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Memorandum

COMMENT

To: David A. Stawick

From: Kathryn Andrews

Date: February 14, 2012

Re: RIN number 3038–AD05

On behalf of Cadwalader, Wickersham & Taft LLP, enclosed is a comment letter regarding the proposed regulations to implement Section 619 of the Dodd-Frank Wall Street Reform & Consumer Protection Act, commonly known as "the Volcker Rule."

If you have any questions, please do not hesitate to contact Lary Stromfeld ((212) 504-6291, lary.stromfeld@cwt.com), Scott Cammarn ((704) 348-5363, scott.cammarn@cwt.com) or me ((212 504-5544, kathryn.andrews@cwt.com).

Best Regards,

KA

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February 9, 2012

By electronic submission

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551
Re: Docket No. R-1432 & RIN 7100-AD82

Commodity Futures Trading Commission
1155 21st Street, NW
Washington, DC 20551

Department of the Treasury
Office of Domestic Finance
1500 Pennsylvania Avenue, NW
Washington, DC 20520

Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, DC 20429
Re: RIN 3064-AD85

Office of the Comptroller of the Currency
250 E Street, SW
Washington, DC 20219
Re: Docket ID OCC–2011-14

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549
Re: File Number S7-41-11

Re: Joint Notice of Proposed Rulemaking Implementing the Volcker Rule

Ladies and Gentlemen:

Cadwalader, Wickersham & Taft LLP ("Cadwalader") appreciates the opportunity to comment on the joint notice of proposed rulemaking (the "Proposal") under Section 619 of the Dodd-Frank Act,[1] commonly known as the "Volcker Rule."

Cadwalader's Municipal Markets Group, formed in 1989, is a nationally recognized leader in tax-exempt financings in the primary and secondary markets and represents the world's most respected financial institutions, including commercial and investment banks, financial guarantors, financial product companies, investment advisers, registered investment companies, hedge funds, electronic trading platforms, government sponsored enterprises, institutional investors, and various industry groups. Included in Cadwalader's client base are several of the largest sponsors of tender option bond ("TOB") programs, many of whom also act

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[1] Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), Pub. L. No. 111-203, 124 Stat. 1376 (2010). The federal regulators (the "Agencies") that jointly issued the proposed regulations were the Securities and Exchange Commission ("SEC"), the Office of the Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Board of Governors of the Federal Reserve System ("FRB") and the Commodity Futures Trading Commission (the "CFTC"). In this comment letter, "we," "us" and "our" refer to Cadwalader, as counsel to many participants in the municipal markets.

as placement agents, remarketing agents and liquidity providers to such programs, as well as a wide variety of investors in the short-term and residual classes of these programs.

We have focused our comments on the potential effects of the Volcker Rule on proprietary trading in municipal bonds issued by state or local government agencies and on banking entities' ability to sponsor or acquire an ownership interest in municipal tender option bond TOB trusts and to enter into the liquidity facilities that are an essential feature of TOB trusts. Municipal obligations are the primary source for financing important government projects and such projects are often financed by agencies of State or local governments. TOB trusts perform another vital function in the municipal bond market, increasing demand for municipal bonds issued by State or local governments by making such bonds eligible for purchase by money market funds. TOB trusts also serve the important purpose of providing the equivalent of "repo financing" that would not otherwise exist for long-term municipal bond investors, including mutual funds and banks.

We appreciate the Agencies' efforts to establish a regulatory framework that would reduce the risks taken on by banking entities and promote the safety and soundness of such banking entities and the financial stability of the United States. However, with respect to the activities that are the focus of this letter, we do not believe that the Volcker Rule regulations set forth in the Proposal would accomplish these goals. For the reasons set forth below we urge the Agencies to amend the existing regulations to allow for proprietary trading in municipal bonds issued by state or local government agencies and to allow banking entities to participate in TOBs.

The Volcker Rule generally restricts banks and all of their affiliates (collectively, "banking entities") from engaging in proprietary trading activities, subject to exemptions that include proprietary transactions in securities that are "obligations of any State or of any political subdivision thereof." The Volcker Rule also restricts banking entities from investing in or sponsoring "hedge funds" or "private equity funds," although it defines those terms to encompass a far broader range of entities than those commonly thought of as hedge funds or private equity funds. For example, for purposes of the Volcker Rule, these terms include special purpose vehicles used in securitizations and financings. In addition, the Volcker Rule prohibits certain transactions between a banking entity and any "hedge fund" or "private equity fund" for which the banking entity or any of its affiliates is the investment adviser, investment manager, or sponsor. The policy underlying the Volcker Rule is that U.S. banks, U.S. nonbank banks, and foreign branches operating in the U.S. enjoy an implied subsidy by virtue of their bank status and deposit-taking authority and should not use that subsidy to engage in certain inherently risky activities that are not consistent with the intended role of banking institutions.[2]

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[2] We understand that the Volcker Rule was adopted by Congress largely without any significant debate or discussion. The Volcker Rule originated in January 2009, when the Group of Thirty issued a white paper, *Financial Reform: A Framework for Financial Stability*, containing 18 recommendations for changes in global financial regulation. The Group of Thirty, an international consultative group chaired by Paul Volcker (formerly the Chairman of the Board of Governors of the Federal Reserve System and the current chairman of the President's Economic Recovery Advisory Board), includes many former foreign central bankers or treasury executives. Recommendation 1 of the white paper called for limits on proprietary securities trading and private

If the Proposal were to be adopted in its present form, the Agencies' interpretation of the types of government securities exempted from the Volcker Rule would prohibit banking entities from proprietary trading in over half of the municipal bonds outstanding in the markets.[3] Likewise, by the Agencies' interpretation, banking entities would be effectively prohibited from sponsoring or acquiring an ownership interest in TOB trusts and from entering into the liquidity facilities that are an essential feature of TOB trusts. As described below, we believe that the Proposal is too narrow in two different respects: (i) in defining the scope of securities exempted from the Volcker Rule, the Proposal fails to include securities by State or municipal *agencies*; and (ii) the Proposal fails to extend the municipal exemption to the covered fund provisions of the Volcker Rule.

