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The Clearing House

THE FINANCIAL SERVICES ROUNDTABLE
Financing America's Economy

American Bankers Association
Building Success. Together.

February 13, 2012

By electronic submission

Re: Comment Letter on the Notice of Proposed Rulemaking Implementing the Volcker Rule – **Hedge Funds and Private Equity Funds**

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association, the American Bankers Association, the Financial Services Roundtable and The Clearing House Association[1] appreciate the opportunity to comment on the "covered funds" portion of the proposed rules (the "**Proposed Rules**") implementing new Section 13 of the Bank Holding Company Act of 1956 (the "**Volcker Rule**"). The Proposed Rules were issued by the Agencies[2] in two notices of proposed rulemaking ("**NPRs**").[3]

Because of "the complexities of the issues involved" and "the variety of considerations involved in its impact and implementation," the Agencies included over 1,300 questions in the first NPR and established a 90-day comment period from the time the Proposed

[1] For information about the trade associations jointly submitting this comment letter, please see **Annex E**.

[2] The Agencies are the Office of the Comptroller of the Currency ("**OCC**"), the Board of Governors of the Federal Reserve System ("**Board**"), the Federal Deposit Insurance Corporation ("**FDIC**"), the Securities and Exchange Commission ("**SEC**") and the Commodity Futures Trading Commission ("**CFTC**"). The rule identifiers are ***OCC*** Docket ID 2011-14 & RIN 1557-AD44; ***FRB*** Docket No. R-14 & RIN 7100 AD; ***FDIC*** RIN 3064-AD85; ***SEC*** File No. S7-41-11& RIN 3235-AL07; ***CFTC*** RIN 3083-AC[●].

[3] The first NPR was released by the OCC, Board, FDIC and SEC on October 11, 2011, and published in the Federal Register on November 7, 2011. *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 76 Fed. Reg. 68846. The second NPR was released by the CFTC on January 13, 2012. *See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds* (the "**CFTC NPR**"), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112c.pdf. The CFTC NPR is substantially identical to the first NPR, except for a number of additional questions and immaterial changes designed to reflect the CFTC's separate issuance of the Proposed Rules.

Rules were first publicly released.[4] In response to a variety of letters requesting additional time to comment, the Agencies that issued the first NPR extended the comment period for the Proposed Rules until February 13, 2012.[5] The CFTC provided for a 60-day comment period for its version of the Proposed Rules, beginning on the date of publication in the Federal Register.[6]

This comment letter is designed to address both NPRs. It relates, however, solely to the "***covered funds***" portion of the Proposed Rules. It does not relate to the proprietary trading portion of those rules, except to the extent it argues that the general prohibitions on investing in and having certain relationships with covered funds should be subject to the same exemptions for underwriting, market making-related activities and risk-mitigating hedging as the general prohibition on proprietary trading. Nor does it address the extent to which the Proposed Rules may disrupt or otherwise interfere with the securitization or municipal securities markets. SIFMA is submitting separate comment letters on proprietary trading,[7] securitization issues[8] and municipal securities.[9]

The Proposed Rules, as they relate to the covered funds portion of the Volcker Rule, reflect an enormous amount of effort on the part of the Agencies. In many respects, the Agencies succeeded in construing important portions of the Volcker Rule in a manner that is consistent with the language, legislative history and structure of the statute, reflects congressional intent and is consistent with the findings and recommendations of the congressionally mandated

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[4] *See* 76 Fed. Reg. at 68849.

[5] *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, 77 Fed. Reg. 23, 23 (Jan. 3, 2012).

[6] See CFTC NPR, *supra* note 3, at 1.

[7] *See* SIFMA Comment Letter on Proprietary Trading (Feb. 13, 2012), available at http://www.sifma.org/issues/item.aspx?id=8589937353; SIFMA Asset Management Group Comment Letter on Proprietary Trading (Feb. 13, 2012), available at http://www.sifma.org/issues/item.aspx?id=8589937354 (discussing the impact of the proprietary trading provisions of the Proposed Rules on liquidity for customers of U.S. asset managers).

[8] *See* SIFMA Securitization Group Comment Letter on Covered Funds (Feb. 13, 2012), available at http://www.sifma.org/issues/item.aspx?id=8589937357 (discussing the impact of the Proposed Rules on securitization, insurance-linked securities and related issues arising from the treatment of the proposed loan securitization exemption).

[9] *See* SIFMA Municipal Securities Division Comment Letter (Feb. 13, 2012), available at http://www.sifma.org/issues/item.aspx?id=8589937356 (discussing the impact of the Proposed Rules on municipal securities and tender option bonds).

studies of the Volcker Rule by the Financial Stability Oversight Council ("**FSOC**") ("**FSOC Study**") [10] and the Government Accountability Office ("**GAO**") ("**GAO Report**").[11]

For example, the Proposed Rules properly exclude certain covered funds from the definition of "banking entity." This eliminates certain internal contradictions that would otherwise exist in the statutory text. The Proposed Rules similarly and appropriately exclude otherwise permitted acquisitions of ownership interests in covered funds from the definition of the term "covered transaction" in subsection (f) of the Volcker Rule (popularly known as "**Super 23A**"). This exclusion also eliminates an internal contradiction that would otherwise exist in the statute. In addition, the Agencies properly recognized that the Volcker Rule only prohibits investments in covered funds when made by a banking entity acting as a principal; the prohibitions do not apply when a banking entity is acting as agent or fiduciary.

Despite these considerable efforts and achievements, however, the Proposed Rules include a number of serious flaws. Perhaps the most far-reaching flaw is how the Agencies have chosen to define the term "covered fund." The proposed definition erases the distinction between hedge funds and private equity funds. It also erases the distinction between funds and non-fund entities, sweeping in a wide range of entities that have never been considered hedge funds or private equity funds. It even appears to sweep in banks and bank holding companies themselves.

As a result, absent clarification, regulatory forbearance or future exclusions, the Proposed Rules would appear immediately upon the Volcker Rule's effectiveness on July 21, 2012 to prohibit bank holding companies from acting as a source of strength for their subsidiary banks or virtually any other subsidiaries or affiliates. It would do so by flatly prohibiting them from entering into any "covered transactions" with any of their subsidiaries or affiliates. The range of prohibited transactions includes fully secured extensions of credit and risk-reducing derivatives transactions. It would even appear to require bank holding companies to divest all of their non-fund subsidiaries and affiliates by the end of the conformance period, while permitting them to retain 3% of any of their subsidiaries and affiliates that are genuine hedge funds or private equity funds, subject to certain conditions. This would turn the Volcker Rule on its head. Rather than increase the safety, soundness and stability of the U.S. and global financial system, the Proposed Rules could destabilize it.

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[10] FINANCIAL STABILITY OVERSIGHT COUNCIL, STUDY & RECOMMENDATIONS ON PROPRIETARY TRADING & CERTAIN RELATIONSHIPS WITH HEDGE FUNDS & PRIVATE EQUITY FUNDS (Jan. 18, 2011), *available at* http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

[11] GAO REPORT, PROPRIETARY TRADING: REGULATORS WILL NEED MORE COMPREHENSIVE INFORMATION TO FULLY MONITOR COMPLIANCE WITH NEW RESTRICTIONS WHEN IMPLEMENTED (July 2011), *available at* http://www.gao.gov/assets/330/321006.pdf.

These absurd results, which Congress could not possibly have intended, show why the Agencies need to observe the principle "first, do no harm" when implementing the Volcker Rule. The Agencies should avoid using a shotgun approach in drafting the implementing rules. Such an approach may eliminate the possibility that some banking entities could "get away with something" that they should not. But it would do so at the cost of potentially causing massive collateral damage to the U.S. and global financial systems and the wider economy. In other words, the Agencies should avoid the all-too-familiar error of trying to eliminate "the last 10 percent" of the problem Congress was attempting to address.[12] Congress's aim will be accomplished if the activities presenting the lion's share of the perceived risk are regulated; every ounce of such behavior need not be regulated, particularly if doing so poses disproportionately negative collateral consequences. Instead, the Agencies should take a more surgical approach in order to achieve the statutory goal of restricting certain investments and relationships with genuine hedge funds and private equity funds without causing collateral damage. They can use their broad anti-evasion powers to deal with "the last 10 percent."

We do not believe that the Agencies intended to produce these unsafe, unsound, inefficient or destabilizing results. Nor do we believe that the Agencies fully understood that their chosen approach could produce these results. Indeed, it took us a considerable amount of time to identify and catalog all of the consequences discussed in this letter, and we continue to identify new problems. We are not confident that we will have identified all of them before the statute becomes effective. Yet in light of the consequences of the Proposed Rules that we and other commenters have highlighted for the Agencies, we believe it to be incumbent upon them to reconsider the approach previously taken when drafting final rules.

The Agencies also failed to conduct a general cost/benefit analysis of the Proposed Rules, much less the sort of rigorous cost/benefit analysis required by the U.S. Court of Appeals for the D.C. Circuit in the *Business Roundtable* decision.[13] We believe that the Agencies are required to conduct such a cost/benefit analysis of the Proposed Rules under a variety of statutes, executive orders, and Agency policy statements. Unless the Agencies conduct an adequate cost/benefit analysis of the Proposed Rules as a whole, and rule-by-rule, and seriously consider all public comments, we believe that the Proposed Rules will be considered "arbitrary and capricious and not in accordance with law" under the Administrative Procedure Act, as construed by the court in the *Business Roundtable* decision.[14]

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[12] *See* Stephen Breyer, BREAKING THE VICIOUS CIRCLE: TOWARD EFFECTIVE RISK REGULATION 11 (1993).

[13] *Business Roundtable v. SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

[14] *See id.* at 1148 (agency's "failure to apprise itself – and hence the public and the Congress – of the economic impact of a proposed regulation makes promulgation of the rule arbitrary and capricious and not in accordance with law") (internal quotation marks omitted).

We believe that all of our recommendations are consistent with the language, structure and legislative history of the Volcker Rule, as well as the FSOC Study and GAO Report. Thus, we believe the Agencies have the authority to implement all of our recommendations, and that if they do so, such actions will be entitled to *Chevron* deference.[15]

The following annexes to this cover letter form the core of our comment letter and include ***interactive hyperlinks*** to key provisions.

Annex A **(Recommendations and Observations)** is a "tear away" list of our recommendations and observations. The list can be torn away from the rest of the comment letter and used as a convenient reference tool. It is also interactive. By clicking on any of the recommendations or observations, you will be hyperlinked to the relevant section in our detailed analysis of the issues in **Annex C**.

Annex B **(Hedge Funds and Private Equity Funds)** provides functional definitions of a hedge fund and private equity fund as commonly understood based on their essential attributes. We believe that an entity should reflect all of these attributes in order to be treated as a covered fund.

Annex C **(Discussion)** contains a detailed analysis of our recommendations and observations, including the source of authority for all recommended Agency actions. Because of the length and complexity of this annex, we have included an interactive table of contents in it. By clicking on any item in the table of contents, you will be hyperlinked to the relevant section in this annex.

Annex D **(Glossary)** contains a glossary of defined terms used in this comment letter and its annexes.

Although this comment letter contains responses to many of the requests for answers to specific questions in the NPRs, we intend to submit a supplemental comment letter by the end of February that responds to each question asked, either by cross reference to this letter or by specific response.

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[15] *Chevron USA, Inc. v. Natural Resources Defense Council*, 467 U.S. 837 (1984).

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We thank the Agencies for their consideration of our comments. If you have any questions, please do not hesitate to call Randall D. Guynn, Davis Polk & Wardwell LLP, at 212-450-4239.

Sincerely,

Securities Industry and Financial Markets Association
American Bankers Association
Financial Services Roundtable
The Clearing House Association

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ANNEX A

RECOMMENDATIONS AND OBSERVATIONS

1. **Authority/Deference**. All of our recommendations are consistent with the language, structure and legislative history of the Volcker Rule. They are based on reasonable interpretations of the statute that are all entitled to *Chevron* deference.

2. **Cost/Benefit Analysis**. The Agencies are required to conduct a rigorous cost/benefit analysis of the Proposed Rules as a whole, and rule-by-rule, as required by the *Business Roundtable* decision.

3. **Exclusion from Covered Fund**.

   a. **Duty and Authority**. The Agencies have a duty and the authority to define "covered fund" in a way that excludes ordinary corporate structures that have never been considered hedge funds or private equity funds, such as wholly owned subsidiaries, joint ventures and acquisition vehicles.

   b. **Proposed Regulatory Definitions**

      (i) **Covered Fund**. The term "covered fund" should be defined as a "hedge fund," "private equity fund" or "designated similar fund" to maintain the distinctions between these different types of covered funds.

      (ii) **Hedge Fund**. The term "hedge fund" should be defined as any issuer that both (A) would be an investment company under the Investment Company Act of 1940 (the "**1940 Act**") but for Sections 3(c)(1) or 3(c)(7) of that Act and (B) has all of the characteristics of a hedge fund as commonly understood, as set forth in **Annex B**.

      (iii) **Private Equity Fund**. The term "private equity fund" should be defined as any issuer that both (A) would be an investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act and (B) has all of the characteristics of a private equity fund as commonly understood, as set forth in **Annex B**.

   c. **Excluded Entities**. The Agencies should define the term "covered fund" in a manner that excludes any issuer that is a wholly owned subsidiary, joint venture, acquisition vehicle, SEC-registered investment company or business development company, financial market utility and any other issuer that is designated as an excluded entity by rule or order of the Agency that is a banking entity's primary federal financial regulator.

      (i) **Wholly Owned Subsidiaries**. The Agencies should exclude all wholly owned subsidiaries from the term "covered fund."

(ii) **Joint Ventures**.

(A) **Operating Company Condition**. The Agencies should eliminate the "operating company" condition in the definition of "joint venture."

(B) **Proposed Definition**. Instead, they should define the term "joint venture" as any company with (i) a limited number of co-venturers and (ii) management pursuant to a shareholders' agreement among the co-venturers, rather than management by a general partner or similar entity.

(C) **Operating Company Definition**. If the Agencies retain the "operating company" condition, the term "operating company" should be defined as any company engaged in activities that are permissible for a financial holding company under Sections 3 or 4 of the BHC Act, other than being a company engaged exclusively in investing in the securities of other companies for resale or other disposition.

(iii) **Acquisition Vehicles**. The Agencies should exclude acquisition vehicles from the term "covered fund" so that such entities are not treated as covered funds under the Volcker Rule for any purpose, including Super 23A.

(iv) **SEC-Registered Investment Companies and BDCs**. The Agencies should exclude SEC-registered investment companies and business development companies from the definition of "covered fund."

(v) **Financial Market Utilities**. The Agencies should exclude financial market utilities from the definition of "covered fund."

(vi) **Other Excluded Entities**. The Agencies should include a mechanism in the Proposed Rules that would permit the Agencies to exclude other categories of entities from the term "covered fund" by rule or order.

4. **Designated Similar Fund**. The term "designated similar fund" should be defined as any "similar commodity pool" or "similar foreign fund."

a. **Similar Commodity Pool**. The term "similar commodity pool" should be defined as any commodity pool, as defined in the Commodity Exchange Act, that satisfies ***all*** of the following conditions:

(i) it is engaged primarily in trading commodity interests; ***and***

(ii) it does not make a public offering of its securities; ***and***

(iii) its securities are beneficially owned by no more than 100 persons or exclusively by qualified purchasers (as defined in the 1940 Act); ***and***

(iv) it has all of the characteristics of a hedge fund or private equity fund as commonly understood, as set forth on **Annex B**; ***and***

(v) it is not an Excluded Entity (as defined below) or an ETF (as defined below).

b. **Similar Foreign Fund**. The term "similar foreign fund" should be defined as any foreign fund that satisfies ***all*** of the following conditions:

(i) (1) it is engaged primarily in the business of investing, reinvesting or trading in securities ***or*** (2) is engaged in investing, reinvesting, owning, holding or trading in securities and the value of its investment securities exceeds 40% of the value of its total consolidated assets; ***and***

(ii) (1) it does not make a public offering of its securities ***or*** (2) is not eligible to make a public offering and is not subject to regulation of its activities or investments; ***and***

(iii) its securities are beneficially owned by no more than 100 persons or exclusively by qualified purchasers (as defined in the 1940 Act); ***and***

(iv) it has all of the characteristics of a hedge fund or private equity fund as set forth on **Annex B**; ***and***

(v) it is not an Excluded Entity (as defined below) or an ETF (as defined below).

5. **Permitted Activities Authority**. As an alternative to our recommendations in paragraphs b and c above, the Agencies should expand their proposed "permitted activities" exemptions for certain wholly owned subsidiaries, joint ventures and acquisition vehicles as follows:

a. **Super 23A**. The Agencies should expand their proposed "permitted activities" exemptions for wholly owned subsidiaries, joint ventures and acquisition vehicles to include all covered transactions otherwise prohibited by Super 23A.

b. **Excluded Entities**. The Agencies should expand the range of entities to which these "permitted activities" exemptions apply to include all Excluded Entities (as defined above) and ETFs (as defined below).

6. **Banking Entity**

a. **Control**. For purposes of the term "banking entity," the terms "subsidiary" and "control" should be defined as set forth in Section 2 of the Bank Holding Company Act of 1956 (the "**BHC Act**"), but in each case without the "controlling influence" prong.

b. **Exclusions**. The following entities should be excluded from the term "banking entity":

(i) **Permitted Covered Funds**. All covered funds that a banking entity is permitted to sponsor or invest in under any "permitted activity" exemption, including the asset management exemption;

(ii) **Exempt Funds**. All issuers that would be investment companies under the 1940 Act, except that they qualify for an exemption under any provision of that Act other than Sections 3(c)(1) or 3(c)(7) of that Act (each, an "**Exempt Fund**");

(iii) **SEC-Registered Investment Companies and BDCs**. All SEC-registered investment companies and business development companies;

(iv) **Public Commodity Pools**. All commodity pools that have made a public offering of their securities and have not been taken private;

(v) **Public Foreign Funds**. All foreign funds that either (i) have made a public offering of their securities and have not been taken private or (ii) are eligible to make a public offering and are subject to regulation of their investments and activities;

(vi) **Portfolio Companies**. All portfolio companies held by a bank holding company under the merchant banking authority of Section 4(k)(4)(H) of the BHC Act or by any other type of depository institution holding company in accordance with applicable federal law;

(vii) **Temporarily Grandfathered Covered Funds**. All covered funds established before the effective date of the Volcker Rule, but only for the duration of the conformance period;

(viii) **Subsidiaries**. All direct or indirect subsidiaries of any of the foregoing; and

(ix) **Investment Management Affiliates**. Solely for purposes of the name sharing condition in the asset management exemption, all investment management affiliates, provided that such investment management affiliates do not share a name with an insured depository institution affiliate or the ultimate parent of such an insured depository institution affiliate.

7. **Permitted Activities**

a. **Super 23A**. The Agencies should provide that all of the "permitted activities" exemptions, other than the asset management exemption, will apply to Super 23A in addition to the general prohibition on sponsoring or investing in a covered fund.

b. **Asset Management**

(i) **Sponsor**.

(A) **Initial Directors, Trustees or Management**. A banking entity should not be treated as the "sponsor" of a covered fund based on selecting a majority of the initial directors, trustees or management of the fund, including any general partner, managing member or board of members, if a majority of the persons or entities selected are independent of the banking entity.

(B) **Limited Trustee**. The Agencies should clarify that a "trustee" would not be deemed to be exercising investment discretion solely by virtue of exercising discretion as to the securities lending or collateral or cash management activities of a covered fund.

(C) **Commodity Pool Operators**. The Agencies should correct a technical oversight in the proposed text of the first condition of the asset management exemption to clarify that a banking entity can satisfy that condition by acting as a commodity pool operator to a covered fund.

(ii) **Attribution Rules**.

(A) **Controlled Investments**. The attribution rule for controlled investments should be limited to controlled entities that fall within the term "banking entity," as properly construed.

(B) **Non-Controlled Investments**. The *pro rata* attribution rule for non-controlled investments should be dropped.

(C) **Parallel Co-Investments**. The attribution rule for parallel co-investments should be limited to a pattern of multiple co-investments that evidences an intent to evade the investment limits in the asset management exemption.

(iii) **Employee and Director Investments**. Investments permissibly made by a director or employee directly engaged in providing investment advisory or other services to a covered fund organized and offered or sponsored under the asset management exemption should not become impermissible solely because the

director or employee ceases to provide such services, absent evidence of an intent to evade the prohibitions of the Volcker Rule.

(iv) **Carried Interest**. The Agencies should clarify that a minimal capital contribution by a banking entity (including any affiliate or employee) to a covered fund for the sole purpose of facilitating certain tax treatment of the banking entity's (including any affiliate's or employee's) carried interest will not affect the exclusion of such carried interest from the definition of "ownership interest."

(v) **Deduction from Regulatory Capital**. The deduction from regulatory capital of investments made in covered funds held under the asset management exemption should be eliminated.

(vi) **Seeding Period Extensions**

(A) **Both Investment Limits**. Extensions of the seeding period should be available for both the per fund and aggregate investment limits.

(B) **Track Records**. A procedure should be established to provide banking entities with extensions for the full three years in advance for the limited purpose of establishing a track record for new funds, if certain rigorous conditions are satisfied.

(vii) **Cure Period**. The Agencies should amend the Proposed Rules to provide banking entities with a six month cure period for any failure to comply with any of the investment limits for reasons beyond their reasonable control.

c. **Credit Funds**

(i) **Specific Exemption**. The Agencies should provide a specific "permitted activities" exemption for sponsoring or investing in, and entering into covered transactions with related, credit funds.

(ii) **Part of Asset-Backed Securities Exemption**. Alternatively, the Agencies should confirm that (A) the "permitted activities" exemption for sponsoring or investing in issuers of asset-backed securities includes credit funds, (B) the term "asset-backed security" includes "ownership interests" in credit funds, (C) the term "loan" includes all extensions of credit, including notes and bonds, and (D) the exemption extends to covered transactions otherwise prohibited by Super 23A.

d. **Underwriting and Market Making-Related Activities**.

(i) **Application to Covered Funds**. A "permitted activities" exemption that extends to Super 23A should be added for underwriting and market-making-related activities with respect to ownership interests in covered funds.

(ii) **Exchange Traded Funds**. The requested exemption for underwriting and market-making-related activities should permit banking entities to continue to serve as authorized participants to an ETF issuer or as market makers for ETF shares.

e. **Risk-Mitigating Hedging**

(i) **Single Exemption**. The Agencies should provide a single hedging exemption for both the proprietary trading and covered fund portions of the Volcker Rule, eliminating the additional conditions for covered funds.

(ii) **Minimum Alternative**. At a minimum, the Agencies should alternatively:

(A) **Profits and Losses Condition**. Clarify that the "profits and losses" condition of the hedging exemption for covered funds does not prohibit banking entities from hedging exposures to covered fund-linked products designed to facilitate customer exposure to either or both the profits (or a portion of the profits) or the losses (or a portion of the losses) of a covered fund reference asset;

(B) **Same Amount of Ownership Interest Condition**. Clarify that, notwithstanding the "same amount of ownership interest" condition, dynamic delta hedging of covered fund-linked products is permitted by the hedging exemption for covered funds and that "portfolio" hedging of exposures to covered fund-linked products is permitted;

(C) **Customer Request Condition**. Clarify or eliminate the "specific customer request" condition in order to ensure that banking entities may continue innovating and offering covered fund-linked products to existing and new customers in accordance with market practice, customer expectations and applicable laws and regulations;

(D) **Non-Banking Entity Condition**. Eliminate the prohibition on hedging a customer exposure where the customer is a banking entity or, at a minimum, amend it to permit reliance on certain customer representations;

(E) **Interaffiliate Transactions**. Clarify that interaffiliate transactions will be deemed part of a coordinated activity for purposes of determining compliance with a permitted activity, including risk-mitigating hedging activities; and

(F) **Grandfathered Hedging Activities**. With respect to covered fund-linked products sold to customers before the effective date of the Volcker Rule, permit banking entities to continue to engage in the types of risk-mitigating hedging activities that they were engaged in before the effective date with respect to such products, so long as they comply with the conditions in the hedging exemption for proprietary trading.

f. **SBICs**. The Agencies should clarify that an "investment that is designed primarily to promote the public welfare, of the type" permitted under 12 U.S.C. 24(Eleventh) is not limited to investments in the United States.

g. **Offshore Exemption**. A foreign banking organization should be permitted to invest as a passive investor in a covered fund sponsored and controlled by an unaffiliated third party as long as such foreign banking organization does not offer or sell ownership interests in the covered fund to U.S. residents and otherwise complies with the statutory conditions of the offshore exemption.

8. **Super 23A**.

a. **Covered Transactions.** The phrase "covered transaction, as defined in section 23A of the Federal Reserve Act" should be construed to mean the list of prohibited transactions contained in Section 23A(a)(7) of that Act, as qualified by the list of excluded transactions contained in Section 23A(d) of that Act, including the exclusion for intraday extensions of credit contained in the Board's Regulation W.

b. **Collateral**. The Agencies should clarify that the DPC exemption permits a banking entity to take ownership interests in a related fund as collateral to secure extensions of credit to a customer notwithstanding Super 23A.

9. **Compliance**.

a. **Which Agency**. The Agencies should provide in the final rules that:

(i) **Interpretation**. The Board will have exclusive authority to interpret the Volcker Rule and the Proposed Rules;

(ii) **Examinations**. Where more than one Agency has examination authority over a given banking entity, the Agencies will ensure that any examination of the banking entity under the Volcker Rule will be done on a coordinated basis;

(iii) **Enforcement**. No enforcement action may be initiated by an Agency under the Volcker Rule unless done on a coordinated basis with all the Agencies.

b. **Timing**. The Agencies should clarify that banking entities will have at least one year following issuance of the final rules to develop and implement compliance programs.

10. **Conformance Period**

a. **Extended Conformance Period**. Because the Agencies were unable to issue final rules implementing the Volcker Rule before the statutory deadline in October 2011, the Board should delay the effective date of the statute until one year after the later of July 21, 2012 and the date on which final rules become effective. Alternatively, the Board should grant a general one-year extension of the conformance period to all covered banking entities in advance.

b. **Non-Funds and Similar Funds**. The Board should amend its conformance rules to permit banking entities to continue sponsoring or investing in, or entering into new covered transactions with a related, entity that (i) may fall within the term "covered fund," but is not a genuine hedge fund or private equity fund as commonly understood or (ii) is a designated similar fund, for the duration of the conformance period.

c. **New Covered Transactions**. The Board should clarify that a banking entity may, during the conformance period, continue to enter into new covered transactions with a covered fund that was established before the effective date of the statute.

d. **Illiquid Funds**. The Board should amend its conformance rules to provide a meaningful extended conformance period for illiquid funds.

ANNEX B

DEFINITION OF HEDGE FUNDS OR PRIVATE EQUITY FUNDS

Hedge Funds:

SIFMA believes that a hedge fund for purposes of the Volcker Rule should be defined as:

(A) An investment fund for third-party investors that invests in a portfolio of investments and:

(i) That is either (x) offered in the United States and 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, and is not otherwise registered under the 1940 Act, or (y) organized and offered exclusively outside the United States and is not eligible to be offered to the public in any jurisdiction; and

(ii) The investment activities, management and operations of which are not subject to regulatory restrictions or limitations (*e.g.*, a requirement to have independent directors on the board of directors, or limitations on borrowing, short sales or types of investments); and

(iii) That provides investors with restricted or limited redemption rights (*i.e.*, not daily or weekly redemption rights); and

(iv) That is advised by an investment manager who earns a performance fee or allocation (*e.g.*, a carried interest) that is performance-based (*i.e.*, it is calculated taking into account the performance of the fund's portfolio over a specified period of time, subject to various measures such as a "high water mark" or other adjustments); and

(v) That is not subject to day-to-day control, or routine management or operation, by its investors; and

(vi) That may (x) borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value (including any committed capital), (y) sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration) or (z) engage in both (x) and (y); or

(B) A fund of funds that itself meets all of the criteria set forth in clauses (i) through (v) of (A) above and invests in underlying funds that meet all of the criteria set forth in (A) above.

Private Equity Funds:

SIFMA believes that a private equity fund for purposes of the Volcker Rule should be defined as:

(A) An investment fund for third-party investors that invests in a portfolio of investments and:

(i) That is either (x) offered in the United States and 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, and is not otherwise registered under the 1940 Act, or (y) organized and offered exclusively outside the United States and is not eligible to be offered to the public in any jurisdiction; and

(ii) The investment activities, management and operations of which are not subject to regulatory restrictions or limitations (*e.g.*, a requirement to have independent directors on the board of directors, or limitations on borrowing, short sales or types of investments); and

(iii) That prohibits investors from withdrawing or redeeming their investments in the fund (other than withdrawals or redemptions for illegality or other regulatory reasons); and

(iv) That is advised by an investment manager who earns a performance fee or allocation (*e.g.*, a carried interest) that is performance-based (*i.e.*, it is calculated taking into account the performance of the fund's portfolio over a specified period of time, subject to various measures such as a "hurdle rate" or other adjustments); and

(v) That is not subject to day-to-day control, or routine management or operation, by its investors; and

(vi) The purpose of which is to generate investment returns by (x) acquiring the unregistered equity or equity-like securities of companies for which there is no public market and for which third-party valuations are not readily available, (y) holding those investments long-term and (z) realizing on such investments and distributing the proceeds thereof to investors before the end of the fund's life; and

(vii) That by its terms is in existence for a specified period of time; and

(viii) That can admit new investors, or permit existing investors to increase their investment in the fund, only during an initial start-up period, after which the fund is closed to new investors; or

A fund of funds that itself meets all of the criteria set forth in clauses (i) through (v) of (A) above and invests in underlying funds that meet all of the criteria set forth in (A) above.

ANNEX C

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DISCUSSION

I. Executive Summary

This annex is the core of our comment letter. It identifies a number of flaws in the Proposed Rules and proposes amendments for resolving them. It identifies the legal authority for the Agencies to implement our recommended amendments, and explains why the proposed amendments reflect reasonable interpretations of the Volcker Rule that are entitled to *Chevron* deference.

The errors and omissions in the Proposed Rules that need to be corrected include the following:

- Failure to conduct a rigorous cost/benefit analysis of the Proposed Rules;
- Defining the term "covered fund" in a manner that eliminates the distinctions between hedge funds and private equity funds and between funds and non-funds;
- Treating regulated public foreign funds, including UCITS,[1] as if they were hedge funds or private equity funds;
- Failure to define "banking entity" in a way that avoids creating internal contradictions within the statute and the Proposed Rules and absurd results;
- Failure to include an express "permitted activities" exemption for sponsoring and investing in credit funds;
- Reading out of the statute or unreasonably limiting the statutory exemptions for underwriting, market-making-related activities and risk-mitigating hedging;
- Certain inappropriate rules implementing the asset management exemption, including the proposed attribution rules and regulatory capital deductions;
- Failure to construe the term "covered transactions" in a way that reflects the exclusions from that defined term, as used in Section 23A of the Federal Reserve Act;

[1] A UCITS is a fund organized under the European Union's Undertakings for Collective Investment in Transferable Securities Directive.

- Failure to specify which Agency is responsible for interpreting, supervising and enforcing the Proposed Rules for a particular banking entity under a particular set of circumstances;

- Restricting the conformance rules to pre-existing activities instead of also applying them to "new" activities during the conformance period; and

- Reading out of the statute a meaningful extended transition period for illiquid funds.

These serious errors and omissions are inconsistent with the language, structure or legislative history of the statute, congressional intent or the findings and recommendations of the FSOC Study or the GAO Report.

This annex first contains a general discussion of the legal authority for the recommended amendments. It then discusses why we believe that the Agencies are required to conduct a thorough cost/benefit analysis of the Proposed Rules in accordance with the standards set forth in the *Business Roundtable* decision. It argues that the Agencies have the duty and authority to define the term "covered funds" in a manner that excludes ordinary business structures that have never been considered hedge funds or private equity funds, such as wholly owned subsidiaries, joint ventures and acquisition vehicles. It argues that the Agencies should exclude all permitted covered funds and certain other entities from the term "banking entity" so that that term will be consistent with the structure of the Volcker Rule. Next it turns to the various "permitted activities" exemptions, including the asset management exemption. It argues that the Agencies should add a "permitted activities" exemption for sponsoring and investing in credit funds. It also argues that the Agencies should construe the "permitted activities" exemptions for underwriting, market-making related activities and risk-mitigating hedging, to be available and essentially identical for both the proprietary trading and covered funds portions of the Volcker Rule. It argues that the SBIC exemption should extend to "public welfare" investments outside the United States. It also recommends that the statutory offshore exemption be construed to provide foreign banks with a meaningful opportunity to continue investing as limited partners in third-party hedge funds and private equity funds, as long as the foreign banks do not offer or sell any of the funds' interests to U.S. residents and otherwise comply with the statutory conditions of the offshore exemption. It argues that the Agencies should define "covered transactions" to reflect the exclusions from that term contained in regular Section 23A of the Federal Reserve Act. Finally, it addresses certain important compliance and conformance issues.

II. Authority for Proposed Amendments

> ***SIFMA observation***: All of our recommendations are consistent with the language, structure and legislative history of the Volcker Rule. They are based on reasonable interpretations of the statute and are therefore entitled to *Chevron* deference.

Before discussing our proposed amendments, we believe it will be helpful to summarize our approach to identifying sources of authority for each requested Agency action and whether the specific action will qualify for deference under *Chevron U.S.A., Inc. v. Natural Resources Defense Council.*[2]

Where the statutory text is clear on an issue, "that is the end of the matter" and the Agencies are obligated to follow the plain meaning of the statute.[3] There are two notable exceptions to this requirement. First, a statute must not be interpreted to produce an absurd result.[4] Second, the statutory Volcker Rule is unusual in that it gives the Agencies authority to establish exemptions from statutory requirements when doing so "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."[5] Consideration of potential exemptions is an appropriate element of the Agencies' implementation of the statute—as already reflected in the Proposed Rules.[6] In the discussion below, we identify specific instances where we believe an exemption is warranted even though the Agencies determined that the statutory language did not permit the substantive approach we recommend.

The "plain meaning" of the statute is to be determined by considering not only the specific statutory words at issue, but through all other appropriate tools of statutory construction. These include the "whole act rule" which provides that statutory provisions must be interpreted in light of the statute as a whole and the legal backdrop against which the statute was enacted.[7] They

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[2] 467 U.S. 837 (1984). *See also INS v. Cardoza-Fonseca*, 480 U.S. 421, 454 (Scalia, J., concurring in the judgment) (restates approvingly the *Chevron* rule of deference); *NLRB v. United Food & Commercial Workers Union, Local 23*, 484 U.S. 112, 133 (1987) (Scalia, J., concurring) (Chevron requires deference to agency whenever a statute is ambiguous or silent on an issue); Antonin Scalia, *Judicial Deference to Administrative Interpretations of Law*, 1989 DUKE L.J. 511, 520-521 (1989) (explaining *Chevron* rule of deference).

[3] *See Chevron*, 467 U.S. at 842-43.

[4] *See, e.g., INS v. Cardoza-Fonseca*, 480 U.S. at 452 (Scalia J., concurring in the judgment) (It is a "venerable principle that if the language of a statute is clear, that language must be given effect – at least in the absence of a patent absurdity.").

[5] *See* 12 U.S.C. § 1851(d)(1)(J).

[6] *See, e.g.*, Proposed Rules § .__14(a) (providing exemptions to certain specified activities).

[7] *See* SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 20:22 (7th ed., Norman J. Singer ed.) ("A proper application of the 'whole act interpretation' will ascribe to the exception equal power over all other provisions of the act unless it is specifically limited to particular sections."). *See also U.S. Nat. Bank of Oregon v. Independent Ins. Agents of America, Inc.* 508 U.S. 439, 455 (1993) ("[i]n expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law," and statutory construction "must account for a statute's full text, language as well as punctuation, structure, and subject

also include the canons that statutes must be interpreted to avoid internal inconsistencies[8] and resolve ambiguities.[9] In the case of the Volcker Rule, there is also legislative history that in some instances bears on the statute's meaning.

Finally, and as the Agencies are aware, when the terms of the statute do not clearly resolve a matter, then under *Chevron* "Step 2" the Agencies have the authority to adopt an interpretation of the relevant statutory language that is "reasonable."[10] In arriving at that interpretation, the Agencies also are obligated to comply with the Administrative Procedure Act and all other applicable statutory requirements.[11]

All of our proposed amendments are consistent with these principles of statutory construction. They reflect reasonable constructions of ambiguous statutory language and reasonable resolutions of internal inconsistencies or absurd results that Congress could not possibly have intended. If adopted by the Agencies, they would all be entitled to *Chevron* deference.

III. Cost/Benefit Analysis

> ***SIFMA observation***: The Agencies are required to conduct a rigorous cost/benefit analysis of the Proposed Rules as a whole, and rule-by-rule, as required by the *Business Roundtable* decision.

As noted in the introduction, the Agencies failed to conduct any substantial cost/benefit analysis of the Proposed Rules, much less the sort of rigorous cost/benefit analysis required by the *Business Roundtable* decision.

The Agencies did conduct a very limited cost/benefit analysis of the information requirements of the Proposed Rules under the Paperwork Reduction Act.[12] The SEC also

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matter.") (internal quotation marks and citation omitted); *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring) (meaning of terms of a statute should determined "on the basis of which meaning is . . . most compatible with the surrounding body of law into which the provision must be integrated.").

[8] *See Eli Lilly & Co. v. Medtronic, Inc.*, 496 U.S. 661 (1990) (Scalia, J.) (resolving ambiguity in text by examining "structure" and purpose of statute).

[9] *See United Savings Ass'n v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988) ("Statutory construction . . . is a holistic endeavor. A provision that may seem ambiguous in isolation is often clarified by the remainder of the statutory scheme—because the same terminology is used elsewhere in a context that makes its meaning clear, . . . or because only one of the permissible meanings produces a substantive effect that is compatible with the rest of the law.").

[10] *See Chevron*, 467 U.S. at 844.

[11] *See Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166 (2010) (although statutory interpretation was "reasonable" under *Chevron* "Step 2," the agency rulemaking adopting the interpretation was arbitrary and capricious).

[12] *See* 76 Fed. Reg. 68846, 68936-68938 (Nov. 7, 2011).

conducted a cost/benefit analysis under Sections 3(f) and 23(a)(2) of the Securities Exchange Act of 1934 ("**1934 Act**") of the compliance and enforcement portions of the Proposed Rules to the extent they would apply to registered broker-dealers and securities-based swap dealers because it relied on the 1934 Act as authority for those portions of the Proposed Rules.[13] None of the Agencies performed a cost/benefit analysis under the Regulatory Flexibility Act because they concluded – wrongly in our view – that the Proposed Rules would not have a significant economic impact on a substantial number of small entities.[14] Nor did the OCC perform a cost/benefit analysis under the Unfunded Mandates Reform Act of 1995 ("**Unfunded Mandates Act**") because it concluded – again wrongly in our view – that the Proposed Rules would not result in expenditures by state, local, and tribal governments, or by the private sector, of $100 million or more in any one year.[15] The SEC did not perform a cost/benefit analysis under the Small Business Regulatory Enforcement Fairness Act of 1996 ("**Small Business Act**"), but requested comment on whether the Proposed Rules would have the sort of impact on the U.S. economy that would require a cost/benefit analysis under that law.[16]

We believe that the Agencies are required to conduct a thorough cost/benefit analysis of the Proposed Rules under these and a variety of other statutes, executive orders and Agency policy statements. For example, we believe that the Agencies must conduct a cost/benefit analysis under the Regulatory Flexibility Act unless the Proposed Rules would not have a significant economic impact on a substantial number of small entities. We do not believe it is enough, under the *Business Roundtable* decision, for the Agencies to provide bare certifications that the Proposed Rules would have no such impact.[17] We believe that the *Business Roundtable* decision requires the Agencies to provide sufficient evidence to support their certifications;[18] otherwise, their certifications will be invalidated as "arbitrary and capricious and not in accordance with law."[19] We do not believe that the Agencies satisfied these mandatory evidentiary requirements.[20]

In the Supplementary Information accompanying the Proposed Rules, the Agencies state that they do not intend to perform an analysis under the Regulatory Flexibility Act of whether the Proposed Rules will have a significant economic impact on a substantial number of small entities because "[t]he proposed rule would not appear" to have such an impact.[21] The Agencies identify two bases for that summary conclusion: (1) "while the proposed rule will affect

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[13] *Id.* at 68939-68942.

[14] *Id.* at 68939.

[15] *Id.*

[16] *Id.*

[17] *See Business Roundtable*, 647 F.3d at 1148 (The court "must assure [itself] the agency has examined the relevant data and articulated a satisfactory explanation for its action.").

[18] *See id.* at 1150 (rule invalid when agency "relie[s] upon insufficient empirical data.").

[19] *Id.* at 1148.

[20] *See* 76 Fed. Reg. at 68938-68939.

[21] *See id.* at 68938.

all banking organizations . . . only certain limited requirements would be imposed on entities that engage in little or no covered trading activities or covered fund activities and investments," and (2) "the scope and size of the compliance program requirements . . . would vary based on the size and activities of each covered banking entity."[22]

That conclusion is incorrect because it fails to take account of the significant impact the Proposed Rules will have on numerous small entities by restricting their access to a variety of products and services, including covered fund-linked products for investment and hedging purposes and underwriting and market-making-related services. When these effects are taken into account, it is clear that the adverse effects on small entities are great and a Regulatory Flexibility Act analysis is required.

A rule "regulates" small entities within the meaning of the Regulatory Flexibility Act if it "directly affects" them, even if the regulation does not apply to those entities primarily or exclusively. For example, in *Aeronautical Repair Station Ass'n, Inc. v. FAA*,[23] the FAA promulgated a regulation mandating that air carriers require drug and alcohol testing of employees.[24] The FAA argued that the Regulatory Flexibility Act did not apply because the air carriers were not small entities. Although the regulation would have affected small repair stations that contracted with air carriers to perform maintenance work, the FAA reasoned that a Regulatory Flexibility Act analysis was unnecessary because those contractors were not "directly regulated" and were not the "targets" of the regulation.[25] The court rejected that argument, holding that the contractors were "subject to the proposed regulation" for purposes of the Regulatory Flexibility Act even though the regulation was "immediately addressed" to the air carriers, because the regulations applied to employees of the contractors, just as it applied to employees of the air carriers.[26] The contractors were "directly affected and therefore regulated" within the meaning of the Regulatory Flexibility Act.

Here, similarly, small entities will be "directly affected and therefore regulated," even though they are not the express "targets" of the Proposed Rules. The Proposed Rules threaten to broadly restrict the provision of services and products, *e.g.*, the provision of covered fund-linked products for investment and hedging purposes and underwriting and market-making-related services. The activities of both the sellers (*i.e.*, banking entities, primarily) and the buyers (*i.e.*, large and small business entities) of those products and services are restricted by the Proposed Rules. Countless small entities will therefore have diminished access to the products and services prohibited or heavily restricted by the Proposed Rules. Although the Proposed Rules would enforce these restrictions by directly regulating only the sellers of those services, *i.e.*, banking entities, the effect, as in *Aeronautical Repair Station*, is to effectively prohibit small

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[22] *See id.* at 68938-68939.

