From: Young-Anglim, Alexander <alexander.young-anglim@davispolk.com>
Sent: Thursday, April 14, 2011 3:33 PM
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Subject: On behalf of SIFMA - comment letter on funds portion of the Volcker Rule
Attach: sifma.comment.letter.Volcker.Rule.funds.portion.pre.NPR.pdf

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Dear all,

SIFMA is pleased to offer the agencies charged with issuing the substantive rules implementing the Volcker Rule our comments in advance of any notice of proposed rulemaking.

The attached comment letter addresses certain implementation issues that we have not addressed in our previous comment letters, and is accompanied by two annexes. The first annex highlights certain recommendations made in our prior comment letters. The second annex includes proposed language implementing our recommendations in the form of proposed rules.

We hope that the agencies find our comments helpful, and we look forward to discussing them in more depth.

Kindly let us know if there is a preferred submission process we should follow apart from this email.

Best regards,

SIFMA

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sifma

Invested in America

April 14, 2011

By electronic submission

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Office of Domestic Finance
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Washington, D.C. 20520

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Board of Governors of the Federal Reserve System
20th Street & Constitution Avenue, N.W.
Washington, D.C. 20551

Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, DC 20219

Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20551

Securities and Exchange Commission
100 F Street, N.E.
Washington DC 20549

Re: **Comment Letter in Advance of Notice of Proposed Rulemaking Implementing the Private Funds Portion of the Volcker Rule**

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association[1] appreciates the opportunity to provide the agencies (the "**Agencies**") charged with issuing the substantive rules implementing new Section 13 of the Bank Holding Company Act of 1956 (the "**Volcker Rule**") with comments on the private funds portion of such rules in advance of any notice of proposed rulemaking.

SIFMA has previously submitted comment letters on the private funds and proprietary trading portions of the study of the Volcker Rule[2] by the Financial Stability Oversight

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds and Private Equity Funds (January 18, 2011) (the "**FSOC Study**"), available at http://www.treasury.gov/initiatives/Documents/Volcker%20sec%20%20619%20study%20final%201%2018%2011%20rg.pdf.

Council (the "**FSOC**") and on the Federal Reserve's proposed rules implementing the conformance period of the Volcker Rule.[3]

As noted in our comment letters on the FSOC Study, SIFMA believes that the issues arising out of the private funds portion of the Volcker Rule are very different from those arising out of the proprietary trading portion. While we urged and continue to urge the Agencies to adopt a careful, staged approach to implementation of the proprietary trading restrictions grounded in market realities, we urged and continue to urge the Agencies to act promptly to provide legal certainty as to which entities will actually be treated as hedge funds or private equity funds and which will be excluded, and to eliminate the internal contradictions, absurd results and unintended consequences of the private funds portion of the Volcker Rule.

The Agencies should also implement the private funds portion of the Volcker Rule in light of the context of global financial markets, recognizing that pushing domestic private funds activity to the unregulated shadow banking system or to foreign financial centers such as Hong Kong, Singapore, London, Frankfurt, Paris or Zurich could have adverse effects on the strength and competitiveness of the United States as a global financial center.

Background

The Volcker Rule generally prohibits any "banking entity" from taking or retaining any "ownership interest" in or "sponsoring" a "hedge fund" or "private equity fund," subject to certain exemptions.

The Agencies are required to issue regulations implementing the Volcker Rule within nine months of the FSOC Study (*i.e.*, by October 18, 2011). They are also required to consider the FSOC Study's findings and recommendations in issuing such regulations.

In proposing rules implementing the private funds portion of the Volcker Rule and reflecting the FSOC Study's findings and recommendations, we ask the Agencies to keep in mind that the purpose of the Volcker Rule is to prevent banking entities from establishing or maintaining investments in or relationships with hedge funds and private equity funds only if they have been deemed inappropriate. A principal goal of the Volcker Rule is to eliminate the temptation of banking entities to bail out investors in sponsored funds, which otherwise might contribute to a banking entity's losses during a financial crisis. The exemptions to the general

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[3] *See* SIFMA Comment Letter on the private funds portion of the FSOC Study dated November 5, 2010, available at http://www.sifma.org/Issues/item.aspx?id=22125; SIFMA Comment Letter on the proprietary trading portion of the FSOC Study dated November 5, 2011, available at http://www.sifma.org/issues/item.aspx?id=22126; and SIFMA Comment Letter on the Federal Reserve's Proposed Conformance Rules dated December 27, 2010, available at http://www.sifma.org/Issues/item.aspx?id=22813.

prohibitions, however, also reflect a decision to balance these considerations with the recognition that appropriate asset management services (*i.e.*, bona fide trust, fiduciary and investment advisory services), traditional lending activities and other corporate or investment activities should not be prohibited. These services and activities, which contribute to "spurring innovation, creating jobs and growing companies," are critical to the nation's economic recovery and ongoing health.[4] Implementation of the Volcker Rule in a manner that unduly restricts these services and activities would have a detrimental effect on the availability of capital and credit to American businesses, job creation and the recovering economy and its continuing health. The Volcker Rule must be implemented in a way that restricts certain relationships with hedge funds or private equity funds without triggering the sort of adverse economic consequences that Congress sought to avoid.

To this end, SIFMA requests that the Agencies develop rules implementing the substantive provisions of the Volcker Rule consistent with the recommendations in the body of this comment letter and in Annex A. In doing so, we ask the Agencies to use the legitimate interpretive and exemptive authorities granted by Congress or recognized by the courts to address certain internal contradictions, absurd results and unintended consequences and otherwise to propose rules that construe the statutory text in accordance with congressional intent. The recommendations contained in the body of this comment letter relate to issues that we have not fully addressed in our prior comment letters or that respond to questions raised by the FSOC Study. The recommendations contained in Annex A are no less important, but relate to issues that we have already discussed in our prior comment letters. We summarize them in Annex A for the sake of convenience and to reflect the findings and recommendations of the FSOC Study.

We have also included proposed language in Annex B for implementing certain of our recommendations in the form of proposed regulations.

Discussion

I. Asset Management Exemption

The asset management exemption in Section (d)(1)(G) of the Volcker Rule was designed to provide banking entities with a limited exemption to continue organizing and offering (including sponsoring) hedge funds and private equity funds as part of the provision of traditional asset management services.[5] It permits banking entities to continue offering investments in such

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[4] Colloquy Between Senate Banking Committee Chairman Christopher Dodd and Senator Barbara Boxer, 156 CONG. REC. S5904 (daily ed. July 15, 2010).

[5] *See* Statement of Senator Hagan (D-NC), 156 CONG. REC. S5870 (daily ed. July 15, 2010) ("I am pleased that as part of the conference report that the Volcker language was modified to permit a banking entity to engage in a certain level of traditional asset management business, including the ability to sponsor and offer hedge and private equity funds."); Colloquy Between Senators Merkley (D-OR) and Levin (D-MI), 156 CONG. REC. S5904

funds to customers of the banking entity. It also permits employees and directors who are involved directly in managing or providing certain services to the funds to invest in the funds in order to align their interests with those of third-party investors. Finally, it permits banking entities to provide up to 100% of the seed capital to a fund for a temporary period and to make permanent investments in up to 3% of the capital of each fund and up to 3% of the Tier 1 capital of the banking entity in order to align the banking entities' interests with those of third-party investors.

The asset management exemption includes certain conditions designed to ensure that it is limited to the provision of asset management services and to protect the safety and soundness of banking entities. To protect banking entities' safety and soundness, the asset management exemption prohibits banking entities from bailing out the investors in a fund or entering into certain transactions with the fund. It also limits the categories of employees who may invest in the funds and the amount a banking entity may invest in the funds. Finally, it requires disclosure designed to ensure that investors understand that any and all losses will be borne entirely by the investors and not by the banking entity, except to the extent of the banking entity's exposure as a permissible investor.

The asset management exemption was designed to ***preserve*** the ability of banking entities to engage in traditional asset management activities – not to disrupt those activities – while protecting against having any losses transferred back to a banking entity in the event of a financial crisis or other event resulting in losses to a fund.

Banking entities have traditionally offered interests in hedge funds and private equity funds as part of the provision of asset management services both to existing customers and to persons who have not previously invested in any of these funds or otherwise established a formal trust, fiduciary or investment advisory relationship with the banking entity. Indeed, a significant portion of investors in these funds have been new customers. But in order for the sale of investments to these new customers to qualify for a private placement exemption from the securities registration requirements of the Securities Act of 1933 (the "**Securities Act**") under Regulation D thereunder, the banking entities or their affiliates or agents have been required to establish a "substantive pre-existing relationship" with the new customers before accepting them as investors in the funds.

Potential investors in these funds also expect and often demand that employees who have a direct relationship with the funds "eat their own cooking" or have "skin in the game" alongside investors' own capital. These arrangements ensure an alignment of interests between

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(daily ed. July 15, 2010) ("Subparagraph (d)(1)(G) permits firms to organize and offer hedge funds or private equity funds as an asset management service to clients."); Statement of Senator Brown (R-MA), 156 CONG. REC. S6241 (daily ed. July 26, 2010) ("The original Volcker Rule would have gone too far in preventing banks from offering appropriate investment services to their clients as a limited and safe part of their business model . . . Preventing banks from offering such services.").

the banking entity providing asset management services and third-party investors, and also act as a check against short-term risk taking for short-term profits. Employees who manage these funds are typically compensated for their management of the funds by receiving a portion of the funds' profits. In addition, it is common practice for banking entity employees engaged in the provision of asset management services to have the choice of deferring part of their compensation and having that deferred amount be linked to the performance of the funds in which the employees are involved. The banking entity then "hedges" that exposure by investing directly in the referenced funds. These compensation arrangements are critical to the retention of banking entity employees engaged in the provision of asset management services.