As we describe below, we are confident that the Volcker Rule regulations as set forth in the Proposal would have the unintended consequence of causing significant disruption to the municipal bond market and would thus impede the goals and policy underlying the Dodd-Frank Act. Given the very negative, and we believe wholly unintended, consequences likely to result from the Proposal, we encourage the Agencies to revise the Proposal (i) to adopt a broader definition of municipal securities that is consistent with the scope of the current municipal bond market and (ii) to exclude TOB trusts from the Volcker Rule's restrictions.

I. The Exemption for Municipal Obligations Should Not be Given a Narrow Interpretation

Municipal obligations are the primary source for financing important governmental projects and programs including healthcare facilities, affordable housing developments, universities, airports, infrastructure projects and other municipal and community projects. These types of projects are often financed by agencies of State or local governments. In the Proposal the Agencies have proposed a narrow interpretation of the exemption for government securities that effectively excludes municipal agency securities from the scope of the exemption. As explained below, such an interpretation would produce negative consequences and run counter to the goals of the Volcker Rule.

The Dodd-Frank Act's Volcker Rule is codified as Section 13 to the Bank Holding Company Act ("BHC Act").[4] The Volcker Rule's general prohibition, codified at Section 13(a)(1) of the BHC Act, provides that "a banking entity shall not (A) engage in

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fund investing activities by large banks, citing the risk of these activities on the stability of the international banking system, as well as the potential for conflicts of interest when a bank trades for its own account. At the suggestion of Mr. Volcker, the Volcker Rule was endorsed by President Obama as part of the Administration reform plan in early 2010, and the Volcker Rule was included in the April version of the Senate bill (S. 3217), well after the House of Representatives had passed its version of financial reform legislation in December 2009 (H.R. 4173). S 3217 passed the Senate with little, if any, debate or discussion of the Volcker Rule. The Volcker Rule was discussed in the House-Senate Conference Committee proceedings in June 2010, and was amended somewhat in Conference. The little legislative history concerning the Volcker Rule stems from the Conference Committee proceedings, or from floor statements by members of Congress before final passage of the legislation in July 2010.

[3] Citi *U.S. Municipal Strategy Special Focus, November 20, 2011.*

[4] 12 U.S.C. §§ 1841 *et seq.*

proprietary trading; or (B) acquire or retain any equity, partnership, or other ownership interest in or sponsor a hedge fund or a private equity fund".[5] That general prohibition in the Volcker Rule contains exemptions for certain permitted activities. One of the exemptions applies specifically to governmental obligations, including "obligations of any State or of any political subdivision thereof".

The above exemption (the "Government Securities Exemption") provides that transactions involving securities issued by State or any political subdivision are exempt from the Volcker Rule's prohibitions. Notably, Congress did not limit the Government Securities Exemption to only certain obligations of these entities based upon the nature of the issuer's obligation under the municipal security or otherwise. Thus, the Government Securities Exemption applies to both (i) general obligations of a municipality and (ii) limited obligations such as revenue bonds. There is a critical and universally-understood distinction between a "general obligation" of a State or local governmental issuer versus any other "obligation" of such an issuer. Acknowledging this, in the Proposal the Agencies agreed that the Government Securities Exemption encompasses "limited as well as general obligations of the relevant government entity."[6]

This result is consistent with existing banking law. Banks historically have been permitted to trade in both types of obligations. The National Bank Act permits all national banks to invest in, underwrite, and deal in ***general*** obligations,[7] and separately permits national banks to invest in, underwrite, and deal in ***limited*** obligations, provided that the national bank is well capitalized.[8] In the Volcker Rule, Congress did not limit the Government Securities Exemption to either type.

In the Proposal, the Agencies rightly construed the Government Securities Exemption to apply to both general and limited obligations of a State or political subdivision. However, the Agencies asserted that "consistent with the statutory language, the ... [Proposal] does not extend the government obligations exemption to transactions in obligations of an agency of any State or political subdivision thereof."[9] The Agencies request comment whether a

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5 12 U.S.C. § 1851(a)(1).

6 76 FED. REG. 68846, 68878.

7 12 U.S.C. § 24 (Seventh) (emphasis added).

8 *Id.* The provision states:
In addition to the provisions in this paragraph for dealing in, underwriting, or purchasing securities, the limitations and restrictions contained in [12 U.S.C. § 24 (Seventh)] as to dealing in, underwriting, and purchasing investment securities for the national bank's own account shall not apply to obligations (including limited obligations bonds, revenue bonds, and obligations that satisfy the requirements of section 142(b)(1) of Title 26) issued on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality in 1 or more States, or any public agency or authority of any State or political subdivision of a State, if the national bank is well capitalized....

Id. The OCC's regulations implement this authority. Under the OCC's rules, these types of securities are referred to as "Type I securities." 12 C.F.R. § 1.2(j).

9 *See* 76 FED. REG. 68846, 68878 n. 165 (emphasis in original).

more expansive definition that encompasses agencies of State or political subdivisions is warranted.[10]

A. The Volcker Rule's Goals are Not Served by a Narrow Interpretation of the Government Securities Exemption

Every State has the constitutional power to exercise its sovereign powers through agencies and other instrumentalities, to form its own political subdivisions and to grant them such powers as it sees fit. A State may also authorize its political subdivisions to carry out their various public purposes by creating agencies or other entities of the political subdivisions. All of these entities are governed and limited by State law, including State constitutional limits. In sum, there is no universal means by which a State may exercise its purposes and powers or authorize its political subdivisions to do so.

