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

Ladies and Gentlemen:

The American Bankers Association (ABA) appreciates the opportunity to provide comments to the federal regulatory agencies (Agencies) responsible for issuing rules that implement Section 619 of the Dodd-Frank Act (Section 619), codified as new Section 13 of the Bank Holding Company Act of 1956, as amended (Volcker Rule or Rule). ABA represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. We have reviewed and analyzed as much as possible the Agencies' Notice of Proposed Rulemaking (Proposed Rules) implementing the provisions of the Volcker Rule.

We appreciate the enormity of the Agencies' task to implement an effective regulatory and supervisory structure for the Volcker Rule. We further commend the Agencies' diligent efforts in laboring through an inadequately drafted statutory scheme that is rife with vague generalities and very loosely defined terms. The sheer number of questions raised by the Agencies in the Proposed Rules demonstrate the daunting and unprecedented challenges that the Agencies are facing in trying to implement the statutory language without causing harm to the financial system and to the customers who rely upon the banking industry for financial services. The Proposed Rules, however, have raised a number of significant concerns which call into question the viability of the of the Agencies' current rulemaking approach on the Volcker Rule.

We request, therefore, that the Agencies: (1) revise the Proposed Rules and their approach by focusing on prohibited activities, defining key terms in a manner that provides certainty to banks that the rules will not impede banks from engaging in bona fide market-making, asset liability management, hedging, and other permissible trading activities, and having relationships with ordinary corporate vehicles (such as wholly-owned subsidiaries) and other entities that bear no resemblance to "hedge funds" and "private equity funds"; and (2) submit the revised Proposed Rules for public comment. Such a rule structure would not only uphold the letter and spirit of the Volcker Rule but also would allow banks to continue responsibly managing their permissible trading and investment activities, outside the clearly drawn boundaries of prohibited activity, with certainty and with a minimum of disruption or costly compliance.

For ease of review, we have divided our response into the following sections: (I) General Concerns; (II) Definition of "Banking Entity"; (III) Covered Funds Activities and Investments; (IV) Proprietary Trading; (V) Compliance Program Requirements; (VI) Conformance Period and Compliance Deadlines; and (VII) Cost-Benefit Analysis. We would note that these comments are complementary of other comments ABA and ABA entities are submitting on the Proposed Rules.

I. General Concerns.

A. The Volcker Rule Provides No Basis for Clear, Comprehensive Rulemaking.

The Volcker Rule was intended by Congress to curb speculative and excessive risk-taking of certain trading and investment activity by banks. The statutory language is aimed at generally prohibiting banks from engaging in proprietary trading and from investing as principal in, or sponsoring, hedge funds and private equity funds. Unfortunately, as enacted, the Volcker Rule fails to provide an adequate foundation upon which proper rulemaking may occur. The activities which the Volcker Rule intends to curtail are so broadly embedded in the traditional business of banking that the Agencies are left with the exceedingly difficult and complicated task to define, unravel, and separate permissible from prohibited proprietary trading and investment activity that is, within each banking institution and across the modern American financial services industry, deeply interlaced and interdependent.

The statutory scheme, furthermore, makes no provision for primary jurisdictional authority among the Agencies, setting the stage for a disordered patchwork quilt of conflicting regulations and interpretations of the Proposed Rules' numerous implementing provisions. The lack of a primary federal regulator as the final arbiter of regulation and interpretation will likely lead to inconsistent application of the regulatory requirements as the Agencies each attempt to flesh out the meaning of the Volcker Rule, further undermining regulatory certainty and compliance efforts by banks. We believe, therefore, that the Agencies should coordinate their rulemaking and interpretive functions, so that there will be consistent treatment of the jointly-issued Rule.

Moreover, Congress has sounded the alarm on the consequences to *global* competitiveness. As stated in a recent letter from Representatives Bachus, Hensarling, Capito, and Garrett to the Agencies, the Proposed Rules may diminish the strength of U.S. banks in the global financial marketplace.[1] There is the additional concern that a number of the activities prohibited under the Volcker Rule would simply migrate to other sectors of the economy, particularly to the nonbanking sector, where much of the recent financial turmoil found its origins.

Finally, we note also that a recent U.S. Government Accountability Office (GAO) report states that "in 2005 regulators tried to define proprietary trading as part of an effort to better oversee such activity but ultimately could not. They noted that preventing proprietary trading *required a subjective, case-by-case evaluation*. Any other approach, they said, would either be too broad and overly inclusive or too narrow – that is, it would miss some activities."[2] The GAO report further states that "FDIC staff, whose organization oversees bank failures, said they were not aware of any bank failures that had resulted from stand-alone proprietary trading."[3] The report concludes that neither proprietary trading nor investments in hedge funds/private equity funds by banks were a proximate cause of the financial crisis of 2008.[4] These findings call into question the necessity of the Volcker Rule, particularly a rule as flawed as Section 619. Despite the multiple billions of dollars of taxpayer and private industry funds, and the thousands of unproductive man-years of bank staff commitment, that will be required to establish and sustain the Volcker Rule, it is more than likely that such a rule will undermine efforts to accomplish what it purportedly sets out to achieve – namely, a safer, more secure, and stable U.S. financial system.

B. The Proposed Rules Fail to Define the Key Terms of the Volcker Rule.

Notwithstanding the fundamental deficiencies of the Volcker Rule, the Agencies possess broad authority to craft a workable regulatory scheme to reflect accurately the intent of Congress to generally prohibit banks from engaging in proprietary trading and from acquiring ownership interests in, or sponsorship of, hedge funds and private equity funds. In order to know with certainty which activities are prohibited in such a way as to assure effective compliance, it is critical that the terms "trading account," "hedge fund," and "private equity fund" are clearly defined. As noted above, Section 619 provides only a broad description of these terms, delegating to the Agencies the task of precisely formulating the scope of their meaning. The flexible framing of the language contained in the statutory definition plainly gives the Agencies wide latitude in the effort to accomplish this objective:

> "*(h) DEFINITIONS. – In this section, the following definitions shall apply:*
>
> *[. . .]*

[1] Letter from Reps. Bachus, Hensarling, Capito, and Garrett to the Agencies (Dec. 7, 2011).
[2] GAO Report, "Regulators Will Need More Comprehensive Information to Fully Monitor Compliance with New Restrictions When Implemented (July 2011). [Emphasis added.]
[3] *Id.*
[4] *Id.*

> *(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 [Agencies] may, by rule, as provided by subsection (b)(2), determine."
> *[. . .]*
>
> *(6) TRADING ACCOUNT*. – The term "trading account" . . . means any account used for acquiring or taking positions in [Volcker Rule covered financial instruments] ***principally*** for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), . . ."[5]

Even though it references the two exclusions in the Investment Company Act of 1940 (sections 3(c)(1) and 3(c)(7)), Section 619 clearly authorizes the Agencies to define with operational clarity the meaning of "hedge fund" and "private equity fund," particularly given the peculiar nature of the statutory definition (classificatory rather than descriptive). Furthermore, Section 619 clearly provides the Agencies the flexibility to determine what type of accounts should be considered a "trading account" for purposes of the "proprietary trading" restrictions of the Volcker Rule. Providing readily understandable definitions and exemptions that provide banks certainty that permissible activity will not – either by rule or through the examination process – be prohibited is needed to ensure a clear, efficient, and successful regulatory regime and to avoid unintended consequences for banks, their customers, and financial markets.

Unfortunately, instead of fleshing out the fundamental terms that clearly protect permissible activities, the Proposed Rules largely restate the statutory language. As a result, regulatory compliance, supervision, and enforcement of the Volcker Rule would rest on a shaky foundation of ambiguity, uncertainty, and (ultimately) subjectivity. It is not surprising, then, that the Proposed Rules – which span nearly 300 single-spaced pages and contain over 1300 questions submitted for public comment – fail to provide concrete, operational guidance or clarity on what in fact constitutes prohibited proprietary trading or what constitutes a hedge fund or private equity fund.

C. Failure to Define Key Terms Creates a Complex, Burdensome, and Ultimately Unworkable Regulatory Regime.

Having largely re-stated what is prohibited using the language of the Dodd-Frank Act's Section 619 (i.e., proprietary trading and investments in hedge funds/private equity funds) under the Proposed Rules, the Agencies have been left to craft hard-to-define exemptions from the general prohibited activity. The result has been vague, loosely-defined prohibitions, paired with amorphously described permitted activities that do not lend themselves to formal, distinct, or set boundaries. This chaotic regulatory construct is a recipe for an arbitrary, inconsistent, and even contradictory application of the Volcker Rule's requirements to banks, not only among the Agencies but within a single Agency's supervisory and enforcement regime.

[5] Bank Holding Company Act § 13(h)(2) & (6) (2010). [Emphasis added.]

Failure to define the basic terms likewise contributes to the needless and burdensome complexity of the rules. Although the Volcker Rule is publicly targeted at the largest banks, *this problem will be faced by every bank, regardless of its size or complexity*. For example, the Proposed Rules would make it extraordinarily difficult, if not impossible, for a bank to determine whether or how its otherwise permitted activities, such as market-making, asset liability management, hedging, and liquidity management, might actually be prohibited. As a result, in spite of having in place appropriate internal controls, policies, and procedures, banks may still not know whether, or on what basis, they may find themselves liable to be found by their regulators to be in violation of the Volcker Rule. Disentangling permitted market-making from prohibited proprietary trading, for example, may often involve a detailed and complex analysis of a bank's trading practices and regulatory metrics, all of which would need to be applied and monitored a continuous basis. Moreover, under the Proposed Rules, *each trade* and *each investment* would need to be continually reviewed since even a lone transaction, regardless of its form or amount, could *at any point in time* result in violating the Volcker Rule regulations.

Such an ill-defined regulatory scheme will inevitably breed a multitude of unintentional and opaque regulatory violations. It will be practically impossible for a bank to conclude readily and reasonably, and with confidence, at any given time, that it is in compliance with the Volcker Rule. Instead, agency supervision of the Volcker Rule will be a perpetual source of frustration for regulators, banks, and bank customers, as banks discover that first-time, ongoing, and fluid interpretation of the Proposed Rules will routinely occur through the enforcement process rather than through regulatory rulemaking.

D. The Proposed Rules Do Not Achieve Regulatory Certainty.

In implementing a statutory mandate, the goal of regulation should be to provide comprehensive guidance aimed at regulatory certainty that enhances the ability of banks to serve their customers. Ironically, the Proposed Rules are both overly complex and insufficiently complete to achieve this objective. Many of the Proposed Rules' requirements simply beg the question on the activity to be regulated, providing little clarity or direction on compliance requirements. This is especially so for the "permitted" activities under the Volcker Rule, which can be likened to precariously situated islands of compliance in an ill-defined and turbulent sea of prohibition.

For example, under the Proposed Rules, a permissible activity includes a bank's wholly owned subsidiary "engaged principally in performing *bona fide* liquidity management activities described in [the proprietary trading section of the Proposed Rules]." However, the terms "principally" and "*bona fide*" are not defined and could be subject to unduly narrow (or at least variable) interpretation by certain Agencies or examination teams. Further, among other things, the proprietary trading section provision requires "that any position taken for liquidity management purposes be *highly liquid* and limited to financial instruments the market, credit, and *other risks* of which the covered banking entity does not expect to give rise to *appreciable* profits or losses as a result of *short-term* price movements." The terms "highly liquid," "other risks," "appreciable," and "short-term" are all undefined and thus run the risk of being construed too narrowly to allow for *bona fide* liquidity management. The terms, in fact, may defy definition since they appear dependent on, and subject to, current and volatile market and macroeconomic conditions, thereby frustrating the consistent application of regulatory requirements.

