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July 15, 2014

Mr. Kevin M. O'Neill
Deputy Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549
File Number S7-14-11
RIN 3235-AK96

Mr. Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551
Docket Number R-1411
RIN 7100-AD70

Mr. Alfred M. Pollard
General Counsel
Attention: Comments/RIN 2590-AA43
Constitution Center
(OGC) Eighth Floor
Federal Housing Finance Agency
1700 G Street, N.W., Fourth Floor
Washington, D.C. 20552

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, S.W., Suite 3E-218, Mail Stop
Washington, D.C. 20219
Docket Number OCC 2013-0010
RIN 1557-AD40

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429
RIN 3064-AD74

Regulations Division
Office of General Counsel
Department of Housing and Urban Development
451 7th Street, S.W., Room 10276
Washington, D.C. 20410-0500
RIN 2501-AD53

Re: Credit Risk Retention

Ladies and Gentlemen:

On October 30, 2013, the Investment Company Institute[1] submitted a comment letter[2] on a proposal ("Proposed Rules") to implement the credit risk retention requirements of Section 15G of the Securities Exchange Act of 1934 ("Exchange Act"), as added by Section 941 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[3] The ICI 2013 Letter focused on, among other issues, the application of the Proposed Rules to municipal tender option bond ("TOB") programs.

Since we submitted the ICI 2013 Letter, developments relevant to the Proposed Rules' application to TOB programs have occurred. Final regulations were adopted to implement Section 619 of the Dodd-Frank Act (the "Volcker Rule").[4] As discussed in further detail below, market participants are concerned that the Volcker Rule's restrictions on banks' relationships with "covered funds" will interfere with the ability of banks to perform their traditional roles with respect to TOB programs. As a result, industry participants are working to develop alternative TOB structures intended to be consistent with the Volcker Rule.

This letter addresses the application of the Proposed Rules to one of those alternative TOB structures, third-party trusts, in which a non-banking entity, most likely a registered investment company ("fund") such as a tax-exempt bond fund or closed-end fund, would assume certain roles that were previously assumed by a bank. Based on our analysis of the third-party trust structure under the Proposed Rules, we believe that several further modifications to the Proposed Rules are necessary to reflect the changed roles and responsibilities of TOB program participants under the third-party trust structure. For your convenience, our comments with respect to TOB programs, as originally stated in the ICI 2013 Letter and supplemented, are below. Our comments with respect to asset-backed commercial paper, commercial mortgage-backed securities, and other issues addressed in the ICI 2013 Letter remain unchanged.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $17.1 trillion and serve over 90 million shareholders.

[2] Letter to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., from Karrie McMillan, General Counsel, Investment Company Institute, dated October 30, 2013 ("ICI 2013 Letter"), *available at* http://www.sec.gov/comments/s7-14-11/s71411-414.pdf.

[3] The Proposed Rules were jointly issued by the Securities and Exchange Commission ("SEC" or "Commission"), Office of the Comptroller of the Currency, Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Federal Housing Finance Agency, and Department of Housing and Urban Development (together, the "Agencies"). *See Credit Risk Retention*, 78 Fed. Reg. 57928 (Sept. 20, 2013) ("Release").

[4] *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536 (Jan. 31, 2014).

I. Background

A. Traditional TOB Program Structure

In a traditional TOB program, a bank deposits one or more investment grade municipal bonds into a trust that issues two classes of tax-exempt securities: a short-term security (the "floater") that is supported by a liquidity facility and a residual floating rate security (the "residual"). The floater is a variable-rate demand security that bears interest at a rate adjusted at specified intervals (daily, weekly, or other intervals up to one year) according to a specific index or through a remarketing process.

The liquidity facility provides a "put" or conditional demand feature, allowing the floater holder to tender the floater, with specified notice, and receive face value plus accrued interest, either from remarketing proceeds or a draw on the liquidity facility.[5] Floater holders bear limited and well-defined insolvency and default risks associated with the underlying bonds, and rely upon their largely unfettered put right to manage these risks. Tax-exempt money market funds are the principal holders of the floaters.

Holders of residuals are typically long-term investors, such as banks, tax-exempt bond funds, closed-end funds, or other institutional investors in municipal bonds. Residual holders receive all cash flows from the underlying bonds that are not needed to pay interest on the floaters and expenses of the trust. Residual holders bear all of the market risk and share the credit risk with the floater holders with respect to the underlying municipal bonds. While, prior to the Volcker Rule, residual holders, such as tax-exempt bond funds and closed-end funds, would sometimes identify the underlying municipal bonds they would like to finance through a TOB program, a bank typically would perform the traditional functions of a TOB program sponsor.

