to make the required interest and principal payments. The most common type of corporate debt purchased by CLOs are senior secured loans, but they also purchase corporate bonds, synthetic securities that reference corporate credits and, for liquidity purposes, government guaranteed securities, money market funds and other highly credit-worthy and liquid investments. The types of investments that a CLO is permitted to make are tightly constrained by the credit rating agencies and investors, and typically do not include any equity securities. CLOs served as a key source of liquidity for the corporate loan market for much of the past two decades, and the reduction in CLO issuances since the height of the financial crisis has been a source of concern.[118] The market for CLO securities is beginning to recover, which is a positive development for the economy as a whole; however, as described below, the Proposed Rule would likely hinder the recovery of this important source of corporate finance.

Reflecting their very different purposes and assets, the capital structures of CLOs are also distinctly different from those of hedge funds or private equity funds. CLOs finance themselves by issuing multiple classes of debt, each with a stated principal amount and coupon, the overwhelming majority of which will be rated, plus a class of preferred stock or debt that absorbs the first losses on the CLO's assets and benefits from excess cash flows if such losses do not occur. This is of course a stark contrast to the equity interests issued by funds that give its investors direct exposure to gains and losses arising from the funds trading and investment activities.

In short, ABCP conduits and CLO issuers have very little in common with hedge funds and private equity funds, other than having multiple investors and relying on the same exemptions from the Investment Company Act. The main reason Congress included limitations

[118] See, e.g. Bernadette Conway, "The Coming CLO Crunch: operational issues for syndicated loans", Crossings: The Journal of Trading and Risk Management, Winter 2010.

on the ability of banking entities to purchase ownership interests in hedge funds and private equity funds was a concern that without such a prohibition, banks could continue to engage indirectly in proprietary trading by sponsoring and investing in funds. Neither ABCP conduits nor CLOs are a means for banks to obtain that type of exposure; rather, they each provide support to the business of lending to many sectors of the economy. Therefore, in defining the proper scope of an exclusion for securitization issuers as suggested above, the Agencies should at a minimum ensure that both fully-supported ABCP conduits and CLOs are excluded from the definition of covered fund and not hindered by the restrictions and prohibitions of the Volcker Rule.

### C. The Application of the Ownership, Sponsorship and 23A Prohibitions to Securitization Issuers That Are Covered Funds Is Unclear and Overbroad

The Proposed Rule would impose strict limits on the relationships between a banking entity and any securitization issuer deemed to be a covered fund. Subject to certain exemptions, the Proposed Rule would prohibit a banking entity from (i) acquiring or retaining an ownership interest in such an issuer; (ii) sponsoring such an issuer; or (iii) engaging in covered transactions with any such issuer that is sponsored, advised or organized and offered by the banking entity. These prohibitions are designed to prevent or minimize a banking entity's exposure to traditional hedge funds and private equity funds, which share certain capital and operational structures—structures that are different in significant ways from securitization structures. Their application to typical securitization structures is ambiguous at best, and leaves the treatment of securitizations under the Volcker Rule subject to great uncertainty. If the Proposed Rule is not revised to exclude securitizations from the Volcker Rule, these provisions could effectively end many forms of securitization, with potentially severe implications for U.S. credit markets and, indirectly, the U.S. economy more generally.

#### 1. Ownership Interest

The definition of "ownership interest" in the Proposed Rule is designed with traditional hedge funds and private equity funds in mind, and its application to securitization structures is uncertain. Such funds typically issue equity interests to their investors, in the form of shares, limited partnership interests or LLC interests. As discussed above, the preamble to the Proposed Rule indicates that covered ownership interests are intended to encompass equity interests and other similar interests, specifically, interests that provide control rights in a fund similar to typical equity control rights (e.g., in the form of voting rights) and/or economic exposure to a fund's performance similar to the exposure an equity interest would have (e.g., through exposure to both the funds profits and losses).[119] These concepts are difficult to apply in the context of securitization, however, where the corporate and ownership structures of securitization vehicles are significantly different from traditional hedge funds and private equity funds. As a result, the Proposed Rule creates significant uncertainty as to which securities, if any, issued by a securitization vehicle would be deemed ownership interests in the vehicle.