[23] 494 F.3d 161, 177 (D.C. Cir. 2007).

[24] *See id.* at 161.

[25] *Id.* at 175-76.

[26] *Id.* at 177.

entities from having access to a deep and liquid market in products and services they otherwise would have.

When these small entities are taken into account, it is clear that the Proposed Rules have a "significant impact" on small entities. The Proposed Rules' restrictions on various activities are severe and will reduce the availability and increase the costs of products and services that are important to small entities. A Regulatory Flexibility Act analysis is therefore required.

We also believe that the OCC, as an executive agency, is required to conduct a thorough cost/benefit analysis under the Unfunded Mandates Act unless it provides sufficient evidence that the Proposed Rules would not result in expenditures by state, local, and tribal governments, or by the private sector, of $100 million or more in any one year. Not only did the OCC fail to provide any evidence to support such a conclusion,[27] but, as more fully discussed in the body of this comment letter, there is substantial reason to believe that the Agencies' failure to exclude all wholly owned subsidiaries from the definition of "covered fund" in Subpart C of the Proposed Rules will – ***alone*** – result in industry-wide compliance and restructuring costs by national banks and their affiliates of more than $100 million in the first year and similar costs annually,[28] with the rest of the Proposed Rules adding substantially to those initial and subsequent annual price tags. In addition, the OCC's determination is highly implausible in light of the Agencies' estimation that recordkeeping and compliance requirements alone will require over 6.5 million hours of work when national banks and their affiliates make up the vast majority of the companies affected by the Proposed Rules.[29] Accordingly, a budgetary impact statement must be prepared.

We further believe that the Agencies are required to perform a cost/benefit analysis under the Small Business Act, unless they affirmatively conclude that the Proposed Rules will not result in an annual effect on the U.S. economy of $100 million or more, a major increase in the costs or prices for consumers or individual industries or significant adverse effects on competition, investment, or innovation ***and*** provide sufficient evidence for their conclusions. The Agencies cannot escape their obligations to perform such a cost/benefit analysis by shifting the burden of proof to the public by requesting comment on the threshold economic impact issue and then relying on any failure by the public to meet that burden of proof as evidence that the threshold was not met.[30] Instead, they must affirmatively reach a conclusion on that threshold economic impact issue ***and*** provide sufficient evidence to support that conclusion in order to satisfy the standard established in the *Business Roundtable* decision.

As the SEC has acknowledged,[31] it is required to do a cost/benefit analysis of the compliance and enforcement provisions of the Proposed Rules under Sections 3(f) and 23(a)(2) of

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[27] *See id.* at 68939.

[28] *See* Section IV.A(3)(a) of this comment letter.

[29] *See* 76 Fed. Reg. at 68938.

[30] *See id.* at 68939.

[31] *See id.* at 68940.

the 1934 Act to the extent they apply to SEC-registered broker-dealers and securities-based swap dealers because it relied on the 1934 Act for authority to issue those portions of the Proposed Rules.[32] Indeed, as a matter of policy and law, the SEC and the other Agencies engaged in this rulemaking should consider the effects of their actions on efficiency, competition, and capital formation even in the absence of an express statutory command that they do so. It is axiomatic that the nation's financial regulatory agencies should minimize the extent to which they impose inefficiencies, reduce competition, or restrict capital formation. When commenters identify alternative means of satisfying the Agencies' statutory responsibilities that have a more favorable impact on efficiency, competition, and capital formation, it would be arbitrary and capricious for the Agencies to reject those commenters' proposal without compelling justification.[33]

The cost/benefit analysis that the SEC did perform, regarding the compliance and enforcement provisions of the Proposed Rules, does not satisfy the *Business Roundtable* standard. The SEC's responsibility is "to determine as best it can the economic implications of the rule it has proposed."[34] That analysis must be made available for public comment during the rulemaking.[35]

The limited analysis in the Proposed Rules falls far short of these requirements. For example, the SEC fails to provide any estimate at all of the costs of the recordkeeping and documentation requirements. Previous SEC rules have been invalidated for comparable deficiencies. In *Chamber of Commerce v. SEC*,[36] the SEC declined to estimate certain regulatory costs because it said it did not know the means that mutual funds would use to satisfy its rule. In remanding, the D.C. Circuit responded: "That particular difficulty may mean that the Commission can determine only the range within which a fund's cost of compliance will fall . . . but . . . it does not excuse the Commission from its statutory obligation to determine as best it can the economic implications of the rule it has proposed."[37] More recently, in *Business Roundtable*, the D.C. Circuit vacated an SEC regulation in part because the SEC "did nothing to estimate and quantify the costs it expected companies to incur" under that regulation.[38]

In the Proposed Rules, the SEC also engages in inconclusive speculation rather than providing the articulable predictions and estimates required for reasoned rulemaking. For example, the SEC speculates that the Proposed Rules' requirements "may marginally reduce the

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[32] 15 U.S.C. § 78c(f) ("Whenever pursuant to this chapter, the Commission is engaged in rulemaking, the Commission must consider . . . whether the action will promote efficiency, competition, and capital formation."); 15 U.S.C. § 78w(a)(2) ("The Commission … shall not adopt any such rule or regulation which would impose a burden on competition not necessary or appropriate in furtherance of the purposes of" the Exchange Act.).

[33] *Cf. Am. Equity Inv. Life Ins. Co. v. SEC*, 613 F.3d 166, 177 (D.C. Cir. 2010).

[34] *See Chamber of Commerce v. SEC* (Chamber I), 412 F.3d 133, 143 (D.C. Cir. 2005).

[35] *See Chamber of Commerce v. SEC* (Chamber II), 443 F.3d 890, 905 (D.C. Cir. 2006) (public was entitled to notice of and an opportunity to comment on materials that were significant to agency's analysis).

[36] *See* Chamber I, 412 F.3d 133 (D.C. Cir. 2005).

[37] *Id.* at 143.

[38] *See* Chamber II, 647 F.3d at 1150.

ability of covered banking entities . . . to compete," "may lead to a decreased competitiveness," "may" cause covered banking entities to "reduce the size or scope of their market-making activities," and "could likewise harm efficiency and capital formation."[39] Indeed, these things will occur and, in any event, it is the SEC's obligation to make its best projection of what will happen and the magnitude of the effect. It is insufficient to muse about what "may" – and by implication "may not" – result from the agency's action.

The SEC's analysis suffers other flaws as well. It appears to count as the only significant benefit of many of the recordkeeping and documentation requirements that "these measures may improve compliance within covered banking entities and thereby reduce the potential consequences associated with noncompliance."[40] But that reasoning would justify any recordkeeping requirement absent a more detailed and nuanced assessment. The SEC's analysis fails to consider the costs and benefits of alternate levels for reporting requirements.

Similarly, the SEC admits that the Proposed Rules' required compliance program will likely have significant costs.[41] The only benefit of the compliance program mentioned is that it "could have positive efficiency effects by generally improving compliance and thereby reduce the potential consequences associated with noncompliance."[42] But again, that reasoning would justify any recordkeeping requirement.

In addition, the SEC proposes to impose the compliance program requirements immediately upon the effective date. But the statute provides for a two-year conformance period, subject to further extension by the Federal Reserve, for banking entities to comply with the Volcker Rule's requirements.[43] Accordingly, under the SEC's own analysis, the sole identified benefit of the compliance program — that it will reduce noncompliance — will not even be realized until the compliance program has been in place for years, imposing significant costs with no corresponding benefit. This is unsupportable.

In sum, the SEC did not provide the sort of evidence required by the *Business Roundtable* decision to support its conclusions that the benefits of those compliance and enforcement provisions outweighed their costs. Instead, the SEC grossly underestimated the compliance and enforcement costs, and exaggerated the benefits of the compliance and enforcement rules. As in *Business Roundtable*, the SEC did "nothing to estimate and quantify the

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[39] *See* 76 Fed. Reg. at 68941-68942 (emphases added).

[40] *Id.* at 68941.

[41] *See, e.g.*, 76 Fed. Reg. at 68941 ("[i]ncurring these costs may marginally reduce the ability of covered banking entities . . . to compete with their non-banking entity counterparts"); *id.* (banking entities could "pass some of the costs along to customers and clients of their services"); *id.* ("the overall reduction in market making activities would likely have a negative impact on market efficiency and liquidity"); *id.* at 68942 (the proposal "could cause the covered banking entity to redirect resources from other business activities that are generally beneficial to market efficiency").

[42] *Id.*

[43] *See* 12 U.S.C. § 1851(c); 76 Fed. Reg. at 68941.

costs" it expected banking entities to incur, nor did it "claim [that] estimating those costs was not possible."[44]

In addition to the statutory mandates discussed above, the OCC is required to conduct a thorough cost/benefit analysis under certain executive orders binding on executive agencies.[45] Under these orders, the OCC is required, among other things, to:

- "propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs";
- "tailor its regulations to impose the least burden on society, consistent with obtaining regulatory objectives, taking into account, among other things, and to the extent practicable, the costs of cumulative regulations"; and
- "select, in choosing among alternative regulatory approaches, those approaches that maximize net benefits (including potential economic, environmental, public health and safety, and other advantages; distributive impacts; and equity)."[46]

The OCC has failed to comply with those executive orders by failing to perform the required cost/benefit analysis of the Proposed Rules.

The CFTC, the FDIC, the Federal Reserve and the SEC are all subject to a similar executive order.[47] Although that order is not by its terms binding on independent agencies, each of these Agencies has announced its intention to comply with the principles contained in the executive order as a matter of policy.[48] As a result, we believe they are required to perform the

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[44] *Business Roundtable*, 647 F.3d at 1150.

[45] *See, e.g.*, Executive Order No. 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011), *available at* http://www.whitehouse.gov/the-press-office/2011/01/18/improving-regulation-and-regulatory-review-executive-order (requiring all executive agencies to perform a thorough cost/benefit analysis of all rules); Executive Order No. 12688, 58 Fed. Reg. 51735 (Sep. 30, 1993), *available at* http://www.reginfo.gov/public/jsp/Utilities/EO_12866.pdf; Office of Management & Budget, Executive Office of the President, OMB Circular No. A-4, Regulatory Analysis (2003), *available at* http://www.whitehouse.gov/sites/default/files/omb/assets/omb/circulars/a004/a-4.pdf.

[46] *See* Executive Order No. 13563, 76 Fed. Reg. at 3821.

[47] *See* Executive Order No. 13579, 76 Fed. Reg. 41587 (July 14, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-07-14/pdf/2011-17953.pdf (urging independent agencies to comply with the cost/benefit mandates in the executive orders applicable to executive agencies).

[48] *See* CFTC, Reducing Regulatory Burden; Retrospective Review Under E.O. 13563, 76 Fed. Reg. 38328, 38328 (June 30, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-06-30/pdf/2011-16430.pdf ("In accordance with Executive Order 13563, . . . the [CFTC] intends to review its existing regulations to evaluate their continued effectiveness in achieving the objectives for which they were adopted. . . . The Executive Order emphasizes several guiding principles, including that: agencies consider the costs and benefits of their regulations and choose the least burdensome path."); FDIC's Plans to Review Existing Regulations for Continued Effectiveness (Nov. 10, 2011), *available at* http://www.fdic.gov/regulations/laws/plans/index.html

sort of thorough cost/benefit analysis of the Proposed Rules contemplated by that executive order unless and until their policies to comply with that order are publicly revoked.

Moreover, if certain pending legislation becomes law, the Agencies could become subject to a new cost/benefit mandate retroactively.[49]

We also note that, under *Business Roundtable*, after the close of the comment period, the Agencies must "respond to substantial problems raised by commenters" — the Agencies may not "duck [] serious evaluation of the costs that could be imposed"[50] as raised by commenters.

If the Agencies perform the sort of cost/benefit analysis required by the *Business Roundtable* decision, we believe they will find that the costs of many provisions of the Proposed Rules will substantially outweigh their benefits. For example, we believe that the enormous compliance, restructuring and other social costs that will result from designating all commodity pools and all foreign funds as similar funds, or from failing to exclude all wholly owned subsidiaries from the term covered fund, will greatly exceed any conceivable public benefits.[51]

In short, unless the Agencies conduct an adequate cost/benefit analysis of the Proposed Rules as a whole, and rule-by-rule, and consider seriously all public comments, we believe that the Proposed Rules will be considered "arbitrary and capricious and not in accordance with law" under the Administrative Procedure Act ("**APA**"), as construed by the court in *Business Roundtable*.[52] Moreover, they cannot cure this defect without re-proposing the rules for public comment with a proper economic analysis in the NPRs. Failure to provide the public with an

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(responding to Executive Order 13579 by describing the FDIC's "longstanding policy of implementing its regulations in the least-burdensome manner possible."); FDIC Statement of Policy on the Development and Review of FDIC Regulations and Policies, 63 Fed. Reg. 25157, 25158 (1998) ("Burdens imposed on the banking industry and the public should be minimized."); Letter from Fed Chairman Ben Bernanke to Mr. Cass Sunstein, OMB, pp 1, 4 (Nov. 8, 2011), *available at* http://www.federalreserve.gov/generalinfo/foia/regulatory-burden-reduction-111115.pdf ("[W]e at the Federal Reserve have . . . for many years tried to abide by the principles described in the Executive Order. . . . The Federal Reserve is committed to adopting rules and policies that are effective in implementing its statutory responsibilities and the intent of Congress without imposing unnecessary costs."); SEC, Retrospective Review of Existing Regulations, 76 Fed. Reg. 56128 (Sept. 12, 2011), *available at* http://www.gpo.gov/fdsys/pkg/FR-2011-09-12/pdf/2011-23179.pdf (inviting public comment on how the SEC can develop a plan to comply with Executive Order 13579).

[49] *See, e.g.*, Financial Regulatory Responsibility Act of 2011, S. 1615, 112th Cong. (2011), *available at* http://www.gpo.gov/fdsys/pkg/BILLS-112s1615is/pdf/BILLS-112s1615is.pdf (requiring all federal financial agencies to perform a rigorous cost/benefit analysis of all rules implementing federal financial statutes, as well as a retroactive cost/benefit analysis of pre-existing regulations).

[50] *Id.*

[51] *See* our discussion of the designation of commodity pools and foreign funds as similar funds and of wholly owned subsidiaries as covered funds below, *infra* IV.B and IV.A(3)(a).

[52] *See Business Roundtable* at 1148 (D.C. Cir. 2011) (agency's "failure to apprise itself – and hence the public and the Congress – of the economic impact of a proposed regulation makes promulgation of the rule arbitrary and capricious and not in accordance with law") (internal quotation marks omitted).

opportunity to comment on a required cost/benefit analysis is what gave rise to the *Chamber II* litigation. In that litigation, the SEC readopted a rule based on materials that had not been exposed to public comment. The SEC argued that re-proposal was unnecessary because the new materials merely confirmed the agency's initial analysis. The court, finding that additional notice and comment was required, vacated the rule.[53]

As in *Chamber II*, the Agencies have not provided the sort of cost/benefit analysis required by law. In one instance, they even asked commenters to provide such analysis.[54] But that would not do, because the Agencies' analysis would not be subject to public comment.[55] The opportunity for the public to comment on the analysis underlying an agency's action is a required part of notice and comment rulemaking under the APA.[56] The Agencies must either develop a more robust economic analysis on their own, or through materials provided by commenters. Either method requires a re-proposal.[57]

IV. Covered Funds

The statutory text of the Volcker Rule defines the terms "hedge fund" and "private equity fund" as follows:

> "The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) [the "**1940 Act**"], but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the [Agencies] may, by rule, as provided in subsection (b)(2), determine."[58]

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[53] *See* Chamber II, 443 F.3d at 903-905.

[54] *See, e.g.*, 76 Fed. Reg. at 68870 (asking for comments on the costs and benefits of proposed market-making definition without providing any indication of the agencies' views); 76 Fed. Reg. at 68926 ("We seek comment on whether, in order to comply with the statutory prohibition on proprietary trading, some banking entities may be inclined to abstain from some market-making activities [and] this could result in reduced liquidity for certain types of trades or for certain less liquid instruments."); *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation: J. Hearing Before the Subcomms. on Cap. Markets and Gov. Sponsored Enterprises and Fin. Institutions and Consumer Credit of the H. Comm. on Fin. Services*, 112th Cong. (2012) (Chairman Schapiro asserting, in response to a question by Rep. Gutierrez, that the Agencies have "asked for extensive comment in the joint release about the costs of implementation as well as the costs and the impacts on competitiveness of the Volcker Rule.").

[55] *See* Chamber II, 443 F.3d at 899-901.

[56] *See id.*; *Engine Mfrs. Ass'n v. EPA*, 20 F.3d 1177, 1182 (D.C. Cir. 1994) (invalidating rule because published materials were too "opaque" and "[t]here [was] no way to know the agency's methodology from what little it reveal[ed] in the cost analysis"); *Prometheus Radio Project v. FCC*, 652 F.3d 431,447-53 (3d Cir. 2011) (vacating and remanding an FCC rule because the FCC released "several additional peer review comments, 'revised' versions of four of the studies, and new peer review studies" on the last day for comments).

[57] *See Portland Cement Ass'n v. Ruckelshaus*, 486 F.2d 375, 393 (D.C. Cir. 1973).

[58] *See* 12 U.S.C. § 1851(h)(2).

The Agencies implemented this definition by replacing the terms "hedge fund" and "private equity fund" with the single term "covered fund." They then defined the term "covered fund" as follows: "The term 'covered fund' means:

> (i) 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 that Act;
>
> (ii) A commodity pool, as defined in section 1a(10) of the Commodity Exchange Act [ ];
>
> (iii) Any issuer . . . that is organized or offered outside the United States that would be a covered fund as defined in [paragraph (i) or (ii) above], were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States; and
>
> (iv) Any such similar fund as the [Agencies] may determine by rule, as provided in [the Volcker Rule statute]."[59]

The Agencies appear to have construed the statutory definition as providing them with discretion to define the term "covered fund" to include any "issuer that would be an investment company, as defined in the [1940 Act], but for section 3(c)(1) or 3(c)(7) of that Act," without regard to whether such an issuer would actually be a hedge fund, private equity fund or other pooled investment vehicle of any kind as commonly understood. They also appear to have construed the statutory phrase "as the [Agencies] may, by rule . . . determine" (the "**Rulemaking Condition**") as modifying only the words "similar funds" in the statute, and not to modify the part of the statutory definition that defines hedge funds and private equity funds as any issuer that would be a investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act (the "**General Definition**"). They also did not limit the term "covered fund" to pooled investment vehicles in the nature of a hedge fund or private equity fund. Nor did they exclude ordinary corporate structures such as wholly owned subsidiaries, joint ventures and acquisition vehicles, even though such structures have never been considered hedge funds, private equity funds or pooled investment vehicles of any type as commonly understood.

Rather than exclude wholly owned subsidiaries, joint ventures and acquisition vehicles from the term "covered fund," the Agencies chose to exercise their authority under Section (d)(1)(J) of the statute to provide that sponsoring and investing in a very restricted universe of those non-fund structures are "permitted activities." But the Agencies limited the range of non-fund structures to which this "permitted activities" exemption applies to wholly owned subsidiaries that are "engaged principally in performing bona fide liquidity management activities," joint ventures that are "operating companies," and acquisition vehicles. They also

[59] 76 Fed. Reg. at 68950.

concluded that Section (d)(1)(J) did not authorize them to treat Super 23A activities with a covered fund as permitted activities.[60]

In contrast to the restrictive manner in which the Agencies construed their authority to grant exclusions or exemptions, they treated their authority to add any type of entity to the term "covered fund" as if it were unfettered. Thus, they designated as covered funds ***all*** commodity pools and potentially ***all*** foreign funds (except for foreign funds that would qualify for an exemption from the 1940 Act other than under Sections 3(c)(1) or 3(c)(7) of that Act (each, an "**Exempt Fund**")), rather than limiting the designations to those commodity pools or foreign funds that are similar to a hedge fund or private equity fund. Because of how broadly the term "commodity pool" is defined in the Commodity Exchange Act, this creates a serious legal risk of sweeping into the term "covered fund" virtually every subsidiary and affiliate in a typical banking group, including parent bank holding companies ("**BHCs**"), subsidiary banks and broker-dealers, Exempt Funds and SEC-registered investment companies.

We believe that the Agencies should revise the definition of the term "covered fund." First, we do not believe it is correct to construe the statutory definition to include any issuer that would be an investment company under the 1940 Act, but for Sections 3(c)(1) or 3(c)(7) of that Act, without regard to whether the issuer is a hedge fund, private equity fund or other pooled investment vehicle of any kind as commonly understood. Thus, we believe it was incorrect for the Agencies to define the term "covered fund" in a way that captured structures that have never been considered hedge funds, private equity funds or pooled investment vehicles of any kind, such as wholly owned subsidiaries, joint ventures or acquisition vehicles.

Second, we believe that the Rulemaking Condition should be interpreted to apply to both the general definition and the similar funds provision. If the Agencies construed the rulemaking condition in this manner, we believe that it would provide them with an additional source of authority to define "covered fund" in a manner that excludes any issuer other than an issuer that is a hedge fund or private equity fund as commonly understood.

Third, the Agencies should construe Section (d)(1)(J) of the Volcker Rule as allowing them to permit banking entities to sponsor and invest in, ***and*** enter into covered transactions with, a genuine hedge fund or private equity fund, as long as those activities would promote and protect the safety and soundness of banking entities and the financial stability of the United States. We believe it was inconsistent with the "whole act rule" for the Agencies to construe Section (d)(1)(J) as not giving them authority to grant exemptions from Super 23A. If the Agencies do not exclude non-fund entities from the term "covered fund" as recommended above, they should at least expand the range of corporate entities to which their permitted activities exemptions apply to include ***all*** wholly owned subsidiaries, joint ventures, acquisition vehicles and other entities described below.

Finally, the Agencies should limit the sort of commodity pools and foreign funds that are treated as covered funds to commodity pools and foreign funds that are similar to hedge

[60] *Id.* at 68912 n. 313.

funds and private equity funds as commonly understood – *i.e.*, commodity pools or foreign funds that have all of the characteristics of a hedge fund or private equity fund as set forth in **Annex B** to this comment letter. At a minimum, they should limit the term "covered fund" to commodity pools and foreign funds that are similar to an issuer that would be an investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act.

A. Exclusions from "Covered Fund"

(1) Duty and Authority

> ***SIFMA observation***: The Agencies have a duty and the authority to define "covered fund" in a way that excludes ordinary corporate structures that have never been considered hedge funds or private equity funds, such as wholly owned subsidiaries, joint ventures and acquisition vehicles.

The Agencies appear to have construed the statutory definition of the terms "hedge fund" and "private equity fund" as allowing them to define the term "covered fund" to include any issuer that does not qualify for an exemption from the 1940 Act other than under Sections 3(c)(1) or 3(c)(7) of that Act, without regard to whether the issuer is a hedge fund, private equity fund or any other pooled investment vehicle as commonly understood. We believe that this is an unsupportable construction of the statute for at least two independent reasons.

First, it would make the words "hedge fund" and "private equity fund" superfluous in the statute, and erase any distinction between the two despite the real differences between them. The Supreme Court has consistently stated that statutes must be interpreted in accordance with the "whole act rule."[61] Under that rule, each term of a statute is presumed to have meaning and to be consistent with each other. Congress clearly intended for the Agencies to preserve the distinction between the two types of funds, when appropriate, as evidenced by Section (h)(7)(B), which expressly excludes certain private equity funds from the term "hedge fund" for purposes of the term "illiquid fund" definition in Section (h)(7)(A) of the Volcker Rule. If Congress had intended for the terms "hedge fund" and "private equity fund" to be superfluous or to erase any distinction between them, it would have used a non-descriptive term such as "covered fund," the way the Agencies did, instead of the distinctive terms "hedge fund" and "private equity fund."

Second, the Agencies' construction of the statutory definition is inconsistent with the *noscitur a sociis* principle. That canon of statutory construction provides that "when two or more words are grouped together, and ordinarily have a similar meaning, but are not equally comprehensive, the general word will be limited and qualified by the special word."[62] In this

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[61] *See supra* note 7.

[62] SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 47:16, at 348-51 (7th ed. 2007) (Norman J. Singer, ed.). *See, e.g., Logan v. United States*, 552 U.S. 23, 30-32 (2007) (applying canon to qualify meaning of general words by reference to nearby specific words); *Washington State Dep't of Social and Health Servs. v.*

case, the special words are "hedge fund," "private equity fund" and "similar funds." The general words are the General Definition of the terms "hedge fund" and "private equity fund." The meanings of those special words, as commonly understood, are similar to but not equally comprehensive with the general words, or with each other. Therefore, under this principle of statutory construction, the general words should be limited and qualified by the special words "hedge fund," "private equity fund" and "similar funds," and each special word should be limited and qualified by the other. The repeated use of the word "fund" indicates that the definition of the term "covered fund" must, at a minimum, be limited to a pooled investment vehicle with third party investors. It is therefore unreasonable to define "covered fund" to include ordinary corporate structures that have never been considered to be hedge funds, private equity funds or any other type of pooled investment vehicles as commonly understood.

We also believe that the Rulemaking Condition gives the Agencies the authority to define the term "covered fund" in a manner that excludes any entity other than a hedge fund or private equity fund as commonly understood, as long as they do so by rulemaking. The Rulemaking Condition is a classic example of an ambiguous modifier.[63] It is ambiguous whether the Rulemaking Condition modifies both the General Definition and the "similar funds" portion of the definition, or only the "similar funds" portion.

The Agencies appear to have resolved this ambiguity by applying the so-called "last antecedent presumption." Their resolution might be plausible as a matter of textual interpretation were it not for the absurd results it would produce, the conflicting legislative history and the lack of any supporting legislative history. The last antecedent presumption rests on a rule of grammar which provides that "qualifying words and phrases, *where no contrary intention appears*, refer solely to the last antecedent."[64] The "last antecedent" is the last word, phrase or clause that can be made an antecedent without impairing the meaning of the sentence."[65] Here, the ambiguous modifier is the Rulemaking Condition and the last antecedent is "similar funds." The Supreme Court has used the last antecedent presumption to resolve ambiguous modifiers.[66]

But the Supreme Court has made it clear that the last antecedent presumption "is not an absolute and can assuredly be overcome by other indicia of meaning."[67] It has departed

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Guardianship Estate of Keffeler, 537 U.S. 371, 382-85 (2003) (same); *FTC v. Ken Roberts Co.*, 276 F.3d 583, 589-90 (D.C. Cir. 2001) (same).

[63] *See* Terri LeClerq. *Doctrine of the Last Antecedent: The Mystifying Morass of Ambiguous Modifiers*, 2 J. LEGAL WRITING INST. 81 (1996).

[64] 2A SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION, § 47.33, at 487 (7th ed. 2007) (Norman J. Singer, ed.) (emphasis added).

[65] *Id.* at 487-489 (internal quotations omitted).

[66] *See, e.g., United States v. Hayes*, 555 U.S. 415, 425-426 (2009); *Jama v. INS*, 543 U.S. 335, 342-343 (2005); *Barnhart v. Thomas*, 540 U.S. 20, 26 (2003); *Nobelman v. American Savings Bank*, 508 U.S. 324, 330-331 (1993); *FTC v. Mandel Brothers, Inc.*, 359 U.S. 385, 389 (1959); *Johnson v. Sayre*, 158 U.S. 109, 114 (1895).

[67] *Barnhart v. Thomas*, 540 U.S. 20, 26 (2003).

from the presumption when there has been conflicting indicia of meaning.[68] Limiting the rulemaking condition to the last antecedent in this case would produce absurd results that Congress could not possibly have intended. It also conflicts with the legislative history and has no support in any other part of the text of the Volcker Rule.

The Supreme Court has consistently held that the words of a statute must be interpreted in light of the statute as a whole, and the legal backdrop against which the statute was drafted.[69] Closely related to this "whole statute rule" is the principle that a statute must be construed in a manner that avoids absurd results that Congress could not possibly have intended.[70] Here, unless the Agencies provide further regulatory clarification, forbearance or future exclusions, the language of the proposed regulatory definition would:

- immediately upon the effective date of the Volcker Rule, prohibit banking entities from entering into any new funding, risk-management or other covered transactions with any subsidiary or affiliate that might from time to time fall within the fact-intensive definition of the term "investment company" unless it qualifies for an exemption other than under Sections 3(c)(1) or 3(c)(7) of the 1940 Act; and

- require banking entities to divest all ownership interests in such subsidiaries and affiliates by the end of the conformance period except for subsidiaries or affiliates that can be conformed to one of the "permitted activities" exemptions such as the asset management exemption.

These prohibitions and divestiture requirements do not appear to be limited to hedge funds or private equity funds as commonly understood – or even pooled investment vehicles of any kind. Instead, the proposed definition appears to makes these prohibitions and

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[68] *See, e.g.*, *United States v. Hayes*, 555 U.S. 415, 425-426 (2009) (holding that the ambiguous modifier at issue applied to an antecedent before the last antecedent because of contrary evidence of meaning); *Nobelman v. American Savings Bank*, 508 U.S. 324, 330-331 (1993) (same).

[69] *See Green v. Bock Laundry Machine Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring in the judgment) (meaning of terms of a statute should determined "on the basis of which meaning is . . . most compatible with the surrounding body of law into which the provision must be integrated."); *Deal v. United States*, 508 U.S. 129, 132 (1993) (Scalia, J.) (it is a "fundamental principle of statutory construction . . . that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used.").

[70] *See, e.g.*, *Green*, 490 U.S. at 527 (Scalia, J., concurring in the judgment) (if the plain language of a statute produces an absurd result, our task is to give some alternative meaning to the statute); *Public Citizen v. Department of Justice*, 491 U.S. 440, 470-471 (1988) (Kennedy, J., concurring in the judgment) ("Where the plain language of the statute would lead to 'patently absurd consequences' . . . that 'Congress could not possibly have intended . . . .we need not apply the language in such a fashion.") (emphasis in original); *Dewsnap v. Timm*, 502 U.S. 410, 427 (1992) (Scalia, J., dissenting) ("If possible, we should avoid construing the statute in a way that produces such absurd results."). *See also* Breyer, *supra* note 12, at 848-849 (legislative history can be used to avoid absurd results); John F. Manning, *The Absurdity Doctrine*, 116 HARV. L. REV. 2387, 2388-2389 (2003) ("From the earliest days of the Republic, the Supreme Court has subscribed to the idea that judges may deviate from even the clearest statutory text when a given application would otherwise produce 'absurd' results.").

divestitures applicable from time to time to virtually any of the subsidiaries and affiliates in a banking group, other than insured depository institutions ("**IDIs**"), broker-dealers and other affiliates that have special exemptions from the 1940 Act.[71] The entities that appear to be covered funds potentially include an ever-changing basket of wholly owned subsidiaries, joint ventures, acquisition vehicles, minority investments in regulated financial market utilities such as securities exchanges and clearing houses, and various other non-fund subsidiaries and affiliates. This is an absurd result that Congress could not possibly have intended, and is not required by the language of the statute.

These subsidiaries, affiliates and minority investments have never been considered hedge funds or private equity funds or pooled investment vehicles of any kind as commonly understood. Yet, many would be swept in by the proposed definition. The reason is that the term "investment company," as defined in the 1940 Act, captures any company that is engaged in lending; acting as a central counterparty or other operator of a securities or derivatives exchange or any payment, clearance or settlement system; or holding any number of traditional banking instruments because the term "investment securities" includes *all* securities (defined broadly to include these traditional banking instruments) *other than* government securities, securities issued by an employee securities company and certain securities issued by a majority-owned entity.[72] Most of the subsidiaries, affiliates and financial investments of a banking entity will from time to time fall within the definition of the term "investment company" under the 1940 Act and will not be able to qualify for any exemption from the Act other than under Sections 3(c)(1) or 3(c)(7),[73] except for wholly owned subsidiaries of certain bank holding companies that may be able to qualify for an exemption under Section 3(b)(3) of the 1940 Act.

This means that absent regulatory clarification or forbearance, the proposed definition of covered fund, when applied in combination with Super 23A and the rest of the Volcker Rule, could immediately upon the effective date of the Volcker Rule prohibit banking entities from entering into any new funding, risk-management or other covered transactions with an ever-changing basket of subsidiaries or affiliates. It would also require them to divest their ownership interests in such subsidiaries and affiliates by the end of the conformance period, unless such investments could be conformed under one of the "permitted activities" exemptions in the statute or the Proposed Rules. Ironically, because it would be impossible or impractical to

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[71] However, as discussed in Section IV.B, IDIs, broker-dealers and other entities that have their own exemptions from the 1940 Act may nevertheless be swept into the term "covered fund" by the designation of "commodity pools" as similar funds, if they buy and sell even a minimal amount of commodity interests for hedging purposes.

[72] *See* 1940 Act § 3(a)(2).

[73] The reason these two exemptions are the most common is that they can be used to exempt any investment company regardless of how it invests or what it invests in so long as it satisfies certain limits on the number or financial characteristics of its investors. Section 3(c)(1) exempts any issuer that is beneficially owned by 100 or fewer persons that does not make a public offering. Section 3(c)(7) exempts any issuer that is beneficially owned exclusively by "qualified purchasers" and does not make a public offering. Section 3(b)(3) appears to exempt the wholly owned subsidiaries of depository institution holding companies that have less than 40% of their assets invested in investment securities.

conform interests in any non-fund subsidiary or affiliate under any of these "permitted activities" exemptions, the Proposed Rules would produce the absurd result that banking entities will be forced to divest all of their interests in non-fund subsidiaries and affiliates, while being permitted to retain 3% of any subsidiaries or affiliates that are genuine hedge funds or private equity funds, subject to certain conditions. This would turn the Volcker Rule on its head. Rather than increase the safety, soundness and stability of the U.S. and global financial system, the Proposed Rules create a serious risk of destabilizing it.

Even if the term "covered fund" is limited to hedge funds and private equity funds as commonly understood, it will result in a radical restructuring of the U.S. and global financial system. But if the Agencies retain their proposed definition of the term "covered fund," it could force a restructuring of non-fund subsidiaries and affiliates that could be destabilizing to the U.S. and global financial system. That, in turn, could have a seriously adverse effect on the wider economy in terms of reduced credit, increased unemployment and reduced output. Even before any such a restructuring, the proposed definition of the term "covered fund" would immediately upon effectiveness of the statute prohibit a banking entity from entering into any covered transactions with its ever changing basket of non-fund subsidiaries and affiliates, including extending credit to or entering into risk-reducing derivatives transactions with such subsidiaries or affiliates even on a fully secured basis. This is one of the most absurd consequences of the proposed definition because it would actually undermine rather than promote the safety, soundness, efficiency and stability of the U.S. and global financial system. Finally, the compliance, restructuring and other social costs that will be imposed on the U.S. and global financial system as a result of the proposed definition would be massive and far in excess of any conceivable public benefits.

We do not believe that the Agencies intended to produce these absurd and inefficient results. Nor do we believe that the Agencies fully understood that their chosen definition would, in the context of the rest of the Proposed Rules, produce such effects. They may also have believed that they had no choice in the matter, and that the statutory language compelled their proposed definition. But as shown above, such a belief would not be correct. Instead, the Agencies had, and still have, a choice between two or more interpretations. The statute does not require that interpretation and, to the extent it is ambiguous, we question whether the choice they made is entitled to *Chevron* deference in light of these absurd, unsafe and unsound results it would produce. We certainly do not believe that their choice would survive the sort of cost/benefit analysis required by the *Business Roundtable* decision.

The Agencies' interpretation of the statute as giving them the discretion to define the term "covered fund" without regard to whether an entity is a hedge fund, private equity fund or other pooled investment vehicle and limiting the Rulemaking Condition to the similar funds designation process is also inconsistent with the legislative history. In contrast, our interpretation is consistent with that history. For example, in a colloquy with one of the named sponsors of the Dodd-Frank Act – House Financial Services Chairman Barney Frank (D-MA) – and Representative Jim Himes (D-CT), a member of Congress who voted in favor of the Volcker Rule, Representative Himes sought confirmation that the Agencies had the discretion to construe

the terms "hedge fund" and "private equity fund" in a way that excluded ordinary corporate structures such as subsidiaries and joint ventures, and that the Agencies would in fact do so. Chairman Frank answered that the Agencies had such authority and a duty to exercise that authority in a manner that excluded such structures:

> "**Mr. Himes**. Madam Speaker, I rise to enter into a colloquy with Chairman Frank. I want to clarify a couple of important issues under section 619 of the bill, the Volcker Rule. The bill would prohibit firms from investing in traditional private equity funds and hedge funds. Because the bill uses the very broad Investment Company Act approach to define private equity and hedge funds, it could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds. I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings.
>
> **Mr. Frank**. . . . The point the gentleman makes is absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do."[74]

Our proposed interpretation is also consistent with Section (d)(1)(J) of the statute, and does not make that exemptive authority superfluous. As noted above, we believe that the Agencies have the authority to define "covered fund" in a manner that excludes any entity, *other than a hedge fund or private equity fund as commonly understood*. If the Agencies attempted to define the term to exclude such funds, we believe it would exceed their statutory authority. Instead, the Agencies' authority with respect to genuine hedge funds or private equity funds is limited to permitting investments or relationships with them under one of the "permitted activities" exemptions in Section (d)(1) of the statute. For example, Section (d)(1)(J) provides the Agencies with the discretionary authority to grant "permitted activities" exemptions by rulemaking for activities with genuine hedge funds or private equity funds when certain safety and soundness and financial stability conditions are satisfied.

Our interpretation of the relationship between the term "covered fund" and the "permitted activities" authority in Section (d)(1)(J) is also consistent with the legislative history. For example, in a colloquy between one of the named sponsors of the Dodd-Frank Act – Senate Banking Committee Chairman Christopher Dodd (D-CT) – and Senator Barbara Boxer (D-CA), another member of Congress who voted in favor of the Volcker Rule, Senator Boxer wanted confirmation that the Agencies had authority to grant "permitted activities" exemptions for venture capital funds. Chairman Dodd confirmed that Section (d)(1)(J) authorized the Agencies

[74] 156 CONG. REC. H5226 (daily ed. June 30, 2010).

to grant a "permitted activities" exemption for "properly operated" venture capital funds because such an exemption would satisfy the safety and soundness and financial stability conditions of Section (d)(1)(J):

> "**Mrs. Boxer**. Mr. President, I wish to ask my good friend, the Senator from Connecticut and the chairman of the Banking Committee, to engage in a brief discussion relating to the final Volcker rule and the role of venture capital in creating jobs and growing companies. . . . I know the chairman recognizes, as we all do, the crucial and unique role that venture capital plays in spurring innovation, creating jobs and growing companies. I also know that the authors of this bill do not intend the Volcker Rule to cut off sources of capital for America's technology startups, particularly in this difficult economy. . . . I believe the intent of the rule is not to harm venture capital investment. Is my understanding correct?
>
> **Mr. Dodd**. Mr. President, I thank my friend, the Senator from California, for her support and for all the work we have done together on this important issue. Her understanding is correct.[75]
>
> . . . [P]roperly conducted venture capital investment will not cause the harms at which the Volcker rule is directed. In the event that properly conducted venture capital investment is excessively restricted by the provisions of section 619, I would expect the appropriate Federal regulators to exempt it using their authority under section 619[d][1](J)."

Finally, the Agencies' proposed definition of "covered fund" also conflicts with the recommendations of the FSOC Study, whereas our proposed definition is consistent with them. The FSOC Study recommended that the Agencies construe the terms "hedge fund" and "private equity fund" to exclude corporate structures that are not pooled investment vehicles.[76]

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[75] 156 CONG. REC. S5904 (daily ed. July 15, 2010).

[76] *See* FSOC Study at 62.

(2) Proposed Regulatory Definitions

> ***SIFMA recommendation***: The term "covered fund" should be defined as a "hedge fund," "private equity fund" or "designated similar fund" to maintain the distinctions between these different types of covered funds.
>
> The term "hedge fund" should be defined as any issuer that both (i) would be an investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act and (ii) has all of the characteristics of a hedge fund as commonly understood, as set forth in **Annex B**.
>
> The term "private equity fund" should be defined as any issuer that both (i) would be an investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act and (ii) has all of the characteristics of a private equity fund as commonly understood, as set forth in **Annex B**.
>
> The term "designated similar fund" should be defined as any "similar commodity pool" or "similar foreign fund," as defined in Section IV.B below.

Instead of defining the term "covered fund" the way they did, the Agencies should define it in a way that preserves the distinction between hedge funds and private equity funds and that excludes non-fund structures such as wholly owned subsidiaries, joint ventures and acquisition vehicles. We recommend that the Agencies do this by defining the term "covered fund" as any "hedge fund," "private equity fund" or "designated similar fund" as set forth in the box above.

Assuming that the Agencies interpret the Rulemaking Condition to apply to the entire statutory definition as we recommend in Section IV.A above, we believe that our proposed definition of the term "covered fund" is correct and, to the extent the statute is ambiguous, certainly would be entitled to *Chevron* deference. Unlike the Agencies' proposal, our recommendation is consistent with construing the Volcker Rule to avoid treating the statutory terms "hedge fund," "private equity fund" and "similar funds" as mere surplusage and with the *noscitur a sociis* principle of statutory construction. We also believe that it is reasonable for the Agencies to interpret the Rulemaking Condition as giving the Agencies discretion to limit the range of entities that will be treated as covered funds to those that both fall within the general statutory definition and have all of the characteristics of a hedge fund or private equity fund as set forth on **Annex B**.

(3) Excluded Entities

> ***SIFMA recommendation***: The Agencies should define the term "covered fund" in a manner that excludes any issuer that is a wholly owned subsidiary, joint venture, acquisition vehicle, SEC-registered investment company or business development company, financial market utility and any other issuer that is designated as an excluded entity by rule or order of the Agency that is a banking entity's primary federal financial regulator.

The Agencies should define the term "covered fund" in a manner that excludes any issuer that is a wholly owned subsidiary, joint venture, acquisition vehicle, SEC-registered investment company, financial market utility and any other issuer that is designated as an excluded entity by rule or order of the Agency that is a banking entity's primary federal financial regulator. To avoid any doubt that such non-fund entities are excluded, the Agencies should expressly exclude them from the definition. This will avoid the absurd, unsafe and unsound consequences, as well as the massive compliance, restructuring and other social costs that would otherwise be produced by the proposed definition.

(a) Wholly Owned Subsidiaries

The Proposed Rules designated investments in a very limited universe of wholly owned subsidiaries as a permitted activity. That proposed exemption is too narrow to avoid most of the unintended consequences described in this comment letter. First, the exemption would only apply to wholly owned subsidiaries that are "engaged principally in performing bona fide liquidity management activities."[77] We have been unable to identify any wholly owned subsidiaries that would clearly satisfy that condition. Second, and perhaps most importantly, such wholly owned subsidiaries would still be treated as covered funds subject to Super 23A.

