American Bankers Association

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Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
250 E Street, NW
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Elizabeth M. Murphy, Secretary
Securities and Exchange Commission
100 F Street, NW
Washington, DC 20549

Robert de V. Frierson, 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
1155 21st Street, NW
Washington, DC 20581

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

Re: Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The American Bankers Association (ABA) appreciates the opportunity to provide comments to the federal regulatory agencies (Agencies) responsible for issuing rules that implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), codified as Section 13 of the Bank Holding Company Act of 1956, as amended (Volcker Rule, or Rule). ABA represents banks of all sizes and charters and is the voice for the nation's $14 trillion banking industry and its two million employees. We have reviewed and analyzed the Agencies' interim final rule, "Treatment of Certain Collateralized Debt Obligations Backed Primarily by Trust Preferred Securities with Regard to Prohibitions and Restrictions on Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds" (January 31, 2014) (Interim Final Rule). The Interim Final Rule follows the Agencies' recent adoption of final rules implementing the Volcker Rule (Final Rules).[1]

We are pleased that the Agencies have incorporated into the Final Rules provisions that expressly authorize banks to continue holding interests in collateralized debt obligations (CDOs) backed primarily by trust preferred securities (TruPS) that have been issued by banks with total assets of less than $15 billion. ABA believes that the Interim Final Rule substantially addresses much of the otherwise adverse impact that the banking industry would have experienced, due to

[1] *See* Interim Final Rule, 78 Fed. Reg. 5223, 5225 (Jan. 14, 2014).

the Final Rules' classification of TruPS CDOs as "covered funds." This designation would have forced many banks to incur immediate and significant losses on their TruPS CDO holdings (notwithstanding that these investments were purchased as a long-term investment, in many cases to be held to maturity), a result never contemplated by the authors of the legislation and not a result that we believe that the regulators intended in the implementing rules. In our view, the Interim Final Rule provides appropriate relief to ensure that these banks may hold these investments without unnecessary write-downs in bank earnings and/or capital.[2]

We believe, however, that the Interim Final Rule overlooks other debt securities held by banks that have been inadvertently captured as "covered funds" under the Final Rules. These include, for example, banks' holdings of TruPS CDOs that are backed by insurance companies and real estate investment trusts (REITs). In addition, the Final Rules appear to require banks to divest the following investments by the end of the conformance period (July 10, 2015): (i) collateralized loan obligations (CLOs); (ii) re-securitized real estate mortgage investment conduits (re-REMICs); (iii) tender option bonds; and (iv) auction rate securities. None of these investments were intended by Congress in the enactment of the Volcker Rule, and all of these investments represent important financial services to bank customers. Therefore, we request that the Interim Final Rule be amended to permit banking entities to continue holding these routine bank investments, consistent with the purposes and objectives of the Volcker Rule, as enacted.

Additionally, we request that the Agencies provide clear and detailed guidance on compliance with the Final Rules so that banks may properly prepare for timely compliance with the Volcker Rule's requirements during the conformance period.

I. Debt Securities Captured by the Definition of "Covered Fund" Under Final Rules.

A. TruPS CDOs Backed by Insurance Companies or REITs.

Although the Interim Final Rule allows for the continued investment in the vast majority of TruPS CDOs, it fails to include bank holdings in *all* TruPS CDOs, specifically those that are backed primarily by insurance companies or by REITs. Consequently, it would appear that banks that hold non-exempted TruPS CDO interests may remain subject to the Final Rules' divestiture requirements merely because the bank-issued portion of the CDO collateral comprises less than 50% of the entire collateral pool. We understand that many of the non-exempted TruPS CDOs have been outstanding for 8-10 years, have unblemished pay histories, contain 100% performing collateral, and have not experienced a collateral default.[3] Further, "there is nothing about the risk characteristics or ownership of these TruPS in bank investment portfolios that even remotely falls into the original target of the Volcker Rule to regulate and limit the speculative nature of proprietary trading desks at large and complex financial institutions."[4] We request, therefore, that the Interim Final Rule be amended further to exempt bank holdings of CDOs that are not primarily backed by bank-issued TruPS.