The Agencies should interpret the conditions of the asset management exemption in light of its overall purpose to preserve the ability of banking entities to continue providing traditional asset management services, including offering interests in hedge funds and private equity funds organized and offered by the banking entities.

A. Customer Condition

The asset management exemption includes two conditions that ensure that the exemption is available only in connection with the provision of asset management services. The first condition provides that the exemption is available only to banking entities that "provid[e] bona fide trust, fiduciary, or investment advisory services," which we refer to collectively as asset management services. The second condition provides that the exemption is available only for hedge funds and private equity funds that are organized and offered in connection with the provision of such asset management services and "only to persons that are customers" of one of those services.

Although these conditions were designed to limit the ability of a banking entity to organize, offer and sponsor hedge funds and private equity funds in certain respects, they were ***not*** designed to disrupt a banking entity's ability to provide asset management services to customers. Instead, they were designed to ***preserve*** the ability of the banking entity to organize, offer and sponsor such funds as part of its provision of asset management services, subject to the safety and soundness protections in the exemption. As a result, these conditions should be interpreted to permit, not constrain, traditional asset management practices with respect to hedge funds and private equity funds, subject only to the safety and soundness protections contained in the asset management exemption itself or in other parts of the Volcker Rule.

The FSOC Study appeared to recognize the purpose of the conditions to the asset management exemption, thus finding that the customer condition would preclude banking entities from being "allowed to put capital at risk by investing in hedge funds and private equity funds

that are ***completely divorced*** from serving the needs of their customers."[6] The clear implication of this statement is that the customer condition will not preclude such investments as long as there is a connection with serving the needs of customers.

Indeed, we believe that it would be unreasonable for the Agencies to construe the customer condition in a manner that makes it so difficult to satisfy that it effectively eliminates the asset management exemption. The language of the statute does not compel any such construction, and it would be contrary to congressional intent to do so.

Providing customers with the opportunity to invest in a wide array of investment products in order to enable the customers to diversify their investment portfolios is a fundamental component of providing asset management services to customers. Offering customers who are sophisticated investors the opportunity to invest in alternative investments such as hedge funds and private equity funds is regarded as vital to enabling the customers to achieve their investment diversification goals.

The requirement that funds be organized and offered in connection with the provision of asset management services should be satisfied if a banking entity (including any of its affiliates) acts as the investment adviser directly to the offered funds and indirectly to any customers who invest in the funds. Because banking entities often deliver such asset management services *through* a fund, rather than directly to the investor, the Agencies should not require banking entities to provide some sort of separate asset management services directly to the investor in order to qualify for the exemption. That would place an artificial limitation on the asset management exemption that is not required by the language of the statute or intended by Congress.

While the customer condition requires banking entities to have a customer relationship at the time they organize and offer any interests in a fund to potential investors, the language does not prohibit new customer relationships from being established, as long as they have been established by the time that ownership interests in a fund are sold to a particular investor. The FSOC Study requested comment on whether it should define the requisite customer relationship based on standards in the banking laws or the securities laws. We believe that the appropriate standard is the "substantive pre-existing relationship" ("**SPR**") standard that the Securities and Exchange Commission ("**SEC**") has established in the context of the Regulation D exemption from the registration requirements of the Securities Act for private offerings of securities.

Under the Securities Act, an offering of ownership interests in a hedge fund or private equity fund is required to be made in a manner so that the offering is exempt from

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[6] *See* FSOC Study at 56 (emphasis added).

registration pursuant to Section 4(2) of the Securities Act. In 1982, the SEC adopted Regulation D under the Securities Act as a safe harbor from the registration requirements under the Securities Act. One of the requirements of Regulation D is that the issuer may not engage in any form of general solicitation of or general advertisement to prospective investors, such as "cold calling" prospective investors or otherwise using the media or other public means to generate interest in the offering from the public generally.

Through case law and a series of no-action letters issued subsequent to the adoption of Regulation D, the SEC has indicated that a general solicitation will not occur if an issuer (*e.g.*, a fund) or a person acting on the issuer's behalf (*e.g.*, a placement agent) establishes an SPR between the issuer and a prospective investor. There are two elements to the SPR requirement: (i) first, the relationship with the investor must be "substantive" in that the issuer (acting directly or through a person acting on the issuer's behalf) must be "aware of the financial circumstances or sophistication of the persons with whom the relationship exists,"[7] and (ii) second, the relationship must be "pre-existing" in that there must be "sufficient time between establishment of the relationship and an offer"[8] of securities pursuant to the applicable private placement. Accordingly, banking entities conduct offerings of interests in issuers they organize and offer, including hedge funds and private equity funds, that rely on Regulation D as the basis for exemption from registration under the Securities Act in a manner that satisfies the SPR requirement.

The SPR requirement strikes an appropriate balance between requiring an established customer relationship and not entirely freezing all customer relationships at a

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[7] *See Mineral Lands Research & Marketing Corp*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2811, at *2 (Dec. 4, 1985). The SEC has stated that a substantive relationship may be created through a questionnaire that is (i) generic in nature, (ii) does not reference any specific investment product currently offered or contemplated for offering and (iii) is sufficiently detailed to properly determine the prospective investor's level of sophistication and financial circumstances. If a relationship is properly created in this manner, the SEC has stated that it is not necessary for prospective investors to have previously invested in other securities offered by the issuer (or by persons acting on the issuer's behalf). *See E.F. Hutton & Co.*, SEC No-Action Letter, 1985 SEC No-Act. LEXIS 2917, at *2 (Dec. 3, 1985).

[8] *Id.* Addressing the length of time required in order to establish that a relationship met the "pre-existing" requirement, the SEC did not object to a 45-day waiting period between initial contact with the prospective investor and solicitation of the investor for a particular securities offering, so long as the securities offering had not been initiated at the time of initial contact. *See Bateman Eichler, Hill Richards, Inc.*, 1985 SEC No-Act. LEXIS 2918 (Dec. 3, 1985). In the more recent Lamp Technologies no-action letter, the SEC found that a pre-existing relationship could be created through a 30-day "cooling off" period between the time the investor was qualified to invest in private placements (in this case private placements of hedge funds) and the investor was offered specific investment opportunities in hedge funds. *See Lamp Technologies, Inc.*, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 638 (May 29, 1997). It should be noted that in Lamp Technologies, the investors were permitted to participate in offerings that were already ongoing at the time they were qualified, but this was in recognition of the fact that hedge funds are generally continuously offering their securities.

particular point in time or otherwise requiring that a separate customer relationship be established in situations where the investor is interested in the services of a banking entity only in connection with a specific hedge fund or private equity fund. It is familiar to personnel at banking entities who provide asset management services because they have long had to comply with it in order to obtain a private placement exemption for the offer and sale of ownership interests in the hedge funds or private equity funds they have organized and offered. Indeed, they already have policies and procedures in place to ensure that an SPR will exist prior to offering any hedge fund or private equity fund to a prospective investor. As noted above, the SEC has provided guidelines on how an SPR can be established with a new customer. In the case of new customers, the SEC requires a minimum of at least thirty days to establish an SPR,[9] but in practice the process generally takes several months to satisfy. In addition, the SPR requirement would apply whether or not the initial contact between the banking entity and the customer had been initiated by the banking entity or by the customer; as a practical matter, drawing a distinction based on which party initiated the relationship would be difficult to implement and monitor. As a result, the SPR requirement imposes the sort of limitations contemplated by the customer condition in Section (d)(1)(G), while preserving the traditional flexibility to establish new customer relationships if certain additional conditions are satisfied.

We note that this approach enables sophisticated institutional investors, including pension funds of state and local government entities, to seek out qualified managers to address their asset allocation needs. For example, many such pension funds issue requests for proposals seeking to identify and hire investment managers with the capability of implementing specific investment strategies, including alternative investment strategies such as hedge funds and private equity funds. The customer condition should permit the establishment of such relationships for the benefit of such pension funds and banking entities alike.

We have proposed language for including the SPR requirement in any rules implementing the customer condition in Annex B.

B. Calculation of Investment Limits

1. Invested or Committed Capital

The FSOC Study also invited comment on whether the *de minimis* investment limits should be based on invested capital or committed capital. SIFMA believes that the investment limits should be based on invested capital, not committed capital. The Volcker Rule does not prohibit commitments to invest in hedge funds or private equity funds. It only prohibits the actual acquisition or retention of ownership interests in them. Until an investment is made, committed capital represents merely the potential for the acquisition of an ownership interest. In

[9] *See Lamp Technologies, Inc.*, SEC No-Action Letter, 1997 SEC No-Act. LEXIS 638 (May 29, 1997).

fact, it is not unusual for a fund to call less than the full amount of an investor's committed capital.

If the Agencies nevertheless decide to include committed capital in any calculations, we believe that the components included in the denominator should be fully parallel with any components included in the numerator. Thus, if the numerator is limited to a banking entity's invested capital, the denominator should consist of the invested capital of all investors (including the banking entity). If the numerator consists of both the banking entity's invested and committed capital, the denominator should consist of all invested and committed capital from all investors.

