



## Hong Kong Investment Funds Association

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February 20, 2012

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Washington, D.C. 20429

Elizabeth M. Murphy  
Secretary  
Securities and Exchange Commission  
100 F Street, N.E.  
Washington DC 20549

Dear Sir/Madam

**Re: Comments on OCC Docket No. OCC-2011-14; FRB Docket No. R-1432 and RIN 7100 AD 82; FDIC RIN 3064-AD85; and SEC File No. S7-41-11: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds**

We refer to the submission made by the European Fund and Asset Management Association (“EFAMA”) dated February 13, 2012 with respect to the captioned releases, which propose rules to implement Section 619 of the Dodd-Frank Act (“Rules”). (Appendix 1 – submission by EFAMA.)

Similar to EFAMA, members of the Hong Kong Investment Funds Association (Appendix 2 - HKIFA backgrounder and a list of HKIFA members) are concerned about the extra-territorial impacts of the proposed Rules. The Rules, as currently drafted, will raise a number of issues for non-U.S.-based fund managers (including members of our Association). We share the concerns that are covered in the EFAMA submission and respectfully exhort the Agencies to consider the recommendations put forward by EFAMA.

In particular, we believe it is pertinent to recalibrate the Rules on a number of key areas:

- Revise the definition of “covered funds” so as to ensure that non-U.S. regulated funds are accorded the same treatment as U.S. mutual funds.
- Revisit the scope and definitions of the key terms (such as ‘solely outside of the US’, ‘resident of the U.S.’, ‘foreign funds’, ‘sponsors’) so as to align with existing market practices, and/or to ensure that exceptions or reliefs can practically be used or applied.
- Amend the Rules so that exception from the proprietary trading prohibitions should not only be available to U.S. Government securities, but to non-U.S. Government

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securities as well.

- Provide carve-outs for national pension schemes (similar to ‘qualified plans’ under IRC section 401). This exemption should apply whether beneficiaries are U.S. residents or not, as employees may change their domiciles during their working lives.

We believe that as an overall policy, the Agencies should strike an appropriate balance – whilst attempting to achieve the Rules’ objectives, they should avoid putting in measures that unnecessarily restrict activities that do not pose risks to the financial stability of the U.S.

We welcome the opportunities to discuss the aforesaid and if you require clarifications or need additional information, please do not hesitate to contact the undersigned on (852) 2537 9912 or email me at [hkifa@hkifa.org.hk](mailto:hkifa@hkifa.org.hk).

Yours sincerely,



Sally Wong  
Chief Executive Officer

Encl.

February 13, 2012

**VIA ELECTRONIC DELIVERY**

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Re: Comments on OCC Docket No. OCC-2011-14; FRB Docket No. R-1432 and RIN 7100 AD 82; FDIC RIN 3064-AD85; and SEC File No. S7-41-11: *Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*

Dear Ladies and Gentlemen:

This letter is respectfully submitted by the European Fund and Asset Management Association (“EFAMA”) in response to a request by the Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System (“Board”), Federal Deposit Insurance Corporation, U.S. Securities and Exchange Commission (“SEC”), and Commodity Futures Trading Commission (“CFTC”) (individually, an “Agency,” and collectively, the “Agencies”) for comments regarding the above-referenced releases, which propose rules to implement Section 619 of the Dodd-Frank Act, commonly known as the Volcker Rule (the “proposed rules”).<sup>1</sup>

EFAMA is the representative trade association for the European investment management industry at large. EFAMA was founded in 1974 under the name “European Federation of Investment Funds and Companies” (“FEFSI” was its French acronym) and changed its name to EFAMA in 2004 to reflect a focus on representing the interests of European investment funds and asset management firms as well as those of national industry trade associations.

Today, EFAMA represents 27 member associations and 46 corporate members who collectively manage over EUR14 trillion in assets. The contributing national associations are located in

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<sup>1</sup> See 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) [hereinafter the “Agency Proposing Release”]; Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Covered Funds, 77 Fed. Reg. [ ] ([ ], 2012) [hereinafter the “CFTC Proposing Release” and, collectively with the Agency Proposing Release, the “Proposing Releases”]. As of the date hereof, the CFTC Proposing Release had not been published in the Federal Register. EFAMA proposes to submit a substantially similar comment letter to the CFTC once the CFTC Proposing Release is formally published in the Federal Register.

Austria, Belgium, Bulgaria, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Ireland, Italy, Liechtenstein, Luxembourg, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, Switzerland, Turkey and the United Kingdom, with Malta being an observer. EFAMA's corporate members include large and mid-sized asset managers located in Europe, including European affiliates of a number of major U.S. asset management groups.

## RECOMMENDATIONS AND SUMMARY OF COMMENTS

EFAMA would like to thank the Agencies for giving non-U.S. asset managers the opportunity to comment on the proposed rules. EFAMA hopes that the Agencies will find this submission helpful in developing a regulatory framework that is consistent with the mandates set forth by the U.S. Congress in the Volcker Rule and effectively protects the safety and soundness of banking entities and the stability of the U.S. financial system, while at the same time not unnecessarily restricting or burdening business and conduct outside the United States that do not in any meaningful way pose a threat to the stability of the U.S. financial system.

EFAMA recognizes the challenges the Agencies face in implementing the Volcker Rule and the need to prevent banking entities in the United States from seeking to circumvent the requirements of the Volcker Rule by choosing to conduct otherwise prohibited activities outside of the United States. We believe, however, that, in their current form, the proposed rules represent an inappropriate extraterritorial application of United States jurisdiction and significantly exacerbate the negative impact that the Volcker Rule will have on the European fund and asset management industry without measurably furthering the purpose or intent of the Volcker Rule.

EFAMA believes that these problems can be avoided, or at least substantially mitigated, without sacrificing the objectives of the Volcker Rule, through revisions to the proposed rules to clarify the application of several provisions and to tailor the scope of other provisions that EFAMA believes are over-inclusive and unfair to non-U.S. funds and their asset managers and other service providers. Please see Exhibit A for a summary of the questions in the Proposing Releases referenced herein and cross-references to the specific sections of this letter in which the relevant questions are referenced.

More specifically, EFAMA recommends that the Agencies:

- 1. Revise the definition of “covered fund” so that non-U.S. regulated funds<sup>2</sup> are treated similarly to their U.S. counterparts, *i.e.*, mutual funds and other investment companies that are registered with the SEC under the Investment Company Act of 1940 (the “1940 Act”) or are not required to register without relying on Sections 3(c)(1) or 3(c)(7) of the 1940 Act.**

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<sup>2</sup> Throughout this letter, references to “non-U.S. regulated funds” are intended to capture funds that are organized outside of the United States and are subject to investment fund regulation under the laws of a country other than the United States.

The proposed rules define covered fund to include not only hedge funds and private equity funds that actually rely on Section 3(c)(1) or 3(c)(7) of the 1940 Act to avoid investment company status, but also investment funds that are organized outside the United States and are not offered to U.S. investors but would be covered funds if the funds were offered to U.S. residents. The breadth of this definition is such that, absent clarification, it could result in every regulated fund organized outside the United States being considered a covered fund, even though the intent is presumably only to capture traditional non-U.S. hedge funds and private equity funds.

**2. Clarify and, if necessary, broaden the scope of the “solely outside of the United States” exception for covered fund activities to conform to industry norms and market practices as reflected in Regulation S under the Securities Act of 1933 (the “1933 Act”) to better effect Congressional intent and to limit the extraterritorial impact of the Volcker Rule’s provisions, and to provide that non-U.S. banking entities that take reasonable steps to avoid offering and selling covered funds to U.S. investors should benefit from the exception even if U.S. residents nevertheless circumvent such steps and purchase interests in such covered funds.**

As proposed, the “solely outside of the United States” exception for covered fund activities is so narrowly drawn that it is unlikely to be available to many non-U.S. banking entities’ covered fund activities even though they take place “outside the United States” as that concept has been widely understood for years for purposes of the U.S. securities laws. Moreover, the inconsistency of the term “resident of the United States” in the proposed rules with the term “U.S. person” in the SEC’s Regulation S could lead to increased compliance costs, significant structural changes to the markets for some non-U.S. covered funds, and competitive disadvantages for certain U.S. investment advisers, all without any measurable benefit or policy justification.

**3. Clarify that (i) both non-U.S. regulated funds and non-U.S. covered funds that qualify for the “solely outside of the United States” exception from the Volcker Rule’s restrictions on covered fund activities should not be considered “banking entities” and (ii) non-U.S. covered funds that qualify for the solely outside of the United States exception should not be subject to the “Super 23A” restrictions under Section \_\_.16 of the proposed rules.**

Surprisingly, covered funds that qualify for the sponsored fund exception (discussed below) are excluded from the definition of a banking entity, but non-U.S. regulated funds and non-U.S. covered funds that qualify for the “solely outside of the United States” exception are not. This appears to be solely an unintended consequence of the proposed rules, and not reflective of any intent to limit the ability of such funds to engage in proprietary trading, and accordingly should be corrected in the final rules. Another apparent unintended consequence of the proposed rules that must be addressed in the final rules is the potential extraterritorial application of the Super 23A prohibitions to covered funds that are managed by a banking entity relying on the solely outside the United States exception. In the absence of relief, the covered fund that has the least connections to the United States could be subject to the harshest restrictions without any policy justification for such a result.