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[2] *Id.* The regulatory guidance infers that interests of such TruPS CDOs that are held by directors, officers, and employees of the banking entity would likewise not be subject to the covered fund prohibitions of the Final Rules. *See id.*

[3] *See* Letter to Agencies from Rep. Stephen Fincher (R-TN) (Jan. 28, 2014), p. 2.

[4] *Id.*

B. Collateralized Loan Obligations.

Collateralized loan obligations are a form of debt security and are an established, traditional, and important part of the U.S. lending market. Recognizing this, Congress declared in the Dodd-Frank Act that nothing in the Volcker Rule should be "construed to limit or restrict the ability of a banking entity . . . to sell or securitize loans in a manner otherwise permitted by law."[5] The Agencies, however, have broadly construed the Volcker Rule to apply to a wide range of legal debt instruments and permit investments only in those CLOs that are comprised *solely* of loans, while not excluding other types of securities (such as bonds) that are commonly found in most CLOs for legitimate business and risk management purposes.[6] This does not appear to be consistent either with the intent of Congress or with the terms of the statute. Indeed, several Members of Congress expressly stated at a recent congressional hearing that CLOs were not intended to be captured by the Volcker Rule.[7]

The Final Rules' distinction between permissible CLOs (those backed solely by loans) and impermissible CLOs (those with residual bond investments) appears not only arbitrary – it may actually *elevate* investment risks, for at least three reasons. First, the forced divestiture of all non-conforming CLOs by banks will likely suppress the value that would otherwise be received for these debt securities, thereby unnecessarily impairing bank earnings and capital. Second, CLOs typically include bond investments (particularly Treasuries) in their portfolios for liquidity and cash management purposes, the absence of which would unnecessarily diminish such funds' efficient operation and administration. Third, CLO investors would be denied the right to exercise normal and typical creditor-related powers common to many loan instruments, such as removal of the investment manager for cause. Consequently, conforming "loan-only" CLOs ironically may be more risky for banks to hold than CLOs that banks are now forced to divest under the Final Rules.

We request, therefore, that the Agencies continue to permit banks to hold CLOs, even where such CLOs hold bonds or other debt instruments. This may be accomplished by amending the Interim Final Rule to exclude bank holdings of CLOs from the covered fund prohibitions of section __.10(a)(1) of the Final Rules. An amendment simply to grandfather all CLOs that were purchased before December 10, 2013 (i.e., the issuance date of the Final Rules) would ensure that banks will not incur unnecessary and substantial losses that otherwise would occur through forced divestiture, but it would not solve the inadequacies that the Rule presents for future CLO instruments.

C. Other Debt Securities (Re-REMICs, Tender Option Bonds, Auction Rate Securities).

In addition to CLOs, there are other traditional bank investments in debt securities that the Final Rules now have prohibited. These include re-REMICs, tender option bonds, and auction rate

[5] Dodd Frank Act § 619(g)(2).
[6] Even for those CLOs that are not currently invested in other securities, the documentation of CLOs commonly allow the investment manager to invest in other debt securities.
[7] *See* Transcript of Hearing of House Committee on Financial Services, "The Impact of the Volcker Rule on Job Creators, Part II" (Feb. 5, 2014) (House Hearing).

securities. As the name implies, a re-REMIC is a re-securitization of real estate mortgage investment conduits – essentially a pool of mortgage securities, the assets of which are ultimately comprised of loans (*i.e.*, a loan securitization where the underlying collateral is loans).[8] A tender option bond is a debt security, the underlying asset of which is a state or local bond.[9] Auction rate securities are debt instruments with a long-term nominal maturity for which the interest rate is regularly reset through a Dutch auction.[10]

Like TruPS CDOs and CLOs, these investments are not hedge funds or private equity funds; rather, it is only under the Final Rules that they have been classified as prohibited investments as a result of the overbroad definition of "covered fund." Like CLOs, these are debt securities intended to reflect and facilitate lending arrangements rather than outright equity investments. Banks, moreover, were not made aware at the proposal stage that these debt securities would be deemed "covered funds" under the Final Rules. We request, therefore, that these investments likewise be exempted from the prohibitions of the Volcker Rule. Grandfathering these investments (if purchased before December 10, 2013) might act so that holders of these investments would not incur unnecessary losses through a forced divestiture of these investments, but that would do little to make these instruments available going forward for the class of customers who have relied upon them as important sources of funding.