Similarly, the nature of the credit underlying an obligation issued by a State or political subdivision is dependent upon a broad range of factors, including State constitutional and statutory issues and the type of project or program being financed. A political subdivision will generally choose to finance a revenue-generating project through the issuance of bonds backed by those revenues and not by taxes. On the other hand, for a variety of reasons, including economic and State law considerations, a political subdivision may choose to finance a revenue-generating project through the creation of a local agency to issue the debt. That same project may also be financed by the State or a State agency for the benefit of the political subdivision. Regardless of whether that project is financed with debt issued by the State, a State agency, a political subdivision or an agency of the political subdivision, the debt will be supported by the same underlying credit source, *i.e.*, the revenue-generating project.

In sum, the same *type of entity* may have different powers and purposes from State to State (or even within a single State). Even the same *specific entity* may issue different types of obligations backed by different sources of credit. Therefore, the regulation of risk related to obligations issued by a State or political subdivision cannot be differentiated in any meaningful way by the type of municipal entity issuing the obligation. In fact, such a distinction would arbitrarily affect bonds having the same credit risk but issued by different entities or in different states. Given the absence of Congressional intent to the contrary, we strongly believe the Agencies should adopt a more expansive interpretation of the types of entities listed in the Government Securities Exemption that would not exclude agencies and other entities created by

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[10] Question 120 reads: "Should the Agencies adopt an additional exemption for proprietary trading in State or municipal agency obligations under section 13(d)(1)(J) of the [BHC Act]? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States?" 76 FED. REG. 68846, 68878.

Question 124 reads: "Are the definitions of 'government security' and 'municipal security' in sections 3(a)(42) and 3(a)(29) of the Exchange Act helpful in determining the proper scope of this exemption? If so, please explain their utility and how incorporating such definitions into the exemption would be consistent with the language and purpose of section 13 of the [BHC Act]." 76 FED. REG. 68846, 68878.

States and their political subdivisions and avoid negatively affecting their ability to raise financing.

B. The Proposed Interpretation of the Government Securities Exemption is Inconsistent with Existing Banking Law

As mentioned above, Section 24 (Seventh) of the National Bank Act expressly permits national banks to invest in, underwrite, or deal in a broad range of municipal securities. However, the National Bank Act also permits a national bank to invest in, underwrite, or deal in municipal *agency* securities, provided only that the national bank is well capitalized. The National Bank Act states:

> In addition to the provisions in this paragraph for dealing in, underwriting, or purchasing securities, the limitations and restrictions contained in [12 U.S.C. § 24 (Seventh)] as to dealing in, underwriting, and purchasing investment securities for the national bank's own account shall not apply to obligations (including limited obligations bonds, revenue bonds, and obligations that satisfy the requirements of section 142(b)(1) of Title 26) issued on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality in 1 or more States, or any public agency or authority of any State or political subdivision of a State, if the national bank is well capitalized....[11]

While well-capitalized national banks are expressly permitted to invest in, underwrite, and deal in municipal agency securities under Section 24 (Seventh), under the Agencies' Proposal the same national bank would be prohibited from engaging in proprietary trading of those same agency securities. Inasmuch as the Volcker Rule's definition of "proprietary trading" is deemed to encompass underwriting and dealing activities, our view is that the Agencies' Proposal to exclude municipal agency securities from the scope of the Government Securities Exemption would be inconsistent with the statutory authority of a well-capitalized national bank to deal in municipal agency securities in Section 24 (Seventh)[12]. We do not believe Congress intended this result.

Thus, in interpreting the Government Securities Exemption to the Volcker Rule, we believe the Agencies should not adopt a restrictive definition of "State or political subdivision" that is inconsistent with this existing statutory authority. Rather, we recommend

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[11] 12 U.S.C. § 24 (Seventh).

[12] If the Proposal is adopted in its current form, a national bank could continue to deal in municipal agency securities only to the extent that the dealing activities rise to the level of "market-making" as defined in the Proposal – a significantly higher standard. *See* __.§4(b). The market making role that dealers play in the municipal securities market is unique both in its level of importance and its unpredictability. As a result of the lack of a true electronic exchange for municipal securities and the significant number of issuers and CUSIPS in the market, some agency and authority securities are comparably illiquid. Consequently, through their market making activities dealers provide a healthy market for certain municipal securities where it might not otherwise exist. For the same reasons, it is at times impossible to quantify the near term demands of clients making it difficult to adhere to restrictive market making standards. We believe that if dealers are unable to qualify for the market making exception under the Volcker Rule and are thus prohibited from dealing in municipal agency securities, such a prohibition would result in lower returns for investors and higher borrowing costs for issuers.

that the Agencies recognize that Congress has already authorized well-capitalized national banks to invest in, underwrite, or deal in securities issued by an agency of a State or political subdivision and, consistent with existing law, construe "State or political subdivision" to include State or local *agencies*.