**4. Modify the “sponsored fund” exception and clarify the meaning of the term “established” with respect to the sponsorship of covered funds by banking entities.**

In its current form, many managers of non-U.S. covered funds would be unable to rely on the sponsored fund exception because of conflicts with local law and other requirements. Moreover, unless the concept of when a covered fund is “established” is appropriately defined to conform to market practice, covered banking entities may be unable to reduce their investments in sponsored funds to below three percent within the permitted time frame, which would effectively prevent them from launching many new covered funds in reliance on this exception.

**5. Clarify that banking entities that provide customary custody, trustee and administrative services to non-U.S. regulated funds should not be deemed to be “sponsors” of such funds.**

European and other non-U.S. regulatory regimes impose significant responsibilities on banking entities that serve as custodians, trustees and administrators to non-U.S. regulated funds, which are greater than those imposed on such service providers for U.S. registered investment companies. The proposed rules could potentially cause such service providers to be deemed “sponsors” of non-U.S. regulated funds, potentially causing the relationship between such banking entities and the respective funds to be subject to the restrictions of the Volcker Rule. Such a result would impose significant burdens on custodians, trustees and administrators without furthering the intent or purpose of the Volcker Rule.

**6. Other recommendations for the Agencies.**

EFAMA’s concerns with the proposed rules are not limited to those issues that primarily affect non-U.S. funds and asset managers. EFAMA also shares the concerns of U.S. asset managers generally with respect to many aspects of the proposed rules and encourages the Agencies to revisit the proposed rules in an effort to limit the potential negative impact on asset managers and financial markets generally. Without limiting the generality of the foregoing, EFAMA recommends that the Agencies:

**A. Extend the exception from the proprietary trading prohibitions for U.S. government securities to the obligations of non-U.S. governments.**

The proposed rules contain an exception from the proprietary trading prohibitions for U.S. government securities, but provide no similar exception for the obligations of non-U.S. governments. Not only is there no policy rationale that supports this distinction, but by limiting the ability of U.S. and non-U.S. banking entities to trade in such securities, the Volcker Rule could substantially reduce available liquidity in the global markets for sovereign debt, with negative implications for global economic conditions, and indirectly increase the risk of financial instability in the United States.

**B. Exercise maximum flexibility in implementation of the Volcker Rule’s provisions to minimize the negative impact on market liquidity.**

EFAMA is concerned that the proposed rules could adversely impact market liquidity generally. Open-ended investment funds, including UCITS and other non-U.S. regulated funds, are especially dependent upon the availability of adequate liquidity in the markets to satisfy redemption requests. EFAMA believes that the Agencies should take all necessary steps to limit unnecessary adverse impacts on the liquidity and efficient operation of the securities markets.

**C. Clarify that the underwriting, market making and insurance company exceptions provided for in the Volcker Rule are equally applicable to banking entities’ covered fund activities as they are to their proprietary trading activities.**

The proposed rules do not include a specific exception from the covered fund activities prohibitions for underwriting, market making and insurance company general account investments as is included for proprietary trading activities. This distinction is not supported by the statutory text of the Volcker Rule and does not further the purpose or intent of the Rule.

**D. The Agencies should apply the final rules and exceptions flexibly, focusing on substance over form, to achieve the Volcker Rule’s objectives without unnecessarily restricting activities that do not pose risks to the financial stability of the United States.**

A strict, literal application of the terms of the proposed rules could inadvertently restrict or even prohibit investments or activity that substantively are no different, and pose no greater risks, than activities that are expressly permitted under the proposed rules. EFAMA would like to highlight and request clarification of the Agencies’ treatment in three such cases, namely, managed account platforms, feeder funds investing in U.S. mutual funds, and investments in unaffiliated covered funds, all of which relate to non-U.S. covered funds that may not qualify for the solely outside the United States exception.

## **DETAILED DISCUSSION OF SPECIFIC COMMENTS AND RECOMMENDATIONS**

**1. The Agencies Should Revise the Definition of “Covered Fund” to Exclude Non-U.S. Regulated Funds to the Same Extent as their U.S. Counterparts. (Reference Is Made to Questions 217, 221, 223, 224, and 225 of the Proposing Releases.)**

EFAMA’s greatest concern with the proposed rules is the potentially disparate treatment of U.S. registered investment companies, on the one hand, and UCITS<sup>3</sup> and other regulated investment

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<sup>3</sup> UCITS, or “undertakings for collective investment in transferrable securities,” are collective investment schemes established and authorized under a harmonized European Union (“EU”) legal framework, currently EU Directive 2009/65/EC, as amended (“UCITS IV”), under which a UCITS established and authorized in one EU Member State (“Member State”) can be sold cross border into other EU Member States without a requirement for an additional full registration. This so-called “European passport” is central to the UCITS product and enables fund promoters to create a single product for the entire EU rather than having to establish an investment fund product on a jurisdiction by jurisdiction basis.

funds available to European investors, on the other. As discussed in greater detail below, U.S. registered investment companies are not considered to be covered funds under the proposed rules, while their regulated non-U.S. counterparts appear to be treated as covered funds. Accordingly, under the proposed rules, banking entities may sponsor and invest in U.S. registered investment companies largely without limitation, but, for all practical purposes, under the proposed rules could be prohibited from equivalent activities involving UCITS and other non-U.S. regulated funds.

No policy reason or justification for this unequal treatment of very similar investment products is offered in the proposed rules. As a result, EFAMA believes that this may simply be an unintended consequence of the Agencies' attempts to prevent banking entities from circumventing the Volcker Rule's restrictions by moving their activities outside of the United States.

***Description of the Problems.*** The Volcker Rule seeks to restrict a banking entity's relationships with "hedge funds" and "private equity funds" each of which terms is defined by the statute as an issuer that would be an investment company as defined in the 1940 Act but for Section 3(c)(1) or 3(c)(7) of the 1940 Act, or such similar funds as the Agencies may determine in the implementing regulations.<sup>4</sup> Implicitly excluded from this definition are issuers that are registered with the SEC under the 1940 Act as investment companies or are able to rely on other exceptions under the 1940 Act to avoid investment company status.

The proposed rules define the term "covered fund" by restating the statutory definition of hedge fund and private equity fund, and, through the use of the "similar funds" authority, expand the term to also treat as a covered fund both (i) "a commodity pool, as defined in Section 1a(10) of the Commodity Exchange Act" and (ii) "any issuer . . . that is organized or offered outside of the United States that would be a covered fund . . . were it organized or offered under the law, or offered to one or more residents, of the United States or of one or more States."<sup>5</sup> Registered investment companies, and other issuers that are able to rely on exceptions other than Section 3(c)(1) or 3(c)(7) to avoid investment company status, are excluded from the definition of covered fund.<sup>6</sup>

The second of these additions to the term covered fund is the primary source of the confusion and concern for non-U.S. managers. The very broad phrasing of this portion of the definition arguably encompasses not only non-U.S. hedge and private equity funds but also most non-U.S. regulated funds, including UCITS and other European regulated funds, because, were they to offer ownership interests to U.S. residents, they could be considered investment companies but for Section 3(c)(1) or 3(c)(7).

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<sup>4</sup> See 12 U.S.C. § 1851(h)(2).

<sup>5</sup> See Section \_\_\_\_ .10(b)(1) of the proposed rules.

<sup>6</sup> See notes 71 and 222 to the Agency Proposing Release, notes 76 and 228 of the CFTC Proposing Release and accompanying text.



The rationale supporting the exclusion of U.S. registered investment companies from covered fund status is equally applicable to non-U.S. regulated funds, such as UCITS and other European regulated funds. Like U.S. registered investment companies, non-U.S. regulated funds are subject to regulation regarding the manner in which they are managed, the securities and financial instruments in which they may invest and the manner in which interests in the funds may be offered to investors. Moreover, the statutory definition of hedge fund and private equity fund in the Volcker Rule itself arguably does not include non-U.S. regulated funds.<sup>7</sup> However, the proposed rules appear to broaden greatly the scope of the Volcker Rule by including non-U.S. regulated funds within the meaning of “covered fund,” despite the fact that non-U.S. regulated funds are comparable to U.S. mutual funds in all material respects. If the proposed rules are not revised, the Volcker Rule could be applied more restrictively, and to a larger group of funds, outside of the United States than within it.