Despite the scrupulous, granular level of detail employed, compliance often will rest on excessively subjective determinations, upon which reasonable persons may disagree. Faced with this distressing lack of clarity in spite of continual labor-intensive analysis and heightened compliance costs, banks will be subject to heightened regulatory risk, forcing too many to scale back or exit the core trading- and investment-related activities that underlie successful risk management, which activity contributes to the very safety and soundness that Congress is seeking to promote within the banking industry. Lack of certainty would unacceptably impede the efficient flow of capital within the U.S. financial system. Reduction in liquidity would increase the costs to bank customers. Consequently, the Proposed Rules, in their current form, will serve more to weaken bank earnings in demonstrably safe activities (e.g., market-making, asset liability management, hedging, liquidity management) rather than provide safety and soundness benefits to the U.S. financial system.

II. Definition of "Banking Entity."

The Proposed Rules broadly define the term "banking entity" in a way that would potentially capture hundreds of thousands of entities that pose no threat to the stability of banking industry, the financial markets, or to the FDIC insurance fund – and may, in fact, destabilize the very institutions that the Volcker Rule seeks to protect. We request, therefore, that the Agencies revise the "banking entity" definition in the manner described herein.

A. Control.

A "banking entity" under the Proposed Rules includes every company that "controls" a bank as well as every company controlled by such an entity. The Proposed Rules incorporate by reference the definition of "control" found in the Bank Holding Company Act (BHCA). The BHCA provides that a company "has control over a bank or over any company if—

> (A) The company directly or indirectly or acting through one or more other persons, owns, controls, or has power to vote 25 per centum or more of any class of voting securities of the bank or company;
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> (B) The company controls in any manner the election of a majority of the directors or trustees of the bank or company; or
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> (C) The [Federal Reserve] determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the bank or company.[6]

The Agencies should not look to subparagraph (C) to determine control, because that test is unworkably vague and overbroad and may capture entities that pose no threat to the stability of the bank. Under the subparagraph (C) standard, even a minority investor in a banking entity's

[6] 12 U.S.C. § 1841(a)(2).

parent company could be deemed a "banking entity" as a result of even a fractional and passive ownership interest.[7] Similarly, a nonbank company in which a banking entity has a small, minority ownership interest should not be subject to the prohibitions of the Volcker Rule unless the banking entity owns 25 percent or more of the voting securities of the nonbank entity.

The Agencies should adopt a bright line test for "control" under subparagraph (A) above. In other words, for purposes of the Volcker Rule, an entity should be deemed to have control of a company only when it owns 25 percent or more of a class of the company's voting securities. While we appreciate the need for a more restrictive "controlling influence" test in other circumstances, if adopted for purposes of the Volcker Rule, such a test could cause market uncertainty, leading to harmful impediments to raising capital and the unnecessary regulation of companies and others that have little connection to banking entities or that hold little or no assets of a bank.

B. Excluded and Registered Funds.

By excluding certain "covered funds" from the definition of "banking entity," the Agencies have recognized the necessity, as well as their statutory authority, to carve out certain entities in order to avoid being "inconsistent with the purpose and intent of the statute."[8] ABA strongly believes that the Agencies should follow through with that reasoning and similarly exclude other funds and entities that plainly should not be subject to the Volcker Rule.

In particular, the Agencies should exclude *all* covered funds that are permissibly controlled by a banking entity under the Volcker Rule, including public welfare funds and SBICs, from the definition of a "banking entity." Although the preamble to the Proposed Rules indicate that this is the Agencies' intent, the rule text only excludes those covered funds permissibly controlled under the "asset management exception" in §__.12 of the Proposed Rules from the definition of a "banking entity."[9]

In addition, the Agencies should explicitly expand the "covered funds" exclusion to <u>all</u> issuers that are excluded from the Investment Company Act under sections other than 3(c)(1) and 3(c)(7) of the Act, as well as Rules 3a-1 through 3a-8 thereunder.[10] Subjecting these funds to the Proposed Rules would not further the Volcker Rule's objectives, because they do not pose a threat to the FDIC insurance fund or to the banking entity. Further, such funds are created to facilitate *client* investments, not investments of the banking entity. Without express

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[7] A problem engendered by the Volcker Rule is that "control" under the BHCA is determined by the Board staff in its discretion below the 25% threshold. Since only a voting interest of less than 5 percent results in a presumption of "noncontrol" (*see* BHCA § 4(c)(6)), it is possible that "control" of a company under the BHCA could occur with as little as a 5 percent voting interest in the company, thereby triggering application of the Volcker Rule.
[8] 76 Fed. Reg. 68,856.
[9] *See* 76 Fed. Reg. at 68,855-56 (nothing that the definition of banking entity "could include a covered fund that a banking entity has permissibly sponsored or made in investment in because, for example, the banking entity acts as general partner or managing member of the covered fund as part of its permitted activities sponsorship activities. If such a covered fund were considered a 'banking entity' for purposes of the proposed rule, the fund itself would become subject to all of the restrictions and limitations of [the Volcker Rule] and the proposed rule, which would be inconsistent with the purpose and intent of the statute.").
[10] This would include excluding funds that are able to rely on more than one exclusion under the Act in addition to relying on sections 3(c)(1) or 3(c)(7).

confirmation that these funds are excluded from the definition, the ensuing uncertainty and confusion will undermine the legitimate and worthy purpose of enhancing investment and risk management of client assets, as well as hinder important revenue from the exercise of traditional fiduciary activities.

Similarly, the Agencies should exclude other funds that the banking entity may administer for the purpose of managing other people's money, such as employees of the banking entity. Many banking entities allow certain employees to invest in employee security companies (ESC) as an important benefit to retain skilled workers. If the Volcker Rule were to apply to ESCs, then these banking entities may lose these important employees to competitors that are not subject to the restrictions, thereby potentially harming the banking entity – another result that is inconsistent with the purpose and intent of Section 619.

Lastly, the Agencies should exclude all types of registered investment companies, including foreign investment companies, from the definition of "banking entity." The preamble to the Proposed Rules suggests that these funds may not be considered a subsidiary or affiliate because of the manner in which they are structured. Although these statements are helpful, it would be best if the language of the Proposed Rules specifically confirmed that these entities would not be deemed a "banking entity."

C. Portfolio Companies.

Portfolio companies that are deemed to be controlled should not be considered banking entities subject to the restrictions of the Volcker Rule. Pursuant to existing limitations under the BHCA, banks do not routinely manage or operate these companies, except in limited and extraordinary circumstances, and generally are prohibited from owning the portfolio company for more than 10 years. A banking entity's investment in portfolio companies is financial in nature and a proper use of the merchant banking authority pursuant to section 4(k)(4)(H) of the BHCA. If the Agencies do not exclude portfolio companies from the definition of "banking entity," the Proposed Rules will have failed to avoid "disrupt[ing] the way the firms structure their normal investment holdings."[11]

D. Passive Investors in Banking Entities.

By eliminating the "controlling influence" prong in the test for control and using a bright line test of 25 percent ownership of voting securities, the Proposed Rules can further avoid capturing passive institutional investors within the definition of "banking entity." Many banking entities would face more limited access to capital if prospective institutional investors, such as pension plans, insurance companies, and domestic and foreign investment companies, were concerned about inadvertently becoming subject to Volcker Rule's prohibitions on trading and investment activities. Such a result would wall off another significant source of funding and investment capital for banks, leading to a weakening of the U.S. banking system.

[11] *See* Colloquy between House Financial Services Chairman Frank (D-MA) and Rep. Himes (D-CT), 156 CONG. REC. H5226 (June 30, 2010).

III. Covered Funds' Activities and Investments.

Subject to certain "permissible activities," the Volcker Rule generally prohibits a banking entity from "acquir[ing] or retain[ing] any equity, partnership, or other ownership interest or sponsor a hedge fund or a private equity fund." Ostensibly, the purpose of these restrictions is to protect the FDIC insurance fund, the financial system at large, and the U.S. taxpayers from the risks to banking entities that are associated with hedge funds and private equity funds, while continuing to allow those activities that facilitate "robust and liquid capital markets and financial intermediation."[12] Nevertheless, because the Agencies have declined to tailor properly the scope of the Volcker Rule to the particular concerns that prompted its enactment, the Proposed Rules do not achieve this objective.

A. Definition of "Hedge Fund" and "Private Equity Fund."

The Agencies should tailor the Volcker Rule as intended by Congress and as recommended in the study of the Financial Stability Oversight Committee (FSOC) by properly defining the terms "hedge fund" and "private equity fund." As the FSOC urged in its study: "In implementing the Volcker Rule, Agencies should consider criteria for providing exceptions with respect to certain funds that are technically within the scope of the 'hedge fund' and 'private equity fund' definition in the Volcker Rule but that Congress may not have intended to capture in enacting the statute."[13] Even though Section 619 directs the Agencies to consider the findings in the FSOC Study, there is no indication in the Proposed Rules or the preamble that such criteria were discussed.

Section 619 defines "hedge fund" and "private equity fund" as "an issuer that would be an investment company… but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as [the Agencies] may, by rule… determine." ABA believes that the rulemaking authority given to the Agencies in the phrase "as [the Agencies] may, by rule…determine" applies not only to their authority to designate "similar funds," but also to their authority to define those funds "that would be an investment company… but for section 3(c)(1) or 3(c)(7) of" the Investment Company Act that should be considered a "hedge fund" or "private equity fund" for purposes of the Volcker Rule. In other words, the Agencies have the statutory authority to define more narrowly "hedge fund" and "private equity fund" further than the crude proxy of exclusions from sections 3(c)(1) and 3(c)(7). With this sensible interpretation of the statute, the Agencies have authority and flexibility to refine the scope of the Proposed Rules so that it is germane, workable, and effective.

If the Agencies decline to specifically identify the subset of section 3(c)(1) or 3(c)(7) funds that should be considered a "hedge fund" or "private equity fund," then the Volcker Rule will inevitably include a host of nonfund corporate structures (such as wholly-owned subsidiaries and joint ventures), as well as a host of funds that bear little or no resemblance to a hedge fund or private equity fund, within the definition of the terms "hedge fund" and "private equity fund." In addition, such entities could well be subject to the "Super 23A" restrictions in the Volcker

[12] FSOC Study at 1.
[13] FSOC Study at 7.

Rule[14]— meaning that banking entities could well be prohibited from providing credit to, or purchasing assets from, their own wholly owned corporate subsidiaries. Clearly, Congress could not have intended such an absurd result. We request, therefore, that the Agencies redefine "hedge fund" and "private equity fund" to comprise only those funds which have characteristics traditionally associated with these investment vehicles, using the SEC's Form PF as a starting point and guide.

