Testimony of Jeffrey Plunkett
On behalf of the
Association of Institutional INVESTORS
Before the House Committee on Financial Services
December 13, 2012

Chairman Bachus, Ranking Member Frank, Members of the Committee, thank you for inviting me to testify today on behalf of the Association of Institutional INVESTORS (the "Association") regarding the Association's suggested changes to Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), which is commonly referred to as the Volcker Rule.

My name is Jeffrey Plunkett, and I am the General Counsel and Executive Vice President for Natixis Global Asset Management, a founding member of the Association. The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment managers in the United States. Our members manage money on behalf of institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and the concerns we raise are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

The Association's Concerns with the Volcker Rule

When the Volcker Rule was originally enacted, it was aimed at limiting high-risk proprietary trading strategies at a handful of very large banks. Since passage of the Dodd-Frank Act, Congress has urged regulators to draw clear lines limiting activities that are clearly proprietary trading, while still allowing banks to engage in permitted banking and market making activities. The regulators, however, have not found this objective easy to meet with the current statutory language, struggling to reach consensus nearly half a year after the deadline for implementation.

We believe that congressional clarification in the form of a technical amendment bill would significantly help the regulators in their implementation efforts.

Despite Congressional intent[1] that the Volcker Rule only affect the proprietary trading activities of large banks while continuing to allow banks to make markets, the proposed rule[2] issued by the regulators in October 2011 would have far-reaching consequences for investors. Asset managers and their clients rely on banks to execute trades. Anecdotal evidence suggests that in today's market well more than half of institutional investment adviser transactions consist of trades with banks, including foreign banks. In this role, banks are providing critical services for the functioning of the secondary market.

The regulators' proposed rule may force bank dealers to stop facilitating transactions for customers because of compliance costs and uncertainty regarding the boundaries of permissible and impermissible activities. This is due, in part, to the rule's complex, after-the-fact tests for determining whether a bank is engaging in proprietary trading, which do not reflect the realities of financial markets. We believe the regulators are simply doing their best to implement the statute as written. However, unless changes are made to the proposed rule, there will be significant disruptions to both liquid and illiquid sectors of the market.

Additionally, the Association understands the need to limit banking entities' relationships with hedge funds and private equity funds. The regulators' interpretation of the statute, however, is over-inclusive, and significantly and unnecessarily harms asset managers that are affiliated with banking institutions. Many of the covered fund restrictions could be drafted in a manner that effectively addresses systemic risk to the financial system without creating a competitive disadvantage for asset managers that are affiliated with banking institutions.

Mr. Chairman, we support your efforts to formulate a less burdensome Volcker Rule and we appreciate your request for industry input on suggested alternatives to the Volcker Rule. While we understand the underlying policy considerations for incorporating the Volcker Rule in the Dodd-Frank Act, we welcome opportunities to work with Congress and with the financial regulators to ensure that the ultimate restriction still permits markets to function efficiently and fairly.

The Association submitted a comment letter on September 7, 2012, in response to the Chairman's request for industry comments, which discusses our specific concerns and offers suggested changes that would address each concern. The letter also offers legislative text that would implement each of the Association's suggestions. We would like to incorporate this letter and its recommendations by reference into the record and have attached this letter as Appendix

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[1] *See e.g.* 156 CONG. REC. S5906 (daily ed. July 15, 2010) (statement of Sen. Bayh (D-IN)): "With respect to the Volcker Rule, the conference report states that banking entities are not prohibited from purchasing and disposing of securities and other instruments in connection with underwriting or market making activities, provided that activity does not exceed the reasonably expected near term demands of clients, customers, or counterparties. I want to clarify this language would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without that flexibility, market makers would not be able to provide liquidity to markets."

[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011).

A. Additionally, many of the Association's concerns are further discussed in the Association's February 13, 2012 comment letter submitted to the regulators in response to their proposed rule. This letter is also incorporated by reference and attached as Appendix B.

Conclusion

Mr. Chairman, as you and the Committee begin to consider draft legislation to amend the Volcker Rule, we hope our suggestions serve as a foundation for your efforts. Each of our suggestions is intended to mitigate unintended, adverse consequences that will ultimately affect the millions of American investors who rely on the continued vitality of their pension plans and 401(k) accounts. We thank you and the Committee for considering our letter and for giving industry concerns with the Volcker Rule the serious attention they deserve. As the Committee progresses toward making technical corrections to Section 619, we stand ready to provide useful guidance as a non-conflicted voice for investors.

Thank you for the invitation to participate in today's hearing.

APPENDIX A

Comments of the Association of Institutional INVESTORS
In Response to Chairman Bachus' Public Request for Input on Volcker Rule Alternatives
September 7, 2012

September 7, 2012

The Honorable Spencer Bachus, Chairman
House Financial Services Committee
2129 Rayburn House Office Building
Washington, D.C. 20515

Re: Public Request for Input on Volcker Rule Alternatives

Dear Chairman Bachus:

The Association of Institutional INVESTORS[1] (the Association) appreciates the opportunity to provide the House Financial Services Committee (HFSC) with specific legislative text and explanatory text that would amend certain provisions of Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the Dodd-Frank Act).[2]

The Association supports HFSC's efforts to formulate a less burdensome alternative to the Volcker Rule and appreciates HFSC's request for additional comments from those that would be directly affected by the rule. We believe the text of Section 619, and by extension the regulators' proposed rule (Proposed Rule),[3] will have resounding effects on the future of our industry, because it will

[1] The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

[2] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

[3] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011).

determine whether banks will continue to serve as liquidity providers and counterparties to trades on behalf of our clients. Therefore, we welcome the opportunity to work with HFSC as it considers how best to make this provision workable, striking a balance between limiting risky behavior at banks and ensuring that banks can continue to serve the needs of our clients.

OVERVIEW OF THE ASSOCIATION'S SUGGESTIONS

The Association represents asset managers that work on behalf of institutional investors, such as pension funds and 401(k) accounts. Although Section 619 of the Dodd-Frank Act, and by extension the Proposed Rule, is focused on the activities of banks, we believe that an inappropriately expansive Volcker Rule will have far reaching consequences for millions of American investors who rely on the continued vitality of these pension plans and 401(k) accounts.

Specifically, financial regulators have interpreted the language of Section 619 and drafted a Proposed Rule that reduces in the breadth of investment options available to American investors. The Proposed Rule could force bank dealers to stop facilitating transactions for customers in situations where the compliance costs and uncertainty about the boundaries of permissible and impermissible activities are too great, even though the banks are not engaging in "proprietary trading." Going forward, we also believe there will be diminished depth of both liquid and illiquid sectors of the market due to the complex nature and interplay of the factors and metrics that seem impracticable to implement. The Proposed Rule also has been subject to significant international criticism, as international bodies such as the G-20 have worked toward international coordination of financial regulatory reform. The Association believes that changes to the statute should be considered to foster international consensus regarding the provision.

To address these harmful and unintended consequences, specific technical amendments must be made to Section 619 of the Dodd-Frank Act. By doing so, we believe it is possible to achieve the goal of limiting risky proprietary trading, while allowing banks to continue legitimate activity on behalf of institutional investors. The following sections of this memorandum discuss specific issues that we believe must be addressed within Section 619, including providing HFSC with a "blackline" of suggested legislative amendments. Appendix A to the document then provides a copy of the Association's suggested legislation to amend Section 619 and implement each of these changes.

SPECIFIC LEGISLATIVE RECOMMENDATIONS WITH EXPLANATORY TEXT

a. Proprietary Trading Restrictions

i. Presumption of Proprietary Trading

Although the Association does not believe it was the intent of Congress, under the Agencies' Proposed Rule, banks must meet a set of criteria to show that they are not engaged in proprietary trading. This creates the presumption that the activity *is* proprietary trading unless the banks prove otherwise. The Association believes this may result in banks being unwilling to take principal risk to provide liquidity services to institutional investors, because Agencies have the ability to second-guess

a bank's actions after it has completed trades, making it difficult or risky for the bank to assist asset managers in executing such trades.

Although we recognize the desire to inhibit efforts to evade the prohibition that could result if the definition were to be drawn too narrowly, we believe these concerns are overshadowed by what may result from an overly broad or unclear definition. Further, given the anti-evasion provisions and significant oversight and reporting requirements, it is unnecessary to draft an over-inclusive definition for fear of attempts to evade the prohibition.

Suggested Change: Congress should clarify that the Agencies should focus on trading activities that "are conducted solely for the purpose of executing trading strategies that are expected to produce short-term profits without any connection to customer facilitation or intermediation," as described by Federal Reserve Governor Daniel Tarullo. This would limit proprietary trading to situations that are "not difficult to identify" and would be consistent with former Federal Reserve Chairman Paul Volcker's statements that it should be easy to recognize proprietary trading.

Legislative Text:
"(h) DEFINITIONS.—In this section, the following definitions shall apply:
"(4) PROPRIETARY TRADING —The term 'proprietary trading', when used with respect to a banking entity or nonbank financial company supervised by the Board, means, subject to the following sentence, engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule as provided in subsection (b)(2), determine. For purposes of this definition, the term 'proprietary trading' is limited to principal transactions effected for the purpose of executing trading strategies that are expected to produce short-term profits without a clear connection to customer facilitation or intermediation.

A. Market Making Exemption

In particular, the market making test under Section 619 (d)(1)(B) is ambiguous and may lead to uncertainty as to whether the Agencies will interpret legitimate behavior as proprietary trading, and thus may make it difficult for banks to engage in market making activity. If banks are unwilling to continue intermediating trades for institutional investors because the Proposed Rule creates uncertainty as to whether such activity is market making, the ultimate harm will fall on individuals and families, who utilize pension funds and 401(k) funds for their retirement savings.

Suggested Change: The Association urges Congress to clarify that market making activities taken on behalf of customers fall within the market making exemption. The meaning of the phrase "reasonably expected near term demands of clients, customers, or counterparties" in Section 619(d)(1)(B) should also be clarified to state that "near term" does not limit the market making trading activity in markets that are illiquid or have episodic liquidity.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(B) The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making related activities reasonably related to customer facilitation or intermediation, to the extent that any such activities permitted by this subparagraph are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. For purposes of this section, the term "reasonably expected near term demands" shall be based on the specific liquidity characteristics of individual markets and products.

