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February 13, 2012

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Board of Governors of the Federal Reserve
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Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
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Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds

Dear Sirs and Madams:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposed rule ("Proposed Rule") issued by the above-listed agencies ("Agencies") to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), commonly known as the "Volcker Rule."[2] Congress enacted this provision to restrict banks from using their own

[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.5 trillion and serve over 90 million shareholders.

[2] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (November 7, 2011) ("Proposing Release"). The Commodity Futures Trading Commission ("CFTC") was not a party to the Proposing Release; instead, it issued a separate yet substantively

resources to trade for purposes unrelated to serving clients and to address perceived conflicts of interest in certain bank transactions. Section 619 was not directed at U.S. investment companies registered under the Investment Company Act of 1940 ("registered funds"), which manage total assets of $12.5 trillion and serve over 90 million shareholders.[3] Unfortunately, the Proposed Rule nonetheless raises deep concerns for the U.S. registered fund industry.[4]

If adopted in its current form, the Proposed Rule would reach much farther than Congress ever intended. For example, the Proposed Rule could treat many registered funds as hedge funds—a result that contradicts the plain language that Congress passed. In Section I of our letter, we discuss this and other ways in which the proposed implementation of the Volcker Rule would impede the organization, sponsorship and normal activities of registered funds.

The Proposed Rule, as currently drafted, also could restrict banks from playing their historic role as market makers buying and selling securities—despite the fact that Congress specifically designated "market making-related activity" as a "permitted activity" for banks under the Volcker Rule. If banks could not provide these services, particularly in the less liquid fixed income and derivatives markets and the less liquid portions of the equity markets, registered funds and other investors likely would face wider bid-ask spreads, higher transaction costs, and diminished returns. The Proposed Rule also could greatly impair the U.S. financial markets by imposing stringent restrictions that go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, potentially hurting our broader economy and impacting job creation and investments in U.S. businesses overall. In Section II of our letter, we describe this and other ways in which the financial markets would be affected.

Section III of our letter describes ways in which the Proposed Rule, as currently drafted, could limit investment opportunities for registered funds and their shareholders. Finally, given the significant changes that we believe are necessary to address our concerns and those of other commenters, we recommend that the Agencies issue a revised proposal for comment before adopting any final rule. We have attached suggested rule text corresponding to our recommendations in Appendix B. We also urge

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similar proposal to implement the Volcker Rule. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (January 11, 2012) ("CFTC Release"), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112c.pdf. ICI plans to file this comment letter with the CFTC once the CFTC Release has been published in the Federal Register.

[3] For ease of reference in this letter, we refer to all types of U.S. registered investment companies—including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts—as "registered funds," unless the context requires otherwise. *See* Appendix A for a brief description of each type of registered fund.

[4] The Proposed Rule's overreach extends beyond U.S. borders, negatively impacting investors, funds, and global markets. A separate letter by our overseas affiliate, ICI Global, discusses these issues. *See* Letter from Dan Waters, Managing Director, ICI Global, to Agencies, dated February 13, 2012 ("ICI Global Letter"), available at www.iciglobal.org.

the Federal Reserve Board to revise the conformance rule it issued in February 2011 and require new activities to comply with the Volcker Rule as of July 2014, rather than July 21, 2012.

SUMMARY OF COMMENTS

Organization, Sponsorship and Normal Activities of Registered Funds:

- **The Rule Expressly Should Exclude All Registered Funds (and Their Non-U.S. Counterparts) from the Definition of "Covered Fund".** Section 619 of the Dodd-Frank Act prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund, private equity fund, or "similar fund" as the Agencies determine by rule—collectively defined in the Proposed Rule as "covered funds." The Proposed Rule would include within "covered fund" any investment vehicle that is considered a "commodity pool" under Section 1a(10) of the Commodity Exchange Act. In so doing, the Proposed Rule would greatly expand the reach of the Volcker Rule, even to the extent of sweeping in some registered funds. ICI believes treating *any* registered fund as "similar" to a hedge fund or private equity fund for purposes of the Volcker Rule is contrary to Congressional intent. Providing an express exclusion for registered funds from the definition of "covered fund" would avoid this result. ICI further recommends that the Agencies expressly exclude non-U.S. retail funds from the definition of covered fund. Non-U.S. retail funds are not managed or structured like hedge funds or private equity funds, and excluding them from "covered fund" is consistent with Congressional intent to limit the extraterritorial impact of the Volcker Rule.

- **The Rule Expressly Should Exclude All Registered Funds from the Definition of "Banking Entity".** The Proposing Release suggests that a mutual fund generally would not be considered a subsidiary or affiliate of the banking entity that sponsors or advises it. Without an express exclusion in the rule text, however, it is possible that some registered funds could become subject to all of the prohibitions and restrictions in the Volcker Rule—a result not intended by Congress. For example, during the period following the launch of a new mutual fund by a bank-affiliated sponsor, when all or nearly all of the fund's shares are owned by that sponsor, the mutual fund could be considered an affiliate of the banking entity, and thus subject to the Volcker Rule in its own right. Providing an express exclusion for registered funds from the definition of "banking entity" would avoid this result (and, we believe, be consistent with the Agencies' intent as expressed in the Proposing Release) without thwarting in any way the policy goals of the Volcker Rule.

- **The Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds and Conduct Related Activities.** The proprietary trading provisions of the Proposed Rule call into question whether banking entities could continue to serve as Authorized Participants ("APs") for exchange-traded funds registered under the Investment Company Act of 1940 ("ETFs") and conduct related activities. ETFs are similar to mutual funds except that they list their shares on a securities exchange,

thereby allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. APs alone transact directly with ETFs, in large amounts (typically involving 50,000 to 100,000 ETF shares) based not on market prices but on the ETF's daily net asset value. AP transactions with an ETF are a unique and controlled form of arbitrage trading that, in the view of the Securities and Exchange Commission ("SEC"), is a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors. Some APs also may engage in traditional market making activities in the ETFs with which they participate. The Agencies should revise the Proposed Rule to ensure that APs can continue to fulfill these important roles.

Impact on the Financial Markets:

- **Liquid and Efficient Markets are Important for Registered Funds**. Banking entities are key participants in providing liquidity in the financial markets, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading. The Proposed Rule has the potential to decrease market liquidity, particularly for the fixed-income and derivatives markets, and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, leading to wider bid-ask spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders.

- **The Complexity of, and Difficulties of Complying with, the Proposed Rule Threaten Market Liquidity and May Adversely Impact Registered Funds**. Much of the concern surrounding the effect of the Proposed Rule on market liquidity arises from the complexity of the Proposed Rule and its exemptions from the proprietary trading prohibition. ICI supports suggestions to recast what appear to be rigid criteria defining permitted activities under the Proposed Rule as guidance that could be incorporated into banking entities' policies and procedures.

    - **The Presumption of Prohibited Activity is Unwarranted**. The Proposed Rule generally presumes that a banking entity's short-term principal trading activity is prohibited proprietary trading. This presumption of prohibited activity prejudices the analysis of a banking entity's trading activity from the outset. Moreover, the process to rebut the Proposed Rule's presumption would be extremely complex and onerous.

    - **The Conditions of the Proposed Exemptions Do Not Reflect the Operation of the Financial Markets**. The Proposed Rule appears tailored primarily for the traditional trading of equities on an agency-based "last sale" model, which differs substantially from how other markets operate. It does not reflect that market makers provide liquidity by acting as principal in the majority of the financial markets and it does not take into account the need to provide flexibility and discretion to market makers to enter into transactions to build inventory.

- **The Conditions of the Proposed Exemption for Market Making-Related Activities are Impractical**. The conditions under the market making-related activities exemption are extremely complex and will be so difficult to comply with as to be effectively unworkable in a number of financial markets and for a significant number of financial instruments.

- **The Risk-Mitigating Hedging Exemption Must be Flexible**. The conditions provided under the proposed risk-mitigating hedging exemption create uncertainty as to whether a specific hedge would fulfill the requirements of the exemption. The exemption should be made flexible enough to allow banking entities appropriately to manage all possible risks and to facilitate hedging against overall portfolio risk; it should not be a transaction-by-transaction analysis.

- **The Proposed Government Obligations Exemption Should be Expanded to Cover All Municipal Securities and Foreign Sovereign Obligations**. The proposed exemption for trading in certain government obligations does not extend to transactions in obligations of an *agency or instrumentality* of any State or political subdivision. ICI recommends that the exemption be expanded to include *all* municipal securities, which would be consistent with the current definition of municipal securities under the Securities Exchange Act of 1934. The Proposed Rule also should be expanded to provide an exemption for foreign sovereign obligations; such an exemption is consistent with Congressional intent to limit the extraterritorial reach of the Volcker Rule and with the purposes of the Volcker Rule.

- **The Agencies' Proposed Implementation of the Proprietary Trading Prohibition Would Impact the Structure of the Financial Markets and the U.S. Economy Overall**. The Agencies' proposed implementation of the proprietary trading prohibition could have negative implications for capital formation. Banking entities also may find it difficult to remain in the market making business, which could lead to less regulated and less transparent financial institutions performing these activities. The over-broad restrictions of the Proposed Rule, which go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, could hurt our broader economy, impacting job creation and investments in U.S. businesses overall.

Limiting Investment Opportunities for Registered Funds and Their Shareholders:

- **The Foreign Trading Exemption Should Be Revised to Avoid Adverse Effects on U.S. Registered Funds' Investments in Certain Foreign Securities**. Although Congress intended that trading outside of the United States be a "permitted activity" under Section 619, the Proposed Rule narrowly defines which transactions would be considered to take place outside of the United States—and, in so doing, departs from an existing and well-understood U.S.

securities regulation (Regulation S under the Securities Act of 1933) that governs whether an offering takes place outside of the United States. Many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States. These transactions often involve non-U.S. banking entities as counterparties. The narrow exemption in the Proposed Rule for trading outside of the United States may well cause some non-U.S. banking entities to avoid engaging in transactions with persons acting on behalf of U.S. registered funds, even when those transactions would comport fully with Regulation S. As a result, U.S. registered funds' access to non-U.S. counterparties could decrease significantly, and liquidity in some markets could be reduced. Revising the Proposed Rule to conform to the existing approach under Regulation S would avoid these highly undesirable results.

- **The Rule Should Exempt Asset-Backed Commercial Paper and Tender Option Bond Programs**. The Proposed Rule would impair two particular types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper ("ABCP") programs and securities issued pursuant to municipal tender option bond ("TOB") programs. This would have significant negative implications for issuers of these financing vehicles and their investors, many of which are registered funds. There is no indication, however, that Congress intended to include ABCP or TOB programs within the scope of the Volcker Rule; rather, Congress specifically sought to avoid interfering with longstanding, traditional banking activities. The provision of credit to companies to finance receivables through ABCP, as well as to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from the types of financial activities that Congress sought to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained. It is therefore important that the Proposed Rule be revised to exempt ABCP and TOB programs.

I. The Proposed Rule Would Impede the Organization, Sponsorship and Normal Activities of Registered Funds

Section 619 of the Dodd-Frank Act adds new Section 13 to the Bank Holding Company Act ("BHCA"). It generally prohibits banking entities—which benefit from federal deposit insurance and access to the Federal Reserve discount window—from engaging in proprietary trading and from having certain relationships with hedge funds and private equity funds. In enacting Section 13, Congress sought to reduce the potential negative consequences that those activities and relationships could have on banks, taxpayers, or U.S. financial stability.[5] In contrast, there is no indication that Congress intended to restrict a banking entity's activities with and relationships to registered funds, or to impede the normal operations of registered funds themselves. Yet, in several ways, the Proposed Rule would do

[5] *See, e.g.*, Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (January 2011) ("Volcker Rule Study"), at 15-16.

just that. It is important, therefore, that the Proposed Rule be modified to avoid jeopardizing registered funds and their long-permitted relationships with banking entities.

A. The Rule Expressly Should Exclude All Registered Funds (and Their Non-U.S. Counterparts) from the Definition of "Covered Fund"

1. Registered Funds

Section 619 generally prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund or private equity fund. The statute defines "hedge fund" and "private equity fund" as "any issuer that would be an investment company, as defined in the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of that Act," or "such similar funds" as the Agencies may determine by rule. The Proposed Rule refers to these investment vehicles as "covered funds." For the reasons outlined below, the Agencies should modify the definition of "covered fund" to make it clear that no registered fund would be considered a covered fund.

First, a plain reading of Section 619 indicates that Congress chose to apply the Volcker Rule to two types of investment funds that are explicitly *excluded* from regulation under the Investment Company Act and, as determined by the Agencies, to funds that are "similar" to those excluded funds. It seems quite clear that Congress did not intend for the Volcker Rule to be applied to registered funds. Put simply, a registered fund is not remotely "similar" to a hedge fund or private equity fund. Registered funds are subject to a comprehensive regulatory regime under the Investment Company Act that focuses first and foremost on investor protection, and such funds are designed to be publicly offered to all investors.[6] Hedge funds and private equity funds, on the other hand, are identified in Section 619 by the two sections of the Investment Company Act that keep those funds *outside* that Act's regulatory protections. In addition, shares of a hedge fund or private equity fund cannot be offered publicly but rather only to a limited number of investors (in the case of a Section 3(c)(1) fund) or to a carefully defined set of sophisticated investors (in the case of a Section 3(c)(7) fund).