In addition, any capital returned to a banking entity or other investor upon the sale or other disposition of a portfolio company or other investment should reduce invested capital or committed capital for purposes of calculating the *de minimis* limits.

We have included proposed language for both options in Annex B.

2. Timing

The FSOC Study invited comment on whether the *de minimis* investment limits should be calculated as a one-time test at the end of the seeding period of each fund or periodically over the life of the funds. We commented on this issue in our comment letter on the FSOC Study. A summary of those comments, with supplemental recommendations, appears in Annex A.

We have included proposed language for this recommendation in Annex B.

3. Carried Interest

The FSOC Study recommended that the Agencies consider whether and when carried interest should be treated as an ownership interest for purposes of the 3% *de minimis* investment limits, including whether carried interest that remains in a fund at the election of the banking entity to which it is allocated should be treated differently from carried interest that is withdrawn when "contractually allocated or earned."[10]

As a general matter, we believe that carried interest should not be treated as an ownership interest aggregated with a banking entity's co-investments for purposes of the *de minimis* limits. Carried interest is incentive compensation paid or allocated to the investment manager or adviser of a covered fund on the basis of a share of capital gains upon or capital appreciation of the assets of the covered fund. It does not represent pre-existing capital put at risk

[10] *See* FSOC Study at 66.

by the banking entity through an investment in the fund.[11] Carried interest is further distinguishable from an equity interest in a fund held by a limited partner in that carried interest does not generally confer traditional ownership rights, such as voting rights.

However, we understand that when a banking entity's carried interest in a fund is available to be paid or distributed as cash or as a distribution in kind at the option of the banking entity, and the banking entity chooses not to promptly withdraw the carried interest, and the carried interest thereafter participates *pro rata* in the overall profits and losses of the fund, the carried interest may resemble an ownership interest. This scenario, most commonly seen in the traditional hedge fund context, is distinguishable from one most commonly seen in the traditional private equity fund context, where a banking entity's carried interest is available to be paid or distributed as cash or as a distribution in kind at the option of the banking entity, and the banking entity chooses not to promptly withdraw it from the fund, but the carried interest does not participate in the profits and losses of the fund. Banking entities choose not to withdraw the carried interest in this context because the carried interest remains subject to "clawback" based on the performance of the private equity fund's other investments. The retention by the banking entity of the carried interest in the private equity fund benefits third-party investors by ensuring that the banking entity has the capital available in the fund in the event the "clawback" is required. Because the carried interest is not reinvested in the private equity fund's assets and is contingent on the overall performance of the fund's other investments, however, we believe that it should not be treated as an ownership interest. Consequently, carried interest should not be aggregated with a banking entity's co-investment in a sponsored private equity fund for purposes of calculating the 3% *de minimis* limits. We also note that because the value of the carried interest may fluctuate over the life of the fund, it would be extremely difficult to monitor compliance with the 3% *de minimis* limits.

We have included proposed language for implementing our recommendations in Annex B.

Please see our comment letter on the FSOC Study for a discussion of other aspects of this issue.[12]

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[11] As an aside, we believe that the regulatory capital treatment of carried interest should not be relevant to determining whether carried interest should or should not be treated as an ownership interest for purposes of calculating the 3% *de minimis* limits. Whether a sponsor's compensation is paid in the form of a performance fee, which no one would argue is an ownership interest, or in the form of a carried interest profit allocation is irrelevant for purposes of regulatory capital. In each instance, to the extent a profit is realized consistent with a firm's accounting practices, an asset is created that must be risk-weighted and reflected in the firm's regulatory capital.

[12] *See* SIFMA FSOC Study comment letter at 20.

4. Permitted Employee/Director Investments

The FSOC Study requested comment on whether permitted employee or director investments should be aggregated with a banking entity's investments for purposes of calculating the *de minimis* limits on the banking entity's investments.

We believe that this comment arose out of the fact that the banking regulators have sometimes aggregated investments by employees and directors with those of a bank or bank holding company for purposes of determining whether the bank or bank holding company has a "controlling influence" over another company or whether a private equity fund qualified for an extended holding period with respect to portfolio investments (*i.e.*, fifteen years instead of ten years under the merchant banking rule contained in Subpart J of the Board's Regulation Y).[13] Even if the aggregation of interests is a reasonable interpretation of the control and merchant banking rules under the banking laws, we believe that the proposed aggregation for Volcker Rule purposes would be inconsistent with the plain language and intent of the asset management exemption.

Congress recognized that employees and directors of a banking entity must be permitted to invest in the funds they manage or support in order to align their interests with those of third-party investors and to retain talented professionals at the banking entity. Section (d)(1)(G)(vii) of the asset management exemption expressly permits a banking entity's employees and directors who are "directly engaged in providing investment advisory or other services" to a sponsored hedge fund or private equity fund to invest in the fund. This section does not impose any limits on the size of such permissible investments. The only limit is that they be made by employees who are directly engaged in providing investment advisory or other services to the fund. In contrast, Sections (d)(1)(G)(iii) and (d)(4), which permit banking entities themselves to make *de minimis* co-investments pursuant to the asset management exemption, expressly limit such investments in any single fund to 3% of the ownership interests in the fund (subject to a temporary exemption for seed capital), and the aggregate amount of investments in all hedge funds and private equity funds to 3% of the firm's Tier 1 capital.

It would be inconsistent with the plain language and intent of the asset management exemption for the Agencies to read into the statute a similar limit on otherwise permitted employee investments. The *de minimis* limits on banking entity co-investments in Section (d)(4) show that Congress knew how to impose an express limit when it intended to do so. The only reasonable explanation for the absence of such a limit on otherwise permitted employee and director investments is that Congress did not intend to impose such a limit.

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[13] Under the merchant banking rule, if a private equity fund satisfies certain conditions, including that a bank holding company does not own or control more than 25 percent of its total equity, then the private equity fund is permitted to hold portfolio companies for up to fifteen years. The only material consequence of failure to satisfy this or any of the other conditions is that the maximum holding period is reduced to ten years.

Nor is such a limit any more justified if the Agencies impose it indirectly by aggregating permitted employee/director investments with banking entity investments for purposes of calculating the limits on banking entity investments. There is nothing in the language or legislative history of the asset management exemption that would justify such an unusual construction of its text. Such an approach would also potentially create conflicts between the banking entity and its employees for the "right" to invest in sponsored funds and limiting investments by investment professional employees of banking entities that would contribute to the flight of talent of employees to non-bank-affiliated fund managers. As a practical matter, it would also virtually eliminate the ability of permitted employees to invest in sponsored funds, because co-investments demanded by third-party investors from the sponsoring banking entities would crowd permitted employee investments out of the 3% *de minimis* limits.

Congress addressed any potential that permitted employee and director investments would contribute to the "bailout risk" of a sponsored fund by explicitly prohibiting such financial support in Section (d)(1)(G)(v) and by the importation of Super 23A in (d)(1)(G)(iv).

We also believe that "other services" should be interpreted to include administrative, oversight and risk management, legal, compliance, regulatory, investor relations, sales and marketing, tax, accounting, valuation and other operational support services. The ability of a banking entity to successfully provide asset management services to its clients depends on the skills of many different kinds of employees, not just those providing investment advice. Recognizing that the market for talent is very competitive, Congress deliberately used the broad term "other services" in the context of permitted employee investments to ensure that banking entities' ability to attract and retain talented employees across the necessary disciplines would not be harmed. We therefore recommend that the Agencies reflect congressional intent by interpreting the words "other services" so that banking entities are kept on a level playing field with non-bank affiliated asset managers. We note that interpreting "other services" in that manner would not result in permitting employees who do not have the requisite financial sophistication to invest in a hedge fund or private equity fund. All employees would be required to satisfy applicable financial tests in order to invest in these funds.

5. Name-Sharing Prohibition

In our comment letter on the FSOC Study, we recommended that the Agencies construe the terms "affiliate" and "subsidiary" to exclude hedge funds and private equity funds in order, among other reasons, to avoid the absurd result that every fund in a family of controlled funds would be required to have a unique name pursuant to the name-sharing condition of (d)(1)(G).[14]

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[14] *See* SIFMA FSOC Study comment letter at 15-16.

We now ask the Agencies to clarify that the name-sharing prohibition does not prevent a banking entity from using its name or disclosing its affiliation with a fund or family of funds in marketing materials for the fund or family of funds, such as offering memoranda or pitch books to investors. To prohibit any mention of the name of an affiliated banking entity in such materials would create a conflict with applicable securities disclosure laws, which require issuers to disclose all material information to investors — the relationship between a fund or a family of funds and any affiliated banking entity would almost certainly be material to most if not all investors. It would also create an internal contradiction with the disclosure requirements of (d)(1)(G), which require that disclosures be made to investors that the fund is not guaranteed by the affiliated banking entity, which necessarily involves naming the affiliated banking entity. It could therefore not have been the intent of Congress to forbid banking entities from using their names or disclosing their affiliation with funds they organize and offer in marketing materials.

We have proposed regulatory language to implement this recommendation in Annex B.

We would also like to bring to the Agencies' attention a potential conflict between the name-sharing prohibition in the Volcker Rule and regulations and guidance issued by the U.K.'s Financial Services Authority applicable to certain offshore funds. The FSA's Open-Ended Investment Companies regulations implementing the Financial Services and Markets Act require that a fund's name not be "undesirable or misleading."[15] FSA guidance states that among other factors the FSA will take into account when making a determination with respect to this requirement is whether a fund's name "might mislead investors into thinking that persons other than the authorised fund manager are responsible for the . . . fund."[16] We are aware of instances in which the FSA has interpreted this to mean that the fund must share a variant of the name of the authorized fund manager.