B. Risk Mitigating Hedging Exemption

The Agencies' Proposed Rule also provides a number of requirements that firms must attain in order to rely on a risk-mitigating hedging exemption. According to the Proposed Rule, the criteria is intended to define the scope of permitted risk-mitigating hedging activities and to prohibit reliance on the exemption for proprietary trading that is mischaracterized as permitted hedging activity.

The Association agrees that hedging is an appropriate indicator of an entity's risk appetite, but believes that this indicator breaks down at the trade-by-trade level. In particular, this indication fails when gauging whether hedging activities are proper for illiquid markets, where perfect hedges are often not available. Further, members of the Association trade with market makers that use generally available hedges to bridge the gap between time and price with various traders in the market. The hedging exemption, therefore, must include a broad definition of what constitutes a "trading unit" (also known as an "aggregation unit") to permit banking entities to hedge adequately their trades with institutional clients.

Suggested Change: Congress should clarify that the Agencies must allow coordinated aggregate risk-mitigating hedging activities that are implemented across trading units. Additionally, Congress should define the term 'trading unit' and the correlation to risk-mitigating hedging activities in the legislation to ensure that banking entities may continue to hedge adequately their trades with institutional clients.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:

"(C) Risk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings. In developing and issuing regulations pursuant to this section, the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall consider coordinated aggregate risk-mitigating hedging activities implemented across trading units. For purposes of this section, the term "trading unit" means each discrete unit engaged in a revenue generation strategy at a banking entity.

ii. Municipal Bond Market Exemption

Section 619(d)(1)(A) permits the purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, as well as obligations of any State or of any political subdivision thereof. While we support this exemption, the Association is concerned that the Agencies' Proposed Rule has been drawn too narrowly, prohibiting banks from trading in a significant portion of the current municipal bond activities, including securities issued by State agencies or instrumentalities. We also disagree with the Agencies' interpretation that its exemption is "consistent with the statutory language," because it does not extend the government obligations exemption to include "transactions in obligations of an *agency* of any State or political subdivision thereof." Without clarification from Congress, the Agencies' current interpretation could have significant unintended consequences, such as limiting the funding availability for projects such as hospitals, affordable housing developments, airports, and universities that receive financing through municipal obligations.

Suggested Change: Congress should clarify the exemption for proprietary trading in State or municipal agency obligations through adopting the definition of "municipal securities" already included in Section 3(a)(29) of the Securities Exchange Act of 1934. Utilizing such a definition in the exemption would provide a clearer line for banks to follow regarding what is covered under the municipal bond market exemption, permitting investors to continue investing in municipal debt at reasonable costs.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(A) 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 chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.), ~~and obligations of any State or of any political~~

~~subdivision thereof~~ and 'municipal securities,' as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c).

b. Covered Funds

i. Definition of "Covered Fund"

Section 619(h)(2) of the Dodd-Frank Act defines "hedge fund" and "private equity fund" as:

> an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine.

The Financial Stability Oversight Council's (FSOC) study on the Volcker Rule acknowledged that the foregoing definition is over-inclusive, and includes funds that are not commonly understood to be either a "hedge fund" or a "private equity fund" and that do not present the same types of risks. It also acknowledged that the definition is under-inclusive and may not capture other vehicles that don't rely on the exemptions, but engage in the activities or share the characteristics of a traditional private equity fund or hedge fund.

In drafting a definition, the FSOC study also recommended that certain factors be considered in determining what funds should be included as "similar funds." Accordingly, the Association believes this language must be tightened up in order to provide the Agencies with better guidance regarding what types of funds should be identified as "similar funds." Under the Proposed Rule, given the lack of guidance, the Agencies have extended this section to other types of funds without actually identifying the characteristics or activities that make such funds problematic or demonstrating that these funds lack adequate regulation by foreign jurisdictions.

For example, the Agencies have proposed to extend the definition of "covered fund" to cover any issuer organized or offered outside of the U.S. which would be a 3(c)(1) or 3(c)(7) fund if offered or organized inside the United States. Since most foreign funds could not meet all of the substantive regulatory requirements of a registered domestic investment company, they necessarily rely on the exemptions of Section 3(c)(1) or 3(c)(7). Thus, this definition captures a significant portion of foreign funds without adequate analysis of whether they share the same attributes as traditional hedge funds or private equity funds.

Additionally, the Agencies proposed to include as similar funds all "commodity pools" (which broadly captures vehicles that trade in commodity interests), as well as the foreign equivalent of any commodity pool and treat them as a "covered funds." According to the Agencies, these entities would be included because they are generally managed and structured similar to a covered fund except that they are generally not subject to the Federal securities laws due to the instruments in which they invest or because they are not organized in the U.S. or one or more States. We do not

believe it was Congress' intent to include these funds, because they do not have similar characteristics or activities of traditional hedge funds and private equity funds.

Further, in the wake of the CFTC's recent repeal of the Rule 4.5 exemption for mutual funds from the definition of commodity pools, and the expansion of the types of instruments that constitute "commodity interests" (i.e., swaps), many mutual funds and other pooled vehicles are likely to fall under the definition of commodity pools even if they trade in relatively small amounts of commodity interests. This may now subject many otherwise exempt registered investments companies to the Volcker Rule because commodity pools are considered "covered funds."

Suggested Change: Congress should revise and narrow the definition of "hedge fund" or "private equity fund" to exclude all registered investment companies and specifically identify the factors (i.e., characteristics and/or activities) that must exist in other pooled vehicles before the regulators may designate them as "similar funds." Additionally, foreign funds that are not actively marketed to U.S. investors and non-U.S. regulated funds, such as UCITS funds and other European regulated funds, which are subject to a degree of supervisory regulation in foreign jurisdictions (such as AIFMD), should also be excluded from the definition.

Legislative Text:
"(h) DEFINITIONS.—In this section, the following definitions shall apply:
"(2) HEDGE FUND; PRIVATE EQUITY FUND.—The terms 'hedge fund' and 'private equity fund' mean an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine, provided that such fund demonstrates characteristics that are similar to traditional hedge funds and private equity funds, such as being a managed portfolio of investments that utilizes significant leveraging or high-risk strategies such as long, short, and derivative positions that increase risk or loss to the fund. The terms 'hedge fund' and 'private equity fund' shall not include: foreign funds that are not actively marketed to U.S. investors and non-U.S. regulated funds, when such funds and their advisers are subject to prudential standards in a home country that are administered and enforced by a comparable foreign supervisory authority

ii. Exemptions

A. Naming Prohibition

Section 619(d)(1)(G)(vi) provides that the banking entity may not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the name. The Agencies' Proposed Rule expands upon this prohibition, stating that the covered fund may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof) and also may not use the word "bank" in the name.

Under Section 619(d)(1)(G)(v), the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests. This restriction is sufficient for ensuring that the entities are viewed separately in the market. We question the necessity for any naming prohibition beyond prohibiting the use of the word "bank" when a prohibition on bailing out funds is in place and where there is disclosure that investors bear the risk of loss in any default. The prohibition on bailing out funds protects against the "too big to fail" problems of the financial crisis and the disclosure requirements provide the necessary warning to investors of the risks involved.

Suggested Change: Congress should amend this provision to prohibit the word "bank" from the names of hedge funds or private equity funds organized and offered by banking entities, without requiring that the fund not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof). As currently drafted, the naming prohibition burdens the industry without providing increasing safeguards to investors. Under the Volcker Rule, banking entities may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the fund or of any fund in which such covered fund invests, and this must be disclosed in writing to prospective and actual investors. This restriction is sufficient for ensuring that the entities are viewed separately in the market.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(G) Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses for the foregoing, only if—
"(vi) the name of the ~~banking entity does not share with the~~ hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, ~~the same name or a variation of the same name~~ does not include the word 'bank;'

B. Investments by Employees and Directors Providing Advisory or Other Services

Section 619 (d)(1)(G)(vii) prohibits any director or employee of the banking entity from taking or retaining an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund.

Suggested Change: The Association believes that this prohibition on employee investment needs to be applied prospectively. Legislation should provide a grandfathering safe harbor for current

directors or employees to retain the interests already in their possession as of July 21, 2012, whether or not the directors or employees are currently providing services to the hedge fund or private equity fund. To do otherwise would cause these investors to suffer potentially significant tax consequences, as well as cause the funds and these investors significant difficulties in situations where interests are currently illiquid due to contractual redemption restrictions or the fund assets are illiquid.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(G) Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses for the foregoing, only if—
"(vii) on or after the effective date, no director or employee of the banking entity ~~takes or retains~~ acquires an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, unless ~~except for any~~ the director or employee of the banking entity ~~who~~ is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund; and

iii. Super 23A

Section 619(f)(1) prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to Section 619(d)(1)(G), and no affiliate of such entity, to enter into a transaction with a fund, or with any other hedge fund or private equity fund that is controlled by such fund, that would be a covered transaction, as defined in Section 23A of the Federal Reserve Act, with the hedge fund or private equity fund, as if such banking entity and the affiliate thereof were a member bank and the hedge fund or private equity fund were an affiliate thereof.

Under the additional restrictions created by this provision, banks and their affiliates would not be able to engage in limited types of covered transactions currently permitted by the exclusions and restrictions under Section 23A when lending to affiliates. Unlike the regulations between banks and their affiliates, where limitations exist but banks are still able to lend, this provision would make it so that advisers are no longer permitted to lend money to funds in the same way as is available for banks to lend to operating affiliates. In practice, this provision would allow banks to engage in more extensive activities with affiliated entities (where the bank's capital is at greatest potential risk of loss) than would be permitted between a bank or its affiliate and an affiliated hedge fund (where the bank's risk of capital loss is less).

The Association also questions the necessity to restrict activity more tightly between banks and affiliates when the banks are engaged in the traditional functions of custodian banks. Custodian banks that also manage covered funds must be able to continue to provide custodian services, such as providing intraday and overnight credit in connection with routine security and currency deliveries of payment transactions. If custodian banks are unable to provide custodian services to affiliated funds in the same manner as unaffiliated funds, then more risk would be introduced into the settlement process for these affiliated funds, because they would have to introduce third party custodians or lending parties to offer intraday or overnight credit to provide the necessary liquidity for routine payment and settlement functions. This would create more disconnect in the securities payment and settlement processing system, and will commensurately increase operational risk to these funds as well as the securities payment or settlement system. Ultimately, this would increase the potential risk to the fund sponsor. In other words, the fund may be more likely to suffer a loss that otherwise could have been anticipated and managed with an affiliated custodian because that custodian has a comprehensive view of the fund's activities and shares an interest to minimize risk of loss caused by disruptions in securities payment and settlements processing.

