American Bankers Association

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Wayne A. Abernathy
Executive Vice President
Financial Institutions Policy
and Regulatory Affairs
202-663-5222
wabernat@aba.com

February 13, 2012

Office of the Comptroller of the Currency
250 E Street, NW
Mail Stop 2-3
Washington, DC 20219

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

Jennifer J. Johnson
Secretary
Board of Governors of the
Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
Washington, DC 20581

Robert E. Feldman,
Executive Secretary
Attention: Comments
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429

Re: Request for Public Comment on Notice of Proposed Rulemaking (Proposed Rules) Implementing the Provisions of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act Concerning Restrictions on Proprietary Trading and Certain Interests in and Relationships with Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Proposed Rules will have a significant impact on midsize banks and their customers. For that reason the American Bankers Council[1] of the American Bankers Association (ABA)[2] formed a Midsize Bank Working Group (Working Group) to consider the proposal, and particularly to evaluate how it will affect the operation of midsize banks and their ability to serve their respective customers and communities. This letter presents the views of the Working Group. It is offered in addition and complementary to other views on the Proposed Rules submitted by ABA on its own and jointly with other financial trade associations.

The Working Group appreciates the opportunity to comment on the Proposed Rules of the federal regulatory agencies (Agencies) responsible for issuing regulations that implement new

[1] The American Bankers Council is made up of the chief executive officers and other senior leaders of more than 70 midsize banks, members of the American Bankers Association.
[2] ABA represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees.

Section 13 of the Bank Holding Company Act of 1956, as amended (BHCA), commonly known as the Volcker Rule.

We are very concerned that the Proposed Rules will have a significant and lasting adverse impact on midsize banks. If not corrected, the Proposed Rules will constrain bank investments in, and limit access to funding for, private businesses (particularly smaller and start up businesses) and local government entities while imposing excessive and unnecessary compliance costs on midsize banks. We request, therefore, that the Agencies revise the Proposed Rules in order to remedy the issues raised below. More generally, we request that the Volcker Rule not be implemented so broadly as to apply to thousands of banks whose trading and fund activities pose little safety and soundness risk to themselves or systemic risk to the economy.

We have divided our comments into the following sections: (1) municipal securities trading; (2) Community Reinvestment Act (CRA) and community development investments; (3) venture capital investments; (4) percentage investment limitations for covered funds; (5) definition of "banking entity" and its impact on industrial banks and their affiliates; and (6) compliance requirements. We note that many if not all of these issues would significantly impact community banks as well as midsize institutions.

1. **The Proposed Rules Fail to Exempt All Municipal Securities from the Prohibition on Proprietary Trading.**

Notwithstanding the general prohibition on proprietary trading, the Proposed Rules allow banking entities to trade in government obligations, including in "obligations of any State or of any political subdivision thereof."[3] The Proposed Rules, however, fail to include within this exemption "obligations of an *agency* of any State or political subdivision thereof."[4] Consequently, trading in municipal securities that are issued by agencies or instrumentalities of a State or local government, or that are guaranteed by a State or local government, agency, or instrumentality, could be prohibited under the Proposed Rules. This unfortunate result would restrict an important activity of midsize banks, such as their significant involvement as a vital source of funding for state and local infrastructure projects (including schools, roads, and water systems) that are made possible by municipal debt issuances.

The Municipal Securities Rulemaking Board (MSRB) has recently urged in writing that the Agencies broaden the government securities exemption to include *all* municipal securities, stating that "the narrowness of the [exemption] is not mandated by statute."[5] We agree. Such interpretation is not only inconsistent with the statutory language but also would reduce liquidity, increase financing costs, and ultimately, both raise the costs and reduce the availability of funding for state and local municipal services and projects, including those supported or sponsored by states and municipalities. We support the MSRB's request to have the Proposed Rules revised to permit banking entities to trade in any security that qualifies as a "municipal security" under the Securities Exchange Act of 1934, and further request that the exemption be interpreted to allow trading in any municipal security *guaranteed* by a State or local government,

[3] BHCA § 13(d).
[4] *See* Proposed Rules n. 165. [Emphasis added.]
[5] Letter from Alan D. Polsky MSRB Chair, to the Agencies (January 31, 2012).

agency, or instrumentality, in order to preserve funding and investment in these public services and projects.