II. Super 23A

As explained in our comment letter on the FSOC Study, Section (f) of the Volcker Rule ("**Super 23A**") raises a host of issues that should be resolved by the Agencies in the implementing regulations. We have described these issues and our related comments in more detail in Annex A. In summary, we have recommended that investments in the securities of affiliated hedge funds and private equity funds be excluded from the term "covered transactions" to avoid internal contradictions; that the term "covered transactions" incorporate the exemptions in Section 23A of the Federal Reserve Act and Regulation W as part of its definition; and that Super 23A not apply to a portfolio company that is not a hedge fund or private equity fund.

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[15] *See* Regulation 15(9), Open-Ended Investment Companies Regulations, 2001, S.I. 2001/1228 (U.K.).

[16] *See* FSA Handbook, Undesirable or misleading names, COLL 6.9.6 G (Release 112, 2011) (U.K.).

The FSOC Study, however, raised an issue that we had not anticipated. That issue is whether Super 23A should be expanded to prohibit covered transactions with third-party hedge funds or private equity funds that do not fall within the literal language of Super 23A, but with which a banking entity or its affiliates have one or more "business relationships."

The FSOC Study observed that the Volcker Rule permits banking entities to "provide customers with access to third-party private equity funds and hedge funds through the organizing and offering of a hedge fund or private equity fund that makes investments in such third-party funds [*i.e.*, a fund of funds]."[17] While Super 23A prohibits covered transactions between a banking entity and any fund in which a sponsored fund of funds has a ***controlling*** investment, it does not prohibit covered transactions between a banking entity and any fund in which a sponsored fund of funds has only a ***non-controlling*** investment. The FSOC Study suggested that this gap in Super 23A was a matter of concern because "conflicts of interest may arise where a banking entity directs a feeder fund or fund of fund investment to a third-party hedge fund or private equity fund with which the banking entity has other business relationships."[18]

As a result of these concerns, the FSOC Study recommended that the Agencies consider the following:

- Whether the banking entity's business relationships with the third-party fund should be subject to Super 23A as well as to the "arm's length" transactions requirements of Section 23B of the Federal Reserve Act; and

- The extent to which such arrangements could create the opportunity and incentive for banking entities to bail out the third-party funds or expose the banking entity to "outsized risk."[19]

We believe that it would be unreasonable for the Agencies to expand Super 23A in this manner. Such an expansion is inconsistent with the plain language of Super 23A. By its terms, Super 23A only prohibits covered transactions with hedge funds or private equity funds that are sponsored, advised, managed or organized and offered by a banking entity, or any other fund that is "controlled" by the first type of fund. It does not apply to unaffiliated funds with which a banking entity or any of its affiliates have a business relationship. Such an expansion is also inconsistent with the legislative history of Super 23A. Early versions of the Volcker Rule introduced in the Senate would have expanded Super 23A to unaffiliated hedge funds or private equity funds – that is, underlying funds in which a

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[17] *See* FSOC Study at 64-65.

[18] *Id.* at 65.

[19] *See* FSOC Study at 65.

sponsored or advised hedge fund or private equity fund has made a non-controlling investment.[20] The text of the final Volcker Rule demonstrates that the Congress rejected this expansion of Super 23A. In light of this text and legislative history, we do not believe the Agencies have the discretion to expand Super 23A in this manner.

III. Hedging transactions

Section (d)(1)(C) of the Volcker Rule provides an exemption for *bona fide* hedging transactions. It is an independent source of authority for qualifying investments in both third-party funds and funds that are organized and offered or sponsored by the banking entity. It has its own conditions that need to be satisfied. These conditions are different from the conditions required to qualify for the asset management exemption or any of the other exemptions in Section (d)(1) of the Volcker Rule. In particular, the numerical limits of Section (d)(4) do not apply. These limits apply only to investments made in reliance on the asset management exemption in Section (d)(1)(G).[21] To qualify for the hedging exemption, a banking entity must be able to show that any long positions are made to hedge specific exposures to hedge funds or private equity funds.

Such exposures might arise out of a variety of permissible transactions, including employee deferred compensation programs or customer-driven transactions such as total return swaps or equity-linked note programs. For example, banking entities frequently establish deferred compensation programs that promise employees involved in providing asset management services the value of certain hedge funds or private equity funds if certain conditions are satisfied. Although it might be uncertain whether the conditions will be satisfied, the banking entity will nevertheless be obligated to perform if they are. Section (d)(1)(C) would permit it to hedge these risks if the conditions of the hedging exemption are satisfied.

We have proposed language to implement this comment in Annex B.

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[20] *See* SA 4101, introduced during the Senate debate by Senators Merkley and Levin. 156 CONG. REC. S3935, at S3937-38 (2010).

[21] *See* Colloquy Among Senators Dodd (D-CT), Merkley and Levin, 156 CONG. REC. S5904 (daily ed. July 15, 2010) ("First, I would like to clarify several issues surrounding the "de minimis" investment provisions in Subsection (d)(4). These provisions complement Subsection (d)(1)(G), which permits firms to offer hedge funds and private equity funds to clients.") If Section (d)(4) is read to apply to any of the other permissible activities described in Section (d)(1) or implied by Super 23A, it would create internal contradictions with Super 23A, which clearly contemplates that fund of funds are permitted to make controlling investments in other funds, and the exemption for offshore funds in Section (d)(1)(I), which clearly contemplates no extraterritorial limits on ownership interests.

IV. Reach of the General Definition of Hedge Funds and Private Equity Funds

As explained in our comment letter on the FSOC Study, Congress recognized that the general definition of hedge fund and private equity fund appeared to sweep in many investment vehicles and other corporate structures that have never been considered hedge funds or private equity funds. As discussed in that letter and more fully below, Congress intended for the Agencies to use their legitimate interpretive and exemptive authorities granted by Congress or recognized by the courts to construe the general definition to be consistent with congressional intent.

The legislative history of the Dodd-Frank Act identifies a number of investment vehicles that Congress did not intend to be included in the general definition. The investment vehicles specifically mentioned were "subsidiaries," "joint ventures" and other "corporate structures" normally used by banking entities to hold investments on their balance sheets,[22] as well as "properly operated venture capital funds."[23] These comments were made by Barney Frank, Chairman of the House Financial Services Committee, in a colloquy with Representative James Himes, Democratic Congressman from Connecticut, and by Christopher Dodd, Chairman of the Senate Banking Committee, in a colloquy with Barbara Boxer, Democratic Senator from California. These comments are especially reliable evidence of congressional intent because the Dodd-Frank Act originated in the Senate Banking Committee and the House Financial Services Committee, Senator Dodd and Representative Frank were the chairmen of those committees, the Act is named after them, all of the senators and representatives making these comments voted in favor of the Act and all of these comments are uncontradicted in the record.

The FSOC Study similarly made findings and recommendations related to the reach of the general definition of hedge funds and private equity funds. The FSOC Study found that the general definition appeared to sweep in "a wide variety of funds and other legal entities that rely on the exclusions" that are used by the statute to define hedge funds and private equity funds, "including special purpose acquisition vehicles and certain ERISA qualified employee pension funds."[24] In light of its findings, the FSOC Study made two important recommendations:

- "In implementing the Volcker Rule, the 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

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[22] *See* 156 CONG. REC. H5226 (daily ed. June 30, 2010) (colloquy between Barney Frank, Chairman of the House Financial Services Committee (D-MA) and Rep. James Himes (D-CT)).

[23] *See* 156 CONG. REC S5904 (daily ed. July 15, 2010) (colloquy between Christopher Dodd, Chairman of the Senate Banking Committee (D-CT) and Sen. Barbara Boxer (D-CA)).

[24] *See* FSOC Study at 61.

Volcker Rule but that Congress may not have intended to capture in enacting the statute."[25]

- The Agencies should "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."[26]

For the reasons provided in our comment letter on the FSOC Study, we agree that the general definition appears to be overbroad and to sweep in many issuers that Congress did not intend to be treated as hedge funds or private equity funds for purposes of the Volcker Rule and that have never been considered hedge funds or private equity funds in any other context. The FSOC Study made clear reference to the problems engendered by the general definition's overbreadth, but did not provide any guidance on how the Agencies should go about construing this definition in accordance with congressional intent. We believe that there are at least five ways in which Congress authorized and expected the Agencies to use their legitimate interpretive and exemptive authorities granted by Congress or recognized by the courts to reduce the general definition's apparent overbreadth and bring it more into line with congressional intent.

First, in Section (b)(2)(A) of the Volcker Rule, Congress required the Agencies to consider the findings and recommendations of the FSOC Study in adopting substantive rules to implement the Volcker Rule. Congress authorized the FSOC to issue findings and recommendations for clarifying and refining the definitions and the provisions of the Volcker Rule to better reflect the intent of Congress. To conclude otherwise would make the plain language of Section (b)(2)(A) and the FSOC Study itself superfluous. The FSOC Study found that the general definition was overbroad and appeared to sweep in issuers that Congress clearly did not intend to treat as hedge funds or private equity funds for purposes of the Volcker Rule. It recommended that the Agencies consider refining the general definition in order to narrow it to be more in line with congressional intent. Indeed, the FSOC Study, mandated by the statute, directs the Agencies to consider the FSOC's findings, which include the recommendations of the Study. While the FSOC Study's findings and recommendations would not justify a wholesale departure from the general definition, we believe it provides the Agencies with authority to make reasonable refinements to the general definition to narrow it to be more in line with congressional intent.