As noted above, this treatment is inconsistent with congressional intent. Congress intended that the Volcker Rule not apply to wholly owned subsidiaries.[78]

Unless all wholly owned subsidiaries are excluded from the term "covered fund," there is a substantial risk that the Volcker Rule will immediately upon its effective date prohibit all banking entities from entering into any new covered transactions with an ever-changing basket of wholly owned subsidiaries, to divest them by the end of the conformance period, and to limit their future use for ordinary business purposes. Among the new covered transactions that a banking entity would be prohibited from entering into with this ever-changing basket of wholly owned subsidiaries would be the following:

- Making any intraday or overnight extension of credit, whether or not fully secured by U.S. government securities or cash collateral, and whether for

[77] *See* Proposed Rules §___.14(a)(2)(iv)(A).

[78] *See* 156 CONG. REC. H5226 (June 30, 2010) (statements of Reps. Jim Himes and Barney Frank).

purposes of funding the subsidiary's operations, centralized expense management or facilitating ordinary transactions in payment and securities settlement systems;

- Acquiring any assets from the subsidiary, whether or not on an arms' length basis; or

- Entering into a swap or other derivatives transaction with the subsidiary, whether or not as part of an enterprise-wide risk management program or on a fully secured basis with U.S. government securities or cash collateral.

Subjecting banking entities to a moratorium on any new covered transactions with a changing basket of wholly owned subsidiaries could have a material adverse effect on the safety, soundness, efficiency and stability of the U.S. and global financial systems. That, in turn, could have a material adverse effect on the wider economy in terms of reduced credit, increased unemployment and reduced output. Among the more absurd, unsafe and unsound consequences would be a moratorium on the ability of BHCs to provide liquidity to or enter into risk-management transactions with such subsidiaries pursuant to the group's enterprise-wide funding and risk management programs.

The requirement to divest all wholly owned subsidiaries that fall within the proposed definition of the term "covered fund" before the end of the conformance period would further undermine the safety, soundness, efficiency and stability of the U.S. and global financial system. As noted above, because non-fund subsidiaries would be unable to conform their activities to any of the "permitted activities" exemptions of the statute or the Proposed Rules, the Proposed Rules would produce the absurd result that banking entities would be required to divest all of their non-fund subsidiaries that are treated as covered funds, but would be permitted to retain 3% of any subsidiaries that are genuine hedge funds or private equity funds. This turns the Volcker Rule on its head and cannot possibly have been intended by Congress.

Finally, the compliance, restructuring and other social costs arising from such a moratorium on covered transactions with the changing basket of wholly owned subsidiaries, the requirement to divest them by the end of the conformance period, and the limits on their future use for ordinary business purposes would be massive. Those massive costs will far outweigh any conceivable public benefits from treating wholly owned subsidiaries as covered funds unless they can qualify for an exemption from the 1940 Act other than under Sections 3(c)(1) or 3(c)(7) of the 1940 Act.

Although some wholly owned subsidiaries can rely on exemptions from the 1940 Act other than Sections 3(c)(1) or 3(c)(7), most can not.[79] As a result, the only way to be sure they are not investment companies is to determine that they are not "investment companies" in the first place. This requires a fact-intensive review of each wholly owned subsidiary of a given

[79] *See* SIFMA Comment Letter, pp. 3-4 (May 9, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=25346.

banking entity to determine whether more than 40% of each subsidiary's assets consist of investment securities. Because the term "investment securities" includes securities, loans and other traditional banking assets, there is a substantial risk that virtually any wholly owned subsidiary of a banking entity could "fail" the 40% test from time to time. In addition, many banking entities have *thousands* of wholly owned subsidiaries. Thus, banking entities will be forced to perform a regular review of all of their legal entities or risk being in violation of the Volcker Rule.

The costs of such regular reviews could be enormous because of the fact-intensive nature of the reviews and the sheer number of wholly owned subsidiaries in a banking entity's organizational structure. Assuming approximately 25,000 wholly owned subsidiaries throughout the U.S. banking industry, for national banks and their affiliates alone, and that conducting the necessary factual review of each one would cost a combined $5,000 per subsidiary in terms of both internal and external costs for the initial review and $1,000 per subsidiary per quarter for all subsequent reviews, the industry-wide compliance costs, for national banks and their affiliates alone, would be $125 million for the initial review and $100 million per year for all subsequent reviews. These massive compliance costs far outweigh any conceivable public benefits from presumptively including wholly owned subsidiaries within the term "covered fund."

Compliance costs are not the only costs that would be imposed on the financial industry and the wider economy as a result of this interpretation. Whenever a banking entity identifies one or more wholly owned subsidiaries that "fails" the 40% test and is unable to qualify for an exemption other than under Sections 3(c)(1) or 3(c)(7) of the 1940 Act, the banking entity would be required either to restructure the assets of the subsidiaries so that they each "pass" the 40% test, or to immediately stop entering into new covered transactions with them and to divest them before the end of the conformance period. These prohibitions and requirements will be extremely disruptive to corporate groups and the entire industry. In addition, the restructuring and termination costs will be substantial. Balanced against these enormous compliance, restructuring and termination costs are virtually no public benefits, including in terms of reducing the Deposit Insurance Fund's exposure to the risks of genuine hedge funds and private equity funds. Thus, the review and compliance process will essentially be a socially useless exercise where the only beneficiaries will be lawyers who specialize in the 1940 Act.

It is critical to note that excluding wholly owned subsidiaries from the definition of "covered fund" would not allow banking entities to engage in impermissible proprietary trading in such subsidiaries. As the direct or indirect subsidiary of a depository institution holding company ("**DIHC**"), IDI or a foreign banking organization that is treated as a BHC ("**FBO**"), any wholly owned subsidiary *would be a banking entity itself* and would therefore be directly subject to the ban on proprietary trading and investing in or having certain relationships with covered funds. That result does not depend on whether the wholly owned subsidiary is deemed to be a covered fund. Any argument that wholly owned subsidiaries must be included within the term "covered fund" in order to prevent them from evading the ban on proprietary trading or investing in or having certain relationships with a covered fund is plainly a red herring.

We therefore believe the Agencies should exclude all wholly owned subsidiaries from the term "covered fund." No wholly owned subsidiary can be a covered fund, even if it relies on Sections 3(c)(1) or 3(c)(7) for an exemption from the 1940 Act, because without third party equity investors it cannot be a pooled investment vehicle. If it is not a pooled investment vehicle, it cannot be a pooled investment vehicle in the nature of a hedge fund or private equity fund.

It should not matter whether the subsidiaries fund themselves by issuing debt to third parties, unless the debt is convertible into ownership interests of the subsidiary at the option of the holder or otherwise has the characteristics of an ownership interest. It is not unusual for certain wholly owned subsidiaries, such as leasing companies, to fund themselves with third-party debt.

(b) Joint Ventures

SIFMA recommendation: The Agencies should eliminate the "operating company" condition in the definition of "joint venture."

Instead, they should define the term "joint venture" as any company with (i) a limited number of co-venturers and (ii) management pursuant to a shareholders' agreement among the co-venturers, rather than management by a general partner or similar entity.

If the Agencies retain the "operating company" condition, the term "operating company" should be defined as any company engaged in activities that are permissible for a financial holding company under Sections 3 or 4 of the BHC Act, other than being a company engaged exclusively in investing in the securities of other companies for resale or other disposition.

The Proposed Rules also designated investments in joint ventures as a permitted activity. That proposed exemption is too narrow to avoid most of the consequences described in this comment letter. First, the Proposed Rules limit the exemption to joint ventures that are operating companies.[80] This means that banking entities would be required to divest their interests in all other joint ventures by the end of the conformance period.

The term "operating company" is not defined in the Proposed Rules. It could be understood to mean simply an entity other than a "company engaged exclusively in investing in the securities of companies for resale." Indeed, that appears to be the meaning given to the term "operating company" as used in Section 211.173(a) of the Board's Regulation Y.[81] If "operating company" were defined to mean a company with nonfinancial operations such as a manufacturing plant that turns out the proverbial "widgets," the exemption would not apply to joint ventures in financial companies. If "operating company" were given a meaning akin to "operating

[80] *See* Proposed Rules § .__14(a)(2)(i).

[81] *See* 12 C.F.R. § 211.173(a).

subsidiary" in the regulations of the Office of the Comptroller of the Currency,[82] the exemption would only apply to joint ventures in companies that are exclusively engaged in activities permissible for a national bank. If "operating company" were given the meaning apparently used in Section 225.23(f)(5)(iii) of Regulation K,[83] it would seem to mean a holding company. The problem with that definition is that joint ventures are frequently structured through holding companies for tax and other purposes. If "operating company" were to have the meaning used by the SEC and 1940 Act lawyers, it would simply mean a company that is not an investment company, as defined by the 1940 Act, which would be tautological.

Second, all joint ventures, including those that are operating companies would still be treated as covered funds subject to Super 23A. Thus, banking entities will be immediately prohibited upon the effective date of the Volcker Rule from entering into any funding, risk-management or other covered transactions with any of their joint venture affiliates. As noted above, this treatment would be inconsistent with congressional intent — specifically, Representatives Himes and Frank agreed that the Volcker Rule categorically does not apply to "joint ventures."[84]

Banking entities rely on joint ventures to engage in many types of permissible, ordinary course activities. For example, banking entities often employ joint ventures to engage in permissible merchant banking activities. The Volcker Rule should not prevent a banking entity from being able to share the risk of a portfolio company investment with third parties. Joint ventures provide important benefits to banking entities and the financial system by allowing banking entities to syndicate exposure, including exposure related to extensions of credit,[85] and to efficiently unwind positions and deploy capital elsewhere in the financial markets. In simple terms, joint ventures serve important risk management purposes by allowing banking entities to limit the size of their exposure to certain investments. Unless joint ventures are excluded from the term "covered fund," banking entities will be at a severe disadvantage as they will be viewed in the marketplace as undesirable partners, and other firms will be unnecessarily limited in their choice of available venture partners.

Imposing an immediate moratorium on new covered transactions with all joint venture affiliates, requiring banking entities to divest all joint ventures that are not operating companies before the end of the conformance period and effectively limiting the future use of joint ventures for normal business purposes could have a significantly adverse effect on the safety, soundness, efficiency and stability of the U.S. financial system. That, in turn, could have a significant adverse effect on the wider economy in terms of reduced credit, increased unemployment and reduced output.

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[82] *See* 12 C.F.R. § 5.34.

[83] *See* 12 C.F.R. § 225.23(f)(5)(iii).

[84] 156 CONG. REC. H5226.

[85] Banking entities often enter into joint ventures to acquire and service non-performing loans, credit card receivables, consumer loans, commercial real estate loans and automobile loans.

For purposes of the proposed exclusion we recommend that the Agencies define joint venture without the "operating company" condition. We believe that the Agencies should define the term "joint venture" as set forth in the first paragraph in the box above. If the Agencies include the requirement that a joint venture be an operating company, the term "operating company" should be defined as any company engaged in any activities that are permissible for a financial holding company under Sections 3 or 4 of the BHC Act, other than a company exclusively engaged in investing in securities in other companies for resale or disposition. This definition would be consistent with the definition apparently used in the Board's merchant banking rules and seems most consistent with congressional intent.

Just as with wholly owned subsidiaries, it is important to note that excluding joint ventures from the definition of "covered fund" would not allow a banking entity to engage in impermissible proprietary trading or covered fund activities through a joint venture company, if the joint venture company were directly or indirectly controlled by the banking entity. As the direct or indirect subsidiary of a banking entity, any controlled joint venture company *would be a banking entity itself* and would therefore be directly subject to the ban on proprietary trading and investing in or having certain relationships with covered funds. That result does not depend on whether the joint venture company is deemed to be a covered fund.

(c) Acquisition Vehicles

The Proposed Rules also designated sponsoring and investing in acquisition vehicles as a permitted activity. That proposed exemption is also too narrow to avoid most of the absurd consequences described in Section A above because acquisition vehicles would still be treated as covered funds subject to Super 23A. Instead, the Agencies should exclude acquisition vehicles from the term "covered fund" so that such entities are not treated as covered funds under the Volcker Rule for any purpose, including Super 23A.

(d) SEC-Registered Investment Companies and BDCs

The Agencies have indicated informally that SEC-registered investment companies ("**RICs**") would not be treated as covered funds, but they have not said so in the Supplementary Information or the Proposed Rules. We believe that this conclusion should be reflected in the text of the final rules. This will greatly improve the legal certainty of the conclusion, and avoid the unintended consequences that could otherwise result.

Similarly, the Agencies should explicitly exclude from the definition of "covered fund" business development companies regulated under the 1940 Act ("**BDCs**"). Seeking to encourage the formation of capital for small businesses, Congress amended the 1940 Act in 1980 to provide for BDCs.[86] While not required to be registered under the 1940 Act, BDCs are public companies that are regulated by the SEC under the 1940 Act and subject to many of the same substantive provisions of the 1940 Act as RICs.[87] In addition, BDCs must comply with strict

[86] *See* H. Rep. No. 1341, 96th Cong.. 2d Sess. 32 (1980); S. Rep. No. 958, 96th Cong.. 2d Sess. 6 (1980).

[87] *See, e.g.*. 1940 Act §§ 54(a), 59.

1940 Act restrictions on the nature of their investments, which generally require BDCs to be "operated for the purpose of making investments" in non-public companies and, with limited exceptions, to offer "significant managerial assistance" to their portfolio companies.[88] Further, BDCs are subject to strict leverage limitations under the 1940 Act, which generally do not permit a BDC's borrowings to exceed 50% of its total assets.[89] Because BDCs, like RICs, are publicly offered and regulated as to their activities and investments, and therefore should not fall within the General Definition of "covered fund," we believe that the Agencies should explicitly exclude them from the General Definition.

(e) Financial Market Utilities

We believe that the Agencies should also exclude financial market utilities ("**FMUs**") from the proposed definition of the term "covered funds." Banking entities have long been both majority and minority investors in U.S. and foreign FMUs, including securities clearing agencies, derivatives clearing organizations, securities exchanges, derivatives boards of trade and alternative trading systems. Many FMUs are privately owned rather than publicly owned.

FMUs have never been considered to be hedge funds or private equity funds. Yet many of them rely on Sections 3(c)(1) or 3(c)(7) for an exemption from the 1940 Act and may not qualify for an alternative exemption. If they become public companies, they typically perform a factual analysis to ensure that less than 40% of their assets are investment securities[90] or obtain a specific exemption from the 1940 Act pursuant to Section 6(c) of the 1940 Act.

Unless FMUs are expressly excluded from the term "covered fund," the Volcker Rule could immediately upon the effective date of the Volcker Rule prohibit banking entities from entering into any new covered transactions with certain related FMUs, require banking entities to divest their investments in certain FMUs by the end of the conformance period, and limit the ability of banking entities to make or retain investments in certain FMUs. These prohibitions and requirements could have a significant adverse effect on the safety, soundness, efficiency and stability of the U.S. and global financial systems, and will not result in any public benefits that the Volcker Rule was designed to produce.

(f) Other Excluded Entities

Because we may not have identified all of the entities that should be excluded from the term "covered fund," we believe that the Agencies should include a mechanism in the Proposed Rules that would permit the Agencies to exclude other categories of entities from the

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[88] *See* 1940 Act § 2(a)(48).

[89] *See* 1940 Act § 61.

[90] The term "investment securities" is defined in Section 3(a)(2) of the 1940 Act to include all securities other than "(A) Government securities. (B) securities issued by employees' securities companies. and (C) securities issued by majority-owned subsidiaries of the owner which (i) are not investment companies, and (ii) are not relying on the exception from the definition of investment company in paragraph (1) or (7) of subsection (c)."

term "covered fund" by rule or order. The purpose of this power is to allow the Agencies to prevent the proposed definition from producing any other absurd results that Congress could not possibly have intended.

B. Designated Similar Funds

> ***SIFMA Recommendation***: The Agencies should define the term "designated similar fund" as any "similar commodity pool" or "similar foreign fund."

Although we agree that the Agencies have substantial discretion to designate other entities as "covered funds," we believe that the Agencies exceeded their statutory authority by designating all commodity pools and potentially all foreign funds (other than Exempt Funds) as "covered funds." It is clear from the language of the statute that the Agencies only have authority to designate entities that are ***similar*** to issuers that would fall within the General Definition of the terms "hedge fund" or "private equity fund" as properly construed. The FSOC Study went even further and recommended that the Agencies limit any similar funds designations to structures that are similar to ***traditional*** hedge funds or private equity funds.[91]

We do not believe that the Agencies' designation of all commodity pools and potentially all foreign funds (other than Exempt Funds) as similar funds is correct in light of the well-recognized dissimilarity between many of these entities and hedge funds and private equity funds as commonly understood. Those designations are inconsistent with the plain language of the statute. Specifically, they are inconsistent with the commonly understood meaning of the word "similar," which qualifies and limits the sort of funds that the Agencies are permitted to add to the universe of entities that otherwise fall within the term "covered fund."

The recommendations below attempt to limit the range of commodity pools and foreign funds that will be treated as similar funds to those that are genuinely similar to the types of funds that would fall within the general statutory definition of the terms "hedge fund" or "private equity fund" as properly construed.

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[91] Specifically, the FSOC Study recommends that the Agencies "consider using their authority to expand the definition by rule to funds that do not rely on either Section 3(c)(1) or 3(c)(7), but that engage in the activities or have the characteristics of a ***traditional*** private equity fund or hedge fund." *See* FSOC Study, *supra* note 10, at 62 (emphasis added).

(1) Similar Commodity Pools

> ***SIFMA Recommendation***: The term "similar commodity pool" should be defined as any commodity pool, as defined in the Commodity Exchange Act (the "**CEA**"), that satisfies ***all*** of the following conditions:
>
> (a) it is engaged primarily in trading commodity interests; ***and***
>
> (b) it does not make a public offering of its securities; ***and***
>
> (c) its securities are beneficially owned by no more than 100 persons or exclusively by qualified purchasers (as defined in the 1940 Act); ***and***
>
> (d) it has all of the characteristics of a hedge fund or private equity fund as set forth on **Annex B**; ***and***
>
> (e) it is not an Excluded Entity (as defined above), an Exempt Entity (as defined below) or an ETF (as defined below).

By designating ***all*** commodity pools as "similar funds," the Agencies dramatically expanded the range of entities treated as covered funds under the Volcker Rule. The Agencies explained that their intent in designating all commodity pools as similar funds was to capture entities that "are generally managed and structured similar to a covered fund, except that they are not generally subject to the Federal securities laws due to the instruments in which they invest."[92] The Dodd-Frank Act amended the CEA to define a "commodity pool" as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests."[93] The term "commodity interest" is defined to include contracts for the purchase or sale of a commodity for future delivery; security futures products; swaps; retail foreign exchange transactions; retail commodity transactions, commodity options; and leverage transactions.[94]

In light of those sweeping definitions, there is a serious legal risk that any company that buys or sells even a minimal amount of commodity interests, even for hedging purposes, could be characterized as "trading in commodity interests."[95] Therefore, absent clarification from the Agencies, the term "commodity pool" could sweep in virtually any subsidiary or affiliate in a banking group that buys or sells even a minimal amount of commodity interests for hedging purposes. This would typically include all BHCs, other DIHCs, IDIs, FBOs,

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[92] *See* 76 Fed. Reg. at 68897.

[93] *See* 7 U.S.C. § 1a(10).

[94] *See* 7 U.S.C. § 1a(10)(A)(i)-(iv).

[95] *See, e.g.*, CFTC Letter No. 98-18, (Mar. 12, 1998). ("[T]here is currently no exception to the obligation to register as a CPO or CTA based solely on the fact that the pool makes…only de minimis investments in the futures markets."); *see also* CFTC, Commodity Pool Operators and Commodity Trading Advisors: Amendments to Compliance Obligations (Feb. 10, 2012), available at http://cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister020912b.pdf (noting that "[O]ne swap contract would be enough to trigger the [commodity pool operator] registration requirement.").

SEC-registered broker-dealers, Exempt Funds, or even SEC-registered investment companies. There is a serious legal risk that all would be commodity pools as defined by the CEA, absent further clarification.

We do not believe that Congress intended to authorize the Agencies to sweep in such a broad range of subsidiaries or affiliates under their "similar funds" designation authority. For one thing, that would lead to results that Congress could not possibly have intended. For example, if an IDI subsidiary were treated as a covered fund because it falls within the definition of "commodity pool," BHCs and other DIHCs would immediately upon the effective date of the Volcker Rule be prohibited from acting as a source of strength for their subsidiary IDIs in the form of providing extensions of credit to or entering into a transaction that reduces the credit risks of an IDI, even if the transactions are fully secured by U.S. government securities or cash collateral. BHCs and other DIHCs would also be required to divest all of their ownership interests in their IDI subsidiaries by the end of the conformance period because an investment in such a company could not be conformed under any of the "permitted activities" exemptions in Subsection (d)(1) of the statute. They would also be subject to a similar prohibition and divesture requirement with respect to any of their other subsidiaries or affiliates that could be characterized as trading in commodity interests because they buy or sell a minimal amount of commodity interests, including for hedging purposes.

The designation of all commodity pools as covered funds would even appear to require BHCs to divest all of their non-fund subsidiaries and affiliates by the end of the conformance period, while permitting them to retain 3% of any of their subsidiaries that are genuine hedge funds or private equity funds, subject to certain conditions. This result follows from the fact that investments in non-fund subsidiaries, including subsidiary IDIs, would not be able to qualify for any of the "permitted activities" exemptions in the Proposed Rules. Rather than increase the safety, soundness and stability of the U.S. and global financial system, the Proposed Rules could therefore destabilize it. Congress could not possibly have intended such a result.

In addition, we do not believe that the statute gives the Agencies unfettered discretion to designate all commodity pools as "covered funds." The statute only authorizes them to include within the term "covered funds" those commodity pools that are not captured by the General Definition of the terms "hedge fund" and "private equity fund," but are similar to the sorts of funds that are captured by the General Definition as properly construed. As noted above, we believe that the General Definition should be construed as any company that (a) would be an investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act, (b) has all of the characteristics of a hedge fund or private equity fund as set forth on **Annex B**, ***and*** (c) is not an excluded entity (as defined above).

In order to be an investment company under the 1940 Act, an issuer must generally either (i) be "engaged primarily" in the business of investing, reinvesting or trading in securities or (ii) be engaged in the business of investing, reinvesting, owning, holding or trading in securities and own investment securities having a value exceeding 40% of the total value of the

issuer's assets.[96] In order to qualify for an exemption under Sections 3(c)(1) or 3(c)(7) of the 1940 Act, an issuer must not make a public offering of its securities, and its securities must be held by no more than 100 persons or exclusively by persons that are "qualified purchasers," as defined in Section 2(a)(51) of the Act. Funds that rely on those exemptions are unregulated in the sense that, although their managers may be subject to the Investment Advisers Act, the funds themselves have no limits on the securities they may buy, the liquidity of their interests, borrowing or diversification. Nor are the operations of the fund subject to substantive requirements, including limitations on fees, redemptions or valuation.[97] In fact, hedge funds and private equity funds as commonly understood are limited in their activities solely by what investors may be willing to accept.

Thus, in order for a commodity pool to be similar to an issuer that falls within the general definition of the terms hedge fund or private equity fund, we believe that it would need to satisfy ***all*** of the conditions in the box above. These conditions are all necessary to confine the range of "commodity pools" treated as covered funds to those that are genuinely similar to hedge funds or private equity funds, as defined by the General Definition as properly construed. They properly exclude ordinary business entities that are not pooled investment vehicles, but may nevertheless use swaps, futures contracts or other commodity interests, for example, to hedge a fixed rate loan, foreign exchange exposure or some other exposure or to facilitate capital investment in conjunction with a line of business.

(a) Engaged Primarily

We attempted to develop an objective numerical test for determining when a commodity pool should be considered to be engaged primarily in trading commodity interests for purposes of the Volcker Rule. We considered a variety of such objective tests, including a percentage of assets, revenues or net income attributable to the activity or provided margin to secure exposures on speculative positions. Unfortunately, we were unable to find such a test that was practical to apply and did a good job of distinguishing similar commodity pools from dissimilar pools. Some of the challenges included the lack of consensus on how to value commodity interests for purposes of an assets-based test. Should they be valued at their notional value, replacement cost value or some other value? After considerable analysis, we concluded that the least bad test was the balancing test that has been used by the SEC staff to distinguish an entity engaged primarily in trading commodity interests from one engaged primarily in investing, reinvesting or trading in securities. That test involves a judgment based on the following three factors: (i) whether the entity looks primarily to commodity interests as its principal expected

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[96] See 1940 Act, § 3(a)(1)(A) and (C).

[97] We note that under the SEC's Form PF, "hedge fund" and "private equity fund" are defined as "private funds," defined in turn to be any issuer that would be an investment company but for section 3(c)(1) or 3(c)(7). *See* Form PF: Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors. SEC 2048 (12-11). Among the conditions of these exemptions is that an issuer not be "making and does not presently propose to make a public offering of its securities." Thus, the SEC has itself acknowledged that a fund that is publicly offered and subject to substantive regulation is not a "hedge fund" or "private equity fund."

source of gains; (ii) whether it anticipates that commodity interests will be its principal expected source of losses; and (iii) whether it holds itself out as engaged primarily in trading commodity interests rather than investing, reinvesting or trading in securities.[98]

Because this balancing test is subjective and indeterminate, however, it is imperative that the Agencies require commodity pools to satisfy all of the conditions set forth in the box above in order to be treated as a similar commodity pool, especially the condition that would require commodity pools to have all of the fundamental characteristics of a hedge fund or private equity fund, as commonly understood, as set forth on **Annex B**.

(b) No Public Offering

In order to qualify as a similar fund, a commodity pool must not make a public offering of its securities. If it does, its commodity pool operator will be subject to regulation on the commodity pool's assets and operations under the CEA or other applicable law. This would make it dissimilar to the sort of issuers that would be treated as "hedge funds" or "private equity funds" under the general definition of those terms in the statute.

(c) Ownership

In order to be similar to a hedge fund or private equity fund as described in the general definition of those terms in the statute, a commodity pool must either have fewer than 100 beneficial owners or its securities must be owned exclusively by qualified purchasers, as defined in the 1940 Act. In order to be a qualified purchaser under the 1940 Act, an investor must generally have investments of at least $5 million for individuals, or $25 million for entities.

(d) Functional Test

Whether or not the Agencies agree that the general definition of the term "covered fund" should include a requirement that an issuer have all of the characteristics of a hedge fund or private equity fund as commonly understood and as set forth in **Annex B**, we believe that a commodity pool must satisfy that test in order to be similar to an entity captured by the general definition. This element of our proposed definition is consistent with the FSOC's recommendations. In its study of the Volcker Rule, the FSOC recommended that the Agencies only designate an issuer as a similar fund if it is similar to a ***traditional*** hedge fund or private equity fund.[99]

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[98] *See Managed Futures Association*, SEC No-Action Letter (July 15, 1996); Peavey Commodity Futures Funds, SEC No-Action Letter (June 2, 1983).

[99] Specifically, the FSOC Study recommends that the Agencies "consider using their authority to expand the definition by rule to funds that do not rely on either Section 3(c)(1) or 3(c)(7), but that engage in the activities or have the characteristics of a ***traditional*** private equity fund or hedge fund." *See* FSOC Study, *supra* note 10, at 62 (emphasis added).

(e) Excluded Entities

Assuming that the Agencies agree that the General Definition of the term "covered fund" should be defined to exclude Excluded Entities (as defined above), we believe that the same entities must be excluded from the term "similar commodity pool," in order for the commodity pool to be similar to an issuer captured by the General Definition of the term "covered fund." This condition would exclude wholly owned subsidiaries, SEC-registered investment companies and other entities that we believe should be excluded from the general definition of the terms "hedge fund" or "private equity fund." If these entities are properly excluded from the General Definition, we do not believe it would be appropriate to sweep them back in as similar commodity pools. They do not become similar to hedge funds or private equity funds as we believe those terms should be construed solely because they trade in commodity interests.

We also believe that Exempt Entities (as defined below) and ETFs (as defined below) should be excluded.

(2) Similar Foreign Funds

SIFMA Recommendation: The term "similar foreign fund" should be defined as any foreign fund that satisfies ***all*** of the following conditions:[100]

(a) (i) it is engaged primarily in investing, reinvesting or trading in securities ***or*** (ii) it is engaged in investing, reinvesting, owning, holding or trading in securities and the value of its investment securities exceeds 40% of the value of its total consolidated assets; ***and***

(b) (i) it does not make a public offering of its securities or (ii) it is not eligible to make a public offering and is not subject to regulation of its activities or investments; ***and***

(c) its securities are beneficially owned by no more than 100 persons or exclusively by qualified purchasers (as defined in the 1940 Act); ***and***

(d) it has all of the characteristics of a hedge fund or private equity fund as commonly understood, as set forth on **Annex B**; and

(e) it is not an Excluded Entity (as defined above) or an ETF (as defined below).

As with the commodity pool designation, the Agencies' foreign fund designation can be read to treat all foreign funds (other than Exempt Funds) as covered funds in the Proposed Rules. This designation dramatically expands the scope of the entities treated as "hedge funds" or "private equity funds" under the Volcker Rule. We believe that this designation of potentially all foreign funds (except Exempt Funds) would exceed the Agencies' authority because the Agencies made no attempt to limit the universe of foreign funds that would be treated as "covered funds" to

[100] We believe that a "similar foreign fund" should satisfy all of the identified conditions.

those that are genuinely similar to "hedge funds" or "private equity funds" as defined in the General Definition in the statutory text. Nor did they limit them to foreign funds that are similar to traditional hedge funds or private equity funds as recommended in the FSOC Study. The Agencies did indicate in the Supplementary Information accompanying the Proposed Rules that they meant to limit the designation to a "foreign equivalent" of a U.S. covered fund,[101] but they made no attempt to define what constitutes an "equivalent" fund in either the Supplementary Information or the text of the Proposed Rules.

This is especially problematic in that the Agencies' interpretation is inconsistent with the "longstanding principle of American law that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States."[102]

Under the Agencies' proposed definition in the Proposed Rules, the term "covered fund" could be read to include virtually every foreign fund (other than an Exempt Fund), as if its securities were offered and sold to U.S. residents, regardless of whether it is truly similar to an issuer that would fall within the General Definition of "hedge fund" or "private equity fund" as properly construed. Instead of taking an approach that tests whether a foreign fund is "similar" to a "hedge fund" or "private equity fund" as defined by the general definition in the statute, the Proposed Rules impose a test that, under one plausible reading, would almost always lead to a determination that a foreign fund is a "covered fund." First, banking entities have to consider for each foreign fund that could fall within the broad definition of "investment company" under the 1940 Act, whether the fund could theoretically register as a U.S. mutual fund or whether there is any exemption other than Sections 3(c)(1) or 3(c)(7) for the fund to rely upon. But the test also requires the banking entity to consider on what basis a foreign fund could be offered to U.S. residents. Except in the rare case where a foreign fund can satisfy the specific conditions of another exemption from the 1940 Act, the only possible exemption from the 1940 Act would be Sections 3(c)(1) or 3(c)(7). Therefore, the foreign fund designation could be read to cause virtually all foreign funds (other than Exempt Funds) to be deemed to be "covered funds."

The foreign fund designation as drafted also fails to consider whether a foreign fund's operations are regulated under local law. Undertakings for Collective Investments in Transferable Securities ("**UCITS**"), for example, must be available for public distribution and are also subject to detailed rules on investment powers and restrictions, as well as provisions regarding management, under the European UCITS Directive and the fund's home jurisdiction. The UCITS badge, which has been available for funds in the European Union for over two decades, is widely recognized globally as denoting safety and protection for investors. UCITS are not only highly regulated in their home jurisdictions but also registered for sale to the public in many other countries both within and outside the European Union. UCITS are the European equivalent of SEC-registered investment companies. The similarity between the governing provisions of the European UCITS Directive and U.S. mutual fund regulation justifies an

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[101] 76 Fed. Reg. at 68897.

[102] *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2877 (2010) (internal quotation marks omitted); see id. at 2877-78 (collecting cases).

exclusion for this type of foreign fund. It demonstrates that a definition of "similar funds" that does not consider whether a fund is eligible to be offered to the public and is subject to regulation will include funds that do not meet the similarity condition of the statue and therefore the Agencies do not have the statutory power to designate them as similar funds.

Treating as covered funds UCITS and other types of foreign funds that are both regulated and offered to the public (the two most basic characteristics that make them dissimilar to funds that rely on Section 3(c)(1) or 3(c)(7) and to hedge funds and private equity funds as those terms are commonly understood) would be extremely disruptive and costly to the U.S. and global financial systems. UCITS alone manage more than $6 trillion in assets and represent significant revenue for foreign affiliates of U.S. banking entities. It is difficult to imagine how the foreign fund designation would satisfy any reasonable cost-benefit analysis.

The statute recognizes that banking entities should be permitted to offer and sponsor hedge funds and private equity funds subject to certain conditions. If publicly offered and regulated funds were captured by the final rules, banking entities would be required to satisfy the conditions set forth in both the asset management exemption and the Super 23A provisions of the Proposed Rules, which were not designed with publicly offered and regulated foreign funds in mind. Therefore, it is not surprising that it would be difficult, if not impossible, for banking entities to comply with those sections with respect to any UCITS and other publicly offered and regulated foreign funds.

The requirement that a fund not share the same name as the banking entity may, depending on the fund's legal structure and applicable regulation, require a shareholder vote and may, in fact, violate applicable law in certain jurisdictions that requires the fund name to be clear and not misleading. The prohibitions contained in the Super 23A provisions would force large fund complexes to cease having an affiliated entity serve as fund custodian or engaging in principal trades, both of which are permitted under non-U.S. law. Having an affiliated entity serve as fund custodian is also permitted under the 1940 Act for SEC-registered investment companies. The limits on employee investing will force thousands of employee investments out of foreign funds that are the equivalent of SEC-registered investment companies. The 3% per fund limit would need to be monitored on a continuous basis because many of the foreign funds that would be treated as similar funds provide daily liquidity to investors. That requirement will force banking entities to sell interests in foreign funds that may be the equivalent of SEC-registered investment companies if, on a single day, the banking entity's position exceeds the 3% limit solely because other investors have exercised their rights to have their ownership interests redeemed.

Such investments would also count toward the aggregate Tier 1 capital limit on *de minimis* investments. We do not believe that Congress took this into account when designing the asset management exemption, or intended to put U.S. financial institutions with foreign asset management operations at a significant competitive disadvantage to foreign financial institutions.

Designating all foreign funds (other than Exempt Funds) as "covered funds," whether or not they are in fact similar to a "hedge fund" or "private equity fund" as defined in the

statute or exhibit the characteristics of a hedge fund or private equity fund as commonly understood, would be contrary to the intent of Congress and does nothing to promote the safety and soundness of U.S. banking entities. In fact, the only benefit that would accrue by expanding the term "covered fund" in this manner would be to unregulated fund managers in the shadow banking system that are not affiliated with regulated DIHCs, IDIs or FBOs. Unfettered by the prohibitions and limits of the Volcker Rule, competitors of regulated DIHCs, IDIs or FBOs in the shadow banking system would flourish, while the international businesses of regulated DIHCs, IDIs or FBOs that have been built up over decades would be forced to restructure at significant costs and face significant losses of revenue without any positive benefit to themselves or for the financial stability of the United States.[103]

As noted above, we do not believe that the statute gives the Agencies unfettered discretion to designate all foreign funds as "covered funds." The statute only authorizes them to include within the term "covered funds" those foreign funds that are not captured by the General Definition of the terms "hedge fund" and "private equity fund," but are similar to the sorts of funds that are captured by the General Definition as properly construed. Also as noted above, we believe that the General Definition should be construed as any company that (a) would be an investment company under the 1940 Act but for Sections 3(c)(1) or 3(c)(7) of that Act, (b) has all of the characteristics of a hedge fund or private equity fund as set forth on **Annex B**, ***and*** (c) is not an excluded entity (as defined above).

In order to be an investment company under the 1940 Act, an issuer must generally either (i) be "engaged primarily" in the business of investing, reinvesting or trading in securities or (ii) be engaged in the business of investing, reinvesting , owning, holding or trading in securities and own investment securities having a value exceeding 40% of the total value of the issuer's assets.[104] In order to qualify for an exemption under Sections 3(c)(1) or 3(c)(7) of the 1940 Act, an issuer must not make a public offering of its securities, and its securities must be held by no more than 100 persons or exclusively by persons that are "qualified purchasers." Funds that rely on those exemptions are unregulated in the sense that, although their managers may be subject to the Investment Advisers Act, the funds themselves have no limits on the securities they may buy, the liquidity of their interests, borrowing or diversification. Nor are the operations of the fund subject to substantive requirements, including limitations on fees, redemptions or valuation. In fact, hedge funds and private equity funds as commonly understood are generally limited in their activities only by what investors may be willing to accept.

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[103] As discussed below in Section VI.B(5), the overbroad definition of "similar funds" will also have a deleterious effect on banking entities' Tier 1 capital. As drafted, section 12(d) of the Proposed Rules requires covered banking entities to deduct the aggregate value of all permitted investments in all covered funds from the banking entity's Tier 1 capital. Thus, an overly expansive definition of "covered funds" will materially impact banking entity's Tier 1 capital. The effect will be not only to inhibit any seeding of non-U.S. funds (even retail funds such as UCITS) but to materially lower Tier 1 capital of U.S. banking entities with large non-U.S. fund businesses.

[104] *See* 1940 Act, § 3(a)(1)(A) and (C).

Thus, in order for a foreign fund to be similar to an issuer that falls within the general definition of the terms hedge fund or private equity fund, we believe that it must satisfy all of the conditions in the box above. These conditions are all necessary to confine the range of "foreign funds" treated as covered funds to those that are genuinely similar to hedge funds or private equity funds, as defined by the General Definition as properly construed. They properly exclude ordinary business entities that are not pooled investment vehicles.

(a) Engaged Primarily

In order to be similar to an issuer that would be an investment company under the 1940 Act, but for Sections 3(c)(1) or 3(c)(7) of that Act, a foreign fund must be engaged primarily in the business of investing, reinvesting or trading in securities. Alternatively, it must be engaged in investing, reinvesting, owning, holding or trading in securities and own investment securities having a value exceeding 40% of the value of its total assets.

(b) No Public Offering

In order to qualify as a similar fund, a foreign fund must not make a public offering of its securities. Alternatively, it must both not be eligible to make a public offering of its securities and not be subject to regulation of its activities and investments. If it makes a public offering, a foreign fund will generally be subject to regulation on its activities and investments under some applicable law. This would make it dissimilar to the sort of issuers that would be treated as "hedge funds" or "private equity funds" under the general definition of those terms in the statute.

(c) Ownership

In order to be similar to a hedge fund or private equity fund as described in the general definition of those terms in the statute, a foreign fund must either have no more than 100 beneficial owners or its securities must be held exclusively by qualified purchasers, as defined in the 1940 Act. In order to be a qualified purchaser under the 1940 Act, an investor must generally have investments of at least $5 million for individuals, or $25 million for entities.

(d) Functional Test

Whether or not the Agencies agree that the general definition of the term "covered fund" should include a requirement that an issuer have all of the characteristics of a hedge fund or private equity fund as commonly understood and as set forth in **Annex B**, we believe that a foreign fund must satisfy that test in order to be similar to an entity captured by the general definition. This element of our proposed definition is consistent with the FSOC's recommendations. In its study of the Volcker Rule, the FSOC recommended that the Agencies

only designate an issuer as a similar fund if it is similar to a ***traditional*** hedge fund or private equity fund.[105]

(e) Excluded Entities

Assuming that the Agencies agree that the General Definition of the term "covered fund" should be defined to exclude Excluded Entities (as defined above), we believe that the same entities must be excluded from the term "similar foreign fund," in order for the foreign fund to be similar to an issuer captured by the General Definition of the term "covered fund." This condition would exclude wholly owned subsidiaries, SEC-registered investment companies and other entities that we believe should be excluded from the General Definition of the terms "hedge fund" or "private equity fund." If these entities are properly excluded from the general definition, we do not believe it would be appropriate to sweep them back in as similar foreign funds. They do not become similar to hedge funds or private equity funds as we believe those terms should be construed solely because they are organized or offered outside the United States.

C. Permitted Activities Authority

> ***SIFMA Recommendation***: As an alternative to our recommendations in paragraphs b and c above, the Agencies should expand their proposed "permitted activities" exemptions for certain wholly owned subsidiaries, joint ventures and acquisition vehicles as described in paragraphs (1) and (2) below.

The Agencies properly interpreted Section (d)(1)(J) of the Volcker Rule to allow them to grant exemptions from the general prohibition on sponsoring, acquiring or retaining interests in a covered fund. They exercised that authority to exempt sponsoring, acquiring or retaining interests in a relatively small category of wholly owned subsidiaries, joint ventures that are operating companies and acquisition vehicles. The Agencies also concluded, however – wrongly in our view – that Section (d)(1)(J) did not authorize them to grant exemptions from the general prohibition on covered transactions in Super 23A.[106]

If the Agencies decide to exclude wholly owned subsidiaries, joint ventures and acquisition vehicles from the definition of "covered fund" as recommended above, they do not need to retain the "permitted activities" exemptions for those corporate structures in the Proposed Rules. But if not, they should expand their proposed exemptions for wholly owned subsidiaries, joint ventures and acquisition vehicles to include covered transactions with such entities notwithstanding Super 23A. In addition, unless the entities defined as Excluded Entities above are excluded from the term "covered fund," the Agencies should expand their "permitted

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[105] Specifically, the FSOC Study recommends that the Agencies "consider using their authority to expand the definition by rule to funds that do not rely on either Section 3(c)(1) or 3(c)(7), but that engage in the activities or have the characteristics of a ***traditional*** private equity fund or hedge fund." *See* FSOC Study, *supra* note 10, at 62 (emphasis added).

[106] *See* 76 Fed. Reg. at 68912-13, n. 313.

activities" exemptions to apply to all of the entities defined as Excluded Entities, including all wholly owned subsidiaries, joint ventures and acquisition vehicles. Finally, for the reasons stated in Section VI.A below, we believe that all of the "permitted activities" exemptions (including exemptions granted under Section (d)(1)(J)), other than the asset management exemption, were intended and should be construed to apply to Super 23A, as well as the general prohibition on sponsoring or investing in hedge funds or private equity funds.

(1) Super 23A

> ***SIFMA Recommendations***. The Agencies should expand their proposed "permitted activities" exemptions for wholly owned subsidiaries, joint ventures and acquisition vehicles to include all covered transactions otherwise prohibited by Super 23A.