Suggested Change: The Association suggests that the legislation should modify this provision to mirror the language of Section 23A of the Federal Reserve Act, permitting banks and their affiliates to engage in limited types of covered transactions permitted by the current exclusions and restrictions under the Federal Reserve Act when lending to affiliates. Additionally, the language should clarify that banks may continue to engage in the traditional functions of custodian banks.

Legislative Text:
"(f) LIMITATIONS ON RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS.—
"(1) IN GENERAL.— A ~~No~~ banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to paragraph (d)(1)(G), and all ~~no~~ affiliates of such entity, ~~may enter into a transaction with a fund, or with any other hedge fund or private equity fund that is controlled by such fund, that would be a covered transaction, as defined in~~ shall abide by the restrictions on transactions with affiliates described in section 23A of the Federal Reserve Act (12 U.S.C. 371c) with the hedge fund or private equity fund, as if such banking entity ~~and the affiliate thereof~~ were a member bank and the hedge fund or private equity fund were an affiliate thereof.

iv. Limitations on Fund Investments

Under Section 619(d)(4)(B)(ii)(I) of the Dodd-Frank Act, banking entities may take an ownership interest in a covered fund if the banking entity's investment is limited to no more than three percent of the total outstanding ownership interests of such fund not later than one year after the date of establishment of the fund. The banking entity may also not invest more than three percent of its Tier 1 capital in covered funds in the aggregate.

Typically, bank asset managers will market affiliated funds that have at least a three-year performance record in order to attract institutional investors. In order to create such a longstanding record, the manager will typically seed a strategy for the initial three years with capital. Few asset managers or investors are willing to invest in a strategy that does not have a three-year performance record. Because of the broad application of the Volcker Rule to bank-affiliated managers, the three percent restriction will severely curtail a bank-affiliated manager from investing its own money to create the three-year performance record, and effectively eliminate an adviser's ability to launch new strategies that are not 40 Act Funds.

Suggested Change: The Association suggests that the legislation should modify the one-year deadline, instead requiring a three-year deadline to limit fund investment. By doing so, the Congressional goal of ensuring banks are not engaging in risky behavior will be met, while still allowing bank asset managers who market affiliated funds to establish their performance record needed in order to attract institutional investors. If appropriate, such three-year extension could be contingent on the per fund investment be subject to a dollar limit and otherwise be explicitly subject to the aggregate investment limit of 3% of Tier 1 capital of the banking entity.

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(4) DE MINIMIS INVESTMENT.—
"(B) LIMITATIONS AND RESTRICTIONS ON INVESTMENTS.—
"(ii) LIMITATIONS ON SIZE OF INVESTMENTS.—Notwithstanding any other provision of law, investments by a banking entity in a hedge fund or private equity fund shall—
"(I) not later than ~~1~~ 3 years after the date of establishment of the fund, be reduced through redemption, sale, or dilution to an amount that is not more than 3 percent of the total ownership interests of the fund, provided that the appropriate Federal banking agencies may impose a dollar limit on the banking entity's investment in an individual hedge fund or private equity fund during its initial 3 year term to address potential undue risk to the banking entity's capital;

v. Definition of Illiquid Fund

Section 619(h)(7) of the Dodd-Frank Act defines illiquid fund as a hedge fund or private equity fund that "as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments, and makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets."

The Association believes this definition utilizes an arbitrary date that may unnecessarily exclude funds that otherwise should meet the definition of being an illiquid fund. While we recognize that the purpose of this definition is to ensure that people are unable to manipulate the system, this definition would exclude, for example, a fund that was entirely liquid on May 1, 2010, but ultimately found itself in an illiquid state due to reasons or factors beyond its control (for example, the illiquidity was not due to any changes in portfolio holdings but was due to market forces). Such a result would harm investors to such funds and cut against the Congressional intent in Section 619 of

the Dodd-Frank Act. It would also not take into account liquidity factors that adversely affect the fund and are beyond the control or foresight of the fund sponsors. This could require sponsors to divest their fund ownership interest at inopportune times (i.e.., when market liquidity is constrained) despite best efforts to reduce their ownership interests by the deadline.

Suggested Change: The definition of illiquid fund should be based on assets rather than being solely based on contractual rights at a specific date in the past. The definition should also provide flexibility for regulators to implement a process for a banking entity to apply for an extension of time to divest its ownership interest in the fund in order to minimize the adverse impacts on, and conflicts of interest with, the fund and the investors, particularly where forcing the banking entity to divest prematurely could abrogate pre-existing contractual agreements or fundamental tenets of the fund's structure and operation. Such application process would allow the regulators to individually analyze whether a fund in existence prior to the statute's enactment has become illiquid through reasons beyond the fund or sponsor's control, and provide for a more tailored and orderly divestment based on the particular facts and circumstances. Further, the legislation should clarify that all funds that otherwise meet the definition of being principally invested in illiquid assets as of the date of implementation are grandfathered in as illiquid funds under the statute, rather than using the date of May 1, 2010.

Legislative Text:
"(h) DEFINITIONS.—In this section, the following definitions shall apply:
"(7) ILLIQUID FUND.—
"(A) IN GENERAL.—The term 'illiquid fund' means a hedge fund or private equity fund that—
"(i) ~~as of May 1, 2010, was~~ (a) on or prior to the enactment date, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments; and
"(~~ii~~b) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets; or
(ii) on or after the enactment date, held liquid assets of which a significant portion became illiquid due to market forces or factors beyond the individual or collective control of such fund, its investment adviser and its sponsor. In issuing rules regarding this subparagraph, the Board shall take into consideration the terms of investment for the hedge fund or private equity fund, including contractual obligations, the ability of the fund to divest of assets held by the fund at a reasonable price, whether the fund has become illiquid through factors or reasons beyond the individual or collective control of the funds, its investment adviser or sponsor, and any other factors that the Board determines are appropriate.

CONCLUSION

The Association recognizes the challenges Congress and the Agencies have in attempting to draft legislation and regulations to limit potentially risky banking activities while permitting banks to continue to provide much needed liquidity. The Association thanks HFSC for the opportunity to provide our suggestions regarding how Section 619 of the Dodd-Frank Act could be improved. We would be happy to discuss these changes with you or the Committee at your convenience. Please

feel free to contact me with any questions you may have at jgidman@loomissayles.com or (617) 748-1748.

On behalf of the Association of Institutional INVESTORS,

John Gidman
President

cc: Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission
Ms. Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve
Mr. Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation
Mr. David A. Stawick, Secretary, Commodity Futures Trading Commission
Mr. Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency

APPENDIX A

SUGGESTED LEGISLATION TEXT

112TH CONGRESS
2ND SESSION

H.R.______

To amend certain provisions in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and for other purposes.

IN THE HOUSE OF REPRESENTATIVES

________, ____ 2012

Mr. Bachus introduced the following bill; which was referred to the House Financial Services Committee.

A BILL

To amend certain provisions in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, and for other purposes.

1 *Be it enacted by the Senate and House of Representatives of*
2 *the United States of America in Congress assembled,*
3 **SECTION 1. SHORT TITLE.**
4 (a) Short Title — This Act may be cited as the "Volcker Act".
5 (b) Reference — Whenever in this Act an amendment or repeal is
6 expressed in terms of an amendment to, or repeal of, a section or
7 other provision, the reference shall be considered to be made to a
8 section or other provision of the Dodd-Frank Wall Street Reform
9 and Consumer Protection Act of 2010.

SECTION 2. PERMITTED ACTIVITIES

(a) Section 619(d)(1)(A) (12 U.S.C. 1851(d)(1)(A)) is amended by striking “and obligations of any State or of any political subdivision thereof” and inserting “any ‘municipal securities,’ as defined in Section 3(a)(29) of the Securities Exchange Act of 1934 (15 U.S.C. 78c).”

(b) Section 619(d)(1)(B) (12 U.S.C. 1851(d)(1)(B)) is amended to read as follows: “(B) The purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) in connection with underwriting or market-making related activities reasonably related to customer facilitation or intermediation, to the extent that any such activities permitted by this subparagraph are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties. For purposes of this section, the term “reasonably expected near term demands” shall be based on the specific liquidity characteristics of individual markets and products.”

(c) Section 619(d)(1)(C) (12 U.S.C. 1851(d)(1)(C)) is amended by inserting “In developing and issuing regulations pursuant to this section, the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission shall consider coordinated aggregate risk-mitigating hedging activities implemented across trading units. For the purposes of this section, the term “trading unit” means each discrete unit engaged in a revenue generation strategy at a banking entity” after the period.

(d) Section 619(d)(1)(G)(vi) (12 U.S.C. 1851(d)(1)(G)(vi)) is amended to read as follows: “(vi) the name of the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, does not include the word ‘bank;’”

(e) Section 619(d)(1)(G)(vii) (12 U.S.C. 1851(d)(1)(G)(vii)) is amended to read as follows: “(vii) on or after the effective date, no director or employee of the banking entity acquires an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, unless the director or employee of the banking entity is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund; and”

(f) Section 619(d)(4)(B)(ii)(I) is amended —

(1) by striking “1 year” and inserting “3 years”; and

(2) by inserting before the semi colon the following: “, provided that the appropriate Federal banking agencies may impose a dollar limit on the banking entity’s investment in an individual hedge fund or private equity fund during its initial 3 year term to address potential undue risk to the banking entity’s capital”.

SECTION 3. LIMITATIONS ON RELATIONSHIPS WITH HEDGE FUNDS AND PRIVATE EQUITY FUNDS

Section 619(f)(1) (12 U.S.C. 1851(f)(1)) is amended to read as follows: “(1) IN GENERAL — A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to paragraph (d)(1)(G), shall abide by the restrictions on transactions with

1 affiliates described in section 23A of the Federal Reserve Act (12
2 U.S.C. 371c) with the hedge fund or private equity fund, as if such
3 banking entity were a member bank and the hedge fund or private
4 equity fund were an affiliate thereof."