In addition to greatly broadening the original scope of the Volcker Rule unnecessarily, including non-U.S. regulated funds in the definition of “covered fund” could cause conflicts with legal requirements in other jurisdictions, and would clearly conflict with market practice, which would effectively preclude many banking entities from organizing and offering non-U.S. regulated funds in such jurisdictions. The primary exception under the proposed rules for covered fund activities is the so-called “sponsored fund exception,”<sup>8</sup> to qualify for which a covered banking entity must satisfy a lengthy laundry list of conditions. While many of the conditions would not be objectionable to non-U.S. regulated funds, certain of these requirements are very problematic, as discussed more fully below in Section 4.

***Recommendations to Address the Problems.*** Accordingly, in keeping with the purpose and intent of the Volcker Rule, we recommend that the definition of “covered fund” in the proposed rules be revised to exclude non-U.S. regulated funds, which should be defined to mean funds that are located outside of the United States and are subject to regulation as investment funds under the laws of their home country. EFAMA believes strongly that non-U.S. regulated funds are

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<sup>7</sup> Consistent with statements of the SEC in regard to the treatment of non-U.S. funds, it would be reasonable to conclude that a non-U.S. regulated fund is simply outside of the potential application of the registration provisions of the 1940 Act, and therefore would not be viewed as an investment company that would need to avail itself of the exemptions contained in Sections 3(c)(1) or 3(c)(7) of the 1940 Act to avoid registration in the U.S. under the 1940 Act. *See* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers with Less than \$150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 at n.294 and accompanying text (June 22, 2011) [hereinafter “Advisers Release”] (stating, “a non-U.S. fund is a [pooled investment vehicle that is excluded from the definition of ‘investment company’ under the 1940 Act by reason of Section 3(c)(1) or 3(c)(7)] if it makes use of U.S. jurisdictional means to, directly or indirectly, offer or sell any security of which it is the issuer and relies on either Section 3(c)(1) or 3(c)(7)”).

<sup>8</sup> *See* Section \_\_\_\_11. Certain qualifying foreign banking entities may also offer covered funds in reliance on the exception for covered fund activities that occur solely outside of the United States (see Section \_\_\_\_13(c)), although as discussed in greater detail below, the proposed conditions for that exception substantially limit its availability.

sufficiently regulated such that they are extremely unlikely to pose risks to a banking entity or the interests of the United States that are greater than U.S. registered funds.

*Recognize Regulated Funds.* EFAMA recognizes that different countries take different approaches to regulation of investment funds offered to their residents. There is nothing in the Volcker Rule, however, to suggest that substantive equivalence of an investment fund's home country regulation with that of the 1940 Act is necessary, nor is there any policy reason to require such equivalence, to be accorded comparable relief from the Volcker Rule's restrictions. The critical determinant should be simply whether the home country subjects the fund to regulation, because the hallmark of hedge funds and private equity funds is that they are not subject to regulation.

While publicly offered retail investment funds, which would include UCITS, listed investment trusts in the United Kingdom and other nationally regulated investment funds, are most like U.S. registered investment companies and clearly should be excluded from the definition of covered fund, there are many other types of non-U.S. regulated funds that similarly should not be treated as covered funds. Examples include the Austrian and German *Spezialfonds*, which are nationally regulated investment funds designed specifically for institutional investors, and, accordingly, are *per se* not publicly offered. Such funds are analogous to so-called "1940 Act only" funds offered to institutional investors in the United States. Other examples would include national pension schemes and employee savings schemes, such as the French *fonds communs de placement d'entreprise* ("FCPEs"), which are comparable to U.S. employee benefit plans that are excluded from the definition of investment company by Section 3(c)(11) of the 1940 Act. Neither 1940 Act only funds nor 3(c)(11) qualifying employee benefit plans are covered funds under the proposed regulations, and their non-U.S. counterparts similarly should not be covered funds.<sup>9</sup>

*Limit Scope of Commodity Pool Definition.* The proposed rules further broaden the scope of the Volcker Rule by making any non-U.S. fund that would meet the definition of "commodity pool" in Section 1a(10) of the Commodity Exchange Act<sup>10</sup> (if it were a U.S. fund) a covered fund.<sup>11</sup> This would greatly expand the scope of the Volcker Rule because a commodity pool as so defined is essentially any pooled investment vehicle that engages in futures trading to any extent. Under this definition, virtually every investment fund in the world would be a covered fund, including U.S. registered investment companies, regardless of whether the fund is subject to regulation by a home country supervisory authority. Presumably this expansion of the definition of covered fund was intended to reach hedge funds that invested primarily in commodities and thus would not have been subject to regulation under the 1940 Act. To avoid an unwarranted and unnecessary extension of the Volcker Rule, the proposed regulations should clarify that investment in commodities will not cause either U.S. registered investment companies or non-U.S. regulated funds to be considered covered funds.

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<sup>9</sup> While presumably not necessary, it is worth emphasizing that the Austrian and German *Spezialfonds* and French FCPEs are but three examples of the types of regulated funds available in the other jurisdictions where EFAMA members are organized and operate, which conceivably could be considered covered funds if the proposed regulations are not revised appropriately.

<sup>10</sup> 7 U.S.C. § 1a(10).

<sup>11</sup> See Section \_\_.10(b)(1)(ii)-(iii).

EFAMA believes that these recommended changes are entirely consistent with the purpose and intent of the Volcker Rule and will not endanger the safety and soundness of any banking entity or the financial stability of the United States. Nonetheless, in the event that it were determined that a non-U.S. regulated fund or group or type of non-U.S. regulated funds posed inappropriate risks, EFAMA notes that the Agencies retain broad supervisory authority over the activities of covered banking entities, which would permit the Agencies to address any such risks, regardless of whether these activities are otherwise permitted by the proposed rules.<sup>12</sup> In light of this residual authority, among other reasons, we believe it would be inappropriate to subject non-U.S. regulated funds to restrictions that were designed to apply to funds that are similar to hedge funds or private equity funds. Such an overly restrictive posture would be inefficient, over-inclusive, and unduly harmful to a large number of entities with no apparent benefit to banking entities or the interests of the United States.

**2. The Agencies Should Clarify, and If Necessary Broaden, the Scope of the Exception for Covered Fund Activities Outside the United States to Better Effect Congressional Intent to Limit the Extraterritorial Impact of the Volcker Rule. (Reference Is Made to Questions 138, 139, 140, 293, 294, and 295 in the Proposing Releases.)**

In recognition of the potential negative consequences of applying its provisions extra-territorially, the Volcker Rule includes an exception for certain covered fund activities outside of the United States.<sup>13</sup> Specifically, qualifying non-U.S. covered banking entities<sup>14</sup> that are not controlled directly or indirectly by a U.S. banking entity are permitted to rely on the exception.<sup>15</sup> In order for

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<sup>12</sup> In addition to the Agencies general supervisory powers, the Volcker Rule also establishes limits on transactions or activities that would “result, directly or indirectly, in a material exposure by the covered banking entity to a high-risk asset or a high-risk trading activity” or would “[p]ose a threat to the safety and soundness of the covered banking entity or the financial stability of the United States.” *See* Section \_\_\_\_ .17(a)(2)-(3).

<sup>13</sup> Specifically, the Volcker Rule provides an exception for:

The acquisition or retention of any equity, partnership, or other ownership interest in, or the sponsorship of, a hedge fund or a private equity fund by a banking entity . . . solely outside of the United States, provided that no ownership interest in such hedge fund or private equity fund is offered for sale or sold to a resident of the United States and that the banking entity is not directly or indirectly controlled by a banking entity that is organized under the laws of the United States or of one or more States.

12 U.S.C. § 1851(d)(1)(I).

<sup>14</sup> Qualifying non-U.S. banking entities are those that are able to rely on Sections 4(c)(9) or (13) of the Bank Holding Company Act of 1956 (“BHC Act”) with respect to their non-U.S. covered fund activities. *See* Section \_\_\_\_ .13(c)(1)(ii), (2).