Second, the legislative history of the Dodd-Frank Act does not support a broad reading of the term "similar fund." To the contrary, the primary authors of the statute, Representative Barney Frank (D-MA) and Senator Christopher Dodd (D-CT), as well as other members of Congress, appear to have been concerned that the Section 619 definition of hedge fund and private equity fund could be interpreted too broadly. As the legislative record reflects, members engaged in colloquies in order to clarify that references to the Section 3(c)(1) and 3(c)(7) exclusions under the Investment Company Act should not be read broadly to sweep in subsidiaries, joint ventures, venture capital funds and other

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[6] *See, e.g.*, 2011 Investment Company Fact Book, Core Principles Underlying The Regulation of U.S. Investment Companies, available at http://www.icifactbook.org/fb_appa.html#core. The investor protections provided by the Investment Company Act also serve to limit systemic risk by, among other things, restricting the ability of a registered fund to engage in leveraged transactions, mitigating conflicts of interest and requiring clear disclosure of fund investment strategies and portfolio holdings to regulators and the public.

structures that rely on those exclusions but "will not cause the harms at which the Volcker rule is directed."[7] It would pervert the intended scope of the Volcker Rule were the Agencies to take too broad a view of what constitutes a "similar fund."

Third, in its study on the implementation of the Volcker Rule, the Financial Stability Oversight Council ("FSOC") suggested that the Agencies should use their authority judiciously, by identifying as similar funds those entities for which the application of the Volcker Rule is necessary "in order to prevent evasion of the intent of the rule."[8] Specifically, the Volcker Rule Study recommended that the Agencies consider using their authority to designate as "similar funds" those funds "that do not rely on the Section 3(c)(1) and 3(c)(7) exclusions but that engage in the activities or have the characteristics of a traditional private equity fund or hedge fund."[9] It is beyond dispute that registered funds neither engage in the same activities nor have the same characteristics as a traditional private equity fund or hedge fund.

Under the Proposed Rule, however, there is the prospect that some registered funds could be considered "covered funds." This is because the definition of "covered fund" includes any investment vehicle that is considered a "commodity pool" as defined in the Commodity Exchange Act ("CEA"). Section 1a(10) of the CEA broadly defines "commodity pool" to include "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests," including, among other things, any security futures product or swap.

A registered fund might use security or commodity futures, swaps, or other commodity interests in varying ways to manage its investment portfolio, including for reasons wholly unrelated to providing exposure to the commodity markets.[10] The broad CEA definition of "commodity pool" could sweep such a registered fund into the Volcker Rule—a result that clearly is inconsistent with Congressional intent.

It appears that the Agencies may not have contemplated that the CEA definition of "commodity pool" could reach some registered funds. The Proposing Release states that the Agencies included "commodity pools" as "similar funds" on the basis that "they are generally managed and

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[7] *See, e.g.*, 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (colloquy between Sens. Dodd and Boxer).

[8] Volcker Rule Study, *supra* note 5, at 3.

[9] *Id.* at 62.

[10] Uses of these instruments include, for example, hedging positions, equitizing cash that cannot be immediately invested in direct equity holdings (*e.g.*, when the stock market has already closed for the day), managing cash positions more generally, adjusting portfolio duration (*e.g.*, seeking to maintain a stated duration of seven years as a fund's fixed income securities age or mature), managing bond positions in general (*e.g.*, in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or managing the fund's portfolio in accordance with the investment objective stated in the fund's prospectus (*e.g.*, an S&P 500 index fund that tracks the S&P 500 using a "sampling algorithm" that relies in part on S&P 500 or other futures).

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."[11] This clearly is not the case for registered funds.[12]

Based on the foregoing, ICI strongly recommends that the Agencies modify the definition of "covered fund" by including an express statement that all funds registered under the Investment Company Act of 1940 are not covered funds.

We have provided suggested rule text for your consideration in Appendix B.

2. Non-U.S. Funds Offered to Retail Investors

As currently drafted, the definition of "covered fund" would include any issuer, as defined in Section 2(a)(22) of the Investment Company Act, that is organized or offered outside of the United States that would be a covered fund, were it organized or offered under the laws, or offered to one or more residents, of the United States. For reasons similar to those discussed above, ICI recommends that non-U.S. retail funds—which are authorized for public sale and substantively regulated in other jurisdictions—be excluded from the definition of "covered fund."

Non-U.S. retail funds are not managed or structured like hedge funds or private equity funds. Rather, non-U.S. retail funds are registered under the laws of the jurisdiction in which they are organized and are subject to regulation governing, among other things: how they may invest and operate; the disclosure they must provide to their investors; the valuation of their portfolio securities; their use of leverage; and their corporate governance. As explained in more detail in the ICI Global Letter, excluding non-U.S. retail funds from the definition of "covered fund" would not compromise Congressional intent in enacting the Volcker Rule and, in fact, is consistent with Congressional intent to limit the extraterritorial impact of the Volcker Rule.[13]

We have provided suggested rule text for your consideration in Appendix B.

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[11] Proposing Release, 76 Fed. Reg. at 68897.

[12] There are further reasons why the definition of "commodity pool" in CEA Section 1a(10) should not be incorporated directly into the definition of covered fund. Subsection (B) of that definition allows the CFTC, by rule, to treat any investment vehicle as a commodity pool if it finds that doing so would effectuate the purposes of the CEA. Such an investment vehicle would be swept automatically into the definition of "covered fund," without any evaluation of whether such vehicle should be considered a "similar fund" for purposes of the Volcker Rule.

[13] The Agencies also may wish to consider excluding from the definition of "covered fund" any non-U.S. fund subject to contractual or other restrictions that effectively limit its investment objectives, policies and strategies to those objectives, policies and strategies that would be permitted for registered funds under the Investment Company Act. *See* Letter from Phillip S. Gillespie, Executive Vice President and General Counsel, State Street Global Advisors, to Agencies, dated February 13, 2012.

B. The Rule Expressly Should Exclude All Registered Funds from the Definition of "Banking Entity"

The Volcker Rule's prohibition on proprietary trading and restrictions on activities involving hedge funds and private equity funds apply to "banking entities."[14] A registered fund would fall within the definition of "banking entity" if it were considered an affiliate or subsidiary of a banking entity (*e.g.*, its investment adviser). In that event, the registered fund itself would be subject to all the prohibitions and restrictions in the Volcker Rule as implemented by the Proposed Rule.

There is no indication that Congress intended this result.[15] Indeed, in the Volcker Rule Study, the FSOC implicitly acknowledged as much. The FSOC noted certain concerns identified in comments submitted in advance of the study related to the definition of "banking entity."[16] One such concern was that, absent clarification, SEC-registered investment companies (*i.e.*, registered funds) that are controlled by a banking entity would be subject to the Volcker Rule. Immediately after reciting this comment, the FSOC stated: "The Council recommends that the relevant Agencies carefully consider the impact of certain BHC Act definitions on the Volcker Rule's definition of banking entity and implement that term in a way that avoids results that Congress clearly did not intend in enacting the Volcker Rule."[17]

The preamble to the Proposed Rule indicates that a mutual fund generally would not be a subsidiary or affiliate of a banking entity if the banking entity only provides advisory or administrative services to, has certain limited investments in, or organizes, sponsors, and manages a mutual fund in accordance with BHCA rules.[18] ICI concurs with this view and is pleased that the preamble reaffirms the Federal Reserve Board's long-held position in this regard. But while the interpretive position noted in the preamble is helpful, it is not reflected in the rule text, which could lead to confusion or misinterpretation of the Agencies' intent.

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[14] The Proposed Rule generally defines "banking entity" to include: (1) an insured depository institution; (2) a company that controls an insured depository institution; (3) a company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978; and (4) subject to certain exceptions, an affiliate or subsidiary of any of the foregoing. "Affiliate" and "subsidiary" are defined by reference to the definitions of those terms in Section 2 of the BHCA.

[15] For example, we do not believe that Congress meant for registered fund portfolio transactions to be considered prohibited "proprietary trading" under the Volcker Rule. While the proposed definition of "proprietary trading" likely would not encompass most portfolio transactions conducted by registered funds, no important policy objective would be served by leaving this open to question.

[16] Volcker Rule Study, *supra* note 5, at 68-69.

[17] *Id.* at 69.

[18] *See* Proposing Release, 76 Fed. Reg. at 68856.

The Agencies have requested comment on whether a registered fund should be expressly excluded from the definition of "banking entity."[19] ICI strongly believes it should be. An express exclusion would eliminate the possibility that a registered fund could become subject to the Volcker Rule, which may be particularly important in the case of fund "seeding."[20]

It is common industry practice for a mutual fund's investment adviser/sponsor to provide the initial, "seed" capital necessary to launch a new fund. During the period following the launch of a new mutual fund, when the banking entity adviser/sponsor owns all or nearly all of the shares of the fund as a result of its investment of seed capital, the mutual fund could be considered an affiliate (as defined in the BHCA) of the adviser/sponsor.[21] If so, the mutual fund would be captured by the proposed definition of "banking entity" and become subject to the Volcker Rule.[22] This could have the effect of essentially barring banking entities from sponsoring the most highly regulated type of investment vehicle and, thereby, limiting investment options for investors. Further, it would, in effect, ban banking entities from engaging in an activity that is permitted under the BHCA and other federal banking laws and that was never intended to be affected by the Volcker Rule.[23] It also would put banking entity sponsors at a competitive disadvantage compared with their non-bank-affiliated peers, which have no limits on their seed capital, despite engaging in precisely the same business.

Similar issues arise in the context of other types of registered funds, including closed-end funds and unit investment trusts ("UITs"). In particular, there are instances in which a banking entity involved in the underwriting of a closed-end fund or UIT temporarily owns a controlling interest in that fund. We do not believe that Congress intended for the Volcker Rule to interfere with the organization or operation of closed-end funds or UITs.

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[19] *Id.* (Questions 6 and 8).

[20] Consistent with Section 13(d)(4) of the BHCA, the Proposed Rule would permit a banking entity to provide the seed capital for a covered fund that it sponsors, subject to certain restrictions. Under the Proposed Rule, the banking entity would be required to actively seek unaffiliated investors and to reduce its ownership to no more than three percent of the fund's total outstanding ownership interests within one year. See §__.12 of the Proposed Rule. As discussed in Section I.A. above, however, Congress did not intend for registered funds to be "covered funds." Therefore, in our view, this provision would not apply.

[21] Most registered funds need to establish a three-year track record before analysts such as Morningstar will cover them, or consultants to institutional investors and pension plans will recommend them. Additionally, registered funds' investment strategies sometimes may be "out of favor" with investors in the funds' early years, but the adviser believes they will be successful investment options when market conditions change. These timing issues make it necessary for registered funds' sponsors to have the ability to leave seed capital in a fund for what may be a lengthy period of time.

[22] A similar result could arise in the ETF context. This issue is discussed more fully in Section I.C. below.

[23] Under the BHCA, banking organizations generally may sponsor and "seed" registered funds so long as they (a) do not exercise managerial control over the portfolio companies of funds, and (b) reduce their ownership stake in sponsored funds to below 25 percent within one year (or seek Federal Reserve Board approval for an extension). 12 CFR 225.86(b)(3).

For some ICI member firms, the insured depository institution that triggers application of the Volcker Rule is small in relation to the overall firm and does not constitute part of the firm's core line(s) of business. Ironically, the impracticality that results from applying the Proposed Rule could well cause these firms to discontinue their limited banking operations even though they do not engage in proprietary trading and may not sponsor or have ownership interests in any hedge funds or private equity funds.

Providing an express exclusion for all registered funds from the definition of "banking entity" would address all of the concerns described above without in any way thwarting the policy goals of the Volcker Rule. Even during the post-launch period, when a banking entity investment adviser or underwriter owns all or nearly all of a fund's shares, the registered fund must be operated in accordance with the comprehensive regulatory regime administered by the SEC under the Investment Company Act and other federal securities laws. Of particular significance in this context, registered funds are subject to oversight by an independent board of directors,[24] strong conflict of interest protections through prohibitions on affiliated transactions,[25] and strict restrictions on leverage.[26]

We note that the Agencies already have recognized that an express exclusion from the definition of "banking entity" is appropriate in a comparable situation—*i.e.,* for certain "covered funds." In explaining that exclusion, the preamble states: "This clarification is necessary because the definition of 'affiliate' and 'subsidiary' under the [Bank Holding Company] Act is broad and could include a covered fund that a banking entity has permissibly sponsored or made an investment in . . . ."[27] The preamble further states that "[i]f such a covered fund were considered a 'banking entity' for purposes of the proposed rule, the fund itself would become subject to all of the restrictions and limitations of section 13 of the [Bank Holding Company] Act and the proposed rule, *which would be inconsistent with the purpose and intent of the statute.*"[28] We believe similar reasoning should apply in the case of, and justify an express exclusion for, registered investment companies.

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[24] *See* Section 10(a) of the Investment Company Act (requiring a mutual fund or closed-end fund to have a board of directors at least 40 percent of which must be independent directors. As of year-end 2010, independent directors made up three-quarters of boards in more than 90 percent of fund complexes. Independent Directors Council and Investment Company Institute, *Overview of Fund Governance Practices, 1994–2010* (October 2011). Given the generally static nature of their investment portfolios, UITs have no board of directors (or investment adviser). Instead, they are subject to oversight by an independent trustee bank, which has a fiduciary duty to the UIT's individual unitholders. We note that some ETFs are organized as UITs but most are organized as open-end investment companies.