Section (d)(1)(J) of the Volcker Rule reads as follows:

> "Notwithstanding the restrictions under subsection (a) [which includes the general prohibition on sponsoring or investing in hedge funds or private equity funds], to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the [Agencies] may determine, the following activities . . . are permitted:
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> . . .
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> (J) Such other activity as the [Agencies] determine, by rule . . . would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."[107]

In reaching their conclusion that the permitted activities authority of Section (d)(1)(J) is limited to providing exemptions from the general prohibition on sponsoring or investing in covered funds in Section (a)(1) of the statute, and does not extend to the prohibition on covered transactions in Super 23A,[108] the Agencies appear to have focused on the lead-in language in Section (d)(1). That language expressly provides that the Agencies may override the general prohibition on sponsoring or investing in hedge funds or private equity funds by providing that any activities that qualify as permitted activities are permitted "[n]otwithstanding the restrictions under subsection (a)."

For the reasons set forth more fully in Section VI.A below, we do not believe that the lead-in language precludes any "permitted activities" exemptions granted under Section (d)(1)(J) from being construed to override the general prohibition on covered transactions in

[107] 12 U.S.C. § 1851(d)(1)(J).

[108] *See* 76 Fed. Reg. at 68912-13 n. 313.

Super 23A, if the conditions of Section (d)(1)(J) are satisfied. In particular, we believe that construing the "permitted activities" exemptions granted under Section (d)(1)(J) so that none of them applies to Super 23A severely narrows, and in some cases renders largely illusory, those exemptions. For example, although the "permitted activities" exemptions in the Proposed Rules granted under Section (d)(1)(J) would *nominally* permit banking entities to continue sponsoring, acquiring and retaining interests in certain wholly owned subsidiaries, joint ventures and acquisition vehicles, those same banking entities would be prohibited from entering into any funding, risk-management or other covered transaction with those affiliates. But if banking entities could not enter into such transactions with these affiliates, they would not be able to conduct the banking group's business in a safe, sound or efficient manner. As a result, despite the nominal exemption from the prohibition on investing in such non-fund entities, banking entities would continue to be prohibited from doing so as a practical matter. Congress could not possibly have intended such an absurd result.

If banking entities are prohibited upon the effectiveness of the Volcker Rule from entering into new covered transactions with a changing basket of their wholly owned subsidiaries, joint ventures and acquisition vehicles, they will no longer be able to enter into funding, risk-mitigating or other ordinary course intercompany transactions with these non-fund affiliates. Rather than promote the safety and soundness of banking entities, or the financial stability of the U.S. and global financial systems, this moratorium on covered transactions with non-fund affiliates could have a significant adverse effect on the safety, soundness, efficiency and stability of the financial system. That, in turn, could have a significant adverse effect on the wider economy in terms of reduced credit, increased unemployment and reduced output. Among the more absurd, unsafe and unsound results would be the legal cloud over whether bank holding companies could continue to act as a source of strength for their IDI subsidiaries by providing liquidity to or entering into risk management transactions with such IDI subsidiaries pursuant to the group's enterprise-wide funding and risk management programs. Indeed, the moratorium would appear to prohibit such intercompany transactions between a banking entity and virtually all of its subsidiaries and affiliates.

We believe that these results are also inconsistent with the purpose of Super 23A. That purpose is to protect the safety and soundness of banking entities, not to undermine that goal. According to Senator Merkley, Super 23A was designed to protect and promote the safety and soundness of banking entities by preventing them from bailing out investors in related funds for reputational purposes.[109] But there are no investors to bail out in a wholly owned subsidiary investment, no evidence that joint ventures or acquisitions vehicles expose banking entities to any material bailout risk, and considerable evidence that imposing a moratorium on covered transactions between banking entities and their non-fund subsidiaries and affiliates will actually undermine the safety and soundness of banking groups. Accordingly, it would be inconsistent with the purpose of Super 23A to fail to grant a "permitted activity" exemption under Section

[109] Colloquy between Senators Merkley and Levin, 156 CONG. REC. S5894 (daily ed. July 15, 2010). See also Colloquy between Senators Merkley, Levin and Dodd, *id.* at S5901 ("the intent of [Super 23A]" is "to prohibit banking entities from bailing out funds they manage, sponsor, or advise, as well as funds in which those funds invest").

(d)(1)(J) for covered transactions between a banking entity and its non-fund subsidiaries and affiliates.

In short, we believe that the "permitted activities" exemptions granted under Section (d)(1)(J) for wholly owned subsidiaries, joint ventures and acquisition vehicles should be construed to permit covered transactions with these non-fund affiliates. We believe that this is the proper interpretation of Section (d)(1)(J) in the context of the statute as a whole, and would therefore be entitled to *Chevron* deference.

(2) Excluded Entities

> **SIFMA Recommendation:** The Agencies should expand the range of entities to which these "permitted activities" exemptions apply to include all Excluded Entities (as defined above).

Unless the entities defined as Excluded Entities in Section A.(3) above are excluded from the term "covered fund," the Agencies should expand their "permitted activities" exemptions to apply to all of the entities defined as Excluded Entities above, including ***all*** wholly owned subsidiaries, joint ventures and acquisition vehicles. Largely for the reasons described in Section IV.A(3) above, we believe that expanding the "permitted activities" exemptions to cover all Excluded Entities would meet the safety and soundness and financial stability conditions of Section (d)(1)(J).

V. <u>Banking Entity</u>

A. Control

> ***SIFMA recommendation***: For purposes of the term "banking entity," the terms "subsidiary" and "control" should be defined as set forth in Section 2 of the BHC Act, but in each case without the "controlling influence" prong.

The term "banking entity" is defined in the Volcker Rule to include all affiliates and subsidiaries of a DIHC, IDI or FBO. The Proposed Rules define the terms "affiliate" and "subsidiary" by reference to the definitions of those terms in Section 2 of the BHC Act. Section 2 defines the term "affiliate" as "any company which controls, is controlled by, or is under common control with another company."[110] It defines "subsidiary" as any company that is directly or indirectly controlled by another company, including having a controlling influence over the

[110] 12 U.S.C. § 1841(k).

company.[111] Although the Proposed Rules do not define the term "control," the release accompanying the Proposed Rules indicates that the "concept of control" under the Proposed Rules "is as defined in section 2 of the BHC Act and as implemented by the Board."[112] Section 2 defines "control" of any company as (1) the ownership or control of 25% or more of any class of voting securities of the company, (2) controlling in any manner the election of a majority of the directors or similar body of the company or (3) having a controlling influence over the management or policies of the company, but only if the Board determines after notice and an opportunity for a hearing that such a controlling influence exists.[113]

We believe that the Agencies should adopt more objective definitions of the terms "subsidiary" and "control" for purposes of the Volcker Rule. The "controlling influence" prongs of the definitions used by the Proposed Rules create too much uncertainty about which companies will be treated as affiliates or subsidiaries of DIHCs, IDIs and FBOs for purposes of the Volcker Rule. This is because, in practice, the "controlling influence" test is an "all facts and circumstances" test.[114] It was developed, and has been construed by the Board, for very different provisions with very different purposes than the Volcker Rule. In addition, other than the Board, none of the Agencies has any experience applying this test. The fact-bound nature of this test will almost inevitably lead to inconsistent applications by the various Agencies, and raises the possibility of regulatory arbitrage.

We believe that a more appropriate definition of each term would be the objective portions of each definition in Section 2 of the BHC Act – that is, each definition without the controlling influence prong. We believe that defining each term in this more objective manner is well within the discretion of the Agencies under the *Chevron* decision. As currently used in the statutory definitions of both terms, the controlling influence test is not self-executing. It is subject to the Board making a specific determination after providing prior notice and a formal hearing. At a minimum, the Agencies will need to determine whether Congress intended for the Board to have the exclusive responsibility to make these determinations, and provide the required due process, for purposes of the Volcker Rule, or whether Congress intended for one or more of the other Agencies to provide the required notice and hold the required hearing with respect to some affiliates and subsidiaries. If the Agencies determine that Congress intended for all of the Agencies to be involved, they will have to determine which Agency should be responsible for making a specific determination, and providing the required notice and holding the required

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[111] The full definition of the term "subsidiary" is "(1) any company 25 per centum or more of whose voting securities . . . is directly or indirectly controlled by such [BHC]; (2) any company the election of a majority of whose directors is controlled in any manner by such [BHC]; or (3) any company with respect to the management or policies of which such [BHC] has the power, directly or indirectly, to exercise a controlling influence . . . ." 12 U.S.C. § 1841(d).

[112] 76 Fed. Reg. at 68855 n. 79.

[113] 12 U.S.C. § 1841(a)(2).

[114] *See, e.g.*, Policy Statement on Equity Investments in Banks and Bank Holding Companies at 5-6 (Issued Sept. 22, 2008) (to be codified at 12 C.F.R. § 225.144).

hearing, with respect to a particular affiliate or subsidiary under a particular set of circumstances for purposes of the Volcker Rule.

The Board itself has adopted more objective definitions of the term "control," when appropriate, in certain of its regulations implementing the BHC Act or the Dodd-Frank Act. For example, the Board defined the term "control" as follows in Appendix G to its Regulation Y, which is its principal regulation implementing the BHC Act:

> "A person or company controls a company if it: (1) Owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; or (2) Consolidates the company for financial reporting purposes."[115]

Similarly, in its proposed regulations implementing the single-counterparty credit limits in Sections 165 and 166 of the Dodd-Frank Act, the Board defined the term "control" as follows:

> "A company controls another company if it (1) owns, controls, or holds with power to vote 25 percent or more of a class of voting securities of the company; (2) owns or controls 25 percent or more of the total equity of the company; or (3) consolidates the company for financial reporting purposes."[116]

The Board explained that it was proposing a definition that was different from the definitions in the BHC Act and Regulation Y because "a simpler, more objective definition of control is more consistent with the objectives of single-counterparty credit limits."[117] We believe that the same rationale justifies our proposed definitions of the terms "subsidiary" and "control" for purposes of the Volcker Rule.

We also believe that the costs of including the controlling influence prong in the definition of the terms "subsidiary" and "control" substantially outweigh the benefits of doing so for purposes of the Volcker Rule. Control determinations that turn on the controlling influence prong are typically highly fact- and circumstance-specific. As stated in its 2008 policy statement on equity investments in BHCs, the Board has long acknowledged that "the complexity of legitimate business arrangements precluded establishing rigid rules designed to cover all situations and that decisions regarding the presence or absence of control must take into account the specific facts and circumstances of each case."[118] This posture requires that Board staff approach control questions "by considering carefully all the facts and circumstances surrounding

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[115] 12 C.F.R. Part 225, Appendix G.

[116] *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594, 649 (Jan. 5, 2012).

[117] *Id.* at 614.

[118] *See* 12 U.S.C. § 225.144.

the investor's investment in, and relationship with, [a] banking organization."[119] In light of the reach of the Volcker Rule which treats each subsidiary and affiliate of a DIHC, IDI or FBO as a banking entity itself, whether an entity constitutes a "subsidiary" or "affiliate" will be critically important for banking entities seeking to comply with the Volcker Rule's restrictions. Because of the uncertainty injected into this analysis by the controlling influence prong in the definitions of the terms "subsidiary" and "control," and the requirement to provide notice and hold a hearing before treating a company as controlled under the controlling influence test, the Board and the other Agencies are likely to be inundated with requests for control determinations, with their required notice and hearings. The costs to banking entities and the demands on the Board and other Agencies could be immense. For these reasons, and consistent with the Board's definition of control in Appendix G of Regulation Y and its proposed definition of control in its regulations implementing Sections 165 and 166 of the Dodd-Frank Act, we recommend that the Agencies establish "a simpler, more objective definition" of the terms "subsidiary" and "control" for purposes of the Volcker Rule.

We do not believe that adoption by the Agencies of a more objective definition of the term "control" for purposes of the Volcker Rule would have any implication for how the Board interprets and administers that term for other provisions of the BHC Act. Unlike the BHC Act generally, with respect to which the Board has sole interpretive, administrative and rulemaking authority,[120] Congress granted all of the Agencies authority to issue regulations implementing the Volcker Rule (other than the conformance period provisions).[121] This clearly evidences that Congress intended the Volcker Rule to be administered in a manner different than other parts of the BHC Act, and an objective definition of "control" for purposes of the Volcker Rule would have no precedential effect for the meaning of that term for other aspects of the BHC Act.

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[119] *See id.*

[120] *See* 12 U.S.C. § 1844(b) (granting the Board authority to issue regulations and orders to administer the BHC Act).

[121] *See* 12 U.S.C. §§ 1851(b)(2), (c)(5), (d)(1)(J), (d)(2)(B), (d)(3), (e), (f)(4), (h)(2), (h)(4), (h)(6).

B. Exclusions

SIFMA recommendation: The following entities should be excluded from the term "banking entity":

(i) **Permitted Covered Funds**. All covered funds that a banking entity is permitted to sponsor or invest in under any "permitted activity" exemption, including the asset management exemption;

(ii) **Exempt Funds**. All issuers that would be investment companies under the 1940 Act, except that they qualify for an exemption under any provision of that Act other than Sections 3(c)(1) or 3(c)(7) of that Act (each, an "**Exempt Fund**");

(iii) **SEC-Registered Investment Companies and BDCs**. All SEC-registered investment companies and business development companies;

(iv) **Public Commodity Pools**. All commodity pools that have made a public offering of their securities and have not been taken private;

(iv) **Public Foreign Funds**. All foreign funds that either (i) have made a public offering of their securities and have not been taken private or (ii) are eligible to make a public offering and are subject to regulation of their investments and activities;

(v) **Portfolio Companies**. All portfolio companies held by a BHC under the merchant banking authority of Section 4(k)(4)(H) of the BHC Act or by any other type of DIHC in accordance with applicable law;

(vi) **Temporarily Grandfathered Covered Funds**. All covered funds established before the effective date of the Volcker Rule, but only for the duration of the conformance period;

(vii) **Subsidiaries**. All direct or indirect subsidiaries of any of the foregoing; and

(viii) **Investment Management Affiliates**. Solely for purposes of the name sharing condition in the asset management exemption, all investment management affiliates, provided that such investment management affiliate does not share a name with an insured depository institution affiliate or the ultimate parent of such an insured depository institution affiliate.

Under one reading of the statutory definition of the term "banking entity," all affiliates and subsidiaries of a DIHC, IDI or FBO would be treated as banking entities. The Agencies, however, have construed the term "banking entity" to exclude any "covered fund" that is organized, offered and held under the asset management exemption in Section (d)(1)(G) of the

Volcker Rule and any subsidiary of such a fund.[122] The Agencies correctly explained that this exclusion is necessary "to avoid application of [the Volcker Rule] in a way that appears unintended by the statute and would create internal inconsistencies in the statutory scheme."[123] In particular, this exclusion is necessary to permit DIHCs, IDIs and FBOs to continue to be able to structure their asset management activities through fund of funds, master-feeder funds and parallel fund structures, as Congress intended,[124] and to avoid the unintended result of prohibiting such funds from engaging in the ordinary businesses of a hedge fund, a fund of funds or a feeder fund, namely to engage in proprietary trading or to invest in other hedge funds or private equity funds or a master fund. The Agencies' construction of the term "banking entity" in a manner that eliminates these and any other internal inconsistencies and unintended consequences identified below is correct and would receive *Chevron* deference.[125] The courts have consistently held that statutes must be construed in a manner that eliminates internal inconsistencies, absurd results and unintended consequences.[126]

Although we agree with the Agencies as far as they have gone, we do not believe that the Proposed Rules have eliminated all of the internal inconsistencies or unintended consequences arising from the interplay between the term "banking entity" and other provisions of the Volcker Rule. To achieve this broader goal, the Agencies need to expand the proposed exclusion to exclude the additional entities listed in the box above, namely permitted funds, Exempt Funds (as defined below), SEC-registered investment companies and business development companies, public commodity pools, public foreign funds, portfolio companies, temporarily grandfathered covered funds, investment management affiliates (for name-sharing purposes only), and all of the direct or indirect subsidiaries of any of the foregoing.

(1) Permitted Covered Funds

Covered funds that are organized, offered and held under the asset management exemption are not the only covered funds that Congress intended to be permitted to continue making controlling and non-controlling investments in other covered funds or to continue engaging in proprietary trading. We believe that Congress clearly intended for ***all*** permitted covered funds to be able to continue making such investments and engaging in such trading activities. If permitted funds were prohibited from doing so because the Agencies construed the term "banking entity" to include any permitted fund that is a subsidiary or affiliate of a DIHC, IDI

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[122] *See* Proposed Rules § __.2(e), 76 Fed. Reg. at 68944.

[123] 76 Fed. Reg. at 68855.

[124] *See* Colloquy between Senators Merkley and Levin, 156 CONG. REC. S5894 (daily ed. July 15, 2010); Statement of Senator Brown, 156 CONG. REC. S6241 (daily ed. July 26, 2010); Statement of Senator Hagan, 156 CONG. REC. S5870 (daily ed. July 15, 2010).

[125] *See Chevron v. National Resources Defense Council*, 467 U.S. 837 (1984).

[126] *See, e.g.*, *Public Citizen v. Department of Justice*, 491 U.S. 440, 454 (1989); William N. Eskridge, Jr., Philip P. Frickey & Elizabeth Garrett, LEGISLATION AND STATUTORY INTERPRETATION 267-71, 390 (2d Ed. 2006); *United States v. Granderson*, 511 U.S. 39, 47 n. 5 (1994); *Dewsnup v. Timm*, 502 U.S. 410, 427 (1992) (Justice Scalia, dissenting).

or FBO, the Volcker Rule would contain an internal contradiction that is inconsistent with this congressional intent.

As the Agencies recognized in the context of excluding covered funds organized, offered and held under the asset management exemption, construing the term "banking entity" to include any "affiliate" or "subsidiary" of a DIHC, IDI or FBO "would create internal inconsistencies with the statutory scheme."[127] Absent the exclusions we recommend in this comment letter, the term "banking entity" would include any covered fund that is directly or indirectly controlled by a DIHC, IDI or FBO. Under the Federal Reserve's definition of control, this would include any covered fund where the general partner, managing member or trustee is directly or indirectly controlled by a DIHC, IDI or FBO. Thus, in the absence of the exclusions we recommend, any such controlled covered fund would be prohibited from engaging in the ordinary businesses of a hedge fund, a fund of funds or a feeder fund – namely, engaging in proprietary trading or investing in other hedge funds or private equity funds or master funds, unless the underlying fund separately complied with a "permitted activity" exemption.

Yet the text and legislative history clearly contemplate that all covered funds that are permissibly controlled by a banking entity – including hedge funds and private equity funds organized and offered under the asset management exemption, the hedging exemption, the small business investment company ("**SBIC**") exemption and the exemption for covered funds acquired in satisfaction of a debt previously contracted ("**DPC**") – will be able to acquire and retain both controlling and non-controlling investments in other covered funds, including third-party funds, *without* the underlying covered fund being required to comply with a separate permitted activity exemption. Among the best examples of such text and legislative history are subsections (f)(1) and (f)(3) of Super 23A and a colloquy between Senators Merkley and Levin, the principal authors of the Volcker Rule. Super 23A plainly contemplates that any fund that is permissibly controlled by a banking entity – including but not limited to any covered fund organized, offered and held under the asset management exemption – is permitted to make and retain both controlling and non-controlling investments in any other covered fund without regard for the restrictions of the Volcker Rule. This follows from the language in subsection (f)(1), which generally prohibits any "banking entity" from entering into any covered transaction with:

- any hedge fund or private equity fund that is managed, advised, sponsored or organized and offered by the banking entity or any affiliate; or
- "***any*** other hedge fund or private equity fund that is ***controlled by*** such fund." (Emphasis added).

If a covered fund were not permitted to make controlling and non-controlling investments in any other covered fund, including a third-party fund, because the covered fund was treated as a banking entity, the second element of subsection (f)(1) would make no sense.

[127] 76 Fed. Reg. at 68855.

Similarly, subsection (f)(3) of Super 23A creates an exemption to the general prohibition in subsection (f)(1) for prime brokerage transactions between a banking entity and "any hedge fund or private equity fund in which a hedge fund or private equity fund managed, sponsored or advised by such banking entity has taken an equity, partnership or other ownership interest. If a covered fund were not permitted to make controlling and non-controlling investments in any other covered funds, this language also would make no sense.[128]

Senators Merkley and Levin confirmed this reading in their colloquy and also confirmed that all permitted covered fund subsidiaries are permitted to invest in third-party funds. If any permitted covered fund subsidiary were treated as a "banking entity," it would be prohibited from investing in third-party funds unless separately exempted under one of the permitted activities provisions in Section (d)(1) of the Volcker Rule. According to Senator Merkley:

> "Subsection (f), paragraph (3), permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of 'prime brokerage' between the banking entity and a third-party advised fund in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest. Essentially, it was argued that a banking entity should not be prohibited, under proper restrictions, from providing limited services to unaffiliated funds, but in which its own advised fund may invest."[129]

This reading is further confirmed by a statement by Senator Hagan, who was also a supporter of the Volcker Rule and the Dodd-Frank Act:

> "[S]ection 619(f) applies sections 23A and 23B of the Federal Reserve Act to transactions between all of a banking entity's affiliates and hedge or private equity funds where the banking entity organizes, offers, serves as an investment manager, investment adviser, or sponsor of such funds under section 619(d). These restrictions are also applied to transactions between a banking entity's affiliates and other funds that are "controlled" by a hedge or private equity fund permitted for the banking entity under section 619. Importantly, these 23A and 23B restrictions do not apply to funds not "controlled" by funds permitted for the banking entity under section 619(d), and it should also be clear that ***under 619 there are no new restrictions of any type placed on the portfolio investments of any hedge***

[128] *See* 156 CONG. REC. S5889 (daily ed. July 15, 2010) (Statement of Senator Hagan) (The Super 23A "restrictions do not apply to funds not 'controlled' by funds permitted for the banking entity under section 619(d).").

[129] 156 CONG. REC. S5898 (daily ed. July 15, 2010).

fund or private equity fund permitted for a banking entity under section 619."[130]

Although Senator Merkley's statement was limited to third-party funds, it would apply with equal force to controlling investments by permitted covered funds in other covered funds – that is, affiliated funds. That follows from the language of Section (f)(1), which only prohibits covered transactions with underlying covered funds that are controlled by permitted covered funds. Since the prime brokerage exemption in Section (f)(3) is an exemption from (f)(1), it is only needed if the investment by the permitted covered fund is a controlling investment in another covered fund. This is consistent with Senator Hagan's statement that Super 23A's restrictions "do not apply to funds not 'controlled' by funds permitted for the banking entity under section 619(d)."[131]

This text and legislative history confirm that Congress not only intended for covered funds organized, offered and held under the asset management exemption to be able to make controlling and non-controlling investments in other covered funds. It also intended for any covered fund that a BHC, IDI or FBO is permitted to sponsor or invest in under any of the permissible activities provisions in the statute or the Proposed Rules to be permitted to make such controlling or non-controlling investments in other affiliated or unaffiliated funds, without being required to find a separate exemption for such underlying investments.[132]

This same statutory text and legislative history — as well as common sense —also make clear that an underlying covered fund that a banking entity is permitted to control under the Volcker Rule should not itself be treated as a banking entity subject to the ban on proprietary trading or the restrictions on sponsoring or investing in other covered funds as a result of that investment. The restrictions on proprietary trading and sponsoring or investing in covered funds both flow from subsection (a)(1) of the Volcker Rule.[133] Thus, the legislative text and history noted above demonstrates that a permitted covered fund was intended to be excluded from the restrictions in subsection (a)(1) relating to sponsoring or investing in covered funds also clearly evidence that such funds were not intended to be subject to the restrictions in subsection (a)(1) on proprietary trading or sponsoring or investing in other funds. Indeed, a contrary reading would largely eviscerate any statutory or regulatory authority for banking entities to sponsor or invest in covered funds as the very business of a hedge fund or private equity fund often involves proprietary trading or making controlling or non-controlling investments in other funds, including a master fund.

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[130] *Id.* at S5889 (statement of Senator Hagan) (emphasis added).

[131] *Id.*

[132] *See id.*

[133] *See* 12 U.S.C. § 1851(a).

(2) Exempt Funds

We also believe that the Agencies should amend the proposed rules to exclude from the term "banking entity" any fund that qualifies for an exemption from the 1940 Act other than Sections 3(c)(1) or 3(c)(7) (each, an "**Exempt Fund**"), and any of its direct or indirect subsidiaries. We do not believe that Congress defined the terms "hedge fund" or "private equity fund" in a manner that was designed to carve out Exempt Funds from that definition only to have the term "banking entity" construed in a manner that would treat any such Exempt Fund as a banking entity, subject to the Volcker Rule restrictions itself, merely because it was controlled directly or indirectly by a DIHC, IDI or FBO. If, as the Agencies recognized, it would be inconsistent with the overall statutory scheme for a covered fund organized and offered under the asset management exemption and its subsidiaries to be treated as a banking entity, it would surely be inconsistent with that overall statutory scheme for an Exempt Fund or its subsidiaries to be treated as a banking entity. This conclusion is also supported by the legislative history, in particular Senator Hagan's statement that under the Volcker Rule, "there are no new restrictions of any type placed on the portfolio investments of any hedge fund or private equity fund permitted for a banking entity under section 619."[134] If this is true for funds that fall within the statutory definition of a "hedge fund" or "private equity fund," surely it must be true for Exempt Funds.

(3) SEC-Registered Investment Companies and BDCs

We also believe that the Agencies should amend the proposed rule text to exclude from the term "banking entity" any SEC-registered investment company ("**RIC**") or business development company ("**BDC**") that is directly or indirectly controlled by a banking entity, and any of its subsidiaries. As implied by the Supplementary Information in the NPRs, the Agencies appear to be under the mistaken impression that banking entities always structure their relationships with RICs so that they are not deemed to be controlling relationships for purposes of the BHC Act.[135] We do not believe that this premise is accurate. For example, if a banking entity owns 5% or more of any class of voting securities and is the investment adviser of a RIC, the RIC will generally be deemed to be controlled by the banking entity for purposes of the BHC Act and Sections 23A and 23B of the Federal Reserve Act.[136] Although it is true that many banking entities often structure their relationships with RICs to avoid having a controlling relationship, this is not universally true.

For those RICs and BDCs that *are* controlled by banking entities, it would clearly be "inconsistent with the purpose and intent of the statute" for such RICs or BDCs to be subject to the Volcker Rule, which would effectively prevent them from engaging in proprietary trading (as defined in the Proposed Rules) or investing in hedge funds or private equity funds unless such

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[134] 156 CONG. REC. at S5889 (statement of Senator Hagan).

[135] *Id.* at 68856.

[136] *See, e.g.*, 12 C.F.R. § 223.2(a)(6)(ii) (when a RIC is deemed an "affiliate" of a member bank for purposes of Sections 23A and 23B); 12 C.F.R. § 225.174(d)(4)(iv) (when a private equity fund is deemed to be controlled by a financial holding company for purposes of the BHC Act).

investments independently qualify for one of the "permitted activities" exemptions in the Volcker Rule. The Volcker Rule was not designed to apply to these types of entities, whose activities and investments are already highly regulated under the 1940 Act and should not be subject to any additional regulation under the Volcker Rule.

Given the substantial similarity between RICs and BDCs described above in Section IV.A.(2(d) above, we also believe that the Agencies should amend the proposed rule text to exclude from the term "banking entity" any BDC that is directly or indirectly controlled by a banking entity, and any of its subsidiaries.

(4) Public Commodity Pools

We also believe that the Agencies should amend the Proposed Rules to exclude from the term "banking entity" any commodity pool that is directly or indirectly controlled by a banking entity, and its subsidiaries, if the commodity pool has been excluded from the term "covered fund" because it has made a public offering of its securities and has not been taken private. Just as it would be inconsistent with the statutory scheme to treat a covered fund organized and offered under the asset management exemption, any other permitted covered fund, any Exempt Fund or any RIC, or any of their subsidiaries, as a banking entity, so it would be inconsistent with that scheme to treat a public commodity pool as a banking entity.

(5) Public Foreign Funds

We also believe that the Agencies should amend the Proposed Rule to exclude from the term "banking entity" any foreign fund that is directly or indirectly controlled by a banking entity, and its subsidiaries, if the foreign fund is excluded from the term "covered fund" because it has made a public offering of its securities and has not been taken private or it is both eligible to make a public offering of its securities and its investments and activities are subject to regulation. Just as it would be inconsistent with the statutory scheme to treat a public commodity pool as a banking entity, so it would be inconsistent with that scheme to treat a public foreign fund as a banking entity.

(6) Portfolio Companies

We also believe that the Agencies should exclude from the term "banking entity" any company directly or indirectly controlled by a BHC or a covered fund under Section 4(k)(4)(H) of the BHC Act ("**portfolio companies**"). Unless the Agencies do so, the term "banking entity" will include all controlled portfolio companies, including those engaged exclusively in nonfinancial activities.[137] Absent modification, this means that all controlled portfolio companies would be subject to the Volcker Rule's prohibitions on investing in hedge funds or private equity funds and on proprietary trading.

[137] A portfolio company, by definition, must be engaged in nonfinancial activities that are not permissible for a financial holding company to conduct directly. *See* 12 C.F.R. § 225.177(c).

Important statutory restrictions exist that limit a BHC's ability to hold or routinely manage and operate a portfolio company acquired pursuant to the merchant banking authority in Section 4(k)(4)(H) of the BHC Act. For example, under regulations implementing Section 4(k)(4)(H) of the BHC Act, BHCs are generally prohibited from engaging in the day-to-day management of such portfolio companies.[138] The Federal Reserve has interpreted this prohibition to mean that (i) no director, officer, or employee of the banking entity may serve as or have the responsibilities of an executive officer of the portfolio company, and no executive officer of the parent financial holding company or certain of its major subsidiaries may serve as or have the responsibilities of an officer or employee of the portfolio company, and that (ii) the banking entity may not restrict, by covenants, agreements, or otherwise, the portfolio company's ability to make routine business decisions. Moreover, BHCs are generally prohibited from owning or controlling a portfolio company for more than 10 years, or 15 years if the company is held through a qualifying private equity fund.[139] In addition, cross-marketing activities between the depository institution subsidiaries of a BHC and a portfolio company are generally prohibited.[140]

The exclusion for portfolio companies should also apply to portfolio companies directly or indirectly controlled by other DIHCs, such as savings and loan holding companies and industrial bank holding companies, and by nonbank financial companies designated as systemically important and therefore subject to the Board's supervision, none which is subject to the BHC Act. Such companies are permitted to hold portfolio companies under separate statutory authority.

As noted above, Congress clearly intended the Agencies to exclude from the reach of the Volcker Rule "ordinary corporate structures" in a manner that avoids "disrupt[ing] the way the firms structure their normal investment holdings."[141] We believe that it is inconceivable that Congress intended for the Volcker Rule to interfere with the investment activities of the direct or indirect portfolio companies of BHCs, other DIHCs or their controlled covered funds or to treat such portfolio companies as banking entities for purposes of the Volcker Rule.

(7) Temporarily Grandfathered Covered Funds

We also believe that the Agencies should exclude from the term "banking entity" any covered funds that were established before the effective date of the Volcker Rule, and their direct or indirect subsidiaries, for the duration of the conformance period. Without such an exclusion, covered funds that may be held under the conformance period exemption would upon the effectiveness of the Volcker Rule immediately become subject to the restrictions on sponsoring or investing in other covered funds or from entering in to covered transactions with such covered funds. This would create an inconsistency under the Proposed Rule. The statute

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[138] *See* 12 C.F.R. § 225.171.

[139] *See* 12 C.F.R. § 225.172.

[140] *See* 12 C.F.R. § 225.176.

[141] *See* Colloquy between House Financial Services Chairman Barney Frank (D-MA) and Rep. Jim Himes (D-CT), 156 CONG. REC. H5226 (daily ed. June 30, 2010).

provides a two-year conformance period during which banking entities are permitted to conform their activities and relationships with covered funds that were established before the effective date, with up to three one-year extensions, and in the case of illiquid funds, an additional five-year extension. Yet, treating these temporarily grandfathered funds as banking entities could require them to conform their activities immediately, even if they are a fund of funds or a feeder fund into a master fund. We do not believe that Congress provided a temporary exemption for banking entities to retain their controlling or non-controlling investments in covered funds established before the effective date only to treat any such controlled covered funds as banking entities immediately subject to the Volcker Rule restrictions.

(8) Investment Management Affiliates

One of the conditions of the asset management exemption is that a covered fund held thereunder "does not share the name or a variation of the name with the banking entity (or an affiliate or subsidiary thereof)."[142] Under the statutory text, the broad definition of "banking entity" leads to the unusual result that every fund in a family of controlled funds would be treated as a banking entity and an affiliate of each other, as well as of any investment advisory affiliate, and is therefore required to have a unique name. Although the proposed definition of the term "banking entity" as drafted solves part of this problem, by excluding controlled covered funds organized and offered under the asset management exemption from the term "banking entity" and thus the name-sharing prohibition, the name-sharing prohibition would still apply to an investment management affiliate. In other words, it would still prohibit a covered fund, including a covered fund held under the asset management exemption, from sharing a name with an investment management affiliate even if the investment management affiliate does not share a name with any of its IDI affiliates or the ultimate parent of such IDI affiliates. Complying with this requirement would be extraordinarily costly and disruptive with no corresponding public benefit.

In addition, unless investment management affiliates are excluded from the term "banking entity" for name-sharing purposes, it could create a conflict with certain non-U.S. regulatory requirements that apply to offshore funds, such as the Markets in Financial Instruments Directive ("**MiFID**").[143]

As a result, we recommend that solely for purposes of the name sharing condition in the asset management exemption, all investment management affiliates would be excluded from the term "banking entity," provided that such investment management affiliate would not be permitted to share a name with any of its IDI affiliates or the ultimate parent of such IDI affiliates.

As drafted, the Proposed Rules would prohibit a covered fund held under the asset management exemption from sharing a name or a variant of the name of an investment management company that acts as the investment adviser of such covered fund, if the investment

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[142] *See* Proposed Rules §__.11(f)(1).

[143] Directive 2004/39/EC of the European Parliament and of the Council.

management company is controlled by a DIHC, IDI or FBO. Banking entities will incur substantial cost with no discernible benefit to the public in connection with changing the names of thousands of covered funds that share a name with their investment advisor. In addition, banking entities will bear substantial costs, both directly and in the form of loss of competitive advantage, by being forced to abandon brands built by banking entities over time through the provision of permissible asset management services.

For example, suppose that Brand Name bank holding company, which controls Brand Name bank, directly or indirectly sponsors a family of funds that are all organized and offered under the asset management exemption. It wants to name each fund after its wholly owned investment advisory affiliate, ABC Asset Management. Because ABC Asset Management would be a banking entity, any covered fund that it advises would be prohibited from sharing the name ABC or a variant of that name. Thus, the banking group would be prohibited from choosing the names ABC Fund 1, ABC Fund 2 and so forth and would instead be required to choose a different name for each fund (e.g., DEF Fund 1, DEF Fund 2, etc.).

We do not believe that Congress intended such a pointless restriction. The loss of the branding value, built by banking entities over time through the provision of permissible asset management services, could be substantial. Moreover, the asset management exemption separately requires clear and conspicuous written disclosure to investors that they (and not the banking entity) will solely bear losses in the covered fund, and that interests in the covered fund are not deposits, obligations of, or endorsed or guaranteed in any way by the banking entity (unless that is the case) and requires a banking entity to reveal "[t]he role of the banking entity and its affiliates, subsidiaries and employees in sponsoring or providing any services to the fund."[144] As long as the investment management affiliate does not share a name with an IDI affiliate or its ultimate parent, we believe it would be needlessly costly to require these disclosures and at the same time to force de-branding. The asset management exemption's disclosure requirements, coupled with its express anti-bailout condition,[145] more than adequately address concerns that sharing a name with the adviser increases the risk that a banking entity will cover investor losses. The economic impact of a forced de-branding does not justify any incremental protection in this regard and will hurt banking entities' ability to remain competitive with non-bank-affiliated asset managers, thereby needlessly harming the profitability of a business built up over many years and increasing the risk of adverse effects on safety and soundness.

VI. Permitted Activities

This section of the comment letter discusses the various "permitted activities" exemptions. Several of our recommendations are presented in the alternative, in case the Agencies do not agree with what we think is the best approach.

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[144] *See* Proposed Rules §__.11(h)(1).

[145] *See* Proposed Rules §__.11(c).

This section first argues that all of the "permitted activities" exemptions, other than the asset management exemption, should be construed to apply to Super 23A, as well as to the general prohibition on sponsoring or investing in hedge funds or private equity funds. It then addresses various issues with the asset management exemption, including the proposed attribution rules and the regulatory capital deductions. It argues that the Agencies should add a "permitted activities" exemption under Section (d)(1)(J) of the Volcker Rule for activities and relationships with credit funds, or exclude them altogether pursuant to the rule of construction in Section (g)(2) of the statute. It next argues that the Agencies should construe the "permitted activities" exemptions for underwriting, market-making-related activities and risk-mitigating hedging to be available and essentially identical for both the proprietary trading and covered funds portions of the Volcker Rule. It contends that the SBIC exemption should extend to "public welfare" investments outside the United States. It argues that the offshore exemption should be construed to provide FBOs with a meaningful opportunity to continue investing as limited partners in third-party hedge funds and private equity funds, as long as the FBOs do not offer and sell any of the funds' interests to U.S. residents and satisfy the other statutory conditions of the offshore exemption.

A. Super 23A

We believe that all of the "permitted activities" exemptions, other than the asset management exemption, should be construed to apply to the general prohibition on covered transactions under Section 23A, as well as to the general prohibition on sponsoring or investing in hedge funds or private equity funds in Section (a) of the statute. Although the Agencies did not express a view on whether all of the "permitted activities" exemptions, other than the asset management exemption, would be limited to the general prohibition in Section (a) and not extend to Super 23A, the Agencies concluded that the "permitted activities" exemptions granted under Section (d)(1)(J) of the Volcker Rule would be so limited.[146]

In reaching their conclusion that "permitted activities" exemptions granted under Section (d)(1)(J) would be limited to Section (a),[147] the Agencies appear to have focused on the lead-in language in Section (d)(1). That language expressly provides that the "permitted activities" exemptions in Section (d)(1) override the general prohibition on sponsoring or investing in hedge funds or private equity funds by providing that any activities that qualify as permitted activities are permitted "[n]otwithstanding the restrictions under subsection (a)."

The lead-in language does not, however, preclude the "permitted activities" exemptions from being construed to override the general prohibition on covered transactions in Super 23A, if the conditions of any of those exemptions are satisfied. Indeed, the lead-in language in Section (d)(1) is silent on whether any of the "permitted activities" exemptions apply exclusively to Section (a)(1), or also apply to activities otherwise prohibited by Super 23A.

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[146] 76 Fed. Reg. 68912-13 n. 13.

[147] *See* 76 Fed. Reg. at 68912-13 n. 313.

We believe that the Agencies should employ standard tools of statutory construction and resort to its interpretive discretion, if necessary, in favor of construing the "permitted activities" exemptions to apply to activities generally prohibited by Super 23A, unless the statute expressly provides otherwise. Construing the "permitted activities" exemptions the way the Agencies appear to have construed the exemptions granted under Section (d)(1)(J) is contrary to the statutory language, will produce absurd results that Congress could not possibly have intended, is inconsistent with the purpose of Super 23A and has no support in the legislative history.

As noted above, the Supreme Court has consistently held that the words of a statute must be interpreted in light of the statute as a whole, and the legal backdrop against which the statute was drafted.[148] Closely related to this canon is the principle that a statute must be construed in a manner that avoids absurd results that Congress could not possibly have intended.[149]

The language of each of the "permitted activities" exemptions in Section (d)(1) is silent on whether any of them applies exclusively to the prohibitions in Section (a) or also apply to Super 23A, except for the asset management exemption in Section (d)(1)(G). Subsection (iv) of that exemption expressly conditions the asset management exemption on compliance with Super 23A.[150] Similarly, Super 23A expressly provides that it prohibits any covered transactions between a banking entity and any covered fund that has been organized and offered under the asset management exemption of Section (d)(1)(G). The fact that Congress expressly conditioned the asset management exemption on compliance with Super 23A, and did not so condition any of the other exemptions, strongly supports the view that Congress intended for the rest of the "permitted activities" exemptions to apply to both the prohibitions in Section (a) and Super 23A.

In addition, construing the "permitted activities" exemptions so that none of them applies to Super 23A in many respects severely narrows, and in some cases renders largely illusory, all but the asset management exemption. For example, although the "permitted

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[148] *See Green v. Bock Laundry Machine Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring in the judgment) (meaning of terms of a statute should determined "on the basis of which meaning is . . . most compatible with the surrounding body of law into which the provision must be integrated."); *Deal v. United States*, 508 U.S. 129, 132 (1993) (Scalia, J.) (it is a "fundamental principle of statutory construction . . . that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used.").

[149] *See, e.g.*, *Green*, 490 U.S. at 527 (Scalia, J., concurring in the judgment) (if the plain language of a statute produces an absurd result, our task is to give some alternative meaning to the statute); *Public Citizen v. Department of Justice*, 491 U.S. 440, 470-471 (1988) (Kennedy, J., concurring in the judgment) ("Where the plain language of the statute would lead to 'patently absurd consequences' . . . that 'Congress could not possibly have intended . . . .we need not apply the language in such a fashion.") (emphasis in original); *Dewsnap v. Timm*, 502 U.S. 410, 427 (1992) (Scalia, J., dissenting) ("If possible, we should avoid construing the statute in a way that produces such absurd results."). *See also* Breyer, *supra* note 12, at 848-849 (legislative history can be used to avoid absurd results); John F. Manning, *The Absurdity Doctrine*, 116 HARV. L. REV. 2387, 2388-2389 (2003) ("From the earliest days of the Republic, the Supreme Court has subscribed to the idea that judges may deviate from even the clearest statutory text when a given application would otherwise produce 'absurd' results.").

[150] *See* 12 U.S.C. § 1851(d)(1)(G)(iv).

activities" exemptions in the Proposed Rules granted under Section (d)(1)(J) would *nominally* permit banking entities to continue sponsoring, acquiring and retaining interests in certain wholly owned subsidiaries, joint ventures and acquisition vehicles, those same banking entities would be prohibited from entering into any funding, risk-management or other covered transaction with those affiliates. But if banking entities could not enter into such transactions with these affiliates, they would not be able to conduct the banking group's business in a safe, sound or efficient manner. As a result, despite the nominal exemption from the prohibition on investing in such non-fund entities, banking entities would continue to be prohibited from doing so as a practical matter. Congress could not possibly have intended such an absurd result.

If banking entities are prohibited upon the effectiveness of the Volcker Rule from entering into new covered transactions with a changing basket of their wholly owned subsidiaries, joint ventures and acquisition vehicles, they will no longer be able to enter into funding, risk-mitigating or other ordinary course intercompany transactions with these non-fund affiliates. Rather than promote the safety and soundness of banking entities, or the financial stability of the U.S. and global financial systems, this moratorium on covered transactions with non-fund affiliates could have a significant adverse effect on the safety, soundness, efficiency and stability of the financial system. That, in turn, could have a significant adverse effect on the wider economy in terms of reduced credit, increased unemployment and reduced output. Among the more absurd, unsafe and unsound results would be the legal cloud over whether bank holding companies could continue to act as a source of strength for their IDI subsidiaries by providing liquidity to or entering into risk management transactions with such IDI subsidiaries pursuant to the group's enterprise-wide funding and risk management programs. Indeed, the moratorium would appear to prohibit such intercompany transactions between a banking entity and virtually all of its subsidiaries and affiliates.