<sup>15</sup> *See* Section \_\_\_\_ .13(c)(1)(i).

the qualifying non-U.S. banking entity to sponsor or acquire an ownership interest in a covered fund in reliance on this authority, however, no ownership interest may be offered or sold to a “resident of the United States,” and the covered banking entity’s activity must occur “solely outside of the United States.”<sup>16</sup> The proposed rules provide that an activity shall be considered to occur solely outside of the United States only if (i) the banking entity involved in the activity is not organized under U.S. law, (ii) no affiliate or employee of the banking entity that is involved in distribution of the covered fund is incorporated or physically located in the United States; and (iii) no ownership interest is offered or sold to a U.S. resident.<sup>17</sup>

**Description of the Problems.** EFAMA believes that, despite the clear intent to limit the extra-territorial reach of the Volcker Rule, the proposed rules draw the conditions of this exception so narrowly that it is unlikely to be available to many non-U.S. banking entities’ covered fund activities even though they clearly take place “outside the United States” as that concept has been widely understood for years for purposes of the U.S. securities laws. The SEC’s Regulation S<sup>18</sup> has since 1990 been the primary source of guidance as to whether securities transactions by non-U.S. issuers have sufficient contacts and effects in the United States to trigger the application of the U.S. securities laws. Regulation S looks at the totality of a non-U.S. fund’s offering, including not only whether U.S. investors acquire securities from the non-U.S. fund, but also whether the non-U.S. fund directly or indirectly is actively seeking to market its securities to U.S. investors, to determine whether the offering occurs outside the United States. By contrast, the proposed rules would deem a qualifying non-U.S. banking entity’s non-U.S. covered fund’s activities to be ineligible for the solely outside of the United States exception if any affiliate or employee involved in the distribution of the non-U.S. covered fund’s securities is organized or physically located in the United States, no matter how immaterial the involvement of the affiliate or employee to the covered fund activities.<sup>19</sup> Similarly, the qualifying non-U.S. banking entity’s non-U.S. covered fund would be ineligible for this exception if any ownership interest is sold to a U.S. resident regardless whether such sale resulted from a deliberate effort to market the fund to U.S. investors or was outside the control of the qualifying non-U.S. banking entity.<sup>20</sup> The more restrictive approach taken by the proposed rules will severely limit the covered fund activities of many non-U.S. banking entities that otherwise would comply with Regulation S.

First, there is a substantial risk that non-U.S. funds, and particularly non-U.S. regulated funds, offered by non-U.S. banking entities will not be able to rely on the exception due to the presence of a limited number of U.S. resident investors. This is partially due to the fact that the proposed rules’ definition of a “resident of the United States” is overly broad, especially in comparison to the Regulation S definition of “U.S. person.” As recognized in the Proposing Releases, the

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<sup>16</sup> See Section \_\_\_\_13(c)(1)(iii)-(iv).

<sup>17</sup> See Section \_\_\_\_13(c)(3).

<sup>18</sup> See 17 C.F.R. §§ 230.902-905.

<sup>19</sup> See Section \_\_\_\_13(c)(3)(ii).

<sup>20</sup> See Section \_\_\_\_13.(c)(3)(iii).

proposed definition of resident of the United States is similar to, but broader than, the definition of U.S. person found in Regulation S under the Securities Act of 1933, as amended (“1933 Act”).<sup>21</sup> The Agencies did not offer any justification, however, as to why they chose to use a different definition. Thus, even where a non-U.S. fund’s procedures and offering documents carefully complied with Regulation S’s limitations and no sales were made to U.S. persons, sales could have been made to investors that would be deemed U.S. residents under the proposed rules. In addition, where a non-U.S. investor in a non-U.S. fund moves to the United States, any new investments in such fund or exchanges of shares of another non-U.S. fund in the same fund family would be considered a “sale” to a U.S. resident, which would cause the non-U.S. regulated fund to lose its ability to rely on the “solely outside of the United States” exception.<sup>22</sup>

Second, because the offer and sale of ownership interests of non-U.S. regulated funds often involve some minimal contacts with the United States, as permitted by Regulation S, many non-U.S. funds will not be able to satisfy the requirement that no subsidiary, affiliate or employee of a non-U.S. banking entity may be involved in the offer or sale. Under Regulation S, offers or sales of non-U.S. funds that involve a foreign issuer and a foreign purchaser that are outside the United States both when the offer is made and the purchase order is placed are deemed to occur “outside the United States,” regardless of whether United States entities are minimally involved in the transaction.<sup>23</sup> It is often the case that U.S. affiliates of non-U.S. banking entities participate in the offer and sale of non-U.S. funds to non-U.S. persons, and EFAMA does not believe that eliminating this common practice will serve to further the purpose or intent of the Volcker Rule.

Third, experience has shown that, notwithstanding the reasonable efforts of non-U.S. banking entities to prevent U.S. residents from investing in their non-U.S. covered funds,<sup>24</sup> investors can and will find ways to circumvent these steps and invest in such covered funds without the knowledge or assistance of the banking entities. Often the non-U.S. banking entity will be unaware that a U.S. resident has managed to acquire ownership interests in one of its non-U.S. covered funds, and, even if it becomes aware of such an investment, may be precluded by national law from forcibly redeeming such investor’s interests or prohibiting purchases by that investor.

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<sup>21</sup> See CFTC Proposing Release, 77 Fed. Reg. at [\_\_\_]; Agency Proposing Release, 76 Fed. Reg. at 68,881-82.

<sup>22</sup> The definition of “sale” and “sell” in the proposed rules mirrors the definitions of those terms found in the 1933 Act and the Exchange Act of 1934. See Section \_\_\_.2(v). With respect to exchanges, courts have commonly found that “sale” or “sell” includes an exchange of a security of one company for a security of another company. See LOUIS LOSS, JOEL SELIGMAN & TROY PAREDES, SECURITIES REGULATION, CH. 3A(2)(A) (Supp. 2011).

<sup>23</sup> See 12 C.F.R. § 230.903(a)-(b)(1). Regulation S deems these types of transactions as “Category 1” transactions.

<sup>24</sup> For example, non-U.S. banking entities typically (i) direct no marketing efforts to U.S. residents, (ii) prominently disclose in a covered fund’s documentation that interests in the fund are not being offered to U.S. residents, and/or (iii) contractually provide that a covered fund’s placement agent is not permitted to contact U.S. residents.

As a result of the restrictive approach taken by the proposed rules in determining whether covered fund activities occur “solely outside of the United States,” many non-U.S. banking entities that have structured their non-U.S. fund operations to avoid marketing and sales of their non-U.S. funds to U.S. persons in full compliance with Regulation S will not be able to satisfy the requirements of the proposed rules without substantial changes to their operations. At a minimum, such non-U.S. banking entities would be required to revise their procedures to monitor two separate compliance regimes, and to update their offering documents and procedures accordingly.

The harm to the fund and asset management industry that likely will result from the proposed definition of resident in the United States is not limited to increased compliance costs. Rather, the different treatment of discretionary accounts under Regulation S and the proposed rules could result in significant structural changes to the markets for certain non-U.S. covered funds. Under Regulation S, a discretionary account with a U.S. adviser held on behalf of a non-U.S. person is considered to be a non-U.S. person,<sup>25</sup> while the proposed rules would treat the discretionary account as a U.S. resident.<sup>26</sup> Accordingly, any non-U.S. covered fund, even a UCITS or other non-U.S. regulated fund, that is managed by a U.S. investment adviser or sub-adviser, potentially could be treated as a U.S. resident under the proposed rules, regardless of whether the non-U.S. fund has any U.S. investors, and could be prohibited from investing in a non-U.S. covered fund by that fund’s manager if the manager is relying on the solely outside of the United States exception. This means that U.S. investment advisers could be placed at a competitive disadvantage in offering non-U.S. funds of hedge funds, and other similar funds that invest in other covered funds, that are offered exclusively to non-U.S. investors because they may be denied the opportunity to invest in many of the available non-U.S. hedge funds which are managed by non-U.S. banking entities. Conversely, non-U.S. banking entities that offer non-U.S. covered funds may be denied access to the investment capital of such funds of hedge funds solely because they are managed by a U.S. investment adviser.

***Recommendations to Address the Problems.*** For all of the above reasons, EFAMA believes that the Agencies should revisit the scope of the solely outside of the United States exception and revise the conditions imposed on qualifying non-U.S. banking entities to better effect the Congressional intent and to limit the extra-territorial impact of the Volcker Rule.

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<sup>25</sup> See 17 C.F.R. § 230.902(k)(2)(i). Regulation S also treats a discretionary account held on behalf of a U.S. person by a non-U.S. adviser to be a non-U.S. person. See *Offshore Offers and Sales*, Securities Act Release No. 6863 (Apr. 24, 1990) (stating that for purposes of Regulation S, an account is not a U.S. person “where a non-U.S. person makes investment decisions for the account of a U.S. person”). In addition to this, unlike Regulation S, which specifically excludes from being a “U.S. person” “the “International Monetary Fund, the International Bank for Reconstruction and Development, the Inter-American Development Bank, the Asian Development Bank, the United Nations, and their agencies, affiliates and pension plans, and any other similar international organizations, their agencies, affiliates and pension plans,” the proposed rules could potentially consider such international entities to be “residents of the United States” as there is no similar exception in the proposed rules. 17 C.F.R. § 230.902(k)(2)(vi).

<sup>26</sup> See Section \_\_\_\_ .2(t)(6)-(7).