II. Addressing the Challenges Raised by a Broad Definition of "Covered Fund."

In our comment and other letters on the proposed rules to implement the Volcker Rule,[11] we stated that the Agencies should avoid a broad definition of "covered fund" so that a range of funds that are plainly not hedge funds or private equity funds would avoid being captured within the term and thereby made unavailable to bank customers. A narrow definition, moreover, would have been consistent with the purposes of the Volcker Rule and would have still preserved the Agencies flexibility to administer the legislative mandate through the bank supervisory process in any isolated cases that might present genuine systemic risks. The prohibition in the statute supports such a reading by specifically referring to "equity" and "ownership interest" in a "hedge fund" or "private equity fund."[12] Instead, the Final Rules have liberally defined "covered

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[8] In a re-REMIC, the restructured security is not repaid unless the underlying loans are repaid and there is no security in the pool that will be paid by other sources or independent of specific loan performance.

[9] Tender option bond programs have historically been used to provide short-term tax-exempt municipal bonds to money market funds. In a typical tender option bond program, the sponsor will deposit a fixed-rate bond or note into a trust, which will issue two new certificates – a floating-rate certificate and a residual certificate. The floating rate certificate will have a tender option, through a liquidity facility that is usually issued by the program's sponsor or an affiliate and shortens the maturity of the bond or note so it becomes eligible to be purchased by a tax-exempt money market fund. Banks establish tender option bond programs as a way to satisfy market demand for exposure to short-term municipal securities.

[10] Auction rate securities may be issued by federal governmental agencies (*e.g.*, Fannie Mae, Freddie Mac) or by financial institutions. Many such securities issued by financial institutions continue to pay dividends in excess of 4%.

[11] *See* Letter from Frank Keating, President & CEO, ABA (Feb. 13, 2012); Letter from Wayne A. Abernathy, Executive Vice President, Financial Institutions Policy and Regulatory Affairs, ABA (Feb. 13, 2012) (comment letters to Agencies' proposed rules on the Volcker Rule). *See also* Letter from Cecelia Calaby, Senior Vice President, ABA, to Agencies (Dec. 17, 2012); Letter from Cecelia Calaby to Rep. Spencer Bachus (Sept. 7, 2012); Letter from Frank Keating to Reps. Shelley Moore Capito and Scott Garrett (Jan. 17, 2012).

[12] Dodd-Frank Act § 619(a)(1)(B).

fund," thereby capturing a range of funds that were not intended to be regulated by the Volcker Rule. The Final Rules attempt to solve this problem by providing a list of express exemptions.[13] Unfortunately, certain of these exemptions (*e.g.*, loan securitizations) are narrowly drawn and have resulted in a number of debt securities being included within the covered fund prohibitions.[14] The Agencies should again consider whether a narrow, precise definition of "covered fund" would provide the best approach to administering the Volcker Rule, with the best result for bank customers and the economy in general.

One possible solution to release captured debt securities would be to modify the language of the definition of "ownership interest" in the Final Rules to clarify that only *equity* interests should be considered an "ownership interest." Debt interests are not ownership interests, and therefore should be excluded from the definition. Drawing a clear distinction would be consistent with the intent and purposes of the Volcker Rule and would provide certainty for banks regarding current and future investments in their fund portfolios.

Additionally, the Federal Reserve should re-visit the conformance period for previously permissible fund investments that do not fit within an exemption under the Final Rules. Many of these ineligible funds may be relatively illiquid yet still not satisfy the rigid requirements for an extension under the Federal Reserve's guidance.[15] The Federal Reserve should provide itself with the flexibility to grant extensions in cases where divestiture within the conformance period would likely result in an unnecessary or significant loss on the investment, regardless of the characteristics of the fund itself or the rights of the investor bank or fund manager. Doing so would uphold the Volcker Rule's intent not to penalize banks for holding what have become (by later regulatory policy) ineligible investments while making sustained, good-faith attempts to divest the investment at a reasonable price.