5 **SECTION 4. DEFINITIONS**

6 (a) Section 619(h)(2) (12 U.S.C. 1851(h)(2)) is amended by insert-
7 ing "provided that such fund demonstrates characteristics that are
8 similar to traditional hedge funds and private equity funds, such as
9 being a managed portfolio of investments that utilizes significant
10 leveraging or high-risk strategies such as long, short, and deriva-
11 tive positions that increase risk or loss to the fund. The terms
12 'hedge fund' and 'private equity fund' shall not include foreign
13 funds that are not actively marketed to U.S. investors and non-U.S.
14 related funds, when such funds and their advisors are subject to
15 prudential standards in a home country that are administered and
16 enforced by a comparable foreign supervisory authority" before
17 the period.

18 (b) Section 619(h)(4) (12 U.S.C. 1851(h)(4)) is amended to read as
19 follows: "(4) PROPRIETARY TRADING —The term 'proprie-
20 tary trading', when used with respect to a banking entity or non-
21 bank financial company supervised by the Board, means, subject
22 to the following sentence, engaging as a principal for the trading
23 account of the banking entity or nonbank financial company su-
24 pervised by the Board in any transaction to purchase or sell, or
25 otherwise acquire or dispose of, any security, any derivative, any
26 contract of sale of a commodity for future delivery, any option on
27 any such security, derivative, or contract, or any other security or

1 financial instrument that the appropriate Federal banking agencies,
2 the Securities and Exchange Commission, and the Commodity Fu-
3 tures Trading Commission may, by rule, as provided in subsection
4 (b)(2), determine. For purposes of this definition, the term 'pro-
5 prietary trading' is limited to principal transactions effected for the
6 purpose of executing trading strategies that are expected to pro-
7 duce short-term profits without a clear connection to customer fa-
8 cilitation or intermediation."
9 (c) Section 619(h)(7)(A) (12 U.S.C. 1851(h)(7)(A)) is amended to
10 read as follows:
11 "(A) IN GENERAL — The term 'illiquid fund' means a hedge
12 fund or private equity fund that —
13 "(i) (a) on or prior to the enactment date, was principally invested
14 in, or was invested and contractually committed to principally in-
15 vest in, illiquid assets, such as portfolio companies, real estate in-
16 vestments, and venture capital investments; and
17 "(b) makes all investments pursuant to, and consistent with, an in-
18 vestment strategy to principally invest in illiquid assets; or
19 "(ii) on or after the enactment date, held liquid assets of which a
20 significant portion became illiquid due to market forces or factors
21 beyond the individual or collective control of such fund, its in-
22 vestment adviser and its sponsor. In issuing rules regarding this
23 subparagraph, the Board shall take into consideration the terms of
24 investment for the hedge fund or private equity fund, including
25 contractual obligations, the ability of the fund to divest of assets
26 held by the fund at a reasonable price, whether the fund has be-
27 come illiquid through factors or reasons beyond the individual or

collective control of the fund, its investment adviser or sponsor, and any other factors that the Board determines are appropriate."

APPENDIX B

Comments of the Association of Institutional INVESTORS
In Response to the Financial Regulators Request for Comments on its Proposed Rule Titled:
Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds
February 13, 2012

February 13, 2012

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Mr. Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
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Mr. John G. Walsh
Acting Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

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

Dear Sirs and Madams,

The Association of Institutional INVESTORS (the "Association")[1] appreciates the opportunity to provide comments related to the proposed rule titled, "Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds" (the "Proposed Rule").[2] The Association recognizes the efforts undertaken by the Securities and

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[1] The Association of Institutional INVESTORS is an association of some of the oldest, largest, and most trusted investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. We recognize the significance of this role, and our comments are intended to reflect not just the concerns of the Association, but also the concerns of the companies, labor unions, municipalities, families, and individuals we ultimately serve.

[2] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011). We recognize the CFTC did not join the other prudential

Exchange Commission ("SEC"), Board of Governors of the Federal Reserve ("Federal Reserve"), Federal Deposit Insurance Corporation ("FDIC"), Office of the Comptroller of the Currency ("OCC"), and Commodity Futures Trading Commission ("CFTC" and together with the other agencies, the "Agencies") to implement rules regarding proprietary trading and restrictions on relationships with covered funds, as required under the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").[3] However, the Association has some concerns with the Proposed Rule relating to both the proprietary trading restrictions and the restrictions on covered fund activity.

The Association represents asset managers that work on behalf of institutional investors, such as pension funds and 401(k) accounts. Although this rulemaking is focused on the activities of banks, we believe that the Proposed Rule will negatively affect the clients of institutional asset managers, and therefore have consequences for millions of American investors who rely on the continued vitality of these pension plans and 401(k) accounts. We are concerned that the implementation of the Volcker Rule as currently constructed will result in a reduction in the breadth of investment options available to the marketplace, as bank dealers exit lines of business due to increased compliance costs and uncertainty about the boundaries of permissible and impermissible activities. The Proposed Rule may also diminish the depth of both liquid and illiquid sectors of the market because the complex nature and interplay of the factors and metrics proposed in the rule are impracticable to implement.

The unintended consequences of this well intentioned Proposed Rule may be to deepen and extend the current economic downturn.

I. PROPRIETARY TRADING RESTRICTIONS

The Association is concerned that the Proposed Rule, as currently drafted, may fundamentally change how, or whether, banks will be willing to serve as major liquidity providers. We believe that the Proposed Rule offers arbitrary and complex tests for determining whether a bank meets the exemptions from the proprietary trading restrictions, which do not adequately reflect the realities of the financial markets. We are concerned that unless significant changes are made to the Proposed Rule, our institutional investment clients will be negatively affected.

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regulators in issuing the Proposed Rule. However, because the Association preliminarily believes the CFTC's proposed rule, RIN 3038-AD05, which has not yet been published in the Federal Register, will be substantially similar to the Proposed Rule, we have determined that it is appropriate to provide the CFTC with the Association's comments at this time. The Association believes that it is important for the CFTC to consider these comments because the prudential regulators must issue final joint regulations together.

[3] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010). Further, although the Association appreciates the Agencies' efforts to implement Section 619 of the Dodd-Frank Act, we also recognize the arguments made by others, including Chairman of the House Financial Services Committee Spencer Bachus (R-AL), who have called for Congress to reevaluate the provision, stating that Section 619 creates a "self-inflicted wound" on the U.S. markets and have noted that other efforts, such as implementing the Basel III capital requirements, may more properly address bank risk taking addressed by the Volcker Rule. *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (opening statement of Rep. Spencer Bachus, Chairman, H. Comm. on Financial Services).

Asset managers and their clients rely on banks to execute trades. Anecdotal evidence suggests that in today's market well more than half of institutional investment adviser transactions consist of trades with banks, including foreign banks. In this role, banks are providing critical services for the functioning of the secondary market. While we understand that the regulators' intention is not to inhibit banks' legitimate market making functions, we remain concerned that unless changes are made to the Proposed Rule, market making activities will be curtailed, causing negative (though unintended) consequences for institutional and individual investors.

In particular, the Proposed Rule's definitions relating to permitted activities do not recognize key differences between markets with continuous liquidity versus episodic liquidity. In markets with episodic liquidity, such as many fixed income markets, banks do not simply engage in agency trading without risk, only buying from a client or an investor seller when they already have counterparty demand and know the price that they will be able to sell the asset. Instead, traditional market making entails banks being able to hold inventory on their books, assuming the role of being a direct counterparty to the client or investor seller. In such a situation, banks will buy illiquid assets from sellers such as asset managers acting on behalf of their clients even if the bank has not yet found a buyer for such assets, agreeing to hold the assets until another buyer wishes to purchase them, which may occur quickly in some situations and slowly in others.

The potential for the Proposed Rule to restrict a bank's ability to engage in principal-based trading and to cause a bank to convert to an agency trading model, where buyers and sellers must be matched before a trade is executed, may have devastating effects on an asset manager's ability to serve the needs of the institutional investors, such as ERISA pension and 401(k) plans. A bank's willingness to take on this risk in order to facilitate customer transactions and hold assets in dealer inventory until a willing buyer is found is essential in less liquid markets because it allows an asset manager to choose which assets it wishes to sell to meet redemption requests from institutional investors. Without it, asset managers may be forced to do a "fire sale" of illiquid assets, or simply sell what assets it *can* sell, not what assets it *wants* to sell. This will result not only in the loss of assets that the asset manager otherwise wanted to retain for the client, but also in the residual portfolio becoming increasingly illiquid. An increasingly illiquid portfolio is harmful to the remaining investors. As liquidity concerns rise, an asset manager may also have to carry additional cash to ensure that it can pay redemption orders at a customer's request. Alternatively, it may be necessary in some cases, where possible, for an asset manager to place additional restrictions on when investors can redeem their money out of a fund. In many cases it may also be difficult or impossible for an asset manager to amend restrictions on various types of funds, including ones established under the Investment Company Act of 1940 ("40 Act Funds"), which have regulations governing redemption requests.

Even if dealers are still willing to make markets for institutional investment advisers, the Proposed Rule may also negatively affect investors by reducing market depth and raising costs. Currently, banks provide investors with choice, offering securities with varying characteristics. The Proposed Rule may cause banks to limit the securities kept in inventory, depleting the pool of available securities for investors and affecting the ability of investors to efficiently manage their portfolios. Further, we believe this Proposed Rule will significantly raise costs for investors, including institutional investors such as pension funds and 401(k) accounts, because the compliance costs for banks will inevitably be passed on to investors.

Bid-ask spreads will also widen, reducing the ultimate return investors will receive. By limiting when banks can engage in principal-based trading, the natural result will be that the difference between the price a buyer is willing to pay for a security, compared with the price in which a seller is willing to sell a security, will increase. These costs, coupled with a tightening of liquidity in the market, will negatively affect the ability of pension funds and 401(k) accounts to function in the most effective manner. By taking on reasonable risk and principal positions, banks enable markets with otherwise episodic liquidity to operate in a vibrant and efficient way for millions of American investors.[4]

In addition to adversely affecting the secondary markets by decreasing liquidity and the depth of markets, the Proposed Rule also has the potential to distress primary markets. Without a vibrant secondary market for fixed income securities, for example, underwriters in the primary market will be less likely to underwrite debt offerings, resulting in fewer options for institutional investors, and U.S. companies will be forced to borrow directly from banks for their capital needs. Complicating this situation, since the economic downturn, many banks are unwilling or unable to lend, which will exacerbate American business's ability to access capital, grow the economy, and create jobs.