C. A Narrow Interpretation of the Government Securities Exemption would have a Negative Impact on Safety and Soundness and Financial Stability

A narrow interpretation of the Government Securities Exemption would fail to serve the goals of the Volcker Rule. In fact, such a reading would have a negative impact on the safety and soundness of banking entities and on the financial stability of the United States. Many studies have demonstrated that virtually all categories of municipal obligations have a significantly lower risk of default than corporate and other debt.[13] Under existing law, banks are given broad authority to invest in, underwrite and deal in municipal obligations.[14] Restricting their ability to engage in proprietary trading of these bonds, and from financing them in a cost-efficient manner, would be contrary to the purposes of the Dodd-Frank Act.[15]

The Agencies' interpretation of the Government Securities Exemption would exclude more than half of the outstanding municipal securities,[16] which would be extremely likely to create disruptions in the municipal markets. For example, we expect that inconsistency between banking and securities laws definitions[17] of "municipal securities" would have a negative impact on pricing and liquidity in the municipal market. By creating separate classes of municipal securities, the Proposal would also increase the cost and impede the ability of banking entities to effectively manage municipal risks. Moreover, the Proposal's impact on non-exempt municipal securities will likely affect the price and liquidity of exempt municipal securities, since they are often issued by the same or closely-related governmental entities.

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13 *See, e.g.*, Moody's Investors Service, *The U.S. Municipal Bond Rating Scale: Mapping to the Global Rating Scale And Assigning Global Scale Ratings to Municipal Obligations, March 2007*. The Report studied defaults in all categories of rated municipal bonds over a 36-year period ending in 2006 and found that the probability of default for all categories of rated municipal bonds was significantly lower than that of Aaa-rated corporate debt.

14 *See, e.g.*, 12 U.S.C. § 24 (Seventh); *see also* C.F.R. § 1.2(j) & 1.3(a) (permitting national banks to invest in municipal securities as so-called "Type I securities" without limit).

15 For the same reasons, the Agencies have recognized that investing in small businesses would be consistent with the safety and soundness of banks and would promote the financial stability of the United States. 76 FED. REG. 68846, 68908.

16 *See Supra* note 3.

17 Section 3(a)(29) of the Securities Exchange Act of 1934 (the "Exchange Act") defines "municipal securities" to mean:

> securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of the Internal Revenue Code of 1954).

15 U.S.C. § 78c(a)(29).

There is no evidence that the purposes of the Volcker Rule would be served by creating these distinctions. We suggest that the Agencies therefore adopt an interpretation of the Government Securities Exemption that includes municipal agency securities within its scope. We believe the definition of "municipal securities" under the Exchange Act would serve the goals of the Volcker Rule and be consistent with existing securities and banking laws.

II. Tender Option Bond Trusts Should be Excluded from the Volcker Rule

As proposed, the Volcker Rule would prohibit banking entities from sponsoring or investing in TOB trusts or entering into the liquidity facilities that are an essential feature of TOB trusts. As explained below, we believe that defining TOB trusts as covered funds under the Volcker Rule would run against Congressional intent. Under the Volcker Rule, institutions deemed to be "banking entities"[18] are prohibited, subject to certain exceptions, from acquiring an "ownership interest" in or becoming a "sponsor" of a "private equity fund" or "hedge fund."[19] The terms "hedge funds" and "private equity funds" are broadly defined in the Volcker Rule to encompass any issuer or similar fund that would be an investment company under the Investment Company Act but for the exemptions set forth in Section 3(c)(1) or 3(c)(7) thereof.[20] In the Proposal, the Agencies use the term "covered fund" to refer to a "hedge fund" or "private equity fund" as defined by the Volcker Rule.[21]

The Volcker Rule also flatly bars any transaction between a covered fund and the banking entity (or its affiliate) if such a transaction would be considered a "covered transaction" within the meaning of Section 23A of the Federal Reserve Act.[22] Generally speaking, this

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[18] 12 U.S.C. § 1851(h)(1). The Proposal defines "banking entities" to mean: (i) FDIC-insured depository institutions (*i.e.*, U.S. banks and thrifts, including nonbank banks, but excluding certain uninsured trust banks); (ii) entities that control an FDIC-insured depository institution (including a bank holding company, a financial holding company, a savings & loan holding company, or a holding company of a nonbank bank), wherever located; (iii) entities that are treated as if they are a bank holding company for purposes of the International Banking Act (including a foreign holding company of a non-U.S. bank with a U.S. branch office, or a foreign holding company that has a U.S. commercial lending subsidiary operating in the United States), wherever located; and (iv) any affiliate of any of the foregoing, wherever located. §_.2(e).

[19] 12 U.S.C. § 1851(a)(1). Under the Proposal, "ownership interest" means any equity interest in a covered fund, including warrants, options, trust certificates and similar interests, in each case whether voting or nonvoting, or any derivative of such an interest. §_.10(b)(3). "Sponsorship" largely focuses on ability to control the decision-making and operational functions of a fund. A "sponsor" is an entity that (i) serves as a general partner, managing member trustee or commodity pool operator of a covered fund, (ii) in any manner selects or controls (or has employees, officers, directors or agents who constitute) a majority of the directors, trustees, or management of a covered fund, or (ii) shares with a covered fund, for the corporate, marketing, promotional, or other purpose, the same name or a variation of the same name. §_.10(b)(5).

[20] 12 U.S.C. § 1851(h)(2); 15 U.S.C. § 80a-3(c)(1), (c)(7).

[21] § _.10(b)(1).

[22] 12 U.S.C. § 1851(f). Section 23A of the Federal Reserve Act is codified at 12 U.S.C. § 371c, and restricts certain transactions, known as "covered transactions," between a bank and its nonbank affiliates. In particular, Section 23A restricts the ability of a bank to extend credit to, or purchase assets from, a nonbank affiliate, subject to certain exemptions and conditions. The Volcker Rule's "Super 23A" applies these same principles to

provision effectively bars the ability of the banking entity (or its affiliate) to purchase assets from, extend credit to, or invest in a covered fund, if the banking entity or its affiliate is the investment adviser, investment manager, or sponsor of the covered fund. This provision of the Volcker Rule is generally referred to as "Super 23A."