Second, Congress expressly authorized the Agencies to grant exemptions from the general definition under Section (d)(1)(J) of the Volcker Rule. That provision empowers the Agencies to grant an exemption if it would promote and protect the safety and soundness of banking entities and the financial stability of the United States. Although this standard establishes

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[25] *Id.* at 7.

[26] *Id.* at 62.

a fairly high bar, it was not intended to be insuperable and Congress intended for it to be interpreted liberally. For example, Senate Banking Committee Chairman Christopher Dodd indicated that Section (d)(1)(J) would permit an exemption for ***properly operated*** venture capital funds because properly operated funds would "not cause the harms at which the Volcker rule is directed."[27] Senator Dodd's comments provide especially reliable evidence of congressional intent for the reasons explained above. There is no question that a venture capital fund falls within the general definition of the term private equity fund and that even a properly operated venture capital fund, which invests in start-up companies, is among the riskier types of private equity funds. Thus, Senator Dodd must be understood to have said that any properly operated fund would satisfy the standard for an exemption under Section (d)(1)(J).

We argued in our comment letter on the FSOC Study that credit funds would satisfy the standard in Section (d)(1)(J) because they promote and protect the safety and soundness of banking entities and the financial stability of the United States. Credit funds are predominantly engaged in originating or investing in loans and other extensions of credit in the primary markets. They promote and protect the safety and soundness of banking entities by facilitating pre-syndication, or the sharing of credit risk on many loans and extensions of credit from the banking system with investors in the credit funds. They promote and protect the financial stability of the United States because they are capitalized and funded with stable long-term instruments and thus do not experience runs during periods of financial distress. Credit funds should also qualify for an exemption under the rule of construction in Section (g)(2) of the Volcker Rule, discussed below.

We also believe that any "properly operated" fund — that is, a fund that is operated by a banking entity in a manner than does not implicate the risks that the Volcker Rule was designed to limit and that promotes the public welfare, as determined by the banking entity's primary federal financial regulatory agency — should satisfy the standard in Section (d)(1)(J). Properly operated funds that should meet this standard include venture capital funds, infrastructure funds and tracking funds. Each of these types of funds serves a variety of public purposes, including job creation. A venture capital fund invests in start-up companies, helping new businesses and the development of new technologies. Infrastructure funds invest in instruments that finance works projects, such as roads, bridges and other public infrastructure. Tracking funds follow an investment strategy of generating returns equal to or in excess of a recognized index, such as the S&P 500, or other benchmark, and that do not employ leverage, short securities or compensate their investment managers with performance-based incentive fees.

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[27] Colloquy Between Senators Boxer (D-CA) and Dodd, 156 CONG. REC. S5904 (daily ed. July 15, 2010) ("In the event that properly conducted venture capital investment is excessively restricted by the provisions of Section 619, I would expect the appropriate Federal regulators to exempt it using their authority under Section 619[d][1](J).").

Third, as clearly implied by the wording of the general definition, Congress authorized the Agencies to confirm that certain categories of issuers that have the option of relying on an exemption from the Investment Company Act other than Sections 3(c)(1) and 3(c)(7) will not be treated as hedge funds or private equity funds or be designated as similar funds for purposes of the Volcker Rule. One example would be wholly-owned subsidiaries of bank holding companies with more than 60% of their assets attributable to insured depository institution subsidiaries or other assets other than investment securities. Such wholly-owned subsidiaries should qualify for an exemption under Section 3(b)(3) of the 1940 Act. We believe that the Agencies should confirm in their implementing regulations that wholly-owned subsidiaries of any banking entity that satisfies the definitions of Sections 3(b)(1) or 3(b)(2) may rely on Section 3(b)(3) for an exemption from the term "hedge fund" or "private equity fund."

Fourth, Congress expressly authorized the Agencies to use the rule of construction for securitizations in Section (g)(2) of the Volcker Rule to exclude certain securitization vehicles that are not eligible for the asset-backed exemption under Rule 3a-7 under the 1940 Act, and instead must rely on Sections 3(c)(1) or 3(c)(7) for an exemption. Section (g)(2) provides that nothing in the Volcker Rule shall be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law. We believe this provides the Agencies with authority to exempt any securitization vehicle that securitizes loans or other extensions of credit or financial instruments based on such assets, including the origination, purchase or sale of such loans or other extensions of credit or financial instruments in connection with such securitization.

Fifth, Congress expected the Agencies to exercise their discretion under the standard of deference set forth in *Chevron v. National Resources Defense Council*[28] to limit the scope of the general definition to avoid certain internal contradictions, absurd results or unintended consequences that are created in the Volcker Rule if the general definition is read literally. Under the Supreme Court's canons of statutory construction, a statute should be construed to avoid such internal contradictions, absurd results and unintended consequences, if possible to do so.[29] We addressed a number of these issues in our comment letter on the FSOC Study. We believe the Agencies have the power to confirm and should confirm that appropriately regulated foreign investment companies, such as Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), are not hedge funds or private equity funds for purposes of the Volcker Rule based on their similarity to SEC-registered mutual funds, which are clearly excluded. We also believe the Agencies have the power, under the *Chevron* standard of deference, to clarify that majority-owned subsidiaries, joint venture subsidiaries and acquisition vehicles that are normally used by banking entities to hold investments on their balance sheets are

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[28] 467 U.S. 837 (1984).

[29] *See* W. Eskridge, P. Frickey & E. Garrett, LEGISLATION AND STATUTORY INTERPRETATION 267-71, 390 (2d ed. 2006).

not hedge funds or private equity funds for purposes of the Volcker Rule if they satisfy certain conditions..

We have not remarked previously on the internal contradictions present in the statute or that will inevitably arise in the implementing regulations by defining hedge funds and private equity funds in identical terms, when the two types of funds are manifestly different from each other. The transition provisions of the Volcker Rule and their implementing regulations make distinctions between hedge funds and private equity funds in various places. For example, the transition rules in both the statute and implementing regulations define "illiquid funds" in a manner that necessarily excludes virtually all hedge funds. In addition, the FSOC Study suggested that hedge funds and private equity funds should be treated differently for purposes of determining whether carried interest might sometimes by treated as an ownership interest instead of as incentive compensation.

We have provided language to exclude these companies from the definition of covered funds in Annex B.

V. Similar Funds

The FSOC Study appears to confirm that the Agencies should perform any similar funds analysis by reference to whether a particular issuer is similar to a ***traditional*** hedge fund or private equity fund, and not whether it is similar to any of the much broader universe of issuers that may fall within the general definition of the terms hedge fund or private equity fund. Specifically, it recommends that the Agencies "consider using their authority to expand the definition by rule to funds that do not rely on either Section 3(c)(1) or 3(c)(7), but that engage in the activities or have the characteristics of a ***traditional*** private equity fund or hedge fund."[30] In determining which funds to designate as similar funds, the FSOC Study recommends that the Agencies "consider the following characteristics of traditional hedge funds or private equity funds:

- ***Related compensation structure***: Does the fund earn an allocation based on fund performance including both realized and unrealized gains?
- ***Trading/Investment strategy***: What trading or investment strategy does the fund utilize?
- ***Use of leverage***: Does the fund borrow or otherwise utilize material leverage for the purpose of increasing investment performance?

[30] *See* FSOC Study at 62 (emphasis added).

- ***Investor composition***: Is the fund's capital received from a broad group of unaffiliated investors?"[31]

We agree that the Agencies are free to perform their similar fund analysis by reference to traditional hedge funds and private equity funds, rather than the broader universe of issuers that may fall within the general definition for the reasons stated in our comment letter on the FSOC Study.[32] Nothing in the statutory text precludes such an interpretation, which is a fair and reasonable interpretation well within the Agencies' discretion under the *Chevron* standard. We do not believe, however, that an issuer should be found to be similar to a traditional hedge fund or private equity merely because it has *one* of the characteristics of a hedge fund or private equity fund listed above. Instead, we believe that an issuer should only be designated as a similar fund if it shares *substantially all* of the characteristics of a traditional hedge fund or private equity fund. We also believe that the Agencies should adopt the definitions for traditional hedge funds and private equity funds proposed in our comment letter on the FSOC Study for purposes of performing any similar fund analysis.

We have proposed language to implement those definitions in Annex B.

VI. BOLI/COLI

In our comment letter on the FSOC Study, we recommended that the Agencies clarify that investments in hedge funds and private equity funds credited to separate accounts established by insurance companies in respect of bank-owned life insurance policies ("**BOLI**") or company-owned life insurance policies ("**COLI**") will not be attributable to the banking entity.[33]

We supplement that recommendation by asking that the Agencies clarify that neither BOLI and COLI policies nor the separate accounts established in respect of them by insurance companies offering the BOLI/COLI policies will be considered hedge funds or private equity funds for the purposes of the Volcker Rule. BOLI and COLI insurance policies held by banking entities are tax efficient, risk mitigating tools employed to defray the cost of employee benefit obligations. The banking agencies have recognized the importance of such policies as "an effective way for [banking] institutions to manage exposures arising from commitments to provide employee compensation and pre-and post-retirement benefits," and have placed significant restrictions on the amount of such insurance that may be purchased, the due diligence associated with a purchase decision and senior management oversight of such policies.[34] The

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[31] *Id.*

[32] *See* SIFMA FSOC Study comment letter at 7-10.

