

INVESTMENT ADVISER ASSOCIATION

February 13, 2012

VIA ELECTRONIC MAIL

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Re: Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (SEC Rel. No. 34-65545, File No. S7-41-11; Federal Reserve Board Docket No. R-1432, RIN 7100-AD 82; FDIC RIN 3064-AD85; OCC Docket ID OCC-2011-14; CFTC RIN 3038-AD05)

Dear Ladies and Gentlemen:

The Investment Adviser Association¹ appreciates the opportunity to submit comments on the Agencies' proposed rules to implement Section 619 of the Dodd-Frank Wall Street

¹ The Investment Adviser Association is a not-for-profit association that represents the interests of SEC-registered investment adviser firms. Founded in 1937, the IAA's membership consists of more than 530 advisers that collectively manage in excess of \$10 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit our web site: www.investmentadviser.org.

Reform and Consumer Protection Act (the “Dodd-Frank Act”), known as the “Volcker rule.”² The Proposal prohibits a “banking entity,” which includes any affiliate of an insured depository institution, from engaging in “proprietary trading” and from acting as a sponsor of a hedge fund or a private equity fund.

Our members are SEC-registered investment advisers that manage assets, typically on a discretionary basis, for individual and institutional clients, including pension plans, trusts, endowments, mutual funds, foundations, and corporations. Advisers also may organize, sponsor, and manage assets for private funds. Investment advisers are subject to a fiduciary duty to, among other things, act in the best interests of their clients and place the interests of their clients before their own, including serving their clients with the highest duties of loyalty and care. Investment advisers are an important segment of the buy-side, managing more than \$43.8 trillion in assets in 2011. Accordingly, the effective functioning of the securities markets, including the ability of market makers to provide liquidity, is of critical importance to advisers and their clients.

We fully support the goal of ensuring that the safety and soundness of banking entities are protected. We recommend several important changes to the Proposal that are consistent with this goal. First, we urge the Agencies to reconsider the proposed approach to distinguish between impermissible proprietary trading and permissible market making in order to ensure that market makers continue to provide essential liquidity to the markets. Second, we recommend that the Agencies narrow the definition of “covered funds” to exclude certain non-U.S. retail funds that are governed by substantive regulation in the home jurisdiction. Finally, we urge the Agencies to modify restrictions in the sponsored fund exemption where such restrictions conflict with non-U.S. law that governs the arrangement. Our concerns are further discussed below.

Effects of the Proposed Market-Making Limitations on Market Liquidity

Section 619(d) enumerates specific activities that are not considered “proprietary trading,” including the purchase or sale of securities or instruments in connection with market-making activities. The Agencies elaborated upon this statutory test for market making in the Proposal and include seven specific requirements that must be met in order for an activity to be deemed made in connection with market-making activities.³

² *Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds*, SEC Rel. No. 34-65545 (Oct. 13, 2011) (“Proposal” or “Proposed Rules”), available at <http://www.sec.gov/rules/proposed/2011/34-65545.pdf>. The Volcker Rule is jointly proposed by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, and the Securities and Exchange Commission. The Commodity Futures Trading Commission issued its release proposing the Volcker rule on January 11, 2012.

³ The Proposal’s seven conditions necessary to conclude that trading activity is “market making” and not “proprietary trading” include: (i) an internal compliance program to ensure no proprietary trading; (ii) the trading desk or unit holds itself out as being willing to buy and sell, including through entering into long and short positions in, the covered financial position for its own account on a regular and continuous basis; (iii) the market-making activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; (iv) the banking entity is a securities dealer or a swap dealer or a security-based

Although the Agencies attempted to tackle challenging definitional issues, the proposed tests for determining whether a trade is an impermissible proprietary trade or a permissible act of market making are complex, lack clarity, and will generate uncertainty. Proposed Appendix B establishes an “after-the-fact” test for determining whether a trade is a proprietary trade or a permissible market-making activity. It is unclear whether the requirements must be applied on a transaction by transaction basis or based on overall activities. Further, the rule would create a presumption that the trading is proprietary unless proven otherwise. In addition, many aspects of the guidance that are intended to establish parameters around permissible conduct are highly subjective and too narrowly drafted. For example, the requirement that activities be “designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties” is subjective and would be difficult to administer in a broad range of scenarios. Because the proposal lacks the sufficient regulatory clarity and certainty, we are concerned that market making activities may be adversely impacted. The regulatory uncertainty posed by the rule could cause covered banking entities to cease or decrease market making in certain market sectors.

Market makers play a critical role in the effective functioning of the securities markets. They provide liquidity so that buyers and sellers can engage in desired transactions on an ongoing basis and provide price quotes on which market participants can rely in their decision-making process. As buyers and sellers of securities on behalf of their advisory clients, investment advisers have a strong interest in ensuring that there is sufficient liquidity and price discovery to execute their investment strategies in a manner that is most beneficial to their clients. We are concerned that the Proposal as drafted will result in a reduction of liquidity for investors in the market, not merely for banking entities trading on their own behalf. A reduction in liquidity would likely increase volatility, impact transparency and price discovery, and therefore result in greater costs imposed on clients of investment advisers.⁴ These developments would result in negative consequences for advisers’ clients, including pension plans, municipalities, and individual investors.