B. Implications of the Volcker Rule for TOB Third-Party Trust Programs

The Volcker Rule generally prohibits a banking entity from having an ownership interest in, or acting as a "sponsor" to, a "covered fund."[6] A traditional municipal TOB trust would likely meet the

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[5] The liquidity facility is subject to termination upon certain major credit events, known as "tender option termination events" ("TOTEs") affecting the issuer of the underlying municipal bonds. TOTEs, which are very limited and remote, include: a default on the underlying municipal securities and credit enhancement where applicable; a credit rating downgrade below investment grade; the bankruptcy of the issuer, and when applicable, the credit enhancer; or the determination that the underlying municipal securities are taxable. Upon the occurrence of a TOTE, the TOB trust would be collapsed and the floater and residual holders would be paid on a *pari passu* basis after the payment of any outstanding trust fees. If the collateral's value were sufficient to pay the trust fees and to return par plus accrued interest to both the floater and residual holders on a *pari passu* basis, then the collateral would be sold and the payments would be made. If the value were insufficient, then the collateral would be delivered on a proportionate basis to the floater and residual holders.

[6] *See* §_.10(a) under the Volcker Rule.

definition of a "covered fund" under the Volcker Rule,[7] and the rule does not explicitly exclude municipal TOB trusts from the definition, or from the rule's requirements.[8] As a result, a banking entity effectively may be precluded from engaging in certain functions with respect to a TOB trust that are critical to the trust's operation, including serving as the trust's sponsor and having an ownership interest in the trust.

The core of the third-party trust structure is that a TOB residual interest holder, such as a tax-exempt bond fund, closed-end fund, or other institutional investor, would assume certain key responsibilities previously handled by, or on behalf of, the banking entity. Under the third-party trust structure, the residual holder, rather than the banking entity, would serve as the "sponsor" and therefore be the "securitizer," of the TOB trust, for purposes of the Proposed Rules.[9]

Under the third-party trust structure, the documentation relating to the liquidity facility may be restructured, so as to preclude the banking entity from acquiring an impermissible ownership interest in the trust. The banking entity, although it no longer would serve as sponsor of the TOB trust, or have an ownership interest in the trust, could assume certain servicing functions with respect to the trust, consistent with the Volcker Rule.[10] The fundamental structure of the TOB trust would remain unchanged: the trust still would issue floaters and residuals with the characteristics and payment flows described above, and the TOB program would include a liquidity facility and remarketing process for benefit of the floater holders.

II. Analysis of the Third-Party Trust Structure under the Proposed Rules

While we continue to believe that sponsors of TOB programs should be exempted, pursuant to Section 15G of the Exchange Act, from the risk retention requirement under the Proposed Rules,[11] we

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[7] *See* §_.10(b) under the Volcker Rule.

[8] As referenced in the introduction to this letter, other alternative TOB structures are being considered by industry participants. For example, in one of these alternatives, the TOB trust would be structured as a joint venture to conform to the applicable exemption of the Volcker Rule.

[9] Under the Proposed Rules, a "securitizer" with respect to a securitization transaction means either: (1) the depositor of the asset-backed securities ("ABS") (if the depositor is not the sponsor); or (2) the sponsor of the asset-backed securities." "Sponsor" is defined under the Proposed Rules as "a person who organizes and initiates a securitization transaction by selling or transferring assets, either directly or indirectly, including through an affiliate, to the issuing entity." The definition of "securitizer" under the Proposed Rules is substantially similar to the statutory definition of securitizer in Section 15G(a)(3) of the Exchange Act.

[10] *See* Rule §_.10(a) under the Volcker Rule.

[11] *See* ICI 2013 Letter, *supra* note 2. Section 15G(c)(1)(G)(i) of the Exchange Act states that the risk retention rules adopted by the Agencies shall provide for "a total or partial exemption of any securitization, as may be appropriate in the public interest and for the protection of investors . . ."

understand from our discussions with the Agencies that such an outcome may be unlikely. We therefore focus in the remainder of this letter on how the Proposed Rules must be modified to make the third-party trust structure viable under any final rules.

A. Confirm that Residual Holders May Serve as Sponsor for Risk Retention Purposes

In the Proposed Rules, the Agencies provide two additional risk retention options for TOB programs. The Proposed Rules provide that a sponsor with respect to an issuance of "tender option bonds"[12] by a "qualified tender option bond entity"[13] may satisfy its risk retention obligation by complying with the standard risk retention methods (*i.e.*, vertical, horizontal, or a combination thereof), or may choose to rely on one of two additional risk retention options tailored for TOBs.