We believe that these results are also inconsistent with the purpose of Super 23A. That purpose is to protect the safety and soundness of banking entities, not to undermine that goal. According to Senator Merkley, Super 23A was designed to protect and promote the safety and soundness of banking entities by preventing them from bailing out investors in related funds for reputational purposes. Here is what he said in a colloquy with Senator Levin:

> "[A] large part of protecting firms from bailing out their affiliated funds is by limiting the lending, asset purchases and sales, derivatives trading, and other relationships that a banking entity or nonbank financial company supervised by the Board may maintain with the hedge funds and private equity funds it advises. The relationships that a banking entity maintains with and services it furnishes to its advised funds can provide reasons why and the means through which a firm will bail out an advised fund, be it through a direct loan, an asset acquisition, or through writing a derivative . . . . These bailout protections will significantly benefit independent hedge funds and private equity funds, and also improve U.S. financial stability.

> Accordingly, [Super 23A] sets forth the broad prohibition on a banking entity entering into any 'covered transactions' as such term is defined in the Federal Reserve Act's section 23A, as if such banking entity were a member bank and the fund were the affiliate thereof."[151]

There is no evidence that banking entities would have any material incentive to bail out covered funds in which they acquired an interest under any of the "permitted activities" exemptions other than the asset management exemption, and considerable evidence that imposing a moratorium on covered transactions will actually undermine the safety and soundness of banking groups. Accordingly, it would be inconsistent with the purpose of Super 23A to construe any of the "permitted activities" exemptions, other than the asset management exemption, as not providing an exemption from Super 23A.

In conclusion, we believe that all the "permitted activities" exemptions, other than the asset management exemption, should be construed to apply to Super 23A, as well as to the general prohibition on sponsoring or investing in hedge funds or private equity funds in Section (a) of the statute.

B. Asset Management

Sections __.11 and __.12 of the Proposed Rules implement the "permitted activities" exemption for asset management activities provided in Section (d)(1)(G) of the Volcker Rule (the "**asset management exemption**"). The asset management exemption authorizes banking entities to organize and offer, or sponsor, a covered fund and to make a *de minimis* co-investment in such fund, subject to certain conditions.

The asset management exemption was designed to preserve the ability of banking entities to continue to provide traditional asset management services to new and existing customers – not to disrupt those activities – while strengthening safety and soundness by prohibiting any transfer of losses from a fund back to the banking entity during a financial crisis or otherwise, except for losses attributable to the banking entity's permitted co-investment interest.[152] As the FSOC study noted, Paul Volcker himself testified to the Senate Banking

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[151] Colloquy between Senators Merkley and Levin, 156 CONG. REC. S5894 (daily ed. July 15, 2010). See also Colloquy between Senators Merkley, Levin and Dodd, *id.* at S5901 ("the intent of [Super 23A]" is "to prohibit banking entities from bailing out funds they manage, sponsor, or advise, as well as funds in which those funds invest").

[152] *See* Statement of Senator Hagan, 156 CONG. REC. S5870 (daily ed. July 15, 2010) ("I am pleased that as part of the conference report that the Volcker language was modified to permit a banking entity to engage in a certain level of traditional asset management business, including the ability to sponsor and offer hedge and private equity funds."); Colloquy Between Senators Merkley and Levin, 156 CONG. REC. S5904 (daily ed. July 15, 2010) ("Subparagraph (d)(1)(G) permits firms to organize and offer hedge funds or private equity funds as an asset management service to clients."); Statement of Senator Brown, 156 CONG. REC. S6241 (daily ed. July 26, 2010) ("The original Volcker Rule would have gone too far in preventing banks from offering appropriate investment services to their clients as a limited and safe part of their business model . . . preventing banks from offering such services.").

Committee during the Dodd-Frank legislative process that key customer services such as investment management and investment advisory services must remain permissible.[153]

In our previous comment letters,[154] we recommended that the Agencies interpret the conditions of the asset management exemption in light of the congressional intent to preserve the ability of banking entities to continue to provide traditional asset management services to new and existing customers. In many respects, Section __.11 reflects that recommendation. In some respects, however, we believe that the Proposed Rules are not fully consistent with that intent. We offer the following recommendations to the Agencies in order to make the asset management exemption more consistent with that intent.

(1) Sponsor

(a) Initial Directors, Trustees or Management

> ***SIFMA recommendation***: A banking entity should not be treated as the "sponsor" of a covered fund based on selecting a majority of the initial directors, trustees or management of the fund, including any general partner, managing member or board of managing members, if a majority of the persons or entities selected are independent of the banking entity.

The Volcker Rule provides that a banking entity will be treated as the "sponsor" of a covered fund if the banking entity "select[s] . . . a majority of the directors, trustees, or management . . . of [the] covered fund."[155] Absent clarification of how this provision would be applied to new funds, we are concerned that it could be inconsistent with the way banking entities have traditionally organized and offered a new fund when they do not want to be deemed to have ongoing control or responsibility as the sponsor of the fund for purposes of the BHC Act.

When a new fund is initially formed by a banking entity, someone must appoint the fund's initial directors, trustees and management. Investors will not invest in the fund unless they know the identity of the fund's director's trustees and management, and the investors are not in a position to select the initial representatives themselves because the investors have not yet made their investments. As a result, the banking entity that organizes the fund typically selects the initial management because there is no one else in a position to do so. If the banking entity does not want to be deemed to have any ongoing control or responsibility as the sponsor of the new fund for purposes of the BHC Act, it will typically attempt to "break" control by ensuring that a majority of the directors, trustees and management is independent of the banking entity.

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[153] *See* FSOC Study at 57-58.

[154] *See* SIFMA Comment Letter, pp. 15-20 (April 14, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=24745; SIFMA Comment Letter, pp. 4-7 (November 5, 2010), *available at* http://www.sifma.org/issues/item.aspx?id=22125.

[155] 12 U.S.C. § 1851(h)(5).

We believe that the Proposed Rules should allow banking entities to follow the same procedure to avoid being deemed to be the sponsor of a covered fund for purposes of the Volcker Rule. We believe that such a construction of the statutory definition would be reasonable and consistent with the purpose of the sponsorship definition. As the Agencies stated in the Supplementary Information accompanying the Proposed Rules, the statutory definition of "sponsor" is "focuse[d] on the ability to control the decision-making and operational functions of the fund."[156] Therefore, where a banking entity appoints a majority of a covered fund's initial directors, trustees or management, but ensures that a majority of such management is [and remains] independent of the banking entity, the banking entity should not be deemed to "sponsor" the fund because it would have no ongoing control over a majority of the directors, trustees or management.

As discussed in our prior comment letters,[157] we recommend that the Agencies adopt a standard of independence in this context that is based on the guidelines currently applied by the FDIC to determine whether audit committee members of IDIs are "independent of management."[158] Because the Volcker Rule operates as a new section of the BHC Act and applies to BHCs (and other DIHCs), IDIs and their affiliates, we believe that it would be appropriate to consider existing standards and guidelines from banking law in formulating a standard of independence in this context. Existing FDIC guidelines are particularly appropriate given the FDIC's role as one of the Agencies charged with implementing the Volcker Rule. In addition, adopting a standard closely based on the FDIC guidelines ensures a familiar approach for regulators and banking entities alike. The FDIC has maintained these guidelines since 1991, and the statute under which they were promulgated (Section 112 of the Federal Deposit Insurance Corporate Improvement Act of 1991) was the model for another important corporate governance provision, Section 404 of the Sarbanes-Oxley Act of 2002. Further, the FDIC guidelines are aligned with analogous standards of independence applied by the New York Stock Exchange and NASDAQ.

(b) Limited Trustee

> ***SIFMA recommendation***: The Agencies should clarify that a "trustee" would not be deemed to be exercising investment discretion solely by virtue of exercising discretion as to the securities lending or collateral or cash management activities of a covered fund.

The Proposed Rules provide that the term "trustee," as used in the definition of the term "sponsor," "does not include a trustee that does not exercise investment discretion with

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[156] *See* 76 Fed. Reg. at 68898.

[157] *See* SIFMA Comment Letter, pp. 8-9 (May 9, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=25346; SIFMA Comment Letter, pp. A-4 (April 14, 2011), *available at* http://www.sifma.org/issues/item.aspx?id=24745.

[158] 12 C.F.R. Part 363, App. A, Guideline 28.

respect to the covered fund, including a directed trustee."[159] We agree that directed trustees satisfy this standard. A directed trustee does not exercise investment discretion, but acts more like a custodian, performing ministerial functions such as safekeeping, settlement, accounting, administrative and other functions relating to asset control. But banking entities that serve as trustees of covered funds may provide a limited range of ministerial services that go beyond those of a directed trustee but do not amount to the exercise of investment discretion. Those services may include exercising discretion as to the securities lending or collateral or cash management activities of a covered fund.

When acting as securities lending trustee of a fund, a banking entity loans securities held by the fund to a broker dealer or other borrower on a fully secured basis. The fund typically establishes the parameters governing the list of eligible borrowers, the type of collateral that can be taken, and the maximum duration of a loan, and the limited trustee would negotiate with the borrower the terms of the loan within these approved parameters. In cases where the collateral pledge is in the form of cash, the limited trustee usually would invest the cash in short-term instruments. Typically, notwithstanding the loan of the securities, the fund would remain entitled to receive payments in lieu of dividends or income, be entitled to participate in corporate actions, and, in the event that it desires to sell a security that is on loan, to recall the security in order to complete the sale in accordance with the normal settlement cycle for that security.

Similarly, banking entities typically act as limited trustees in offering a covered fund custodial services, including a number of sweep options for short-term cash management. In some cases, the sweep will be into a money market fund or into commercial paper of an issuer selected by the fund manager. In others, however, the sweep product may involve a degree of discretion by the banking entity acting as limited trustee, including cases where the sweep is to short-term instruments such as repurchase agreements, commercial paper or deposits at other banks, where the limited trustee essentially shops around for the best rate. Here too, the limited trustee would be acting within the strict parameters of its arrangements with the fund, including limits on eligible counterparties, maximum counterparty exposures and the maximum term of any instrument. The limited trustee's discretion would be confined to selecting the best available rate offered within those parameters.

We do not believe that such ministerial services should be deemed to constitute the exercise of investment discretion. Therefore, we request that the Agencies clarify that a banking entity would not be deemed to be a trustee and hence a sponsor, solely because it exercises discretion as a limited trustee as to the securities lending or collateral or cash management activities of the covered fund.

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[159] *See* Proposed Rules § __.10(b)(6).

(c) Commodity Pool Operators

> ***SIFMA recommendation***: The Agencies should correct a technical oversight in the proposed text of the first condition of the asset management exemption to clarify that a banking entity can satisfy that condition by acting as a commodity pool operator to a covered fund.

The Proposed Rules expand the statutory definition of "sponsor" to include serving as a commodity pool operator of a covered fund.[160] In order to comply with the first condition of the asset management exemption, a banking entity acting as "sponsor" to a covered fund must "provide" certain services.[161] The Agencies expanded the list of such services identified in the statutory text of the asset management exemption to include "commodity trading advisory services."[162] Given the expansion of the definition of "sponsor" in the Proposed Rules, it appears to be a technical oversight that "acting as a commodity pool operator" is not included in this list. We request that the Agencies correct this oversight.

(2) Attribution Rules

Section __.12(b)(1) of the Proposed Rules contains a set of attribution rules that are designed to supplement the investment limits contained in Sections (d)(1)(G)(iii) and (d)(4) of the statutory text and the regulatory capital deduction requirements in Section __.12(d) of the Proposed Rules.

The statutory text of the Volcker Rule provides that banking entities may continue to organize and operate covered funds as part of their asset management businesses, and co-invest in such funds, provided that they comply with various conditions.[163] The purpose of the asset management exemption is to ensure that the asset management business of the banking industry is not disrupted, and that banking entities continue to have a meaningful opportunity to engage in it. It would be inconsistent with the purpose of the exemption if the attribution rules had the effect of depriving banking entities of that meaningful opportunity, unless required by the text of the statute.

Among the conditions to the asset management exemption are that any permissible co-investments must comply with certain investment limits. Those limits include a "**per-fund limit**" and an "**aggregate limit**." The per-fund limit provides that a banking entity may not invest in more than 3% of the total ownership interests of a fund organized and offered under the asset management exemption, subject to an exception for larger investments during a seeding period.[164] The aggregate limit provides that the aggregate amount of investments made

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[160] *See* Proposed Rules § __.10(b)(5)(i); 12 U.S.C. § 1851(h)(5).

[161] *See* Proposed Rules § __.11(a); 12 U.S.C. § 1851(d)(1)(G)(i).

[162] *Id* at § __.11(a).

[163] *See* 12 U.S.C. § 1851(d).

[164] *See* 12 U.S.C. § 1851(d)(4)(B)(ii)(I).

by a banking entity in all covered funds under the asset management exemption may not exceed 3% of the banking entity's Tier 1 capital.[165]

Section __.12(d) of the Proposed Rules provides that a banking entity must deduct the aggregate value of all permitted investments in all covered funds made or retained by the banking entity under the asset management exemption, "[f]or purposes of calculating capital pursuant to the applicable capital requirements."[166] As discussed in Section VI.A(4), we believe that the proposed regulatory capital deduction exceeded the Agencies' statutory authority. But we analyze the attribution rules in light of the proposed regulatory capital deduction to illustrate how the attribution rules could produce adverse consequences that Congress could not possibly have intended.

The attribution rules address three situations: controlled investments, non-controlled investments, and certain parallel investments. The rules are designed to determine when and to what extent investments in covered funds should be attributable to the banking entity for purposes of the investment limits and the required regulatory capital deductions. The proposed attribution rules are reproduced below:

> "(1) *Attribution of ownership interests to a covered banking entity.* The amount and value of a banking entity's permitted investment in any single covered fund shall include:
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> (i) *Controlled investments.* Any ownership interest held under §__.12 by any entity that is controlled, directly or indirectly, by the covered banking entity for purposes of this part; and
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> (ii) *Noncontrolled investments.* The *pro rata* share of any ownership interest held under §__.12 by any covered fund that is not controlled by the covered banking entity but in which the covered banking entity owns, controls, or holds with the power to vote more than 5 percent of the voting shares.
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> . . .
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> (ii) *Inclusion of certain parallel investments.* To the extent that a covered banking entity is contractually obligated to directly invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the covered banking entity, whether or not pursuant to an express agreement,

[165] *See id.* § 1851(d)(4)(B)(ii)(II).

[166] *See* Proposed Rules § __.12(d).

such investments shall be included in any calculation required under paragraph (a)(2) of this section."[167]

These attribution rules were not derived from the statutory text of the Volcker Rule. The text does not contain any attribution rules or any provision directing the Agencies to adopt attribution rules. Instead, the attribution rules reflect a pure exercise of regulatory discretion by the Agencies.

The proposed attribution rules appear to reflect an attempt to adapt and expand the attribution rules traditionally used by the Board for purposes of determining whether a BHC is in compliance with the general activities and investment limits in the BHC Act. In general, those traditional attribution rules operate like an on/off switch. If a BHC is deemed to control a company, ***all*** of the company's activities and investments and those of each company in the chain of controlled entities below the company are attributed to the BHC as if they were conducted or held directly by the BHC. Conversely, if a BHC is deemed not to control a company, ***none*** of the company's activities or investments or those of any company below it in the ownership chain are attributed to the BHC. The Board generally has not attributed investments on a proportionate basis if a BHC has a non-controlling interest.

The proposed attribution rules for controlled investments are flawed because they do not distinguish subsidiaries and affiliates of a banking entity that are themselves banking entities from those that are not, as the term "banking entity" is properly construed. For the reasons explained below, the failure to reflect that distinction is inconsistent with the purpose of the asset management exemption. The proposed attribution rules for non-controlling investments above 5% are also inconsistent with that purpose. Absent clarification, both sets of attributions rules have the potential to deprive banking entities of the sort of meaningful opportunity to continue in the asset management business that Congress intended them to have. In addition to imposing heavy compliance costs on banking entities, the attribution rules would appear to have the effect of severely contracting the capacity that Congress provided for banking entities to continue to engage in the asset management business under the investment limits and multiplying the size of any regulatory capital charges to many times the banking entity's loss exposure.

(a) Adverse Consequences

Although we discuss in the following paragraphs other negative effects that could result if these attribution provisions are not amended in the final rules, we want to draw the Agencies' attention to the impact these provisions would have on the ability of banking entities to use three of the most common fund structures in the asset management business: (i) funds of funds, in which a banking entity organizes and offers a fund that invests in other affiliated or third party funds, (ii) master-feeder structures, in which a banking entity organizes and offers separate "feeder" entities for the purpose of facilitating investment in a "master" fund and (iii) parallel fund structures, in which multiple parallel entities are operated as if all the entities constituted a single fund.

[167] *See* Proposed Rules § __.12(b)(1).

Fund of funds. Banking entities traditionally offer customers the opportunity to invest indirectly through a fund of funds sponsored by a particular banking entity. The fund of funds invests in a portfolio of other funds. That portfolio of other funds may consist of funds sponsored and managed by the banking entity or by one or more third parties. Customers demand this type of investment vehicle because it provides them with exposure to the performance of a portfolio of funds, while also permitting them to benefit from the operational, administrative, corporate governance and risk monitoring oversight of the banking entity that sponsors the fund of funds in which they invest. Apart from these risk-mitigating benefits, funds of funds allow customers to gain exposure to a diverse fund portfolio without having to satisfy the minimum investment required to invest in each of the funds directly, facilitating diversification at lower cost than if the customer were to invest directly in the funds.

Parallel and master-feeder structures. Parallel and feeder entities are established for a variety of client-driven reasons. For example, U.S. tax-exempt investors may need certain terms in their fund agreements in order to avoid undesirable tax consequences (such as incurring income that is taxable to them despite their tax-exempt status), which terms would be sub-optimal for a U.S. taxable investor. To address this need, a banking entity might establish a separate entity with the required features, which generally have no significant practical impact on the investment holdings or the strategy of the parallel or feeder entities, to accommodate the tax exempt investors' needs, and a separate vehicle without these features for U.S. taxable investors.

Together, master and feeder funds constitute a single investment program, in which the master fund holds and manages investments in portfolio assets and the feeder funds typically make no investments other than in the master fund (subject to very limited exceptions for investment of cash in short-term instruments pending investment in the master fund, payment of expenses or liabilities, facilitating redemptions and making distributions). In many cases, feeder funds hold more than 3% of the ownership interests of the master funds in which they were formed to invest.

As with master-feeder structures, in a parallel fund structure the parallel entities are typically operated as if all the entities constituted a single investment program. For example, contractual obligations embedded in each entity's governing documents cause the entities to function as a single investment program. Each investment program operates under a single strategy and is treated functionally as though it were one entity when dealing with the sponsoring banking entity, employees, limited partners, lenders and counterparties. The mechanisms used to cause the separate legal entities to operate as closely as possible to a single "fund" include requirements in each entity's governing documents that such entity (and all the other entities in the parallel fund structure) have an identical investment strategy, and, subject to very limited exceptions, invest in the same investments, at the same time, on the same terms and in proportion to each vehicle's capital commitments relative to the overall fund program. Similar mechanics govern dispositions of investments. As a result, while they are separate legal entities, all the parallel entities participate in the same underlying investment program *pro rata* and "lockstep" with each other.

Each of the entities in parallel fund structures and master-feeder structures, respectively, can have the same general partner or managing member. In addition, the separate entities are typically only able to take certain actions by a vote that aggregates the interests of all investors across all of the entities that constitute the fund program, thereby avoiding an entity-by-entity vote with potentially conflicting outcomes. Units in each entity are typically sold using the same private placement memorandum, in some instances with a brief "wrapper" attached to the memorandum explaining the particular characteristics of that vehicle.

In the following paragraphs, we discuss the materially negative impact that the attribution rules in Section §__.12 could have on banking entities' asset management businesses, including their fund of funds businesses and their ability to employ master-feeder and parallel fund structures, among other problems. We also recommend amendments to the Proposed Rules that would alleviate the concerns we identify while ensuring that each banking entity "calculates its investment in a covered fund accurately and does not evade the per-fund investment limitation."[168]

(b) Controlled Investments

> ***SIFMA Recommendation***: The attribution rule for controlled investments should be limited to controlled entities that fall within the term "banking entity," as properly construed.

As currently written, the attribution rules for controlled investments could be read to require that 100% of all investments made by entities controlled by a banking entity be attributed to the banking entity, regardless of whether the controlled entity is itself a "banking entity," as properly construed.[169] This reading would effectively re-introduce the unintended consequences that the Agencies attempted to avert by excluding from the term "banking entity" all covered funds organized, offered and held under the asset management exemption and their subsidiaries. Of particular concern is the threat that this reading of the attribution rules would pose to sponsored funds of funds and master-feeder structures. The Agencies clearly recognized that these structures, which will often be held under the asset management exemption, should not be prohibited by the Volcker Rule. As discussed in Section V above, we believe that the exclusion of these permitted covered funds was a correct, and in fact necessary, reading of the statute. In addition, we believe that a wider variety of controlled entities and their subsidiaries should be excluded from that term, including all other permitted covered funds, exempt funds, SEC-registered investment companies and business development companies, public commodity pools, public foreign funds, portfolio companies and temporarily grandfathered covered funds during the conformance period. This list of excluded entities would not include wholly owned subsidiaries, joint ventures or acquisition vehicles. They would be treated as banking entities and 100% of their investments in covered funds would be attributable to their parent banking entities.

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[168] 76 Fed. Reg. at 68904.

[169] By "as properly construed," we mean as construed in accordance with our recommendations regarding appropriate exclusions from the definition of "banking entity" in Section V. above.

If the attribution rules were applied to controlled entities that are excluded from the term "banking entity" or not properly treated as a banking entity, they would appear to have the effect of multiplying the amount of the investments properly attributable to the banking entity (and therefore counted toward the investment limits and required to be deducted from regulatory capital) by many times the banking entity's actual loss exposure.

For example, suppose that a banking entity is the general partner of a covered fund organized and offered under the asset management exemption. Under the definition of control in Section 2 of the BHC Act, the banking entity would be deemed to control the permitted covered fund. Now suppose that the banking entity has no ownership interest in the fund. Its loss exposure is zero, so the amount of any investment that counts toward the per-fund and aggregate limits is of course zero. But suppose that the permitted covered fund is a fund of funds, has committed capital of $100 million and invests all of that committed capital in a portfolio of ten affiliated or third-party hedge funds. Under one plausible reading of the attribution rules for controlled entities, 100% of the permitted covered fund's investments in the other funds would be attributed to the banking entity for purposes of the investment limits and required regulatory capital deduction. It is not clear what impact this would have on the per fund limit, but it would appear that $100 million would be attributed to the banking entity for purposes of the aggregate limit and required to be deducted from the banking entity's regulatory capital.

This defies common sense since the banking entity's loss exposure remains ***zero***. It cannot possibly be consistent with the purpose of the asset management exemption to treat $100 million of a banking entity's Tier 1 co-investment capacity as having been used up when its loss exposure on the investments made by the fund of funds remains zero. Nor can it be consistent with that purpose to require the banking entity to deduct $100 million from its regulatory capital when its loss exposure remains zero. That is equivalent to an infinite capital requirement. Even though Section (d)(3) of the Volcker Rule authorizes the Agencies to impose additional capital requirements on "permitted activities" investments if appropriate to protect the safety and soundness of banking entities, imposing an infinite capital requirement on any of those activities would not be a justifiable exercise of that discretion.

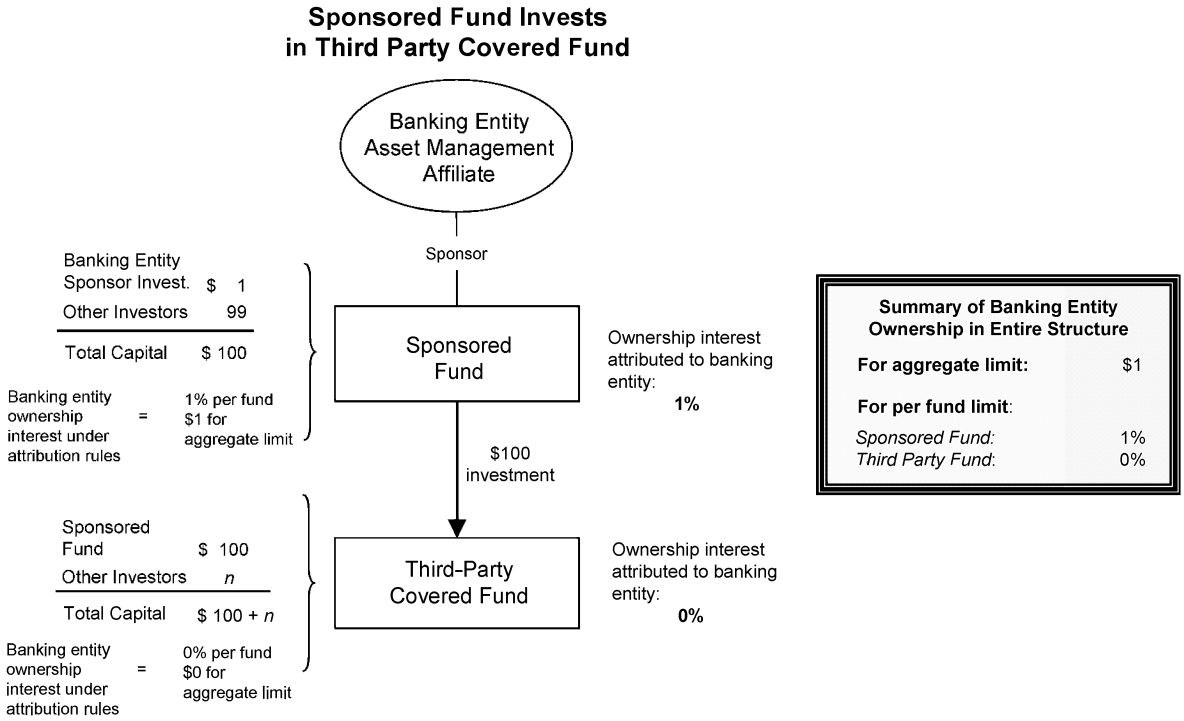
This anomalous result is not limited to situations where a banking entity makes no co-investment in a covered fund organized, offered and held under the asset management exemption. Indeed, a similar result could occur in the ordinary situation where a banking entity makes a 3% co-investment in the fund of funds described above. In the first step of that case, $3 million would count toward both the per-fund and aggregate limits and be deducted from regulatory capital. Subject to our discussion of the regulatory capital deduction below, that would seem appropriate since the banking entity's loss exposure is 3% of the fund's losses, up to a maximum of $3 million. But the anomaly noted above would arise if the fund of funds invests all of its capital in related or third-party hedge funds. The full investment, or $100 million, would be attributed to the banking entity for purposes of the investment limits and the capital deduction requirement, even though the banking entity's maximum loss exposure remains limited to $3 million.

Nor is this anomalous result limited to situations in which a fund of funds organized and offered under the asset management exemption is involved. It would apply to situations where a banking entity had a controlling interest in any other entity, including any covered fund held under any of the other "permitted activities" exemptions, if the banking entity were deemed to control it. Under the Board's control rules, a banking entity will be deemed to control a covered fund if it holds more than 25% of the fund's total capital, even if another party exercises true and exclusive control. This could cause attribution of investments by funds held under the SBIC, underwriting, market-making-related, risk-mitigating hedging and offshore exemptions. It could also cause attribution of investments by funds entirely exempt from the 1940 Act under an exemption other than Sections 3(c)(1) or 3(c)(7), SEC-registered investment companies or public business development companies, public commodity pools, public foreign funds, portfolio companies held in accordance with the merchant banking authority and temporarily grandfathered covered funds held during the conformance period.

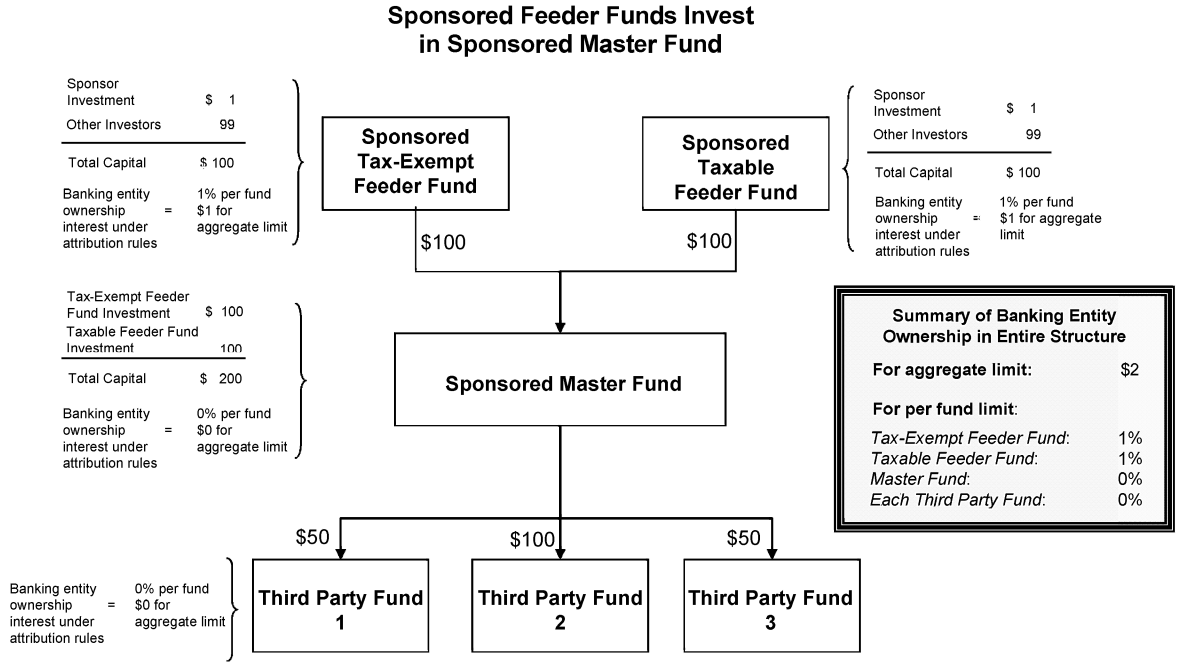
The attribution rules need to be revised so that they do not have the effect of causing more than a banking entity's genuine loss exposure on a permitted covered fund investment from being attributed to the banking entity for purposes of the investment limits or regulatory capital deduction. In order to do so, we believe the Agencies should limit the attribution rule for controlled investments to controlled investments by entities that fall within the term "banking entity," as properly construed.[170]

[170] The simplest method of implementing this recommendation would be to insert the word "banking" before "entity" in the attribution rule that appears in the Proposal. striking the redundant language that remains: "Any ownership interest held under § _.12 by any banking entity"

The following diagram is consistent with this recommendation and how we believe the Agencies intended to apply the attribution rules, despite the plausible readings described above. The structure depicted represents a typical investment by a banking entity-sponsored fund that invests substantially all of its assets into an underlying third party fund, with a proprietary co-investment in the sponsored fund:



Our recommendation would also be consistent with how the attribution rules are applied in the following diagram, which represents a typical investment by banking entity-sponsored feeder funds in a banking entity-sponsored master fund, with proprietary co-investments in the feeder funds.



We note that nothing in the statutory text of the Volcker Rule suggests that Congress intended the Agencies to constrain the ability of banking entities to engage in the fund of funds business or to employ master-feeder structures. Indeed, Super 23A plainly contemplates that *any* sponsored hedge fund or private equity fund is permitted to make and retain both controlling and non-controlling investments in *any other* covered fund.[171] Legislative history lends further support to this view. In a statement on the Senate floor, Senator Scott Brown, whose vote was essential to the passage of the Dodd-Frank Act in the Senate, noted explicitly that a fund of funds "is not restricted as a percentage of any of those investment partnerships, hedge funds, or private equity funds that it might be invested in . . ."[172] As Senator Brown pointed out, there is no need to limit a fund of funds' interest in another covered fund because the interest of the sponsoring banking entity in the fund of funds is "still limited to 3 percent" of such fund, "mitigating any chance of a concentration risk or bailout incentive."[173] This logic applies equally to master-feeder structures, which are effectively funds of funds that invest in a single underlying fund.

(c) Non-Controlled Investments

> ***SIFMA Recommendation***: The *pro rata* attribution rule for non-controlled investments should be dropped.

The proposed attribution rule for non-controlled investments would require that a *pro rata* portion of all investments made by covered funds that are not controlled by a banking entity but in which the banking entity owns or controls 5% or more of the voting shares be attributed to the banking entity.[174]

This attribution rule is inconsistent with the Board's traditional rules for attributing activities and investments to BHCs for purposes of the general activities and investment limits in the BHC Act. It would also appear to require a banking entity to count investments toward its investment limits and regulatory capital deduction that are significantly greater than the banking entity's genuine loss exposure. The Agencies have not articulated any justification for this departure from the Board's traditional attribution rules.

Moreover, this attribution rule could be read to apply to investments by a controlled covered fund held under a "permitted activity" exemption other than the asset management exemption, in contravention of congressional intent and the Agencies' stated interpretation of that intent. As the Agencies note, "other provisions of [the Volcker Rule] provide independent exemptions which permit a banking entity to acquire or retain an ownership interest in a covered fund."[175] Because by definition a banking entity can hold no more than 3%

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[171] *See* 12 U.S.C. § 1851(e).

[172] Statement of Senator Brown, 156 CONG. REC. S6241 (daily ed. July 26, 2010).

[173] *Id.*

[174] *See* Proposed Rules § __.12(b)(1)(B).

[175] 76 Fed. Reg. at 68901.

of the ownership interests of any covered fund under the asset management exemption, a "covered fund that is not controlled by the covered banking entity but in which the covered banking entity" holds more than 5% voting equity must be a covered fund in which the banking entity holds interests based on a "permitted activities" exemption other than the asset management exemption or pursuant to some other part of the statute. Attributing a *pro rata* share of the ownership interests held by such funds to a banking entity for purposes of calculating the investment limits or regulatory capital deduction which, as the Agencies acknowledge, are applicable under the statute only to investments made pursuant to the asset management exemption, ignores congressional intent.

Finally, this attribution rule is simply impracticable: a banking entity has very limited ability to monitor investments of a covered fund that it does not control, and by definition no power at all to direct or restrain such a fund's investment decisions.

We therefore request that the Agencies amend the Proposed Rules to eliminate the *pro rata* attribution rule for non-controlled investments.

(d) Parallel Co-Investments

> ***SIFMA Recommendation***: The attribution rule for parallel co-investments should be limited to a pattern of multiple co-investments that evidences an intent to evade the investment limits in the asset management exemption.

The Proposed Rules provide that, to the extent a banking entity "is contractually obligated to directly invest in, or is found to be acting in concert through knowing participation in a joint activity or parallel action toward a common goal of investing in, one or more investments with a covered fund that is organized and offered by the covered banking entity," such investment will be attributed to the banking entity.[176] The Agencies noted in the preamble that this provision "prevents a banking entity from evading the limitations under § __.12 of the proposed rule through committed co-investments."[177]

We appreciate the Agencies' effort to provide clear guidelines with respect to the scope of permitted co-investments and the need to police potentially evasive arrangements. But this attribution rule could have the effect of requiring many investments to be attributable to a banking entity when no evasion is occurring. The reason is that the rule can be read to be triggered by a single parallel investment. Instead, the rule should require a pattern of co-investments that establishes an intent to evade before any attribution is mandated.

Unless so clarified, this attribution rule could inappropriately impinge on the ability of banking entities to make otherwise permissible principal investments, *e.g.*, pursuant to the BHC Act's merchant banking authority. The Volcker Rule does not prohibit or restrict such

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[176] See Proposed Rules § __.12(b)(2)(B).

[177] 76 Fed. Reg. at 68904.

investments. We believe that to do so through an overbroad parallel investment attribution rule would exceed the Agencies' statutory authority, and in any event would be an unnecessarily overbroad and blunt means of preventing evasion.[178]

We support the Agencies' effort to guard against evasive investment arrangements. However, in light of the enormous costs the rule as drafted could impose in the form of required restructuring of thousands of existing investments, investment opportunities lost and a burdensome and unwieldy compliance regime, and given the Agencies' expansive authority to order a banking entity to terminate any evasive behavior, we believe that it is unnecessary for the Agencies to craft such a restrictive rule in an effort to preclude any possibility of evasion.

We recommend that the Agencies amend the parallel attribution rule to require a pattern of co-investments before presuming an intent to evade. Even if a pattern of such co-investments arises, the Agencies should allow a banking entity to rebut any presumption of an intent to evade by evidence that: (i) the banking entity's direct investment was made pursuant to an independent evaluation of the investment opportunity, and was not compelled by any contractual or other obligation to invest alongside the sponsored covered fund; (ii) the banking entity and the sponsored covered fund have separately negotiated investment agreements; and (iii) the banking entity is not contractually compelled to retain, transfer, increase or decrease its investment in lockstep with the sponsored covered fund.

We believe that this approach, unlike the parallel investment attribution rule as drafted, would be within the authority of the Agencies to adopt under the statute, and would avoid contravening congressional intent not to disrupt ordinary course investing activities.

(3) Employee and Director Investments

> ***SIFMA recommendation***: Investments permissibly made by a director or employee directly engaged in providing investment advisory or other services to a covered fund organized and offered or sponsored under the asset management exemption should not become impermissible solely because the director or employee ceases to provide such services, absent evidence of an intent to evade the prohibitions of the Volcker Rule.

The statutory text of the asset management exemption provides that, where a banking entity organizes and offers or sponsors a hedge fund or private equity fund under the asset management exemption, only employees or directors of the banking entity who are "directly

[178] In addition, we note that unless the Agencies adopt our recommendations regarding appropriate exclusions from the definition of "banking entity" above, the parallel investment attribution rule could be read to effectively prohibit any investment (even inadvertent) alongside a covered fund organized and offered or sponsored by a banking entity pursuant to the asset management exception by any other entity controlled by the banking entity — which is therefore itself a banking entity — including permitted covered funds, Exempt Funds, RICs and BDCs, portfolio companies held under Section 4(k)(4) of the BHC Act, and any subsidiaries of the foregoing.

engaged in providing investment advisory or other services" to the fund may "take[] or retain[]" an ownership interest in the fund.[179] Although we do not take issue with the Agencies' proposed implementation of the core restriction contained in this condition, we are concerned that the condition could be read to require a director or employee who has made a permissible investment in a sponsored covered fund to divest his or her ownership interest should the director or employee cease to provide such services — for example, where an employee is transferred to a different role at the banking entity, or where the services he or she provides to the fund are provided at intermittent intervals. Many covered funds, particularly private equity funds, contractually bind their investors to retain their ownership interests for a set duration, which can extend for many years. In addition, many funds are by nature illiquid, meaning that a director or employee could not easily divest his or her ownership interest. Forcing a director or employee to divest his or her ownership interest prematurely would almost certainly result in a negative effect on the ability of the director or employee to receive fair value for his or her ownership interest. As a result, directors or employees who are genuinely directly engaged in providing services to a sponsored covered fund would be effectively prevented from acquiring such an ownership interest in the first instance.

The Agencies note in the Supplementary Information accompanying the Proposed Rules that the purpose of Congress' explicit permission for a limited class of directors and employees to invest in sponsored covered funds was to "align" "incentives with those of [the banking entity's] customers by allowing [an] individual to have 'skin in the game' with respect to a covered fund for which that individual provides management or advisory services (which customers or clients often request)."[180] We therefore believe that Congress could not have intended to effectively prevent directors and employees from making such investments, and request that the Agencies clarify that such investments will not become impermissible solely because the director or employee ceases to provide services to a covered fund, absent evidence of an intent to evade the prohibitions of the Volcker Rule.

(4) Carried Interest

> ***SIFMA Recommendation***: The Agencies should clarify that a minimal capital contribution by a banking entity (including any affiliate or employee) to a covered fund for the sole purpose of facilitating certain tax treatment of the banking entity's (including any affiliate's or employee's) carried interest will not affect the exclusion of such carried interest from the definition of "ownership interest."

The Proposed Rules exclude carried interest from the definition of "ownership interest" subject to the banking entity (including any affiliate or employee) not "provid[ing] funds to the covered fund in connection with acquiring or retaining this [carried] interest."[181] Although

[179] *See* 12 U.S.C. § 1851(d)(1)(G)(vii). The Proposed Rules implement this condition at § __.11(g).

[180] *See* 76 Fed. Reg. at 68902.

[181] *See* Proposed Rules § __.10(b)(3)(ii).

we agree that a carried interest should not be deemed to be an "ownership interest" for purposes of the Volcker Rule, we are concerned that this condition could be interpreted to prohibit the traditional separate contribution by a general partner (or an employee entitled to carried interest) of a small amount of capital (typically less than 1%) to a fund to facilitate certain tax treatment of such carried interest.

As the Agencies acknowledge, many banking entities that serve as investment adviser or in a similar role with respect to a fund (including certain employees) are compensated for the services they provide through incentive compensation paid or allocated on the basis of a share of capital gains upon or capital appreciation of the assets of the covered fund. This carried interest does not represent pre-existing capital put at risk by the banking entity (or its employees) through an investment in the fund, and is distinguishable from an equity interest in a fund in various other ways. Tax advisors often recommend the separate contribution of a small amount of capital to a fund in connection with receipt of carried interest in order to preserve the appropriate characterization of such carried interest under tax law. Such contributions by a banking entity (although not those of an employee of the banking entity, consistent with treatment of permissible employee investments under the Proposed Rules) should be aggregated with a banking entity's ownership interests for purposes of the 3% investment limits under the asset management exemption. However, such a contribution should not affect the exclusion of a genuine carried interest from the definition of "ownership interest."

We therefore recommend that the Agencies clarify that a separate, minimal capital contribution by a banking entity (including any affiliate or employee) to a covered fund for the purpose of facilitating certain tax treatment of carried interest will not cause such carried interest to be deemed an "ownership interest" for purposes of the Volcker Rule.

(5) Deduction from Regulatory Capital

> ***SIFMA Recommendation***: The deduction from regulatory capital of investments made in covered funds held under the asset management exemption should be eliminated.