Unlike hedge funds or private equity funds, which raise money by issuing equity interests in the funds, securitizations obtain funding through the issuance of securities that

[119] See 76 Fed. Reg. at 68,897.

include primarily debt securities, perhaps with one tranche of securities representing a residual interest that has certain equity-like economic characteristics. These junior or subordinate securities can take the form of preference shares or subordinated notes or have other similar designations. Although some of the securities may have certain equity features in terms of economics (e.g., bears the first risk of loss and receives the excess cash flow available on payment dates and when the securitization is wound up), they do not carry the same types of voting or control rights or economic participation as equity interests in a hedge fund or private equity fund.

In traditional hedge funds and private equity funds, investors who have voting rights that may influence, and provide economic exposures to, the gains and losses of the fund may be fairly said to have an ownership interest in the fund. In contrast, the debt tranches issued in a securitization typically would have no rights to the "upside" performance of the asset pool, and while holders of ABS securities representing "equity" economics have exposure to the credit risk of a securitization issuer's underlying asset pool, they generally have limited or no corresponding voting rights.[120] Generally the rights available to the holders of the residual interest in a securitization (if any) are limited to the right to direct the redemption of all of the securities under certain circumstances and, in a managed transaction, the right to terminate the agreement with the investment adviser or the servicer, but those rights are often subject to the consent of the other classes and certain other restrictions. Only the most senior tranche of securities would have any rights to direct the liquidation of the pool of assets after a default under the transaction documents; the holder of the residual interest would have no rights to direct the liquidation or winding up of the securitization.

The voting rights generally associated with "ownership" are often a part of the true legal equity of the securitization issuer that, in many cases, is not held by investors but is held pursuant to trust agreements or similar arrangements that significantly restrict the ability to vote the shares. Other securitizations or structured products may issue only one class of securities, such as trust certificates that represent an undivided interest in the assets of the issuer, that also do not carry with them the type of control over the issuer or the potential economic upside associated with traditional equity securities. Thus, it is difficult to characterize holders of ABS securities in most securitizations as having "ownership interests" in any common understanding of the term.

Overall, the concept of "ownership interest"—originally conceived as a limit on the exposure banking entities can have to hedge funds and private equity funds—is a poor fit for the securitization market, underscoring the benefits of excluding securitization issuers from the definition of covered fund entirely. If the Agencies do not take such an approach, however, at a minimum the final rule must provide clearer guidance on how the market is to determine which interests in a securitization are in fact "ownership interests" under the rule. If the Proposed Rule were adopted as written it would create significant market uncertainty, which would further slow the recovery of the securitization market.

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120 Typically, only the most junior class of securities—those with first loss exposure to the asset pool—would have the right to the upside performance of the asset pool.

2. Sponsorship

Under the Proposed Rule, a banking entity "sponsors" a covered fund if it "serve[s] as a general partner, managing member, trustee, or commodity pool operator of a covered fund; [or] [i]n any manner . . . select[s] or . . . control[s] . . . a majority of the directors, trustees, or management of a covered fund. . . ."[121] The proposed definition is, in some ways, similar to the definition of control under the BHCA with respect to investment funds, under which a company is deemed to control a fund if it serves as the fund's general partner or managing member (and thus has authority to take control of the fund's operations by, for example, terminating the investment adviser), but the company is not deemed to control the fund merely by serving as investment adviser or commodity trading adviser. BHCA control doctrines are not straightforward in the context of securitizations, and we expect similar challenges to arise in the context of analyzing the Volcker Rule's definition of sponsorship with respect to securitizations.[122]