[25] *See* Section 17(a) of the Investment Company Act; Section 23A of the Federal Reserve Act.

[26] *See* Section 18 of the Investment Company Act (restrictions applicable to mutual funds and closed-end funds). UITs must issue only redeemable securities, "each of which represents an undivided interest in a unit of specified securities." See Section 4(2)(C) of the Investment Company Act. Thus, their legally mandated structure restricts them from using leverage.

[27] Proposing Release, 76 Fed. Reg. at 68855.

[28] *Id.* at 68855-56 (emphasis added).

We have provided suggested rule text for your consideration in Appendix B.

C. The Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds and Conduct Related Activities

The Proposing Release asks whether "particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed" in the Proposed Rule.[29] They do. Specifically, the proprietary trading provisions of the Proposed Rule call into question whether banking entities could continue to serve as Authorized Participants ("AP")[30] for ETFs[31] and conduct related activities, because such activities may not come within the permitted trading exemptions provided for in the Proposed Rule. If left unchanged, these uncertainties would create substantial risks that banking entities would cease to serve as APs to ETFs, thereby seriously disrupting the operation of the ETF market. This in turn would have a substantial negative impact on investors and the capital markets generally.[32] It is therefore important that the Proposed Rule be revised or clarified to avoid this result.

1. Background – ETFs, APs, and their Trading Activities

ETFs are similar to mutual funds, except that they list their shares on a securities exchange, thereby allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. APs alone transact directly with ETFs, in large amounts (typically involving 50,000 to 100,000 ETF shares) based not on market prices but on the ETF's daily net asset value. How these transactions must take place, and the substantial market disclosures that the ETF must make to facilitate them, are spelled out in the SEC order pursuant to which the ETF operates.[33]

Many of the most active APs in the ETF market are banking entities. Generally speaking, there are two broad categories of trading activities in which an AP may engage with respect to ETFs. First, as noted above, APs may transact directly with an ETF to create or redeem ETF shares. These

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[29] 76 Fed. Reg. 68873 (Question 91).

[30] An AP is a financial institution or other institutional investor that has entered into an agreement with the ETF governing the terms of the AP's transactions with the ETF.

[31] Our comments do not relate to exchange-traded funds that operate outside of the Investment Company Act.

[32] As of December 31, 2011, approximately $939 billion was invested in ETFs registered under the Investment Company Act (excluding ETFs that invest primarily in other ETFs). *See* http://www.ici.org/info/etfs1211.xls. A detailed breakdown of the monthly ETF data is available on ICI's website at http://www.ici.org/info/etfdata.xls.

[33] Due to various unique features relating to their ability to trade on an exchange at market prices, ETFs require exemptive relief from the SEC. The SEC has proposed a rule that would codify the relief granted in many ETF exemptive orders, but that rule has not yet been adopted. *See* SEC Release No. 33-8901 (March 11, 2008) (the "ETF Rule Proposing Release"). ETFs comply with all of the key investor protection provisions in the Investment Company Act including, among others, those regarding leverage, conflicts of interest, and corporate governance.

transactions may be undertaken in connection with traditional market making activity, on behalf of the AP's own clients, or for the AP's own account. In all cases, these transactions typically take place when the market price for ETF shares diverges from their underlying value, enabling the AP to realize a profit. For example, if the ETF shares are trading at a premium to their underlying value, an AP may create ETF shares by delivering to the ETF a basket of securities and cash, the contents of which are established and publicly disclosed by the ETF each trading day, in exchange for a block of ETF shares. In connection with this transaction, an AP typically is acquiring the basket of securities on the secondary market and selling the ETF shares it has created. Redemptions are the inverse: the AP delivers ETF shares, which it typically acquires on the secondary market at a discount to their underlying value, in exchange for the underlying securities.[34]

These creation and redemption transactions represent a unique and controlled form of arbitrage trading. Such transactions minimize differences between the market price for ETF shares and the underlying net asset value of those shares. The SEC views this arbitrage process as a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors from the risks of persistent deviations from net asset value.[35] The FSOC similarly has recognized that this trading activity provides liquidity, to the benefit of ETF investors, and that any reduction in that activity by APs could cause heightened price volatility in the ETF market.[36]

Second, in connection with their role as APs, some banking entities also may engage in traditional market making activities in the ETFs with which they participate.[37] For example, they may hold inventory with which to make markets, or support the launch of new ETFs by "seeding" them (*i.e.,* purchasing and holding ETF shares, possibly for an extended period of time, until the ETF establishes regular trading and liquidity on the secondary market).[38]

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[34] For an explanation of the ETF share creation and redemption process, *see* ETF Basics: The Creation and Redemption Process and Why It Matters, available at http://www.ici.org/viewpoints/view_12_etfbasics_creation. For a more detailed description of ETFs, *see* http://www.ici.org/etf_resources.

[35] A primary concern for the SEC in its efforts to establish a regulatory framework for ETFs was to ensure that the process for this type of trading could function effectively. *See* Part IV.B of SEC Release No. IC-25258 (November 17, 2001). ETF exemptive orders contain conditions specifically designed to provide for a sufficiently robust, but controlled, arbitrage process. *See, e.g.*, In the Matter of Pacific Investment Management Company LLC, et al, Investment Company Act Release Nos. 28949 (October 20, 2009 (notice)) and 28993 (November 10, 2009 (order)); and In the Matter of Claymore Exchange-Traded Fund Trust 3, et al, Investment Company Act Release Nos. 29256 (April 23, 2010 (notice)) and 29271 (May 18, 2010 (order)).

[36] *See* FSOC, 2011 Annual Report, Box E (at 67) (noting, in part, that "[a] departure of arbitrageurs from the market could result in ETF shares trading at a persistent discount or premium relative to their [net asset value]").

[37] In connection with its trading activities, an AP often will hedge its positions by transacting in the ETF's underlying securities or in the futures markets.

[38] Other banking entities that are not APs also provide meaningful liquidity to the ETF market through their market making activities. It is thus very important to ETFs and their investors that the Agencies address the shortcomings of the

2. ETF Trading Activities by Banking Entity APs May Not Come Within Various Exemptions from the Proprietary Trading Prohibition

Under the Proposed Rule, short-term principal trades in a banking entity's trading account constitute "proprietary trading" and are prohibited unless they meet the requirements of a specified exemption. A "trading account" is defined, in relevant part, as an account in which the banking entity seeks to realize "short-term arbitrage profits."[39] Language in the Proposing Release suggests that the Agencies propose to take a broad view of what constitutes arbitrage profits in this context.[40]

Section 619 of the Dodd-Frank Act identifies several types of trading as "permitted activities" and thus exempt from the Volcker Rule prohibition. It may be difficult, however, for APs to utilize these exemptions as proposed by the Agencies. As discussed in more detail in Section II below, several of the proposed exemptions are subject to complex conditions and do not reflect the manner in which the financial markets operate.

a) Exemption for Market Making-Related Activities

The proposed exemption for "market making-related activities" is too narrow to accommodate all ETF trading activities by banking entity APs. In order to rely on this exemption, an AP would have to be registered with a listing exchange, undertake to enter and maintain two-sided quotes and make a market in ETF shares, and otherwise comply with the requirements of the exemption. First, APs that transact directly with an ETF to create or redeem shares but do not hold themselves out as market makers would not qualify for the exemption as drafted. Such trading activity, however, plays a very important role in making ETF shares available to the market at prices close to the ETF's underlying net asset value.

Second, even APs that hold themselves out as market makers in ETF shares may find it difficult to meet the requirements specified in the exemption for some of their ETF trading activity. An AP's transactions directly with an ETF may fall within the exemption's literal conditions; since the ETF is the AP's counterparty, such transactions should be "designed not to exceed the reasonably expected near term demands of [the AP's] . . . counterparties."[41] Other ETF-related trading by the AP, however, appears to fall outside the exemption as currently drafted. This could include an AP's secondary market trading in ETF shares and in an ETF's portfolio securities, which trading is necessary to enable the AP

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proposed exemption for market making-related activities. ICI's concerns regarding that exemption are discussed in detail in Section II.B.2 below.

[39] §___.3(b)(2)(A)(3) of the Proposed Rule.

[40] *See* Proposing Release, 76 Fed. Reg. at 68858 ("a position acquired to lock in arbitrage profits would include positions acquired or taken with the intent to benefit from differences in multiple market prices, even in cases in which no movement in those prices is necessary to realize the intended profit.") (emphasis in original).

[41] §___.4(b)(2)(iii) of the Proposed Rule.

both to engage in transactions directly with the ETF and to hedge its positions.[42] The AP may have trouble demonstrating, for example, that such trading was "designed not to exceed the reasonably expected near term demands of clients, customers or counterparties."[43] It also could be difficult, during periods of limited trading in an ETF's shares, for the AP to demonstrate that its secondary market trading involved "[a] pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity."[44] Finally, as part of their market making activities, APs often "seed" new ETFs. Depending on how much interest the ETF garners in the marketplace, an AP could hold a substantial amount of a new ETF's shares for an extended period of time.[45] In this instance, an AP could have difficulty demonstrating compliance with the conditions of the exemption.

If this exemption were adopted as proposed, banking entities may be reluctant to transact directly with ETFs to create or redeem shares, to seed new ETFs and otherwise make markets in ETF shares unless they are confident that they can sell their positions immediately. This would provide a major disincentive for banking entities to act as APs for ETFs and make it much more difficult for new ETFs to launch.

b) Exemption for Underwriting Activities

An AP generally would not qualify for the exemption for permitted underwriting activities as drafted in the Proposed Rule. Under current law, whether an AP is considered an underwriter is a question of facts and circumstance.[46] The Proposed Release explains that in determining whether a banking entity is acting as an underwriter as part of a distribution of securities, the Agencies will consider, among other things, the extent to which an entity is (a) performing due diligence, (b) advising the issuer on market conditions and assisting in the preparation of a registration statement or other offering documents, and (c) participating in or organizing a syndicate of investment banks.[47] APs

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[42] *See* Section II.B.2.c. below for a discussion of our concerns regarding the proposed exemption for risk-mitigating hedging, the conditions of which must be met by any hedging conducted as part of a banking entity's market making-related activity.

[43] §___.4(b)(2)(iii) of the Proposed Rule.

[44] According to the Proposing Release, such a pattern of trading would be indicative of whether the AP "holds itself out as being willing to buy and sell . . . the covered financial position for its own account on a regular or continuous basis," as is required by the exemption. Proposing Release, *supra* note 2, at 68870. Many of an AP's transactions are in fact designed to comprise "a pattern of trading that includes both purchases and sales in roughly comparable amounts to provide liquidity;" however, because the trading does not involve the purchase and sale of a single security, but rather groups of equivalent securities (*i.e.*, the ETF shares and the basket of securities and cash that is exchanged for them), it may not satisfy this requirement.

[45] For this and other reasons, it is very important for the final version of the Volcker Rule to exclude ETFs and other registered investment companies from the definition of "banking entity." *See* Section I.B. above.

[46] *See, e.g.*, ETF Rule Proposing Release, *supra* note 33, at n.22.

[47] *See* Proposing Release, *supra* note 2, at 68867.

typically do not perform some or all of these activities with respect to an ETF's shares. Accordingly, most APs would not meet the requirements of the exemption for permitted underwriting activities as it is currently drafted.

c) Exemption for Trading on Behalf of Customers

As noted above, some APs trade directly with an ETF on behalf of the AP's own clients. Section 619 of the Dodd-Frank Act specifically states that "the purchase, sale, acquisition or disposition of securities [or other financial instruments] on behalf of customers" is a permitted activity. The Agencies, however, have narrowly identified three categories of transactions that would qualify for this exemption, none of which appears to contemplate the unique type of arbitrage trading in which APs engage. There is no policy reason why the Proposed Rule should forbid any customer-driven transactions on the part of APs.

3. The Rule Explicitly Should Designate ETF Trading Activity by Banking Entity APs as a Permitted Activity

The Proposed Rule should be revised to designate trading activity of APs with respect to ETF shares as a permitted activity. It is appropriate, in our view, for such modification to cover APs' trading activities regardless of whether such trading occurs in an AP's capacity as a traditional market maker, on behalf of an AP's clients, or solely for an AP's own account. In each of those cases, the AP's purchase and sale transactions with the ETF are a unique and controlled form of arbitrage trading that does not present the risks that Congress intended to address through the Volcker Rule. Moreover, the SEC consistently has recognized the importance of this AP trading in facilitating the proper functioning of the ETF market, thus benefitting ETF investors.

Question 91 in the Proposing Release appears to contemplate that the exemption for "market making-related activities," as currently proposed, may not "appropriately differentiate between market making-related activities in different markets and asset classes."[48] As noted above, it asks whether "the market for exchange-traded funds . . . raise[s] particular issues that are not adequately or appropriately addressed in the proposal."[49] It further specifically asks whether the requirements for market making-related activity should "be modified to include certain arbitrage trading activities engaged in by market makers that promote liquidity or price transparency, but do not serve customer, client or counterparty demands, within the scope of market making-related activity[.]"[50]

Designating the trading activity of APs as a specific form of permitted activity is consistent with the Agencies' goal of providing "appropriate latitude" to banking entities to provide services that "are

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[48] Proposing Release, 76 Fed. Reg. 68873.

