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Office of the
Secretariat

Association
of
Institutional
INVESTORS™

September 7, 2012

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

Re: Public Request for Input on Volcker Rule Alternatives

Dear Chairman Bachus:

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

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

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

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

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

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

OVERVIEW OF THE ASSOCIATION'S SUGGESTIONS

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

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

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

SPECIFIC LEGISLATIVE RECOMMENDATIONS WITH EXPLANATORY TEXT

a. Proprietary Trading Restrictions

i. Presumption of Proprietary Trading

Although the Association does not believe it was the intent of Congress, under the Agencies' Proposed Rule, banks must meet a set of criteria to show that they are not engaged in proprietary trading. This creates the presumption that the activity *is* proprietary trading unless the banks prove otherwise. The Association believes this may result in banks being unwilling to take principal risk to provide liquidity services to institutional investors, because Agencies have the ability to second-guess a bank's actions after it has completed trades, making it difficult or risky for the bank to assist asset managers in executing such trades.

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

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

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

A. Market Making Exemption

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

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

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

B. Risk Mitigating Hedging Exemption

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

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

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

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

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

ii. Municipal Bond Market Exemption

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

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

Legislative Text:
"(d) PERMITTED ACTIVITIES.—
"(1) IN GENERAL.—Notwithstanding the restrictions under subsection (a), to the extent permitted by any other provision of Federal or State law, and subject to the limitations under paragraph (2) and any restrictions or limitations that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission, may determine, the following activities (in this section referred to as 'permitted activities') are permitted:
"(A) The purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution chartered under and subject to the provisions of the Farm Credit Act of 1971 (12 U.S.C. 2001 et seq.), ~~and obligations of any State or of any political~~

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

b. Covered Funds

i. Definition of "Covered Fund"

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

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

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

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

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

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

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

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

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

ii. Exemptions

A. Naming Prohibition

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

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

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

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

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

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

Suggested Change: The Association believes that this prohibition on employee investment needs to be applied prospectively. Legislation should provide a grandfathering safe harbor for current directors or employees to retain the interests already in their possession as of July 21, 2012, whether or not the directors or employees are currently providing services to the hedge fund or private equity fund. To do otherwise would cause these investors to suffer potentially significant tax consequences, as well as cause the funds and these investors significant difficulties in situations where interests are currently illiquid due to contractual redemption restrictions or the fund assets are illiquid.

Legislative Text:

"(d) PERMITTED ACTIVITIES.—

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

"(G) Organizing and offering a private equity or hedge fund, including serving as a general partner, managing member, or trustee of the fund and in any manner selecting or controlling (or having employees, officers, directors, or agents who constitute) a majority of the directors, trustees, or management of the fund, including any necessary expenses for the foregoing, only if—

"(vii) on or after the effective date, no director or employee of the banking entity ~~takes or retains~~ acquires an equity interest, partnership interest, or other ownership interest in the hedge fund or private equity fund, unless ~~except for any~~ the director or employee of the banking entity ~~who~~ is directly engaged in providing investment advisory or other services to the hedge fund or private equity fund; and

iii. Super 23A

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

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

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

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

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

iv. Limitations on Fund Investments

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

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

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

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

v. Definition of Illiquid Fund

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

The Association believes this definition utilizes an arbitrary date that may unnecessarily exclude funds that otherwise should meet the definition of being an illiquid fund. While we recognize that the purpose of this definition is to ensure that people are unable to manipulate the system, this definition would exclude, for example, a fund that was entirely liquid on May 1, 2010, but ultimately found itself in an illiquid state due to reasons or factors beyond its control (for example, the illiquidity was not due to any changes in portfolio holdings but was due to market forces). Such a result would harm investors to such funds and cut against the Congressional intent in Section 619 of the Dodd-Frank Act. It would also not take into account liquidity factors that adversely affect the fund and are beyond the control or foresight of the fund sponsors. This could require sponsors to divest their fund ownership interest at inopportune times (i.e.., when market liquidity is constrained) despite best efforts to reduce their ownership interests by the deadline.

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

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

CONCLUSION

The Association recognizes the challenges Congress and the Agencies have in attempting to draft legislation and regulations to limit potentially risky banking activities while permitting banks to continue to provide much needed liquidity. The Association thanks HFSC for the opportunity to provide our suggestions regarding how Section 619 of the Dodd-Frank Act could be improved. We would be happy to discuss these changes with you or the Committee at your convenience. Please feel free to contact me with any questions you may have at jgidman@loomissayles.com or (617) 748-1748.

On behalf of the Association of Institutional INVESTORS,

John Gidman
President

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

APPENDIX A

SUGGESTED LEGISLATION TEXT

112TH CONGRESS
2ND SESSION

H.R.______

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

IN THE HOUSE OF REPRESENTATIVES

________, ____ 2012

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

A BILL

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

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

SECTION 1. SHORT TITLE.

(a) Short Title — This Act may be cited as the "Volcker Act".

(b) Reference — Whenever in this Act an amendment or repeal is expressed in terms of an amendment to, or repeal of, a section or other provision, the reference shall be considered to be made to a section or other provision of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.

SECTION 2. PERMITTED ACTIVITIES

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

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

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

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

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

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

(1) by striking "1 year" and inserting "3 years"; and

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

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

Section 619(f)(1) (12 U.S.C. 1851(f)(1)) is amended to read as follows: "(1) IN GENERAL — A banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund pursuant to paragraph (d)(1)(G), shall abide by the restrictions on transactions with affiliates described in section 23A of the Federal Reserve Act (12 U.S.C. 371c) with the hedge fund or private equity fund, as if such banking entity were a member bank and the hedge fund or private equity fund were an affiliate thereof."

SECTION 4. DEFINITIONS

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

(b) Section 619(h)(4) (12 U.S.C. 1851(h)(4)) is amended to read as follows: "(4) PROPRIETARY TRADING —The term 'proprietary trading', when used with respect to a banking entity or nonbank financial company supervised by the Board, means, subject to the following sentence, engaging as a principal for the trading account of the banking entity or nonbank financial company supervised by the Board in any transaction to purchase or sell, or otherwise acquire or dispose of, any security, any derivative, any contract of sale of a commodity for future delivery, any option on any such security, derivative, or contract, or any other security or financial instrument that the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in subsection (b)(2), determine. For purposes of this definition, the term 'proprietary trading' is limited to principal transactions effected for the purpose of executing trading strategies that are expected to produce short-term profits without a clear connection to customer facilitation or intermediation."

(c) Section 619(h)(7)(A) (12 U.S.C. 1851(h)(7)(A)) is amended to read as follows:

"(A) IN GENERAL — The term 'illiquid fund' means a hedge fund or private equity fund that —

"(i) (a) on or prior to the enactment date, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments; and

"(b) makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets; or

"(ii) on or after the enactment date, held liquid assets of which a significant portion became illiquid due to market forces or factors beyond the individual or collective control of such fund, its investment adviser and its sponsor. In issuing rules regarding this subparagraph, the Board shall take into consideration the terms of investment for the hedge fund or private equity fund, including contractual obligations, the ability of the fund to divest of assets held by the fund at a reasonable price, whether the fund has become illiquid through factors or reasons beyond the individual or collective control of the fund, its investment adviser or sponsor, and any other factors that the Board determines are appropriate."