Similar Funds

Without explaining their reasoning or how it fulfills congressional intent,[15] the Agencies have further expanded the definition of "covered fund" to capture foreign funds that would have to rely on Sections 3(c)(1) or 3(c)(7) if organized and offered in the United States, as well as commodity pools as defined under the Commodity Exchange Act (CEA). We understand that the Agencies may wish to address the potential for evasion by including *certain* foreign funds and commodity pools into the definition of "covered fund." However, not *all* funds that fall into these broad categories are "similar" to hedge funds or private equity funds. As proposed, "similar fund" could sweep in every foreign pooled investment vehicle, and every domestic or foreign entity that invests in commodity interests, including entities that qualify for exemptions under the Investment Company Act other than section 3(c)(1) or 3(c)(7), as well as SEC-registered investment companies, which Congress clearly did not intend the Volcker Rule to cover.

Accordingly, the Agencies should limit the types of foreign funds and commodity pools being treated as covered funds to commodity pools and foreign funds that are similar to an issuer that would be an investment company under the Investment Company Act but for sections 3(c)(1) or 3(c)(7) of that Act *and* have the characteristics associated with a traditional hedge fund or private equity fund.

Commodity Pools

The Dodd-Frank Act amended the CEA to define a "commodity pool" as "any investment trust, syndicate, or similar form of enterprise operated for the purpose of trading in commodity interests."[16] The CFTC staff has taken the position – which has yet to be explicitly withdrawn – that any entity entering into a *single* futures contract could be characterized as "trading in commodity interests."[17] In other words, under existing CFTC interpretation, the scope of a "commodity pool" could be vastly overbroad.

By designating *all* commodity pools as "similar funds," the Agencies have significantly expanded the range of entities treated as covered funds under the Volcker Rule. Without a more targeted approach, *any company* that buys or sells a minimal amount of swaps or futures, even

[14] *See* 12 U.S.C. § 1851(f).

[15] We further question whether under the Administrative Procedure Act, the Agencies may designate a "similar fund" without any regulatory analysis as to how the fund is similar, and correspondingly, without any opportunity for public comment on such analysis.

[16] 7 U.S.C. § 1a(10).

[17] *See, e.g.*, CFTC Interpretative Letter No. 86-22, Comm. Fut. L. Rep. (CCH) ¶ 23,280 (Sept. 19, 1986).

for hedging purposes or equitization of small amounts of a fund's cash position,[18] may be characterized as "trading in commodity interests." Without a sensible exception or clarification, the proposed definition could be interpreted to capture SEC-registered investment companies, funds that meet other exemptions under Section 3 of the Investment Company Act (such as collective investment funds), and operating companies.

For these reasons, the Agencies should only designate as a "similar fund" those commodity pools that hold the characteristics of a traditional hedge fund or private equity fund as noted above, that are "principally engaged" in trading commodity interests, and that are not one of the entities that we recommend should be excluded from the definition of "covered fund" in Section B. Furthermore, we believe that the Agencies should clarify that a commodity pool is "principally engaged" only if more than fifty percent of its assets are deposited with a derivatives clearing organization as required margin, option premiums, or secured deposits for transactions in commodity interests, excluding transactions undertaken for risk-management or hedging purposes. Such a framework would provide a relatively easy standard with which to comply and enforce and would be consistent with the CFTC's rules and guidelines in similar contexts.[19]

Foreign Funds
Similar to the commodity pool designation, the Proposed Rules designate all foreign funds as covered funds, dramatically expanding the scope of the entities treated as "hedge funds" or "private equity funds" under the Volcker Rule. We believe that in order for a foreign fund to be deemed a similar fund under Section 619, it must be similar to the types of companies that would fall within the general definition as outlined above. The approach proposed by the Agencies would result in nearly *all* foreign funds being covered funds, because the test requires an analysis of whether a non-U.S. fund could be offered to a U.S. person in the United States. We believe it would be rare for a non-U.S. fund to satisfy the specific requirements of an exemption other than section 3(c)(1) or 3(c)(7). The Proposed Rules also do not consider whether a foreign fund's operations are regulated under local law. We believe a sensible test for foreign funds would be any company that (i) would be an investment company under the Investment Company Act but for sections 3(c)(1) or 3(c)(7) of that Act, (ii) has all of the characteristics traditionally associated with a hedge fund or private equity fund, and (iii) that is not one of the entities that we recommend should be excluded from the definition of "covered fund" in Section III.B.

ABA believes that the unintended and unnecessary application can be cured if the Agencies properly define the term "covered fund" to target those domestic and foreign funds and commodity pools that clearly exhibit the characteristics of traditional hedge funds and private equity funds – funds that Congress was concerned would "cause the harms at which the Volcker rule is directed."[20]

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[18] Some funds "equitize" the cash balances (typically, less than 5% of a fund's total assets) that they maintain for normal subscription and redemption activity. For index funds, cash equitization through index futures provides an efficient tool for reducing benchmark tracking error while ensuring the availability of cash for investor transactions.
[19] *See, e.g.*, 17 C.F.R. § 4.13(a)(3), which provides for a 5 percent net margin.
[20] Statement by Sen. Dodd (D-CT), 156 CONG. REC. S5905 (July 15, 2010).

B. Exclusions from the Definition of "Hedge Fund" and "Private Equity Fund."

In addition to recommending a targeted definition of "hedge fund" and "private equity fund," ABA urges the Agencies to expressly exclude certain entities that may rely on section 3(c)(1) and 3(c)(7) of the Investment Company Act.

Wholly-Owned Subsidiaries

As "banking entities," wholly-owned subsidiaries would be subject to the Volcker Rule's limitations on proprietary trading and investments in covered funds, as well as subject to the anti-evasion authority of the Agencies. We believe that all wholly-owned subsidiaries should be explicitly excluded from the Proposed Rules' definition of a "hedge fund" and "private equity fund." By definition, wholly-owned subsidiaries should not be considered "funds" because there are no outside investors to which interests are offered. Furthermore, these entities also would likely be excluded from the Investment Company Act under section 3(b)(3). If these entities are not excluded from the definition, then under the Agencies' interpretation of Section 619, they would be subject to the "Super 23A" restrictions, which would absurdly limit the types of covered transactions in which the bank may engage with its subsidiaries.

Although the Proposed Rules do provide an exception to the ownership prohibition of certain wholly-owned subsidiaries, it is limited to those that are engaged in *bona fide* liquidity management activities.[21] The narrowness of this exception allows the definition of fund to needlessly implicate other wholly or substantially-owned subsidiaries (*i.e.,* those wholly owned indirectly) engaged in permissible activities and may result in disruption of ordinary course holding company corporate structures in direct violation of congressional intent, as expressed in the legislative colloquies. A broad exception for wholly-owned subsidiaries would avoid this result. An exception for subsidiaries would also recognize some of the technical limitations of relying on other exceptions to the definition of investment company under the Investment Company Act and should include subsidiaries that are wholly-owned, except for employee investments in the form of compensation or carried interests.[22]

Venture Capital Funds

Banks should be allowed to continue their investments in venture capital funds, which are a vital ingredient and catalyst for economic growth locally and nationally. As members of Congress acknowledged,[23] these funds provide much-needed capital to high-growth startup companies – the powerful engines of business innovation and job creation, especially in the technology sectors of the economy. Properly managed investments in venture capital funds are low risk and do not raise the concerns that precipitated Section 619, because they do not incur significant leverage the way that hedge funds and private equity funds often do.[24] In fact, these investments promote the economic growth and competitiveness of the U.S. in much the same way as, but to a

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[21] Section __.14 (a)(2)(iv)

[22] For example, some banking entities allow their employees to co-invest in limited partnership or limited liability companies that make merchant banking investments.

[23] *See* Statement by Rep. Eshoo (D-CA), 156 CONG. REC. E1295 (July 13, 2010); colloquy between Sen. Dodd (D-CT) and Sen. Boxer (D-CA), 156 CONG. REC. S5904-5 (July 15, 2010).

[24] *See* 17 CFR 275.203(l)-1 (SEC Rule defining venture capital fund).

greater degree than, investments in entities that are expressly allowed by statute, such as small business investment companies (SBICs).

For these and other reasons, the FSOC Study urged the Agencies to consider narrowing the scope of the terms "hedge fund" and "private equity fund" to address these concerns:

> Specifically, a number of commenters suggested that venture capital funds should be excluded from the Volcker Rule's definition of hedge funds and private equity funds because the nature of venture capital funds is fundamentally different from such other funds and because they promote innovation. The Council believes that the issue raised by commenters in this respect is significant. In connection with implementing an exclusion from registration for advisers solely to venture capital funds as provided under the Dodd-Frank Act, the SEC has recently proposed rules that distinguish the characteristics and activities of venture capital funds from those of other private equity funds and hedge funds. The Council recommends that Agencies carefully evaluate the range of funds and other legal vehicles that rely on the exclusions contained in section 3(c)(1) or 3(c)(7) and consider whether it is appropriate to narrow the statutory definition by rule in some cases.[25]

We support the FSOC's recommendations and urge the Agencies to carve out expressly entities that would fall within the traditional boundaries of a venture capital fund.

Joint Ventures
The Proposed Rule Section __.14 permits a banking entity to invest in joint ventures that are considered covered funds. This permitted investment is limited to those joint ventures that are operating companies and do not engage in certain activities or investments prohibited by the Rule.

In order to preserve a bank's ability to make joint venture investments that "promote and protect the safety and soundness of banking entities and promote and protect the financial stability of the United States,"[26] the Agencies should define a permissible joint venture as any company with a limited number of co-venturers that is managed pursuant to a shareholders' agreement, as opposed to managed by a general partner. In other words, the "operating company" condition applicable under the Proposed Rules to joint ventures should be eliminated because it imposes a vague and too narrow limitation on permissible investments and implicates many of the same issues that arise for wholly-owned subsidiaries.

If the Agencies do not permit more wide-ranging joint ventures, banks may be hindered in conducting merchant banking activities efficiently and successfully. Often a bank may wish to share the risk of an investment with third-party investors in order to manage effectively the investment risk. Given the benefit of these important investments, the Agencies should avoid

[25] FSOC Study at 62.
[26] Release, 76 Fed. Reg. 68,913.

making it harder for banks to find co-venturers because of the limitations imposed by the Volcker Rule.[27]

Real Estate Investment Trusts

The Agencies should also carve out of the final definition of "hedge fund" and "private equity fund" passive, pass-through entities that hold interests in real estate investment trusts (REITs) and that are used solely for purposes of issuing REIT preferred securities that qualify as Tier 1 capital (REIT Preferred Securities). The minority interests resulting from the issuance of REIT Preferred Securities qualify as Tier 1 regulatory capital of the issuing bank and its parent bank holding company (BHC) under the Risk-Based Capital Guidelines of the Office of the Comptroller of the Currency and the Federal Reserve.[28] Furthermore, under the Basel III framework established by the Basel Committee on Banking Supervision (Basel Committee), minority interests in consolidated subsidiaries, such as the minority interest associated with REIT Preferred Securities, would continue to be eligible for inclusion in the Tier 1 capital of the parent bank and its parent bank holding company, subject to certain limitations.[29] The inclusion of the minority interests in consolidated subsidiaries resulting from the issuance of REIT Preferred Securities in Tier 1 capital recognizes the fact that the securities provide significant loss absorption to banking organization issuers.