Applying the concepts of control and sponsorship to a securitization will create additional regulatory uncertainty in the securitization market if the Volcker Rule is applied to securitizations. Banking entities engage in a variety of roles in a securitization—e.g., as underwriter, distributor, placement agent, originator, depositor, investment adviser, servicer, administrative agent, "securitizer",[123] etc.—and without clarification market participants may be concerned that these roles could potentially be implicated by the Volcker Rule's restrictions on sponsorship. The resulting uncertainty is likely to further chill the securitization market unless a clear understanding develops about which activities may continue, and under what constraints, under the Volcker Rule. If securitizations are not otherwise excluded from the definition of covered fund, the Agencies should clarify, just as they have with respect to certain trustees,[124] that a banking entity will not be deemed to "sponsor" a covered fund simply by serving as underwriter, distributor, placement agent, originator, depositor, investment adviser, servicer, administrative agent, securitizer or similar role.

3. Covered Transactions

Under the Proposed Rule, one significant consequence of deeming a securitization issuer to be a covered fund would be the application of the 23A Prohibition. As discussed above, the 23A Prohibition would prohibit covered banking entities from entering into covered transactions with any securitization issuer that is a covered fund if the banking entity or an

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[121] Proposed Rule § __.10(b)(5).

[122] Notably, the Federal Reserve declined to address the relationship between banking organizations and securitization vehicles in its Regulation W adopting release, citing the complexities of the issues involved. See 67 Fed. Reg. 76,560, 76,567-68 (Dec. 12, 2002).

[123] The concept of a "securitizer"—as proposed to be defined by the Agencies and other regulators for purposes of Dodd-Frank's risk retention rules—is significantly broader than the Volcker Rule's concept of "sponsor", and should not be used as a proxy for determining whether a banking entity "sponsors" a securitization. See 76 Fed. Reg. 24,090, 24,098-99 (Apr. 29, 2011) (proposed rule to implement Dodd-Frank Section 941's requirement that securitizers and/or originators of securitizations retain a portion of the risk of a securitization).

[124] See, e.g., Proposed Rule § __.10(b)(6)

affiliate sponsors, advises, or manages the issuer, or organizes and offers the issuer pursuant to the Asset Management Exemption. Banking entities engage in a wide range of typical lending and other transactions that are critical to the existence of the securitization market. The market for ABCP conduits is particularly dependent on banking entities providing a source of liquidity, and the application of Super 23A to such lending vehicles would make it impossible for them to function in their current form.

With respect to securitizations generally, the 23A Prohibition creates doubt about the ability to extend pre-closing warehouse lines of credit to such issuers, enter into interest rate or foreign exchange hedge agreements with such issuers, or create wholly or partially synthetic securitizations, all of which are customary arrangements in the securitization market. Application of the 23A Prohibition could therefore significantly limit securitizations, and would be a particular obstacle for banking entities that have affiliates engaged in asset management. Furthermore, as drafted, the 23A Prohibition could be read to effectively prohibit banking entities from purchasing any securities (including debt securities) issued by a securitization issuer it sponsors or advises, including in its capacity as underwriter or as a market-maker for such securities.

We therefore recommend that, if the Agencies decline to fully exclude securitization issuers generally from the definition of "covered fund" , the Agencies at a minimum should interpret the 23A Prohibition in a manner consistent with the Securitization Exclusion, and should not apply the 23A Prohibition in the securitization context. This would give effect to the Securitization Exclusion's direction to preserve standard market transactions and would avoid conflict with other parts of Dodd-Frank that have sought to strengthen, not disrupt, the securitization market. As we explain above, the Agencies have ample discretion to interpret the 23A Prohibition in a way that gives effect to the plain language and statutory intent of the Volcker Rule. In this case, the Securitization Exclusion's prohibition against construing any part of the Volcker Rule (including the 23A Prohibition) to limit or restrict a banking entity's ability to sell or securitize loans should require the Agencies to interpret the 23A Prohibition to permit standard market transactions between banking entities and securitization issuers.