2. **The Proposed Rules Would Force Banks to Divest Certain CRA and Community Development Investments, Thereby Restricting Bank Investment in Public and Private Local and Regional Public Welfare Projects.**

In spite of containing general prohibitions on investments in covered funds, the Proposed Rules expressly exempt from the Volcker Rule's coverage investments in Small Business Investment Companies (SBICs), investments designed primarily to promote the public welfare, and investments in qualified rehabilitation expenditures with respect to a qualified rehabilitation building or certified historic structure.[6] The Agencies' objective is to ensure that the Volcker Rule's broad reach does not infringe upon CRA investments and other investments designed to promote the public welfare (including housing, services, and jobs) and, through investments in SBICs, bank funding of small businesses.[7]

The proposed exemption, however, does not account for community development investments that are made through a variety of investment vehicles to fund and support local and regional development and public welfare projects. For example, while a bank may make an investment in an SBIC, it is not clear whether the Proposed Rules permit a bank to invest in a *fund* which invests solely in SBICs, or to invest in community development projects eligible for CRA credit that may be structured as a venture capital fund or similar fund. A number of CRA/community development investments are structured in this way (*e.g.*, SBIC "fund of funds," and venture capital community development funds) in order to allow banks to encourage the activities and progress of small and start-up businesses serving local and regional communities and employing residents of those communities.

We request, therefore, that the Agencies confirm that *any* investment that is eligible for CRA credit and any direct or indirect investment in a SBIC or similar fund would not be subject to the Volcker Rule, on the basis that any such investment – as the Agencies have already determined regarding SBICs and public welfare investments – is consistent with the safe and sound operation of banking entities and would serve the purposes of congressionally supported programs to promote the financial stability of local and regional communities. This would allow the Agencies to continue making case-by-case determinations under the CRA and implementing regulations that an investment may count toward CRA credit on its own merit, without misplaced interference from the Volcker Rule.

3. **The Proposed Rules Would Restrict Small Business Capital Raising by Preventing Venture Capital Investments.**

As drafted, the Proposed Rules would further prevent banks from investing in venture capital funds, which investments support early-stage, entrepreneurial businesses and are a significant creator of jobs nationwide. Already there are reports that some venture capital companies believe that they may be unable to move on to the next stage of development funding due to the

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[6] *See* Proposed Rules § ___. 13(a).

[7] There is no evidence, either in the statute or legislative history, that the Volcker Rule was intended to halt investments in community development projects, in small/local businesses, or in other public welfare initiatives.

Volcker Rule. This adversely impacts these companies' ability to reach the scale, momentum, and efficiencies required to continue building on their early successes. Recognizing their important contribution to economic recovery and growth as well as to commercial innovation, congressional colloquies on the legislation uniformly confirm that limiting venture capital investments is outside the intent of the Volcker Rule.[8]

We request, therefore, that venture capital funds be expressly excluded from the definition of "covered fund" under the Proposed Rules. This could be accomplished by defining a hedge fund and a private equity fund to address their business characteristics[9] or by simply expressing that a hedge fund and private equity fund do not include venture capital funds. A venture capital fund could be defined using the SEC definition under Rule 203(1)-1, applied at the time a banking entity makes its commitment to the fund, but the definition should at a minimum be modified to allow investments in (i) venture capital funds that make loans to their portfolio companies, and (ii) in venture capital fund of funds (funds that invest solely in other venture capital funds). Alternatively, the Agencies could permit banking entities to sponsor and invest in venture capital funds pursuant to their exemptive authority under section (d)(1)(J) of the Volcker Rule.

4. **The Proposed Rules Do Not Permit Banks Reasonably to Rely on the *de Minimis* Investment Limitation on Covered Funds.**

The Proposed Rules require that a banking entity that makes or retains an investment in a covered fund be subject to three principal limitations: (1) the covered fund investment may not exceed 3 percent of the total outstanding ownership interests of such fund (after expiration of the seeding period); (2) the covered fund investment may not result in more than 3 percent of the losses of the covered fund being allocable to the banking entity's investment; and (3) the banking entity may invest no more than 3 percent of its Tier 1 capital in covered funds.[10] This last limitation is an instance of the Volcker Rule's parameters design for very large institutions being misapplied to significantly smaller banks, making it exceedingly difficult if not impossible for these banks to invest at all in covered funds.