Many banks issue REIT Preferred Securities through passive, pass-through trusts that rely on section 3(c)(1) or 3(c)(7), even though the trusts hold only the preferred securities of a REIT entity that itself qualifies for the exclusions in sections 3(c)(5) or 3(c)(6) of the Investment Company Act. The use of a pass-through trust (rather than the REIT entity itself) to issue the REIT Preferred Securities to investors helps improve the marketability of the REIT Preferred Securities by eliminating undesirable tax consequences for foreign investors. Importantly, this structure does <u>not</u> alter the loss absorption benefits of the REIT Preferred Securities, nor does it disqualify the minority interest arising from the issuance of REIT Preferred Securities from inclusion in the organization's Tier 1 capital.

Moreover, these passive, pass-through trusts do *not* exhibit the attributes that ABA believes should define a "covered fund," and therefore, should not be subject to the prohibitions of the Proposed Rules. For example, these trusts (i) exist *only* to provide regulatory capital and loss absorption capacity for the parent banking organization; (ii) have *no* investment gain or loss objective other than to provide income for their investors that depends primarily on cash flows from the assets held by the underlying REIT entities, all of which are assets that the parent banking organization could otherwise hold directly; (iii) do *not* engage in activities that pose

[27] Even if the Agencies carved out joint venture from the definition of "covered fund" or expanded the definition of permissible joint venture to include other arrangements, the joint venture may in certain circumstances still be considered a "banking entity" and subject to the applicable Volcker Rule limitations.

[28] *See* Office of the Comptroller of the Currency, Corporate Decision 97-109 (Dec. 1997); Comptroller's Licensing Manual, Capital and Dividends, p. 13 (Nov. 2007); Federal Reserve, Supplementary Materials Accompanying Final Rule on Risk Based Capital Standards: Trust Preferred Securities and the Definition of Capital, 70 Fed. Reg. 11,827, 11,828 (2005).

[29] *See* Basel Committee on Banking Supervision and Regulation, Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems (Dec. 2010). The regulatory capital treatment of REIT-preferred securities is not affected by the so-called "Collins Amendment" to the Dodd-Frank Act, which provides for the phase-out of trust-preferred securities. *See* 12 U.S.C. § 5371.

material risks to the bank or its BHC; (iv) are *not* designed to be a source of profit for the banking organization; and (v) are *not*, in practice, actively managed.

Credit Funds

In addition to the previously listed funds, the Agencies should explicitly exempt from the definition of "hedge fund" and "private equity fund" partnership vehicles that extend credit of the type banks are authorized to undertake on their own balance sheets. It is critical that the Proposed Rules clarify that these vehicles are not subject to the covered fund restrictions.

Using a fund or partnership structure[30] can create a broader and deeper pool of capital for lending than might otherwise be available by facilitating third-party investments. These structures can also reduce risk for both the bank and the financial system. Additionally, because they have pre-committed capital, these vehicles can extend credit during times of distress and volatility, when other forms of lending are more difficult to secure.

Given banks' role as lenders and the importance of credit extension to a sustained economic recovery, the Proposed Rules should not restrict banks from using credit funds. In light of the rule of construction in Section 13(g)(2) of the BHCA, the statute mandates that the Agencies use their exemptive authority to exclude credit funds from the definition of "hedge fund" or "private equity fund" or to exempt credit funds from the covered fund restrictions. If the Agencies fail to do so, the Volcker Rule would restrict lending on the basis of form rather than function.

C. Expansion of Permitted Investments.

ABA appreciates the Agencies' acknowledgement that SBICs and public welfare investments are "consistent with the safe and sound operation of banking entities, and would also promote the financial stability of the United States." In order to preserve these worthy investments, the Agencies should clarify that certain investments that may otherwise be within the definition of hedge fund or private equity fund – even as narrowly defined as we recommend – are permissible if they constitute an investment in an SBIC or similar fund (as described below) or if they constitute a community development or public welfare investment. The Agencies should also clarify that certain investments are permissible and should also apply their authority under section (d)(1)(J) to exempt the application of Super 23A to transactions with these permitted funds.

Funds That Provide Capital to Small and Middle-Market Companies

The Volcker Rule permits banking entities to continue to invest in and sponsor covered funds that are operated as an SBIC.[31] The Agencies' commentary on this exception notes that permitting SBIC investments would provide valuable funding and assistance to small business, be consistent with the safe and sound operation of banking entities, and promote the financial stability of the United States.[32] The exception for SBICs, however, does not go far enough. Many small businesses and smaller middle market businesses do not meet the criteria to be

[30] These vehicles often rely on the exclusions in sections 3(c)(1) and 3(c)(7) of the Investment Company Act.
[31] 12 U.S.C. § 1851(d)(1)(E).
[32] *See* 76 Fed. Reg. at 68,908.

considered a "small business" in which an SBIC may invest.[33] In addition, even if a fund is established to provide equity capital to SBIC-eligible small businesses, its fund managers may choose not to obtain an SBIC license due to the extended regulatory approval process and the compliance and regulatory costs associated with becoming an SBIC. Further, the size of the SBIC market is but a small fraction of the private equity and venture capital finance market serving small and middle market businesses.[34]

Small and middle market businesses are a crucial underpinning of our economy. Prohibiting banking entities from owning an interest in non-SBIC funds that provide funding to small businesses and smaller middle market businesses will make it much harder for these businesses to raise needed capital and create jobs and will cause unnecessary market disruption. Although under the Proposed Rules banking entities would continue to be able to lend or invest directly in these companies, permitting investments through funds would both encourage investment and promote safety and soundness by allowing banking entities to utilize the fund managers' expertise in identifying the best opportunities and managing the risks of such investments at the local and regional levels.

Subsection (d)(1)(J) of the Volcker Rule provides the Agencies with discretion to permit banking entities to continue to invest in and sponsor a hedge fund or private equity fund if the Agencies find such activities promote and protect the financial stability of the United States and the safety and soundness of banking entities.[35] Permitting banking entities to invest a small portion of their capital in third-party managed funds that provide funding to small and lower middle market companies would satisfy those criteria because the risk of loss to a banking entity and the financial system would be limited. In addition, because the fund would be managed by an unaffiliated third party, the indirect reputational or other risks associated with the investment also would be mitigated. Moreover, providing such an exemption would increase the pool of equity capital available to those businesses, keeping their cost of capital lower than would otherwise be the case, and enhancing the growth and stability of such businesses and the overall U.S. economy.

Community Development and Public Welfare Investments

The Proposed Rules expressly exempt from the Volcker Rule's ownership and sponsorship restrictions investments designed primarily to promote the public welfare and investments in qualified rehabilitation expenditures with respect to a qualified rehabilitation building or certified historic structure.[36] The proposed exemption, however, does not account for community development investments that are made through a variety of investment vehicles to fund and support local and regional development and public welfare projects. For example, community development projects eligible for Community Reinvestment Act (CRA) credit may be structured as a venture capital fund or similar fund. Many CRA/community development investments in fact are structured in this manner (for example, a "fund of funds" or a venture capital community

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[33] *See* 13 C.F.R. §§ 107.700, 121.

[34] From 1994 through 2010, it is estimated that approximately 500 SBICs were licensed and funded with less than $30 billion in committed capital. This compares to an estimated $220 billion in committed capital for the more than 2,200 venture capital and private equity funds estimated to have been established during this same period.

[35] 12 U.S.C. § 1851(d)(1)(J).

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

development fund), which allow banks to meet the particular needs of local communities. The Agencies, therefore, should explicitly designate as permissible all investments that qualify for CRA credit, including direct and indirect investments in a community development fund, SBIC, or similar fund. This would permit the Agencies to continue rulemaking allowing an investment to count toward CRA credit on its own merit, without unnecessarily entangling CRA activity within the Volcker Rule.

D. Definition of "As Principal."

The Agencies should clearly state that when investing in all fiduciary capacities, including as trustee on a charitable trust or for the bank's own employee benefit plan, the bank is *not* acquiring an interest in a covered fund as principal. Language in the preamble of the Proposed Rules[37] misleadingly implies that some acquisitions of "ownership interest" in a covered fund in a fiduciary capacity is an acquisition as "principal" if the bank is investing as trustee of any trust that could be classified as a "company" under the BHCA. The relevant text reads:

> The Agencies note that the general prohibition in §__.10(a) of the proposed rule applies solely to a banking entity's acquisition or retention of an ownership interest in or acting as sponsor to a covered fund "as principal, directly or indirectly." As such, the proposed rule would not prohibit the acquisition or retention of an ownership interest (including a general partner or membership interest) in a covered fund: (i) By a banking entity in good faith in a fiduciary capacity, except where such ownership interest is held under a trust that constitutes a company as defined in section (2)(b) of the BHC Act; … (iii) by a "qualified plan," as that term is defined in section 401 of the Internal Revenue Code of 1956 (26 U.S.C. 401), if the ownership interest would be attributed to a

The confusion arises from the statement that the Proposed Rules do not prohibit an acquisition of a covered fund interest "by a banking entity in good faith in a fiduciary capacity, *except where such ownership interest is held under a trust that constitutes a company as defined in section (2)(b) of the BHC Act*." [Emphasis added.] Under section 2(b) of the BHCA, "company" is defined to include any trust whose term exceeds 25 years (or 21 years, 10 months after the death of the individuals living on the effective date of the trust.[38] A variety of *bona fide* trusts, however, may be deemed a "company" under the BHCA by virtue of not being subject to the rule against perpetuities or other termination event. Many charitable and endowment trusts, for example, are not subject to a defined termination date and make investments in private funds as part of their long-term investment objectives to support their charitable missions. Similarly, most trusts established for pension or benefit plans are not subject to a defined termination date. In addition, many states permit the settlors of a trust to waive the rule against perpetuities for property held in the trust or limit application of the rule against perpetuities only to real property held in trust. Accordingly, a variety of trusts may be deemed a "company" under the BHCA.

[37] 76 Fed. Reg. 68,896.
[38] *See* BHCA § 2(b).

Consequently, the phrase in the preamble above would disrupt the *bona fide* trust and fiduciary activities of banks by prohibiting a bank trustee from investing the trust assets of a covered fund, even where the bank trustee determines that such an investment is consistent with the trust documents and the bank's fiduciary duties, including the duty to diversify the investments of the trust pursuant to state fiduciary laws, such as the Uniform Prudent Investor Act. We do not believe that the Volcker Rule was intended to prevent bank trustees from effectively meeting their trust and fiduciary obligations to customers.

E. Definition of "Directed Trustee."

Under section __.10(b)(6) of the Proposed Rules, directed trustees are excluded from the definition of "sponsor" of a covered fund. While the Agencies are correct to distinguish directed trustees from trustees that exercise investment discretion, the scope of directed trustee needs to be expanded. The Proposed Rules refer only to section 403(a)(1) of the Employee Retirement Income Security Act to define the scope of directed trustee but omit other similar custodial or administrative arrangements that may not meet those requirements. For example, in some foreign jurisdictions, a "directed trustee," essentially a custodian of a fund, may have the limited authority under foreign law to provide certain fiduciary or administrative services that do not involve the exercise of investment discretion. The Proposed Rules, therefore, should expand the definition of "directed trustee" to include any situation in which a banking entity serves solely in a directed, fiduciary, or administrative role in situations where a third-party exercises investment discretion.