Section __.12(d) of the Proposed Rules provides that "***[f]or purposes of calculating capital pursuant to the applicable capital rules***, a covered banking entity shall deduct the aggregate value of all permitted investments in all covered funds made or retained by a covered banking entity pursuant to this section [__.12] . . . from the banking entity's tier 1 capital . . ."[182] In the Supplementary Information accompanying the Proposed Rules, the Agencies stated that this proposed rule "implements the provision in section 13(d)(4)(b)(iii) of the BHC Act [*i.e.*, Section (d)(4)(b)(iii) of the Volcker Rule] regarding the deduction of a banking entity's aggregate

[182] 76 Fed. Reg. at 68952 (emphasis added).

investment in a covered fund held under [the asset management exemption] from the assets and tangible equity of the banking entity."[183]

If Section (d)(4)(b)(iii) of the Volcker Rule is the source of statutory authority for Section __.12(d) of the Proposed Rules, then the Agencies exceeded their statutory authority. Section (d)(4)(b)(iii) of the statute does not authorize or require the Agencies to require banking entities to deduct their investments in covered funds held under the asset management exemption "[f]or purposes of calculating capital pursuant to the applicable capital rules." It only authorizes them to require such deductions "***[f]or purposes of determining compliance with applicable capital standards under paragraph (3)" of Section (d) of the Volcker Rule***. Section (d)(3) of the Volcker Rule authorizes the Agencies to "adopt rules imposing additional capital requirements . . . regarding the activities permitted under [Section (d)(1) of the statute] if the [Agencies] determine that additional capital . . . [is] appropriate to protect the safety and soundness of banking entities engaged in such activities." This authority is permissive rather than mandatory.

There is nothing in the Proposed Rules or any other rulemaking of which we are aware to suggest that the Agencies have made the necessary safety and soundness findings or issued the necessary rules imposing any additional capital requirements on any activities permitted under Section (d)(1) of the Volcker Rule. Yet it is clear from the language of Section (d)(4)(b)(iii) that the imposition of additional capital requirements pursuant to Section (d)(3) is a prerequisite to the exercise of any capital deduction authority under Section (d)(4)(b)(iii). In addition, the authority of the Agencies to impose any capital deduction requirement pursuant to Section (d)(4)(b)(iii) of the statute is limited to doing so "[f]or purposes of determining compliance with" any such additional capital requirements, and does not extend to doing so for purposes of calculating capital generally pursuant to the applicable capital rules.

The starting point for any determination regarding the appropriateness of additional capital requirements pursuant to Section (d)(3) of the statute should be an analysis of the current regulatory capital treatment for ownership interests in covered funds.[184] There is no evidence that the banking agencies' current generally applicable capital treatment for such positions is insufficient to ensure the safety and soundness of banks,[185] particularly in light of the

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[183] 76 Fed. Reg. at 68905.

[184] *See* 12 C.F.R. part 208, Appendices A, E, and F (capital adequacy guidelines for a state member bank); 12 C.F.R. part 225, Appendices A, E, and G (for a bank holding company); 12 C.F.R. part 3, Appendices A, B, and C (for a national bank); 12 C.F.R. part 325, Appendices A, C, and D (for a state nonmember bank); and 12 C.F.R. part 167, Appendix C (for a federal thrift).

[185] We note that in the over-the-counter derivatives context, the banking agencies have recently determined that "existing regulatory capital rules already specifically take into account and address the unique risks arising from derivatives transactions and activities." On the basis of this determination, the banking agencies have proposed to rely on their existing capital rules "as appropriate and sufficient to offset the greater risk to the covered swap entity and the financial system arising from the use of swaps and security-based swaps that are not cleared and to protect the safety and soundness of the covered swap entity." *See* Margin and Capital Requirements for Covered Swap Entities, 76 Fed. Reg. 27564 at 27569, 27569 (May 11, 2011). *See also* Sections 731 and 764 of the Dodd-Frank Act (requiring the banking agencies to adopt rules jointly for swap

added protection provided by the capital floors in Section 171 of the Dodd-Frank Act, the so-called the Collins Amendment.[186]

In the Proposed Rules, the Agencies did not make any determination or present any evidence to show that the current generally applicable capital requirements for ownership interests in covered funds are insufficient to protect banking entities. Under the banking agencies' general risk-based capital rules, which implement Basel I, a banking organization is already required to deduct from its core capital elements a portion, ranging from 8 to 25 percent, of the aggregate adjusted carrying value of its nonfinancial equity investments.[187] Similarly, the Simple Modified Look-Through Approach in the banking agencies' internal-ratings-based and advanced measurement approaches, which partially implements Basel II, would require a banking organization to assign risk weights of between 0 to 400 percent, and in one situation, 1,250 percent, to its equity exposures to investment funds.[188] Given the current minimum total risk-based capital ratio of 8 percent, a risk weight of 1250 percent is roughly equivalent to a full deduction from capital while a risk weight of 400 percent is roughly equivalent to a 32 percent capital charge.

In the Proposed Rules, the Agencies did not make any determination or present any evidence to show that the current generally applicable capital requirements for ownership interests in covered funds are insufficient to protect banking entities. Since the Basel III standards adopted by the Basel Committee on Banking Supervision do not propose any regulatory capital deductions or increased capital charges for equity exposures to investment funds (except to the extent such investments may represent investments in the capital of banking, financial and insurance entities outside the scope of regulatory consolidation), we respectfully submit that the current consensus of the bank supervisory authorities and central banks that are members of the Basel Committee is that the current capital requirements are in fact sufficient.

Nor did the Agencies perform a cost-benefit analysis of the full deduction approach in the Proposed Rules, which generally imposes a significantly higher capital charge for exposures to covered funds than under the Agencies' current capital rules or the Basel III standards. In any event, even if the Agencies intended the proposed regulatory capital deduction to reflect a determination under paragraph (d)(3) of the Volcker Rule that "additional capital

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entities under their respective jurisdictions imposing (i) capital requirements and (ii) initial and variation margin requirements on all non-cleared swaps and non-cleared security-based swaps).

[186] Under the Collins Amendment, the banking agencies are required to establish minimum leverage and risk-based capital requirements to apply to insured depository institutions, bank and thrift holding companies and systemically important nonbank financial companies. These minimum requirements must be not less than the generally applicable risk-based capital and leverage capital requirements, and not quantitatively lower than the above requirements that were in effect for insured depository institutions as of the date of enactment of the Dodd-Frank Act (July 21, 2010).

[187] *See, e.g.*, 12 C.F.R. part 208, Appendix A, Section II.B.5 and Table 1: Deduction for Nonfinancial Equity Investments.

[188] *See, e.g.*, 12 C.F.R. part 208, Appendix F, Part VI. Section 54 and Table 10: Modified Look-Through Approaches for Equity Exposures to Investment Funds.

requirements" should be imposed, or intend to make such a determination, we believe that such a determination should be made in the context of the banking agencies' broader efforts to implement the Basel III capital framework and other capital-related provisions under the Dodd-Frank Act. This would ensure that the regulatory capital treatment of exposures to covered funds is part of an integrated, comprehensive set of capital standards calibrated to banking organizations' risks as a whole, not as a separate case whose impact is divorced from that of the generally applicable standards.

In addition, we believe that if the Agencies retain the capital deduction, they should clarify that the 3% Tier 1 *de minimis* investment limit will be calculated based on the acquisition cost, rather than the "value," of a banking entity's ownership interests in covered funds held pursuant to the asset management exemption. To do otherwise would have the perverse effect of penalizing a banking entity by reducing the headroom available under the 3% Tier 1 *de minimis* cap for additional investments when a banking entity's investments perform well, and increasing that headroom when a banking entity's investments do not perform well.

This flawed approach is outside the scope of the statute. The statute makes no mention of accounting standards. Nor does it use the term "value." Instead, the statute limits the "size of investments" and the banking entities "interests."[189] Imposing accounting requirements and adding a "value" limitation are outside of the Agencies' statutory authority and therefore invalid.[190] At a minimum, the agencies would have to explain and provide a reasoned basis for any exercise of interpretative authority given the adverse consequences that would result under their approach — something they have failed to do.[191] This falls short of reasoned decisionmaking.[192]

(6) Seeding Period Extensions

(a) Both Investment Limits

> ***SIFMA Recommendation***: Extensions of the seeding period should be available for <u>both</u> the per fund and aggregate investment limits.

The Volcker Rule provides that a banking entity is permitted a one-year seeding period following establishment of a covered fund organized and offered or sponsored under the asset management exemption, during which the banking entity may own any percentage of the total ownership interests of the covered fund.[193] The statute also provides that the Federal Reserve may extend this seeding period for up to two additional years under certain

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[189] *See* 12 U.S.C. § 1851(d)(4)(B)(ii). (ii)(II).

[190] *See Am. Library Ass'n*, 406 F.3d at 699–700.

[191] *See* 76 Fed. Reg. at 68906–68907.

[192] *See Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43.

[193] *See* 12 U.S.C. § 1851(d)(4)(B)(ii)(I).

circumstances.[194] The Agencies note in the Supplementary Information section of the NPRs that "[t]he statute provides the possibility of an extension only with respect to the per-fund limitation, and not to the aggregate funds limitation."[195] Although we agree that the statute on its face can be read not to contemplate an extension of the seeding period with respect to the aggregate 3% *de minimis* investment limit, we recommend that the Agencies exercise their exemptive authority under subsection (d)(1)(J) to provide for the possibility of such an extension.

Banking entities must have sufficient time to establish track records for new strategies in order to attract unaffiliated investors. Congress recognized this when it provided for the possibility of an up-to-three year seeding period for new covered funds organized and offered or sponsored under the asset management exemption. As Senator Merkley noted in his colloquy with Senators Levin and Dodd, the seeding period is intended to permit, "[d]uring the start-up period" of a covered fund, ownership "sufficient to effectively implement the investment strategy."[196] But if banking entities are required to count toward the aggregate 3% *de minimis* limit all interests in newly seeded funds, then the extension for the per fund investment limit is rendered illusory. Banking entities would be forced to 'set aside' a significant portion of their 3% permitted aggregate investment in covered funds held under the asset management exemption in anticipation of the possibility that they would need to seek an extension of the seeding period with respect to a given fund, in order to avoid breaching the aggregate investment limit. In addition, banking entities would be effectively prohibited from seeding covered funds for which investors traditionally expect to see a greater-than-one-year track record. We do not believe that Congress intended this result, which would dramatically disrupt the traditional asset management businesses of banking entities. Nor do we believe that this result is consistent with the stated general approach of the Agencies in drafting the Proposed Rules not to "unduly constrain banking entities in their efforts to safely provide" "traditional asset management services" and to permit the "continued provision of client-oriented financial services."[197]

Failing to provide for the possibility of an extension as we recommend would cause banking entities to severely shrink their client-oriented asset management businesses, and provide materially fewer options for customers in the marketplace. Providing for the possibility of this extension, by contrast, would in our view promote and protect the safety and soundness of banking entities and U.S. financial stability by ensuring a continued, sufficient range of investment diversification options for investors and not causing the sudden exit of banking entities from a significant portion of their client-oriented asset management businesses.

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[194] *See* 12 U.S.C. § 1851(d)(4)(C).

[195] *See* 76 Fed. Reg. at 68906.

[196] Colloquy Between Senators Merkley, Levin and Dodd, 156 CONG. REC. S5901 (daily ed. July 15, 2010).

[197] 76 Fed. Reg. at 68849.

(b) Track Record

> ***SIFMA Recommendation***: A procedure should be established to provide banking entities with extensions for the full three years in advance for the limited purpose of establishing a track record for new funds, if certain rigorous conditions are satisfied.

As noted above, investors demand sufficient evidence of the likely future success of a fund's investment strategy before they will invest in a new fund. This evidence takes the form a of "track record," that is, a record showing the actual performance of the strategy over a given period of time. To produce this track record, fund managers "seed" a fund, putting a small amount of their own capital at risk in the market pursuant to the investment strategy and recording the results.

The duration of the track record that investors demand before investing in a new fund can depend on a number of factors. As a rule of thumb, the longer the track record, the better a prospective investor can evaluate the likelihood that past performance will be predictive of future results. Conventions have evolved in the market for the minimum acceptable track record duration for certain types of funds. For example, strategies for mutual funds, which are often marketed to retail and institutional investors, may require three years of track record. Strategies for funds that will be offered only to small numbers of sophisticated investors may require less time.

As noted above, Congress explicitly recognized the need for a banking entity to have a sufficient seeding period following establishment of a covered fund organized and offered or sponsored under the asset management exemption to build a track record for the purpose of attracting unaffiliated investors.[198] Although the seeding provision in the asset management exemption provides the possibility of up to three years in which to build a track record, only the first year is guaranteed — the remaining two years are available only at the discretion of the Board, following review of a number of factors.[199] But a banking entity may not prudently be able to seed a new fund of the type that requires more than a single year's track record — for example, many types of mutual fund — if it cannot be confident that an extension will be granted during the seeding period. This could effectively prohibit banking entities from creating new funds that are not even captured by the Volcker Rule.

We understand the Agencies' concern that a seeding period could conceivably be used as a means of evading the proprietary trading prohibition.[200] However, given the small

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[198] *See* 12 U.S.C. § 1851(d)(4)(B)(ii)(I).

[199] *See* Proposed Rules § __.12(c).

[200] *See* 76 Fed. Reg. 68906 n. 288 ("[T]he Agencies recognize the potential for evasion of the restrictions contained in section 13 of the BHC Act through organizing and offering a covered fund pursuant to the authority contained in § __.11 of the proposed rule. Therefore, in addition to taking action against a banking entity that does not actively seek unaffiliated investors to reduce or dilute the investment of the banking entity as provided under § __.12(a)(2) of the proposed rule, the Agencies expect that if a banking entity is habitually or routinely

amounts of proprietary capital typically involved in seeding, the Agencies' robust anti-evasion authority and the inflexibility of investors' expectations with respect to track records for new funds, we believe that this concern should not be the primary consideration underlying the scope of the seeding exception.

We believe that the Agencies would appropriately accommodate the market-driven need for sufficient seeding periods and the Agencies' anti-evasion concerns by providing that, where a banking entity seeds a new fund in accordance with a set of rigorous conditions, the Board will grant the banking entity the full three year seeding period *in advance*, subject to rescission upon a determination by the Board (following notice and opportunity for a hearing) that the banking entity has acted with evasive intent.

We would propose the following conditions that a banking entity must satisfy in order to qualify for an advance seeding period extension:

- The seeding takes place within a banking entity's asset management division;
- No more than $10 million of the banking entity's proprietary capital may be at risk in a single seeded fund, subject to the possibility of increase at the discretion of the Board;[201]
- The banking entity establishes, maintains and enforces internal controls and risk management reasonably designed to ensure that the seeding activity complies with the banking entity's written policies and procedures and is not undertaken for any purpose other than to establish a fund and provide the fund with sufficient initial equity for investment to permit the fund to attract unaffiliated investors.

(7) Cure Period

SIFMA Recommendation: The Agencies should amend the Proposed Rules to provide banking entities with a six month cure period for any failure to comply with any of the investment limits for reasons beyond their reasonable control.

The Proposed Rules do not include a cure period for instances in which a banking entity exceeds the *de minimis* limits for reasons beyond the banking entity's reasonable control, such as a decline in Tier 1 capital or third-party investor redemptions. We recommend that the

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seeking an extension of the one-year period provided under § __.12(a)(2)(i)(B), this could be evidence of seeking to evade the restrictions contained in the proposed rule and, as appropriate, the Agencies may take action against such banking entity.").

[201] In limited circumstances, a strategy may require more seed capital in order to execute. For example, certain fund of funds strategies, which necessarily must invest in multiple funds that may have minimum investment requirements, may require a larger amount of seed capital.

Agencies amend the Proposed Rules to provide that a banking entity will have a six month cure period following any date on which it is discovered that a *de minimis* limit has been exceeded for reasons other than a contribution of capital to a covered fund by the banking entity with respect to which the banking entity knows or should know that such capital contribution will cause a *de minimis limit* to be exceeded.

C. Credit Funds

The Proposed Rules include two "permitted activities" exemptions for sponsoring or investing in issuers of asset-backed securities, provided that the assets are limited to loans and other extensions of credit and certain derivatives for hedging purposes.[202] We agree that these exemptions are necessary both to give effect to section (g)(2) of the statutory text of the Volcker Rule, which provides that nothing in the Volcker Rule shall be construed to limit or restrict the ability of a banking entity to sell or securitize loans,[203] and to mitigate the impact of the overbroad definition of "covered fund." We believe that credit funds fall within these exemptions.

But because credit funds are such an important source of credit to small and medium-sized businesses, and are available during times of financial stress when the rest of the credit market can be locked up, we believe that the Agencies should provide a specific "permitted activities" exemption for sponsoring and investing in, and entering into certain covered transactions with related, credit funds. Alternatively, they should confirm that the "permitted activities" exemptions for sponsoring or investing in issuers of asset-backed securities includes credit funds that are organized as partnerships or limited liability companies and not just those that are organized as traditional securitization vehicles. As part of this confirmation, they should also confirm that the term "asset-backed security" includes an "ownership interest" in a credit fund and that the term "loan" includes all extensions of credit, including in the form of notes and bonds.

A banking entity's ability to engage in its core business of lending should not be limited by choice of structure. Credit funds engage in activities that are at the core of activities permissible for banking entities under applicable banking laws – lending money on a long-term basis to companies and providing support, liquidity and stable credit for capital formation needs. Credit funds are predominantly engaged in originating or investing in loans and other extensions of credit in the primary markets, and strengthen the overall economy and promote job creation by providing credit to companies, many of which are small and medium-sized companies that are not able to access the public markets.

Banking entities are permitted to engage directly in prudent lending and should not be limited in their ability to do so through a fund structure. Using a fund structure facilitates investment by third-party investors, which creates a broader and deeper pool of capital than might otherwise be available for lending. Investors in credit funds, such as pension funds and

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[202] 76 Fed. Reg. at 68953-54.

[203] *See* 12 U.S.C. § 1851(g)(2).

governmental entities, represent a significant amount of domestic and foreign capital that might otherwise not be available to the United States lending market.

Credit funds are generally operated in a safe and risk-controlled manner. Using third-party investor capital in lending activities in a fund structure or joint venture with clients is inherently prudent because it allows the banking entity to pre-syndicate its lending exposure and more efficiently manage its capital at risk. Lending activities backed by pre-committed capital are promote safety and soundness of the sponsoring banking entity and the financial stability of the United States. With significant committed capital, credit funds are a source of credit during times of financial stress when other financing and syndication markets are not functioning properly. This contributes to liquidity and stability in the financial markets and reduces systemic risk within the United States banking system.

Credit funds are professionally managed, adhere to strong underwriting standards, are selective in acquiring assets and typically hold assets for the long term. Of course, like other credit providers, they do, and should be permitted to, dispose of or restructure positions as part of prudent portfolio or risk management, for example to address bad credits or reduce exposure to certain geographical, sector or other concentrations. With sole authority to manage or advise the fund, a credit fund sponsor can typically agree to amendments and restructurings without seeking consent of investors. Moreover, the extension of credit and other financing activities of credit funds can be required to be conducted in compliance with Federal banking law standards, including underwriting standards, diversification requirements, concentration limits, real estate appraisals and other safety and soundness standards. Accordingly, these funds can be required to be operated in substantially the same manner as banking entities engage in similar credit and other financing activities themselves – a prudent manner that would serve the public interest and promote the safety and soundness of the banking entity and the financial stability of the United States.

Credit funds are quite different from issuers of collateralized debt obligations ("**CDOs**"). Credit funds originate traditional loans or invest in traditional loan participations, including notes and bonds – they do not invest in asset-backed securities, much less the lowest-rated debt tranches of an issuer of asset-backed securities. Nor do they fund themselves with structured tranches of debt securities the way a CDO does. Indeed, they are primarily funded with equity capital, and generally have a debt-to-equity ratio of less than 4:1. As a result, it is not possible for them to become a CDO or a CDO-squared.

(1) Specific Exemption

> ***SIFMA Recommendation***: The Agencies should provide a specific "permitted activities" exemption for sponsoring or investing in, and entering into certain covered transactions with related, credit funds.

We believe that the Agencies should exercise their authority under Section 13(d)(1)(J) of the BHC Act to provide a "permitted activities" exemption for sponsoring or

investing in, and entering into certain covered transactions with related, credit funds. We believe that credit funds will promote and preserve the safety and soundness of banking entities and the financial stability of the United States, if they are permitted subject to certain conditions. These conditions in our view should include the following:

- The credit fund is **predominantly engaged** in the origination of loans and other extensions of credit or the acquisition of loans and other extensions of credit in the primary debt originations market;[204]

- The credit fund intends to **hold such loans and other extensions of credit for the lesser of at least three years or maturity**;[205]

- The credit fund is funded primarily with equity and debt with an original maturity exceeding one year, and has a **debt-to-equity ratio of not more than 4:1**;

- The credit fund does **not** (i) buy or sell loans or other extensions of credit with the **intent to profit from short-term price movements** or (ii) buy or sell **synthetic securities** (including total rate of return swaps or credit default swaps), except related to management of problem credits or for the purpose of obtaining leverage, or to hedge or otherwise reduce credit risk of the overall portfolio or with respect to an individual borrower within the portfolio for portfolio or **risk management purposes**, for example to reduce geographical, sector or other concentrations in accordance with the fund's investment guidelines.[206]

We also believe that a credit fund should be required to observe prudent credit underwriting standards, real estate appraisal standards and other credit standards, such as diversification requirements and concentration limits, reasonably designed to ensure the fund is operated in a safe and sound manner, which may include syndication of loans or other extensions of credit. The minimum requirements for a credit fund should be: (i) active management and investment discretion by the general partner, fund investment committee (or their equivalent) or

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[204] We propose that a reasonable definition of "predominantly engaged" would require that at least 85% of the credit fund's assets be attributable to such activities.

[205] The final rules should recognize that, although a credit fund may intend to hold debt for a certain period of time, it may sell debt before the expiration of such intended holding period so long as it does so for a non-speculative purpose related to portfolio or risk management pursuant to the investment guidelines under which the credit fund operates.

[206] Although we believe that these are the essential criteria of a credit fund, the Agencies could also consider requiring that (i) at least 5% of a credit fund's equity capital commitment be contributed by the banking entity that sponsors it; (ii) a banking entity sponsoring a credit fund disclose to investors that it will not guarantee the obligations of the credit fund or otherwise provide financial support or assistance to investors in connection with their investment; and (iii) the credit fund's operating documentation include the terms and other required criteria necessary to satisfy the proposed criteria.

the investment adviser/investment manager over the investments within the fund; (ii) documented, independent credit analysis prior to the acquisition of loans or other extensions of credit; (iii) a limit on the credit fund's holdings of no more than 75 such instruments at any time; and (iv) a prohibition on holding any instrument that would account for more than 15% of the leveraged capital commitment of the fund.

We believe that a credit fund that satisfies these conditions would promote and preserve the safety and soundness of banking entities and the financial stability of the United States. Such credit funds would engage in activities that are at the core of activities permissible for banking entities under applicable banking laws – lending money on a long-term basis to companies and providing support, liquidity and stable credit for capital formation needs. They would strengthen the overall economy and promote job creation by providing credit to companies, many of which are small and medium-sized companies, that are not able to access the public markets. Because they are funded primarily with equity capital and debt with an original maturity of more than one year and a debt-to-equity ratio of less than 4:1, credit funds would be able to be a source of credit during times of volatility when other financing and syndication markets are not functioning properly.

For the reasons stated in Section IV.C(1) above and VII.A below, we believe that the Agencies have the power to grant an exemption under Section (d)(1)(J) from Super 23A for intraday extensions of credit and extensions of credit fully secured by U.S. government securities and cash collateral. Such exemptions promote and preserve the safety and soundness of banking entities and the financial stability of the United States. They are also consistent with the proper construction of the phrase "covered transaction, as defined by Section 23A of the Federal Reserve Act." We believe that the requested exemption for credit funds should include such exemptions from Super 23A.

(2) Part of Asset-Backed Security Exemption

> ***SIFMA Recommendation***: Alternatively, the Agencies should confirm that the "permitted activities" exemption for sponsoring or investing in issuers of asset-backed securities includes credit funds, (ii) the term "asset-backed security" includes "ownership interests" in credit funds, (iii) the term "loan" includes all extensions of credit, including notes and bonds, and (iv) the exemption extends to covered transactions otherwise prohibited by Super 23A.

Alternatively, the Agencies should confirm that the "permitted activities" exemptions for issuers of asset-backed securities should include covered funds organized as limited partnerships or limited liability companies. They should also clarify that the term "asset-backed security," for purposes of the exemptions for issuers of asset-backed securities, is not limited to the definitions under Section 3(a)(77) of the Exchange Act or the SEC's Regulation AB. Instead, they should confirm that the term includes any "ownership interest" in an issuer of asset-backed securities, including a general or limited partnership interest or limited liability company interest in a credit fund. This would be consistent with the purpose behind the asset-

backed securities exemptions, as expressed by the Agencies in the Supplementary Information section of the NPRs – to "increas[e] availability of funds to individuals and small businesses, as well as provide greater diversification of risk" through the loan securitization exemptions.[207] We note that, as recommended above, if the Agencies provide a specific permitted activity exemption for credit funds, there would be no need to clarify the interpretation of the term "asset-backed security" as described. Finally, because not all permissible lending arrangements are structured as loans, the Agencies should clarify that the permitted holdings of a credit fund under the loan securitization exemptions include all extensions of credit that banking entities have traditionally been permitted to hold, including notes and bonds.

We believe that the Agencies have the power to grant an exemption under Section (g)(2) from Super 23A for intraday extensions of credit and extensions of credit fully secured by U.S. government securities and cash collateral. The language of Section (g)(2) – that nothing in the Volcker Rule shall be construed to limit or restrict the ability of a banking entity to sell or securitize loans – is sweeping – and clearly extends to Super 23A.

D. Underwriting and Market-Making-Related Activities

(1) Application to Covered Funds

> ***SIFMA recommendation***: A "permitted activities" exemption that extends to Super 23A should be added for underwriting and market-making-related activities with respect to ownership interests in covered funds.

The Proposed Rules include a "permitted activities" exemption from the prohibition on proprietary trading for underwriting and market making-related activities, but they do not contain such an exemption from the restrictions on hedge fund and private equity fund activities.[208] The Agencies indicated that they do not believe that the statutory exemption for underwriting or market making-related activities was intended to apply to the restrictions on hedge fund and private equity fund activities.[209] In contrast, we believe that the statutory exemption applies to both proprietary trading ***and*** hedge fund and private equity fund activities. In our view, the statute is unambiguous on this point, and nothing in the legislative history is inconsistent with our reading.[210]

Section (a) of the Volcker Rule is entitled "In General" and is followed by Section (a)(1), entitled "Prohibition," which contains the basic prohibition of the Volcker Rule. It reads:

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[207] *See* 76 Fed. Reg. at 68914.

[208] *See* Proposed Rules §§ __.4(a), (b).

[209] 76 Fed. Reg. at 68908 and n. 293.

[210] In this regard, we agree with the views expressed in a Memorandum to the Board's General Counsel, Scott G. Alvarez, et al., dated January 23, 2012, from Cleary Gottlieb Steen & Hamilton, Davis Polk & Wardwell, and Sullivan & Cromwell. This section draws heavily from that three law firm memorandum.

"Unless otherwise provided in this section, a banking entity shall not—

(A) engage in proprietary trading; or

(B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund."

The prohibition on proprietary trading and the restrictions related to hedge funds and private equity funds are both contained in Section (a).

Section (d) is entitled "Permitted Activities," and its first subsection, (d)(1), is also entitled "In General." In this "In General" subsection, Congress sets out the language that will govern all permitted activities in the list that follows. Section (d)(1) reads:

> "***Notwithstanding the restrictions under subsection (a)***, to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the [Agencies] may determine, ***the following activities (in this section referred to as 'permitted activities') are permitted*** . . ."[211]

Because the "In General" subsection of (d)(1) does not distinguish between the proprietary trading prohibition in subsection (a)(1)(A) and the restrictions related to hedge funds and private equity funds in subsection (a)(1)(B) and instead says "[n]otwithstanding the restrictions under ***subsection (a)***," the general principle established by the language an structure of the statutory text is that each of the enumerated exceptions for permitted activities in subsection (d)(1) applies equally to ***both*** the proprietary trading ***and*** the restrictions related to hedge funds and private equity funds within subsection (a). Structurally, each one of the permitted activities is listed in a subsection of, and hence has a meaning consistent with, the introductory language of the "In General" section of 13(d)(1). The language and structure of the general section make clear, therefore, that to the extent Section (d)(1) contains no further textual direction, a permitted activity will apply to both the proprietary trading prohibition in subsection (a)(1)A) and the restrictions related to hedge funds and private equity funds in subsection (a)(1)(B).[212]

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[211] All emphasis in statutory text in this section of the comment letter has been added.

[212] *See* SUTHERLAND, STATUTES AND STATUTORY CONSTRUCTION § 20:22 (7th ed., Norman J. Singer ed.) ("A proper application of the 'whole act interpretation' will ascribe to the exception equal power over all other provisions of the act unless it is specifically limited to particular sections."). *See also, Gonzales v. Oregon*, 546 U.S. 243, 273 (2006) ("statutes should not be read as a series of unrelated and isolated provisions.") (internal quotation marks and citation omitted); *Conroy v. Aniskoff*, 507 U.S. 511, 515 (1993) (it is a "cardinal rule that a statute is to be read as a whole…since the meaning of statutory language, plain or not, depends on context.") (internal quotation marks and citation omitted); *U.S. Nat. Bank of Oregon v. Independent Ins. Agents of America, Inc.* 508 U.S. 439, 455 (1993) ("[i]n expounding a statute, we must not be guided by a single sentence or member of a sentence, but look to the provisions of the whole law." and statutory construction "must account for a statute's full text, language as well as punctuation, structure, and subject matter.") (internal quotation marks and citation omitted); *Green v. Bock Laundry Mach. Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring) (The

Section (d)(1)(B) of the Volcker Rule describes the permitted activity of underwriting and market-making-related activities. This section refers to "the purchase, sale, acquisition, or disposition of *securities and other instruments described in subsection (h)(4).*"[213] The cross reference to subsection (h)(4), which in its totality is the definition of the core defined term "proprietary trading," is used to incorporate only the list of "securities and other instruments" in that subsection into the permitted activities exemptions,[214] as neither the Volcker Rule nor any other section of the BHC Act defines "securities or other instruments."[215]

In contrast, when Congress wanted to use its core defined term "proprietary trading," it did so without hesitation. For example, Section (d)(1)(H) of the Volcker Rule applies only to the proprietary trading restrictions and specifically exempts *"[p]roprietary trading* conducted by a banking entity pursuant to paragraph (9) or (13) of section 4(c) [of the BHC Act], provided that the trading occurs solely outside of the United States." Section (d)(1)(G) and (I) apply only to the covered funds prohibitions and exempt "[o]rganizing and offering *a private equity or hedge fund*" and "[t]he 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 pursuant to paragraph (9) or (13) of section 4(c) [of the BHC Act] solely outside of the United States." Thus, it is inescapable that Congress drafted language differently when it intended for a specific exemption to apply only to the proprietary trading prohibitions or only to

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meaning of terms on the statute books ought to be determined by that which is most compatible with the surrounding body of law into which the provision must be integrated); *United Savings Ass'n of Texas v. Timbers of Inwood Forest Assocs.*, 484 U.S. 365, 371 (1988) (Scalia, J.); Antonin Scalia, A MATTER OF INTERPRETATION: FEDERAL COURTS AND THE LAW 17 (1997) (courts should construe congressional statutes to mean what "a reasonable person would gather from the text of the law, placed alongside the remainder of the *corpus juris*.").

[213] Section (h)(4) describes "...any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine." An "equity, partnership or other ownership interest" in a hedge fund or private equity fund that is a security would clearly be included in this description, as evidenced by the proposed definition of the term "Ownership interest" in §__.10(b)(3) of the Proposed Rules. 76 Fed. Reg. 68846, 68950 (Nov. 7, 2011).

[214] The statutory text of the Volcker Rule frequently cites other statutes to incorporate definitions but not to incorporate operative provisions. For example, Section (d)(1)(E) cites the definition of "small business investment companies" in Section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662); Section (h)(1) cites the definition of "insured depository institution" in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813); Section (h)(2) defines "hedge fund" and "private equity fund" by reference to an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act.

[215] The text and structure of Section (h)(4) also support this reading since (h)(4) itself contains two parts: first a description of short-term principal trading and then, separated by a comma, a laundry list of the types of securities and other instruments covered.

the covered fund restrictions, and Congress quite plainly did not use such language in subsection (d)(1)(B) of the Volcker Rule.[216]

In short, we believe that it is clear in the plain language and structure of the Volcker Rule, and the absence of any legislative history to the contrary, that the scope of the permitted activities of underwriting and market-making-related activities includes *all* activities otherwise prohibited under subsection (a), whether those activities would involve proprietary trading or hedge funds or private equity funds.

(2) Exchange Traded Funds

> ***SIFMA recommendation***: The requested exemption for underwriting and market-making-related activities should permit banking entities to continue to serve as authorized participants to an ETF issuer or as market makers for ETF shares.

As discussed in detail in our letter on the proprietary trading portion of the Volcker Rule, certain provisions of the Proposed Rules could be read to impede the continued functioning of the exchange traded fund ("**ETF**") market, both in the United States and globally.[217] These concerns center on the scope of the underwriting and market-making-related activities and underwriting exemptions as drafted, which could threaten the ability of a U.S. banking entity to continue to serve as an Authorized Participant ("**AP**")[218] to an ETF issuer or as a market maker in ETF shares.[219]

Although ETFs are by definition exchange traded, offered to retail investors, subject to regulation of their investments and activities, and do not otherwise have the characteristics of a hedge fund or private equity fund as commonly understood, we are concerned that if the Agencies do not adopt our recommendations to appropriately narrow the scope of the

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[216] *See Keene Corp.* v. *United States*, 508 U.S. 200, 208 (1993) ("where Congress includes particular language in one section of a statute but omits it in another . . . , it is generally presumed that Congress acts intentionally and purposely in the disparate inclusion or exclusion.") (internal quotations omitted).

[217] *See* SIFMA Comment Letter on Proprietary Trading at Section II.Q.

[218] The role of AP is unique to ETFs. Creation and redemption of ETF shares requires the intermediation of an AP because an ETF does not, like a mutual fund, sell shares directly to, or redeem shares from, individual investors. APs facilitates continuous issuance and redemption of ETF shares and, thus, liquidity in the ETF's shares. The issuance of ETF shares occurs in a "creation" transaction, in which the AP assembles and tenders to an ETF's custodian bank the securities underlying the ETF in exchange for large blocks of ETF shares, which it then sells to investors. In a redemption transaction, the AP purchases ETF shares from customers, redeeming creation units, and receiving the underlying assets in return.

[219] U.S. banking entities play a substantial role in the U.S. and global ETF markets, which represent a very large and growing segment of the broader markets. According to the Investment Company Institute, as of November 30, 2011, the shares of over 1,000 ETF issuers, with aggregate assets in excess of $1 trillion, were traded in the United States alone, representing approximately 25 percent of all equity trading volume on U.S. securities exchanges. *See* Exchange Traded Funds Assets: November 2011, ICI (December 29, 2011), http://www.ici.org/etf_resources/research/etfs_11_11.

"similar funds" designation in the Proposed Rules, many ETFs could be treated as covered funds. This would compound the problems identified in our letter on the proprietary trading portion of the Volcker Rule by effectively preventing U.S. banking entities from sponsoring ETFs, investing in ETFs or holding ETF shares in inventory as part of their normal, ordinary course activities as APs and market makers. The exit of U.S. banking entities from U.S. and foreign ETF markets would be severely disruptive to the markets, and particularly harmful for the many retail and institutional investors that invest in ETFs. We hope that the Agencies agree that ETFs should not be treated as covered funds under the Volcker Rule, and reiterate our recommendations that the types of foreign funds and commodity pools that are designated as "similar funds" will be appropriately limited as described in Section IV above.

E. Risk-Mitigating Hedging[220]

(1) Single Hedging Exemption

> ***SIFMA Recommendation***: The Agencies should provide a single hedging exemption for both the proprietary trading and covered fund portions of the Volcker Rule, eliminating the additional conditions for covered funds.

Although the plain language of the single hedging exemption in Section (d)(1)(C) of the statutory text of the Volcker Rule applies equally to proprietary trading and covered fund activities, the Proposed Rules provide for two distinct hedging exemptions. Despite the lack of any similar statutory distinction or rationale articulated in the Supplementary Information to the Proposed Rules, the hedging exemption in the covered funds portion of the Proposed Rules is materially more restrictive than the hedging exemption in the proprietary trading portion. Banking entities offer customers products linked to the performance of many asset classes, including covered funds. The overly restrictive hedging exemption for covered funds unnecessarily singles out covered fund-linked products, which should be treated no differently from, and do not present any heightened risk of evasion compared to, products linked to the performance of other asset classes.

Unlike the hedging exemption for proprietary trading, the hedging exemption for covered funds contains four significant limitations on the types of hedging it would permit by imposing restrictive conditions on the acquisition for hedging purposes of ownership interests in a covered fund. The exemption would require that such an acquisition be made (i) in connection with an obligation assumed by a banking entity in the course of providing a customer exposure to

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[220] *See* Proposed Rules §__.5; §__.13(b). Our discussion and recommendations assume that the final rules will appropriately narrow the definition of "covered fund" to include only hedge funds and private equity funds as commonly understood. See our discussion in Section IV above. The definition of "covered fund" in the Proposal could capture, among other entities that are not hedge funds or private equity funds as commonly understood, funds publicly offered in jurisdictions outside the United States, and severely disrupt the significant markets for products linked to such funds. Were the "covered fund" definition in the Proposed Rules to remain unchanged in the final rules, SIFMA would have substantial additional concerns with the proposed hedging exemption for covered funds.

"the profits *and* losses"[221] of a covered fund (the "**profits and losses condition**"); (ii) "in the same amount of ownership interest in [a] covered fund" (the "**same amount of ownership interest condition**"); (iii) "solely to accommodate a specific customer request with respect to . . . that covered fund" (the "**customer request condition**"); (iv) "when acting as intermediary on behalf of a customer that is not a banking entity" (the "**non-banking entity condition**").

These conditions could be read to disallow hedging of many types of covered fund-linked products, thereby effectively forcing banking entities to cease offering such products and to unwind many existing transactions with customers.[222] First, the profits and losses condition could be read to prevent banking entities from hedging exposures to covered fund-linked products that offer customers downside protection (*e.g.*, products in which customers have economic exposure to all or a portion of the profits but only some or none of the losses) or other payouts. Such products make up a significant portion of the covered fund-linked products market and provide customers with products that meet their particular investment needs, risk/return profiles or hedging needs with respect to products issued or sold by them or to them by other financial institutions. Second, the same amount of ownership interest condition could be read to prohibit dynamic delta hedging of covered fund-linked products. This condition could also be read to prohibit "portfolio" hedging of aggregated risks across multiple customer trades with correlated exposures. Without the ability to use these fundamental, industry-standard methods of risk management, banking entities would be unable to meet customer demands for many covered fund-linked products. Third, the specific customer request condition could be read to force banking entities to cease their longstanding practice of bringing innovative or timely product ideas to customers seeking tailored covered fund exposures who rely on banking entities for their market knowledge and structuring expertise. Finally, the non-banking entity condition could inappropriately and unnecessarily impose on those banking entities that are providers of covered fund-linked products the burden of policing compliance with the Volcker Rule by other banking entities who will be responsible for their own compliance with the Volcker Rule.

We believe that the Agencies will agree that the very different hedging exemptions in the proprietary and covered fund contexts are not appropriate once they have considered the breadth and attributes of the covered fund-linked products market and the risk management practices that banking entities employ to hedge their exposure to such products. In the paragraphs below, we discuss several common fund-linked products and the methods banking entities use to hedge them. Through this discussion, we hope to deepen the Agencies' understanding of the substantially similar hedging needs of banking entities in the proprietary trading and covered funds contexts.[223]

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[221] *See* Proposed Rules §__.13(b)(1)(i)(A) (emphasis added).

[222] This is not because the Proposed Rules prohibit the offering of such products outright, but because the Proposed Rules could be read to prohibit the hedging of risk assumed in the course of offering them.

[223] We also believe that the costs imposed on banking entities by effectively forcing them to exit traditionally permissible, safe and sound business lines because they have been stripped of the ability to appropriately manage associated risks would fail the cost/benefit analysis that the Agencies are obliged to perform with respect to every element of the Proposed Rules.

We therefore ask that the Agencies provide for a single hedging exemption applicable to both the proprietary trading and covered funds portions of the Volcker Rule, eliminating the additional conditions in the hedging exemption for covered funds as proposed, consistent with congressional intent.[224]

(2) Minimum Alternative

SIFMA Recommendation: If the agencies do not adopt a single hedging exemption as requested above, the Agencies should, at a minimum:

(a) **Profits and Losses Condition**. Clarify that the "profits and losses" condition does not prohibit banking entities from hedging exposures to covered fund-linked products designed to facilitate customer exposure to either or both the profits (or a portion of the profits) or the losses (or a portion of the losses) of a covered fund reference asset;

(b) **Same Amount of Ownership Interest Condition**. Clarify that, notwithstanding the "same amount of ownership interest" condition, dynamic delta hedging of covered fund-linked products is permitted by the hedging exemption for covered funds and that "portfolio" hedging of exposures to covered fund-linked products is permitted;

(c) **Customer Request Condition**. Clarify or eliminate the "specific customer request" condition in order to ensure that banking entities may continue innovating and offering covered fund-linked products to existing and new customers in accordance with market practice, customer expectations and applicable laws and regulations;

(d) **Non-Banking Entity Condition**. Eliminate the prohibition on hedging a customer exposure where the customer is a banking entity or, at a minimum, amend it to permit reliance on certain customer representations;

(e) **Interaffiliate Transactions**. Clarify that interaffiliate transactions will be deemed part of a coordinated activity for purposes of determining compliance with a permitted activity, including risk-mitigating hedging activities; and

(f) **Grandfathered Hedging Activities**. With respect to covered fund-linked products sold to customers before the effective date of the Volcker Rule, permit banking entities to continue to engage in the types of risk-mitigating hedging activities that they were engaged in before the effective date with respect to such products, so long as they comply with the conditions in the hedging exemption for proprietary trading.

[224] We note that our recommendation that the Agencies provide for a single hedging exemption should not be interpreted as an unqualified endorsement of the hedging exemption for proprietary trading as drafted. Although the hedging exemption for proprietary trading is more appropriate in scope than the hedging exemption for covered funds, we ask the Agencies to address a number of issues with the hedging exemption for proprietary trading in our separate letter on the proprietary trading portion of the Volcker Rule.

If the Agencies do not adopt a single hedging exemption as requested above, we request that at a minimum they clarify or amend the conditions for the hedging exemption for covered funds as discussed below.

(a) Examples of Fund-Linked Products[225]

Customers look to banking entities to facilitate tailored exposure to the performance of funds, including hedge funds, other private funds and mutual funds. Just as a customer might buy swaps, call options or other products linked to the performance of a single stock or the S&P 500 Index, a customer can also purchase such instruments or products linked to the performance of a fund, a basket of funds, or a fund index (each, a "**fund reference asset**," and, where appropriate, a "**covered fund reference asset**").[226] In other words, funds are simply another asset class to which customers seek exposure in order to diversify their investment portfolios and hedge risk. As with any other investment product, customers demand customization of covered fund-linked products for diversification purposes and to reflect the idiosyncrasies of their businesses and investment and risk management needs. The benefits of products linked to covered fund reference assets, including options, principal-protected notes and other products, generally relate to this need for customization and diversification.