*Align with Regulation S.* Question 139 in the Proposing Releases asks whether the definition of “resident of the United States” should “more closely track, or incorporate by reference, the definition of ‘U.S. person’ under the SEC’s Regulation S.”<sup>27</sup> EFAMA believes that the best and most efficient way to achieve the Congressional intent would be to more closely align the conditions of the exception to the approach utilized by Regulation S. This would include at a minimum incorporating by reference the Regulation S definition of “U.S. person” into the “resident of the United States” definition. While the Proposing Releases suggest that having a similar definition to Regulation S “should promote consistency and understanding among market participants that have experience with the concept from the SEC’s Regulation S,”<sup>28</sup> EFAMA submits that by adopting a definition that contains a number of critical differences from the Regulation S definition, the Agencies would create unnecessary confusion and would cast doubt on the ability of market participants to rely on the well-established body of law underlying the Regulation S definition.<sup>29</sup>

The Agencies should also revise the conditions of the solely outside of the United States exception to recognize, as does Regulation S, that the limited involvement of persons located in the United States in the distribution of a non-U.S. covered fund’s securities should not disqualify the fund from relying on this exception.

*Adopt Pragmatic Approach Recognizing Reasonable Efforts to Prevent Sales to U.S. Residents.* Similarly to Regulation S’s acceptance of limited U.S. involvement in marketing, the presence of a limited number of U.S. resident investors in a non-U.S. covered fund offered by a qualifying non-U.S. banking entity should not disqualify the fund from relying on this exception unless the banking entity has actively marketed the fund’s securities to U.S. investors. Accordingly, the Agencies should provide in the final rules or adopting release that qualifying non-U.S. banking entities may still rely on the solely outside the United States exception if they take reasonable steps to prevent U.S. residents from acquiring ownership interests in non-U.S. covered funds.<sup>30</sup>

*Grandfather Existing Offshore Funds.* Regardless of what decisions the Agencies finally make in this area, they should also “grandfather” all existing non-U.S. covered funds and deem them to

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<sup>27</sup> CFTC Proposing Release, 77 Fed. Reg. at [\_\_\_]; Agency Proposing Release, 76 Fed. Reg. at 68,882.

<sup>28</sup> CFTC Proposing Release, 77 Fed. Reg. at [\_\_\_]; Agency Proposing Release, 76 Fed. Reg. at 68,927.

<sup>29</sup> We note that the SEC recently incorporated the Regulation S definition into a regulation implementing a provision of the Dodd-Frank Act, which required a determination of whether a client or investor should be considered to be “in the United States.” See Advisers Release, *supra* note 7. In adopting this regulation, the SEC noted that “Regulation S provides a well-developed body of law with which advisers to private funds and their counsel must today be familiar to comply with other provisions of the federal securities laws.” *Id.*

<sup>30</sup> This approach is consistent with the “reasonable belief” concept that the SEC discussed in the Advisers Release. Such reasonable items could include: (i) direct no marketing efforts to U.S. residents, (ii) prominently disclose in a covered fund’s documentation that interests in the fund are not being offered to U.S. residents, and/or (iii) contractually provide that a covered fund’s placement agent is not permitted to contact U.S. residents.

qualify for the solely outside of the United States exception so long as they met the final rule's requirements on a going forward basis. Failure to provide such relief for existing relationships could cause substantial disruption to non-U.S. covered funds and significantly harm investors with no clear benefit.

While all non-U.S. covered funds offered by qualifying non-U.S. banking entities will benefit from EFAMA's recommended changes, it is worth noting that these changes will be of critical importance to non-U.S. regulated funds if such funds are not excluded from the definition of covered fund. If non-U.S. regulated funds are considered covered funds and the solely outside of the United States exception is not available, then non-U.S. banking entities seeking to invest in or sponsor covered funds outside the United States would be required to comply with the requirements of the "sponsored fund" exception,<sup>31</sup> which, as noted above and discussed in greater detail in Section 4 below, are burdensome and impractical, while U.S. banking entities offering U.S. mutual funds would not be subject to similar restrictions.

*Pragmatic Approach to Compliance Program Rule.* On a related point, EFAMA notes that Section \_\_.20 of the proposed rules generally requires banking entities to develop and administer on an ongoing basis a detailed program to ensure and monitor compliance with the Volcker Rule prohibitions and restrictions, with certain exceptions to the extent a banking entity does not engage to a significant extent in activities that are subject to such prohibitions and restrictions. EFAMA respectfully submits that both non-U.S. regulated funds, which should be excluded from the definition of covered fund as recommended in section 1 above, and covered funds qualifying for the solely outside the United States exception as clarified in accordance with the recommendations discussed in this section 2, should be outside the scope of that compliance program, and requests that the Agencies include confirmation of this point in the final rules or adopting release.

**3. The Agencies Should Clarify (i) that Non-U.S. Regulated Funds and Non-U.S. Funds that Rely on the Solely Outside of the United States Exception Are Not Banking Entities and (ii) that Non-U.S. Funds that Rely on the Solely Outside of the United States Exception Should Not Be Subject to the "Super 23A" Restrictions under Section \_\_.16 of the Proposed Rules. (Reference Is Made to Questions 5, 6, 7, 314, 315, and 316 in the Proposing Releases.)**

The Agencies need to reconsider two aspects of the proposed rules that, if not corrected, could substantially undercut the benefits of the solely outside of the United States exception and the recommended exclusion of non-U.S. regulated funds from the definition of covered fund. Specifically, EFAMA recommends that the Agencies (i) revise the definition of banking entity to exclude both non-U.S. regulated funds and covered funds that rely on the solely outside of the United States exception, and (ii) exclude covered funds that rely on the solely outside of the United States exception from the so-called "Super 23A" restrictions.

*Limit Scope of Banking Entity Definition.* The amendment to the definition of banking entity is necessary to avoid creating the anomalous situation where both non-U.S. regulated funds and covered funds that have the least connections to the United States are subject to the harshest

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<sup>31</sup> See Section \_\_.12.



restrictions. The Proposing Release acknowledges that the Volcker Rule definition of banking entity is so broad, and potentially circular, that a covered fund offered by a banking entity could itself be found to be a banking entity and therefore be subject to a prohibition on proprietary trading.<sup>32</sup> To avoid this clearly unintended result, the proposed rules create an exception for covered funds that rely on the sponsored fund exception,<sup>33</sup> but are silent as to the treatment of both non-U.S. regulated funds and those covered funds relying on the solely outside of the United States exception.

If not corrected, non-U.S. regulated funds and covered funds sponsored by European banking entities that qualify for the solely outside the United States exception could be prohibited from engaging in proprietary trading on behalf of investors in those funds. When coupled with the prohibition on proprietary trading in obligations of non-U.S. governments discussed in Section 6 below, this could lead to absurd results, effectively prohibiting European banking entities from investing not only their own assets, but also their customers' assets, in their home country's sovereign debt. No policy reason was articulated for treating non-U.S. regulated funds or non-U.S. covered funds that have little or no contacts with the United States as banking entities, and accordingly a similar exception to the definition of banking entity should be provided.

*Limit Extraterritorial Reach of Super 23A.* The exclusion of covered funds that rely on the solely outside of the United States exception from application of the Super 23A restrictions is needed to avoid an unnecessary and largely unprecedented application of United States jurisdiction to activities that are unrelated to the United States and do not raise the issues that the Volcker Rule was intended to prevent, while at the same time placing significant burdens on foreign funds and their service providers. The Super 23A restrictions would prohibit a banking entity and any of its affiliates from engaging in a broad range of "covered transactions" with a covered fund for which the banking entity or affiliate serves as an investment manager, commodity trading adviser, or sponsor.<sup>34</sup> These prohibitions are often referred to as the Super 23A restrictions because, while they are based on Section 23A of the Federal Reserve Act, they prohibit transactions that are merely limited under Section 23A and are not accompanied by the related exceptions and qualifications of that Section and Regulation W, its implementing regulation.<sup>35</sup> In addition, in

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<sup>32</sup> CFTC Proposing Release, 77 Fed. Reg. at [\_\_\_]; Agency Proposing Release, 76 Fed. Reg. at 68,855-56.

<sup>33</sup> See Section \_\_\_.2(e)(4).

<sup>34</sup> See Section \_\_\_.16 of the proposed rules. This provision prohibits a banking entity and any affiliate that serves as an investment manager, commodity trading adviser, or sponsor to a covered fund from engaging in any transaction with the covered fund that would constitute a "covered transaction" under Section 23A of the Federal Reserve Act, as if the banking entity and affiliate were a member bank and the covered fund were an affiliate thereof.

<sup>35</sup> See 12 U.S.C. § 371c, as interpreted and implemented by Subparts B through D of Regulation W (12 C.F.R. § 223.11 *et seq.*). Section 23A and Regulation W contain various qualifications and exceptions for various types of transactions that would constitute "covered transactions." However, Super 23A simply prohibits all covered transactions, without regard to whether the covered transactions would be subject to an exception or qualification under Section 23A or Regulation W.

contrast to Section 23A, which is intended to protect a member bank from excessive exposure to the bank holding company and all of its subsidiaries, the Super 23A restrictions are intended to protect the member bank, the bank holding company and all of its subsidiaries from any exposure to the covered funds managed by the banking entity.