[49] *Id.*

[50] *Id.*

important to the U.S. financial markets and the participants in those markets."[51] The ability to identify APs (by virtue of the limited pool of eligible entities and the requirement for any AP to execute an agreement with the ETF) and the unique and controlled form of arbitrage involved make it feasible to identify and distinguish the trading relating to ETF shares conducted by any such AP from other prohibited proprietary trading. The Agencies could, for example, require that a banking entity's compliance policies and internal controls take a comprehensive approach to the entirety of an AP's trading activity, so that such trading can be easily monitored to ensure compliance with the Proposed Rule.

We have provided suggested rule text for your consideration in Appendix B.

II. The Proposed Rule Could Greatly Impair the Financial Markets

Section 619 of the Dodd-Frank Act prohibits a banking entity from engaging in proprietary trading of securities, derivatives, and certain other financial instruments for its own account. Notwithstanding this broad prohibition, the statute provides exemptions for a banking entity to engage in certain "permitted activities." Significantly, as discussed further below, exemptions are provided for positions taken in connection with market making-related activities, risk-mitigating hedging activities, and trading in certain U.S. government securities. Exemptions also are provided for trading "on behalf of customers,"[52] activities conducted solely outside of the United States by certain non-U.S. banking entities, underwriting activities, and trading by regulated insurance companies.

ICI supports the overall goals of the Volcker Rule's proprietary trading prohibition, particularly the need to address systemic risk concerns surrounding truly speculative proprietary trading. We do not believe, however, that the Proposed Rule's proprietary trading restrictions, as currently drafted, will achieve these goals. Instead, they may adversely impact the financial markets and the ability of registered funds and other investors to participate in the markets. The implications of the Proposed Rule for the markets actually may be inconsistent with the goals of Section 619, in that the Proposed Rule, if adopted, might increase—not decrease—systemic risk.

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[51] Proposing Release, 76 Fed. Reg. 68849. Alternatively, an AP's ETF trading activity could be excluded from the definition of "trading account." We note that Question 25 of the Proposal asks how the proposed definition of "trading account" should address arbitrage positions and whether all arbitrage positions should be included in that definition. Proposing Release, 76 Fed. Reg. at 68861. As described above, we believe it is possible to identify ETF trading activities on the part of APs and distinguish them from other trading activities included within a banking entity's "trading account."

[52] In the context of the exemption for trading on behalf of customers, the Proposal states that "[f]or example, in the case of a banking entity acting as investment adviser to a registered mutual fund, any trading by the banking entity in its capacity of investment adviser and on behalf of that fund would be permitted pursuant to [the proposed rule], so long as the relevant criteria were met."

A. Liquid and Efficient Markets are Important for Registered Funds

For registered funds, the availability of liquidity is a critical element of efficient markets. Banking entities are key participants in providing this liquidity, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading.[53]

Liquidity is particularly important in the everyday operations of mutual funds, which typically offer their shares on a continuing basis and are required by the Investment Company Act to issue "redeemable securities."[54] Mutual funds must have efficient markets to invest cash they receive when investors purchase fund shares as well as to meet investor redemption requests on a daily basis.[55]

Registered funds also are dependent on adequate liquidity when making investment decisions and when trading the instruments in which they invest. Important investment criteria analyzed by portfolio managers at registered funds include a security's liquidity, as well as whether a position can easily be sold in a timely and cost efficient manner. If registered funds cannot transact effectively in the financial markets due to a lack of liquidity, they may be reluctant to invest in certain instruments altogether.[56]

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[53] *See* Testimony of Alexander Marx, Head of Global Bond Trading, Fidelity Investments, at Joint Hearing of the Capital Markets and Government Sponsored Enterprises Subcommittee and the Financial Institutions and Consumer Credit Subcommittee, House Financial Services Committee, *Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation*, January 18, 2012 ("Joint Hearing") ("... the typical role of market maker banks ... is to bridge the gap between buyers and sellers and to provide the liquidity necessary for these markets to function. This results in the ability for mutual funds to be more fully invested in the capital markets.") ("Fidelity Testimony").

[54] *See* Section 2(a)(32) of the Investment Company Act (generally defining "redeemable security" as "any security . . . under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.").

[55] *See* Testimony of Douglas Peebles, AllianceBernstein, at Joint Hearing ("... the potential impact on liquidity would have negative consequences for mutual fund investors. Products that feature less liquid investments, like many fixed income funds, could experience difficulties with subscription and redemption activity. If banking entities reduce their role to agents and there is no other counterparty available, then mutual funds might face challenges in redeeming shares at the stated NAV.").

[56] One ICI member observed that without a ready market maker for smaller issuers, issuers in volatile sectors, or issuers with a lower credit rating, portfolio managers may be unwilling to purchase such securities, making it more difficult for such issuers to raise capital after the implementation of the Volcker Rule. Another member reported that the ability to adjust and manage fund portfolios in shareholders' best interests would be inhibited greatly by the potential reduction in liquidity and the associated higher costs that could be incurred by registered funds. Finally, another member noted that a reduction in liquidity would affect the overall market by creating an "illiquidity" premium for all newly issued fixed income instruments. As a result, borrowing costs will increase. For those instruments already in the market without this built-in premium, the price of the fixed income instrument could fall suddenly to reflect the appropriate premiums. All of these changes would affect fixed income funds and the types of instruments that portfolio managers are willing to purchase for the funds.

Finally, adequate liquidity in the markets also helps dampen volatility; the impact of volatility on the costs of trading for investors, as well as investor confidence overall, cannot be discounted. The volatility experienced by the financial markets over the past several years has taken a toll on overall investor confidence, making the availability of adequate liquidity of key importance.

As discussed further below, we are deeply concerned that the Proposed Rule would decrease liquidity, particularly for those markets that rely most on banking entities to provide liquidity, such as the fixed income and derivatives markets and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, leading to, among other things, wider bid-ask spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders.[57]

B. The Complexity of, and Difficulties of Complying with, the Proposed Rule Threaten Market Liquidity and May Adversely Impact Registered Funds

Much of the concern surrounding the effect of the Proposed Rule on liquidity arises from the complexities of several provisions of the Proposed Rule and of the exemptions from the proprietary trading prohibition. Although the Volcker Rule was not intended to inhibit legitimate market making activities of banking entities,[58] the Proposed Rule's presumption of prohibited activity, combined with its complexity and uncertainty as to how the Agencies will assess compliance, could preclude market makers from providing needed liquidity and make the Rule unworkable. In light of the associated compliance costs, it would not be surprising if banking entities were to determine that their current business practices are not economically sustainable, prompting them either to exit the market making business altogether or significantly curtail both the size and scope of their market making activities.

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[57] *See* Statement of BlackRock, Inc., at Joint Hearing ("... the Proposed Rule creates significant uncertainties for market makers which will disrupt the markets for certain securities. ... A disruption in dealer activities will lead to less liquidity in the market, resulting in wider bid-ask spreads and higher borrowing costs, which will have significant negative economic consequences for savers as well as for corporate and municipal borrowers."). *See also Oliver Wyman SIFMA, The Volcker Rule Restrictions on Proprietary Trading: Implications for the U.S. Corporate Bond Market* (December 2011) (based on current holdings of U.S. corporate bonds ($7.7 trillion), investors may lose between $90-$315 billion in immediate value in those securities due to decreased liquidity. Ongoing transaction costs for this asset class could further impair investor returns by $1-$4 billion). As of year-end 2010, registered funds held approximately $1.5 trillion in corporate bonds or 13% of the corporate bond market. *See* 2011 Investment Company Fact Book, Role of Investment Companies in Financial Markets, available at http://www.icifactbook.org/fb_ch1.html#role. If the estimates in the Oliver Wyman-SIFMA study are correct, the shareholders in those funds likely would face immediate and ongoing losses of a very substantial amount.

[58] *See* Letter from Sen. Kirsten E. Gillibrand (D-NY) to Agencies, dated January 25, 2012 ("In crafting this legislation, Congress sought to balance the need of financial institutions to hold assets in order to maintain liquidity in the marketplace with the restrictions imposed by the rule. The ability of firms to continue to make markets, particularly in less liquid markets where buyers and sellers are not always immediately available, is important for the continued competitiveness of the US financial industry and the broader strength of the US economic system which relies on deeply liquid financial markets.").

Many of ICI's concerns with the Proposed Rule, as discussed further below, relate to the apparent rigidity of the requirements of the Proposed Rule and conditions associated with the accompanying exemptions. We believe the Volcker Rule should deter banking entities from engaging in truly speculative proprietary trading. We support suggestions from other commenters, however, to recast what appear to be rigid criteria to define permitted activities as instead guidance that could be incorporated into policies and procedures to be adopted by banking entities.[59] These policies and procedures, in combination with a robust compliance program required to be employed by banking entities, the use of relevant quantitative metrics to evaluate banking entity trading activity,[60] and examinations by the Agencies to ensure that speculative proprietary trading is not occurring, should facilitate the continued availability of market making activities and other activities needed by registered funds to trade efficiently in the financial markets. Under such approach, it would be important for the final rule to state explicitly that the criteria are solely indicia of permitted trading activity, and that a banking entity that violates one or more of those criteria will not automatically be deemed to violate the Rule, provided that the banking entity's overall trading activity substantially represents permitted activity. Suggested language to implement this guidance approach is provided in Appendix B.

1. The Presumption of Prohibited Activity is Unwarranted

Proprietary trading includes engaging as principal for the "trading account" of a banking entity in any transaction to purchase or sell certain types of financial positions.[61] The Proposed Rule generally presumes "guilt"—that a banking entity's short-term principal trading activity is prohibited proprietary trading. Most significantly, the Proposed Rule creates a presumption that an account is a trading account, and therefore subject to the proprietary trading prohibition, if it is used to acquire or take a covered financial position that the banking entity holds for a period of 60 days or less. While the Proposed Rule provides a mechanism to rebut this presumption, doing so appears extremely complex, onerous, and risky. Inevitably, it would expose a banking entity to hindsight interpretations of key compliance decisions with respect to each individual financial position.

This presumption of prohibited activity prejudices the analysis of a banking entity's trading activity from the outset. Given the difficulties of overcoming the presumption, market makers

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[59] *See* SIFMA Comment Letter on Volcker Rule – Proprietary Trading. The FSOC has suggested that the Agencies should implement the Volcker Rule through a combination of internal compliance policies and procedures, reporting and review of quantitative metrics and supervisory review. *See* Volcker Rule Study, *supra* note 5.

[60] The Proposal contains a number of quantitative metrics that will be used to identify and monitor permitted activities. We believe that certain quantitative metrics may be useful to highlight data that would be informative to the Agencies in the context of examinations. We do not believe, however, that all of these metrics should be considered as bright line triggers for enforcement or remedial action; some metrics may be more relevant than others for a particular asset class, activity, market and unique characteristics of each banking entity for which they are being measured.

[61] Most significantly, the definition of trading account includes positions taken principally for the purpose of short-term resale, benefitting from short-term price movements, realizing short-term arbitrage profits, or hedging another trading account position.

understandably will be highly reluctant to make markets with respect to any instrument they believe could fall within the proprietary trading prohibition.

2. The Exemptions from the Proprietary Trading Prohibition are Complex and Unworkable

In light of the presumption of prohibited activity built into the Proposed Rule, it is imperative that the terms and conditions of the exemptions from the proprietary trading prohibition be clearly delineated and that they reflect accurately the practices in the varied markets to which they apply.

a) The Conditions of the Exemptions Do Not Reflect the Operation of the Financial Markets

The Proposed Rule appears tailored primarily for the operations of the traditional trading of equities on an agency-based "last sale" model (*i.e.*, on the securities exchanges), the operations of which differ substantially from those of other markets, such as the fixed-income and derivatives markets. For example, by importing the Securities Exchange Act of 1934 and Regulation SHO definitions of a "market maker," the Proposed Rule appears dependent on the model of a market maker in liquid equities, whose characteristics vary significantly from those of most other financial instruments.

In the majority of the financial markets, however, market makers provide liquidity by acting as principal, and not as agent. The Proposed Rule therefore does not reflect accurately the manner in which those other financial markets operate: fixed-income securities and derivatives are traded "over-the-counter" rather than on exchanges; their instruments are not as liquid as equities; and the markets and their instruments are more fragmented. As a result, market making in fixed-income securities and derivatives is more complex than in the majority of equity securities and is fundamental to how these markets operate.

While many of the concerns already expressed about the Proposed Rule in the comment letter record focus on the impact on the fixed-income and derivatives markets, it is important to recognize that the Proposed Rule also may create difficulties for the manner in which registered funds trade in the equity markets. For example, block trading is an important trading strategy used by registered funds in the equity markets when the execution of a large amount of securities at one time is desired. Block trades can be structured in several ways but generally, banking entities acting as dealers guarantee a minimum price or volume for the block trade to a customer. As a result, block trading relies heavily on banking entities acting as market makers trading on a principal basis. We are concerned that the Proposed Rule may inhibit block trading, particularly in less liquid equity securities.