[33] *See* SIFMA FSOC Study comment letter at 8-9.

[34] *See* Interagency Statement on the Purchase and Risk Management of Life Insurance (December 7, 2004) ("**Interagency Statement**").

banking agencies also recognize that when such a policy is purchased there should be an intent to hold it over the long term, as the tax benefits are recognized only through holding the policy for its full term and surrender of a BOLI/COLI policy prior to maturity will subject a banking entity to tax liabilities, surrender charges and potentially other penalties. Banking entities are expressly prohibited from purchasing such policies for "speculative purposes." BOLI/COLI policies are regulated under state insurance laws.

As of the end of the third quarter of 2010, a report by Michael White Associates LLC prepared based on banks' regulatory filings reported that BOLI life insurance was held by 915 bank holding companies and 7,760 stand-alone banks, thrifts and FDIC-supervised savings banks.[35] The Michael White report stated that the reported BOLI/COLI asset total for banking entities was approximately ***$140 billion*** at the end of the third quarter of 2010, an amount, based on the International Monetary Fund's 2010 ranking of 181 countries by GDP, that exceeds the GDP of 131 countries.

When a banking entity purchases a BOLI/COLI policy from an insurance company, a separate account is set up by the insurance company in respect of the policy, but the banking entity does not, and may not under the relevant tax provisions, own the separate account or exercise undue control over the investments in it. The banking entity pays the premiums, owns the cash value of the policy and is the designated beneficiary. Under insurance law, the assets of a separate account are considered to be assets of the insurance company, although the assets are not subject to the claims of the general creditors of the insurance company or any other part of the company's business and consequently protect the policy holder from credit risks associated with the creditworthiness of the insurance company. The SEC has determined that the separate account is an investment company in its own right and therefore the separate account is organized to rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act in order to be exempt from registration under that Act. Because of this reliance on these exemptions, the separate account, but not the BOLI/COLI policy itself, falls within the Volcker Rule's general definition of a hedge fund or a private equity fund.

We believe that Congress did not intend for either the BOLI/COLI life insurance policies held by banking entities or the separate accounts held by insurance companies in respect of such policies to be subject to the restrictions of the Volcker Rule. The FSOC Study confirmed this view, recommending that the Agencies "examine [commenters' concerns that some separate account products could be included in the definitions of 'hedge fund' and 'private equity fund']

[35] Summarized at http://www.lifeandhealthinsurancenews.com/News/2011/3/Pages/BOLI-Assets-Grow.aspx.

carefully so as not to preclude certain insurance products that may not have been intended to be limited by the Volcker Rule."[36]

We believe that the Agencies have ample authority to clarify this issue under Section (d)(1)(J) or to confirm that the purchase of a BOLI/COLI policy and the separate account held by the insurance company in respect of such policy is a permissible hedging activity under Section (d)(1)(C). If banking entities could no longer hold BOLI/COLI life insurance policies because they or the related separate accounts were treated as hedge funds or private equity funds under the Volcker Rule, based on the numbers reflected in the Michael White report, 8,675 banking entities would be required, at the same time, to surrender their policies having a total asset value of $140 billion — an amount that, as noted above, is greater than the GDP of 131 out of the 181 countries tracked by the IMF in 2010. While banking entities would not lose the entire value of their policies, there would likely be a significant negative impact to certain banks and to U.S. financial stability – not merely as a consequence of the detrimental impact to the capital of banking entities and resources lost to meet their employee benefit obligations, but also through the simultaneous liquidation in the market of the investments held in the related separate accounts to pay the cash surrender values of the policies. The banking agencies originally granted banking entities permission to purchase BOLI/COLI to promote their safety and soundness through the prudent management of employee liabilities on a tax-advantaged basis, and they and the other Agencies should exercise their exemptive authority under the Volcker Rule to confirm this and to promote U.S. financial stability. Through their supervisory authority, the banking agencies today have, and will continue to have, ample authority to assure that banking entities that purchase BOLI/COLI fulfill the requirements of the Interagency Policy and, consequently, that such policies are not speculative.

We have proposed language to implement this recommendation in Annex B.

[36] *See* FSOC Study at 75.

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We thank the Agencies for their consideration of our comments in advance of the issuance of proposed rules. If you have any questions, please do not hesitate to call me at 212-313-1114, or our counsel, Randall D. Guynn, Davis Polk & Wardwell LLP, at 212-450-4239, or Yukako Kawata, Davis Polk & Wardwell LLP, at 212-450-4896.

Sincerely,

Randolph C. Snook
Executive Vice President
Securities Industry and Financial Markets Association

Note: *The paragraphs below summarize comments made in our comment letters submitted to the Financial Stability Oversight Council and the Board of Governors of the Federal Reserve System on the FSOC Study and the conformance rules, respectively. SIFMA would like to briefly highlight these issues again for the Agencies in light of the issuance of the FSOC Study and the final conformance rules. We have proposed language to implement all of these recommendations in Annex B.*

(a) **Reach of hedge fund and private equity fund definition**

(1) ***SIFMA recommendation***: The Agencies should clarify that if an issuer may rely on any exemption from the 1940 Act other than Sections 3(c)(1) or 3(c)(7) it will not fall within the general definition of hedge fund and private equity fund.

By defining a hedge fund or private equity fund as any issuer that would be an investment company "but for" Sections 3(c)(1) or 3(c)(7), the general definition in the Volcker Rule reaches only those issuers that would be investment companies if Sections 3(c)(1) or 3(c)(7) did not exist. Therefore, the general definition does not reach any issuer that falls entirely outside the definition of "investment company" (for example, an issuer more than 60% of the assets of which are not investment securities) or that qualifies for one of the other exemptions from that term under the 1940 Act.

Please see our comment letter on the FSOC Study for further discussion of these issues.[1]

We have included proposed language for this recommendation in Annex B.

(2) ***SIFMA recommendation***: The Agencies should clarify, as noted in the FSOC study, that only issuers that are substantially similar to ***traditional*** hedge funds and private equity funds will be designated as "similar funds."

As the FSOC Study noted, Congress granted the Agencies the rulemaking authority to designate "similar funds" in order to ensure that issuers that "share the characteristics of ***traditional*** private equity funds or hedge funds" do not escape the reach of the Volcker Rule simply because they fall outside the general definition.[2]

Please see our comment letter on the FSOC Study for further discussion of this issue.[3]

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[1] *See* SIFMA FSOC Study comment letter at 4-7.

[2] *See* FSOC Study at 62. (Emphasis added.)

[3] *See* SIFMA FSOC Study comment letter at B-4–B-8.

We have included proposed language for this recommendation in Annex B.

(3) ***SIFMA recommendation***: The Agencies should clarify that wholly-owned subsidiaries of BHCs that qualify for an exemption under Section 3(b)(3) of the 1940 Act, and subsidiaries that would qualify but for not being wholly-owned, fall outside the general definition of hedge fund and private equity fund and will not be designated as "similar funds."

Section 3(b)(3) of the 1940 Act exempts from the definition of "investment company" any issuer "all the outstanding securities of which (other than short-term paper and directors' qualifying shares) are directly or indirectly owned by a company excepted from the definition of investment company [by Sections 3(b)(1) or 3(b)(2)[4] of the 1940 Act]." Because issuers that may rely on the 3(b)(3) exemption are not investment companies "but for" Sections 3(c)(1) or 3(c)(7) of the 1940 Act, they do not fall within the general definition of hedge fund and private equity fund. In addition, wholly-owned subsidiaries clearly do not resemble traditional hedge funds or private equity funds, not least because they have no unaffiliated investors, and so should not be designated as "similar funds."

We have included proposed language for this recommendation in Annex B.

(4) ***SIFMA recommendation***: The Agencies should grant an exemption for credit funds from the general definition of hedge fund and private equity fund under the Agencies' (d)(1)(J) authority, the (g)(2) rule of construction or otherwise.

We believe that the Agencies should explicitly exempt from the definition of hedge fund and private equity fund credit funds that are predominantly engaged in originating or purchasing loans and other extensions of credit in primary debt originations, activities that are at the core of banking entity-permissible activities. Credit funds lend money on a long-term basis, supporting liquidity and stable credit, strengthening the overall economy and promoting job creation by providing credit to companies that cannot access public markets.

Please see our comment letter on the FSOC Study for further discussion of this issue.[5]

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[4] Section 3(b)(1) of the 1940 Act exempts from the definition of "investment company" any issuer "primarily engaged, directly or through a wholly-owned subsidiary or subsidiaries, in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities," and Section 3(b)(2) exempts any issuer "which the Commission, upon application by such issuer, finds and by order declares to be primarily engaged in a business or businesses other than that of investing, reinvesting, owning, holding, or trading in securities."

[5] *See* SIFMA FSOC Study comment letter at 10-11.

We have included proposed language for this recommendation in Annex B.

(5) ***SIFMA recommendation***: The Agencies should clarify that regulated foreign investment companies (*e.g.*, UCITS) do not fall within the general definition of hedge fund and private equity fund even if they are offered or sold to one or more U.S. investors under Section 3(c)(1) or 3(c)(7) of the Investment Company Act.

We recommend that the Agencies explicitly exempt from the definition of hedge fund and private equity fund regulated foreign investment companies, such as UCITS, that resemble SEC-registered investment companies rather than traditional hedge funds or private equity funds.

Please see our comment letter on the FSOC Study for further discussion of this issue.[6]

We have included proposed language for this recommendation in Annex B.