Absent clarification in the final rules, the Super 23A restrictions could prohibit not only loans or extensions of credit to a covered fund (the classic “covered transaction”), but also potentially purchases of assets from a covered fund, the acceptance of securities or other debt obligations issued by a covered fund as collateral security for a loan or extension of credit to any person, and a variety of other transactions that could cause the banking entity to have credit exposure to the covered fund. These restrictions would apply to transactions between a banking entity and a covered fund it sponsors, manages, organizes or offers, even where the participants in the transactions are neither incorporated in nor present in the United States, and the transactions are conducted solely outside of the United States.

While one can perhaps understand the policy reasons for applying the Super 23A restrictions to covered funds that comply with the sponsored fund exception, those policy reasons do not support their application to covered funds relying on the solely outside of the United States exception. The sponsored fund exception is based upon a banking entity’s compliance with a series of prudential limitations designed to minimize the risk to the banking entity. By contrast, the solely outside of the United States exception is based upon the fact that the covered fund activities in question are conducted by non-U.S. banking entities outside the United States with such limited U.S. contacts that the extraterritorial application of the Volcker Rule is inappropriate. EFAMA submits that the extraterritorial application of the Super 23A restrictions to these funds is equally inappropriate.

**4. The Agencies Should Modify the “Sponsored Fund” Exception and Clarify the Meaning of Establishment of a Covered Fund. (Reference Is Made to Questions 244, 245, 248, 253, 254, 258, 260, and 263 in the Proposing Releases.)**

If the “sponsored fund” exception and the overall limitations on investments in covered funds are to serve their intended purposes with respect to non-U.S. covered funds, the Agencies must modify these provisions in three principal ways: (1) remove the requirement that a sponsored fund may not share a name with its sponsor where local law requires the opposite; (2) remove the prohibition against directors and employees of banking entities from investing in a sponsored fund when in conflict with local law or other requirements; and (3) clarify the meaning of the term “establishment” with respect to covered funds to more appropriately reflect the realities of launching covered funds.

*Address Name Issues.* Under the sponsored fund exception contained in Section \_\_.11 of the proposed rules, a covered fund may not share the same or a similar name as the sponsoring banking entity or an affiliate or subsidiary of the banking entity.<sup>36</sup> However, certain jurisdictions

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<sup>36</sup> Section \_\_.11(f)(1).

require a fund to have a name that has a direct connection with its sponsor.<sup>37</sup> In such a case, a banking entity subject to the Volcker Rule would be precluded from organizing and offering a covered fund in that jurisdiction because it would not be able to comply with both the Volcker Rule and the local requirements. Therefore, to fully implement the intent of this exception for non-U.S. covered funds, it is necessary, at a minimum, to clarify that a sponsored fund would not be precluded from sharing its name with the sponsoring banking entity or its affiliates where doing so is required by local law.

In addition, the Agencies should also adopt an alternative approach to the name issue that could mitigate most of the concerns around the name issue while still addressing the underlying rationale for this provision in the Volcker Rule. More specifically, the policy concern appears to be that a covered fund's use of a name that is similar to the name of the insured depository institution might confuse investors into believing that the insured depository institution will guarantee the fund's performance. Regardless how one feels about the likelihood of that confusion as a general matter, there is no good reason to believe that risk exists when the names of the investment management affiliates that sponsor and manage a covered fund are different from that of the "core banking entity," *i.e.*, the insured depository institution and its parent holding company. By applying the name restrictions only with respect to the name of the core banking entity and not with respect to the name of the asset manager that sponsors the covered fund,<sup>38</sup> many of the problems in this area could be eliminated.

*Modify Restrictions on Investments in Covered Funds by Directors and Employees.* In addition, to rely on the sponsored fund exception, no director or employee of a banking entity may invest in a covered fund offered or organized by the banking entity, except for directors or employees who are directly engaged in providing investment advisory or other services to the covered fund.<sup>39</sup> This requirement will directly conflict with European law, essentially making it a violation of law for European banking entities to establish and sponsor covered funds in accordance with the sponsored fund exception. The Alternative Investment Fund Managers Directive will in the near future require certain European fund managers to structure the variable compensation of their senior management, risk takers, control functions and those who are compensated in equivalent amounts to these personnel such that at least 50% of their variable compensation is paid in units or

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<sup>37</sup> For example, the United Kingdom's Financial Services Authority ("FSA") has taken the position that a regulated fund organized in that jurisdiction must share a variant of the name of its manager. *See* FSA Handbook, Undesirable or misleading names, COLL 6.9.6G (Release 112, 2011) (U.K.) (noting that a factor in determining whether an authorized fund's name is undesirable or misleading is whether the name "might mislead investors into thinking that persons other than authorised fund manager are responsible for the authorised fund").

<sup>38</sup> For example, if ABC bank holding company owned XYZ asset manager, the covered fund could not be called the ABC Fund, but could be called the XYZ Fund or even the A Fund if that name is sufficiently different from that of the core banking entity.

<sup>39</sup> Section \_\_.11(g).

shares of the applicable fund.<sup>40</sup> Moreover, in certain jurisdictions, including the Netherlands, directors and other personnel of fund managers often are required to hold units or shares of the funds managed by the fund manager as part of their pensions. Such personnel may have no control over the initiation or divestment of these investments. Therefore, if the sponsored fund exception is to achieve its intended purpose with respect to non-U.S. sponsored funds, the exception must be modified to permit investments in the sponsored fund by directors and employees of the sponsoring banking entity to the extent required by local law or outside of the discretion of such directors and employees.

To the extent that non-U.S. regulated funds are included in the definition of covered funds under the final rules, it would be nearly impossible for such funds to ensure that none of their directors or employees have invested in the funds, since these funds typically are publicly offered to retail investors. Moreover, while such investment limitations may be appropriate in the context of traditional hedge funds and private equity funds, there is absolutely no policy reason that could justify application of such a prohibition to non-U.S. regulated funds but not to their U.S. registered investment company counterparts.

*Define “Establishment” to Conform to Market Practice.* Pursuant to Section \_\_.12 of the proposed rules, a covered banking entity may acquire any ownership interests in a covered fund organized and offered by the banking entity, including a sponsored fund, to “establish” the fund and provide it with sufficient equity to attract unaffiliated investors.<sup>41</sup> However, absent specific exemptive relief from the Board, the covered banking entity would be required to bring its level of investment in the covered fund to below three percent within a year after the establishment of the fund. The meaning of the term “establish” is not defined in the proposed rules.

Often, private equity funds gather investors over a period of time before they close to new investors and begin operating in accordance with their investment objectives. If a private equity fund is deemed to be “established” when it is created as a corporate entity, it is possible that a banking entity sponsor of a private equity fund would be required to redeem most of its interests in a fund before it becomes fully operational. Under this scenario, it would be impossible for the banking entity sponsor to provide the covered fund with enough equity over a long enough period of time to attract sufficient unaffiliated investments for the fund to operate as intended. This would nullify the intended result of the exception and preclude banking entities from establishing private equity funds of this type.

This lack of clarity would also raise difficulties with respect to traditional hedge funds. In many cases, it may take more than one year for a sponsor of a hedge fund to raise sufficient capital for the fund to begin investing fully in conformance with its stated investment objective, restrictions and strategies. In such cases, a banking entity sponsor would be required to reduce its ownership interests in the hedge fund to below three percent, even though the banking entity would not yet

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<sup>40</sup> See Annex II para. 1(m), *Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers*, which is due for transposition and entry into force by July 21, 2013.

<sup>41</sup> Section \_\_.12(a).

have had sufficient time to attract enough investments for the fund to achieve its investment goals. Once the banking entity divests itself of the interests in the fund in compliance with the exception, it would likely be difficult for the fund to continue to attract unaffiliated investments sufficient to achieve its goals.

Question 258 in the Proposing Releases asks whether the proposed rules should specify at what point a covered fund is “established” for these purposes.<sup>42</sup> For the reasons set forth above, we believe the Agencies should clearly define the term “established” in this context to mean: (i) in the context of a private equity fund, when the fund has completed its asset raising phase and has closed to new investors and (ii) for other types of covered funds, when the fund has attracted sufficient unaffiliated investments to begin investing in accordance with its stated investment objective, restrictions and strategies.