F. Limitations on Ownership in Hedge Funds and Private Equity Funds.

ABA believes that without refinement, the ownership limitations proposed in Section __.12 would create perverse investment incentives, unduly restrict worthwhile and economically useful investments, and may put the banking entity in an irreconcilable position as a fiduciary. We urge the Agencies to adopt these recommendations to address those concerns.

Cost Basis Valuation of Three Percent Interest
Under the Proposed Rules, banking entities should be allowed to value investments permitted under the "customer fund" exception on a cost basis rather than a fair value basis. Accounting rules require fair value so shareholders can see unrealized gains and losses. If banks were required to use the same method to account for their three percent of Tier 1 capital limits, then they would effectively be penalized for making profitable investments (because such investments increase in value) while allowing banking entities to retain poorly performing investments (because such investments decrease in value). It also could force a banking entity into non-compliance simply because an investment performed well.

The Agencies should allow banks to choose between cost and net asset value (NAV) regardless of what is required by Generally Accepted Accounting Principles (GAAP), similar to the SEC's approach to the "20 percent non-conforming basket" in its definition of a venture capital fund for the exemption to investment advisor registration. The basket would be determined either on a cost basis or NAV at the fund manager's discretion, as long as a particular valuation method is consistently applied (*i.e.*, no switching back and forth between valuation methods).

Timing of Calculation of the Three Percent Investment Limitation
Section __.12(b) of the Proposed Rules describes how a banking entity should track and calculate the amount of its ownership of a covered fund. In particular, subsection (b)(3) states that a banking entity's ownership in a covered fund "may *at no time* exceed the limits in this paragraph after conclusion of" the 12-month seeding period, suggesting the undertaking of a burdensome, daily calculation.[39]

ABA urges the Agencies to clarify that the compliance calculations for all funds should be done quarterly, assuming there are no new acquisitions. For funds that do not calculate their value daily, the preamble states that the calculation would be done at least quarterly – this requirement itself should be incorporated into the Proposed Rules. Even for funds that have a daily valuation, a daily calculation to assure conformance would be unduly burdensome and costly. A daily calculation would not justify the benefits and would be generally inconsistent with the way the Investment Company Act imposes investment restrictions, which is at the time of acquisition.

Attribution and Inclusion Rules for Calculating the Three Percent Investment Limitation
The Proposed Rules in Section __.12 impose certain attribution rules for purposes of calculating the three percent *de minimis* investment limitation. These proposed rules require the banking entity to include ownership interests in a covered fund by *any* entity that is "controlled" by the banking entity, as well as the *pro rata* share of any ownership interest held by a covered fund that it does not control of which the banking entity owns more than five percent of the voting shares. In other words, the banking entity may have to include investments held by controlled and non-controlled covered funds, as well as other "controlled" pooled investment vehicles that are offered to fiduciary customers. In addition, Section __.12(b)(2)(ii) requires that any investment that the banking entity is contractually obligated to invest in alongside a sponsored covered fund (*i.e.*, parallel investments) be included in the ownership interest in the covered fund.

The Agencies should not apply these restrictive and harmful attribution and inclusion rules for the purpose of meeting the three percent investment limitation. There is no basis in the statute for this approach – Section 619 simply states that the *banking entity* may not have more than three percent total ownership in any single fund, nor more than three percent of Tier 1 capital invested in all hedge funds and private equity funds.

Instead of promoting the banking entity's safety and soundness, as Proposed Rules would put the banking entity in a conflicted position in which its fiduciary activities and duty to its shareholders may be at odds. When making fiduciary decisions while managing *client* funds, a fiduciary must base its decisions on the merits of the investment from the perspective of the fiduciary client. The situation under the Proposed Rules, however, would unacceptably restrain the fiduciary in fulfilling its duty to the beneficiaries. Similarly, when a BHC is making legitimate investments pursuant to its merchant banking authority, its obligations to its shareholders should not be restricted. Not only would including these two situations in the aggregated total create irresolvable conflicts of interest for the BHC, but Section 619 itself does

[39] *See* Proposed Rules § __.12(b).

not require them to be aggregated into the calculation because they do not constitute, as Section 619 requires, an investment by the banking entity in a hedge fund or private equity fund.

For all the reasons above, ABA recommends the following:

- Limit the attribution rule to investments made by subsidiaries or affiliates that are "banking entities," and not include investments made by covered funds organized and offered or sponsored under the asset management exception, or other pooled investment vehicles that are offered and managed for fiduciary customers.

- Impose the *pro rata* attribution rule only on investments held through companies in which a banking entity holds a controlling interest of 25 percent or more of voting shares; and

- Permit a banking entity to calculate its *de minimis* co-investment for a parallel fund structure with reference to the aggregate fund structure rather than any individual entity, and, unless a pattern of evasion is found, do not attribute to a banking entity a parallel co-investment alongside a sponsored covered fund.

Aggregate Investment Limit and Capital Deduction
Section__.12(d) of the Proposed Rules would require that a banking entity deduct from its Tier 1 capital the aggregate value of all investments made in covered funds under §__.12. This deduction should apply only for purposes of determining whether the banking entity's aggregate investment in §__.12 permissible funds is in compliance with the 3 percent of Tier 1 capital limit in §__.12. It should not apply for other regulatory capital purposes. Furthermore, the regulatory capital rules apply to an organization's consolidated balance sheet and, thus, a risk-weight or capital deduction normally is not required for assets that are not reflected on the bank's consolidated balance sheet. Similarly, no deduction under §__12(d) should be required for covered fund investments that are held by an entity that is not consolidated with the banking entity for financial reporting purposes under GAAP.

Such an approach is consistent with the Agencies' indication that a banking entity's aggregate investments made in funds permitted under §__.12 should be determined "in accordance with applicable accounting standards." Because covered fund investments held by entities that are not consolidated with the banking entity for financial reporting purposes do not appear on the entity's GAAP balance sheet, the Agencies should clarify that this means that covered fund investments held by such unconsolidated entities do not count toward the banking entity's three percent aggregate capital limit.

Collateral Interest in Covered Funds
Section __.14(b) permits acquisition of an ownership interest in a covered fund if it occurs in the ordinary course of collecting a debt previously contracted in good faith. Thus, a bank can foreclose on a borrower's ownership interest in a covered fund. It is not clear, however, whether the bank could accept a collateral interest in the covered fund at the inception of the debt/loan when the bank is the sponsor of the covered fund. Section __.14(b), therefore, should be

clarified to permit also the acceptance of a collateral interest in a covered fund in connection with a loan to third-party bank customers.

If the Proposed Rules are not clarified as referenced above, banks would be in the illogical position of being able to foreclose on a borrower's interest in a covered fund but not able to take a security interest in such interest at the inception of the applicable loan. This leaves banks in the untenable position of either avoiding such loans altogether, or making unsecured loans.

To address these situations, we suggest the following changes to Section __.14(b):

> The prohibitions contained in __.10(a) and __.16(a) do not apply to the acquisition or retention by a covered banking entity of any ownership interest in, security interest in, or acting as sponsor to, a covered fund, but only if such ownership interest or security interest is acquired or retained by covered banking entity (or an affiliate or subsidiary thereof):
>
> (i) In the ordinary course of securing a debt, or collecting a debt previously contracted in good faith, if the covered banking entity divests the ownership interest within applicable time periods provided for by the [Agency];

Naming Restrictions for Covered Funds
The Agencies should only prohibit covered funds from sharing the name of the insured depository institution with which it is affiliated or from using the word "bank" in its name. Without this reasonable approach, banks would lose tremendous intellectual capital and market reputation from having to abandon names that they and their affiliates have marketed, developed, and spent significant resources on over the years. We strongly believe there is very little incremental benefit to the public from prohibiting names that are a slight variation of the sponsoring entity's name. In fact, changes to these names would likely only add to customer confusion.

G. Application of Section 23A of the Federal Reserve Act.

The Volcker Rule includes restrictions on affiliate transactions through the enactment of so-called "Super 23A," which prohibits banking entities from entering into any transaction with a hedge fund or private equity fund if the transaction would be a "covered transaction" under Federal Reserve Act Section 23A. Under the Proposed Rules, however, the term "covered transaction" fails to incorporate the exceptions the Federal Reserve has thought appropriate to make available for certain affiliate transactions under Section 23A and the Federal Reserve's Regulation W. Without those essential exceptions to the term "covered transaction," banks may be limited or prohibited from providing routine settlement services to the covered funds they sponsor. For example, a bank providing custody to a covered fund may be limited in providing intra-day or overnight overdrafts to facilitate securities settlement, contractual settlement, pre-determined income, or similar custody-related transactions. These custody-related transactions do not pose a risk of undue credit support for sponsored and advised funds, and in fact without this requested relief, there will be more risk injected into the settlement process for a bank's sponsored funds, thereby increasing the bank's own risk and disrupting the settlement process.

Unless the Agencies provide the necessary relief, affected banking entities would not be able to provide normal custody for their covered funds. As a result, sponsors and advisers of "covered funds" could be required to seek new providers of these services, creating market disruption and higher risk to payment systems, with no corresponding systemic or institution specific risk reduction benefits.

IV. Proprietary Trading.

The scope of the proprietary trading prohibition focuses on the meaning and operation of a "trading account." The Proposed Rules' overbroad definition of "trading account," however, would cause traditional bank activities important for safety and soundness to fall within the prohibition on proprietary trading to the detriment of banking organizations, customers, and financial markets. This definition, therefore, should be narrowed extensively and activities that are important to the safety and soundness (liquidity and asset-liability management (ALM) activities) of banking institutions should be carved out entirely.

A. Definition of "Trading Account."

Market Risk and Status Prongs

The statutory text of the Volcker Rule defines "trading account" as "any account used for acquiring or taking positions in [covered financial positions] principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)" and other accounts determined to be "trading accounts" by the Agencies.[40] The Proposed Rules, however, expand on the statutory text by creating a three-pronged approach. The first prong, the "purpose test," follows the statutory language most closely. The second and third prongs, the "status test" and "market risk capital rule test," are unnecessary and unhelpful additions that go beyond the requirements of Section 619 and serve only to make the trading account determination needlessly more complex and difficult. As a result, ABA believes the definition of trading account should consist only of the purpose test (as modified below).

We are also concerned that the language of the market risk capital rule test relies on *proposed* revisions to the market risk capital rules, as opposed to a final rule.[41] Basing the trading account definition in part on a proposed, rather than final, market risk capital rule, makes it impossible adequately to duly consider and comment on the effect that the test might have. In addition, the

[40] *See* BHCA § 13(h)(6).

[41] The federal banking agencies' respective market risk capital rules are at 12 C.F.R. § 3, Appendix B (OCC); 12 C.F.R. § 208, Appendix E and 12 C.F.R. § 225, Appendix E (Federal Reserve); and 12 C.F.R. § 325, Appendix C (FDIC). In January 2011, the Board, the FDIC and the OCC proposed substantial amendments to the MRC rules that would largely implement Basel II.5 in the United States. *See* OCC, Federal Reserve, and FDIC, Risk-Based Capital Guidelines: Market Risk, 76 Fed. Reg. 1890 (2011). The Agencies indicated, in the Notice of Proposed Rulemaking, that the prong of the trading account definition relying on the MRC rules is premised on the MRC rules as proposed to be revised and that, if those revisions are not adopted, "the Agencies would expect to take that into account in determining whether or how to include the proposed second prong of the trading account definition . . . ." 76 Fed. Reg. 68,846, 68,859.