4. Application to Existing Securitizations

Many existing securitizations have securities with maturity dates beyond, and contractual commitments that will continue in place until after, the Effective Date and in some cases through and beyond the conformance period. If securitization issuers are not excluded from the definition of covered fund, numerous issues will arise with respect to existing relationships between banking entities and securitization issuers. Some of these issues could be addressed to the extent the Federal Reserve revisits its Conformance Rule.[125] Others could be addressed by the Agencies through their exemptive authority under the Volcker Rule. Unresolved questions regarding whether covered funds will have to dissolve key relationships with covered banking entities, or potentially breach existing contractual obligations, in order to avoid a Volcker Rule violation would be damaging to the securitization market. The Agencies should seek to avoid such a result.

[125] We address in Part IV.A of this Appendix our suggestion that the Federal Reserve revise the Conformance Rule.

D. The Exemptions from the Ownership and Sponsorship Prohibitions Are Too Narrow to Accomplish Their Intended Purpose

The Proposed Rule provides securitizations with two narrow, targeted exemptions from the prohibition on ownership and sponsorship of covered funds that attempt to partially resolve the difficult issues described above. First, the Loan Securitization Exemption would apply to securitizations the assets of which are exclusively loans.[126] Second, the Risk Retention Exemption would permit banking entities to own or sponsor a securitization issuer that is a covered fund, but only to the extent necessary to comply with the risk retention requirements in Section 15G of the Exchange Act (Section 941 of Dodd-Frank).[127] In some cases, securitization issuers and banking entities might also be able to rely on the generally available exemptions for ownership and sponsorship of covered funds pursuant to the Asset Management Exemption and the Foreign Funds Exemption.

We believe these limited exemptions are too narrow to prevent the Volcker Rule from seriously interfering with common securitization structures. Moreover, none of these exemptions as implemented in the Proposed Rule would provide relief from the 23A Prohibition. As a result, we believe the Proposed Rule, as currently drafted, could severely disrupt the securitization market. Rather than forcing banking entities to conform their securitization activities to these narrow, partial exemptions, the Agencies should entirely exclude securitizations from the Volcker Rule's scope.

1. The Loan Securitization Exemption

Congress directed that "nothing" in the Volcker Rule was to "limit or restrict the ability of a banking entity . . . to sell or securitize loans".[128] The loan securitization exemptions in the Proposed Rule, however, apply only if the securitization issuer's assets are "solely" comprised of loans, contractual rights or assets directly arising from those loans, or interest rate or foreign exchange derivatives that materially relate to those loans.[129] This formulation fails to account for the fact that most loan securitizations include some assets other than "loans" as defined in the Proposed Rule, including other asset-backed securities, synthetic securities referencing other debt and hedge agreements, as well as cash and cash equivalent investments.[130]

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126 Proposed Rule § __.13(d), § 14(a)(2)(v).

127 Id. § __.14(a)(2)(iii).

128 BHCA § 13(g)(2).

129 Proposed Rule § __.13(d) and § 14(c)(2)(v). A "loan," in turn, is defined to mean "any loan, lease, extension of credit, or secured or unsecured receivable." Proposed Rule § __.2(q). As currently drafted, it appears that the Proposed Rule might even prohibit an issuer relying on Section __.13(d) from holding cash, unless that cash directly arose from loans in the pool. Although we assume this is a technical oversight, if applied literally it could be a significant problem for the formation and collateralization stages of a securitization.

130 In addition, lenders to companies that become distressed may receive equity interests or other securities in the context of a workout or restructuring, all of which could become assets of loan-based securitizations that hold loans to such companies. Although such "work-out" assets should be deemed to be "directly

We are concerned that the limits on the types of assets held by issuers relying on the proposed Sections __ 13(d) or 14(a)(2)(v) could exclude many legitimate securitizations from the exemption, with the result that securitizations that are commonly understood in the market to be loan securitizations would become subject to the Volcker Rule's limits on ownership and sponsorship of covered funds. If the Agencies do not fully exclude securitizations from the definition of covered fund as we recommend, they should at a minimum (i) revise the exemption to permit a securitization issuer relying on the exemption to hold cash and cash equivalent investments, as well as to provide greater flexibility in an issuer's use of interest rate, foreign exchange and credit swap hedging agreements, (ii) clearly indicate that the benefit of the Loan Securitization Exemption is not lost if a securitization receives non-loan assets in a workout, restructuring or other similar situation, and (iii) revise the exemption to permit a securitization issuer relying on the exemption to hold assets other than loans, such as asset-backed securities or synthetic securities referencing other debt, perhaps subject to a maximum of at least 10% of the issuer's total assets.