To the extent that a TOB is considered a "covered fund" under the Volcker Rule, a banking entity would be restricted from investing in or sponsoring a TOB.[23] Moreover, to the extent that a banking entity is serving as the sponsor, investment adviser, or investment manager to a TOB, the Volcker Rule would prohibit the banking entity (or any of its affiliates) from entering into certain transactions with the TOB, including liquidity facilities and credit enhancement facilities.

A. Overview of the TOB Structure

A TOB is a financing arrangement in which one or more highly-rated, tax-exempt municipal bonds is deposited into a trust that issues two classes of securities: a floating-rate class (the "Floaters") and an inverse floating-rate, or residual, class (the "Inverse Floaters"). Each class evidences an ownership interest in the underlying municipal bonds.[24] The Floaters bear interest at a short-term floating rate, and are designed to be eligible for investment by tax-exempt money market funds and other short-term institutional investors. A critical feature of the Floaters provides investors (*e.g.*, the money market funds) with the option, typically on 7-days' notice, to put the Floaters to the trust for purchase at par plus accrued interest. To support this put feature, the TOB trust enters into (1) an agreement with a broker-dealer under which Floaters that have been put by investors are remarketed to new investors and (2) a liquidity facility with a highly-rated bank to purchase any Floaters that cannot be remarketed.[25] Above all else, the TOB must be designed so that payments of interest to Floater investors retain their tax-exempt character and so that the Floaters receive credit ratings that make them eligible for investment by tax-exempt money market funds.[26]

The Inverse Floaters issued by TOBs are either retained by the sponsor of the TOB or are sold to long-term institutional municipal bond investors, including banks and mutual

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transactions between any banking entity and certain covered funds, as if the banking entity (or its affiliate) were treated as a "bank" and the fund as a nonbank "affiliate."

[23] The Agencies state in the Proposal that "a banking entity whose only relationship with a covered fund involves the provision of non-discretionary investment services would not be a sponsor under the Proposal." 76 FED. REG. 68846, 68929.

[24] TOBs are generally static trusts that do not involve buying or selling assets and do not engage a servicer or manager.

[25] Typically, the entity that enters into the liquidity facility with the TOB (the "Liquidity Provider") is the sponsor of the TOB or an affiliate thereof.

[26] Floaters are designed to have both short-term ratings (which are based upon the credit rating of the Liquidity Provider) and long-term ratings (which are based upon the ratings of the municipal bonds in the TOB) in the two highest rating categories. These ratings, as well as other structural features of TOBs, are necessary for the Floaters to be eligible under the investment criteria of the Investment Company Act applicable to tax-exempt money market funds.

funds. Like the Floaters, the Inverse Floaters typically receive interest on a tax-exempt basis[27] and have long-term ratings that are based upon the ratings of the municipal bonds held by the TOB.[28] Unlike the Floaters, the Inverse Floaters are not subject to a put by their holders. Rather, investors in the Inverse Floaters are exposed to changes in the market value of the municipal bonds held in the TOB trust, subject to certain exceptions that are necessary for interest on the bonds to flow through to TOB investors on a tax-exempt basis.[29]

The securities issued by TOB trusts (*i.e.*, the Floaters and Inverse Floaters) are generally sold to institutional investors in reliance upon the "private placement"[30] and "qualified institutional buyer" ("QIB") exemptions[31] from registration under the Securities Act of 1933. TOB trusts also rely upon the private placement or "Qualified Purchaser" exemptions of the Investment Company Act of 1940 (the "Investment Company Act").[32]

National banks have long since been authorized to own, organize and sponsor TOBs.[33] However, as described below, because of TOB trusts' reliance on certain exemptions from the Investment Company Act, TOB trusts may be argued to fall within the broad definition of a "hedge fund" or "private equity fund" and, as a result, would be subject to the Volcker Rule's prohibitions.[34]

B. The Function of TOBs in the Municipal Markets

The U.S. municipal bond market had $3.73 trillion in outstanding principal amount as of September 30, 2011. As of that date, the municipal mutual fund market was $906 billion, of which $292 billion was comprised of short-term money market funds.[35]

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27 Payments of interest on the Inverse Floaters are generally equal to the long-term fixed rate borne by the underlying municipal bonds, minus the short-term floating rate paid on the Floaters and minus any administrative fees of the TOB.

28 Specifically, TOBs do not involve credit tranching under which one class of securities absorbs credit risks for the benefit of another.

29 These exceptions are, primarily, that a small portion of any appreciation in the market value of the municipal bonds is paid to Floater investors upon liquidation of the TOB and that any market loss on the municipal bonds is shared proportionately between the Floaters and Inverse Floaters upon the occurrence of certain standard events. In the latter case, these standard events are designed to accommodate tax and rating agency requirements, as well as the investment criteria of the Investment Company Act applicable to money market funds. The events are, in general, bankruptcy of the municipal bond issuer, payment default or downgrade below investment grade of the municipal bonds, and a determination of taxability with regard to the municipal bonds.

30 17 C.F.R. §§ 230.501 *et seq.*

31 17 C.F.R. §§ 230.144A.

32 15 U.S.C. § 80a-3(c)(1), (c)(7).

33 *See, e.g.*, OCC Corp. Dec. No. 96-52 (Sept. 20, 1996); OCC Interp. Ltr. No. 1070 (Sept. 6, 2006).

34 § _.10(b)(1) and 12 U.S.C. § 1851(h)(2) and 15 U.S.C. § 80a-3(c)(1), (c)(7).

35 Board of Governors of the Federal Reserve System, *Flow of Funds Accounts of the United States – Statistical Report Z.1* (3rd Quarter 2011), p. 80.