To address these concerns, we believe the Agencies should focus on client activity when drafting a workable test for the markets, starting from a presumption that the bank is engaged in permitted activity, rather than presuming that the trading activity is proprietary unless the bank can meet one of the permitted activity tests. The Proposed Rule essentially characterizes banks as guilty until proven innocent, which the Association believes is an unwise and unsound position that will result in numerous negative consequences. As discussed in further detail below, the Association is particularly concerned with potential negative consequences that could result from the Agencies' narrow interpretations of: (1) the market maker exemption; (2) the risk mitigating hedging exemption; and (3) the municipal bond exemption.

A. Presumption of Proprietary Trading

The exemptions enumerated in the Proposed Rule require banks to meet a set of criteria to show that they are not engaged in proprietary trading, creating a presumption that the activity *is* proprietary trading unless the banks prove otherwise. This is inconsistent with congressional intent and may result in banks being unwilling to take principal risk to provide liquidity services to institutional investors. Unless this is changed, the Proposed Rule would allow the Agencies to second-guess a bank's actions after it has completed trades, making it difficult or risky for the bank to assist asset managers in executing such trades. This result may unnecessarily constrain liquidity in secondary markets and cause asset managers and others to look to alternative non-U.S. markets to service client needs. Such actions may also decrease transparency in the marketplace, in direct contrast to the Dodd-Frank Act's stated goals, and result in the U.S. losing market share, potentially hurting the still-fragile economy.[5]

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[4] In that regard, we note that while retail investors generally trade equity securities on exchanges (on a commission-basis through an agent), fixed-income markets are more commonly sold on a bid-ask spread through a principal intermediary, and thus, will be greatly impacted by the Proposed Rule. Further, even though a substantial portion of equity trading is conducted on an agency basis, a considerable amount of equity trades entered into by the funds and accounts managed by our members is traded on a principal basis and will, therefore, also be impacted.

[5] *See* 156 CONG. REC. S5912-13 (daily ed. July 15, 2010) (statement of Sen. Leahy (D-VT)): "The conference report we are voting on today goes directly to the heart of the Wall Street excesses that brought our economy to the brink. For far too long Wall Street firms made risky bets in the dark and reaped enormous profits. Then, when their bets went sour,

During the Dodd-Frank Act Conference Committee negotiations, Senator Jeff Merkley (D-OR) noted that the Agencies can distinguish proprietary trading from market making based on, "volume of trading, the size of the positions, the length of time that positions remain open, and the volatility of profits and losses."[6] While we agree that these factors may generally help differentiate market making from proprietary trading, if implemented incorrectly, these same factors could unnecessarily constrict what a bank is willing, or even able, to accomplish and likely lead to liquidity drying up for the secondary market, which Congress was trying to avoid by including the market making exemption.[7]

Under the Proposed Rule's market making exemption test, regulators will scrutinize behavior after-the-fact and may "discover" proprietary trading, when banks were actually engaged in market making. Ambiguities in the test and uncertainty as to whether the Agencies will interpret legitimate behavior as proprietary trading may make it difficult for banks to remain in this role. Congress noted that market making is a "customer service," assisting customers in the "speedy acquisition or disposition of certain financial instruments."[8] If banks are unwilling to continue intermediating trades for institutional investors because the Proposed Rule creates uncertainty as to whether such activity is market making, the ultimate harm will fall on individuals and families, who utilize pension funds and 401(k) funds for their retirement savings.

This presumption will limit the tools available to asset managers to hedge and diversify their risk exposure. It will create problems not only for fixed-income markets, but also for equity markets, including millions of individuals invested through retail accounts and workplace retirement plans such as 401(k) accounts. While retail investors and smaller institutional investors often trade equities using an agency-based "last sale" model, larger investors trade in a myriad of ways with covered banking entities in an effort to reduce execution costs, mitigate risk, and improve returns. It is

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they turned to America's taxpayers to bail them out. This bill is about changing the culture of rampant Wall Street speculation and doing what needs to be done to get our economy back on track. We need more transparency and oversight of Wall Street. These improvements will increase transparency in and oversight of the financial sector . . . It has seemed to me that promoting transparency should be a vital element of Wall Street reform. Transparency is a cleansing agent for healthy markets. Open information helps investors make sound decisions. When information is murky, market decisions must be based on guesses or rumors that corrode trust and that encourage fraud and deception."

[6] *See* 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley (D-OR)): "Market-making is a customer service whereby a firm assists its customers by providing two-sided markets for speedy acquisition or disposition of certain financial instruments… Academic literature sets out the distinctions between making markets for customers and holding speculative positions in assets, but in general, the two types of trading are distinguishable by the volume of trading, the size of the positions, the length of time that positions remains open, and the volatility of profits and losses, among other factors. Regulations implementing this permitted activity should focus on these types of factors to assist regulators in distinguishing between financial firms assisting their clients versus those engaged in proprietary trading."

[7] *See* 156 CONG. REC. S5906 (daily ed. July 15, 2010) (statement of Sen. Bayh(D-IN)): "With respect to the Volcker Rule, the conference report states that banking entities are not prohibited from purchasing and disposing of securities and other instruments in connection with underwriting or market making activities, provided that activity does not exceed the reasonably expected near term demands of clients, customers, or counterparties. I want to clarify this language would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without that flexibility, market makers would not be able to provide liquidity to markets."

[8] *See* 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley (D-OR)).

crucial for advisers to large institutional clients to have access to covered banking entities' traditional equity securities market making activities, including the ability to enter into block trades and hedge without undue restriction, so that end investors are not subject to unnecessary increased risk and costs.

Similarly, the ability of institutional investors to continue to use over-the-counter (OTC) derivatives products to safely diversify their portfolios and effectively hedge or manage risks may also be impaired unless the presumption is changed. Activity in OTC derivatives markets can easily be misinterpreted as proprietary trading because market makers in this asset class usually act as principals who take positions in instruments with episodic liquidity in order to facilitate customer needs. Market making is also fundamental to OTC derivatives trading, as dealers use derivatives as part of their overall fixed income or equity trading to hedge out risk on a portfolio basis. Unless the market making exemption is sufficiently expanded to ensure that banks may continue to act as market makers with respect to OTC derivatives, the result for our investment funds, and ultimately our investors, will be diminished liquidity, less portfolio diversification, less ability to hedge, and increased costs. Also, in the event that banks limit their OTC derivatives trading as a result of the Proposed Rule, it would lead to less counterparty diversification, which increases counterparty risk for the funds and accounts managed by our members.

We recognize that determining the exact criteria to be used in defining proprietary trading is difficult. With that said, we agree with Federal Reserve Governor Daniel Tarullo that while some trades are "textbook examples" of proprietary trading or market making, the majority of trades include buyers and sellers arriving "at different times, in staggered numbers, and often have demands for similar but not identical assets."[9] Therefore, the Association suggests that the Agencies make the rule simpler, focusing on "trading activities that are organized within a discrete business unit, and that are conducted solely for the purpose of executing trading strategies that are expected to produce short-term profits without any connection to customer facilitation or intermediation," in defining proprietary trading, in a way which is, "not difficult to identify."[10] By doing so, the Agencies would be consistent with former Federal Reserve Chairman Paul Volcker's statements that it should be easy to recognize proprietary trading.[11]

We are disappointed with Governor Tarullo's statement that the Agencies considered and rejected simpler tests to determine proprietary trading. We disagree that such tests would "fail to adequately capture the full range of activities that are prohibited under the [Dodd-Frank Act]," because, as stated previously, even former Chairman Volcker believed that true proprietary trading should be easy to spot. We are concerned that the Agencies are attempting to determine motive and intent under the Proposed Rule, and urge the Agencies to make the distinction as clear as possible.[12] At a

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[9] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Federal Reserve Governor Daniel Tarullo).

[10] *See id.*

[11] *See e.g.* Lauren Tara LaCapra, *Paul Volcker Says Identifying Speculative Trading Is Easy*, REUTERS, May 4, 2011, http://www.reuters.com/article/2011/05/05/us-volcker-idUSTRE74385W20110505.

[12] House Financial Services Committee Chairman Spencer Bachus also noted concerns with the Agencies' attempt to determine motive and intent, stating "when we have to determine peoples' motive, we're on thin ice." *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and*

minimum, we hope that the Agencies will meet the expectation noted by House Financial Services Committee Ranking Member Barney Frank (D-MA), who said that banks should not have to worry about getting "too close to the line," because the agencies will not be predisposed to considering such market making activities to be proprietary trading.[13]

B. Market Making Exemption

As required under the statute, the Proposed Rule exempts market making activities.[14] In order to satisfy the market making exemption under the Proposed Rule, a banking entity must be able to *prove* that the activity meets a list of seven criteria, including: (1) establishment of an internal compliance program; (2) the activity must meet bona fide market making requirements; (3) trades must match the reasonably expected near-term demands of clients, customers, and counterparties; (4) the banking entity relying on the exemption must be appropriately registered under securities or commodities laws; (5) market making-related activities must be designed to generate revenues primarily from fees, commissions, bid/ask spreads or other similar income; (6) compensation incentives must not be designed to reward proprietary trading activities; and (7) consistency with the commentary attached to the rule in Appendix B.[15]

While the Association understands that it was "particularly challenging"[16] for the Agencies to determine how to distinguish permissible market making related activities from prohibited proprietary trading, the Proposed Rule's current exemption does not adequately fulfill the congressional goal of ensuring that legitimate market making activities remain permissible.[17] Instead, the market making exemptions' strict and complicated requirements, including: "(1) seven criteria that a banking entity's activities must meet to rely on the market making exception, including establishment of a compliance program; (2) six principles that the Agencies will use as a guide in distinguishing bona fide market making from prohibited proprietary trading; and (3) seventeen quantitative metrics that a banking entity with significant trading activities must report for each of its trading units at every level of the organization,"[18] will in fact jeopardize legitimate activity. Rather

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Government Sponsored Enterprises and Financial Institutions and Consumer Credit, 112th Cong. (Jan. 18, 2012) (statement of Rep. Spencer Bachus, Chairman, H. Comm. on Financial Services).

[13] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Rep. Barney Frank, Ranking Member, H. Comm. on Financial Services).

[14] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,848.

[15] *Id.*

[16] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Acting Comptroller of the Currency John Walsh).