We note that the Agencies have specifically requested comment on whether the definition of "loan" should be narrowed to exclude securities, or expanded to include other types of traditional banking products. As noted, many securitization vehicles, and ABCP conduits in particular, acquire ownership of loans indirectly through the purchase of variable funding notes, trust certificates, asset-backed securities (including securities issued by intermediate vehicles in a securitization of loans) and other instruments that may be considered securities. ABCP conduits also may extend financing through repurchase agreements in addition to secured loans. Economically, however, all these arrangements are consistent with providing funding or extensions of credit to customers. Given these longstanding practices and Congress's direction to interpret the Volcker Rule so as to not limit or restrict the ability of a banking entity to sell or securitize loans, we believe the definition of "loan" should not be narrowed to exclude securities such as bonds, variable funding notes and asset-backed securities collateralized predominantly by loans and financial assets, and other similar instruments.

2. The Risk Retention Exemption

Section __.14(a)(2)(iii) of the Proposed Rule provides another limited exemption for banking entities to sponsor and hold ownership interests in securitization issuers, but only to the extent that the banking entity is, as "securitizer" or "originator", required to hold an "economic interest in a portion of the credit risk for an asset-backed security . . . in compliance with the minimum requirements of section 15G of the Exchange Act . . . and any implementing regulations issued thereunder."[131] This exemption is also very narrow, applying only to the "securitizers" and "originators" of a securitization, and only to the extent that holding an ownership interest in an issuer is necessary to satisfy the 5% credit-risk retention requirement in Section 15G.

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arising" from the issuer's loans and therefore permitted within the exemption, the Agencies should clarify this point in the final rule.

131 Id. § __.14(a)(2)(iii). Section 15G of the Exchange Act was added by Section 941 of the Dodd-Frank Act and requires "securitizers" (and in some cases "originators") to retain at least 5% of the credit risk of their transactions. The federal agencies charged with promulgating rules to implement this requirement have issued proposed rules for comment but have not finalized them. See 76 Fed. Reg. 24,090 (Apr. 29, 2011).

Even for banking entities that are able to rely on the Risk Retention Exemption, the current proposal raises many difficult questions. For example, it is not clear whether a banking entity may choose any of the available risk options under Section 15G of the Exchange Act, or if the Volcker Rule would require the banking entity to limit itself to the smallest possible ownership interest. More fundamentally, as discussed above, it is unclear which securities issued by a securitization issuer would be "ownership interests" that a banking entity would hold pursuant to this exemption. (A securitizer that holds debt securities of a securitization issuer to satisfy Section 15G would also have to contend with the 23A Prohibition, which could prohibit investments in such securities if the securitizer were deemed to be a sponsor or advisor to the issuer.) In addition, the prohibition on ownership could conflict with risk retention requirements in other jurisdictions, which may require an originator or securitizer to retain risk if securities are being offered in their jurisdiction. For example, Article 122a of the Banking Consolidation Directive (Directive 2006/48/EC, as amended) includes risk retention requirements that are required for purchases of ABS by credit institutions in the European Union. If the risk retention under such requirements would be greater than the minimum requirements of Section 15G, U.S. participants in the securitization market could be greatly disadvantaged by not being able to offer and sell securities outside the United States. If the Agencies decline to exclude all securitizations from the Volcker Rule generally, these ambiguities and potential conflicts must be addressed in the final rule.

3. The Asset Management Exemption

As currently drafted, the Asset Management Exemption appears not to be helpful in the context of securitization. It would permit a banking entity to invest in a covered fund that it has organized and offered provided that the investment does not exceed 3% of "the total amount of outstanding ownership interests" of the fund.[132] As explained above, the concept of "ownership interest" is problematic in securitizations. To the extent that ownership interest refers to the most junior class in the capital structure, such a class comprises only a portion of the overall capital structure. Because 3% of the most junior class would represent a negligible portion of a securitization issuer's securities, such a formula would effectively foreclose banking entities from relying on the Asset Management Exemption with respect to holding ownership interests in securitizations.