Consistent with the third-party trust structure described above, we request confirmation that funds or other institutional investors in municipal bonds that purchase residual interests in a municipal TOB trust may serve as "sponsor," and therefore "securitizer," for purposes of the Proposed Rules, and may satisfy the risk retention obligations with respect to the TOB trust.[14]

We acknowledge that the ICI 2013 Letter requested that residual holders be permitted to satisfy risk retention obligations of a banking entity sponsor *without being deemed the sponsor themselves* for purposes of the Proposed Rules. As discussed above, as a result of the Volcker Rule, fund residual holders anticipate, under the third-party trust structure, assuming the key functions with respect to a TOB trust formerly performed by, or on behalf of, a banking entity. Fund residual holders believe these functions would cause them to meet the definition of "sponsor" for purposes of the Proposed Rules and have gained additional comfort with the implications of funds being deemed sponsors under the Proposed Rules. Accordingly, we are changing the nature of our request for confirmation.

B. Definition of "Qualified Tender Option Bond Entity"

1. Clarify that Multiple Fund Residual Holders are Permitted

The Proposed Rules would require, among other things, that a "qualified tender option bond entity," as defined under the Proposed Rules, issue no securities other than (i) a single class of TOBs with a preferred variable return payable out of capital and (ii) *a single residual equity interest* that is entitled to all remaining income of the TOB issuing entity.[15] If this language means that the residual interest may not be held by more than one entity, it is inconsistent with current market practice.

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[12] *See* Proposed Rule §_.10.

[13] *Id.*

[14] *See supra* note 9.

[15] Proposed Rule §_.10(a)(2) (italics added).

As discussed in the ICI 2013 Letter, several funds in a fund complex that are managed by the same, or an affiliated, investment adviser often purchase residuals issued by a single TOB trust. One reason for this practice is that the TOB trust must be of sufficient size to be marketable to potential floater holders because purchasers of floaters generally have minimum purchase requirements to reduce costs and administrative burdens. A single smaller fund would not be able to purchase all of the residuals issued by such a trust without breaching issuer concentration limits. We therefore recommend that the Agencies clarify the definition of "qualified tender option bond entity" to explicitly permit more than one fund in a fund complex to hold residuals in the trust, as is common practice in the TOB market. Doing so would allow multiple funds to invest in the residuals issued by a single trust, thus enabling smaller funds to have access to securities that otherwise would be unavailable to them. We strongly believe that permitting multiple funds in a fund complex that are managed by the same investment adviser (or an affiliate) to hold residuals in a TOB trust is fully consistent with the regulatory objectives of the Proposed Rules, as fund residual holders would still hold interests in a single class of securities, and having several fund holders would not change the alignment of interests of trust holders.

2. Clarify that Credit Enhancement is a Permitted Asset

Under the Proposed Rules, the definition of "qualified tender option bond entity" also would require that the entity be collateralized "solely by servicing assets and municipal securities that have the same municipal issuer and the same underlying obligor or source of payment (determined without regard to any third-party credit enhancement), and such municipal securities are not subject to substitution."[16] "Servicing assets" are defined, in relevant part, as "rights or other assets designed to assure the timely distribution of proceeds to ABS interest holders and assets that are related or incidental to purchasing or otherwise acquiring and holding the issuing entity's securitized assets . . . "[17] It is not unusual for a TOB trust to include credit enhancement, such as letters of credit, with respect to the underlying municipal securities and, indeed, this is explicitly contemplated by the Proposed Rules. In order to reflect the role of credit enhancement, in some cases, in assuring the timely distribution of proceeds to floater holders in TOB programs, we recommend that the Agencies clarify explicitly that servicing assets, in the context of a TOB program, may include credit enhancement, if any, with respect to the underlying municipal bonds held by the TOB trust.

C. Recommended Revisions to TOB Risk Retention Options

After reviewing the risk retention options for TOB programs under the Proposed Rules, we continue to believe that one of the options under the Proposed Rules must be clarified to reflect the

[16] Proposed Rule §_.10(a)(2).

[17] Proposed Rule §_.2.

cash flows characteristics of TOB programs, as currently structured[18] and under the third-party trust structure. We also recommend two additional risk retention options be permitted for TOB program sponsors to reflect market practice, and to address the implications of the Volcker Rule.

The Proposed Rules provide that a sponsor with respect to TOBs issued by a "qualified tender option bond entity"[19] may satisfy its risk retention obligation by complying with the standard risk retention methods (*i.e.*, vertical, horizontal, or a combination thereof), or may choose to rely on one of two additional risk retention options particular to TOBs:

- The sponsor may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but that upon the occurrence of a "tender option termination event" (TOTE), as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84, will meet requirements of an eligible vertical interest.