The great preponderance of municipal bonds are issued with fixed interest rates and long-term maturities to better enable state and local governments to manage their borrowing costs. On the other hand, money market funds, which represent a significant portion of the investment demand for municipal debt, are required by the Investment Company Act to invest only in short-term debt. As a result, there is a chronic mismatch of supply and demand for short-term debt in the municipal market. For over 20 years, this mismatch between supply of, and demand for, short-term municipal debt has been partially relieved by adding a short-term put to a long-term bond through the TOB structure.

TOB trusts also provide the equivalent of "repo financing" for long-term investors in municipal bonds, including banks and mutual funds. There is no traditional repo market for municipal bonds. Rather, investors rely upon the TOB structure to provide efficient short-term financing of municipal bonds while preserving the tax-exempt character of their interest payments. To achieve that result, ownership of the bonds must be held by a trust (which for tax purposes is treated as a partnership).[36]

While the TOB structure – utilizing a trust to hold the municipal bonds and the "put feature" – both enables investment by money market funds and preserves the tax-exempt character of the interest on the municipal bond, this structure also happens to cause the TOB to fall within the broad definition of "hedge fund" and "private equity fund" as used in the Volcker Rule, because the TOB trust traditionally relies on Section 3(c)(1) or 3(c)(7) of the Investment Company Act, as explained more fully below.

C. The Potential Effect of the Volcker Rule on TOBs

If adopted in the form proposed by the Agencies, the Volcker Rule Proposal would effectively prohibit TOBs. Any vehicle that limits the issuance of its securities to private transactions or to sophisticated investors so that it falls within Section 3(c)(1) or 3(c)(7) of the Investment Company Act is conclusively deemed to be a "covered fund" under the Volcker Rule. If a TOB trust is considered a "covered fund," the Volcker Rule would prevent a banking entity from investing in or sponsoring it. We believe this would result in very negative consequences for the municipal bond market.

Another negative consequence of being a "covered fund" is that the banking entity (and its affiliates) would be prohibited under the Super 23A provisions of the Volcker Rule from entering into "covered transactions" with the TOB trust if the banking entity (or its affiliates) acted as the investment adviser, investment manager, or sponsor of the TOB trust. Consequently, the banking entity would be barred from providing liquidity to the TOB trust under a liquidity facility, which is a necessary feature of the TOB structure.[37] The vast majority of TOB sponsors provide liquidity to their own programs. The inability to do so would make

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[36] *See* Rev. Proc. 2003-84, 2003-2 C.B. 1159. TOBs are specifically recognized as a partnership deserving special tax treatment based upon their structure and ownership of municipal bonds.

[37] *See supra* note 25 and related text.

TOB programs prohibitively expensive for TOB sponsors and would in turn eliminate the municipal bond market demand served by TOB programs.[38]

In certain cases, a bank may choose to credit-enhance a municipal bond as part of the financing achieved through a TOB trust. This practice is consistent with a bank's general authority to issue letters of credit to back municipal bonds. However, including TOBs within the scope of the Volcker Rule could prevent banks from credit enhancing bonds held in a TOB trust.[39] Eliminating the ability to provide credit enhancement on bonds held within TOBs would provide a further constraint on the ability for TOBs to serve their important market functions, including creating short-term tax-exempt investment product.[40]

D. The Volcker Rule's Legislative History Does Not Support Restricting TOBs

Most TOB structures would appear to fall within the Volcker Rule's statutory definition of a "private equity fund" or "hedge fund" because most TOB trusts rely on Sections 3(c)(1) or 3(c)(7) of the Investment Company Act. We do not believe, however, that Congress intended that TOBs be subject to the restrictions of the Volcker Rule.

The original language of the Volcker Rule, as first included in the Senate counterpart to the financial reform legislation in the Spring of 2010, contained sweeping prohibitions against proprietary trading and investing in or sponsoring a private equity fund or hedge fund.[41] The Senate bill did not contain freestanding exemptions from the Volcker Rule (as in the final legislation); instead, each of these sweeping prohibitions had certain exemptions embedded within the definitional language or within the prohibition itself. With respect to the prohibition on proprietary trading, the original Senate bill provided in relevant part:

(b) Prohibition on Proprietary Trading-

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38 Therefore, if an exemption is crafted for TOBs, for all practical purposes the exemption must not only enable a banking entity to sponsor or invest in a TOB, but must also enable a banking entity to enter into transactions that would fall within Super 23A. We note that the Agencies have astutely recognized, and attempted to reconcile, inconsistencies in the Proposal like the one that would occur if the Agencies were to provide an exemption to allow these vehicles to exist but fail to provide the related relief from Super 23A that would allow them to function efficiently. For example, see the discussion regarding the implementation of the Super 23A regulations under § _.16(a)(2), 76 FED. REG. 68846, 68916.

39 76 FED. REG. 68846, 68901.

40 In Question 78 of the Proposal, the Agencies have specifically requested comment as to whether the underwriting or market-making exemptions should be expanded to include the sale of municipal bonds by a banking entity to an intermediate entity as part of the creation of a TOB. It is not clear to us why that sale is not already exempt as a permitted activity under the Government Securities Exemption, unless perhaps the Agencies were referring to municipal agency securities, which, as discussed above, the Agencies do not believe fall within the scope of the Government Securities Exemption. However, to the extent the Agencies are raising the question, we would request clarification. 76 FED. REG. 68846, 68868-69.

41 By that time, the House of Representatives had already passed its version of financial modernization legislation, and the House bill contained nothing similar to the Volcker Rule.