4. The Foreign Funds Exemption and Securitization Outside the United States

Foreign banks rely on securitization issuers and similar vehicles for a number of purposes, including increasing available funding for commercial lending activities through structuring, offering and making markets in a variety of asset-backed securities, raising capital through special purpose issuers of capital qualifying securities, and providing financing for a wide range of operating companies through asset-backed commercial paper conduits.

The Foreign Funds Exemption could be a viable alternative for certain securitization activities of foreign banks outside of the United States, but the constraints it places on the marketing and sales of such foreign covered funds are unjustified and inappropriate in the

132 Proposed Rule § __.12(a)(2)(i)(B).

context of securitization. As described in Part III of this letter, the Proposed Rule's requirement that a banking entity not utilize personnel or affiliates located in the United States in connection with offers or sales of ownership interests in covered funds improperly limits the reach of the Foreign Funds Exemption. Likewise, the U.S. Marketing Restriction could cause severe disruptions in foreign securitization activities if interpreted in a manner that expands the Restriction beyond its plain language or intended effects.[133]

The Foreign Funds Exemption also currently addresses only the ownership and sponsorship limitations, and does not affect the application of the 23A Prohibition. The 23A Prohibition would prohibit international (and U.S.) banks from providing financing or liquidity support to, purchasing assets from, or otherwise engaging in "covered transactions" with, the securitization vehicles they advise or sponsor that are deemed to be covered funds. Such transactions are critical to the viability of many securitization structures.

If the Agencies decline to exclude all securitizations from the Volcker Rule generally, these issues should be addressed in the final rule to avoid unnecessary and unintended harm to the securitization markets in the United States and abroad, particularly at a time when expanding access to credit is critical for economic recovery.

### E. Authority for Excluding Securitization Issuers from the Covered Fund Definition

The simplest path to resolving these issues in a manner consistent with the statutory language and congressional intent would be to exclude securitization issuers altogether from the definition of covered fund. As discussed in Part X, we believe that the Agencies have the authority to revise the covered funds definition by interpretation either to move to a characteristics-based approach or exclude entities such as securitization issuers that Congress did not intend to regulate as covered funds. An exclusion for securitization would be consistent with Congress' explicit directive in the Securitization Exclusion that nothing in the Volcker Rule should be construed to limit or restrict the ability of a banking entity to sell or securitize loans. An exclusion from the definition of covered fund would also be consistent with the Agencies' exemptive authority under BHCA Section 13(d)(1)(J), because it would enhance the safety and soundness of banking entities, improve financial stability and encourage economic activity and growth.

## XIV. Other Suggested Revisions and Clarifications

### A. Clarifications to the Definition of Sponsor

Under the Proposed Rule, a banking entity is deemed the "sponsor" of a fund if it (i) serves as general partner, managing member, trustee or CPO; (ii) in any manner selects or controls (or has employees, officers, directors or agents who constitute) a majority of the directors, trustees, or management of a fund; or (iii) shares with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[134] Application

[133] See Part III.B.3, above.

[134] See Proposed Rule § __.10(b)(5).

of this definition in practice raises numerous technical issues, the most important of which are described below.

1. Selection of the Initial Directors or General Partner of a Fund

We recommend the Agencies clarify that the reference to a banking entity selecting a majority of the directors, trustees or management of a covered fund applies where a banking entity has the ability to select such persons on an ongoing basis. It should not apply in situations where the banking entity plays a role in selecting the initial directors of a fund at the time the fund was formed, if such directors are subsequently independent and may not be removed and replaced in the banking entity's discretion. Similarly, a banking entity should not be deemed to sponsor a fund if it selects an independent general partner, managing manager or trustee of a new fund, so long as such general partner, managing member or trustee may not be terminated and replaced in the banking entity's discretion. Such an approach would be consistent with current BHCA doctrines of control in the fund context, which focus on the current authority to control the operations and management of a fund (by, for example, having the authority to replace a general partner).