- The sponsor may satisfy its risk retention requirements by holding municipal securities from the same issuance of municipal securities deposited in the qualified tender option bond entity, the face value of which retained municipal securities is equal to 5 percent of the face value of the municipal securities deposited in the qualified tender option bond entity.[20]

We recommend that the first TOB risk retention option be modified slightly to reflect the cash flows in TOB trusts, both as currently structured and in third-party trusts. Specifically, because TOB trusts are designed to ensure that the tax-free nature of the income of the underlying municipal securities passes through to the floater holders and the residual holders, it is not clear that upon issuance, a residual would technically meet the definition of an "eligible horizontal residual interest,"[21] or that upon the occurrence of a TOTE, a residual would technically meet the definition of an "eligible vertical interest."[22] While during the trust's normal operations, the floater holders receive income from

[18] *See* ICI 2013 Letter, *supra* note 2.

[19] Proposed Rule §_.10.

[20] *Id.*

[21] Under the Proposed Rules, an "eligible horizontal residual interest" means, with respect to any securitization transaction, an ABS interest in the issuing entity: (1) that is an interest in a single class or multiple classes in the issuing entity, provided that each interest meets, individually or in the aggregate, all of the requirements of this definition; (2) with respect to which, on any payment date on which the issuing entity has insufficient funds to satisfy its obligation to pay all contractual interest or principal due, any resulting shortfall will reduce amounts paid to the eligible horizontal residual interest prior to any reduction in the amounts paid to any other ABS interest, whether through loss allocation, operation of the priority of payments, or any other governing contractual provision (until the amount of such ABS interest is reduced to zero); and (3) that has the most subordinated claim to payments of both principal and interest by the issuing entity.

[22] Under the Proposed Rules, an "eligible vertical interest" means with respect to any securitization transaction, a single vertical security or an interest in each class of ABS interests in the issuing entity issued as part of the securitization transaction that constitutes the same portion of the fair value of each such class.

the trust prior to the residual holders, at the time a TOTE occurs, the floater and residual holders are paid on a *pari passu* basis after the payment of any outstanding trust fees. If the collateral's value is sufficient to pay the trust fees and to return par plus accrued interest to both the floater and residual holders on a *pari passu* basis, then the collateral is sold and the payments are made. If the value is insufficient, then the collateral is delivered on a proportionate basis to the floater and residual holders.

We understand the Agencies' regulatory purpose in proposing the first TOB risk retention option, and believe that this purpose could be achieved through technical modifications to this option. We therefore recommend that the Agencies modify this option to permit a sponsor to satisfy the risk retention requirement by purchasing and retaining a residual interest having an up-front cash investment value equal to five percent of the fair value of the assets deposited in the TOB trust, determined as of the date of the deposit.[23] As discussed in our prior letters, holding the residual in a TOB program is substantially equivalent to holding horizontal risk prior to the occurrence of a TOTE and a vertical interest after a TOTE because: (i) prior to the occurrence of a TOTE, the residual holder bears all market risk,[24] and (ii) after the occurrence of a TOTE, any credit losses are shared pro rata between the floaters and the residuals.[25] For this reason, among others detailed in the ICI 2013 Letter, we believe this option would be fully consistent with the Agencies' regulatory objectives.

We support the second TOB risk retention option,[26] although we recommend several minor clarifications. First, we suggest that the final risk retention rule clarify that the calculation is determined only once, at the time of deposit. Second, we suggest that the final risk retention rule explicitly state that the sponsor may aggregate the amount of any TOB residual interest it holds with any municipal securities it holds outside of the TOB program in satisfying this risk retention option. Such a calculation should be determined as of the date of deposit. We believe this approach, which would effectively combine the first and second risk retention options, would be consistent with the Agencies' flexible approach under the Proposed Rules.[27]

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[23] We recommended a similar option previously. *See* Letter to Office of the Comptroller of the Currency, et al., from Ashurst LLP, Citibank, N.A., Deutsche Bank AG, New York Branch, Société Générale, New York Branch, Wells Fargo Bank, N.A., Investment Company Institute, dated August 31, 2012 ("ICI 2012 Letter").

[24] This is because, when the residual holder is an entity that is not related to the liquidity provider, the residual holder may be subject to a full recourse obligation to reimburse the liquidity provider for any losses with respect to the liquidity facility, may have posted cash or cash equivalent collateral at the time of closing to secure the liquidity provider for any losses, or may have subordinated its right to payment to the floater holders and the liquidity provider until the occurrence of a TOTE. *See* ICI 2013 Letter, *supra* note 2; *see also* ICI 2012 Letter, *supra* note 23, at notes 12, 14.