> (1) IN GENERAL- [E]xcept as provided in paragraph (2) or (3), the appropriate Federal banking agencies shall, through a rulemaking under subsection (g), jointly prohibit proprietary trading by an insured depository institution, a company that controls, directly or indirectly, an insured depository institution or is treated as a bank holding company for purposes of the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.), and any subsidiary of such institution or company.
>
> (2) EXCEPTED OBLIGATIONS-
>
> (A) IN GENERAL- The prohibition under this subsection shall not apply with respect to an investment that is otherwise authorized by Federal law in--
>
> (i) obligations of the United States or any agency of the United States, including obligations fully guaranteed as to principal and interest by the United States or an agency of the United States;
>
> (ii) obligations, participations, or other instruments of, or issued by, the Government National Mortgage Association, the Federal National Mortgage Association, or the Federal Home Loan Mortgage Corporation, including obligations fully guaranteed as to principal and interest by such entities; and
>
> ***(iii) obligations of any State or any political subdivision of a State.***[42]

The above prohibition on proprietary trading contained an explicit exemption for trading in municipal securities. In contrast, the original Volcker Rule's prohibition on *fund sponsorship or investing activities* made no mention of municipal securities, and seemed reasonably clear that a fund whose assets consisted solely of municipal securities *was not exempt* from the fund sponsorship or investment provisions. The original Senate language remained unchanged and passed the Senate in May 2010.

In the House-Senate Conference Committee, however, the structure and language of the Volcker Rule was dramatically changed.[43] First, the Conference Committee created a new subsection (a) which combined into a single provision the prohibitions against proprietary trading and against fund sponsorship and investing. The Conference Committee then added a new subsection (d) of the Volcker Rule that set forth a laundry list of exemptions from the prohibitions in subsection (a). Certain of the exemptions were expressly limited to either the proprietary trading or the fund activities prongs of subsection (a). For example, the exemptions

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[42] S. 3217, § 619(b), 111th Cong., 2d Sess. (2010) (emphasis added).

[43] *See supra* notes 4 and 5 and related text.

pertaining to private client group activities and activities outside the U.S. were specifically limited to either the proprietary trading prong or the fund prong of the Volcker Rule.[44] Notably, the remaining exemptions were not so limited.[45]

The Government Securities Exemption is among the exemptions that were not limited to either proprietary trading or fund activities. With respect to TOBs, therefore, the question is whether the above statutory language permits a banking entity to invest in TOB securities, or to sponsor or own an interest in a trust that issues TOB securities, if the TOB trust itself holds no assets other than "obligations of any State or of any political subdivision thereof." Under the Proposal, the Government Securities Exemption is construed to apply *solely* to proprietary trading activity, thereby prohibiting investments or sponsorship in funds whose assets consist solely of assets within the Government Securities Exemption, such as a TOB trust. However, unlike other provisions of the Volcker Rule, the language of the Government Securities Exemption is not *expressly* limited to proprietary trading.[46]

Moreover, we believe such a construction lacks economic purpose. In effect, the Proposal permits a banking entity to continue to engage in proprietary trading of municipal securities. Under existing law, banks and their affiliates are already permitted to make long-term investments in municipal bonds, given that long term investing is not barred by the Volcker Rule and municipal securities constitute eligible investments for both banks and bank holding companies.[47] Likewise, banking entities are permitted to underwrite and deal in municipal securities.[48] Given a banking entity's broad authority to own, underwrite, and deal in municipal securities, we find it difficult to believe that Congress intended that a banking entity cannot, however, sponsor or invest in a fund whose assets consist solely of municipal securities.[49]

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[44] 12 U.S.C. § 1851(d)(1)(G) – (I).

[45] 12 U.S.C. § 1851(d)(1)(A) – (F) & (J).

[46] It could be argued that a somewhat similar phrase appears within the statutory definition of "proprietary trading" in subsection (h)(4). That provision defines proprietary trading to include certain transactions "to *purchase* or *sell*, or otherwise *acquire* or *dispose* of, any security." *See* 12 USC § 1851(h)(4). Arguably, Congress, by using similar language in subsection (h)(4), intended that subsection (d)(1)(A) be applied solely to proprietary trading activities. We think this argument is somewhat weak, especially given that Congress chose to affirmatively remove the language limiting the scope of the municipal bond exemption to the proprietary trading prong, and, in other subsections, insert express language limiting the exemption to either the proprietary trading prong or the fund prong of the Volcker Rule.

[47] *See, e.g.,* 12 C.F.R. § 1.2(j) & 1.3(a) (permitting national banks to invest in municipal securities as so-called "Type I securities" without limit).

[48] *Id.*

[49] Furthermore, as proposed, the Volcker Rule prohibition is inversely related to the percentage of ownership held by the banking entity. If the banking entity held 100% of the TOB trust, then the TOB trust arguably would not be a hedge fund or private equity fund at all because it would not need to resort to Section 3(c)(1) or 3(c)(7) of the Investment Company Act – in such a case, the TOB itself simply wouldn't be an "investment company" under the Investment Company Act and no exemptions would be needed. Further, such 100% ownership would be entirely permissible for a banking entity because the activities of the vehicle – owning municipal securities – are entirely permissible for a bank or bank holding company. The TOB trust would be considered a wholly owned subsidiary of the bank or bank holding company and would be subject to the same activity and

E. The Policies Underlying The Volcker Rule Do Not Support Restricting TOBs

The Agencies state in the Proposal that they have attempted to implement the Dodd-Frank Act's restrictions without unduly constraining banking entities from continuing to provide client-oriented services in a safe and prudent manner.[50] As described above, TOBs serve a unique and important function in the municipal capital markets and do not present the kinds of risks to banking entities that are the intended focus of the Volcker Rule.