2. Commodity Pool Operators

We recommend the Agencies remove banking entities that serve as CPO from the definition of sponsor. Although CPOs sometimes also serve as the general partner of a fund (or the equivalent) with the power to direct management and control the operations of the fund, the status of CPO is not always associated with such powers. In some cases an investment adviser to a fund that is also a commodity pool will register as the CPO of the fund even though it does not serve as general partner or the equivalent.[135] A CPO should be treated as a sponsor only if it meets the other statutory criteria as a sponsor under the Volcker Rule (e.g., if it has the power to select or control (or has employees, officers, directors or agents who constitute) a majority of the directors, trustees, or management of a fund).

3. The Name Sharing Prohibitions

The Agencies should clarify that the prohibitions on sharing a name with a covered fund would permit a banking organization's sponsored and/or advised funds to use the

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135 The CFTC has interpreted a CPO to be the person or entity with day-to-day authority over the operation of the pool, including authority to retain or change the pool's advisor or broker, similar to the general partner or managing member of a fund. In some cases, however, investment managers or other entities related to a fund may opt to be designated as a commodity pool's CPO. While the CFTC has indicated that a registered investment company's underwriters, investment advisers, depositors or sponsors, who might be regarded as within the literal scope of the CPO definition, are generally not CPOs, in another context the CFTC staff has taken the position that the entity engaged in arranging, promoting and underwriting a corporate fund, and not the fund's directors, should be regarded as the fund's CPO. See, e.g., 50 Fed. Reg. 15868, 15,871 (Apr. 23, 1985); CFTC Interpretative Letter No. 85-16 (Aug. 15, 1985) (sponsors and underwriters of insurance companies also generally not CPOs); CFTC Interpretative Letter No. 86-8 (Apr. 4, 1986) (the activities of an investment adviser to a trust are analogous to the investment activities of an investment adviser to an investment company); CFTC Interpretative Letter No. 92-3 (Jan. 29, 1992) (taking the position that the entity engaged in arranging, promoting and underwriting a corporate fund, and not the fund's directors, should be regarded as the fund's CPO).

name of the banking entity's asset management affiliates so long as such affiliates do not bear the name (or a variation of such name) of any of their insured depository institution affiliates or the ultimate parent of such insured depository institution affiliates. Banking entities with asset management arms have devoted substantial time and resources to developing the value of their asset management brands, and the costs of forced rebranding would far outweigh any potential benefit in terms of reducing the risk that a banking entity may be pressured to "bail out" its funds. (Indeed, we believe the application of the 23A Prohibition to advised and sponsored covered funds and the prohibition on guaranteeing a fund's obligations under the Asset Management Exemption definitively mitigates the risk of such bail outs.)

The Agencies should also clarify that the name sharing prohibition does not apply in the context of offering documents that carry the names of the manager, sponsor, distributor, etc. as well as the name of the fund itself. For clarity's sake, we also ask the Agencies provide clear guidance on how similar a name must be before it is deemed a prohibited "variation of the same name" under the definition of sponsor and the Asset Management Exemption.

B. Clarifications and Revisions to the Application of the Per-fund and Aggregate Investment Limits under the Asset Management Exemption

1. Cure Periods for Passive Breaches of the Per-fund and Aggregate Asset Management Exemption Investment Limits

The Agencies should provide a cure period for passive breaches of the 3% per-fund and aggregate investment limits imposed under Section __.12 of the Proposed Rule. In some cases, a banking entity may exceed these limits due to events beyond the banking entity's control, such as a decline in Tier 1 capital, third-party investor redemptions, or even appreciation in the value of the banking entity's investments due to the performance of the underlying funds. We recommend that the Agencies include a six-month cure period for banking entities to bring their investments back within the per-fund and aggregate investment limits under Section __.12 following any date on which the banking entity discovers that it has exceeded such a limit for reasons other than a contribution of capital to a covered fund by the banking entity that the banking entity knows or should know would cause a limit to be exceeded.