Basel Committee is currently conducting a fundamental review of the market risk framework out of which substantial changes to the market risk framework could emerge. As an international body, the Basel Committee will not likely consider how changes to the market risk framework will impact the Agencies' implementation of the Volcker Rule. As a result, the market risk capital test injects substantial uncertainty into the trading account definition. We therefore urge the Agencies to remove this prong.

In addition, the status test itself is overbroad and, as mentioned above, does not accord with the statutory definition of "trading account." The Agencies note in the Proposed Rules that the status test reflects the fact that dealers typically enter into positions with short-term intent. However, this is not always the case. Moreover, to the extent that dealers enter into covered financial positions with short-term intent, those positions will be included in the trading account through the modified purpose test, making the status test unnecessary. ABA, therefore, urges the Agencies to likewise remove the status test from the definition of trading account.

"Trading Account" as Sum of Trading Positions

Trading account is defined to include "accounts" that have a position that fails one of the three prongs of the trading account definition. However, it is unclear what an "account" is for the purposes of the Volcker Rule. Arguably, it intends to capture the "booking account." If this belief is correct, under the Proposed Rules, a single trading position within a booking account could taint the entire account. For example, if a booking account had nine long term positions and one position that falls within the purpose test, then all ten exposures in the booking account would be captured by the trading account definition. We urge the Agencies to limit the trading account to the *positions*, as opposed to the accounts, that trigger the trading account definition. In the example of a booking account that has nine long term positions and one position that falls within the market risk rule, only the one exposure that falls within the purpose test should be captured by the trading account definition.

"Purpose Test," Rebuttable Presumption, and GAAP Trading Classification

The purpose test includes a presumption that any covered financial position that is held for 60 days or less is a trading account position. This presumption has no statutory basis and is inconsistent with the legislative intent of the trading account definition. Moreover, if the definition of trading account is a position-based definition (see above), the rebuttable presumption would be unworkable since the triggering position would already be sold. Faced with a position held for 60 days or less, a covered bank will be required to meet the high hurdle of rebutting the presumption by showing, "based on all the facts and circumstances, that the covered financial position, either individually or as a category, was not acquired or taken *principally* for any of the purposes described in [the purpose test]." It is unclear how "principally" will be interpreted and how to rebut this presumption using evidence, and even less clear how the Agencies could apply this facts-and-circumstances based language to make consistent determinations. This creates an unnecessary and inappropriate burden for the covered bank and may interfere with liquidity and ALM activities should the transaction falls outside the liquidity exclusion. The rebuttable presumption casts such a wide net that it could even ensnare warrants and convertible loans under the general prohibitions on proprietary trading.[42]

Under the Proposed Rules, the Agencies have all the regulatory tools necessary to determine which positions fall within the Volcker Rule's ban without resorting to a laborious and artificially constrained construct. Therefore, we request that the Agencies to remove the rebuttable presumption.

We further request that the Agencies use accounting classification as a limiting factor within the purpose test. Specifically, a covered financial position should not be considered a trading account position if it would not otherwise qualify as a GAAP trading position. A GAAP trading position, however, would have to meet the Volcker Rule's "purpose test" before being labeled also as a Volcker Rule trading account position.[43] Using the GAAP trading classification in this way would help clarify the scope of the Volcker Rule and create a safe harbor for available-for-sale and held-to-maturity securities.

B. Asset Liability Management and Liquidity Activities.

Explicit Exclusion for ALM

ALM is at the heart of bank safety and soundness and is essential to the stability of the U.S. and global financial systems. Banking organizations engage in ALM in order to manage a variety of risks that arise from the business of banking, including risks posed to the value of their assets (such as loans) and liabilities (such as deposits) and to net interest income as well as to manage liquidity, market, credit, foreign exchange, and interest rate risks. ALM activities therefore advance, rather than detract, from Congress's objective of reducing risk and enhancing bank safety and soundness.[44] ALM transactions are not entered into "principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements)"[45] and therefore should fall safely outside the statutory prohibition on proprietary trading.

Unfortunately, the Proposed Rules' expansive definition of trading account would cause important ALM activities to fall within the prohibition on proprietary trading. In particular, under the Proposed Rules, any account used to make trades not held for at least 60 days will be

[42] In these types of transactions, holders typically realize the instrument's value in two steps. First, they exercise the warrants or convert the convertible loans and thereby acquire the underlying securities. Second, they sell the underlying securities, typically immediately upon acquisition, for cash. The holder's intent is to realize the long-term gain in the value of the warrant or the convertible loan rather than to make small profits on the short-term price fluctuations of the underlying securities. However, if regulators only focus on the second step, *i.e.*, the sale of the security, rather than the transaction as a whole, these transactions could fall within the prohibition.

[43] This is because under GAAP certain positions may have to be classified as trading securities even if the banking entity does not intend to sell the position in the near term. Such positions include those that have an embedded option (e.g., a prepayment option) if the holder cannot determine that it will recover all or substantially all of the value of the position (including any option premium) prior to maturity or disposition.

[44] *See* 12. U.S.C. § 1851(b)(1)(A) (requiring the FSOC to make recommendations on implementing the Volcker Rule so as to "promote and enhance the safety and soundness of banking entities").

[45] *See* 12 U.S.C. § 1851(h)(6). At the time an ALM transaction is entered into, it may be the case that the position is expected to be resold in the near term. However, the *purpose* of an ALM transaction is not short term resale; rather the purpose is to prudently manage the banking organization's risks, as described in this letter.

presumed to be a trading account; further, accounts used to take "covered positions" as defined under the proposed market risk capital rules of the Federal Reserve, OCC, and FDIC (with limited exceptions) will also be trading accounts. In order to manage effectively the risks that arise in the ordinary course of a bank's business of serving its customers (for example, asset and liability mismatches), ALM activities may involve entering and exiting a position within 60 days or taking "covered positions." As a result, many *bona fide* ALM activities would fall within the prohibition on proprietary trading, unless there is an exemption for these activities or the account used to conduct these activities falls under an exclusion from the Proposed Rule's definition of trading account.

In the Proposed Rules, the only exemption that generally touches upon ALM activities (and not just transactions involving specific types of instruments, such as U.S. Treasury or agency securities) is the exemption for risk-mitigating hedging transactions, and the only exclusion that generally touches upon ALM activities (and not just specific types of transactions, such as repurchase/reverse repurchase agreements and securities lending/borrowing transactions) is the exclusion for *bona fide* liquidity management. We are concerned, however, that neither the exemption nor the exclusion will be sufficient for a wide range of ALM activities.

The exemption provided in the Proposed Rules for risk-mitigating hedging activities would not be available for many *bona fide* ALM hedging activities because of the following imposed requirements:

- the requirement that risk-mitigating hedges relate to risks to which a banking organization is "already exposed";

- the requirement that hedges not earn "appreciably more profits" than a banking organization stood to lose on the related hedged position;

- the requirement that hedges be "reasonably correlated" to the risk being hedged; and

- the requirement that hedges not give rise to "over-hedging" or "significant exposures that were not already present" in the underlying position.

More importantly, regardless of whether a particular ALM transaction in fact ultimately qualifies for the risk-mitigating hedging exemption in the Proposed Rules, it will often be impossible for risk managers to know at the outset of a transaction whether it falls within the exemption because of the uncertainty created by the foregoing requirements and the fact that a risk manager's judgment will always be susceptible to an after-the-fact review by one or more of the Agencies.

This uncertainty is magnified by the proposed use of Value at Risk (VaR) based measures to monitor whether *bona fide* ALM activities fall within the exemption for risk-mitigating hedging. The application of VaR measures to ALM activities is generally inappropriate and would generate numerous false positives.

Similarly, the *bona fide* liquidity management exclusion from the definition of trading account also is too restrictive to accommodate many *bona fide* ALM activities that pertain even to the narrow goal of liquidity risk management. Especially problematic are the exclusion's requirements that (i) liquidity positions be limited to an amount consistent with the banking organization's "near-term" funding needs, be "highly liquid," and not give rise to "appreciable profits,' and (ii) the liquidity management plan specifically authorize the circumstances in which a particular instrument may or must be used.

In view of the foregoing limitations of the risk-mitigating hedging exemption and the liquidity management exclusion as applied to *bona fide* ALM activities, ABA urges the Agencies to replace the exclusion provided for *bona fide* liquidity management activities with an exclusion that would cover transactions in covered financial positions that further a banking organization's *bona fide* ALM activities (which include, but are not limited to, transactions in furtherance of *bona fide* liquidity management activities). ABA's proposed exclusion would, among other things, require, in furtherance of the *bona fide* criterion, that (i) any such transactions be conducted pursuant to a documented ALM policy, (ii) appropriate compensation limitations apply to persons serving in the ALM function, (iii) a compliance and audit regime designed to ensure compliance with the Volcker Rule is established, and (iv) the day-to-day management of the ALM function is separate from the day-to-day management of non-ALM trading functions (for example, permissible market-making and underwriting activities).

Liquidity Management Exclusion
We strongly support the concept of a liquidity management exclusion. Banks often use their investment portfolios as liquidity buffers in their asset-liability management operations, and such activities serve important safety and soundness objectives. ABA is concerned, however, that the scope of the exclusion captures only a fraction of a bank's liquidity management activities, the remainder of which could be prohibited by the Volcker Rule as proprietary trading.

The Proposed Rules exclude from the definition of trading account activities taken for "*bona fide* liquidity management" pursuant to a documented liquidity management plan that: (1) authorizes each instrument that can be used for liquidity management and the circumstances under which it can be used, (2) requires all liquidity activities to be principally for the purpose of liquidity management, (3) requires any liquid position to be highly liquid and limited to financial instruments the market, credit, and other risks of which the covered bank does not expect to give rise to appreciable profits or losses as a result of short term price movements, (4) limits the size of any liquid position to one that is consistent with the bank's "near term funding needs" which must be estimated and documented under the plan, and (5) is consistent with supervisory requirements, guidance, and expectations regarding liquidity management.

The conditions enumerated below needlessly circumscribe a bank's ability to manage liquidity as described herein.

Near-term funding needs: Limiting the use of short-term securities to filling the "near-term funding needs" of a bank ignores the need to manage both on- and off-balance-sheet assets normally and during times of stress. In order to manage liquidity prudently, banks must consider not only the near-term, but also longer periods of exposure such as a year or more. The federal banking agencies have recognized this, requiring banks to "ensure that their vulnerabilities to changing liquidity needs and liquidity capacities are appropriately assessed within meaningful time horizons, including intraday, day-to-day, short-term weekly and monthly horizons, mediumterm horizons of up to one year, and longer-term liquidity needs of one year or more."[46] Credit rating agencies likewise evaluate the liquidity of banking institutions over a long term period; for example, at least one credit rating agency currently requires at least 18 months of liquidity funding.

In contrast, the Proposed Rules allow a banking entity to buy and sell covered financial positions only to meet short-term liquidity needs. The result renders the Proposed Rules inconsistent with current regulations, practices, and Basel III initiatives, all of which are aimed at stabilizing the banking sector throughout a sustained liquidity crisis. We urge that the exception for "near-term funding needs" reflect a longer time horizon, such as a year or more, in order to avoid undermining banks' and federal regulators' efforts to ensure adequate management of liquidity.