Covered banking entities provide much of the current market making activities in the markets. The extent to which other market participants would replace the market making functions of covered banking entities and the effectiveness of those functions is uncertain. Accordingly, we urge the Agencies to revise the rule to provide greater clarity in delineating the line between proprietary trading and market making.

swap dealer or municipal securities dealer or a government securities dealer; (v) the market-making activities are designed to generate revenues from fees, commission, bid/ask spreads or other income and are *not* attributable to appreciation in value of covered financial positions in trading accounts or hedging of these products held in a trading account; (vi) the market-making activities are consistent with the Proposal’s Appendix B guidance; and (vii) the compensation arrangements of persons performing the market making-related activities are designed not to reward proprietary risk-taking.

⁴ See e.g., Letter from Perry Traquina, President and CEO, Wellington Management Company LLP, to Agencies, dated January 12, 2012; Letter from Amy E. Koch, Director of Fixed Income Trading, Standish Mellon Asset Management Company LLC, to Agencies, dated January 19, 2012.

Overbroad Definition of Covered Funds

Section 619 of the Dodd-Frank Act prohibits a “banking entity,” which includes any affiliate of an insured depository institution, from acting as a sponsor in a “hedge fund” or a “private equity fund.” Section 619 defines the terms “hedge fund” and “private equity fund” to mean an issuer that would be an investment company under the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act. The Agencies further expand the statute by encompassing “hedge fund” and “private equity fund” into a broader category called a “covered fund” in the Proposal. A covered fund includes any issuer organized or offered outside the U.S. that would be a covered fund were it organized or offered under the laws, or offered to one or more residents, of the U.S. or states, and any similar fund as the Agencies may determine.

We are concerned that the Agencies have defined “covered fund” too broadly and have inappropriately included non-U.S. retail funds as covered funds. In particular, the proposed rule broadens the statutory language by including as covered funds all foreign equivalents to U.S. covered funds, including many types of regulated, publicly-offered funds (*e.g.*, UCITS funds, UK investment trusts). In addition, the proposed rule would extend to non-U.S. retail funds even if they are not offered or sold in the U.S. or to U.S. persons or do not rely on the Sections 3(c)(1) or 3(c)(7) registration exemptions under the Investment Company Act. We urge the Agencies to exclude such funds from the definition of “covered fund.” These publicly offered non-U.S. retail funds are not similar to traditional private funds.⁵ Instead, they are the non-U.S. equivalent of registered investment companies, which are not included in the “covered fund” definition. We do not believe the statutory provision intended to capture non-U.S. retail funds, and no policy reason exists to treat non-U.S. regulated funds differently than U.S. regulated investment companies. Therefore, the Agencies should exclude non-U.S. retail funds that are publicly offered outside the U.S. and are subject to substantive regulation in their home jurisdiction where the fund is organized.

Restrictions on Banking Entities Acting as Sponsors to Covered Funds

Under Section 619 and the Proposal, an investment adviser affiliated with a banking entity (covered banking entity) may not “sponsor” a “covered fund” except under certain limited conditions. In particular, a covered banking entity may organize and offer a covered fund, including acting as a sponsor of the fund, only if certain criteria are met. One of the effects of the overbroad inclusion of foreign funds discussed above is the interplay with these conditions, which may conflict with the current local law in the fund’s home jurisdiction.

⁵ The January 2011 Financial Stability Oversight Council (“FSOC”) study recommended that the Agencies consider using their authority to expand the definition of hedge fund and private equity fund to “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.” See *Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds*, available at <http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf> at 62.

For example, one of the criteria is that the covered fund, for corporate, marketing, promotional, or other purposes, may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary of the banking entity). However, application of this name prohibition to foreign funds may directly conflict with non-U.S. regulations or regulatory guidance that require regulated funds to have the same name as the investment manager.⁶

Similarly, the conditions include restrictions on covered banking entities and/or their directors and employees investing in covered funds. These restrictions conflict with the laws of many jurisdictions requiring that advisers and/or their directors and employees invest in the funds they manage.⁷

These types of conflicts would effectively prevent firms from organizing and offering non-U.S. funds in many countries where the firm could not comply with both U.S. and local law. Therefore, we request the Agencies affirmatively accommodate these conflicts in the final rules and permit banking entities to comply with the local law in the jurisdiction applicable to the covered fund in question.

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⁶ In certain instances, the U.K. Financial Services Authority has taken the position under Section 6.9.6 of the Collective Investment Schemes Information Guide (<http://fsahandbook.info/FSA/html/handbook/COLL/6/9>) that the authorized fund must have a name representative of the authorized investment manager to avoid misleading fund investors.

⁷ *E.g.*, Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS), Article 29. *See also*, Annex II para. 1(m), Directive 2011/61/EU of the European Parliament and the Council of 8 June 2011 on Alternative Investment Fund Managers (AIFM) (due for transposition and entry into force by July 21, 2013).

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We appreciate the Commission's consideration of our comments on the Proposed Rules to implement the provisions in Section 619 of the Dodd-Frank Act. Please do not hesitate to contact Karen L. Barr, IAA General Counsel, or the undersigned at (202) 293-4222 if we may provide any additional information regarding our comments or any other matters.

Sincerely,

Monique S. Botkin
IAA Assistant General Counsel

cc: The Honorable Mary L. Schapiro, Chairman
The Honorable Elisse B. Walter, Commissioner
The Honorable Luis A. Aguilar, Commissioner
The Honorable Troy A. Paredes, Commissioner
The Honorable Daniel M. Gallagher, Commissioner

Ms. Eileen Rominger, Director, Division of Investment Management
Mr. Robert Plaze, Deputy Director, Division of Investment Management