We are therefore concerned that the Rule will inhibit the ability of banking entities to conduct their market making activities effectively across all asset classes to provide necessary capital to registered

funds by acting as principal in a transaction.[62] As Fidelity Investments stated in recent testimony on the Volcker Rule:

> Fidelity's funds rely on the fact that a dealer will be able, at any particular time, to provide an ample source of liquidity for the funds when they would like to purchase particular securities. Similarly, a dealer can purchase securities from Fidelity's funds upon request because the dealer can hold the securities in its inventory until it finds a purchaser for those securities. In this manner, the process by which a fund buys or sells securities does not require the fund to find another investor in the market who is a perfect match for that particular trade. Rather, a dealer's ability to hold inventory on its books allows it to be a direct counterparty to the funds, thereby facilitating the funds' day-to-day trading needs. In this capacity, the dealer is not trading solely on behalf of a third-party client in its transactions with the funds (a process known as trading on an "agency" basis), but instead on a principal basis. This type of principal trading differs from speculative proprietary trading. In customer-facing principal trading, the dealer is making a market in securities, which allows customers, such as the Fidelity mutual funds, to transact efficiently.[63]

The Proposed Rule also does not take into account the need for flexibility and discretion by market makers to enter into transactions to build inventory, which is a significant element of market making. As a result, the exemptions provided in the Proposed Rule from the proprietary trading prohibition, particularly the exemption for market making-related activities, likely will be of very limited utility for banking entities, as described below. If that is the case, trading activity that registered funds rely on will be restricted, negatively impacting transaction costs, increasing shareholder risk, and ultimately impacting fund shareholder returns.

b) The Conditions in Meeting the Market Making-Related Activity Exemption are Impractical

The Proposed Rule's implementation of Section 619's market making-related activity exemption contains numerous conditions that must be met by a banking entity.[64] Based on discussions

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[62] *See* Statement by Governor Daniel K. Tarullo, at Joint Hearing ("... instances of ... riskless market making in our trading markets are rare. In actual markets, buyers and sellers arrive at different times, in staggered numbers and often have demands for similar but not identical assets. Market makers hold inventory and manage exposures to the assets in which they make markets to ensure that they can continuously serve the needs of their customers.").

[63] *See* Fidelity Testimony, *supra* note 53.

[64] These conditions include, among other things: establishing an internal compliance program; ensuring that the trading desk that makes a market in a covered financial position holds itself out as being willing to buy and sell the covered financial position, for its own account, on a regular or continuous basis; ensuring that market making-related activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; ensuring that market making-related activities generate revenues primarily from fees, commissions, bid/ask spreads, or other income that is not attributable to appreciation in the value of covered financial positions held as inventory or their hedges; and that

with market participants on both the sellside and the buyside, we believe these conditions, as currently drafted, make the exemption extremely complex and so difficult to comply with as to be effectively unworkable in a number of financial markets and for a significant number of financial instruments.

For example, the Proposed Rule would require banking entities to ensure that their market making activities generate revenues primarily from fees, commissions, bid/ask spreads or other income that is not attributable to appreciation in the value of covered financial positions held as inventory or hedging of such covered financial positions. As discussed above, market making in fixed-income and derivatives instruments simply does not function in that way, as market makers provide liquidity by acting as principal, and not as agent, in these markets. This condition ignores that market makers holding inventory may seek to generate revenue and profit from the appreciation, and avoid losses from the depreciation, of the covered financial position during the time they hold the position in inventory. Given the difficulties of complying with this condition, market makers understandably will be highly reluctant to make markets with respect to any instrument they are not reasonably confident they can resell immediately; in fact, the Proposed Rule will encourage market makers to dispose of every position as quickly as possible to avoid any appreciation in value. Banking entities not only may be hesitant to make markets in less liquid securities held by registered funds but also may charge higher fees to compensate for the risks associated with the need to quickly sell out of a position. We therefore recommend that the Proposed Rule take into account the fact that market making often involves the need to take short-term positions that may ultimately result in a profit or loss.

Similarly, in less liquid markets where trades are infrequent and customer demand is hard to predict, it may be difficult for a market maker to satisfy the condition that its activity be "designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties." As one ICI member reported, from time to time, market makers inevitably will purchase securities based on a reasonable estimate of customer demand that does not materialize, or acquire a position from a customer that appreciates in price prior to its subsequent sale. It is important for market participants to have comfort that failure of their reasonable expectations to materialize will not result in their being deemed to have engaged in proprietary trading.

Finally, to comply with the market making-related activities exemption, a banking entity must establish a compliance program meeting significant and costly requirements and comply with a host of quantitative tests and measures that will be used to identify and monitor permitted market making-related activity. We understand that the compliance burdens and costs to satisfy these requirements will be onerous at best, and that they alone may dissuade a banking entity from attempting to comply with the market making-related activities exemption. Requiring a compliance program in connection with the Volcker Rule is reasonable; however, the Agencies should reexamine the compliance requirements with a view to ensuring that the benefits of the requirements will justify their costs.

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compensation arrangements for employees performing market making-related activities must be designed not to reward proprietary risk-taking.

The fact that a failure to meet any one of the many conditions in the exemption could disqualify a banking entity's trading unit from engaging in the permitted marking making-related activity creates a difficult burden to overcome. In discussions with staff of the Agencies, we understand that the intent of some is to apply the conditions holistically, rather than on a trade-by-trade basis, to determine whether a follow-up discussion with the banking entity is warranted. We are concerned, however, that the examination process of other Agencies historically has been more rigid, "check the box," and enforcement oriented. We therefore recommend, as discussed above, that the Agencies institute an oversight program under which the conditions of the exemption would serve solely as guidance for when proprietary trading may be occurring. Activity falling outside of the guidance would signal that follow-up discussions with the banking entity should occur for the relevant oversight Agency to better understand the purpose behind the trading in question.

c) The Risk-Mitigating Hedging Exemption Must be Flexible

The ability of banking entities to hedge their positions and manage the risks taken in connection with their activities is a critical element of a liquid and efficient market. It is therefore imperative to ensure that banking entities can hedge their positions appropriately to allow them effectively to provide needed services to registered funds.

The exemption provided for hedging under the Proposed Rule appears to raise a number of potential concerns for the activities of banking entities and overall market liquidity. For example, to comply with the requirements of the risk-mitigating hedging exemption, a transaction must be "reasonably correlated ... to the risk or risks the purchase or sale is intended to hedge or otherwise mitigate." This provision raises uncertainties about what constitutes a "reasonable" correlation to a specific hedge and whether a specific hedge meets this test. In addition, it is unclear whether the exemption's continuing review requirements must be done on an individual hedge level or across the overall portfolio of a trading unit.

The risk-mitigating hedging exemption should be flexible enough to allow banking entities to appropriately manage all possible risks and to facilitate hedging against overall portfolio risk; it should not be a transaction-by-transaction analysis.[65]

Similar to our recommendations discussed above in relation to the market making-related activities exemption, the risk-mitigating hedging exemption should contain a general statement that risk-mitigating hedging is permitted and encouraged, with the current rigid criteria changed to become

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[65] Banking entities often conduct program risk trading, which enables advisers to registered funds to efficiently trade multiple securities in a single transaction and manage significant flows into and out of funds in a cost-effective manner. The Proposed Rule should ensure sufficient flexibility to permit banking entities to adequately aggregate their positions for purposes of hedging their trades; it is important for advisers to registered funds to have access to banking entities' traditional equity securities market making activities, including their ability to enter into block trades and to hedge without undue restriction, so that fund shareholders will not be faced with unnecessarily increased costs and risks.

guidance, and with a requirement that banking entities adopt risk limits and policies and procedures commensurate with the Agencies' guidance. The Agencies then would review risk-mitigating hedging through metrics and examinations.

d) The Government Obligations Exemption Should be Expanded to Cover All Municipal Securities

One of the permitted activities specified in Section 619 is trading in certain government obligations, including obligations of any State or political subdivision.[66] The language of the permitted activity provision, however, does not extend expressly to transactions in obligations of an *agency or instrumentality* of any State or political subdivision. The Proposed Rule carries forth this narrow statutory language into the proposed government obligations exemption.

It has been suggested that excluding obligations of an agency or instrumentality of a State or political subdivision will subject almost half of the securities currently outstanding in the municipal securities market to the proprietary trading prohibition.[67] Banking entities currently play a significant role in underwriting and facilitating a secondary market for municipal securities of agencies and instrumentalities. These instruments represent one of the more conservative asset classes in the capital markets, and registered funds are significant investors in these securities.

We submit there is no rational basis upon which to exclude this particular class of municipal securities. Doing so will restrict trading in these instruments, pose liquidity challenges for registered funds holding these securities, and widen bid-ask spreads.[68] Moreover, excluding agency or instrumentality obligations unreasonably will impair the ability of many local government entities to raise capital, with significant adverse consequences for the finances of these entities. As discussed above, the fixed-income market as a whole is more dependent on market makers than other markets; the municipal securities market arguably is even more dependent on market makers than the other parts of the fixed-income market. Institutional investor involvement also is lower in the municipal securities market as compared to other fixed-income markets, and banking entities therefore play an increased

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[66] Specifically, new Section 13(d)(1)(A) of the BHCA includes as one of the permitted activities the "purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution . . . *and obligations of any State or of any political subdivision thereof.*" (Emphasis added.)

[67] *See, e.g.*, Citigroup Global Markets, US Municipal Strategy Special Focus, *Volcker Rule – Potentially Negative Implications for Municipals*, November 20, 2011 ("Citi Paper").

[68] One study of the impact on the municipal securities market of the Proposed Rule predicts that underwriters potentially would be unable to take down unsold positions on new deals beyond the life of the underwriting and would have to price deals at higher yields to assure that they were fully sold during the underwriting, and new issues also would have to be sold at higher yields to risk-adjust for a less liquid secondary market. *See* Citi Paper, *supra* note 67.

role as liquidity providers.[69] Finally, the municipal securities market is more fragmented, with more CUSIPs and issuers overall.[70] We recommend that the permitted activity exemption for government obligations be expanded to include *all* municipal securities by cross-referencing the current definition of "municipal securities" under the Securities Exchange Act of 1934.[71] We believe that such a change would meet the Agencies' statutory requirement to show that an exemption "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."[72]

e) The Government Obligations Exemption Should be Expanded to Cover Foreign Sovereign Obligations

While the Proposed Rule tracks the statute and exempts U.S. government obligations from the Volcker Rule's proprietary trading prohibitions, the Proposed Rule does not provide a similar exemption for other sovereign obligations. If the Proposed Rule is not revised, trading in obligations of foreign governments and international and multinational development banks will suffer. As several foreign governments have pointed out, the absence of U.S. and other internationally active banks from the market for these sovereign obligations could reduce liquidity in sovereign markets, which in turn would engender greater volatility and make it more difficult, riskier and costlier for foreign countries to issue and distribute their debt.[73]

Many registered funds invest in foreign sovereign obligations, and harm to the trading and liquidity of these instruments would impact directly investors in these funds. Excluding such debt from the government obligations exemption will ultimately restrict U.S. registered funds and foreign publicly offered funds in the types of investments that they currently undertake.

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[69] As of September 2011, retail investors held about half of all tax-exempt debt directly and another 23 percent of tax-exempt debt through registered funds (Sources: Flow of Funds Accounts published by the Federal Reserve and ICI).

[70] According to one study, the municipal securities market consists of over two million CUSIPs and close to a hundred thousand issuers as compared to the corporate market, which has only a hundred thousand CUSIPs and about ten thousand issuers. *See* Citi Paper, *supra* note 67.

[71] Section 3(a)(29) of the Securities Exchange Act of 1934 defines "municipal securities" as "securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, *or any agency or instrumentality of a State or any political subdivision thereof*, or any municipal corporate instrumentality of one or more States, ..." (Emphasis added.)

[72] *See* Section 13(d)(1)(J) of the BHCA.

[73] *See, e.g.*, Letter from European Union Commissioner Michel Barnier (dated February 8, 2012); Letter from Financial Services Agency, Government of Japan, and Bank of Japan, to Mr. John G. Walsh, Acting Comptroller of the Currency, Office of the Comptroller of the Currency, and others, dated December 28, 2011 and Letter from Julie Dickson, Superintendent, Office of the Superintendent of Financial Institutions Canada, to Department of the Treasury, Office of the Comptroller of the Currency, and others, dated December 28, 2011.

Exempting foreign sovereign obligations from the ban on proprietary trading is consistent with the clear Congressional objective of limiting the extraterritorial reach of the Volcker Rule and, more fundamentally, would seem to be consistent with the purposes of the Rule. We recognize that exempting foreign sovereign obligations may require the Agencies to satisfy the standard set forth in Section 13(d)(1)(J) of the Bank Holding Company Act, which requires a showing that an exemption "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." In our view, this standard readily can be met. The inter-connectedness of global financial and inter-bank markets is at this point well established; one needs to look no further than the serious potential repercussive effects to the United States and to U.S. banks from the European Union debt crisis and the possible failure of even a small country, Greece, to honor its obligations. An exemption for foreign sovereign obligations, which would enhance the liquidity and price stability of foreign sovereign debt, also would enhance the stability of the U.S. financial system and protect the safety and soundness of U.S. banking entities.[74] By contrast, a failure to adopt such an exemption could invite reprisals from foreign governments, which public press reports indicate already may be considering such steps. Such actions could harm the functioning of financial markets and trading of U.S. and other sovereign obligations at a time when shrinking the liquidity in such markets seems particularly counterproductive.

If foreign sovereign obligations are not exempted through this exemption, the Agencies should ensure that the market making-related activities exemption and other relevant exemptions are revised to allow banking entities to engage in these activities.