2. Timing of Calculation of Investment Limits

The 3% per-fund limit for investments in covered funds permitted under Section __.12 of the Proposed Rule would be required to be calculated as often as redemptions are allowed or valuation is calculated for the particular fund, but no less frequently than quarterly. For certain hedge funds, this could be as frequently as daily. We do not believe the requirement for daily monitoring is necessary or justified, and it would impose significant compliance burdens on banks to engage in daily monitoring of their interests in covered funds as compared to the funds' overall investments. We recommend that the Agencies require banking entities to make these calculations on a quarterly basis, consistent with the calculation of a banking entity's aggregate fund investment limits.

3. Application of the Aggregate Asset Management Limit and Deductions from Tier 1 Capital to Foreign Banking Organizations

Under the statute and the Proposed Rule, a banking entity's aggregate investments in funds pursuant to the Asset Management Exemption are limited to 3% of the banking entity's tier 1 capital, and the aggregate amount of such investments must also be deducted from a banking entity's tier 1 capital. The Proposed Rule does not address how these requirements would be applied to foreign banking organizations. We assume that they will be applied consistent with traditional practices regarding the capital of foreign banking organizations, and request that the Agencies confirm that foreign banks would use their consolidated tier 1 capital as calculated under home country standards for purposes of the 3% aggregate limitation and that a capital deduction would not be applied to those home country calculations of tier 1 capital.

4. Investments in Feeder Funds

Under our understanding of the Proposed Rule and preamble, a banking entity would be permitted to acquire and hold more than 3% of the interests in a single feeder fund in a master-feeder structure, so long as, on an aggregate basis, the banking entity's investment in the entire master-feeder structure represents less than 3% of the interests of the aggregate structure. This would reflect the reality of many master-feeder structures, where individual feeder funds, established for a variety of administrative and other reasons, only invest in interests of the master fund (and in highly liquid assets reserved to meet redemption requests and other liquidity needs). We recommend that the Agencies clarify this understanding in the final rule.

C. "DPC" Authority

We request that the Agencies provide guidance regarding the permissible holding periods for ownership interests in covered funds acquired in the ordinary course of collecting a debt previously contracted. The analogous "DPC" provision in Section 4 of the BHCA and the Federal Reserve's Regulation Y, which provides for an initial holding period of two years with the possibility of extensions, would seem to be an appropriate model for the divestiture process for DPC interests in the Volcker Rule context.[136]

D. Insurance Company Investments in Covered Fund Interests

BHCA Section 13(d)(1)(F) permits banking entities that are regulated insurance companies and their affiliates to purchase and sell securities and other financial instruments for the general account of the insurance company (the "Insurance Exemption"). For the same reasons set forth in Part IX.B.1 above, we think it is clear from the plain language of Section 13 and the absence of any legislative history to the contrary that the scope of the Insurance Exemption includes all activities otherwise prohibited under BHCA Section 13(a), including investing in covered funds. The Proposed Rule, however, applies this exemption only to the proprietary trading prohibition in Section __.3(a), and not to the fund sponsorship and

136 See BHCA § 4(c)(2) and 12 C.F.R. § 225.22(d)(1) (permitting up to three years of extensions from the Federal Reserve, and more limited authority for an additional five years under certain circumstances).

investment prohibition in Section __.10(a). We believe that this would be an unjustified narrowing of the scope of the Insurance Exemption.

We urge the Agencies to interpret the Insurance Exemption according to its plain statutory language, to allow trading in any security, derivative or other instrument—including interests in covered funds and fund-linked products—for the general account of a regulated insurance company. Insurance companies, which are subject to prudential regulation of their investment activities, frequently invest a portion of their assets in covered funds as a legitimate means of diversification and management of assets. Applying the covered fund restrictions to insurance companies affiliated with banking entities would place them at a significant disadvantage as compared to insurance companies that are not affiliated with a banking entity.