[17] *See* 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sen. Merkley (D-OR)): "Accordingly, while previous versions of the legislation referenced 'market-making,' the final version references "market- making-related" to provide the regulators with limited additional flexibility to incorporate those types of transactions to meet client needs, without unduly warping the common understanding of market-making."

[18] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Acting Comptroller of the Currency John Walsh).

than providing clear guidelines by which traders are encouraged to continue permissible trading, traders will likely restrict their activity out of fear of getting too close to the ambiguous line.

The Association is particularly concerned that the criteria requiring that trades, "match the reasonably expected near-term demands of clients, customers, and counterparties," may be too ambiguous to be meaningful. The "reasonably expected near-term demands of clients, customers, and counterparties," means different things in different markets – for certain illiquid markets, the "near-term" may be much longer than in other, more liquid, markets. While we recognize that this requirement is congressionally mandated, the Association urges the Agencies to construe it as narrowly as possible and define "near-term" in a way that considers the needs of markets that are illiquid or have episodic liquidity.

Requiring banks to prove that their activities are designed to "generate revenues from fees, commissions, bid-ask spreads or other similar income that is not related to proprietary trading"[19] does not adequately ensure that legitimate market making is protected because this test is an over-inclusive indicator. Banks engaged in market making do not always have a matched trade ready when the assets must be purchased from the asset manager. A bank facilitating client demand may hold an asset that will appreciate in value as it remains on the books until a willing buyer is located. The Proposed Rule will create fear that this appreciation may be deemed proprietary speculation and result in banks refraining from the market making that is essential to maintain market liquidity, particularly in fixed income markets. The Agencies should focus on ensuring positions taken by a bank relate to the customer activity, regardless of the magnitude or length the positions are held open, or whether the bank is acting as an agent or principal in the trade. As long as a bank's positions relate to customer activity, then its activities should be presumed to be market making, and not proprietary.

Further, the Association appreciates the Agencies' desire to maintain legitimate market making activities, but believes this could be achieved in a manner that presumes that a bank's activity is **not** proprietary trading unless proven otherwise. Since the Dodd-Frank Act passed, some banks have already begun discontinuing proprietary trading desks.[20] The industry has demonstrated, in advance of the Proposed Rule's effective date, that they understand and are willing to change their business models to comply with the purpose of the Proposed Rule. In light of these good faith efforts, we urge the Agencies to simplify the Proposed Rule to ensure that banks are able to continue those market making related activities that Congress intended to be protected, as our members rely on these activities for trading by the funds and accounts that they manage.

C. Risk Mitigating Hedging Activity

Section __.5 of the Proposed Rule, similar to the market making exemption, provides a number of requirements that firms must attain in order to rely on a risk-mitigating hedging exemption available

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[19] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,962.

[20] Liz Rappaport, *Goldman to Shut Global Macro Trading Desk*, WALL STREET JOURNAL, Feb. 15, 2011, http://online.wsj.com/article/SB10001424052748704409004576146702013530680.html (Goldman Sachs closed its Global Macro Proprietary Trading desk "to comply with the Volcker Rule.").

under Section 13 of the Bank Holding Company Act ("BHC").[21] According to the Proposed Rule, the criteria is intended to define the scope of permitted risk-mitigating hedging activities and to prohibit reliance on the exemption for proprietary trading that is mischaracterized as permitted hedging activity.[22]

The Association agrees that hedging is an appropriate indicator of an entity's risk appetite, but believes that this indicator breaks down at the trade-by-trade level. In particular, this indication fails when gauging whether hedging activities are proper for illiquid markets, where perfect hedges are often not available. Although we appreciate SEC Chairman Mary Schapiro's assurances, in response to a question from Ranking Member Barney Frank at a House Financial Services Committee hearing on the Volcker Rule, that the Agencies will not be looking at trading activity at the trade-by-trade level, we ask that the Agencies make this more explicit in the final rulemaking.[23] Without making this explicit in the final rulemaking, we worry that trades will still be looked at on an individual basis, potentially finding proprietary trading in situations that are not, when considered overall.[24]

Further, members of the Association work to reduce execution costs, mitigate risk, and improve returns for millions of investors in the funds and accounts that they manage. These goals are achieved by trading with market makers that use generally available hedges to bridge the gap between time and price with various traders in the market. The hedging exemption, therefore, must include a broad definition of what constitutes a "trading unit" (also known as an "aggregation unit") to permit banking entities to hedge adequately their trades with institutional clients.

If the Agencies interpret "trading unit" too narrowly, or if the market making exemption is too restrictive, the ability of funds to enter into block trades with banking entities could be significantly diminished, to the detriment of funds and their investors. Block trading is traditionally used when the size of the trade would strain the market and potentially result in increased execution costs, as a result of adverse market movements, and increased risk, because the trade requires an extended time period for completion. In order for a banking entity to fill this need, it may gauge risk across its entire platform, rather than across one trading desk, and agree to take positions on its books until an appropriate buyer is available. In doing so, banking entities are effectively mitigating risk.

If the Agencies look too narrowly at the hedging correlation, i.e., on a trade-by-trade basis, it may in actuality increase risk. It will disallow banking entities to continue to effectively hedge, thus limiting activity with funds and keeping the risk in the marketplace, but at the fund level, thereby exposing individual investors to this unhedged risk. Similarly, program risk trading, in which banking entities manage their risk across the entire trading organization, enables asset managers to swiftly and

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[21] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,875.

[22] *Id. at* 68,874.

[23] *See Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation Before the H. Subcomms. On Capital Markets and Government Sponsored Enterprises and Financial Institutions and Consumer Credit*, 112th Cong. (Jan. 18, 2012) (statement of Securities and Exchange Commission Chairman Mary Schapiro).

[24] Indeed, House Financial Services Committee Chairman Spencer Bachus noted that he shared similar concerns, stating that although Chairman Schapiro says the SEC will not look at individual trades, he "doesn't know how you enforce a rule without looking at individual trades." *See id.*

efficiently trade multiple securities in a single transaction. It also allows asset managers to manage significant flows into and out of funds and accounts in a cost-efficient manner. Program risk trading would be significantly impaired if the proposed restrictive interpretation of hedging and trading units were adopted under the Proposed Rule. The result would be significantly reduced ability for funds and accounts to trade with banking entities and diminished market liquidity, as the elimination or substantial reduction of program risk trading would likely result in less trading in general.

D. Municipal Bond Market Exemption

Section __.6(a) of the Proposed Rule describes the government obligations in which a banking entity may trade, notwithstanding the prohibition on proprietary trading, including government obligations and U.S. State and municipal obligations.[25] This exemption is too narrow because it prohibits banks from trading in a significant portion of the current municipal bond activities, including securities issued by State agencies or instrumentalities. We respectfully disagree with the Agencies' interpretation that its exemption is "consistent with the statutory language," because it does not extend the government obligations exemption to include "transactions in obligations of an *agency* of any State or political subdivision thereof."[26]

Further, the Association disagrees with the Agencies interpretation that statutory silence on State agencies is reason to not include State agency transactions within the exemption. Such an interpretation is inconsistent with legislative history. Congress did not intend to limit the funding availability for projects such as hospitals, affordable housing developments, airports, and universities that receive financing through municipal obligations, and in fact, the Dodd-Frank Act specifically permits trading with regard to "obligations of any State or of any political subdivision thereof."[27] Consistent with exercising its sovereign powers through agencies and other instrumentalities, States may authorize political subdivisions to finance a revenue-generating project through the issuance of municipal bonds backed by bond revenues, not taxes. Particularly since the same type of entity may have differing powers from State to State, it is simply unworkable for the Agencies to construct such a narrow interpretation of this exemption.

If the Proposed Rule is implemented as currently drafted, it may have a significant impact on the municipal bond market, affecting not only institutional investors that regularly invest in these markets, but also the States and municipal agencies that will no longer have access to the capital provided by such investors. The municipal markets provide valuable tax-exempt tools for institutional investors. Despite the challenges that municipal issuers face in the current economy, municipal securities continue to have a lower risk of default than other types of debt and are also beneficial to States and municipalities.[28] The result of the Volcker Rule may be the creation of an

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[25] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,877.

[26] *Id. at* 68,878 n.165 (emphasis in original).

[27] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376, 1624 (2010).

[28] "In comparing the riskiness of municipal and corporate bonds, at least in terms of expected default, municipal bonds can be considered much safer than equally rated corporate bonds. According to the rating agency Moody's, there have been only 54 defaults by municipal bond issuers since 1970. Research firm Robini Global Economics estimates the size of the U.S. municipal bond market to be $2.7 trillion. On the other hand, there were 191 defaults by corporate bond issuers in 2009 alone. According the Fitch, the size of the US corporate bond market is about $4 trillion." Stephen J.

unnecessary bifurcation of the municipal securities market, which will impede the ability of tax-exempt organizations to raise capital and negatively affect the liquidity of the municipal markets.

Therefore, the Association urges the Agencies to expand its exemption for proprietary trading in State or municipal agency obligations under Section 13(d)(1)(J) of the BHC.[29] This could be accomplished by adopting the definition of "municipal securities" already included in Section 3(a)(29) of the Securities Exchange Act of 1934. Utilizing such a definition in the exemption would promote the financial stability of the U.S., providing a clearer line for banks to follow on what is covered under the municipal bond market exemption and permitting investors to continue investing in municipal debt at reasonable costs.

II. COVERED FUNDS

Section __.10(a) of the Proposed Rule implements Section 13(a)(1)(B) of the BHC Act and prohibits a banking entity from, as principal, directly or indirectly acquiring or retaining an equity, partnership, or other ownership interest in, or acting as sponsor to, a covered fund, unless certain exemption criteria are met.[30] The covered fund restrictions create a competitive disadvantage for asset managers that are affiliated with banking institutions.

A. Definition of "Covered Fund" and Applicability to Covered Foreign Funds

Although we recognize the Agencies need to address the potential for evasion from the Volcker Rule by capturing certain foreign funds and commodity pools, the approach taken is over-inclusive and should be refined. Currently, the Proposed Rule defines "covered fund" as including both hedge funds and private equity funds.[31] It also covers other funds that are not commonly understood to be either a "hedge fund" or a "private equity fund" by including issuers that are investment companies, as defined in the Investment Company Act, but for Section 3(c)(1) or 3(c)(7) of the Act.[32] The "covered fund" definition includes an issuer organized or offered outside of the U.S. which would be a 3(c)(1) or 3(c)(7) fund if offered or organized inside the United States. Sections 3(c)(1) and 3(c)(7) are exclusions from the definition of "investment company" that are commonly relied on by a wide variety of entities that would otherwise be covered by the broad definition of "investment company."