Highly liquid assets: The exception fails to recognize that current liquidity management practices prudently use securities that may not be "highly liquid," as it requires. Existing guidance naturally requires a bank's cushion to be comprised of liquid securities, but those securities generally include commercial paper, certificates of deposit, short-term loans, interbank deposits, Fed Funds, and more, in addition to highly liquid securities. This broader group of securities are liquid investments that are effective in supporting the stability of a bank.

Restricting the exception to the highly liquid subset of such investments neither supports the purpose of prohibiting trading for short-term profit nor supports liquidity management. First, the degree of liquidity alone does not reflect a short-term profit motive. Second, the liquidity of instruments can change due to market fluctuations, introducing uncertainty as to the application of the exception. Third, limiting investments to highly liquid securities would negatively impact a bank's flexibility during times of excess liquidity, or, alternately, prevent liquidity from re-circulating throughout private credit markets during times of scarce liquidity. Fourth, as issuers of commercial paper and other securities, banks should not be constrained from purchasing such instruments as part of their liquidity management strategy, because that would in turn be detrimental to their capital and funding management strategies. Fifth, this unnecessary limitation may not mesh with liquidity management requirements of U.S. bank branches located in foreign jurisdictions. Finally, while an overly restrictive requirement to manage liquidity using "highly liquid" investments does not prevent for-profit trading, diversification in liquidity management enhances safety and soundness.

Give rise to appreciable profits or losses: Requiring that investment for the purpose of liquidity management not "give rise to appreciable profits or losses" adds uncertainty and subjects the Proposed Rules to differing applications based on market fluctuations. Just as the degree of liquidity does not alone reflect a profit motive, the degree of resulting profit itself is not a material indicator of profit motive. Using this unreliable metric will instead undermine liquidity management. Attempting to determine the profit associated with an individual transaction to apply this exception will render liquidity management unpredictable. The only natural result will be to chill investment that is otherwise prudent. Moreover, liquidity management is not done in isolation but is managed in connection with the balance sheet.

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[46] Office of the Comptroller of the Currency; Board of Governors of the Federal Reserve System; Federal Deposit Insurance Corporation; Office of Thrift Supervision; and National Credit Union Administration, "Interagency Policy Statement on Funding and Liquidity Risk Management" 75 Fed. Reg. 13,656, 13,663 (2010).

Chilling and penalizing investments that result in a strong rate of return, for example, does not enhance safety and soundness when the bank is viewed as a whole. Rather, the exception should support predictable and effective liquidity management in the broader context of bank management.

Specifically…authorize…the circumstances in which the particular instrument must be used: Bank management cannot adequately address changing circumstances that affect liquidity management and capital assets if its liquidity management plan must "specifically…authorize …the circumstances in which the particular instrument may or must be used." Needless to say, the banks and federal banking agencies encourage formulation and documentation of liquidity management plans and procedures, and there is much guidance thereon. Generally, practice accepts that these plans will accommodate changes that reflect the dynamic market for liquid securities as well as the general economic health of the nation and world. In addition, changes may occur in legal funding requirements in other jurisdictions or simply in the availability of funding in wholesale markets globally. Management must continually monitor and respond to new information in order to carry out properly its task of ensuring sufficient liquidity. In light of the broader context of liquidity management, it is evident that expecting a liquidity management plan to specify the "circumstances in which [a] particular instrument may or must be used" will undermine effective management and add nothing substantive to existing guidance. Permitting bank management flexibility will promote safety and soundness, while current guidance (and guidance anticipated from Basel III) will ensure that liquidity management plans are prudent and serve the intended purpose.

As discussed above, ABA urges the Agencies to replace the exclusion provided for *bona fide* liquidity management activities with an exclusion that would cover transactions that are in furtherance of a banking organization's *bona fide* ALM activities. Such exclusion should not have the same limiting factors contained in the Proposal's *bona fide* liquidity management exclusion. Instead, the *bona fide* ALM exclusion should be broad enough to cover all of a bank's liquidity management activities.

C. Permitted Hedging Exception.

ABA supports excluding risk mitigating hedges from application of the Volcker Rule. In particular, we support the exemption from the prohibition on proprietary trading for risk-mitigating hedging activities in connection with aggregated positions.

We disagree, however, that proper risk mitigating hedges should be prohibited if the hedge results in appreciable profits. It is not necessary to cast doubt on proper hedging transactions based on whether they might, over the duration of the hedge, generate profits. Rather, the proper focus should be on (i) the purpose for entering into the transaction; and (ii) whether the hedge is correlated to the underlying risks being hedged (in other words, whether the hedge is *effective* in mitigating risk).

We also disagree with the requirement that permitted hedging cannot give rise to "significant risks at inception." This requirement does not appear to recognize that all hedging activity subjects the bank to new, possibly significant risks. We note that the preamble acknowledges that hedging transactions “will inevitably give rise to certain types of new risk…”; however, this language is not reflected in the Proposed Rules’ text. We encourage the Agencies to acknowledge, in the rule text, that permitted hedging can give rise to significant risk.

Finally, ABA interprets the Proposed Rules as creating a safe harbor for hedging positions that satisfy FAS 133 hedging activity accounting standards. We are supportive of this approach, because it will reduce burden by allowing banks to use a single set of monitoring and compliance programs. ABA would appreciate confirmation of this view.

D. Market Making.

In addition to the views expressed on market making in other letters submitted by ABA jointly with other financial trade associations, ABA would like to emphasize that not all banks that make markets for fixed-income securities stand ready to buy and sell all fixed-income securities. For example, some banks will only purchase securities that they feel are suitable for their retail and institutional customer base. ABA is concerned that the requirement for a bank to “hold[] itself out” as being willing to buy and sell securities in section __.4 (b) could be construed narrowly to include only banking entities that provide a very broad swath of market liquidity. If so, banks that provide limited liquidity by buying securities that are suitable only for their customer base could find themselves prohibited from this activity. In order to avoid unduly restricting bank activities, we request confirmation that a bank is “holding itself out” when it buys and sells these securities that are suitable for its customers.

E. Municipal Securities.

The Proposed Rules, as drafted, would permit a bank to trade only in “obligation[s] of any State or political subdivision thereof.”[47] Thus, the Proposed Rules would *not* appear to allow banking entities to trade in the wide range of tax-exempt municipal securities that are issued by agencies or instrumentalities of a State or local government, or that are guaranteed by a State or local government, agency, or instrumentality.

We believe the exception in section 13(d)(1)(A) of the BHCA was intended to encompass the wide range of tax-exempt securities that are issued or guaranteed by State or local governments, or by the agencies and instrumentalities of those governmental bodies. Otherwise, the Volcker Rule would limit an important source of liquidity for thousands of issuers of tax-exempt municipal debt—an outcome that Congress likely did not intend. Reduced liquidity would raise the financing costs for these issuers and, ultimately, increase the cost and reduce the availability of a wide range of government or government-supported services. Reduced liquidity would also have the unintended consequence of lowering the value of outstanding municipal securities that did not qualify for the unduly narrow exception in the Proposed Rules.

For these reasons, we believe that the Agencies should modify the Proposed Rules to allow banking entities to trade in any security that qualifies as a “municipal security” under the

[47] Proposed Rules at §__.6(a)(1)(iii) and (2).

Securities Exchange Act of 1934.[48] This would allow banks to continue to provide liquidity for securities that are (i) 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 (ii) tax-exempt industrial development bonds (as defined in section 103(c)(2) of the Internal Revenue Code). Importantly, trading in such securities does not pose any special safety and soundness risks to banking organizations—a fact recognized by Congress in 1999 when it authorized well capitalized national banks to underwrite and deal in, without limit, general obligation, limited obligation and revenue bonds issued by or on behalf of any State, or any public agency or authority of any State or political subdivision of a State.[49]

V. Compliance Program Requirements.

In discussing compliance requirements, we note at the outset that banks already are subject to the full range of regulation and supervision regarding their trading and investment activities. These activities furthermore are continually supervised and regularly examined. Regulatory tools can and should be effectively leveraged, rather than duplicated, in implementing the Volcker Rule. This embodies what the Administration and Congress both refer to as "smart" regulation. Consequently, the Agencies should strive to integrate Volcker Rule compliance into the *existing* regulatory framework, cultivating an efficient, effective implementation of the Proposed Rules without interfering with the business of banking or interrupting the provision of banking services to customers.

A. Banking Entities Not Engaged in Proprietary Trading or Covered Fund Activity.

The Proposed Rules institute "tiers" of compliance levels for banking entities based on the volume of trading and covered fund activity. In doing so, the Agencies require that every bank alter its existing compliance programs, policies, and procedures to accommodate the requirements of the Volcker Rule, even if the banking entity does not engage in any such activity. This imposes substantial start-up and ongoing financial and human resource costs on the vast majority of banking entities that will engage in little or no proprietary trading or covered fund activity. Moreover, the absence of clear boundaries between permissible and impermissible proprietary trading and covered fund activity means that, despite fully incorporating "measures" into its compliance program that is designed to prevent Volcker Rule-related activity, a banking entity still may not know if or when a single, lone trade is permitted or prohibited by the Proposed Rules.

The Proposed Rules, therefore, should be modified to exempt banking entities entirely from coverage under the Volcker Rule if such banking entities do not engage in proprietary trading or covered fund activity. Similarly, banking entities required to establish enhanced compliance

[48] *See* 15 U.S.C. § 78c(a)(29). We believe the Agencies have the authority to interpret the exception in 12 U.S.C. § 1851(d)(1)(A) in this manner. However, section (d)(1)(J) of the Volcker Rule also provides the Agencies the authority to ensure that banking entities may continue to provide liquidity to all issuers of tax-exempt municipal securities in light of the important public benefits provided by such activities.

[49] *See* 12 U.S.C. § 24(Seventh).

regimes due to trading/investment volumes should no longer be required to do so if they fall below the relevant dollar threshold. This would substantially save on costly compliance while still placing such activity squarely within the purview of the supervisory and examination process, thus preserving financial safety and soundness. Specifically, if a banking entity were found to have inadvertently engaged in such activity, the agency, pursuant to Section __.21(a) of the Proposed Rules, may grant the banking entity such time to divest such holdings or investments in order to avoid coverage under the Volcker Rule. As stated above, defining key terms such as "trading account," "hedge fund," and "private equity fund" in a manner that provides certainty on their meaning would further assist compliance departments and bank examiners alike in monitoring and detecting impermissible proprietary trading and covered fund activities.

B. Phase-In of Compliance Requirements.

It is not appropriate nor feasible to require a banking entity to have in place by July 21, 2012 a program to ensure compliance with the Proposed Rules when finalized. All banking entities will need a sufficient period of time *after* final regulations are adopted in order to implement a workable compliance plan. This will include adequate time to: (i) assess the terms and requirements of the final regulations, (ii) develop an implementation plan for a program that is appropriate to the nature, scope, and complexity of the banking entity and its covered trading and fund activities, (iii) obtain necessary internal approvals, and (iv) implement the program.