III. Guidance on Compliance with Final Rules.

The volume and complexity of the Final Rules have imposed an immediate and substantial compliance burden on all banks and their affiliates in determining which activities and investments are covered under the Volcker Rule. Due to the difficulty in making such determinations, all banks appear to be forced to perform a "Volcker Rule analysis" on each prospective fund investment, *regardless* of whether the investment is actually covered under the Final Rules. Indeed, because the definition of "covered fund" is tethered to Sections (3)(c)(1) and (3)(c)(7) of the Investment Company Act of 1940 (1940 Act), banks are discovering that provisions of the 1940 Act itself must be reviewed and analyzed (often together with other federal securities laws and regulatory interpretations of the Securities and Exchange Commission) in order to conclude whether or not a fund investment is prohibited under the Final Rules.

This highlights a very expensive and time-consuming unintended consequence of the Volcker Rule: for any fund investment, banking entities – including community and midsize banks – may be required to hire and retain 1940 Act counsel to verify the legality of such investment. Even a

[13] *See* Final Rules § __.10(c)(1) - (14).
[14] *See id.* § __.10(c)(8).
[15] *See* 76 Fed. Reg. 8265, 8275-77 (Feb. 14, 2011).

favorable determination by counsel would not preclude an initially legal fund investment from later becoming an ineligible investment, due to circumstances often beyond the control of the bank investor.[16] Consequently – as stated in one of our earlier comment letters, "a bank may . . . still not know with an operational degree of certainty whether its [investments] are outside the scope of the [Final] Rules. This makes bank compliance efforts costly, risk-averse, and potentially ineffective."[17]

We request, therefore, that until such time as a sensibly drawn definition of "covered fund" is adopted, the Agencies provide clear and comprehensive examination guidance to banks in order to assist them in ascertaining permissible versus prohibited investments and in streamlining the legal and regulatory analysis required. For example, the Agencies could provide: (i) a detailed community bank guide in the form of "frequently asked questions" (FAQ) that would meaningfully respond to common questions regarding compliance with the Final Rules; (ii) a template for applying a Volcker Rule/Final Rules analysis to investment activity; (iii) standards for due diligence, including its form and extent, regarding fund investments; and (iv) guidance for working with internal and outside accountants, and how regulators will approach accounting –related issues. Such initiatives would show a commitment to contain bank compliance labor and costs. More important, these regulatory steps would permit banks to continue responsibly managing their permissible trading and investment activities with the necessary degree of certainty and with minimal disruption to their routine banking operations on which their banking customers have come to rely.

IV. Volcker Rule Interagency Group.

At a recent hearing before the House Committee on Financial Services,[18] Agency representatives stated that they had established an interagency working group (Interagency Group) charged with administering the provisions of the Final Rules. We are encouraged that the Agencies are committed to working together, rather than piecemeal, in order to provide for consistent and unified implementation and interpretation of the Volcker Rule and the Final Rules. It would be helpful to know the manner in which the Interagency Group intends to operate and which Agency or Agencies will possess ultimate decision-making authority in which instances. We request, therefore, that the Agencies explain in writing how coordination between and among them will work via the Interagency Group, especially with respect to the process and procedures for requesting and receiving regulatory guidance and relief. This will greatly assist banks as we continue to work with the Agencies in implementing the Final Rules.

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[16] For instance, a bank may be invested in a fund operating under an exemption under the 1940 Act other than Section 3(c)(1) or 3(c)(7), which fund may later lose that exemption and (for the sake of other institutional investors) may need to rely on (3)(c)(1) or (3)(c)(7) to avoid investment company status. Additionally, a bank may be invested in a loan securitization or asset-backed securitization vehicle which fund subsequently loses its Volcker Rule exemption due to an errant investment made by that fund, or it may be invested in a public welfare investment fund which includes an investment that the regulators later determine is not a public welfare investment. In each of these cases, the bank would have to monitor continually its initial investment in these funds to ensure that each such fund remains exempt from the definition of "covered fund," and the bank may be penalized by regulators for not exercising constant surveillance over every such investment.

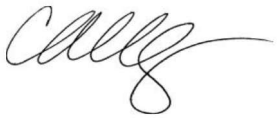
[17] ABA Letter from Wayne A. Abernathy, *supra*, p. 6.

[18] *See* House Hearing, *supra*.

We would be glad to work with the Agencies in addressing the Volcker Rule issues described herein and other issues as they arise. If you have any questions or need additional information, please do not hesitate to contact me at 202-663-5325 or Timothy E. Keehan at 202-663-5479.

Thank you for the opportunity to provide comments to the Interim Final Rule.

Sincerely yours,



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