Additionally, the Proposed Rule incorporates the statutory application of the rule to cover "such similar funds as the Agencies may determine by rule as provided in Section 13(b)(2) of the BHC Act."[33] Under this power, the Agencies propose to include commodity pools, as well as the foreign

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Huxley, Ph.D. and Brent Burns, SAFETY OF INVESTMENT GRADE BONDS: EXAMINING CREDIT RATINGS AND DEFAULT RATES OF MUNICIPAL AND CORPORATE BONDS 5 (Asset Dedication 2011).

[29] 12 U.S.C. § 1851(d)(1)(J) (2006).

[30] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,896.

[31] *Id. at* 68,897.

[32] *Id.*

[33] *Id.*

equivalent of any entity identified as a "covered fund."[34] According to the Agencies, these entities are included because they are generally managed and structured similar to a covered fund except that they are generally not subject to the Federal securities laws due to the instruments in which they invest or because they are not organized in the U.S. or one or more States.[35]

Many asset managers operate funds outside of the U.S. that are registered and regulated in those foreign jurisdictions. The Proposed Rule is over-inclusive because it covers all such funds without actually identifying the characteristics that make such funds problematic for U.S. banks, or demonstrating that these funds lack adequate regulation by foreign jurisdictions. Such foreign funds are different from traditional hedge funds or private equity funds, and the Association suggests that the Agencies exclude from the Proposed Rules restrictions on funds that do not present the risks that the Volcker Rule is intended to address. We propose a number of suggested changes to this end:

- As the scope of the Volcker Rule restrictions is intended to be limited to funds with U.S. resident investors, the Agencies should consider simply excluding all foreign funds that are not actively marketed to U.S. investors. This would have the additional benefit of clarifying that inadvertent sales of interests in foreign funds to persons who are or who become U.S. residents would not subject the fund to the restrictions of the Volcker Rule.

- The Agencies should further consider excluding non-U.S. regulated funds, such as UCITS funds and other European regulated funds, that are subject to a degree of supervisory regulation in foreign jurisdictions that make it unlikely that they would pose significant risk to a banking entity or the United States.

- In the alternative, we urge the Agencies to focus on specific characteristics rather than attempting to cover all foreign funds. The Agencies should consider adopting an exemption from the definition of covered funds using a system based on the characteristics suggested in Form PF. Form PF requires reporting of certain information by advisers to hedge funds and private equity groups. It focuses on these funds because they possess the type of risky trading strategies that typically concern regulators, which are also at the heart of the Volcker Rule prohibitions. Form PF also excludes funds that pose minimal systemic risk, while the Volcker Rule has no such exemptions. For example, State-registered advisers and "Exempt Reporting Advisers" are exempt from having to file Form PF with the SEC because they pose minimal systemic risk. Therefore, we suggest the Agencies consider covering only foreign funds, which exhibit several of the following attributes: (1) engaging in significant leverage; (2) having significant investment in derivatives and illiquid instruments; (3) not providing frequent liquidity rights of investors; and (4) incentivizing managers to engage in risky investments or techniques through performance fees.

This scope should also be applied to covered funds and private equity funds in both the U.S. and foreign markets to create a logical and consistent approach for the Agencies to address the core aspects of the Volcker Rule, which is to reduce systemic risk without violating important market

[34] *Id.*

[35] *Id.*

functions. By establishing such a system, the Agencies would be excluding foreign funds regulated similarly to mutual funds and bank common and collective funds. This would exclude funds offered to retail investors that are substantively regulated, such as UCITS funds, where less risk exists.

The Proposed Rule's extension to "commodity pools" may now include 40 Act Funds. Narrowing the commodity pool scope to exclude those funds that invested in commodities for hedging purposes and otherwise cover their exposure consistent with SEC Release IC-10666 and related no-action letters is a prudent approach. Under SEC Release IC-10666 the SEC typically allows investments in commodities and derivatives among other financial instruments so long as assets are segregated from core exposure and are in amounts sufficient to cover all of the hypothetical borrowing.[36]

Finally, the "covered funds" definition should be amended to exclude wholly owned subsidiaries, rather than exempting only those engaged in liquidity management. Since the definition of covered funds is so expansive it will cover wholly owned subsidiaries engaged in non-risky, permissible activity which was to be protected and ultimately hinder the ordinary course of business for holding companies.

B. Exemptions

Section __.11 of the Proposed Rule sets out the conditions that must be met in order for a banking entity to own an interest in a covered fund.[37] These conditions include: (i) the banking entity must provide *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services; (ii) the covered fund must be organized and offered only in connection with the provision of *bona fide* trust, fiduciary, investment advisory, or commodity trading advisory services and only to persons that are customers of such services of the banking entity; (iii) the banking entity may not acquire or retain an ownership interest in the covered fund except as permitted under the Proposed Rule; (iv) the banking entity must comply with the restrictions governing relationships with covered funds under the Proposed Rule; (v) the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests; (vi) the covered fund, for corporate, marketing, promotional, or other purposes, (A) may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and (B) may not use the word "bank" in its name; (vii) no director or employee of the banking entity may take or retain an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund; and (viii) the banking entity must (A) clearly and conspicuously disclose, in writing, to any prospective and actual investor in the covered fund (such as through disclosure in the covered fund's offering documents) the enumerated disclosures contained in the Proposed Rule, and (B) comply with any additional rules of the appropriate Agency or Agencies, designed to ensure that losses in such covered fund are borne solely by investors in the covered fund and not by the banking entity.[38] While the Association agrees

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[36] Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25,128 (Apr. 27, 1979).

[37] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,900.

[38] *Id.*

with some provisions included in these exemptions, including the bona fide services provisions and the provisions on investments by employees and directors providing advisory or other services, we have concerns with the naming prohibition.

1. Bona Fide Services

The Association fully supports the bona fide services provisions included under Section __.11(a) of the Proposed Rule. The Association agrees that entities must have the ability to provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to customers and supports the Agency's conclusion that the customer's relationship does not need to be pre-existing. When a bank is engaging in such bona fide services, the goal is to support the customer's needs, not to engage in risky behavior. Further, this exemption avoids a potential conflict of interest for asset managers that are affiliated with banks and may otherwise have difficulty continuing to provide advisory services to their clients without changing their business model.

2. Naming Prohibition

Section ___.11(f) of the Proposed Rule provides that the covered fund, for corporate, marketing, promotional, or other purposes, (1) may not share the same name or a variation of the same name with the banking entity (or an affiliate or subsidiary thereof), and (2) may not use the word "bank" in its name.[39]

We believe the naming prohibition proposal over-reaches, and we urge the Agencies to interpret the congressional mandate as narrowly as possible. We note that at present, the Proposed Rule's language expands beyond the Dodd-Frank Act, which amends the BHC Act to include that a banking entity may not share with the hedge fund or private equity fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name.[40] The Dodd-Frank Act does not require the Agencies' rulemaking to preclude the use of the name of investment management firms affiliated with banking institutions, and we therefore urge the Agencies to limit the definition of "banking entity" in this context to U.S.-insured depository institutions.

As the Proposed Rule currently stands, the naming prohibition burdens the industry without providing adequate corresponding benefits. Under Section ___.11, the banking entity may not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the covered fund or of any covered fund in which such covered fund invests.[41] This restriction is sufficient for ensuring that the entities are viewed separately in the market. We question the necessity for any naming prohibition when a prohibition on bailing out funds is in place and where there is disclosure that investors bear the risk of loss in any default. The prohibition on bailing out funds protects against the "too big to fail" problems of the financial crisis and the disclosure requirements provide the necessary warning to investors of the risks involved. Further restricting the name of the fund, and in particular restricting the name of the fund beyond the name of the U.S.-insured depository institution, does not provide sufficient additional benefits.

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[39] *Id. at* 68,902.

[40] *Id.*

[41] *Id. at* 68,901.

It will be burdensome and expensive for funds currently affiliated with banks or bank-owned asset managers to change the name of the fund. Not only will the process be costly, but potential reputational costs also exist, as many of these funds have developed a solid reputation and good will within the marketplace that is affiliated with the fund's current name. Such actions will also inevitably lead to investor confusion, as many already associate certain fund names in the marketplace with certain characteristics. Ultimately, this restriction will place these funds affiliated with banking entities at a disadvantage and further hurt the financial condition of such funds and their bank-affiliated asset managers.

3. Investments by Employees and Directors Providing Advisory or Other Services

Section ___.11(g) of the Proposed Rule implements Section 13(d)(1)(G)(vii) of the BHC.[42] The provision prohibits any director or employee of the banking entity from acquiring or retaining an ownership interest in the covered fund, except for any director or employee of the banking entity who is directly engaged in providing investment advisory or other services to the covered fund.[43] The Association generally supports the Agencies' approach and agrees it is essential that fund managers or advisers and support staff be permitted to have, "skin in the game." Indeed, many institutional investor clients require this as an additional check on the fund manager's or adviser's loyalty and diligence.

The Proposed Rule also recognizes that director or employee investments in a covered fund may provide an opportunity for a banking entity to evade the limitations regarding the amount or value of ownership interests a banking entity may acquire or retain in a covered fund or funds contained in Section 13(d)(4) of the BHC Act and Section l.12 of the Proposed Rule.[44] To address this concern, the Proposed Rule would generally attribute an ownership interest in a covered fund acquired or retained by a director or employee to such person's employing banking entity, if the banking entity either extends credit for the purpose of allowing the director or employee to acquire such ownership interest, guarantees the director or employee's purchase, or guarantees the director or employee against loss on the investment.[45] Once again, the Association agrees that this solution adequately addresses the problem while still permitting such employees the ability to meet client needs.

C. Sections 23A and 23B of the Federal Reserve Act

The Dodd-Frank Act mandates additional restrictions on transactions between affiliates, amending Section 13(f)(1) of the BHC Act to generally prohibit a banking entity that, directly or indirectly, serves as an investment manager, investment adviser, commodity trading adviser, or sponsor to a covered fund from engaging in any transaction with a covered fund if the transaction would be a "covered transaction" as defined in Section 23A of the Federal Reserve (FR) Act, as if the banking

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[42] *Id. at* 68,902.