C. The Agencies' Proposed Implementation of the Proprietary Trading Prohibition Will Impact the Structure of the Financial Markets and the U.S. Economy Overall

The Agencies' proposed implementation of the proprietary trading prohibition could have negative implications for capital formation. Banking entities also may find it difficult to remain in the market making business, which could lead these activities to be performed by less regulated and less transparent institutions. We therefore believe the over-broad restrictions of the Proposed Rule, which go well beyond what is necessary to effectuate Congress' intent in enacting Section 619 of the Dodd-Frank Act, could hurt the broader economy, impacting job creation and investments in U.S. businesses overall. Our recommendations discussed above to relieve some of the burdens on compliance with the Rule and the exemptions thereunder should help alleviate some of these negative implications.

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[74] We believe the Agencies have ample authority to review and examine banking entity investment activities in sovereign debt, and the Agencies can use this authority—as they do now—to ensure that no banking entity takes excessive positions in any foreign government issuer. The Agencies also have other tools, such as the Basel capital rules, to increase the risk weights that are applied to certain government debt obligations; these alternative means to control and evaluate risk present, in our view, a more refined and appropriate tool to manage any risk concerns. We note, in this regard, that the federal banking agencies appear to have used just such measures in their recent capital proposals, which allow lower risk weights for certain sovereigns meeting the Organization for Economic Cooperation and Development's country risk classification standards. *See* 76 Fed. Reg. 79380 (December 21, 2011).

1. Impact on Capital Formation

As currently drafted, the proprietary trading prohibition likely will impact overall capital formation. Banking entities play a critical role in initial capital formation, often providing companies with the capital necessary to go public.

The Proposed Rule contains an underwriting exemption that permits a bank to purchase or sell securities in connection with the bank's underwriting activities if the activities satisfy certain criteria. We understand, however, that in their current form, the conditions for relying on the exemption would make it risky for banking entities to purchase securities for their own account, out of concern that investor demand could fall short of expectations. If banking entities find that the restrictions contemplated by the Proposed Rule prohibit or greatly impede their serving this role, they will be less willing to provide capital, adversely affecting registered funds and other investors.

If issuers and dealers face increased costs in the capital formation process due to the Proposed Rule, this could restrict access for registered funds to suitable investments, and the availability of investments for registered funds overall will decline. As one member reported, because banks likely would be unwilling to assume this risk, higher rates would be required to lure investors, causing the cost of raising capital to increase; this likely would result in a more concentrated supply of securities, thereby decreasing the opportunity for diversification in registered funds' portfolios.

2. Changes to the Adequacy and Availability of Liquidity Providers

If banking entities currently serving as market makers are unable to continue to provide necessary services to registered funds and other investors, or are forced to exit the market making business altogether, the non-banking entity market makers that remain may be unable to provide the liquidity necessary for funds to conduct trades efficiently in the markets. We are skeptical that other entities that purport to conduct market making activities will be able to replace the many well-capitalized banking entities that currently provide needed services to funds, particularly in less liquid markets. It is not clear that other entities will be able to step in to replace market makers that may exit the business due to an aggressive implementation of the Volcker Rule. Even if they do, this likely will not occur immediately. It may take some time for a new trading environment to evolve, following a period of potentially significant market dislocation. We urge careful consideration of whether a more nuanced implementation of the Volcker Rule could avoid or mitigate this upheaval and its attendant costs (*i.e.*, wider spreads and diminished shareholder confidence).

III. The Proposed Rule Could Limit Investment Opportunities for Registered Funds and their Shareholders

A. The Foreign Trading Exemption Should Be Revised To Avoid Adverse Effects on U.S. Registered Funds' Investments in Certain Foreign Securities

Section 619 of the Dodd-Frank Act states that trading outside of the United States is a "permitted activity," evidencing Congressional recognition that there should be limits on the extraterritorial reach of the Volcker Rule. The Proposed Rule greatly limits the utility of this exemption, however, by departing—without explanation—from the long-established and well understood standards of Regulation S under the Securities Act of 1933. Regulation S governs whether a securities offering takes place outside of the United States and therefore is not subject to U.S. registration requirements.[75] If adopted as proposed, the Proposed Rule would have negative consequences for registered funds and their shareholders.

Pursuant to their stated investment policies, many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States.[76] These investments often involve non-U.S. counterparties that fall within the definition of "banking entity" under Section 13 of the BHCA and the Proposed Rule (*e.g.*, a foreign bank with a U.S. branch). Such counterparties ("non-U.S. banks") thus will be subject to the requirements of the Proposed Rule, including the prohibition on proprietary trading and, accordingly, they will need to comply with one or more of the exemptions for permitted activities.

To implement the provision of the Volcker Rule designating trading outside of the United States as a permitted activity, the Proposed Rule contains an exemption from the general prohibition on proprietary trading for non-U.S. banks that engage in trading solely outside of the United States ("foreign trading exemption").[77] In order to satisfy the "solely outside of the United States"

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[75] *See* Regulation S (Rules Governing Offers and Sales Made Outside of the United States Without Registration Under the Securities Act of 1933), 17 C.F.R. §§230.901-230.905.

[76] As of September 30, 2011, U.S. mutual funds (other than money market funds) held $662.8 billion in non-U.S. debt securities.

[77] *See* § ___.6(d)(1). To qualify for this exemption, the non-U.S. bank must not be directly or indirectly controlled by a banking entity that is organized under the laws of the United States or one or more of the states, the purchase or sale must be authorized by Section 4(c)(9) or 4(c)(13) of the BHCA and the purchase or sale must occur solely outside of the United States. Section ___.6(d)(2) provides the requirements for a purchase or sale to be authorized by Section 4(c)(9) or 4(c)(13) of the BHCA.

requirement, a transaction must meet various conditions, including that no party to the transaction may be a "resident of the United States."[78]

We believe that many non-U.S. banks will seek to rely on the foreign trading exemption to engage in market making and other trading activities, given the compliance burdens associated with the market making and other possible exemptions in the Proposed Rule, as discussed in Section II, above.[79] If so, the expansive manner in which the Proposed Rule defines "resident of the United States" for purposes of the foreign trading exemption would meaningfully hamper registered funds' ability to invest in some securities by significantly reducing access to non-U.S. counterparties.

The Proposed Rule would define "resident of the United States" more broadly than "U.S. person" is defined in Regulation S and interpretations of that Regulation for purposes of determining whether an offer or sale takes place in the U.S. securities markets—and thus is subject to registration requirements under the U.S. securities laws. For example, the Proposed Rule provides that a "resident of the United States" includes "any discretionary or non-discretionary account . . . held by a dealer or fiduciary for the benefit or account of a resident of the United States."[80] By contrast, under Regulation S, a discretionary account held by a non-U.S. fiduciary such as a non-U.S. investment adviser is considered a non-U.S. person.[81]

Moreover, the SEC specifically indicated when it adopted Regulation S that if an authorized person employed by a U.S. registered fund or its investment adviser places a buy order outside the United States on behalf of the registered fund, the requirement that the buyer be outside the United States will be met.[82] By contrast, in these circumstances the Proposed Rule treats the U.S. registered fund as a "resident of the United States," thus precluding a non-U.S. bank counterparty relying on the foreign trading exemption from trading with the U.S. registered fund.

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[78] *See* § ___.6(d)(3). The other conditions are: (i) the banking entity conducting the purchase or sale must be a non-U.S. bank; (ii) no personnel of the non-U.S. bank who is directly involved in the purchase or sale may be physically located in the United States; and (iii) the purchase or sale must occur solely outside of the United States.

[79] To the extent the Agencies revise the market making and other exemptions as we recommend above, that should alleviate our concerns with the foreign trading exemption.

[80] *See* §___.2(t)(6).

[81] *See* Offshore Offers and Sales, Securities Act Release No. 6863 (Apr. 24, 1990) ("Regulation S Adopting Release") (noting that, under Regulation S, "where a non-U.S. person makes investment decisions for the account of a U.S. person, that account is not treated as a U.S. person"). Conversely, the proposed definition treats a discretionary account for a non-U.S. resident (such as a non-U.S. retail fund) held by a U.S. adviser as a U.S. resident. Under Regulation S, such accounts are considered non-U.S. persons. *See id.* (noting that "U.S. professional fiduciaries acting with discretion for the accounts of persons . . . who are not themselves U.S. persons" are exempt from being a U.S. person under Regulation S).

[82] *Id.*

We understand from our members that, if adopted in its current form, the Proposed Rule could cause some non-U.S. banks to avoid engaging in transactions with persons acting on behalf of U.S. registered funds—even though those transactions would comport fully with well-established and widely understood standards regarding which transactions are considered "offshore" under the U.S. securities laws. By limiting the pool of counterparties with which U.S. registered funds may be able to conduct securities transactions, the Proposed Rule's approach also is likely to reduce the liquidity in some markets. Although it is difficult to predict the precise impact of the Proposed Rule on U.S. registered funds' ability to invest in foreign markets, anecdotal evidence suggests it could be quite significant. For example, one large fund complex has informed us that for the year-to-date period as of September 30, 2011, approximately 69% of non-U.S. sovereign bond trades for the funds and accounts they manage involved a non-U.S. dealer/bank as counterparty. Across all asset classes (excluding U.S. government securities, mortgage-backed securities, municipal securities, and money market instruments), trades with a non-U.S. dealer/bank totaled about 48% over the same period. Similarly, other ICI members have indicated that a significant portion of their U.S. funds' non-U.S. securities trades involve non-U.S. bank broker-dealers as counterparties.

The Agencies have requested comment on whether the proposed definition of "resident of the United States" should be revised to more closely track the definition of "U.S. person" under Regulation S.[83] ICI very strongly believes that it should. Changing the Proposed Rule in this manner would avoid the highly undesirable outcomes described above—namely, reduced access to non-U.S. counterparties for registered funds that invest in certain foreign securities and less liquidity in the markets for some of those securities.

Several other factors also weigh in favor of adhering to the Regulation S approach. First, we recognize that the different bodies of law under which the various Agencies operate provide their own approaches to offshore conduct; because the foreign trading exemption deals with *securities* transactions, however, it is both logical and appropriate to look to the U.S. securities laws to determine the locus of the transaction. Those laws already address—under Regulation S—when a securities transaction is considered to take place outside of the United States. Market participants around the world, including registered funds, have built their compliance systems and processes based on Regulation S, which has been in place for over 20 years. Diverging from the Regulation S approach would be disruptive and confusing.

Second, there is no indication that Congress intended to create a new or different standard for determining when a securities transaction takes place outside of the United States for purposes of the Volcker Rule. [84]

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[83] *See* Proposing Release, 76 Fed. Reg. at 68882 (Question 139).

[84] Some have noted that like the Proposed Rule, the statute refers to trading that "occurs *solely* outside of the United States." Section 13(d)(1)(H) of the BHCA (emphasis added). The types of transactions with which we are concerned would meet this requirement, as they are executed—*i.e.*, "occur"—in non-U.S. markets. On a related point, we note that Regulation S is

Third, the Agencies have not provided any policy rationale for adopting a different standard. The Proposing Release notes that the proposed definition of "resident of the United States" is similar but not identical to the definition of "U.S. person" for purposes of Regulation S, but it provides no specific explanation to justify this important difference.[85] In fact, it states that this similarity "should promote consistency and understanding among market participants that have experience with the concept from the SEC's Regulation S."[86] Unfortunately, this statement overlooks the fact that the differences between the foreign trading exemption and Regulation S as interpreted by the SEC severely undercut any such benefit, particularly for registered funds.

For these reasons, ICI strongly urges that the proposed definition be revised to conform to the Regulation S approach. In particular, consistent with the SEC's interpretation of Regulation S, the final rule should make clear that a non-U.S. bank may rely on the foreign trading exemption if it engages in a transaction in which (1) a non-U.S. person makes investment decisions for the account of a U.S. person, or (2) an authorized person employed by a U.S. registered fund or its investment adviser places a buy order outside the United States on behalf of the registered fund.

B. <u>The Proposed Rule Should Provide Sufficient Exemptions for Asset-Backed Commercial Paper and Tender Option Bond Programs</u>

The Proposed Rule would impair two particular types of traditional banking activities—sponsorship of asset-backed commercial paper ("ABCP") and municipal tender option bond ("TOB") programs. Restrictions on offering such ABCP and TOB programs by banking entities would have significant negative implications for investors in these programs, including ICI members, such as money market funds and other registered funds.[87]

Specifically, under the Proposed Rule, ABCP and TOB issuers would fall within the definition of "covered fund" solely because they typically are entities that rely on Section 3(c)(1) or Section

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consistent with subsections 4(c)(9) and 4(c)(13) of the BHCA in the sense that those provisions do not preclude all U.S. contacts.

[85] *See* Proposing Release, 76 Fed. Reg. at 68881-82.

[86] *Id.* at 68927.

[87] For example, closed-end funds use TOBs as an alternative to the cash bond market in order to achieve a targeted structure for their overall investment portfolio as efficiently as possible, and also as an additional source of financing that complements traditional forms of financing such as bank borrowings and preferred stock. Approximately 80 percent of municipal closed-end funds use TOBs for this purpose. *See ICI Perspective, The Closed-End Fund Market, 2010* for more information about closed-end funds, available at http://www.ici.org/pdf/per17-01.pdf). ABCP and TOBs also are important to money market funds. As of November 2011, taxable money market funds held $126 billion of the $348.1 billion ABCP outstanding, which represented approximately 5.4 percent of taxable money market funds' total assets as of that date. Industry participants estimate that TOBs have $75 to $100 billion outstanding and that they represent approximately 20 to 25 percent of the assets of tax-exempt money market funds.