Requiring a banking entity to have in place on July 21, 2012, all aspects of its Volcker Rule compliance program also is inconsistent with the automatic two-year period that Section 619 itself provides banking entities to bring their activities and investments into compliance with the requirements of the Volcker Rule.[50] It would seem illogical to believe that Congress intended banking entities to have fully developed compliance programs in place on July 21, 2012, when the statute itself does not require banking entities to be in full compliance with the Volcker Rule's substantive restrictions until July 21, 2014, at the earliest.

C. Dollar Threshold for Trading Assets and Liabilities.

ABA urges the agencies to raise substantially the proposed $1 billion threshold for trading assets and liabilities in §__.20(c)(2) and Appendix A, Part I, to well beyond $10 billion, for several reasons. First, the costs of establishing and maintaining the detailed and extensive "programmatic" compliance program required by Appendix A, and the trading reporting and recordkeeping requirements in Appendix A, are substantial. Second, even if the minimum dollar threshold were raised to $10 billion, an overwhelming percentage of the trading assets and liabilities in the banking industry would still remain subject to the heightened compliance and reporting requirements of Appendix A and Appendix C. Within the banking industry, trading assets and liabilities are heavily concentrated at the largest, most complex banking organizations. Finally, the 10 percent asset threshold included in the Proposed Rules would continue to ensure that *any* banking entity that had aggregate trading assets and liabilities that constituted a significant percentage of the entity's overall assets would continue to be subject to the heightened compliance requirements in Appendix C.

[50] *See* 12 U.S.C. § 1851(c)(2).

D. Covered Fund Thresholds.

We also believe that the $1 billion thresholds on covered fund investments and assets in §__.20(c)(2)(ii) should *not* include the amount of investments in, or assets of, funds that (i) are SBICs or similar funds that support small businesses or community development projects; (ii) are designed primarily to promote the public welfare of the type permitted by 12 U.S.C. § 24(Eleventh), such as investments and funds that qualify for low-income housing tax credits (LIHTC) or New Markets Tax Credits (NMTC); or (iii) qualify for Federal historic tax credits (HTC) or similar state HTC programs.

Investments in, and sponsorship of, each of these types of funds is expressly permitted by the statute itself[51] precisely because of the substantial public benefits associated with these types of investments and funds. For example, SBICs and similar funds provide funding to our nation's small businesses. Funds that are designed primarily to promote the public welfare provide financial support for, among other things, affordable housing for low- and moderate-income individuals, small businesses that are located in low- and moderate-income areas or areas targeted for redevelopment, and community development financial institutions.[52]

Including these investments and funds in the dollar thresholds that trigger the programmatic compliance requirements of Appendix C, however, provides banking entities a powerful disincentive to invest in, or sponsor, SBICs and similar funds, public welfare funds, or HTC funds if doing so could cause the organization to become subject to these extensive requirements. We believe such a result would be inconsistent with the purposes of the statutory exceptions for these types of funds.

We also believe that *existing* investments in, and relationships with, a covered fund that a banking entity is required to divest or terminate under the Proposed Rules should *not* count toward the dollar thresholds that trigger compliance with Appendix C. It would be incongruous for the rules to require a banking entity to develop and implement the extensive programmatic compliance regime mandated by Appendix C simply as a result of investments in, or other relationships with, a covered fund that the banking entity is required to divest or terminate under the Volcker Rule. If such were the case, a banking entity may well be required to implement these compliance requirements only to see its obligation to maintain such a compliance regime disappear during the very same conformance period that Section 619 explicitly gave the banking entity to bring its investments and activities into compliance with the Volcker Rule's restrictions.

E. Compliance Metrics.

Metrics that are flexible and can account for different types of activities and asset classes could be useful in helping the Agencies determine whether a reporting trading unit's activities are impermissible proprietary trading. We believe, however, that the Spread Profit and Loss, VaR Exceedance, and Pay-to-Receive Spread Ratio metrics are fundamentally flawed and should be removed from the list of required metrics. Moreover, the Risk Factor Sensitivities is not a good

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[51] *See* 12 U.S.C. § 1851(d)(1)(E).
[52] *See* 12 C.F.R. § 24.6.

measure for riskless principal transactions where the gross asset factors are offset by the same factors in gross liability. We believe these metrics are difficult to compute and would not provide the Agencies with useful data. We are confident that a reasonable cost-benefit analysis would not justify including them as barometers of proprietary trading.

F. Delineation of Jurisdictional Authority Among the Agencies.

Neither the Volcker Rule nor the Proposed Rules provide for coordination among the Agencies in administering the regulatory requirements. This will inevitably lead in some cases to multiple regulators supervising and examining a single banking entity's activities, with the possibility of conflicting or inconsistent application of the Proposed Rules. The Proposed Rules should clearly delineate the jurisdictional authority of each of the agencies, so that supervision and enforcement of the Volcker Rule remains completely and exclusively with the primary federal regulator of the banking entity. Further, the Agencies should coordinate their actions in order to ensure a consistent application and interpretation of the regulatory requirements. Finally, the Agencies should defer to the Federal Reserve's sole authority to interpret those provisions of the Volcker Rule that intersect with the statutory provisions that confer jurisdictional authority on the Federal Reserve (*e.g.*, "Super 23A" with Sections 23A and 23B of the Federal Reserve Act).

VI. Conformance Period and Compliance Deadlines.

The Volcker Rule provides a two-year conformance period between the adoption of regulations and compliance with their requirements. The Federal Reserve's previously-issued conformance period regulation (Conformance Rule) sets out when compliance must occur and further allows for an extended time period (generally up to three one-year periods) for conformance to the Volcker Rule's requirements. Under the Conformance Rule, however, there is some lack of certainty on a banking entity's ability to obtain extensions on illiquid investments.

A. Conformance Period for Pre-Volcker Rule Investments.

The Proposed Rules need to clarify the treatment of investments in customer funds that have been made prior to the Volcker Rule's enactment. Such investments should be grandfathered and permitted to run off in due course and not count against the 3 percent Tier 1 capital limit or be deducted from general capital requirements.

B. Contractual Obligation to Remain Invested in Illiquid Funds.

As required by the Volcker Rule, the Federal Reserve may extend the period for illiquid funds to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010. Significantly, Section 619 does not elaborate on, nor does it limit, the meaning of a contractual obligation. In its final rule on the conformance period, however, the Federal Reserve narrows the meaning of the term "contractual obligation" to comprise only those situations in which the banking entity is (a) prohibited from redeeming or selling its interest, or (b) obligated to provide additional capital, and further (c) either prohibited from terminating the obligation or, if the obligation may be terminated, required to use its "reasonable best efforts" to obtain consent to terminate and such consent has been denied.[53]

This last requirement (part (c) above) appears to be unnecessarily restrictive. Under state statutory and common law, contracts may be amended or terminated upon the consent of all parties. In addition, fund agreements routinely include provisions for "regulatory outs", allowing the investor to sell (and not necessarily redeem) its interest before the redemption period, if subsequently required by statute or regulation. The Proposed Rules, however, appear to require banking entities – without exception – to use reasonable best efforts to obtain consent in order to terminate their "contractual obligation," because that obligation may be terminable. This leaves open the meaning of "reasonable best efforts" – in addition to unnecessarily imposing costs on banks required to obtain consent to terminate, there is the uncertainty of whether a bank's diligent attempts in fact rise to the level of "reasonable best efforts."

Banking entities should not be forced to sell their interest at a loss or at a substantial discount to a buyer that takes advantage of the banking entity's predicament (*i.e.*, the decision to divest its holdings in an illiquid fund due to uncertainty of the meaning of "contractual obligation," in order to avoid a possible regulatory violation). This scenario is especially likely with illiquid funds where there is no ready market or pricing data and the buyer may be aware of the banking entity's forced divestiture. The Volcker Rule was intended to reduce risk, not become a source of risk, and the Proposed Rules should embody that intention. A simpler reading of the term "contractual obligation," and one more consistent with congressional intent, would include without limitation *any* contractual obligation or agreement in effect on May 1, 2010, to take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund. This would provide needed regulatory certainty to banks trying to manage the transition to compliance of their illiquid holdings.

VII. Cost-Benefit Analysis.

Regulatory agencies generally are required to include a cost-benefit analysis for regulations that have a significant impact on small entities (*cf.* Regulatory Flexibility Act), involve a significant expenditure by the private sector (*cf*, Unfunded Mandates Act), or that have a significant cost or adverse impact on commerce (*cf*, Small Business Act), among other purposes and requirements. Such analysis is intended to ensure that regulation achieves its purposes consistent with the costs imposed. With this objective in mind, President Obama last year issued Executive Order 13563, (Executive Order) which states in part that:

> Our regulatory system must . . . promote predictability and reduce uncertainty. It must identify and use the best, most innovative, and least burdensome tools for achieving regulatory ends. . . . [E]ach agency must, among other things: (1) propose or adopt a regulation only upon a reasoned determination that its benefits justify its costs . . .[54]

[53] *See* 76 Fed. Reg. 8265, 8277 (2010).
[54] Executive Order 13563 (Jan. 18, 2011).

The Agencies, however, have provided no cost-benefit analysis under the Acts referenced above, thereby exposing the Proposed Rules to one or more statutory violations. There is no compelling basis for omitting such an analysis, particularly when it is incumbent on the Agencies to identify and employ the "least burdensome tools" in implementing the Volcker Rule's provisions. To begin with, the Agencies should conduct a cost-benefit analysis of the Proposed Rules' impact on all banks (including the smallest community banks) and on the thousands of local businesses and other bank customers who depend on banks for funding and investment.

We are confident that the Agencies will find that the magnitude of the cost of the Proposed Rules, in dollars and manpower, far exceeds their projected benefits in at least two respects. First, every bank, regardless of size or activity, will be required to examine, revise, and adapt its compliance policies and procedures to fit within the parameters of the Volcker Rule, even where it is not engaged in any proprietary trading or covered fund activity. Moreover, such compliance review would need to occur at least annually, as the Volcker Rule's meticulous requirements are continually fleshed out by Agency rules and interpretations. Second, every banking organization will need to conduct an initial and ongoing review of its entire corporate structure as it seeks to avoid possible entanglement with the Volcker Rule. On the other hand, neither the public nor the banking entities that are not engaged in prohibited activity under the Volcker Rule would stand to benefit from the Proposed Rules, as regulatory compliance costs are needlessly driven up to stave off violations of a non-existent activity for the vast majority of banks.

Consequently, the Agencies should be required to perform a thorough cost-benefit analysis of the Proposed Rules in order to identify and quantify the specific benefits and compare these against the enormous projected costs. Only then would the Agencies be able to attempt a "reasoned determination," consistent with the letter and spirit of the Executive Order, that the benefits (if any) of the Proposed Rules collectively justify their costs. We also believe that such analysis should also achieve the Executive Order's goal to "promote predictability and reduce uncertainty." Certainty on what the Proposed Rules mean, and predictability in their application, are an important part of ensuring that the Volcker Rule is properly and fairly implemented.

VIII. Conclusion.

The Agencies, therefore, should revise the Proposed Rules as described herein and then submit them for public comment after having completed a thorough cost-benefit analysis. If you have any questions or need additional information, please do not hesitate to contact me at 202-663-5111 or Timothy E. Keehan at 202-663-5479.

Sincerely,

Frank Keating
President & CEO