[43] *Id.*

[44] *Id.*

[45] *Id.*

entity and any affiliate thereof were a member bank and the covered fund were an affiliate thereof.[46] Section 23A and Regulation W limit the aggregate amount of "covered transactions" between a bank and any single affiliate to 10 percent of the bank's capital stock and surplus, and limit the aggregate amount of covered transactions with all affiliates to 20 percent of the bank's capital stock and surplus.[47] A "covered transaction" under 23A includes, for example, the extension of credit by a bank to an affiliate and the issuance by a bank of a guarantee on behalf of an affiliate.[48]

Section __.16 of the Proposed Rule, consistent with the Dodd-Frank Act requirements, is more restrictive than Section 23A. Section __.16 generally prohibits a banking entity and any of its affiliates from entering into any such transaction, while Section 23A permits covered transactions with affiliates so long as the transactions meet certain requirements.[49] Essentially, the Proposed Rule would prohibit all entities in a banking organization, and not merely the "bank," that act as an investment adviser or sponsor to a covered fund from engaging in certain transactions, including providing loans to or investments in a covered fund. Unfortunately, the Proposed Rule does not recognize certain standard exemptions available under Section 23A and Regulation W, whereby certain activities are recognized to not inhibit the goals of safety and soundness and allow for a functioning market to continue.

Under the additional restrictions provided for in the Proposed Rule, banks and their affiliates would not be able to engage in limited types of covered transactions currently permitted by the exclusions and restrictions under Section 23A when lending to affiliates. Unlike the regulations between banks and their affiliates, where limitations exist but banks are still able to lend, the Proposed Rule would make it so that advisers are no longer permitted to lend money to funds in the same way as is available for banks to lend to operating affiliates. In practice, this provision would allow banks to engage in more extensive activities with affiliated and unaffiliated entities than would be permitted between a bank or its affiliate and an affiliated hedge fund, creating an unequal playing field for affiliated funds and potentially increasing interconnectedness amongst major banks.

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[46] Under Section 23A a member bank and its subsidiaries may engage in a covered transaction with an affiliate only if: (A) in the case of any affiliate, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 10 per centum of the capital stock and surplus of the member bank; and (B) in the case of all affiliates, the aggregate amount of covered transactions of the member bank and its subsidiaries will not exceed 20 per centum of the capital stock and surplus of the member bank. *See* 12 U.S.C. § 371c(a) (2006).

[47] 12 U.S.C. § 371c(a)(1) (2006); 12 CFR §§ 223.11, 223.12 (2012).

[48] 12 U.S.C. § 371(b)(7) (2006); 12 CFR § 223.3(h) (2012).

[49] For reference, under Section 23B of the FR Act a member bank and its subsidiaries may engage in: (A) Any covered transaction with an affiliate; (B)The sale of securities or other assets to an affiliate, including assets subject to an agreement to repurchase; (C) The payment of money or the furnishing of services to an affiliate under contract, lease, or otherwise; (D) Any transaction in which an affiliate acts as an agent or broker or receives a fee for its services to the bank or to any other person; or (E) Any transaction or series of transactions with a third party if an affiliate has a financial interest in the third party, or if an affiliate is a participant in such transaction or series of transactions, only in certain circumstances. A member bank and its subsidiary may engage in these activities only: (1) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies; or (2) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies. *See* 12 U.S.C. § 371c–1 (2006).

The Association also questions the necessity to restrict activity more tightly between banks and affiliates when the banks are engaged in the traditional functions of custodian banks. Custodian banks that also manage covered funds must be able to continue to provide custodian services, such as providing intraday credit in connection with routine security and currency deliveries of payment transactions. While the Association acknowledges that lines of credit may create potentially risky situations, provisional liquidity services in connection with payment transactions merely facilitate the trade and ensure that delays caused by unavoidable situations, such as currency issues, do not derail the trade. Custodian banks need to continue this activity to provide at least some straight-thru processing for their managed funds. If custodian banks are unable to provide custodian services, more risk would be introduced into the settlement process, because funds would have to find third party custodians or others to offer intraday credit to provide the necessary liquidity. Turning to third parties for such intraday credit may create operational challenges and disrupt the settlement process without providing any benefit to the market or end investor. It would also increase risk to the banking organization and markets without providing corresponding benefit, as the bank may still perform the same role and engage in the same types of activities with unaffiliated funds.

D. Limitations on Fund Investments

Section __.12 of the Proposed Rule describes one of the limited circumstances under which a banking entity may acquire or retain, as an investment, an ownership interest in a covered fund that the banking entity or its affiliates offer.[50] Banking entities may take an ownership interest in a covered fund if the banking entity's investment is limited to no more than three percent of the total outstanding ownership interests of such fund (after the expiration of any seeding period provided under the rule).[51] The Proposed Rule also requires that the banking entity's investment in a covered fund may not result in more than three percent of the losses of the covered fund being allocable to the banking entity's investment.[52] Further, the banking entity may not invest more than three percent of its Tier 1 capital in covered funds in the aggregate.[53]

The Association believes this restriction will be harmful to bank-owned asset managers, by both eliminating the ability of these managers to launch non-40 Act Funds and also limiting the ability of bank-owned managers to launch innovative strategies that address the needs of institutional clients, such as large pension funds, if the fund may not meet all of the requirements of 40 Act Funds. This would harm investors generally, as well as bank-owned asset managers.

Typically, bank asset managers will market affiliated funds that have at least a three-year performance record in order to attract institutional investors. In order to create such a longstanding record, the manager will typically seed a strategy for the initial three years with capital. Few asset managers or investors are willing to invest in a strategy that does not have a three-year performance record. Because of the broad application of the Volcker Rule to bank-affiliated managers, the three percent restriction will severely curtail a bank-affiliated manager from investing its own money to

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[50] Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. at 68,903.

[51] *Id.*

[52] *Id.*

[53] *Id.*

create the three-year performance record, and effectively eliminate an advisor's ability to launch new strategies that are not 40 Act Funds.

We acknowledge that the Agencies must adhere to the statutorily mandated restriction which includes a one-year time limit. However, we encourage the Agencies to implement a system whereby an additional two-year extension is available upon request for incubation of new and innovative products, as this would be "consistent with safety and soundness and in the public interest," particularly where separate capital of the manager is used and the fund does not utilize capital from the insured depository institution.[54] We worry that the factors required under the final rule on the Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities create too high of a hurdle to meet, or at a minimum, create uncertainty as to whether a bank will qualify for the extension.[55] Rather than requiring an entity to essentially extinguish all other options, we argue an additional two years should be presumed to be granted in situations where a bank can establish that its actions are part of a legitimate product development program.

III. AGENCY COORDINATION

The Association also is concerned that the Agencies have not adequately clarified which Agency will be responsible for ensuring compliance with various components of the Proposed Rule. We worry that without the proper coordination, entities will be subjected to overlapping and potentially inconsistent regulation. Beyond wanting to ensure that our member firms fully understand how to comply with the final regulations, when issued, it would also be helpful to ensure that there is no disconnect between the Agencies that could translate into the same regulations being interpreted differently by different Agencies. Many of our members are regulated by more than one of the Agencies. For example, both the SEC and bank regulatory authorities regulate our members that are affiliated with banks. The Association requests that the final rulemaking articulate that the Agencies will coordinate oversight efforts and clarify which agency will supervise in various situations.

IV. DELAY OF IMPLEMENTATION

The Association agrees with House Financial Services Oversight and Investigations Subcommittee Chairman Randy Neugebauer (R-TX) and the other House Financial Services Committee Members who urged the Agencies in a December 20, 2011, letter to consider comments to the Proposed Rule and then issue an interim final rule reflecting comments from affected stakeholders.[56] We commend the Agencies for including numerous questions and making public statements on their willingness to consider industry concerns with the Proposed Rule, and would appreciate the opportunity to further comment before the rulemaking is final. Further, although we understand that it may take

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[54] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111–203, 124 Stat. 1376 (2010).

[55] Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 76 Fed. Reg. 8,265 (Feb. 14, 2011).

[56] Letter from Rep. Randy Neugebauer to Chairman Ben Bernanke, Fed. Reserve Bd., Chairman Gary Gensler, Commodity Futures Trading Comm'n, Acting Comptroller of the Currency John Walsh, Office of the Comptroller of the Currency, Chairman Mary Schapiro, Sec. and Exch. Comm'n, and Acting Chairman Martin Gruenberg, Fed. Deposit Insurance Corp. (Dec. 20, 2011), *available at* http://randy.house.gov/uploads/Neugebauer%20House%20Volcker%20Rule%20Ltr1.pdf.

congressional action to delay implementation of the final rule (as Section 619 becomes effective on July 21, 2012, even without a final rule), we note that there have been other situations where statutory deadlines were missed because of the complexity or challenges faced by the Agencies in implementing rules within the time frame established by Congress.[57] Therefore, we urge the Agencies to delay the time for compliance with this deadline in view of the many unsettled questions and issues they raise and the need for the industry to have final guidance before making significant investment of time and resources to modify their operations. It is important to ensure that regulators have the time necessary to re-propose the rulemaking, and market participants need time to adjust activities to comply with the final rulemaking. Although we recognize that covered banking entities have a two-year conformance period to bring existing activities and investments into compliance with Section 619 of the Dodd-Frank Act, we argue this does not adequately replace providing the Agencies with enough time to consider market concerns without worrying about an arbitrary deadline.

V. CONCLUSION

The Association recognizes the challenges the Agencies face in implementing these new requirements and appreciates the Agencies considering our concerns. We thank the Agencies for the opportunity to comment on the Proposed Rule. Please feel free to contact me with any questions you may have on our comments at jgidman@loomissayles.com or (617) 748-1748.

On behalf of the Association of Institutional INVESTORS,

John R. Gidman

[57] As of February 1, 2012, a total of 225 Dodd-Frank rulemaking requirement deadlines have passed. More than half of these deadlines have been missed. For example, last July the SEC and CFTC announced that they would miss deadlines on derivatives rulemakings and suspend some new derivatives rules so that the Commission had time to consider what if any further action was required. Press Release, Securities and Exchange Commission, SEC Proposes Exemptions from Registration Requirements for Security-Based Swaps Issued by Certain Clearing Agencies (June 10, 2011), *available at* http://www.sec.gov/news/press/2011/2011-124.htm.