We request that the Agencies use their exemptive authority under section (d)(1)(J) of the Volcker Rule to permit midsize banks to invest in covered funds in an amount that is, in the aggregate, the greater of (i) $1 billion, subject to prudential investment limitations (as determined by Agency rule and interpretation) and safety and soundness concerns; or (ii) 3 percent of Tier 1 capital. This would ensure that the Volcker Rule's requirements do not unfairly exclude midsize banks from the opportunity to make *de minimis* investments in covered funds.

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[8] *See, e.g.*, Anna G. Eshoo (CA), "Conference Report – H.R. 4173," Congressional Record 156 (2010) p. E1295 ("funds that invest in technology startup companies, such as venture capital funds, are not captured under the Volcker Rule and fall outside the definition of 'private equity funds.' "); *see id.* at S5905, Chris Dodd (CT) ("In the event that properly conducted venture capital investment is excessively restricted by the provisions of section 619, I would expect the appropriate Federal regulators to exempt it using their authority under section 619(J)").

[9] Some of these characteristics include use of leverage, investments in derivatives and public markets, controlling investments, and the ability of investors to withdraw or redeem their investments on short notice. Venture capital funds do not have these same characteristics and generally come within the SEC's definition of a venture capital fund under Rule 203(1)-1 of the Investment Advisers Act.

[10] *See* Proposed Rules §§ ___.12(b)(2), (c).

5. **<u>The Proposed Rules' Outsized Definition of "Banking Entity" Unfairly Penalizes Nonfinancial Companies' Ownership of Industrial Banks</u>.**

The definition of "banking entity" under the Proposed Rules includes every company that controls a bank as well as every company controlled by such an entity. There are, however, a number of commercial enterprises, such as a public utility company and an automobile manufacturer, which own an industrial bank and that are not bank holding companies due to the industrial bank exemption under the BHCA.[11] The sweeping definition of "banking entity" means that every commercial and industrial company that controls a bank – but due to an exemption under the BHCA, is not a "bank holding company" (BHC) and thus not subject to the BHCA requirements – would nevertheless be subject to the Volcker Rule, together with each of its affiliates. This absurd result would discourage investment in such banks in at least two ways: (1) it would unnecessarily restrict affected commercial and industrial companies, and their nonbank subsidiaries and affiliates, from engaging in routine capital raising, funding, and other financial and investment-related activities; and (2) it would further burden each of these entities with inapplicable recordkeeping and compliance obligations. The Proposed Rules, therefore, should exclude from coverage any company and its nonbank affiliates, where such company is not deemed to be a BHC under the Proposed Rules.

Such an amendment also would further remedy another significant flaw in the Proposed Rules, which would include as a "banking entity" any *affiliate* of such company (*i.e.*, any company that controls, is controlled by, or is under common control with, another company). We note that "control" of a company under the Volcker Rule occurs automatically when a 25 percent voting interest in the company is attained and might occur with as little as a 5 percent voting interest in such company.[12] In a number of instances, this far-reaching definition could inadvertently capture an institutional or passive investor in the nonfinancial company that owns a bank, as well as each of the other, unrelated companies in which such an investor may be invested. There is nothing in the public record of the deliberations involving the Volcker Rule to suggest that this was the intention of Congress, nor would it be recommended by the public policy objectives of reducing bank risk.

In our example, a manufacturing company that is looking to invest in a commercial enterprise that owns an industrial bank may face the risk of its activities becoming entangled in the enforcement of the Volcker Rule. Further, and even more nonsensically, other companies which the manufacturing company may own or be invested in could also, under the Volcker Rule definitions, become considered a "banking entity" and thus be pulled into the Volcker Rule enforcement world. We request that the Agencies amend the definition of "banking entity" to exclude non-BHC companies and their affiliates from the Volcker Rule, in order to ensure that such unintended consequences do not occur.

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[11] *See* BHCA § 2(c)(2)(H).