**5. Banking Entities That Provide Traditional Custodial, Trustee and Administrative Services to Non-U.S. Regulated Funds Should Not Be Deemed to Be Sponsors of such Funds. (Reference Is Made to Question 242 in the Proposing Releases.)**

The European regulatory regime imposes significant responsibilities on the banking entities that serve as custodians, trustees and administrators for UCITS and other non-U.S. regulated funds, which are significantly greater than the responsibilities imposed on custodian banks and administrators for U.S. registered investment companies. EFAMA is concerned that, as a result of these heightened responsibilities, the broad definition of “sponsor” included in the proposed rules could inadvertently subject European custodians, trustees and administrators to the Volcker Rule’s restrictions, including the Super 23A restrictions, with respect to their relationships with covered funds for which they serve solely as custodian or administrator. In some countries it is customary or required that entities acting as a directed trustee or custodian to a non-U.S. regulated fund, or serving a similar role, have the residual authority to select investment managers for such funds or perform other administrative services. Such activities could cause the service provider to be deemed a “sponsor” of the non-U.S. regulated fund under the proposed rules.<sup>43</sup> To the extent that the service provider is a banking entity, the proposed regulations would subject the non-U.S. regulated fund to the restrictions of the Volcker Rule, even if the non-U.S. regulated fund had no other characteristics that would qualify the fund for regulation under the Rule. If not clarified, such a result could wreak havoc on existing relationships and interfere with the ability of European authorities to establish the responsibilities of custodians and administrators for UCITS and other non-U.S. regulated funds.

We note that a trustee that does not exercise investment discretion or qualifies as a directed trustee under the Employee Retirement Income Security Act is excluded from the definition of “sponsor”

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<sup>42</sup> CFTC Proposing Release, 77 Fed. Reg. at [\_\_\_]; Agency Proposing Release, 76 Fed. Reg. at 68,906.

<sup>43</sup> “Sponsor” is defined to include, among other things, a “trustee” of a covered fund. “Trustee” is defined to exclude trustees that do not have investment discretion with respect to the covered fund. Therefore, it appears that custodians which have residual investment discretionary authority over a non-U.S. regulated fund may potentially be deemed to be a sponsor of such fund. See Sections \_\_\_.10(b)(5) and \_\_\_.10(b)(6).

in the proposed rules.<sup>44</sup> While EFAMA expresses no view as to whether this exclusion is sufficient for trustees operating in the United States, we believe that this exception is clearly insufficient to cover traditional and routine custodial and administrative arrangements in Europe and elsewhere with respect to non-U.S. regulated funds. Therefore, we recommend that, especially in the event that the definition of covered funds is not clarified to exclude non-U.S. regulated funds, the definition of “sponsor” in the proposed rules be clarified to indicate that customary custodial and administrative services performed outside the United States for non-U.S. regulated funds in accordance with local law or custom will not result in the providers of such services becoming sponsors of the funds.

Applying the Super 23A restrictions to custodial relationships would place significant and unnecessary burdens and limitations on custodians and the funds they serve, in addition to hindering the efficient operations of the markets. Frequently, custodians to non-U.S. regulated funds (as is the case with U.S. registered funds) provide services to the funds that are ancillary to the provision of custody services. Among these services are intra-day provisions of credit in connection with the settlement of securities transactions. For example, a custodian may extend credit to a fund in an amount equal to the proceeds the fund would have received in connection with a failed trade until the custodian can assist the fund in completing the trade or receiving funds from the securities exchange through which the trade was attempted. To the extent that a non-U.S. regulated fund’s dealings with its custodian are subject to the Super 23A restrictions, it would appear that the fund would not be able to take advantage of this and similar services under the proposed rules.<sup>45</sup> This would result in disruption to the efficient operation of these funds and the markets on which the funds trade, and would not serve to further the purpose or intent of the Volcker Rule.

## **6. Other Recommendations for the Agencies.**

### **A. The Agencies Should Extend the Exception from the Proprietary Trading Prohibitions for U.S. Government Securities to the Obligations of Non-U.S. Governments. (Reference Is Made to Question 122 in the Proposing Release.)**

The proposed rules permit proprietary trading by banking entities in U.S. government securities.<sup>46</sup> However, this proprietary trading exception is not extended to obligations of non-U.S.

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<sup>44</sup> *See id.*

<sup>45</sup> We note that providing intraday credit in these situations is similar to “giving immediate credit to an affiliate for uncollected items received in the ordinary course of business,” which is generally excluded from the restrictions of Section 23A pursuant to Section (d)(3). Although these transactions would be excluded from the requirements of Section 23A, they would not be excluded from the Super 23A limitations under the proposed rules because the transactions would still constitute “covered transactions” under Section 23A.

<sup>46</sup> *See* Section \_\_,6(a)(1). U.S. government securities include (i) an obligation of the United States or any agency thereof, (ii) an obligation, participation, or other instrument of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural

governments. As a policy matter, there is no reason to exclude U.S. government securities and not obligations of non-U.S. governments. In addition, as has been addressed by other commenters, unless the proprietary trading exception is extended to obligations of non-U.S. governments, the liquidity of the markets for such governments' obligations could be undermined. Given the interconnectedness of the global financial system, any market liquidity issues for non-U.S. governments could adversely impact the U.S. financial system. Question 122 in the Proposing Releases asks whether the Agencies should adopt a proprietary trading exception for non-U.S. government obligations, and EFAMA believes that such an exception should be adopted.<sup>47</sup>

**B. The Agencies Should Exercise Maximum Flexibility in Implementing the Volcker Rule's Provisions to Minimize the Negative Impact on Market Liquidity.**

The liquidity needs of open-ended non-U.S. regulated funds are largely driven by the need to respond to both redemptions and subscriptions on an "open-ended" basis. For example, the UCITS Directive requires UCITS to meet redemption requests within a set time-frame at the same time as it limits the ability of UCITS to borrow money to fund redemptions. Effectively, then, during a period of material redemptions a fund often is a forced seller of securities and during a period of heavy inflows a fund often will wish to invest these assets in accordance with its investment strategies as quickly as possible. It is under such circumstances that UCITS managers turn to market-makers to find the liquidity necessary to meet these demands.

For this reason and others, EFAMA is concerned about some of the effects that the proposed rules may have on the liquidity of the markets and access by funds to adequate market making services. EFAMA supports comments from others regarding this issue, and encourages the Agencies to take a flexible approach to the application of the proposed rules to limit unnecessary adverse impacts on the liquidity and efficient operation of the securities markets.

**C. The Agencies Should Clarify the Applicability of the Underwriting, Market Making and Insurance Company Exceptions to Covered Fund Activities. (Reference Is Made to Questions 64, 80, and 128 in the Proposing Releases.)**

Section 13(d) of the BHC Act contains a laundry list of "permitted activities" for banking entities, which serve as exceptions to the Volcker Rule's prohibitions on proprietary trading and covered fund activities. While the phrasing of Section 13(d) indicates that the entire list of exceptions is applicable to both proprietary trading and covered fund activities, the proposed rules only discuss certain exceptions in the context of propriety trading, creating a potential inference that those exceptions are not applicable to covered fund activities. Of specific concern are the exceptions for underwriting, market making and insurance company general account investments. To avoid the anomalous situation where a banking entity might be prevented from underwriting or making a market for shares of a covered fund it sponsors, or an insurance company from making an investment in a covered fund, even though it could underwrite or make a market or invest in the

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Mortgage Corporation, or certain Farm Credit System institutions, or (iii) an obligation issued by any state or any political subdivision thereof.

<sup>47</sup> CFTC Proposing Release, 77 Fed. Reg. at [\_\_\_]; Agency Proposing Release, 76 Fed. Reg. at 68,878.

securities held by the covered fund, EFAMA recommends that the Agencies clarify in the final rules that there was no intent to limit the applicability of these statutory exceptions to proprietary trading activities, and should make the exceptions equally applicable to covered fund activities. To the extent the Agencies determine certain exceptions should be limited to proprietary trading, they should articulate the reasons for departing from the express language in the statute and provide an opportunity for comment.

**D. The Agencies Should Apply the Final Rules and Exceptions Flexibly, Focusing on Substance over Form, to Achieve the Volcker Rule's Objectives Without Unnecessarily Restricting Activities That Do Not Pose Risks to the Financial Stability of the United States.**

Many examples could be provided of situations where a strict, literal application of the terms of the proposed rules could inadvertently restrict or even prohibit investments or activity that substantively are no different, and pose no greater risks, than activities that are expressly permitted under the proposed rules. EFAMA would like to highlight three such examples and to request clarification of the Agencies' treatment in these cases, all of which relate to non-U.S. covered funds that would not qualify for the solely outside the United States exception.

*Managed Account Platforms and Super 23A.* (Reference is made to Questions 314, 315, 316, and 317 in the Proposing Releases). The first involves what are often referred to as "managed account platforms," which substantively, for the purpose of ascertaining covered transactions under Section 23A, are very similar to funds of hedge fund structures for which the Volcker Rule provides relief from the Super 23A restrictions with respect to prime brokerage transactions between a banking entity that sponsors a covered "fund of hedge funds" and the underlying hedge funds in which the covered fund invests. The rationale for such relief is that the underlying hedge funds are independently managed by unaffiliated third parties, whose selection of prime brokers is not controlled by the banking entity.