3(c)(7) of the Investment Company Act despite the fact that they have none of the characteristics of a hedge fund or private equity fund. Similarly, an ABCP or TOB program would fall within the definition of "banking entity" if it were considered an affiliate of a banking entity (*e.g.*, because the banking entity is acting as sponsor of that ABCP or TOB program), subjecting the program itself to all of the requirements of the Volcker Rule, including the proprietary trading limits. Finally, even when an ABCP or TOB issuer is not viewed as part of the banking entity, the proprietary trading limits could be construed to prevent banking entities from engaging in necessary transactions with ABCP or TOB issuers.

There is no indication, however, that Congress intended to include ABCP or TOB programs within the scope of the Volcker Rule. Quite the opposite—the Volcker Rule specifically sought to avoid "interfer[ing] inadvertently with longstanding, traditional banking activities that do not produce high levels of risks or significant conflicts of interest."[88] Furthermore, Congress permitted certain activities to continue outside the Rule's scope "to ensure that the economy and consumers continue to benefit from robust and liquid capital markets and financial intermediation."[89] The provision of credit to companies to finance receivables through ABCP, and to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from any type of high-risk, conflict-ridden financial activities that Congress sought to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained. It is therefore important that the Proposed Rule be revised to provide sufficient exemptions for ABCP and TOB programs.

1. Background on ABCP and TOBs

Before addressing certain provisions of the Proposed Rule, we outline the specific characteristics of ABCP and TOBs that distinguish them from the private equity or hedge funds that are the focus of the Volcker Rule.

a) ABCP

ABCP programs are senior-secured customer working capital financing vehicles that issue instruments in the money market. They are issued by a special purpose trust or corporation and established by the program's sponsor, which is often a major commercial bank. ABCP programs provide financing for issuers by continuously offering short-term notes that carry repayment dates that usually range from overnight up to 270 days. ABCP programs are referred to as "asset-backed" because the bankruptcy remote, special-purpose vehicles that issue the ABCP own, or have security interests in, multiple pools of various types of receivables from a wide variety of corporations, such as

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[88] S. REP. NO. 111-176, at 91 (2009).

[89] Volcker Rule Study, *supra* note 5, at 1.

manufacturers, banks, finance companies, and broker-dealers, looking to obtain low-cost financing for a diverse range of trade and financial receivables, including manufacturing account receivables, commercial loans, equipment loan and lease receivables, consumer loans, auto loans and leases, and student loans. ABCP investors primarily seek safety of principal along with yields that are comparable to money market and short-term bank financing rates, in contrast to the elevated risk/reward trade-off that is typically associated with the investment vehicles that are targets of the Volcker Rule.

ABCP programs also typically are supported by credit enhancement and committed liquidity facilities. The liquidity support for an ABCP program typically equals the face amount of ABCP outstanding.

b) TOBs

Municipal TOB programs are funding vehicles structured to preserve the tax-exempt nature of interest on municipal bonds by allowing the tax-exempt income from the underlying bonds to pass through to the holders of the securities issued by the TOB. In effect, TOBs serve as the municipal market equivalent of repurchase agreements (which are specifically excluded from the scope of the Volcker Rule under proposed Section__.3(b)(2)(iii)(A)) or secured lending by permitting investors to finance their municipal securities positions at short-term money market rates. Specifically, a TOB program is created by a sponsor bank that deposits one or more high-quality municipal bonds into a trust that issues two classes of tax-exempt securities: a short-term floating rate certificate (the "floater") that is supported by a liquidity facility and a residual certificate (the "residual"). The floater is a variable-rate demand security that bears interest at a rate adjusted at specified intervals (daily, weekly, or other intervals up to one year) according to a specific index or through a remarketing process.[90] Floater holders bear limited and well-defined insolvency and default risks associated with the underlying bonds, and rely upon their largely unfettered put right to manage these risks. Tax-exempt money market funds are the principal holders of the floaters. Holders of residuals are typically long-term investors, such as the TOB program sponsor bank or an affiliate, tax-exempt bond funds, closed-end funds, or other institutional investors in municipal bonds. Residual holders receive all interest payments from the underlying bonds that are not needed to pay interest on the floaters and expenses of the trust.

2. ABCP and TOB Issuers as "Covered Funds"

The definition of "covered fund" and the related exemptions should be delineated to reflect Congress' clear intent to restrict private equity and hedge funds, while preserving the liquidity and viability of traditional banking activities such as the ABCP and TOB markets. Otherwise, important investment opportunities, along with the credit funding provided to companies and municipalities that rely on these instruments, will be reduced.

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[90] A remarketing agent—a bank or other entity—helps to make a market for the securities and ensures that a floater holder's put is honored by reselling the products, holding them in its own inventory, or arranging for the floater holder to be paid from the bank liquidity facility.

a) ABCP and TOB Exemption

In light of the specific structural characteristics that distinguish them from any type of high-risk, conflict-ridden financial activities that Congress sought to restrict under the Volcker Rule, the Agencies should exclude ABCP and TOB programs either by construing the definition of "covered fund" to exclude these programs or by using the Agencies' authority under BHCA Section (d)(1)(J) to similar effect.[91] In contrast to hedge funds or private equity activities, ABCP programs are traditional banking activities with key characteristics that include the fact that they are continuously offered, rely on credit and liquidity arrangements, and are collateralized primarily by high-quality, short-term instruments.

Similarly, the underlying collateral in a TOB trust is limited to municipal bonds that are of the highest long-term quality, and that are generally publicly traded. As the FSOC noted in discussing the exemption in BHCA Section (d)(1)(A), municipal securities "have historically served a significant role in traditional banking activities, providing a low-risk, short-term liquidity position."[92] Indeed, for this reason, as discussed above in Section II.B.2.d., we recommend that the permitted activity exemption for government obligations be expanded to include all municipal securities—including those issued by an agency or instrumentality of any State or political subdivision—which would be consistent with the current definition of municipal securities under Section 3(a)(29) of the Securities Exchange Act. Because TOBs are merely a repackaging of such municipal securities, TOBs also should be excluded from the Volcker Rule on the basis that they fall within the permitted activity regarding government obligations. Moreover, as noted above, TOB programs are economically similar to repurchase agreements, which the Agencies specifically propose to exclude from the prohibitions on proprietary trading. From a banking entity's perspective, the TOB trust in a TOB program is not an investment, but rather a way to finance its ownership of the underlying municipal securities. Similarly, banking entities enter into repurchase agreements with counterparties that provide cash funding to the banking entity in exchange for exposure to the banking entity's assets and a specified rate of return. As an economic matter, therefore, a banking entity's credit exposure and risk are no different for TOB trusts. Subjecting these trusts to the covered fund restrictions because the interests are sold to investors pursuant to a particular section of the Investment Company Act simply ignores the economic reality of the transaction.

Exempting ABCP and TOBs from the scope of the Proposed Rule would allow for the continuation of traditional banking activities that are designed to promote and protect the safety and

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[91] Notwithstanding the Volcker Rule's prohibitions regarding private equity, hedge funds or proprietary trading activities, Section 13(d) of the BHCA provides a list of permitted activities including subsection (d)(1)(J) that states "[s]uch other activity as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission determine, by rule, as provided in subsection (b)(2), would promote and protect the safety and soundness of the banking entity and the financial stability of the United States."

[92] Volcker Rule Study, *supra* note 5, at 46.

soundness of the banking entity and the financial stability of the United States. To this effect, we have provided suggested rule text regarding a revised definition of "covered fund" that would exempt ABCP and TOB programs in Appendix B.

b) Securitization Vehicle Exemption

As an alternative to a specific ABCP and TOBs exemption, ICI requests that the Agencies clarify the types of assets that may be included in the exemption for certain securitization vehicles found in Section__.13(d) of the Proposed Rule in order to assure that this exemption covers ABCP and TOBs vehicles.

The "rule of construction" found in BHCA Section13(g)(2) is a clear indication that the Volcker Rule was not intended to apply to securitization vehicles such as ABCP or TOB programs. The statutory language used is unambiguous: "nothing" in the Volcker Rule "shall be construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans."[93] This treatment makes sense both because Congress addressed securitization programs in other parts of the Dodd-Frank Act and because asset-backed securities in general and ABCP and TOB programs in particular are not comparable to private equity or hedge funds. Instead, as noted, they perform a traditional banking function—credit extension activity. ICI supports the inclusion of the securitization vehicle exemption in Section__.13(d), which is designed to assist in implementing Section 13(g)(2); nonetheless, as described below, ICI strongly believes that several aspects of the exemption require confirmation, clarification, or modification.

First, although ICI supports the Agencies' interpretation of the definition of "loan" contained in Section__.13(d) of the Proposed Rule to include "a broad array of loans and similar credit transactions,"[94] we urge the Agencies to confirm that this definition includes the broad array of receivables that back ABCP in addition to municipal debt obligations of the type that back TOBs. Such an interpretation would cover the types of extensions of credit that have long been recognized as crucial traditional banking activities. Furthermore, this interpretation would be consistent with the federal banking agencies' interpretation of "extension of credit" in other contexts, such as with regard to affiliate transactions in Regulation W, which includes debt securities, cash advances, and commercial paper.[95]

Additionally, ICI supports the allowance for the holding of contractual rights or assets directly arising from loans as well as interest rate and foreign exchange derivatives that are used for hedging purposes within the loan securitization exemption. ICI requests that, in addition to these non-loan

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[93] As the FSOC stated, "the creation and securitization of loans is a basic and critical mechanism for capital formation and distribution of risk in the banking system." Volcker Rule Study, *supra* note 5, at 47.

[94] Proposing Release, *supra* note 2, at 68865.

[95] 12 C.F.R. Section 223.3 (2011).

items, the Agencies allow for ABCP programs to hold a limited percentage of cash and cash-like instruments that are ordinarily held for liquidity and related purposes in such loan securitization vehicles, as well as a limited set of other related assets of the kinds that traditionally have been included in ABCP programs. Permitting ABCP programs to hold these types of assets would reflect the general existing business practice and would not increase the risks associated with securitization activities.

We have included suggested rule text that clarifies the types of assets that may be included in the definition of "loans" in Appendix B.

3. Impact of Super 23A on ABCP and TOB Programs

Unless ABCP and TOBs expressly are exempted from the definition of "covered fund," ICI is concerned that Section__.16 of the Proposed Rule (the so-called "Super 23A" provision) would apply even to those covered funds meeting the stringent requirements of the securitization exemption under Section__.13(d) or other exemptions from Section__.10(a). As noted above, for the benefit of investors, ABCP programs typically are supported by credit enhancement and committed liquidity facilities and the floater in a TOB program is supported by a liquidity facility that allows for the "put" or demand feature. Therefore, an interpretation that subjects even covered funds exempted under the securitization exemption to Super 23A would prohibit banks from extending credit (including liquidity and credit enhancement facilities) to any ABCP or TOB programs, which would threaten the viability of such programs.

Congress intended that if a banking entity's investment into a securitization vehicle is considered a "permitted activity" (other than under the asset management exception under BHCA Section 13(d)(1)(G)), then the relationship between the banking entity and the securitization vehicle should not be subject to the restrictions of Super 23A. Applying Super 23A to permitted securitization activities is unnecessary to achieve Congress' intent that banking entities not be permitted to aid those hedge funds and private equity funds for which the banking entities acted as investment adviser, investment manager, or sponsor.[96] Congress gave the Agencies express authority to avoid the application of Super 23A in the context of BHCA Section 13(d)(1)(J), which allows the Agencies to permit not only investments but "such . . . activity" as the Agencies determine meets the statutory standard. Moreover, an application of Super 23A to all funds permitted under BHCA Section 13(d) would render superfluous the statutory language in BHCA Section 13(d)(1)(G), which specifically applies Super 23A to funds organized and offered under the asset management exception. ICI requests confirmation of this view.

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[96] *See* 156 Cong. Rec. S5898 (statement of Sen. Merkley) (discussing how BHCA Section 13(f)(1) was intended to reduce bailout risks associated with "independent hedge funds and private equity funds" to which a banking entity acts as investment adviser, investment manager or sponsor and hedge fund and private equity funds organized and offered under BHCA Section 13(d)(1)(G)).

In the alternative, ICI requests a specific exemption from the restrictions of Super 23A for ABCP and TOB programs. As noted above, the Agencies clearly are authorized to craft an exemption from Super 23A under the rule of construction found in BHCA Section 13(g)(2). The FSOC has interpreted this rule of construction to mean that "*none* of the restrictions of the Volcker Rule ... will apply to the sale or securitization of loans."[97] This rule of construction necessarily includes ancillary activities, such as credit and liquidity support, that long have been a part of securitization activities.

Furthermore, we note that Section 621 of the Dodd-Frank Act, and the SEC's proposed rule thereunder, create an express exemption to allow securitization participants to provide liquidity to asset-backed securities vehicles.[98] The application of Super 23A to such vehicles could be interpreted to prohibit liquidity arrangements for bank-sponsored or advised programs. Such a result would be inconsistent with Congress' intent in enacting the express exception for liquidity commitments in Section 621, and is unnecessary to address the conflict of interest concerns against which the Volcker Rule was designed to protect.

To address the impact of Super 23A on ABCP and TOB programs, we have provided suggested rule text in Appendix B.

4. Impact of the Proprietary Trading Limits on ABCP and TOB Programs Affiliated with a Banking Entity

ICI also requests clarification on how the Volcker Rule proprietary trading limits will apply in circumstances in which an ABCP or TOB vehicle itself is deemed to be a banking entity.