[25] *Id.*

[26] Proposed Rule § __.10(d).

[27] *See, e.g.,* Proposed Rule § __.10(b).

We also recommend, similar to our previous recommendation (but modified slightly to address the implications of the Volcker Rule), that the Agencies deem a sponsor's risk retention requirement to be satisfied in a TOB program transaction in which the sponsor is unaffiliated with the liquidity provider, and either (a) agrees to subordinate its right to payment to the floater holders and the liquidity provider until the occurrence of a TOTE; or (b) agrees to reimburse the liquidity facility provider for any losses, in recognition of the fact that all of the market risk associated with the underlying assets is already borne by the residual interest holder.[28] As discussed in our prior letters, we believe that exposure to 100 percent market risk, along with the pro rata credit risk in the event of a TOTE, is a more than adequate (and arguably more stringent) substitute for a five percent credit risk under the proposed standard risk retention options.[29]

Offering all three of these risk retention options would accomplish the Agencies' regulatory objectives, while providing sponsors with the flexibility necessary to accommodate current and developing market practices for issuers, sponsors, and investors in TOB programs.[30]

III. Risk Retention Requirements Only Should Apply Prospectively

We reiterate our strongly held view that any risk retention requirements the Agencies may adopt should apply only on a prospective basis, and request confirmation that the rules will operate in this manner.[31] The Agencies have stated that "[c]onsistent with section 15G of the Exchange Act, the risk retention requirements would become effective, for securitization transactions collateralized by residential mortgages, one year after the date on which final rules are published in the Federal Register, and two years after that date for any other securitization transaction."[32] We request confirmation that the final risk retention rules will *not* apply retroactively to ABS structures in existence on the effective date of those rules, as such application would result in significant adverse operational and tax consequences. Instead, we request confirmation that the final rules will apply prospectively only to ABS structures created after the effective date of the final rules.

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We appreciate the Agencies' efforts to better tailor the risk retention requirements to reflect how municipal TOB programs are structured. We urge the Agencies to further modify the Proposed

[28] ICI 2013 Letter, *supra* note 2; ICI 2012 Letter, *supra* note 23.

[29] *Id.*

[30] *Id.*

[31] ICI 2013 Letter, *supra* note 2; ICI 2012 Letter, *supra* note 23.

[32] Release, *supra* note 3, at 57931.

Rules to better reflect how these programs are, or are anticipated to be, structured, in light of the Volcker Rule.

In our prior letters, we expressed concern that, because of the joint nature of this rulemaking, the Agencies must develop workable standards for risk retention guidance *prior* to the rules' adoption. We stated that we do not believe the statements in the Release concerning subsequent interpretations or similar guidance suggest that the Agencies have developed an adequate process to achieve the necessary and timely coordination in the event post-issuance clarifications are necessary, and urged the Agencies to do so promptly.[33] Given the additional overlay of the Volcker Rule and its implications for TOB programs, there is even greater urgency for the Agencies to establish workable standards now to coordinate any guidance that may be necessary subsequent to the final risk retention rules being issued. If there is any way we may further assist the Agencies, please feel free to contact me directly at (202) 218-3563 or Sarah Bessin at (202) 326-5835.

Sincerely,

/s/ Dorothy M. Donohue

Dorothy M. Donohue
Acting General Counsel

cc: The Honorable Mary Jo White
The Honorable Luis A. Aguilar
The Honorable Daniel M. Gallagher
The Honorable Kara M. Stein
The Honorable Michael S. Piwowar
Securities and Exchange Commission

Katherine Hsu, Chief
David Beaning, Special Counsel

[33] In the original proposal, the Agencies stated their intent to jointly approve any written interpretations, written responses to requests for no-action letters and general counsel opinions, or other written interpretive guidance concerning the scope or terms of Section 15G of the Exchange Act and the final rules issued thereunder that are intended to be relied on by the public. The Agencies also stated that they intended for the appropriate Agencies to jointly approve any exemptions, exceptions, or adjustments to the final rules. In response to comments expressing concerns about the practicality and uncertainty of this process, the Agencies stated that they "continue to view the consistent application of the final rule as a benefit and intend to consult with each other when adopting staff interpretations or guidance on the final rule that would be shared with the public generally." They stated, however, that they are "considering whether to require that such staff interpretations and guidance be jointly issued by the agencies with rule writing authority and invite comment."

Arthur Sandel, Special Counsel
Office of Structured Products
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