Like funds of hedge funds, managed accounts are covered funds that seek to achieve their investment objective by allocating their assets to experienced, high performing hedge fund managers. Unlike funds of hedge funds, which invest in the existing hedge funds of such managers, managed accounts contract directly with the hedge fund managers to manage the account's assets in parallel with their existing hedge funds. Importantly, the underlying hedge fund managers in a managed account structure typically retain the same level of independence with respect to the selection of prime brokers as they do when managing their own hedge funds. Accordingly, even though the managed account structure does not meet the literal requirements for the prime brokerage exception to the Super 23A restrictions for fund of hedge fund structures, we believe such relief is equally appropriate.

*Feeder Funds for Registered Investment Companies.* A second example involves offshore funds that have been set up as feeders into U.S. registered investment companies. Under the proposed rules, such funds will not be able to qualify for the solely outside the United States exception either because interests may be sold to U.S. residents or because the sponsor is a U.S. banking entity. As a result, non-U.S. banking entities will not be permitted to invest in such feeder funds, and thereby obtain indirect exposure to the U.S. registered investment company, even though they could under

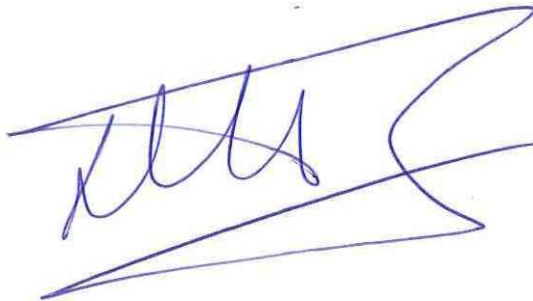


the Volcker Rule invest directly in such registered investment company. To avoid prohibiting a banking entity from doing indirectly what it could do directly, the Agencies should allow banking entities, when assessing the permissibility of an investment, to look through the feeder fund and base its decision on the nature of the underlying fund in which the feeder fund invests.

*Investments in Unaffiliated Covered Funds.* A final example involves investments by non-U.S. banking entities in covered funds that they do not sponsor or manage, and over which they have no control or ability to prevent interests in the covered fund from being offered or sold to U.S. investors. In the absence of such control, a non-U.S. banking entity could conceivably make a permissible investment in a non-U.S. covered fund that qualifies for the solely outside the U.S. exception, only to find out a month, a year or two years later that such fund has begun selling interests to U.S. residents, thereby rendering it ineligible for the exception. Rather than requiring divestiture by the non-U.S. banking entity under such circumstances, the Agencies should grandfather any such investment that was in compliance with the rules at the time it was made. The banking entities also should be entitled to rely on simple representations from the foreign funds, or on the funds' disclosure documents that they do not offer interests to U.S. persons when determining whether they qualify for the exception, without additional due diligence obligations.

\* \* \*

We thank you for the opportunity to comment on the proposed rules. Please do not hesitate to contact the undersigned at +32.2.513.39.69 or [peter.deproft@efama.org](mailto:peter.deproft@efama.org), if you have any questions about the foregoing comments. Upon request, we would be happy to further assist the Agencies with regard to these matters.



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Peter De Proft  
Director General

**EXHIBIT A**

<b>Question(s) in the Proposing Releases</b>	<b>Section in the Comment Letter</b>
5-7	Section 3
64	Section 6.C
80	Section 6.C
122	Section 6.A
128	Section 6.C
138-40	Section 2
217	Section 1
221	Section 1
223-25	Section 1
242	Section 5
244-45	Section 4
253-54	Section 4
258	Section 4
260	Section 4
263	Section 4
293-95	Section 2
314-16	Section 3, Section 6.D
317	Section 6.D

# Hong Kong Investment Funds Association

## Appendix 2

### **Hong Kong Investment Funds Association - Introduction**

The Hong Kong Investment Funds Association ("HKIFA") is the professional body that represents the asset management industry in Hong Kong.

Established in 1986, the HKIFA has two major roles, namely consultation and education. On consultation, it acts as the representative and consulting body for its members and the fund management industry generally in all dealings concerning the regulation of unit trusts, mutual funds, retirement funds and other funds of a similar nature. Towards this end, it reviews, promotes, supports or opposes legislative and other measures affecting the fund management industry in Hong Kong. Another very important task is to educate the public about the role of investment funds in retirement planning and other aspects of personal financial planning.

The HKIFA has four categories of members, namely full member, overseas member, affiliate member and associate member. A fund company can qualify as a full member or an overseas member if it is either the manager or the investment adviser of at least one Investment Fund.

An "Investment Fund" means

- an authorized unit trust/mutual fund; or
- a pooled retirement fund authorized under the Code on Investment-Linked Assurance Schemes or the Code on Pooled Retirement Funds; or
- a retirement scheme registered under the Occupational Retirement Schemes Ordinance; or
- a provident fund scheme registered under the Mandatory Provident Fund Schemes Ordinance; or
- a closed-end investment company listed on a recognized exchange.

The main difference between these two types of members is that a full member must be a company incorporated in Hong Kong or if it is incorporated outside Hong Kong, has established a place of business in Hong Kong whereas an overseas member must be a company incorporated outside Hong Kong.

An affiliate member is a company that has obtained a licence from the Hong Kong Securities and Futures Commission for type 9 regulated activities or it is a fund company incorporated in the People's Republic of China; and its primary business is fund management including the management of discretionary accounts, segregated portfolios or providing investment management services for non-collective investment schemes or the manager or investment adviser of any fund investment company or arrangement not included as an Investment Fund.

An associate member is a company conducting or providing any service of accounting, legal, trustee, custodian, administration, banking, distribution, and technological support to the fund management industry or any related professional services.

At present, HKIFA has 48 fund management companies as full/overseas members, managing 1,220 SFC-authorized funds. Assets under management amounted to about US\$890 billion as at the end of December 2011. In addition, it has 69 affiliate and associate members.

<http://www.hkifa.org.hk>

(Prepared: February 2012)

# Hong Kong Investment Funds Association

## LIST OF HKIFA MEMBERS

### Full/Overseas Members 基金公司會員及海外會員

Aberdeen International Fund Managers Limited 安本國際基金管理有限公司  
Access Investment Management (H.K.) Limited 安信投資管理 (香港) 有限公司  
AllianceBernstein Hong Kong Limited 聯博香港有限公司  
Allianz Global Investors Hong Kong Limited 德盛安聯資產管理香港有限公司  
Amundi Hong Kong Limited 東方匯理資產管理香港有限公司  
AXA Rosenberg Investment Management Asia Pacific Limited 安盛羅森堡投資管理亞太有限公司  
Barclays Bank PLC 巴克萊銀行  
Baring Asset Management (Asia) Limited 霸菱資產管理 (亞洲) 有限公司  
BlackRock (Hong Kong) Limited 貝萊德 (香港) 有限公司  
BNP Paribas Investment Partners Asia Limited 法國巴黎投資管理亞洲有限公司  
BOCI-Prudential Asset Management Limited 中銀國際英國保誠資產管理有限公司  
Citigroup First Investment Management Limited  
CSOP Asset Management Limited 南方東英資產管理有限公司  
DB Platinum Advisors  
Deutsche Asset Management (Hong Kong) Limited 德意志資產管理 (香港) 有限公司  
Eastspring Investments (Hong Kong) Limited 瀚亞投資 (香港) 有限公司  
FIL Investment Management (Hong Kong) Limited 富達基金 (香港) 有限公司  
First State Investments (Hong Kong) Limited 首域投資 (香港) 有限公司  
Franklin Templeton Investments (Asia) Limited 富蘭克林鄧普頓投資 (亞洲) 有限公司  
GAM Hong Kong Limited 環球投資 (香港) 有限公司  
GF Asset Management (Hong Kong) Limited 廣發資產管理 (香港) 有限公司  
Goldman Sachs (Asia) L.L.C. 高盛(亞洲)有限責任公司  
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Hang Seng Investment Management Limited 恒生投資管理有限公司  
Henderson Global Investors (Hong Kong) Limited 亨德森全球投資(香港)有限公司  
HSBC Global Asset Management (Hong Kong) Limited 滙豐環球投資管理 (香港) 有限公司  
ING Investment Management Asia Pacific (Hong Kong) Limited  
Invesco Hong Kong Limited 景順投資管理有限公司  
Investec Asset Management Asia Limited 天達資產管理亞洲有限公司  
Janus Capital Asia Limited 駿利資產管理亞洲有限公司  
J.P. Morgan Asset Management 摩根資產管理  
Legg Mason Asset Management Hong Kong Limited 美盛資產管理香港有限公司  
Lloyd George Management (Hong Kong) Limited 羅祖儒投資管理 (香港) 有限公司  
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# Hong Kong Investment Funds Association

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KNEIP Asia Limited  
KPMG 畢馬威會計師事務所  
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