We do not believe that exempting TOBs from the Volcker Rule would open the door for banking entities to speculate in high risk investments. As described above, TOB trusts hold a static pool of highly-rated municipal bonds and related contract rights, do not employ a manager or servicer, and do not involve credit tranching. They are simply an efficient way for municipal bond investors to achieve the equivalent of short term financing. Like other types of exempt activities, allowing banking entities to continue to finance municipal bonds through TOBs, rather than resorting to less common and less efficient means such as traditional repo financing, would promote the safety and soundness of banking entities and promote and protect the financial stability of the United States.

We believe it is clear that TOBs do not create the kind of risks for banking entities that the Volcker Rule was intended to eliminate. The Volcker Rule contains exemptions that are specifically designed to scale-back overly-broad prohibitions that may prevent financial markets from engaging in safe, low-risk transactions. The Proposal reflects this balance and exempted from the Volcker Rule, for example, "positions arising under certain repurchase and reverse repurchase agreements or securities lending transactions [and] bona fide liquidity management"[51] because such arrangements are essentially a form of financing that "do not appear to involve the requisite short-term trading intent."[52] As described above, TOBs are a means of obtaining this same type of financing for municipal bonds.

If it were possible for banking entities to finance the underlying municipal bonds under a repurchase agreement without compromising the tax-exempt character of the interest payments, such an arrangement would be outside of the reach of the Volcker Rule's ban on proprietary trading. If the only assets held by TOB trusts are municipal securities that are already exempt from the proprietary trading ban (and related contract rights), we do not see any economic justification for treating an interest in or sponsorship of such a fund any differently from proprietary trading of municipal bonds or entering into repurchase arrangements.

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investment restrictions as applicable to the bank or bank holding company, which, as explained above, permit ownership of municipal bonds. However, if the banking entity were to hold *less than* 100%, then the TOB would arguably require an exemption from the Investment Company Act and would be considered a "covered fund" subject to the Volcker Rule. We think that in consideration of the goals of the Volcker Rule, it is very unlikely that Congress intended that a banking entity could own 100% of a TOB but could not own a lesser amount, *e.g.*, 99.9%.

[50] 76 FED. REG. 68846, 68849.

[51] § _.3(b)(2)(iii).

[52] 76 FED. REG. 68846, 68850.

As described above, TOB trusts are not utilized for the purpose of transferring risk and do not carry the type of risk to banking entities that the Volcker Rule was intended to curb. A TOB trust's only asset is a highly-rated municipal bond that is commonly offered to retail investors. As investments in municipal bonds are not in violation of the Dodd-Frank Act, we do not believe any economic justification exists for prohibiting investments in a fund that solely owns a municipal bond. We believe the Agencies' Proposal, in maintaining this distinction, would not provide support to financial markets by limiting the risks taken by banking entities and could actually negatively affect financial markets by raising financing costs for issuers of municipal securities by curtailing the market demand created by TOBs.[53]

F. The Agencies Should Expressly Exempt TOBs From The Volcker Rule

Even if the Agencies determine that a narrow reading of the Government Securities Exemption is appropriate, we urge the Agencies to use their authority to expressly include TOBs as a permitted activity pursuant to Section (d)(1)(J). Under that provision, TOBs would be recognized as an activity that "would promote and protect the safety and soundness of the banking entity and the financial stability of the United States." We believe that allowing banks to acquire ownership interests in and sponsor TOB trusts would provide a deeper and richer pool of potential investors, a more liquid market for municipal bonds, and greater efficiency and risk diversification.[54] It would therefore promote the safety and soundness of the banking entity and the financial stability of the United States to enable banking entities to finance those activities in a manner that is most efficient and that is economically equivalent to other permitted activities.

Finally, given the importance of TOBs to the municipal markets, the restrictions imposed by the Volcker Rule on TOBs would have the further economic impact of disrupting the municipal markets, including the mutual fund markets, and increasing the costs of borrowing for State and local governments.

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State and local municipal obligations serve an important and unique role in the United States economy. For the reasons described in this letter, a narrow interpretation of the exemption for municipal obligations would not serve the goals of the Volcker Rule, would be

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[53] The Proposal makes clear that the purpose of the "ownership" definition was to focus on whether it "provides the bank with economic exposure to the profits and losses of the covered fund." 76 FED. REG. 68846, 68897. Where a third-party (e.g., a long-term mutual fund) owns the Inverse Floater, the bank does not have these exposures, so should not be treated as having an "ownership" interest, even where it may be the owner of a small interest for tax purposes or become the owner through either remarketing or liquidity agreements. A small or incidental amount of ownership of the TOB trust would also be consistent with the exemptions set forth in § _.12 of the Proposal (banking entities are allowed to establish a "covered fund" provided the banking entity reduces its ownership to a *de minimis* level). Of course, where the bank owns the Inverse Floater, it has these risks, just as it would from owning the bond and financing it, which it is permitted to do and which is what the TOB accomplishes.

[54] As such, TOBs promote safety and soundness and the financial stability of the U.S. financial markets in much the same way that the Agencies recognize for loan securitizations. 76 FED. REG. 68846, 68914.

inconsistent with existing banking law, and would have a negative impact on the safety and soundness of banking entities and the financial stability of the United States. In addition, municipal tender option bond trusts containing exempt securities should be deemed to fall outside the scope of the Volcker Rule, and if not, we ask that the Agencies, recognizing their importance to the marketplace, use their authority to exclude them altogether from the Volcker Rule.

We appreciate your consideration of our comments on the Proposal and our suggestions for amendments concerning municipal agency securities and TOBs. If we can answer any questions or provide any further information, please contact Lary Stromfeld ((212) 504-6291, lary.stromfeld@cwt.com), Scott Cammarn ((704) 348-5363, scott.cammarn@cwt.com) or Kathryn Andrews ((212) 504-5544, kathryn.andrews@cwt.com).

Very truly yours,

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