(6) ***SIFMA recommendation***: The Agencies should clarify that an issuer that engages in the origination, purchase, sale or securitization of loans or assets based on loans, including the accumulation of loans for the purpose of securitization or investments in CLOs, CDOs or other securities issued by securitization vehicles, should be exempted from the definition of hedge fund and private equity fund.

We recommend that the Agencies explicitly exempt from the definition of hedge fund and private equity fund issuers that originate, buy, sell or securitize loans or assets based on loans. Doing so would be consistent with the rule of construction that Congress set forth in Section (h)(2) of the Volcker Rule, which provides that "[n]othing in [the Volcker Rule] shall be construed to limit or restrict the ability of a banking entity or nonbank financial company supervised by the Board to sell or securitize loans in a manner otherwise permitted by law." The inclusion of this provision, which we believe authorizes the Agencies to carve out loan-related securitization vehicles from the reach of the Volcker Rule, evidences Congress's recognition of the critical role that securitization plays in the lending markets.

We have included proposed language for this recommendation in Annex B.

(b) **Employee pension funds**

SIFMA recommendation: The Federal Reserve should exercise its discretionary authority under Section 2(g)(2) of the Bank Holding Company Act, which otherwise attributes to a bank holding company all investments made by employee

[6] *See* SIFMA FSOC Study comment letter at 9.

pension funds, so that such investments are not so attributed to the bank holding company or any of its affiliates for purposes of the Volcker Rule.

Employee pension funds, which are highly regulated under ERISA, should not be restricted from investing in hedge funds and private equity funds for purposes of diversification, asset allocation and portfolio management. In the absence of the exercise by the Federal Reserve of its discretionary authority under Section 2(g)(2) of the Bank Holding Company Act,[7] these investments would be attributed to the bank holding company and subject to the restrictions of the Volcker Rule, a consequence that Congress could not have intended.

Please see our comment letter on the FSOC Study for further discussion of this issue.[8]

We have included proposed language for this recommendation in Annex B.

(c) **Reach of "sponsor" definition: selecting an initial slate of directors**

SIFMA recommendation: The Agencies should clarify that a banking entity will not be deemed to be the sponsor of a newly organized hedge fund or private equity fund solely by virtue of selecting a majority of its directors or trustees, provided that a majority of such directors or trustees is independent of the banking entity and its affiliates.

We believe that it would be impractical, and serve none of the policy interests underlying the Volcker Rule, to treat a banking entity as the sponsor of a fund merely because it proposed a board of directors upon formation of a new fund, if a majority of the board is independent.

Please see our comment letter on the FSOC Study for further discussion of this issue.[9]

We have included proposed language for this recommendation in Annex B.

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[7] Section 2(g)(2) provides as follows: "[S]hares held or controlled directly or indirectly by trustees for the benefit of . . . the employees (whether exclusively or not) of a company, shall be deemed to be controlled by such company, ***unless the Board determines that such treatment is not appropriate*** in light of the facts and circumstances of the case and the purposes of the Act."). U.S.C. § 1841(g)(2) (emphasis added).

[8] *See* SIFMA FSOC Study comment letter at 16-17.

[9] *See* SIFMA FSOC Study comment letter at B-8.

(d) **Reach of "banking entity" definition**

> ***SIFMA recommendation***: The Agencies should clarify that hedge funds and private equity funds will be excluded from the definition of "banking entity" to avoid internal contradictions within the Volcker Rule. The Agencies should also clarify that asset management affiliates of bank holding companies will be excluded from the term "banking entity" solely for purposes of the name-sharing prohibition in Section (d)(1)(G).

Unless the Agencies construe the terms "affiliate" and "subsidiary" to exclude hedge funds and private equity funds for purposes of the Volcker Rule, the term "banking entity" would include any hedge fund or private equity fund that is sponsored or otherwise controlled by a bank holding company or any of its direct or indirect subsidiaries. Such a controlled fund would itself be subject to the restrictions of the Volcker Rule and prohibited, for example, from making controlling investments in other hedge funds and private equity funds, creating an internal contradiction with Super 23A, which explicitly contemplates controlling investments by sponsored fund of funds. As a practical matter, banking entities could not operate a fund of funds business. Moreover, the traditional master-feeder structure, a mainstay of the funds business, would no longer be permissible for banking entities. These are the sorts of internal contradictions and absurd results that must be avoided under the Supreme Court's canons of statutory construction.

We also recommend that asset management affiliates of bank holding companies be excluded from the term "banking entity" solely for purposes of the name-sharing prohibition in (d)(1)(G), provided they do not share a variant of the name of an affiliated depository institution or depository institution holding company. Otherwise, each affiliated hedge fund or private equity fund that shares the name of the asset management affiliate but not of the bank or its holding company will have to have a unique name. We believe that Congress did not intend this result.

Please see our comment letter on the FSOC Study for further discussion of these issues.[10]

We have included proposed language for this recommendation in Annex B.

(e) **Super 23A**

(1) ***SIFMA recommendation***: The Agencies should exclude from the definition of "covered transactions" acquisitions by a banking entity of any ownership interests in a hedge fund or private equity fund advised, managed, sponsored or organized

[10] *See* SIFMA FSOC Study comment letter at 12-14.

and offered by the banking entity to avoid creating internal contradictions, including between Super 23A and (d)(1)(G).

We recommend that the Agencies clarify that the acquisition by a banking entity of ownership interests in a hedge fund or private equity fund that the banking entity advises, manages, sponsors or organizes and offers pursuant to a permitted activity in Section (d)(1) does not constitute a "covered transaction" for purposes of Super 23A. In the absence of this clarification Super 23A by its terms would prohibit any such acquisition, including *de minimis* co-investments in a sponsored fund authorized by Section (d)(1)(G) and hedging investments in advised funds pursuant to Section (d)(1)(C).

Please see our comment letter on the FSOC Study for further discussion of this issue.[11]

We have included proposed language for this recommendation in Annex B.

(2) ***SIFMA recommendation***: The Agencies should incorporate into the definition of "covered transactions" all of the exemptions in Section 23A and Regulation W, such as the exemption for transactions that are fully secured by U.S. government securities or cash collateral and for intraday extensions of credit that facilitate settlement, but should not incorporate the attribution rule of Section 23A.

We recommend that the Agencies interpret Super 23A to incorporate all of the exemptions in Section 23A(d) of the Federal Reserve Act and subpart E of the Federal Reserve's Regulation W, including the exemptions for extensions of credit fully secured by cash or United States government or agency securities and for intraday extensions of credit, which are necessary for the efficient settlement of securities and other transactions.[12] These exemptions are just as necessary to prevent Super 23A from having unintended consequences as they are in actual Section 23A.

We also note that we read the plain language of Super 23A to exclude the so-called "attribution rule" of Section 23A(a)(2). Section 23A(b)(6) of the Federal Reserve Act states in relevant part that "the term 'covered transaction' means ***with respect to*** an affiliate of a member bank . . . [list of transactions that are covered]." (Emphasis added.) Super 23A, by contrast, states in relevant part that "[n]o 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 no affiliate of such entity, may enter into a transaction ***with*** the fund . . . that would be a covered transaction . . . ." In light of the language in Super 23A, we believe that Congress intended to

[11] *See* SIFMA FSOC Study comment letter at 13-14.

[12] 12 U.S.C. § 371c(d)(4); 12 C.F.R. § 223.42(c), (l).

restrict the application of Super 23A to transactions between a banking entity and a covered fund and not to extend it to transactions with third parties based on the attribution rule in Section 23A.

We recommend that the Agencies specifically clarify that Super 23A would not prevent a banking entity from underwriting a securities offering by, or otherwise providing an extension of credit to, a portfolio company of a hedge fund or private equity fund sponsored, advised, managed, or organized and offered by the banking entity.

Please see our comment letter on the FSOC Study for further discussion of this issue.[13]

We have included proposed language for this recommendation in Annex B.

(3) **SIFMA recommendation**: Super 23A should not apply to a portfolio company that is not itself a hedge fund or private equity fund, that is, Super 23A should not prohibit a banking entity or one of its affiliates from underwriting an IPO or a secondary offering of a portfolio company of a sponsored, advised, managed, or organized and offered fund.

We recommend that the Agencies clarify that the terms "affiliate" and "subsidiary" do not include the portfolio companies of controlled hedge funds or private equity funds for purposes of the definition of "banking entity" under the Volcker Rule. In the absence of clarification, any portfolio company in which a controlled fund has a controlling investment would also be treated as a banking entity for purposes of the Volcker Rule. It is inconceivable that Congress intended for the Volcker Rule to interfere with the investment activities of the controlled portfolio companies of such hedge funds or private equity funds or to treat portfolio companies as banking entities for purposes of Super 23A.

Please see our comment letter on the FSOC Study for further discussion of this issue.[14]

We have included proposed language for this recommendation in Annex B.

(4) ***SIFMA recommendation***: The Agencies should clarify that there is a "reasonable inquiry" or similar standard for the CEO certification requirement in connection with the prime brokerage exception to Super 23A.

Section (f)(3)(A)(ii) of the Volcker Rule provides that in order for a banking entity to avail itself of the exception from Super 23A for prime brokerage transactions with hedge funds

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[13] *See* SIFMA FSOC Study comment letter at 19-20.