Fund-linked Notes. Customers often obtain exposure to the performance of fund reference assets through notes.[227] These notes may offer full or partial downside protection, allowing customers to gain exposure to the performance of a fund reference asset while limiting their potential losses. For example, in a simple fully principal protected note (a "**PPN**"), a customer might purchase a note issued by the banking entity at an issue price of $1,000. The PPN would promise a payment at maturity equal to the initial $1,000 principal amount plus a supplemental amount based on any upside performance of a notional investment in the fund reference asset. One way in which the banking entity could hedge its liability under this type of PPN would be to (i) acquire a zero-coupon bond portfolio, such as U.S. Treasury strips (the "**bond hedge**") that matures concurrently with the PPN and promises a payment at maturity of $1,000 (*i.e.*, equal to the principal amount of the PPN) and (ii) invest an amount equal to the excess of the principal amount of the PPN over the cost of the bond hedge in the fund reference asset, either through a simple investment in the fund reference asset or through an option linked to

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[225] The products we discuss in this section do not represent the entire universe of fund-linked products, but serve simply as useful context for the discussion of hedging fund-linked products that follows.

[226] We refer to "covered fund reference assets" and "covered fund-linked products" where relevant to the discussion of the operation of the hedging exemption for covered funds, but the examples of fund-linked products discussed below and the methods that banking entities use to hedge risk incurred in connection with them are equally relevant in the case of products linked to the performance of covered funds and in the case of products linked to the performance of funds that are not captured by the Volcker Rule.

[227] Although we discuss fund-linked notes here to illustrate a type of customer product that could be affected by the Proposed Rules' overly narrow hedging exemption for covered funds, we note that exposure to the performance of a covered fund provided through a note could generally also be provided through an over-the-counter derivative, such as a swap, which could be similarly affected. Customers determine which type of instrument best serves their needs.

its performance.[228] In the simplest example of the former structure (a "**Bond Plus Equity PPN**"), the allocation to the bond portfolio and the fund reference asset, respectively, is generally static. In the latter structure (a "**Bond Plus Option PPN**"), the banking entity would dynamically delta hedge its exposure to the embedded option, continually adjusting its position in the underlying fund reference asset, as described below under "Fund-linked Call Options."

In one commonly-used permutation of the Bond Plus Equity PPN structure, referred to as a "constant proportion portfolio insurance," or "**CPPI**," note, the allocation between bond exposure and fund reference asset exposure is dynamically adjusted during the life of the CPPI note according to a pre-established algorithm based on the relative values of these two components. This typically permits greater customer exposure to the profits and losses of the fund reference asset over the life of the note than is available in the statically hedged Bond Plus Equity PPN. In a CPPI note, when the fund reference asset is performing well, the amount notionally allocated to the fund reference asset is increased and the amount notionally allocated to the bond is decreased. Conversely, when the fund reference asset's performance is weak, the bond allocation is increased and the fund reference asset allocation is decreased. The payout on the bond will be equal to the greater of (a) the face amount of the bond and (b) the aggregate performance at maturity of the bond allocation and the fund reference asset allocation.

Fund-linked Call Options. Another common fund-linked product is a cash-settled call option linked to the performance of a fund reference asset. Similar to a plain vanilla option on any other asset, a customer pays a premium to a banking entity in return for a payment at maturity linked to the increase in value, if any, of the fund reference asset over the strike price. The exposure of the customer to the fund reference asset is typically greater than the premium amount paid. To the extent that the net asset value of the fund reference asset is less than the strike price at maturity, the option expires worthless. As described above, such options may be embedded in notes linked to fund reference assets.

Similar to any other equity option, call options on fund interests are generally hedged by dynamic delta hedging in the underlying reference equity interest — in the case of fund-linked options, the reference fund asset. At a basic level, this hedging methodology is based on the principle that the value of a call option on an equity interest may be replicated at any point in time by a position of a particular size in the underlying equity asset and a position in a risk-free bond, such as a Treasury bond. The size of this equity position, which, prior to the time of expiration, will always be less than the notional amount of equity underlying the option, is determined through proprietary option valuation models (typically derived from commonly used methodologies, such as the Black-Scholes methodology) that are validated and controlled by independent risk managers within the banking entity. These models take into account a variety of inputs including, for example, the initial value of the equity interest, the volatility of the value of the equity interest, interest rates, the strike price of the option, the time remaining until expiration of the option and expected distributions on the equity interest. The relationship of the value of the

[228] PPNs that offer partial principal protection would have a bond hedge that would provide a payment at maturity equal to this lower amount.

option at any time to that of the required hedge position in the underlying asset is referred to as the option's "delta." "True options" nearly always have a delta of less than 1.0. Since the inputs to the option valuation model will constantly vary during the life of the option, the delta will change. Delta hedging therefore requires ongoing dynamic adjustment to the size of the hedge position (which will never be equal to the amount of exposure when the delta is less than 1.0) to maintain delta neutrality, typically accomplished in part by buying and selling interests in the fund reference asset.

Other Fund-Linked Products. Because payouts can be structured in many different ways to meet varying customer needs, customers are not limited to the structures described above. Innovation in structuring has resulted in the development of a wide array of different features in recent years, including, for example, coupons (guaranteed fixed payments over a given period), financing (a note with a financing component conveying exposure to a greater notional fund position than could be acquired with the issue price of the note), buffers (conditional protection of principal), "best of" options (tying payouts to the best performing of a given basket of underlying funds), contingencies (payouts conditioned on an underlying fund not breaching one or more barriers), gearing (keying payouts to price movements over the life of a product), among others. These features, and many others, can be added to a product to meet a customer's specific investment or hedging needs.

(b) Profits and Losses Condition

As described above, the hedging exemption for covered funds as drafted permits a banking entity to acquire an interest in a covered fund for customer-related hedging purposes only to facilitate exposure by a customer to the "profits and losses" of the covered fund.[229] We are concerned about the impact of this condition on the ability of banking entities to continue to offer customers certain PPNs, options or other covered fund-linked products that are designed to provide customers with exposure to either or both the profits (or *a portion of the profits*) or the losses (or *a portion of the losses*) of a covered fund reference asset. In other words, the "profits and losses" condition could be read to permit banking entities to hedge only covered fund-linked products with a delta of 1.0 (so-called "delta-one" products) such as total return swaps, that is, products the value of which generally[230] fluctuates in lockstep with the value of the underlying covered fund reference asset.

Given the evolution of the fund-linked products market (as with products linked to other asset classes), customers may choose from a wide array of features that permit customers to tailor potential payouts and loss protection to their particular investment needs, risk/reward profiles or hedging requirements. The fundamental purpose of these features is to provide a

[229] *See* Proposed Rules §__.13(b)(1)(i)(A).

[230] Note that a delta one product can be structured to include financing provided at a specified rate (typically LIBOR plus some spread), resulting in the value fluctuating with interest rates. The important point, however, is that the "profits and losses" condition to the hedging exemption for covered funds could be read to prohibit hedging of covered fund-linked products that offer downside protection or payouts that do not pass through to customers 100% of the profits and losses of a covered fund reference asset.

customer with the freedom to choose *to what extent* it will be exposed to the profits and losses of a fund reference asset. The availability of this optionality, which results in embedded economic optionality, is critical for customers seeking to offset idiosyncratic exposures, diversify their investment portfolios or meet regulatory limitations on permissible investments. For example, pension funds and insurance companies must maintain portfolio values above certain values prescribed by regulation, but thereafter can accept reasonable risks.

Without the ability to adequately hedge a product, banking entities will cease to offer it. We do not believe that Congress intended the Agencies to deprive customers of access to covered fund-linked products issued by banking entities, who represent the majority of participants in the sell-side covered fund-linked products market. Nor do we believe that Congress intended the dramatic negative impact on banking entities' fund-linked products businesses that would result, without discernible accompanying public benefits.

(c) Same Amount of Ownership Interest Condition

The hedging exemption for covered funds also provides that a banking entity may acquire an ownership interest in a covered fund for hedging purposes only "in the same amount of ownership interest in that covered fund . . . ."[231] This condition could be read to prohibit dynamic delta hedging of covered fund-linked products, such as covered fund-linked options and Bond Plus Option PPNs. As discussed above, delta hedging fund-linked products with embedded options is premised on the principle that properly hedging the option requires an ownership interest[232] in the reference asset that is equal to the option's delta rather than the full notional amount underlying the option.

The discussion of the hedging exemption for proprietary trading in the Supplementary Information section of the Proposed Rules shows that the Agencies recognized this, since they noted that:

> "a banking entity ***may need to engage in dynamic hedging***, which involves rebalancing its current hedge position(s) based on a change in the portfolio resulting from permissible activities or from a change in the price, or other characteristic, of the individual or aggregated positions, contracts, or other holdings [being hedged]. The Agencies recognize that, ***in such dynamic hedging***, material changes in risk may require a corresponding modification to the banking entity's current hedge positions."[233]

This applies equally to covered fund-linked products. Therefore, we strongly urge the Agencies either to provide a single hedging exemption applicable to both the proprietary trading and

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[231] *See* Proposed Rules §__.13(b)(1)(ii)(B).

[232] Such ownership interest could take the form of a direct acquisition of securities issued by a covered fund or a synthetic investment through a derivative, each of which would be an "ownership interest" as that term is defined in the Proposed Rules. *See* Proposed Rules §__.10(b)(3).

[233] *See* 76 Fed. Reg. at 68875 (emphasis added).

covered fund portions of the Volcker Rule, eliminating the additional conditions in the hedging exemption for covered funds as proposed, or to clarify that the same amount of ownership interest condition explicitly permits delta hedging of covered fund-linked products.

The same amount of ownership condition also could be read to prohibit certain forms of portfolio hedging of customer transactions. We believe that no discernible policy purpose underlying the Volcker Rule would be served by requiring banking entities to forgo the advantages of portfolio hedging. As the Agencies state in the preamble, the "essential element" of the hedging exemption for proprietary trading is "that the transaction hedge or otherwise mitigate one or more specific risks," which, "[n]otably, and consistent with the statutory reference to mitigating risks of individual or aggregated positions . . . would include the hedging of risks ***on a portfolio basis***."[234] We believe that the "hedging of risks on a portfolio basis" deemed permissible by the Agencies in the proprietary trading context[235] is equally applicable in the context of portfolio hedging through positions in covered funds, which the final rules should reflect.[236]

(d) Customer Request Condition

The hedging exemption for covered funds as drafted also provides that a banking entity may acquire an interest in a covered fund to hedge only those customer products written "solely to accommodate a specific customer request."[237] This condition could be read to effectively prohibit banking entities from taking initiative in innovating products to match the needs of customers by prohibiting hedging of any covered fund-linked product offered to customers in anticipation of such needs — that is, it could prohibit hedging of covered fund-linked products that a banking entity develops and makes available to existing customers, or offers to new customers, rather than sells to a specific customer only after being approached by the customer in the first instance. Prevented from hedging such products, banking entities would be effectively forced to refrain from developing them. This result ignores longstanding market practice, which is grounded in customer expectations that banking entities will use their unique expertise and familiarity with evolving customer needs to create and offer, in accordance with applicable laws and regulations, new products that reflect such needs. We believe that developing new covered fund-linked products and bringing them to the attention of new and existing customers, which enables customers to leverage the resources and expertise of banking entities as they design their own investment and risk management portfolios, is an important and traditional function of the banking industry.

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[234] *See* 76 Fed. Reg. at 68875 (emphasis added). This is consistent with Senator Merkley's clarification in a colloquy that under the statutory hedging exemption a permissible hedge "[must apply] to specific, identifiable assets, whether it be on an individual or aggregate basis. For example, it would include the hedging of one or more specific risks arising from a portfolio of diverse holdings, such as the hedging of the aggregate risk of one or more trading desks." *See* Colloquy between Senators Merkley and Levin, 156 CONG. REC. S5894 (daily ed. July 15, 2010).

[235] *See* 76 Fed. Reg. at 68875.

[236] *See id.* (emphasis added).

[237] *See* Proposed Rules §__.13(b)(2)(B)(1).

We therefore recommend that, should the Agencies determine not to adopt our recommendation to provide a single hedging exemption, the Agencies eliminate the customer request condition in order to preserve the ability of banking entities to bring innovative or timely product ideas to existing and new customers seeking tailored covered fund exposure who rely on banking entities for their market knowledge and structuring expertise.

(e) Non-Banking Entity Condition

§ __.13(b)(1)(A) of the Proposed Rules appears to provide that a banking entity may not permissibly hedge a customer exposure where the customer is a banking entity. This condition is not required by the statute, and the Agencies do not discuss the rationale for it in the preamble. Yet the condition has the potential to impose a substantial compliance burden and introduce needless uncertainty into the financial markets by effectively requiring that a banking entity entering into a customer trade independently determine whether its customer is a "banking entity."

As discussed in Section V.A above, embedded within the definition of "banking entity" is a test for whether a given entity is an "affiliate" of another banking entity. This test in turn incorporates the definition of "control" under the Bank Holding Company Act. This definition of "control" captures entities, among others, over which a "controlling influence" is exerted, a determination that the Federal Reserve has described as an "all facts and circumstances" test.[238] The availability of the hedging exemption for covered funds can therefore be read to be effectively conditioned on a banking entity determining whether a potential customer is subject to the "control" of another banking entity. In light of the nebulous nature of the control determination that a banking entity would be required to undertake and the difficulty of making such judgments (if even possible) in the timeframe the market demands, this condition could introduce great uncertainty into a closely interconnected market that depends on the ability of participants to honor their mutual obligations.

Moreover, we believe that the non-banking entity condition is unnecessary even where a potential customer can be determined conclusively to be a banking entity, since any banking entity will already be prohibited from entering into trades that do not constitute a permitted activity. In fact, it is not uncommon for banking entities to enter into permitted, *bona fide* hedging transactions with each other. For example, the fund-linked products desk of one banking entity might hedge covered fund exposure arising from a customer driven transaction by entering into a risk mitigating derivative transaction with the fund-linked products desk of a different banking entity, rather than directly subscribing to an interest in the underlying fund. Banking entities should not be charged with policing the Volcker Rule compliance of other banking entities. Imposing this additional layer of restriction on permissible customer-related transactions through the hedging exemption for covered funds would serve no policy purpose but would inject needless uncertainty into the market and unnecessarily prohibit otherwise valid transactions.

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[238] *See* Policy Statement on Equity Investments in Banks and Bank Holding Companies at 5-6 (Sept. 22, 2008) (to be codified at 12 C.F.R. § 225.144).

We therefore recommend that the Agencies provide that a banking entity may (i) rely on a representation from a potential customer to the effect that the potential customer is not a "banking entity," even if such potential customer is later determined to have been a banking entity at the time of such representation; and (ii) permissibly hedge a customer exposure where the customer is a banking entity so long as the customer banking entity represents that it is engaging in a permitted activity under the Volcker Rule in connection with the transaction giving rise to such exposure.

(f) Interaffiliate Transactions

We agree with the recommendation in the SIFMA comment letter on the proprietary trading portion of the Volcker Rule[239] that otherwise permissible activities by affiliated banking entities linked through use of interaffiliate swaps should be viewed as a single transaction for purposes of complying with a permitted activity exemption, including the hedging exemption for covered funds. Failing to allow for such ordinary course practices would impose a needless impediment on the ability of banking entities to manage customer-driven risk, without any discernible corresponding public benefit.

(g) Anti-Evasion Authority

In support of their determination to narrowly limit the hedging exemption for covered fund activities, the Agencies suggest that hedging through investments in covered funds poses a higher risk of evasive behavior than is posed by hedging through investments in other asset classes, noting that "because of the possibility that using an ownership interest in a covered fund as a hedging instrument may mask an intent to evade the limitations on the amount and value of ownership interests in a covered fund or funds under §__.12, the proposed rule contains several [requirements in addition to those imposed on the hedging exemption for proprietary trading] . . ."[240]

The Agencies provide no evidentiary or even theoretical support for this statement. Covered funds are simply one among a wide variety of asset classes to which banking entities offer their customers exposure through structured products. We believe that the suggestion that hedging in covered funds poses higher risks of evasive behavior is unfounded. Fund-linked products, including those linked to the performance of covered funds, are subject to the same internal compliance policies and supervision as all other products offered by banking entities. We believe that the Agencies should not restrict the scope of the hedging exemption for covered funds based on the unsupported premise that this asset class is somehow more susceptible to abuse than any other.

Moreover, addressing evasion concerns through an overly restrictive permitted activity for risk-mitigating hedging activities unnecessarily limits the ability of banking entities to

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[239] *See* SIFMA Comment Letter on Proprietary Trading at Section VII.G.

[240] *See* 76 Fed. Reg. at 68909.

effectively manage risk in spite of the Agencies' robust authority to order banking entities to terminate evasive behavior. The statutory text of the Volcker Rule provides that when an Agency has "reasonable cause to believe" that a banking entity under its jurisdiction has "made an investment or engaged in an activity in a manner that functions as an evasion of the requirements of [the Volcker Rule] (including through an abuse of any permitted activity) or otherwise violates the restrictions under [the Volcker Rule]," such Agency may, after due notice and opportunity for hearing, order the banking entity "to terminate the activity and, as relevant, dispose of the investment."[241] Further, the statute provides that the anti-evasion provision may not be construed "to limit the inherent authority of any Federal agency . . . to further restrict any investments or activities under otherwise applicable provisions of law."[242] In light of this expansive authority to order a banking entity to terminate evasive behavior, we believe that it is unnecessary for the Agencies to provide an overly narrow permitted activity exemption for risk-mitigating hedging activities that would materially limit the ability of banking entities to manage risk effectively.

We also believe that, coupled with the Agencies' anti-evasion authority, reasonably designed policies and procedures governing when an acquisition of an ownership interest in a covered fund is a permissible hedge, which will be established in connection with the Proposed Rules' compliance requirements, and which will be subject to review by regulators during the supervisory process, should sufficiently address any evasion concerns that may have led the Agencies to draft an overly narrow hedging exemption for covered funds.

(h) Grandfathered Hedging Activities

Although the recommendations above address the potential impact of the hedging exemption for covered funds on the *future* ability of a banking entity to provide covered fund-linked products to customers, the same conditions could cause substantial disruption to ongoing risk-mitigating hedging activities involving acquisitions of ownership interests in covered funds to hedge *existing* covered fund-linked products already sold to and held by customers. Banking entities to date have sold a large number of products linked to the performance of covered funds, many of which have five- to seven-year (or even longer-dated) maturities. As discussed above, although the Proposed Rules would not directly prohibit banking entities from maintaining obligations to customers incurred in connection with the sale of these products, the ability of banking entities to appropriately hedge their associated risk exposure is imperiled by the conditions to the hedging exemption for covered funds. Banking entities are concerned that under the Proposed Rules they could be prevented from dynamically hedging, and engaging in other customary hedging practices with respect to, such exposure. As a consequence, a conflict could arise between the Proposed Rules' effective prohibition on hedging such exposure, on the one hand, and banking entities' obligations to properly manage risk as part of the conduct of safe and sound banking activities, on the other. To resolve this conflict and remain in compliance with their regulatory obligations, banking entities might have no alternative other than to seek to

[241] *See* 12 U.S.C. § 1851(e)(2).

[242] *See id.*

invoke contractual rights, such as hedging disruption or other change-in-law or illegality clauses, in order to prematurely terminate existing agreements with customers.

Widespread termination of existing agreements is likely to harm customers by disrupting their investment and risk management programs and potentially triggering losses due to premature redemption. In the wake of widespread redemptions by banking entities of covered fund interests held as hedges of customer transactions, asset managers of such covered funds could be forced to sell underlying fund assets to generate sufficient redemption proceeds. This could create price pressure for assets in other markets. Widespread unwind of previously permissible hedges of customer-driven transactions could also have a knock-on impact as investors are forced to unwind their own hedges. Banking entities sell covered fund-linked products to institutional customers seeking to hedge exposure incurred in connection with selling such products to their own customers. Given the maturities of these products, many will still be outstanding at the end of the conformance period. We believe that Congress could not have intended these disruptive and costly results, and we believe that it is incumbent on the Agencies to prevent the potential harm to investors, the safety and soundness of banking entities and U.S. financial stability that would accompany it.

We therefore request, in the event that the Agencies determine not to adopt our other recommendations, that the Agencies provide that banking entities may continue to engage in the types of risk-mitigating hedging activities that they have undertaken to date in respect of covered fund-linked products sold to customers before the effective date of the Volcker Rule, so long as such risk-mitigating hedging activities comply with the conditions that appear in the hedging exemption for proprietary trading.

F. SBICs

> ***SIFMA Recommendation***: The Agencies should clarify that an "investment that is designed primarily to promote the public welfare, of the type" permitted under 12 U.S.C. 24(Eleventh) is not limited to investments in the United States.

The Proposed Rules implement and expand the statutory exemption for acquiring or retaining an ownership interest in small business investment companies and certain similar investments, including those "designed primarily to promote the public welfare, of the type permitted under [12 U.S.C. 24(Eleventh)] (the "**SBIC exemption**"). In doing so, the Agencies note in the preamble that permitting banking entities to sponsor and invest in such entities "will provide valuable expertise and services to these types of entities, as well as help enable banking entities to provide valuable funding and assistance to small business and low- and moderate-income communities."[243]

[243] 76 Fed. Reg. at 68908.

We strongly support the Agencies' implementation of the SBIC exemption, and request that the Agencies clarify in the final rules that the SBIC exemption extends to investments outside the United States that are "of the type permitted under [12 U.S.C. 24(Eleventh)]" including so-called "microfinance" and "social finance" investments. Many banking entities have developed investment strategies of this type with an intent to generate impact beyond financial return, simultaneously earning a reasonable rate of return while achieving positive impact on low-income and excluded populations around the world. Microfinance initiatives, for example, allow borrowers to start or expand small, self-sufficient businesses. These businesses support borrowers' exit from poverty, contributing to improved living conditions, nutrition and educational opportunities. Other social finance investments take the form of investments in infrastructure or local businesses.

Clarifying that the SBIC exemption extends to such investments is the proper interpretation of the statutory text, and is consistent with congressional intent. The statutory phrasing, "of the type," conveys that this exemption should be broadly interpreted and that 12 U.S.C. § 24 merely provides an example of a permitted investment. The Agencies must give effect to this interpretation — otherwise the words "of the type" would be rendered superfluous, which is impermissible.[244] Indeed, the underlying legislative history confirms that Congress intended for this language to be interpreted broadly. As Senator Merkley noted in his colloquy with Senator Levin, the SBIC exemption is intended to exempt investments that "advance a 'public welfare' purpose. It permits investments in [SBICs], which are a form of regulated venture capital fund in which banks have a long history of successful participation. The subparagraph also permits investments 'of the type' permitted under the paragraph of the National Bank Act enabling banks to invest in a range of low-income community development and other projects." In Senator Merkley' words, the SBIC exemption "***is flexible enough to permit the regulators to include other similar low-risk investments with a public welfare purpose***."[245] We believe that microfinance and social finance investments outside the United States, so long as banking entities can demonstrate that they advance a public welfare purpose, are therefore clearly contemplated within the statutory text of the SBIC exemption, and that the Agencies should clarify this in the final rules.

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[244] *E.g.*, *United States v. Alaska*, 521 U.S. 1, 59 (1997) ("The Court will avoid an interpretation of a statute that renders some words altogether redundant.").

[245] Colloquy between Senators Merkley and Levin, 156 CONG. REC. S5894 (daily ed. July 15, 2010) (emphasis added).

G. Offshore Exemption

> ***SIFMA Recommendation***: A foreign banking organization should be permitted to invest as a passive investor in a covered fund sponsored and controlled by an unaffiliated third party as long as such foreign banking organization does not offer or sell ownership interests in the covered fund to U.S. residents and otherwise complies with the statutory conditions of the offshore exemption.

Section (d)(1)(I) of the Volcker Rule contains a "permitted activities" exemption for offshore transactions by foreign banking organizations that are not directly or indirectly controlled by a U.S. company. That exemption provides, in relevant part, as follows:

> "The acquisition or retention of any equity, partnership or other ownership interest in, or sponsorship of, a hedge fund or a private equity fund by a banking entity . . . solely outside 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 . . . ."

Because the proviso is written in the passive voice, it is ambiguous whether the condition applies only to offers or sales to a U.S. resident by the FBO or also to offers or sales made by third parties over which the FBO has no control. We believe that the Agencies should interpret the condition as being limited to offers or sales by the FBO. If this condition were construed so that the offshore exemption could be lost based on the actions of third parties beyond the FBO's control, the Volcker Rule would severely restrict an important channel of foreign investment in the United States. This could have an unprecedented extraterritorial impact that Congress could not possibly have foreseen and should not be presumed to have intended in the absence of clear and unmistakable language to that effect.

Tens of billions of dollars of foreign investment in the United States are currently made by FBOs through investments directly in U.S. hedge funds and private equity funds, including hedge funds and private equity funds that are unaffiliated with any banking entity, or indirectly through foreign feeder funds that invest in U.S. funds. The range of entities constituting FBOs include sovereign wealth funds that own or control foreign banks with branches, agencies, commercial lending companies or bank subsidiaries in the United States. Indeed, FBOs (including sovereign wealth funds) can account for the lion's share of the limited partnership interests ("**LP interests**") or limited liability company interests ("**LLC interests**") in some of the largest U.S. hedge funds and private equity funds, including those unaffiliated with a banking entity. Those foreign investment dollars will have to be withdrawn, with potentially serious adverse effects on the U.S. financial economy, if FBOs are no longer permitted to retain investments in such funds because fund interests have been offered or sold to U.S. residents by their third-party sponsors. It would also cause an important source of future foreign investment dollars to dry up.

We do not believe that Congress intended for the Volcker Rule to cause this important source of foreign investment in the United States to be disrupted or dry up, solely because someone other than an FBO has offered or sold interests in third-party funds to a U.S. resident, if the FBO's investments otherwise satisfy all of the statutory conditions of the offshore exemption, including taking and holding the investment outside the United States.

To envision the potential extraterritorial impact of the Volcker Rule if the offshore exemption were construed to prohibit offers or sales to U.S. residents by persons other than an FBO, consider the following example. Suppose that an FBO acquired an interest in a hedge fund or private equity fund that was organized under foreign law and sponsored by an unaffiliated third party, but was otherwise considered to be a covered fund or a similar foreign fund. That fund invested solely in foreign real estate or foreign companies. The FBO acquired and held its interests in the fund through an account located outside the United States. Now suppose that the sponsor of the fund offered or sold a single interest in the fund to a single U.S. resident, a possibility that is very likely in our increasingly globalized world. If such an action were construed to be inconsistent with the offshore exemption, the FBO could be in violation of the Volcker Rule and be required to divest its interest.

It is inconceivable that Congress intended for the Volcker Rule to prohibit essentially foreign investments by foreign banking entities in foreign property, without saying so plainly and unmistakably. Indeed, it is not clear that an interpretation of the offshore exemption that could lead to this result would survive judicial scrutiny under *Morison v. National Australian Bank*.[246]

In short, we request that the offshore exemption be construed so that FBOs may continue to make passive investments in third-party U.S. and foreign hedge funds and private equity funds, as long as the FBOs are not the ones who offer or sell any ownership interests in the funds to U.S. residents and otherwise comply with the statutory conditions of the offshore exemption.

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[246] *Morrison v. Nat'l Australia Bank Ltd.*, 130 S. Ct. 2869, 2877 (2010) (internal quotation marks omitted); see id. at 2877-78 (collecting cases).

VII. Super 23A

A. Covered Transactions

> ***SIFMA Recommendation***: The phrase "covered transaction, as defined in section 23A of the Federal Reserve Act" should be construed to mean the list of prohibited transactions contained in Section 23A(a)(7) of that Act, as qualified by the list of excluded transactions contained in Section 23A(d) of that Act, including the exclusion for intraday extensions of credit contained in the Board's Regulation W.

Super 23A prohibits a banking entity from entering into any transaction with certain related hedge funds and private equity funds, if the transaction "would be a covered transaction, as defined in section 23A of the Federal Reserve Act." The Agencies construed the phrase "covered transaction, as defined in section 23A" to be any prohibited transaction listed in Section 23A(b)(7) of the Federal Reserve Act, without taking into account the excluded transactions contained in Section 23A(d) of that Act. We believe that this interpretation of the phrase conflicts with the plain language and legislative history of Section 23A of the Federal Reserve Act. The phrase should have been construed to be any prohibited transaction listed in Section 23A(b)(7) of the Federal Reserve Act, as qualified by the excluded transactions in Section 23A(d) of that Act, including the exclusion for intraday extensions of credit contained in the Board's Regulation W.[247]

The Supreme Court has consistently held that when the language of a statute is clear and unambiguous and does not produce an absurd result or suggest a scrivener's error, that is the end of the matter.[248] An agency interpretation of a statute that is inconsistent with the plain language of the statute is not entitled to *Chevron* deference.[249] The Supreme Court has also

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[247] 12 C.F.R. Part 223. Regulation W is the Board's regulation that implements the provisions of Sections 23A and 23B of the Federal Reserve Act.

[248] *See, e.g.*, *Chevron U.S.A., Inc. v. Natural Resources Defense Council*, 467 U.S. 837, 842-843 (1984) ("If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.") (Stevens, J., opinion of the Court); *Green v. Bock Laundry Machine Co.*, 490 U.S. 504, 509-510 (1989) (Stevens, J., opinion of the Court) (when the literal reading of a statute produces an "odd result," we turn to the legislative history for guidance as to congressional intent and implement that intent no matter how plain the text of the statute); *id.* at 527-28 (Scalia, J., dissenting) (agreeing that the plain language rule does not apply when a statute would produce an "absurd . . . result" and that the statute should be interpreted to avoid the absurd result, but disagreeing on the use of legislative history to resolve the interpretive problem); *INS v. Cardoza-Fonseca*, 480 U.S. 421, 452 (1987) (Scalia J., concurring in the judgment) (It is a "venerable principle that if the language of a statute is clear, that language must be given effect – at least in the absence of a patent absurdity."). *See also* Breyer, *supra* note 12, at 848-851 (legislative intent as evidenced by legislative history can be used to override the plain meaning of a statute if the plain meaning produces an absurd result or reflects a scrivener's error).

[249] *Chevron* 467 U.S. at 842-843 ("If the intent of Congress is clear, that is the end of the matter; for the court, as well as the agency, must give effect to the unambiguously expressed intent of Congress.")

consistently held that the words of a statute must be interpreted in light of the statute as a whole, and the legal backdrop against which the statute was drafted.[250] The language of Section 23A of the Federal Reserve Act and its evolution over time, as well as the exclusion for intraday extensions of credit in the Board's Regulation W, which was mandated by Congress in the Gramm-Leach-Bliley Act of 1999 (the "**GLB Act**"), are part of the legal backdrop against which Super 23A must be construed.

We believe that the language of Section 23A of the Federal Reserve Act, as incorporated by reference into Super 23A, is clear and unambiguous on the following point: that the term "covered transaction" means the list of transactions contained in Section 23A(b)(7), as qualified by the list of excluded transactions contained in Section 23A(d).

Section 23A(b)(7) defines the term "covered transaction" as consisting of the following transactions entered into by a "member bank":

> "(A) a loan or extension of credit to the affiliate;
>
> (B) a purchase of or an investment in securities issued by the affiliate;
>
> (C) a purchase of assets, including assets subject to an agreement to repurchase, from the affiliate, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;
>
> (D) the acceptance of securities issued by the affiliate as collateral security for a loan or extension of credit to any person or company; or
>
> (E) the issuance of a guarantee, acceptance, or letter of credit, including a endorsement or standby letter of credit, on behalf of an affiliate."

Section 608(a) of the Dodd-Frank Act has amended this list, effective one year after the "transfer date," meaning July 21, 2012, which is the first anniversary of the date on which the functions of the Office of Thrift Supervision were transferred to the OCC.[251] It also happens to be the date on which the Volcker Rule becomes effective. Below is the amended list, blacklined to show the changes:

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[250] *See Green* 490 U.S. at 528 (Scalia, J., concurring in the judgment) (meaning of terms of a statute should determined "on the basis of which meaning is . . . most compatible with the surrounding body of law into which the provision must be integrated."); *Deal v. United States*, 508 U.S. 129, 132 (1993) (Scalia, J.) (it is a "fundamental principle of statutory construction . . . that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used.").

[251] The "transfer date" occurred on July 21, 2011. *See* 76 Fed. Reg. 39246, 39246 (July 6, 2011).

"(A) a loan or extension of credit to the affiliate, including a purchase of assets subject to an agreement to repurchase;

(B) a purchase of or an investment in securities issued by the affiliate;

(C) a purchase of assets, except such purchase of real and personal property as may be specifically exempted by the Board by order or regulation;

(D) the acceptance of securities <u>or other debt obligations</u> issued by the affiliate as collateral security for a loan or extension of credit to any person or company; ~~or~~

(E) the issuance of a guarantee, acceptance, or letter of credit, including a endorsement or standby letter of credit, on behalf of an affiliate;

<u>(F) a transaction with an affiliate that involves the borrowing or lending of securities, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate; or</u>

<u>(G) a derivatives transaction, as defined in paragraph (3) of section 5200(b) of the Revised Statutes of the United States . . . with an affiliate, to the extent that the transaction causes a member bank or a subsidiary to have credit exposure to the affiliate</u>."

Section 23A(d) provides that "***[t]he provisions of this section [i.e., Section 23A]***, except paragraph (a)(4) of this section, ***shall not be applicable to***" a specified list of excluded transactions. We do not believe that the meaning of these words could be more plain and unambiguous: If the provisions of Section 23A are not applicable to the list of transactions set forth in Section 23A(d), then those transactions cannot be "covered transactions" for purposes of that statute. If they are not covered transactions for purposes of Section 23A of the Federal Reserve Act, they are not covered transactions for purposes of Super 23A.

The transactions that Section 23A(d) excludes from the term "covered transaction" consist of the following:

(1) any transaction, subject to the prohibition contained in subsection (a)(3) of this section, with a bank—

(A) which controls 80 percentum or more of the voting shares of the member bank;

(B) in which the member bank controls 80 per centum or more of the voting shares; or

(C) in which 80 per centum or more of the voting shares are controlled by the company that controls 80 per centum or more of the voting shares of the member bank;

(2) making deposits in an affiliated bank or affiliated foreign bank in the ordinary course of correspondent business, subject to any restrictions that the Board may prescribe by regulation or order;

(3) giving immediate credit to an affiliate for uncollected items received in the ordinary course of business;

(4) making a loan or extension of credit to, or issuing a guarantee, acceptance, or letter of credit on behalf of, an affiliate that is fully secured by—

(A) obligations of the United States or its agencies;

(B) obligations fully guaranteed by the United States or its agencies as to principal and interest; or

(C) a segregated, earmarked deposit account with the member bank;

(5) purchasing securities issued by any company of the kinds described in section 1843(c)(1) of [title 12 of the United States Code] [i.e., a bank service company];

(6) purchasing assets having a readily identifiable and publicly available market quotation and purchased at that market quotation or, subject to the prohibition contained in subsection (a)(3) of this section, purchasing loans on a nonrecourse basis from affiliated banks; and

(7) purchasing from an affiliate a loan or extension of credit that was originated by the member bank and sold to the affiliate subject to a repurchase agreement or with recourse."

Assuming that the Proposed Rules properly define the term "covered fund" to exclude any "bank" as defined by Section 3 of the FDI Act or any bank service company as defined by Section 4(c)(1) of the BHC Act, the exclusions in paragraphs (1), (2) and (5) above would not have any relevance. Those paragraphs only exclude the defined transactions to the extent they are entered into with affiliates that are "banks" or bank service companies. In contrast, we believe that the rest of the exclusions are highly relevant in limiting the scope of transactions defined as "covered transactions" for purposes of Super 23A.

If Congress had intended the phrase "covered transaction, as defined by Section 23A" to mean the list of prohibited transactions in Section 23A(a)(7), without regard to Section

23A(d), it could have used the words "covered transactions, as defined by Section 23A(a)(7)." Instead, it used the words "as defined by Section 23A," meaning the entirety of Section 23A. In our view, the plain language of the entirety of Section 23A dictates that the term "covered transactions" means the list of prohibited transactions contained in Section 23A(a)(7), as qualified by the list of excluded transactions in Section 23A(d).

This conclusion based on the plain meaning of the words used in Section 23A is also supported by the original wording of Section 23A and the evolution of those words and the structure of Section 23A over time. As originally enacted in 1913, Section 23A did not contain lettered subsections such as current subsections (a)(7) or (d) or a defined term "covered transaction." Instead, the statute simply prohibited a list of transactions substantially similar to the transactions currently listed in Section 23A(a)(7), and excluded from this prohibition a list of transactions substantially similar to the excluded transactions currently listed in Section 23A(d). It was clear from this original structure of the statute that the transactions covered by the statute were the sum of the list of prohibited transactions, as qualified by the list of excluded transactions.

In 1982, Congress amended the statute by assigning lettered subsections to the original wording of Section 23A. It assigned new subsection (a)(7) to the paragraph containing the list of prohibited transactions and added the label "covered transaction" to those words. It assigned new subsection (d) to the paragraph containing the list of excluded transactions and added the heading "exemptions" to that new subsection. Despite this new grouping and labeling, Congress did not make any substantive changes to the wording of these two paragraphs. In particular, the wording of the paragraph containing the excluded transactions continues to describe them as transactions to which the statute does not apply. As a result, we do not believe that Congress intended to make any substantive changes to the statute, but instead to continue treating the list of transactions "covered" by the statute as the sum of the prohibited transactions in new subsection (a)(7) as qualified by the list of excluded transactions in new subsection (d).[252]

This conclusion is supported by the report of the Senate Banking Committee issued in connection with the 1982 amendments. According to that report, the 1982 amendments were largely based on the Federal Reserve's recommendations in a 1981 report to the Committee.[253] In that report, the Federal Reserve complained that Section 23A was "a very difficult statute to interpret" partly because it was "poorly drafted," which made compliance and

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[252] We do not believe that the insertion of the word "exemptions" instead of the word "exclusions" as the heading for Section 23A(d) is inconsistent with this conclusion. The Supreme Court has consistently held that headings should not be given much weight in interpreting the meaning of a statute. *See*, e.g., *Trainmen v. Baltimore & Ohio R.R.*, 331 U.S. 519, 528 (1947) ("[H]eadings and titles are not meant to take the place of the detailed provisions of the text. Nor are they necessarily designed to be a reference guide or a synopsis. Where the text is complicated and prolific, headings and titles can do no more than indicate the provisions in a most general manner . . .").

[253] S. Rep. No. 97-536, at 30 (1982). The Federal Reserve initially proposed amendments to Section 23A in 1978, which were resubmitted in 1981 with clarifying technical amendments.

enforcement difficult.[254] In addition, the Federal Reserve noted that "the statute cannot be analyzed effectively without first substantially reorganizing it into a more logical structure."[255] "Transactions . . . covered by Section 23A," according to the Federal Reserve, "[were] spread rather haphazardly over several paragraphs of the statute" and "exemptions [were] scattered over various parts of the statute."[256] Since the list of prohibited transactions now grouped in subsection (a)(7) were all grouped in a single paragraph of the original statute, and the list of excluded transactions now grouped in subsection (d) were grouped in another paragraph of the original text, the wording of the Federal Reserve's report – that the "[t]ransactions covered by Section 23A [were] spread rather haphazardly over several paragraphs of the statute" – is further evidence that the list of transactions considered to be "covered transactions" for purposes of Section 23A were intended by Congress to consist of the sum of the list of prohibited transactions in the one paragraph as qualified by the list of excluded transactions in the separate paragraph.

Based on the same reasoning, we believe that the phrase "covered transaction, as defined in Section 23A" must be construed to exclude any intraday extension of credit from a banking entity to a related fund, as long as it satisfies the conditions of Section 223.42(l) of the Board's Regulation W, as if the banking entity were the member bank and the related covered fund were the affiliate. Although the exclusion for intraday extensions of credit contained in Section 233.42(l) of Regulation W was promulgated by the Board rather than enacted by Congress, it was promulgated at the express direction of Congress in Section 121(b)(3) of the Gramm-Leach-Bliley Act and has not been revisited by Congress.[257] Thus, the intraday extension of credit exclusion should be viewed as one of the excluded transactions that Congress intended as qualifications to the list of transactions that are deemed to be covered transactions for purposes of Section 23A, and hence Super 23A.

Although we believe that the Agencies are required by the plain language of Super 23A, as construed in light of the legal backdrop of Section 23A of the Federal Reserve Act and Regulation W, to define the term "covered transactions" in a manner that excludes all of the relevant transactions listed in Section 23A(d) and intraday extensions of credit under Regulation W, the exclusions for the following transactions are most critical for purposes of preserving and promoting the safety, soundness, efficiency and stability of the U.S. and global financial system:

- transactions fully secured by U.S. government securities and cash collateral;

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[254] Board of Governors of the Federal Reserve System, *A Discussion of Amendments to Section 23A of the Federal Reserve Act Proposed by the Board of Governors of the Federal Reserve System* 2 (1981).

[255] *Id.*

[256] *Id.* at 29.

[257] Financial Services Modernization Act of 1999, PUB. L. NO. 106-102, 113 STAT. 1380 (1999) ("Not later than 18 months after the date of the enactment of the Gramm-Leach-Bliley Act, the Board shall adopt final rules under this section to address as covered transactions credit exposure arising out of derivative transactions between member banks and their affiliates and intraday extensions of credit by member banks to their affiliates.").

- intraday extensions of credit made in connection with the clearance and settlement of transactions in financial instruments.

As a result, we urge the Agencies to exclude these two categories of transactions from the prohibitions of Super 23A as a matter of priority.

B. Collateral

> ***SIFMA Recommendation***: The Agencies should clarify that the DPC exemption permits a banking entity to take ownership interests in a related fund as collateral to secure extensions of credit to a customer notwithstanding Super 23A.

The Proposed Rules provide an exemption for the acquisition or retention of ownership interests in, or sponsorship of, a covered fund "in the ordinary course of collecting a debt previously contracted in good faith . . ." (the "**DPC exemption**").[258] The Agencies explain in the preamble that this exemption "will enable banking entities to manage their risks and structure their business in a manner consistent with their chosen corporate form and in a manner that otherwise complies with applicable laws."[259] The Agencies appear to have exercised their exemptive authority under subsection (d)(1)(J) in order to establish the DPC exemption, as they explain in the preamble that doing so "would promote and protect the safety and soundness of a banking entity, and would also promote and protect the financial stability of the United States."[260]

We strongly support the Agencies' establishment of a DPC exemption. The power to take equity in satisfaction of a debt obligation or to take equity to secure performance of a debt obligation, including interests of third-party borrowers in related covered funds, is one of the most basic incidents of the power to extend credit and to do so in a manner that promotes and preserves the safety and soundness of the banking entity and the financial stability of the United States. The absence of such power would compromise safety and soundness and could have an adverse impact on the financial stability of the United States.