As discussed above, Congress did not intend for the Volcker Rule to regulate (and potentially disrupt) traditional securitization activities, including situations in which an ABCP or TOB vehicle would itself be considered an "affiliate" of a banking entity, such as when a banking entity is acting as sponsor of that ABCP or TOB program. Such ABCP and TOB vehicles should be excluded from the definition of banking entity in the same fashion that funds relying on Section __.11 of the Proposed Rule (which implements the asset management exception under BHCA Section 13(d)(1)(G)) are excluded.[99] We have included suggested rule text regarding a revised definition of "banking entity" that would exclude ABCP and TOB programs in Appendix B.

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[97] Volcker Rule Study, *supra* note 5, at 47 (emphasis added).

[98] For an overview of ICI's position on the SEC's proposed rule implementing Section 621, *see* Letter from Karrie McMillan, General Counsel, Investment Company Institute, to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, dated February 13, 2012.

[99] This exclusion should extend to any securitization vehicle that is viewed as an affiliate of a banking entity, whether or not it is a covered fund, including those vehicles relying on Rule 3a-7 and Section 3(c)(5) of the Investment Company Act.

In the alternative, the Proposed Rule should be clarified so that the proprietary trading prohibitions are not applied to an ABCP or TOB vehicle that is a banking entity in ways that might impede traditional ABCP or TOB program activities. To accomplish this clarification, the accounts of ABCP and TOB programs should not be considered "trading accounts" because they do not engage in the requisite "short-term" transactions. To this end, we have included suggested rule text regarding a revised definition of "trading account" that would exclude ABCP and TOB programs in Appendix B.

5. Impact of the Proprietary Trading Limits on ABCP or TOB Programs That are Not Affiliated with a Banking Entity

Even where an ABCP or TOB program is not viewed to be part of a banking entity, the Agencies should make it clear that the proprietary trading rules will not be construed to impede securitization activities by preventing banking entities from engaging in transactions with ABCP or TOB programs.

To this end, the Agencies should provide an exemption for activities relating to the establishment of ABCP or TOB programs and other transactions that are part of the traditional securitization activities engaged in by banking entities. In particular, per Question 78 in the Proposing Release,[100] ICI requests that the transfer of assets to an intermediate vehicle, such as an intermediate TOB vehicle, not be viewed as proprietary trading, so long as it is made in the ordinary course of securitization. This can be accomplished by permitting, as part of the underwriting exemption, the sale of assets to an intermediate ABCP or TOB program if it is part of the creation of a structured security.[101]

* * * * *

We appreciate this opportunity to outline ICI's significant concerns regarding the Proposed Rule. While focused on the specific ways in which the Proposed Rule could negatively affect registered funds and their shareholders, our comments echo the same overarching theme that has been voiced by many stakeholders—this Proposed Rule would reach farther than Congress ever intended and could greatly impair the U.S. financial markets.

We urge the Agencies to modify the Proposed Rule to avoid such outcomes and to issue a new proposal. Although we recognize the importance of providing certainty to the markets, the issues presented by the Proposed Rule are of such significance and far-reaching impact as to warrant the

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[100] Among other things, Question 78 asks whether the sale of a security by a banking entity to an intermediate entity as part of the creation of a structured security such as a TOB program should be permitted under one of the exemptions to the prohibition on proprietary trading currently included in the Proposed Rule. Proposing Release, *supra* note 5, at 68868-69. We believe that it should be permitted.

[101] As discussed in Section II.B.2.d, this also could be accomplished by expanding the government obligations exemption to include municipal agencies.

Agencies' careful consideration and, thereafter, a meaningful opportunity for additional public comment prior to the adoption of any final rule.

We also recommend that the Federal Reserve Board revise its conformance rule to require new activities to comply with the Volcker Rule as of July 2014, rather than July 21, 2012.[102] Given that a final rule will not be issued until the very eve of the statutory effective date, at best, it is imperative that banking entities and other market participants have adequate time to understand the implementing rules and have the full statutorily granted conformance period to adjust their business models. Revising the conformance period in this way would allow an orderly transition and minimize market disruptions, as Congress intended.[103] ICI respectfully submits that, while the Federal Reserve Board's original approach to the conformance period may have been warranted a year ago, that approach no longer is viable given the understandable delay in the Agencies' rulemaking process.

If you have any questions regarding our comments or would like additional information, please feel free to contact me at (202) 326-5901, or Karrie McMillan, ICI General Counsel, at (202) 326-5815. Thank you for your consideration of these comments.

Sincerely,

/s/

Paul Schott Stevens
President & CEO
Investment Company Institute

Attachments

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[102] *See* 76 Fed. Reg. 8265 (Feb. 14, 2011).

[103] 156 Cong. Rec. S5899 (July 15, 2010) ("The purpose of this extended wind-down period is to minimize market disruption while steadily moving firms away from the risks of the restricted activities.") (statement of Sen. Merkley).

The Different Types of Registered Investment Companies

Fund sponsors in the U.S. offer four types of registered investment companies: open-end investment companies (commonly called mutual funds), closed-end investment companies, exchange-traded funds (ETFs), and unit investment trusts (UITs). All four are subject to comprehensive regulation under the four major federal securities laws, including the Investment Company Act of 1940.

Mutual Funds - The vast majority of investment companies are mutual funds, both in terms of number of funds and assets under management. Mutual funds can have actively managed portfolios, in which a professional investment adviser creates a unique mix of investments to meet a particular investment objective, or passively managed portfolios, in which the adviser seeks to track the performance of a selected benchmark or index. One hallmark of mutual funds is that they issue redeemable securities, meaning that the fund stands ready to buy back its shares at their current net asset value (NAV). The NAV is calculated by dividing the total market value of the fund's assets, minus its liabilities, by the number of mutual fund shares outstanding.

Closed-End Funds - Unlike mutual funds, closed-end funds do not issue redeemable shares. Instead, they issue a fixed number of shares that trade intraday on stock exchanges at market-determined prices. Investors in a closed-end fund buy or sell shares through a broker, just as they would trade the shares of any publicly traded company.

Exchange-Traded Funds - ETFs are described as a hybrid of other types of investment companies. They are structured and legally classified as mutual funds or UITs (discussed below), but trade intraday on stock exchanges like closed-end funds. ETFs only buy and sell fund shares directly to authorized participants in large blocks, often 50,000 shares or more.

Unit Investment Trusts - UITs are also a hybrid, with some characteristics of mutual funds and some of closed-end funds. Like closed-end funds, UITs typically issue only a specific, fixed number of shares, called "units." Like mutual funds, the units are redeemable, but unlike mutual funds, generally the UIT sponsor will maintain a secondary market in the units so that redemptions do not deplete the UIT's assets. A UIT does not actively trade its investment portfolio, instead buying and holding a set of particular investments until a designated termination date, at which time the trust is dissolved and proceeds are paid to shareholders.

Suggested Rule Text
(with references to applicable discussion in the ICI comment letter)

Exclusion from the Definition of "Covered Fund" for Registered Funds and Their Non-U.S. Counterparts [discussed in Section I.A]

Revise §___.10(b)(1) by adding the following statement at the end of the proposed text:

Notwithstanding (i) through (iv) above, the term "covered fund" does not include an investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1et seq.) or any issuer that is organized or formed under non-U.S. law, authorized for public sale in the jurisdiction in which it is organized or formed, and regulated as a public investment company in that jurisdiction.

Exclusion from the Definition of "Banking Entity" for Registered Funds [discussed in Section I.B]

Revise §___.2(e)(4) as follows:

(4) Any affiliate or subsidiary of any entity described in paragraphs (e)(1), (2), or (3) of this section, other than an affiliate or subsidiary that is:

(i) A covered fund that is organized, offered and held by a banking entity pursuant to § __.11 and in accordance with the provisions of subpart C of this part, including the provisions governing relationships between a covered fund and a banking entity; ~~or~~

(ii) An entity that is controlled by a covered fund described in paragraph (e)(4)(i) of this section; or

(iii) An investment company registered under the Investment Company Act of 1940 (15 U.S.C. 80a-1et seq.).

ETF Trading Activity by Banking Entity Authorized Participants [discussed in Section I.C]

Revise §___.4 by inserting new subsection (c) as follows:

(c) Permitted trading by Authorized Participants relating to ETFs.

(1) The prohibition on proprietary trading contained in § __.3(a) does not apply to the purchase or sale of a covered financial position by a covered banking entity in connection with certain qualified transactions relating to ETFs.

(2) For purposes of paragraph (c)(1) of this section, a purchase or sale of a covered financial position by a covered banking entity shall be considered to be in connection with certain qualified transactions relating to ETFs if the purchase or sale:

(i) Is conducted by a covered banking entity that has entered into an agreement with an exchange-traded fund (an "ETF"), governing the terms under which such entity may purchase shares directly from, or redeem shares directly with, such ETF (such entity being an "Authorized Participant" or "AP");

(A) For purposes of this section, an ETF is an exchange-traded fund which is:

(1) Registered under the Investment Company Act of 1940, as amended, or

(2) Organized or formed under non-U.S. law, is authorized for public sale in the jurisdiction in which it is organized or formed, and is regulated as a public investment company in that jurisdiction.

(ii) Is made by an AP;

(iii) Involves solely covered financial positions consisting of:

(A) Shares of such ETF (whether in transactions with such ETF directly or in the secondary market); and

(B) Positions in underlying securities held by such ETF (or other instruments reasonably intended to provide substantially similar economic exposure) for the purpose of creating or redeeming shares of the ETF or hedging the AP's exposure to the shares of such ETF.

(iv) Is made in accordance with the written policies, procedures and internal controls established by the covered banking entity pursuant to subpart D of this part, which policies and procedures must be reasonably designed to ensure that the covered banking entity is not entering into purchases or sales of ETF shares (or transactions meant to provide substantially similar exposure through indirect or synthetic means) for the purpose of benefitting from appreciation or depreciation in the value of such ETF shares (other than appreciation or depreciation resulting from transactions designed to arbitrage price differences between the market price and net asset value of such ETF shares).

Complexity of, and Difficulties Complying with, the Rule [discussed in Section II.B]

Insert the following at the beginning of Subpart B, just above §__.3):

Preliminary Note. In view of the objective of these rules and the policies underlying the statute, the criteria set forth in the requirements and conditions associated with permitted activities to the prohibition on proprietary trading should be viewed solely as indicia of compliance with the permitted activities, and not as a dispositive tool for the identification of permissible or impermissible trading activity. A banking entity in non-compliance with one or more of those criteria will not automatically be deemed to violate the rule, provided that on balance and based on the overall trading activity by the banking entity, the activity substantially represents permitted activity under the rule. The examination of a banking entity's trading activity for purposes of the prohibition on proprietary trading should be performed on an aggregate basis, rather than on a trade-by-trade basis.

Covered Fund Exemption for ABCP and TOBs [discussed in Section III.B]

Revise §__.14 as follows:

§__.14 Covered fund activities determined to be permissible.

(a) The prohibition contained in §__.10(a) does not apply to the acquisition or retention by a covered banking entity of any ownership interest in or acting as sponsor to:

(2) *Certain other covered funds.* Any of the following entities that would otherwise qualify as a covered fund:

(vi) an issuer that is a Special Purpose Entity as defined under SEC Rule 2a–7 (17 CFR 270.2a–7(a)(3)), the assets or holdings of which are substantially comprised of Qualifying Assets, as defined under SEC Rule 2a–7 (17 CFR 270.2a–7(a)(3)).

(vii) an issuer that is a trust, the assets or holdings of which are substantially comprised of municipal securities, as that term is defined under Section 3(a)(29) of the Securities Exchange Act of 1934.

(c) The limitations contained in §__.16(a)(1) do not apply to transactions between a covered banking entity or any affiliate of such entity and a covered fund described in paragraph (a)(2)(vi) or (a)(2)(vii) of this section.

Securitization Vehicle Exemption [discussed in Section III.B]

§__.2 Definitions.

(q) *Loans* means any loan, lease, extension of credit, or secured or unsecured receivable, including Qualifying Assets, as defined under SEC Rule 2a–7 (17 CFR 270.2a–7(a)(3)), and municipal securities, as that term is defined under Section 3(a)(29) of the Securities Exchange Act of 1934.

§__.13 Other permitted covered fund activities and investments.

(e) The limitations contained in §__.16(a)(1) do not apply to transactions between a covered banking entity or any affiliate of such entity and a covered fund described in paragraph (d) of this section.

Exclusion from the Definition of "Banking Entity" for ABCP and TOB Programs
[discussed in Section III.B]

§__.2 Definitions.

(e) *Banking entity means*:

(4) Any affiliate or subsidiary of any entity described in paragraphs (e)(1), (e)(2), or (3) of this section, other than affiliate or subsidiary that is:

(iii) an entity described in §__.14(a)(2)(vi) or §__.14(a)(2)(vii) of this part.

Exclusion from the Definition of "Trading Account" for ABCP and TOB Programs
[discussed in Section III.B]

§__.3 Prohibition on proprietary trading.

(b) *Definition of "proprietary trading and related terms."* For purposes of this subpart:

(2) *Trading account.*

(iii) an account shall not be deemed a trading account for purposes of paragraph (b)(2)(i) of this section to the extent that such account is used to acquire or take a position in one or more covered financial positions:

(D) That are described in § __.14(a)(2)(vi) or § __.14(a)(2)(vii) of this part and that are acquired or taken by a covered banking entity.