[12] Because it is part of the BHCA, the definition of "control" under the Volcker Rule is keyed off the definition found in the BHCA. Part of the problem engendered by the Volcker Rule is that "control" under the BHCA is determined by the Federal Reserve in its discretion below the threshold of a 25 percent voting interest. Since only a voting interest of less than 5 percent results in presumption of "noncontrol" under the BHCA, it is possible that "control" of a company under the BHCA could occur with as little as a 5 percent voting interest in the company, thereby possibly triggering application of the Volcker Rule. *See* BHCA § 4(c)(6).

6. The Proposed Rules Impose Costly and Burdensome Compliance Requirements.

Although the Volcker Rule is intended to apply only to proprietary trading and covered fund activities, the Proposed Rules require that *every* banking entity's compliance policies and procedures "include measures that are designed to prevent" the bank from becoming engaged in Volcker Rule-prohibited activity.[13] Thus, every bank and every affiliate thereof, regardless of its size or activities, will need to read and understand the Proposed Rules in order to determine what constitutes impermissible proprietary trading and a prohibited relationship with, or ownership interest in, a hedge fund/private equity fund. Without exception, this will be a complex, and ultimately, fruitless exercise for nearly all midsize banks, compounded by the problem that in many cases it is not readily apparent under the Proposed Rules what is permissible versus impermissible trading and investment activity, much being left to regulatory judgment and the even more serious problem of variant interpretations among the several agencies to which a midsize bank would be subject.

Indeed, in many cases, a bank often may not know whether it is engaged in impermissible activities until it is notified in the course of a bank examination. In other words, a bank may still be required to undertake an initial *and ongoing* careful legal analysis to determine which trades and investments will, or might, fall within the constraints of the Volcker Rule, and still not know with an operational degree of certainty whether its activities are outside the scope of the Proposed Rules. This makes bank compliance efforts costly, risk-averse, and potentially ineffective.

We note that banks already are subject to the full panoply of regulations and interpretive guidance related to trading and investment fund activities for which they are supervised and regularly examined. These *existing* regulatory tools should be leveraged, rather than duplicated, in order to assist both banks and the Agencies monitor activities that might stray into those activities subject to the Volcker Rule. This approach is the essence of "smart" regulation touted by both the Administration and Congress, which has as its mission an efficient, and correspondingly effective, regulatory system.

We request, therefore, that the Agencies adopt the following approach with regard to midsize banks as being more optimal and more likely to meet the intention and requirements of the Volcker Rule without unintentionally stifling important economic activity.

1. As a general matter, Agencies would acknowledge the declarations of a midsize bank that the Volcker Rule does not apply to the activities of the bank.

2. As part of the normal supervisory examination process, Agencies would note whether there were any activities clearly not in accord with such declaration and address them promptly through supervisory procedures.

We believe that such an approach would be particularly workable if the Agencies amend the Proposed Rules and their rulemaking approach by sharpening their focus on what constitutes *prohibited activities*, thereby allowing banks to avoid those activities and get on with the rest of

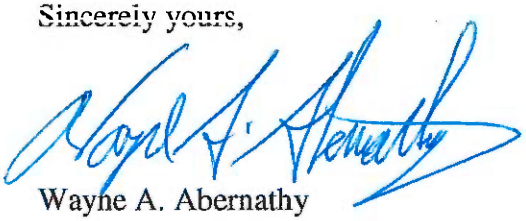
[13] *See* Proposed Rules § ___.20(d).

the business of banking. This change in the approach of the regulation would include defining key terms (such as "trading account," "hedge fund," and "private equity fund") in a manner that provides certainty to banks that the rules will not impede banks from engaging in *bona fide* market-making, asset liability management, hedging, and other permissible trading activities, and from having relationships with ordinary corporate vehicles and other entities that are not the covered funds that the Volcker Rule is intended to regulate. This would permit midsize banks to continue responsibly managing their permissible trading and investment activities – outside the clearly drawn boundaries of Volcker Rule-prohibited activity – with the necessary degree of certainty and with a minimum of disruption to their routine banking operations on which their banking customers have come to rely.

We would be glad to work with the Agencies as they continue their regulatory rulemaking efforts on the Volcker Rule. If you have any questions or need additional information, please do not hesitate to contact me (at 202-663-5222) or Timothy E. Keehan (at 202-663-5479).

Thank you for your time and consideration of these views.

Sincerely yours,



Wayne A. Abernathy
Executive Vice President
Financial Institutions Policy and Regulatory Affairs