The DPC exemption as drafted, however, conflicts with these safety and soundness goals because it does not expressly provide that banking entities may take ownership interests in related covered funds as collateral to secure any extensions of credit to their customers notwithstanding Super 23A. By its terms, Super 23A prohibits a banking entity from entering into a "covered transaction," as defined in Section 23A of the Federal Reserve Act, with any related fund. "Covered transaction" is defined in Section 23A of the Federal Reserve Act to mean, *inter alia*, "the acceptance of securities or other debt obligations issued by [an] affiliate as collateral security for a loan or extension of credit to any person or company."[261] As a result, under the

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[258] *See* Proposed Rules § __.14(b)(i).

[259] 76 Fed. Reg. at 68914.

[260] *See id.*

[261] *See* 12 U.S.C. § 371c(b)(7)(D).

Proposed Rules, a banking entity is permitted to take ownership interests in related funds in satisfaction of a debt previously contracted, but may not be clearly permitted to take such ownership interests as collateral to secure the extension of credit in the first place. This seems to defy common sense and may reduce the ability of a banking entity to use certain classes of collateral to secure extensions of credit.

We therefore request that the Agencies clarify that the DPC exemption permits a banking entity to take ownership interests in related funds as collateral to secure extensions of credit, notwithstanding any language to the contrary in Super 23A.

If the Agencies do not implement our recommended clarification, we request that they at least clarify that Super 23A does not prohibit a banking entity from accepting interests in related covered funds as collateral for an extension of credit so long as the banking entity does not, in fact, extend credit based on that collateral. It is customary for borrowing clients to hold their interests in covered funds in a single securities account, together with their other investments, and pledge the entire account to a banking entity as collateral. The amount of credit made available by the banking entity is a function of the value of the securities held as collateral and applicable regulations limiting such "margin" lending (the so-called "borrowing base"). Super 23A, however, as written would appear to prohibit a banking entity from accepting interests in related covered funds as collateral even if no extension of credit were made in reliance on the pledged interests in related covered funds (*e.g.*, the interests in related covered funds would be given no collateral value). Without the requested clarification, Super 23A would require a significant restructuring of customer accounts: customers would have to establish a new and separate unencumbered account into which the interests in related covered funds would have to be transferred in order to avoid taking the interests in related funds as collateral in violation of Super 23A.

We believe that an alternative and less burdensome and costly approach would be to clarify that a banking entity would not be a violation of Super 23A if it accepted interests in related funds as collateral so long as the banking entity did not, in fact, extend credit based on that collateral, effectively giving such collateral no collateral value.

VIII. Compliance

A. Which Agency

> ***SIFMA Recommendation***: The Agencies should provide in the final rules that:
>
> (a) **Interpretation**. The Board will have exclusive authority to interpret the Volcker Rule and the Proposed Rules;
>
> (ii) **Examinations**. Where more than one Agency has examination authority over a given banking entity, the Agencies will ensure that any examination of the banking entity under the Volcker Rule will be done on a coordinated basis by the Agencies concerned;
>
> (iii) **Enforcement**. No enforcement action may be initiated by an Agency under the Volcker Rule unless done on a coordinated basis with all the Agencies.

The Proposed Rules do not specify which of the Agencies will have interpretive, examination or enforcement authority with respect to a given banking entity for purposes of the Volcker Rule. The statutory text instructs the five Agencies charged with implementing the Volcker Rule to work together to ensure that their respective rules "are comparable and provide for consistent application and implementation . . . to avoid providing advantages or imposing disadvantages" on the banking entities subject to the Volcker Rule.[262] However, if every banking entity is subject to the interpretive, examination and enforcement authority of as many as all five Agencies at once, there will either be gridlock or Congress's goal of "consistent application and implementation" of the Volcker Rule will assuredly fail. The potential for conflicting interpretive guidance, burdensome and duplicative examinations and the threat of multiple enforcement actions brought by different Agencies despite (or as a result of) good faith compliance with the directives of multiple Agencies is real and could be avoided by implementing the recommendations in this section.

The problem stems largely from the fact that a single "banking entity," for example, a bank subsidiary of a bank holding company, could engage in multiple activities or have multiple legal statuses that result in jurisdiction over the banking entity by more than one Agency. Although outside of the Volcker Rule context the Agencies' exercise of their respective authorities would generally not overlap, without clarification the Agencies could be presumed to have equal and entirely overlapping authority under the Volcker Rule. For example, a bank subsidiary that is a national bank with insured deposits would be regulated by both the OCC and FDIC, for differing purposes. If swap and security-based swap dealer activities were conducted in the bank, the bank would also have to register with, and therefore be supervised by, the CFTC and the SEC with respect to those activities. As a member of the Federal Reserve System, the bank subsidiary would also be subject to a degree of oversight by the Board.

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[262] *See* 12 U.S.C. § 1851(b)(2)(B)(ii).

Without a streamlined Volcker Rule supervisory regime, banking entities could easily receive inconsistent and perhaps even irreconcilable interpretations of the Volcker Rule. Even if the Agencies were to enter into an interagency memorandum of understanding for purposes of coordinating interpretive guidance, the frictions and delays of such an unwieldy process would freeze banking entities' ability to make critical decisions in fast-moving financial markets. The overlapping supervisory framework could also lead to redundant and duplicative examination and compliance costs, as up to five different Agencies exercise their examination authority over the same activities involving the same legal entity at different times. Where a banking entity has, as the Proposed Rules contemplates, an enterprise-wide Volcker Rule compliance policy, conflicting examination reports could lead to crippling uncertainty about how to redress perceived compliance weaknesses, with the knock-on effect of the potential for multiple and conflicting interpretations, examination reports and enforcement actions.

We therefore recommend that the final rules invest a single Agency with authority to interpret the Volcker Rule and the Proposed Rules, subject to consultation with the other Agencies as appropriate. Because the Volcker Rule is an amendment to the BHC Act, we believe that this role is most appropriately played by the Board.

We also recommend that the final rules provide that the Agencies will engage in coordinated examinations of any given banking entity under the Volcker Rule, resulting in a single report of examination and accompanying findings and requirements for each banking entity.

Finally, we recommend that the final rules provide that any enforcement action under the Volcker Rule be initiated by an Agency only on a coordinated basis with all the other Agencies.

B. Timing

> ***SIFMA Recommendation***: The Agencies should clarify that banking entities will have at least one year following issuance of the final rules to develop and implement compliance programs.

The Agencies state in the Supplementary Information that banking entities will be required "to have developed and implemented the required [compliance] program" by the Volcker Rule's effective date of July 21, 2012.[263] The imposition of compliance requirements before the other aspects of the Volcker Rule are operative, and potentially before final rules have even been issued, is contrary to the statute and lacks any reasoned basis.

First, the statute provides a two-year conformance period (subject to further extension by the Federal Reserve) for regulated entities to come into compliance. This provision, on its face, applies to all provisions of the Volcker Rule under Section 13 of the BHC Act,

[263] *See* 76 Fed. Reg. 68855.

including the compliance requirements. However, the Agencies propose to apply the conformance provision to all aspects of the Proposed Rules *except for* the compliance requirements, which would go into effect on the July 21, 2012 effective date. This would impermissibly conflict with the plain text of the statute, which allows for additional time for banking entities to design and implement well considered and effective compliance programs.

Second, there is no reasoned basis to subject banking entities to onerous recordkeeping and reporting requirements immediately for the purpose of monitoring compliance with substantive provisions of the Volcker Rule that will not have operating effect until possibly several years later. Indeed, the compliance provisions are intended to facilitate compliance with, and enforcement of, the Volcker Rule's requirements, but they cannot fulfill this regulatory aim until the underlying requirements are fully in place.

The Agencies acknowledge that the fundamental value of the compliance program is that it "could have positive efficiency effects by generally improving compliance and thereby reduce the consequences associated with noncompliance."[264] As discussed above, it is contrary to law to impose regulatory requirements with such massive costs for years with no corresponding benefit.

Third, the Agencies' final rule may not be issued until well after the proposed July 21, 2011 implementation date for the compliance program requirements, creating significant uncertainty and burdens for banking entities. Developing and implementing a compliance program with respect to the many new restrictions and requirements of the Volcker Rule will be an enormously complex and costly process. Although banking entities have already committed significant resources to designing a compliance program, by necessity banking entities can only anticipate the contours of the final rules. In light of the complexity of the Proposed Rules and the over 1300 questions therein on which the Agencies have sought comment, it is difficult if not impossible to predict the requirements that will ultimately be imposed in the final rules.

For example, banking entities will need time to plan, develop, and implement new systems, policies, procedures, and programs. Although banking entities have existing written policies, procedures, risk limits, and compliance structures in place, they will need to be reviewed and likely substantially revised to comply with the Volcker Rule. This task is further complicated by the global application of the Volcker Rule, since markets and internal systems function differently across geographic regions and may therefore require significant updates and tailored approaches. These various tasks will require significant planning and resources, and it is impossible for banking entities to predict the content of the final rules in order to fully undertake these efforts prior to July 21, 2011.

In light of these considerations, we believe that the Agencies should clarify that banking entities will have the full conformance period provided under the statute, concurrent with the other provisions of the Volcker Rule, to develop and implement compliance programs.

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[264] *See* 76 Fed. Reg. at 68941.

We also believe that the compliance program requirements should be linked to the activities that trigger application of the compliance regime.

Under the Proposed Rules, a banking entity that exceeds the thresholds established for trading assets and liabilities must comply not only with those aspects of Appendix C that relate to proprietary trading activities, but also with those related to covered fund activities *even if the entity's covered fund activities do not meet the thresholds set forth in §__.20(c)(2)(ii).*[265] Likewise, a banking entity that exceeds the thresholds for covered fund activities in §__.20(c)(2)(ii) would have to comply with those aspects of Appendix C that relate to proprietary trading activities, *even if the entity's proprietary trading activities did not meet the thresholds applicable to trading assets and liabilities.*

We do not believe it is appropriate to require a banking entity that has very limited trading activities to establish the type of detailed and costly compliance regime dictated by Appendix C for its trading activities simply because the entity has covered fund investments or activities that exceed the thresholds determined to warrant a detailed "programmatic" compliance regime for those activities. The same is true in the reverse situation — a banking entity with more than $1 billion in trading assets and liabilities, but with covered fund investments and relationships that do not meet the final dollar thresholds applicable to covered fund activities, should not be required to establish and maintain the type of "programmatic" compliance regime described in Appendix C for its limited covered fund activities simply because of the size of its trading activities.

We also believe that the $1 billion thresholds on covered fund investments and assets in §__.20(c)(2)(ii) should not include the amount of investments in, or assets of, funds that (i) are an SBIC, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. § 662); (ii) are designed primarily to promote the public welfare of the type permitted by 12 U.S.C. § 24(Eleventh), such as investments and funds that qualify for low-income housing tax credits ("**LIHTC**") or New Markets Tax Credits ("**NMTC**"); or (iii) qualify for Federal historic tax credits ("**HTC**") or similar state HTC programs.

Investments in, and sponsorship of, each of these types of funds is expressly permitted by the statute itself[266] precisely because of the substantial public benefits associated with these types of investments and funds. For example, SBICs provide funding to our nation's small businesses. Funds that are designed primarily to promote the public welfare provide financial support for, among other things, affordable housing for low- and moderate-income individuals, small businesses that are located in low- and moderate-income areas or areas targeted for redevelopment, and community development financial institutions.[267]

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[265] *See* Proposed Rules § __.20(c).

[266] *See* 12 U.S.C. § 1851(d)(1)(E).

[267] *See* 12 C.F.R. § 24.6.

Including these investments and funds in the dollar thresholds that trigger the programmatic compliance requirements of Appendix C, however, provides banking entities a powerful disincentive to invest in, or sponsor, SBICs, public welfare funds, or HTC funds if doing so could cause the organization to become subject to these burdensome requirements. We believe such a result would be inconsistent with the purposes of the statutory exceptions for these types of funds.

We also believe that existing investments in, and relationships with, a covered fund that a banking entity is required by the Volcker Rule and the Agencies' implementing regulations to divest or terminate should not count towards the dollar thresholds that trigger compliance with Appendix C. It would be incongruous for the rules to require a banking entity to develop and implement the costly programmatic compliance regime mandated by Appendix C simply as a result of investments in, or other relationships with, a covered fund that the banking entity is required to divest or terminate under the Volcker Rule. If such were the case, a banking entity may well be required to implement these compliance requirements only to see its obligation to maintain such a compliance regime disappear during the very same conformance period that the statute gave the firm to bring its investments and activities into compliance with Volcker Rule's restrictions.

Finally, we believe that the covered fund threshold should be determined on a consolidated basis. The $1 billion trading assets/trading liabilities threshold for determining whether a banking entity is subject to Appendices A and C is determined on a consolidated basis, including the trading assets and liabilities of the entity's consolidated subsidiaries and affiliates (but excluding the trading assets and liabilities of unconsolidated affiliates). A similar approach should be taken with respect to the investment and asset thresholds applicable to covered funds in §__.20(c)(2)(ii) of the Proposed Rules. In particular, these thresholds should be based on the investments made in covered funds, and the assets of covered funds sponsored or advised, by the relevant banking entity and its consolidated subsidiaries and affiliates.

IX. Conformance Period

Section (c) of the Volcker Rule grants banking entities an initial conformance period of two years following the effective date to bring their activities and investments in hedge funds and private equity funds into compliance with the Volcker Rule.[268] The Board also has the discretionary authority to provide two types of additional extensions to the initial conformance

[268] *Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities*, 76 Fed. Reg. 8265, 8276 (Feb. 14, 2011). The Board indicates in the Supplementary Information that it is proposing to relocate the initial conformance rules, which became effective in April 2011, from §§ 225.180-182 of Regulation Y to subpart E of the proposed rule text, with certain immaterial conforming and technical changes. The Board has solicited comment on whether the initial conformance rules should be revised. See 76 Fed. Reg. at 68923, 68968. When referring to the initial conformance rules in this letter, we cite to subpart E of the proposed rule text.

period.[269] First, the Board may grant up to three additional years for any non-conforming activities or investments in funds.[270] Second, it may grant up to five additional years after this first set of extensions for investments in, or additional capital contributions to, certain illiquid funds, but only to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010.[271] We also believe that the Board has authority to determine, based on all the facts and circumstances, that any fund is an "illiquid fund" and to provide temporary extended transition periods for illiquid investments in funds that do not fall within the definition of "illiquid fund," in each case if certain standards are satisfied.

The purpose of the conformance provisions is to ensure that banking entities move steadily toward conforming their activities and investments in hedge funds and private equity funds, while minimizing any disruption to the market, such as harm to the relevant banking entity, the funds it sponsors or invests in, the investors in such funds, the companies or other entities in which the funds are invested and the shareholders of the banking entity.[272] This purpose is apparent from the face and structure of the statute, and supported by statements by Senators Merkley and Hagan during the Senate's consideration of the Volcker Rule.[273] The reason for providing the longest transition period for investments in illiquid funds is that they are the most difficult investments to divest without significant harm to the banking entity and those other stakeholders.

The Board has the exclusive authority to issue regulations implementing the statutory conformance provisions. It does not share that rulemaking authority with the other Agencies. The Board issued initial conformance rules on February 14, 2011.[274] The Board stated that it would revisit the initial conformance rules after the Agencies proposed substantive rules.[275]

We believe that the Board should do a complete review of its conformance rules in light of the Proposed Rules, and amend them to address various issues, including the treatment of non-fund entities, new covered transactions and illiquid funds.

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[269] *See* Proposed Rules §§ 248.31(a)(3) and 248.31(b).

[270] *See* Proposed Rules § 248.31(a)(3).

[271] *See* Proposed Rules § 248.31(b).

[272] 75 Fed. Reg. 72741, 72742, 72743 (Nov. 26, 2010).

[273] 156 CONG. REC. S5889, S5899 (daily ed. July 15, 2010).

[274] 75 Fed. Reg. 72741 (Nov. 26, 2010).

[275] *Id.* at 8266.

A. Extended Conformance Period

> ***SIFMA Recommendation***: Because the Agencies were unable to issue final rules implementing the Volcker Rule before the statutory deadline in October 2011,[276] the Board should delay the effective date of the statute until one year after the later of July 21, 2012 and the date on which final rules become effective. Alternatively, the Board should grant a general one-year extension of the conformance period to all covered banking entities in advance.

B. Non-Funds and Similar Funds

> ***SIFMA Recommendation***: The Board should amend its conformance rules to permit banking entities to continue sponsoring or investing in, or entering into new covered transactions with a related, entity that (i) may fall within the term "covered fund" but is not a genuine hedge fund or private equity fund as commonly understood or (ii) is a designated similar fund, for the duration of the conformance period.

We believe that the Board should amend its conformance rules to permit banking entities to continue sponsoring or investing in an entity, and entering into new covered transactions with a related entity, that (i) may fall within the general definition of the term "covered fund" but is not a genuine hedge fund or private equity fund or (ii) is a designated similar fund, for the duration of the conformance period. This would include any covered fund that does not have all of the characteristics of the hedge fund or private equity fund set forth in **Annex B**. It would also include any commodity pool or foreign fund designated as a similar fund. The relief should continue for the duration of the conformance period, including any extensions.

We believe that such relief should be granted for two reasons. First, the proposed definition of the term "covered fund" potentially sweeps in all sorts of legal entities that have never been considered to be hedge funds and private equity funds. Second, the Agencies failed to finalize their regulations implementing the Volcker Rule before the statutory deadline in October 2011,[277] and may not be able to finalize them substantially before the July 21, 2012 effective date of the statute. As a result, there has been considerable uncertainty throughout the process about what will be included within the term "covered fund" in addition to genuine hedge funds and private equity funds. It would be unfair to require immediate compliance with any of the prohibitions in the Volcker Rule, especially Super 23A, with respect to such non-fund entities or designated similar funds.

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[276] *See* 12 U.S.C. § 1851(b)(2)(A).

[277] *Id.*

C. New Covered Transactions

> ***SIFMA Recommendation***: The Board should clarify that a banking entity may, during the conformance period, continue to enter into new covered transactions with a covered fund that was established before the effective date of the statute.

We believe that the Board should also clarify that the reference to "activities" in Section (c)(2) of the statutory text includes all non-conforming activities, including new covered transactions entered into with sponsored or advised funds. A banking entity would therefore be permitted to continue to enter into new covered transactions with covered funds established before the effective date of the Volcker Rule for the duration of the applicable conformance period as determined by the Board.

The text of Section (c)(2) of the Volcker Rule does not limit the applicability of the transition period to any particular class of activities, stating only that "A banking entity . . . shall bring its ***activities and investments*** into compliance with the requirements of [the Volcker Rule] not later than 2 years after the [effective date]."[278] (Emphasis added). Senators Merkley and Levin similarly made no distinction among types of activities in their colloquy discussing Section (c)(2), referring only to "activities" that must be brought "in conformity with the law" by the end of the transition period.[279] We therefore recommend that the Board clarify that it will interpret the general conformance period and potential extensions to apply to all of a banking entity's activities, including new covered transactions entered into with preexisting funds.

D. Illiquid Funds

> ***SIFMA Recommendation***: The Board should amend its conformance rules to provide a meaningful extended conformance period for illiquid funds.

The Board should also revisit the provisions of the conformance rules implementing the extended conformance period for illiquid funds (the "**illiquid funds extension**").[280] The Board's chosen definitions for the elements of the term "illiquid fund" are so narrow that almost no fund will qualify, including most genuinely illiquid funds. Unless corrected, these narrow definitions will have the effect of forcing banking entities to unwind most of their investments in illiquid funds at depressed or even fire sale prices. Such forced sales at depressed prices will damage the capital and earnings of the banking entities. They will also potentially harm investors who based their investment decisions on the assumption that the banking entities would continue alongside them as sponsors and investors for the life of the funds.

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[278] *See* 12 U.S.C. § 1851(c)(2).

[279] 156 CONG. REC. S5898 (daily ed. July 15, 2010).

[280] *See* Proposed Rule § 248.30(b)-(c).

We believe that the rules governing the special extended conformance period for illiquid funds are inconsistent with the purpose of Section (c). The purpose of the Volcker Rule is to promote the safety and soundness of banking entities, not to weaken safety and soundness by causing unnecessary losses to banking entities. The statute gives the Board ample discretion to define the elements of the term "illiquid fund" in ways that are consistent with its purpose. Broader definitions of those elements are consistent with the statutory purpose because they preserve the Board's discretion: the Board can always deny an extension request if the facts and circumstances warrant denial.

Our comments are designed to restore the Board's statutorily mandated discretion to grant – or deny – the special extended conformance period for illiquid funds. To illustrate how the comments in our letter could be implemented, please see our comment letter on the proposed conformance rules.[281]

(1) Pre-Existing Illiquid Funds

We believe that the statutory definition of the term "illiquid fund" is too narrow. Accordingly, we suggest in Section IX.D(2) of this comment letter that, where warranted, the Board should exercise its authority to determine, based on all the facts and circumstances, that any fund is an "illiquid fund." We also believe that the initial conformance rules further restrict the statutory definition in a manner that Congress did not require or intend. The problem arises out of how the initial rules define certain elements of the term that are not themselves defined in the statute, such as "illiquid assets," "contractual obligations" and "necessary to fulfill a contractual obligation." We believe that the definitions of these elements in the conformance rules are inconsistent with the purpose of Section (c) because they will result in the exclusion of many genuinely illiquid funds that were principally invested, or contractually committed to principally invest, in illiquid assets as of May 1, 2010.

The Board has ample discretion to define these elements in a manner that is consistent with the purpose of Section (c). We believe that the definitions would be more consistent with the purpose of Section (c) if they preserved the Board's discretion to treat more, rather than fewer, funds as illiquid funds. As noted above, a broader definition will preserve the Board's option to grant an extension for a genuinely illiquid fund if the facts and circumstances justify it. The Board can always deny an extension if the facts and circumstances do not justify it, even if the fund otherwise comes within the definition of an illiquid fund.

(a) Definition

While examples of illiquid assets are given in Section (h)(7) of the statute, the term "illiquid assets" is not comprehensively defined. We believe the term should have been defined in the rules to be sufficiently comprehensive to cover all assets that are genuinely illiquid, including any real property, security, obligation, or other illiquid asset held by a fund, such as an

[281] *See* SIFMA Comment Letter to the Board on the Proposed Conformance Rules dated December 27, 2010, **Annex A**, available at http://www.sifma.org/issues/item.aspx?id=22183.

investment in a portfolio company, a venture capital investment or any equity, partnership or other ownership interest in another fund.

Illiquid assets should include otherwise liquid assets that become illiquid during a market disruption or other unusual market conditions, such as those experienced during late 2008. Such assets should be considered illiquid if they cannot be sold to unaffiliated third parties during such periods, except at a material discount to what their fair value was or is expected to be under normal market conditions.

Illiquid assets should also include the portion of any assets held by a banking entity or fund to the extent such portion cannot be promptly sold to a third party other than at a price that is materially lower than the prevailing market price for a "normal quantity" of such assets in the relevant market (as described below). This situation can arise in a variety of circumstances. For example, when a private equity fund takes a portfolio company public, it is typical for the offering to relate to a small percentage of the company's total stock, for example 10 to 15 percent. In such a case, most of the remaining percentage would be very difficult for the private equity fund to sell except in smaller quantities over time and should be considered illiquid.

We believe that the prevailing market price should be determined by reference to paragraphs (c)(2), (3) or (4) of Section 248.30 of the initial rules and that a fair, reasonable and useful definition of a normal quantity of assets is 25 percent of the average daily trading volume of such assets in the relevant market during the immediately preceding four calendar weeks.[282] That is the definition used by the SEC in Rule 10b-18 under the 1934 Act for one of the conditions of its safe harbor from liability for market manipulation for public companies that repurchase their own equity securities.[283] We believe that this definition is an appropriate definition of a normal quantity because the SEC has determined that repurchases of such amounts are unlikely to have a material adverse effect on the prevailing market prices.

Finally, the term "illiquid assets" should include any other assets that the Board determines to be illiquid under all the facts and circumstances. As the Board recognized in its discussion of the term "liquid asset," "there may be situations where other, non-enumerated assets may be liquid even though they are not included in the [regulatory definition of liquid assets]."[284] By the same token, we believe that there will be situations where assets that are not enumerated in the regulatory definition of "illiquid assets" will be genuinely illiquid.

We believe that the Board should clarify that ownership interests held by one fund in another fund will be classified as illiquid assets for purposes of the illiquid fund test if the ownership interests themselves qualify as illiquid assets, regardless of whether the fund invested in is principally invested in illiquid assets.

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[282] For assets such as bonds or loans for which "average daily trading volume" may not be a useful metric, we suggest that prevailing market price be calculated with reference to such similar measure of price to quantity as the Board determines is appropriate.

[283] *See* 12 C.F.R. § 240.10b-18.

[284] *Id.*

(b) Contractual Obligation

The initial conformance rules provide that the extended conformance period for illiquid funds is only available to the extent "necessary to fulfill a contractual obligation of the banking entity that was in effect on May 1, 2010."[285] In this respect, it mirrors the statutory language of the Volcker Rule. We believe, however, that the definition of "contractual obligation" and the implementation of the "necessary" condition in the initial rules are not consistent with the purpose of Section (c).

The initial rules contain a provision that would treat a banking entity as having a contractual obligation only if the banking entity does not have the unilateral right to terminate the obligation and has not been able to obtain any necessary consents after using its reasonable best efforts to obtain them.[286] This provision appears to be intended to give effect to the "necessary" condition discussed above. We believe that the initial rules are far more restrictive than required under any reasonable interpretation of the "necessary" condition and are therefore inconsistent with the purpose of Section (c).

With respect to investments in sponsored funds, the initial conformance rules could be read to condition the extended conformance period on the exercise of all regulatory outs or other excuse provisions even if the exercise of such provisions would be inconsistent with the written commitments, representations or other undertakings provided by the banking entity to investors before they made their investment in the funds.[287] With respect to investments in third-party funds, the initial rules could be read to condition the extended conformance period on exercising regulatory outs or the taking of reasonable best efforts to obtain all necessary third-party consents even if obtaining such consents would require the banking entities to incur significant losses or suffer other material adverse effects.[288]

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[285] *Id.* at 72750.

[286] *See* Proposed Rule § 248.31(b)(3)(iii).

[287] *See* Proposed Rule § 248.31(b)(3). A banking entity will be deemed to have a contractual obligation to provide additional capital to a covered fund where, as sponsor of such fund, it is required to do so by the terms of a written representation made by the banking entity in the fund's offering materials distributed to potential. However, a subsequent provision of the rules could be read to make such a contractual obligation irrelevant unless the obligation "may not be terminated by the banking entity under the terms of its agreement with the fund," a condition that technically may not be met where a "regulatory out" exists. We do not believe it was the Board's intent to treat a written representation in a fund's offering materials as a binding obligation, only to ignore those obligations in determining whether a banking entity had a binding "regulatory out" in other documentation.

[288] We note that the definition of "necessary" under the proposed rules creates a circularity that prevents the Board from granting an extended conformance period with respect to any investment by a banking entity in a fund for which a regulatory out exists, as shown in the following example: (i) regulatory outs become exercisable because it has become or may become illegal for a banking entity to hold an interest in a fund; and (ii) holding the interest becomes illegal or may become illegal when an extension is not or may not be available; but (iii) the reason the extension is not or may not be available is because the regulatory out exists. We believe that this kind of circularity is not consistent with the purpose of Section 13(c).

Under plausible readings of these standards, which are not required by the statute, the extended conformance period would be unavailable for almost all illiquid funds. In the case of sponsored funds, fund documents almost always contain regulatory outs or other excuse provisions or rights to consent to certain actions for the sponsor. For example, fund documents almost always provide that a limited partner may transfer its limited partner interest in the fund with the consent of the fund's general partner. Where a banking entity is the general partner, it is possible that the banking entity would have the unilateral contractual power to consent to a transfer of an interest it holds as a limited partner, at least if any other constraints on such power are disregarded as the initial rules would apparently do. In these circumstances, no such sponsored fund would be able to meet the "necessary" condition in the initial rules and would therefore never be entitled to the extended conformance period despite the fact that these funds may be genuinely illiquid funds. We do not believe that such a result is consistent with the purpose of Section (c). In the case of third-party funds, there is technically always a price at which consent can be obtained from the sponsor, other investors or other stakeholders. The question is how high a cost a banking entity must accept in order to satisfy the reasonable best efforts condition.

As the sponsor of a fund, a banking entity owes fiduciary and other duties to the fund and to the fund's investors. The exercise by a banking entity of its excuse provisions or its right to consent to a redemption or transfer of its own interest in a sponsored fund could harm the fund, and the fund's investors, in violation of the banking entity's duties. If, for example, a redemption would result in the banking entity being paid in cash, the fund would need to liquidate investments to generate the cash and the fund's more liquid investments would likely be liquidated first to fund the redemption. This could give rise to a conflict of interest, as the banking entity would be determining the value of its interest and the non-redeeming investors would be left with a more illiquid (and potentially less desirable) pool of assets than before the redemption.

Conflicts could also arise by virtue of the fact that the banking entity redeemed its interest ahead of other investors, or a 'race to the exit' could be sparked by the banking entity's announcement of its intent to redeem its interest. In many instances, particularly in the private equity context, redemption of the banking entity's interest would be impossible because of the illiquidity of the fund's assets, in which case the banking entity would presumably be forced to transfer its interest in the secondary market in order to comply with the initial rules. Conflicts of interest could arise if the consent of the general partner alone was sufficient to effect such a transfer because the banking entity would effectively be approving its own transfer.

Forcing banking entities to exercise their excuse provisions or rights to transfer would also violate the reasonable expectations of investors who, at the time they made the decision to invest in the fund, relied on the commitments, representations or other similar undertakings made by the fund or the fund sponsor in the fund's organizational documents or offering materials. It has been standard market practice, for example, for investors to require that sponsors invest in the funds they sponsor in order to align the incentives of the sponsor and other investors – often this sponsor commitment has been substantial. We believe that requiring a

sponsor to redeem or transfer its interest in a fund midway through the life of the fund contravenes the expectations of investors and materially alters the basis on which investors made their investment decisions.[289]

We believe that the initial rules would be more consistent with the purpose of Section (c) if they were amended so that contractual obligations would qualify as "necessary" as long as:

- In the case of funds that are not sponsored by the banking entity:
  - the obligation may not be terminated in the banking entity's sole discretion; and
  - the banking entity has tried in good faith to obtain any necessary consents and has not been able to obtain them or act upon them without making material concessions.
- In the case of sponsored funds, the termination of the contractual obligation would be inconsistent with any written commitment, representation or other undertaking provided to investors before they made their investment in the fund.

Under the initial rules, the extended conformance period would expire immediately upon the termination of a contractual obligation.[290] Because a banking entity will not be able to predict with any certainty when a contractual obligation will formally terminate (for example, when the general partner of a third-party fund consents to the transfer of the banking entity's interest, or when a sufficient number of limited partners consents to the termination of the banking entity's obligation to a sponsored fund), the initial rules would be impractical and cause a banking entity to be in violation of the Volcker Rule without notice. We note that where a banking entity has multiple contractual obligations to a fund, the termination of one contractual obligation should not affect the continuation of the others or the banking entity's need for an extended conformance period in order to honor those other obligations. We therefore recommend that a banking entity have a six-month grace period following termination of all contractual obligations to bring its activities and investments in a fund to which it no longer has a contractual

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[289] A substantial investment on the part of the sponsor in its private equity fund has always been considered to be a critical factor in an investor's evaluation of the fund. We note that the Institutional Limited Partners Association ("**ILPA**") adopted the ILPA Private Equity Principles more than a year ago, before the Volcker Rule had even been proposed by the Obama Administration. These principles were intended to set out "best practices" for investors to be mindful of when investing in private equity funds. More than 140 respected institutional investors, including some of the largest public and private pension funds, endowments and foundations, endorsed the principles. Among the best practices recommended in the principles is that "[t]he general partner should have a substantial equity interest in the fund to maintain a strong alignment of interest with the limited partners . . ." *See* ILPA Private Equity Principles, at 3 (September 8, 2009).

[290] 76 Fed. Reg. 68969 (§ 248.31(b)(2)(ii)).

obligation into compliance with the Volcker Rule, subject to extension by the Board for an additional six months.

(2) New Illiquid Funds

We believe that the statutory definition of "illiquid fund" is too narrow because it only applies to funds that were illiquid as of May 1, 2010.[291] This means that, among other consequences, the extended conformance period will not apply to funds that become illiquid after that date. We also believe that the extended conformance period is too narrow because it only considers the illiquidity of a fund and ignores the illiquidity of an ownership interest in the fund. While the initial conformance rules appear to permit a banking entity to treat illiquid investments held by one fund in another fund as illiquid assets of the first fund for purposes of deciding whether the first fund is an illiquid fund,[292] they do not provide an extended conformance period for *illiquid* investments in *liquid* funds.

We believe that the Board has the authority under Section (d)(1)(J) to determine, based on all the facts and circumstances, that any fund is an "illiquid fund" and to provide temporary extended conformance periods for illiquid investments in funds that do not fall within the statutory definition of the term "illiquid fund," in each case if certain standards are satisfied.

Section (d)(1)(J) authorizes the Board to issue a rule exempting banking entities from any of the prohibitions or restrictions of the Volcker Rule if such an exemption would "promote and protect the safety and soundness of the banking entity and the financial stability of the United States." It is important to note that the Board's use of the authority contained in Section (d)(1)(J) of the statute to determine, based on all the facts and circumstances, that any fund is an "illiquid fund" and to provide temporary extended transition periods for illiquid investments in funds that do not fall within the definition of "illiquid fund" does not mean that the Board would have to grant any extended transition period requested by a banking entity. The Board could always deny an extension request if the facts and circumstances warranted denial.

It is impossible to anticipate all the circumstances under which a genuinely illiquid fund might not be covered by the general definition of "illiquid fund." In at least one common circumstance, a fund that was not principally invested in illiquid assets as of May 1, 2010 could become principally invested in such assets thereafter. This could occur because the fund subsequently acquired more illiquid assets, disposed of some of its liquid assets, or otherwise became genuinely illiquid because of changing market conditions or other factors. In many cases, assets that were liquid as of May 1, 2010 may become illiquid after that date, with the effect of causing a once liquid fund to become an illiquid fund.

In the absence of Board discretionary authority to provide an extended conformance period for investments in such genuinely illiquid funds, banking entities might be required to divest their interests in such funds at prices significantly below fair value, which

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[291] *See* 12 U.S.C. §1851(h)(7).

[292] *See* 12 U.S.C. §1851(d)(1)(J).

would have a negative impact on their earnings and capital. This result would be contrary to the purpose of the transition rules and, to the extent it applies system-wide, could hinder or threaten the safety and soundness of certain banking entities and the stability of the U.S. financial system. We believe this is sufficient to satisfy the standard to issue a rule under Section (d)(1)(J).

We therefore urge the Board to exercise its authority under Section (d)(1)(J) to issue a rule under which the Board would have the authority to determine, based on all the facts and circumstances, that any fund not otherwise covered by the statutory definition is an "illiquid fund." We believe such an exercise of authority would make the extended conformance period for illiquid funds more consistent with the purpose of Section (c).

(3) Illiquid Ownership Interests

The harm that banking entities and other stakeholders could face if banking entities are forced to liquidate their genuinely illiquid investments in liquid funds too quickly is similar to the harm that the extended conformance period for investments in illiquid funds is designed to avoid or mitigate. For example, a banking entity could hold an ownership interest in a hedge fund sponsored by a third-party manager, which ownership interest is illiquid pursuant to the terms of the fund, such as where the interest is subject to a "lock-up" for a certain period of time and cannot be redeemed by the banking entity or the third-party manager has imposed a "gate" limiting redemptions by investors.[293] Under these circumstances, even if the hedge fund were not an "illiquid fund," the ownership interest that the banking entity held in the hedge fund would be illiquid. Yet the statute does not provide an extended conformance period for such illiquid investments. It only allows such investments to be treated as illiquid assets for purposes of determining whether a particular fund is an "illiquid fund."

In the absence of Board discretionary authority to provide an extended conformance period for illiquid investments in liquid funds, banking entities might be required to divest such illiquid investments at prices significantly below fair value, which would have a similar negative impact on their earnings and capital as being forced to divest their interests in illiquid funds. This result would be contrary to the purpose of the transition rules and, to the extent it applies system-wide, could hinder or threaten the safety and soundness of certain banking entities and the stability of the U.S. financial system. We believe this is sufficient to satisfy the standard to issue a rule under Section (d)(1)(J).

We therefore urge the Board to exercise its authority under Section (d)(1)(J) to provide temporary extended transition periods for illiquid investments in funds that do not fall within the definition of "illiquid fund," similar to the extended conformance period for investments in illiquid funds. We believe such an exercise of authority would make the extended conformance periods more consistent with the purpose of Section (c).

[293] We note that many sponsors of hedge funds imposed "gates" during the fall of 2008.

ANNEX D

GLOSSARY

1933 Act	Securities Act of 1933.
1934 Act	Securities Exchange Act of 1934.
1940 Act	Investment Company Act of 1940.
Agencies	Board, CFTC, FDIC, OCC and SEC.
APA	Administrative Procedure Act.
Asset Management Exemption	"Permitted activities" exemption in Section (d)(1)(G) of the Volcker Rule.
BHC	Bank holding company.
BHC Act	Bank Holding Company Act of 1956.
Board	Board of Governors of the Federal Reserve System.
CEA	Commodity Exchange Act.
Commodity Pool	Commodity pool, as defined by the Commodity Exchange Act.
DIHC	Depository institution holding company, as defined in Section 3 of the Federal Deposit Insurance Act.
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.
DPC	Debts previously contracted.
DPC Exemption	"Permitted activities" exemption in the Proposed Rules for ownership interests in a covered fund acquired in good faith in satisfaction of debts previously contracted.
Excluded Entities	Wholly owned subsidiaries, joint ventures, acquisition vehicles, financial market utilities, SEC-registered investment companies, business development companies and any other issuer designated as an "excluded entity" by rule or order of the Agency that is the banking entity's primary federal financial regulator.
Exempt Funds	Any issuer that would be an investment company under the 1940 Act, but for qualifying for an exemption other than under Sections 3(c)(1) or 3(c)(7) of that Act.
FBO	Foreign banking organization as defined in the Board's Regulation K, 12 C.F.R. Part 211.

FDIC	Federal Deposit Insurance Corporation.
Feeder Fund	A fund that invests in a master fund in a master-feeder fund structure.
FINRA	Financial Industry Regulatory Authority.
First NPR	Notice of Proposed Rulemaking Issued by the Board, the FDIC, the OCC and the SEC, published in 76 Fed. Reg. 68846 (Nov. 7, 2011).
FMU	Financial market utility, as defined in Title VIII of the Dodd-Frank Act.
FSOC	Financial Stability Oversight Council.
FSOC Study	*Study & Recommendations on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds* (Jan. 18, 2011).
Fund of Funds	A fund that invests in other funds.
GAO	Government Accountability Office.
GAO Report	*Proprietary Trading: Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented* (July 2011).
General Definition	The portion of the Volcker Rule that defines a "hedge fund" and "private equity fund" generally as any issuer that would be an investment company under the 1940 Act, but for Sections 3(c)(1) or 3(c)(7) of that Act.
Temporarily Grandfathered Covered Fund	Any covered fund that was established before the effective date of the Volcker Rule, but only for the duration of the conformance period under the Volcker Rule.
IDI	Insured depository institution, as defined in Section 3 of the Federal Deposit Insurance Act.
Master Fund	A fund into which one or more feeder funds make investments in a master-feeder fund structure.
MiFID	Markets in Financial Instruments Directive of the European Union (2004).
NPRs	The first NPR and the second NPR.
OCC	Office of the Comptroller of the Currency.
Offshore Exemption	"Permitted activities" exemption contained in Section (d)(1)(H) of the Volcker Rule.
Permitted Covered Fund	Any covered fund as to which certain investments and

	relationships are "permitted activities" under Section (d)(1) of the Volcker Rule.
Portfolio Company	Any company held by a BHC under the merchant banking authority of Section 4(k)(4)(h) of the BHC Act or by another DIHC under applicable federal law.
Proposed Rules	Proposed rules implementing the Volcker Rule as contained in the first and second NPRs.
Public Commodity Pool	All commodity pools that have made a public offering of their securities and have not been taken private.
Public Foreign Fund	All foreign funds that either (i) have made a public offering of their securities and have not been taken private or (ii) are eligible to make a public offering and are subject to regulation of their investments and activities.
Related Covered Fund	A covered fund with which a banking entity is prohibited from entering into a covered transaction pursuant to Super 23A.
Rulemaking Condition	The portion of the statutory definition of the terms "hedge fund" and "private equity fund" that qualifies the General Definition and the similar funds designations by the words "as the [Agencies] may, by rule, . . . determine."
SBIC	Small Business Investment Company.
SBIC Exemption	"Permitted activities" exemption contained in Section (d)(1)(E) of the Volcker Rule.
Second NPR	Notice of Proposed Rulemaking Issued by the CFTC (January 13, 2012).
SEC	Securities and Exchange Commission.
Section 23A	Section 23A of the Federal Reserve Act.
Section 23B	Section 23B of the Federal Reserve Act.
SIFMA	Securities Industry and Financial Markets Association.
Small Business Act	Small Business Regulatory Enforcement Fairness Act 0f 1996.
SRO	Self-regulatory organization.
Super 23A	Section 13(f) of the BHC Act.
UCITS	A fund organized under the European Union's Undertakings for Collective Investment in Transferable Securities Directive.

Unfunded Mandates Act	Unfunded Mandates Reform Act of 1995.
Volcker Rule	Section 13 of the BHC Act.

ANNEX E

About the Associations

SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit **www.sifma.org**.

The **American Bankers Association** represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its 2 million employees. Learn more at **www.aba.com**.

The **Financial Services Roundtable** represents 100 of the largest integrated financial services companies providing banking, insurance, and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs. *See* the Financial Services Roundtable's web page at **http://www.fsround.org**.

Established in 1853, **The Clearing House** is the oldest banking association and payments company in the United States. It is owned by the world's largest commercial banks, which collectively employ over 2 million people and hold more than half of all U.S. deposits. The Clearing House Association L.L.C. is a nonpartisan advocacy organization representing—through regulatory comment letters, amicus briefs and white papers—the interests of its owner banks on a variety of systemically important banking issues. Its affiliate, The Clearing House Payments Company L.L.C., provides payment, clearing, and settlement services to its member banks and other financial institutions, clearing almost $2 trillion daily and representing nearly half of the automated-clearing-house, funds-transfer, and check-image payments made in the U.S. *See* The Clearing House's web page at **www.theclearinghouse.org**.