[14] *See* SIFMA FSOC Study comment letter at 17-18.

or private equity funds in which a hedge fund or private equity fund managed, sponsored or advised by the banking entity invests, the CEO of the banking entity must certify annually that the banking entity is in compliance with the anti-bailout provision in (d)(1)(G)(v). We recommend that the Agencies clarify that, as with the requirement in Section 302 of the Sarbanes-Oxley Act that CEOs and CFOs of public companies certify certain findings with respect to the effectiveness of internal controls over financial reporting, a banking entity CEO be able to rely on a process designed by, or under the supervision of, the CEO and principal financial officers, or persons performing similar functions, and effected by the banking entity's board of directors, management and other personnel, to provide reasonable assurance regarding compliance with the anti-bailout condition.

(f) **Conformance rules**

(1) ***SIFMA recommendation***: The Federal Reserve should revisit the conformance rules because the definitions of "contractual obligation" and "illiquid fund" are so restrictive as to be inconsistent with congressional intent.

We recommend that the Federal Reserve revisit the conformance rules after the completion of the interagency rulemaking process, as the Federal Reserve indicated in the rulemaking release accompanying the final conformance rules that it expects to do.[15] In particular, we believe that the definition of "contractual obligation" in the conformance rules is so restrictive as to eliminate the possibility of an extended conformance period for almost all illiquid funds, a result that Congress clearly did not intend. Almost every illiquid fund has a provision that permits transfers of interests with applicable consent or that permits withdrawal because of a change in applicable laws. We continue to believe that the mere fact that illiquid funds contain those provisions should not negate the availability of the extended five-year conformance period, provided that the other provisions of the rule are satisfied. The resulting forced sales of fund interests at depressed or even fire sale prices would be disruptive to the U.S. economy, damaging to the capital and earnings of U.S. banks, and harmful to unaffiliated investors. In addition, we believe that the definition of "illiquid fund" in the conformance rules is far more restrictive than Congress intended, and would inappropriately restrict the availability of an extended conformance period for funds rendered genuinely illiquid by the size of their positions, adverse market conditions or events occurring subsequent to May 1, 2010, among other circumstances.

Please see our comment letter on the proposed conformance rules for further discussion of this issue.[16]

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[15] *See* Final Conformance Rules at 8266.

[16] *See* SIFMA Conformance Rules comment letter at 4-12, 16-17.

(2) ***SIFMA recommendation***: Fundamental fairness requires that the Federal Reserve provide appropriate transition periods for issuers designated as "similar funds" to permit banking entities to bring the funds' operations into compliance with the Volcker Rule upon such a designation.

It is virtually impossible for banking entities to predict in advance what sort of funds the Agencies in the future may designate as a similar fund until they actually do so or provide specific guidance as to which types of funds would be treated as similar funds. We believe that issuers designated as "similar funds" should be eligible for the same conformance period, including extensions, as funds in existence prior to the effective date of the Volcker Rule,

Please see our comment letter on the proposed conformance rules for further discussion of this issue.[17]

(g) **Calculation of 3% of Tier 1 capital *de minimis* limit**

(1) ***SIFMA recommendation***: The 3% of Tier 1 capital *de minimis* limit should be calculated on a consolidated basis at the level of the ultimate parent of a banking entity, based on the parent's most recent consolidated regulatory capital report.

We believe that calculating the 3% of Tier 1 de minimis capital limit at the level of each affiliate that organizes and offers a fund, rather than on a consolidated basis at the ultimate parent level, would effectively read the sponsoring exception in Section (d)(1)(G) of the Volcker Rule out of the statute, because these affiliates are typically special purpose vehicles that have almost no capital independent of their bank holding company parent. In addition, affiliates that organize and offer funds are not required, and do not have the systems, to calculate their own Tier 1 capital.

Please see our comment letter on the FSOC Study for further discussion of this issue.[18]

We have included proposed language for this recommendation in Annex B.

(2) ***SIFMA recommendation***: During the conformance period (including extensions), the 3% of Tier 1 capital *de minimis* limit should be calculated with reference only to new sponsored funds that comply with Section (d)(1)(G) of the Volcker Rule.

We believe that the Agencies should clarify that during the conformance period, including extensions thereof, the 3% of Tier 1 capital *de minimis* limit should be calculated with

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[17] *See* SIFMA Conformance Rules comment letter at 14; *see also* SIFMA FSOC Study comment letter at 10.

[18] *See* SIFMA FSOC Study comment letter at 21-22.

reference only to new funds that comply with Section (d)(1)(G). Nothing in the statutory text or legislative history of the Volcker Rule suggests that Congress intended to prevent banking entities from sponsoring new funds in compliance with Section (d)(1)(G) until all pre-existing funds are conformed, a process that the conformance period by its own terms contemplates taking as long as ten years.

(h) **Timing of calculation of 3% *de minimis* limits**

(1) ***SIFMA recommendation***: The 3% per fund *de minimis* limit should be calculated as a snapshot as of the end of the applicable seeding or conformance period, and the 3% of Tier 1 capital *de minimis* limit should be calculated on an ongoing basis as of the last calendar day of each quarter.

We believe that for purposes of determining whether a banking entity complies with the *de minimis* limits in Section 13(d)(4)(B)(ii), the Agencies should clarify the following:

With respect to the per fund limit in Section 13(d)(4)(B)(ii)(I), the banking entity's ownership interest in a covered fund measured as a percentage of the total ownership interests in such covered fund should be calculated as of the last day that the banking entity is permitted to hold ownership interests in the fund in excess of 3% (that is, at the end of the seeding period or conformance period, as applicable), and should be calculated again only on each subsequent date, if any, on which the banking entity acquires additional ownership interests in the fund.

With respect to the Tier 1 limit in Section 13(d)(4)(B)(ii)(II), the banking entity's total ownership interests in covered funds measured as a percentage of the Tier 1 capital of the banking entity's ultimate parent should be calculated as of the last day of each calendar quarter.

This approach would prevent banking entities from inadvertently violating the 3% per fund limit as a result of events outside their control, such as redemptions of other investor interests, changes to the permitted components of Tier 1 capital, or increases in the value of a banking entity's ownership interest in a fund (which would increase the numerator for the Tier 1 calculation), while also ensuring that banking entities comply with the 3% of Tier 1 limit on an ongoing basis.

Please see our comment letter on the FSOC Study for further discussion of this issue.[19]

We have included proposed language for this recommendation in Annex B.

[19] *See* SIFMA FSOC Study comment letter at 20-21.

(2) ***SIFMA recommendation***: The term "date of establishment" in Section (d)(4) of the Volcker Rule should refer to the date on which third-party investors are admitted to a hedge fund or private equity fund or acquire interests in such fund, and not to the fund's date of formation.

(i) **Reach of sponsor definition — directed trustees**

SIFMA recommendation: Directed trustees should be excluded from the definition of the term "trustee" as used in the definition of "sponsor" in Section (h)(5) of the Volcker Rule, since directed trustees do not manage or control funds or exercise investment discretion, but act more like custodians performing ministerial functions, such as safekeeping, settlement, accounting, administrative and other functions relating to asset control.

For a full discussion of this issue, see the comment letter on the FSOC Study submitted by SIFMA members BNY Mellon, State Street and Northern Trust.[20]

We have included proposed language for this recommendation in Annex B.

(j) **DPC investments in hedge funds or private equity funds**

SIFMA recommendation: Banking entities should be allowed to foreclose on pledged ownership interests in hedge funds or private equity funds in satisfaction of a debt obligation without implicating the Volcker Rule.

We believe that the ability of banking entities to foreclose on collateral, including pledged ownership interests in hedge funds or private equity funds, in satisfaction of a debt obligation is among the most basic incidents of the power to extend credit and promotes and protecting the safety and soundness of banking entities and the financial stability of the United States. We therefore recommend that the Agencies clarify that an interest in a hedge fund or private equity fund acquired by a banking entity in satisfaction of a debt previously contracted does not constitute an "ownership interest" for purposes of the Volcker Rule.

Please see our comment letter on the FSOC Study for further discussion of this issue.[21]

We have included proposed language for this recommendation in Annex B.

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[20] This comment letter is available at http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0002-0042.1.

[21] *See* SIFMA FSOC Study comment letter at 18-19.

(k) **Exemption for investments in SBICs and certain public welfare investments**

> ***SIFMA recommendation***: The Agencies should interpret the exemption in Section (d)(1)(E) of the Volcker Rule to permit public welfare investments that are of the same nature as those permitted under 12 USC § 24(Eleventh).

We believe that legislative history supports an interpretation of Section (d)(1)(E) of the Volcker Rule that would permit public welfare investments of the same nature as those permitted under 12 USC § 24(Eleventh), even if not expressly permitted under that section.

Please see our comment letter on the FSOC Study for further discussion of this issue.[22]

[22] *See* SIFMA FSOC Study comment letter at B-11.

Note: *The following proposed definitions are offered to illustrate how the comments in the body of our letter or Annex A could be implemented.*

I. Definitions

(a) *Acquisition vehicle* means any company that would be an investment company, as defined in the Investment Company Act of 1940, but for section 3(c)(1) or 3(c)(7) of that Act that is formed for the purpose of investing directly or indirectly in a single company for the purpose of long-term price appreciation.

(b) *Affiliate* has the same meaning as in section 3(k) of the Bank Holding Company Act.

(c) *Appropriately regulated foreign investment company* means any issuer that is regulated by a foreign government authority to a substantially similar extent as a registered investment company is regulated by the Securities and Exchange Commission under the Investment Company Act.

(d) *Bank Holding Company Act* means the Bank Holding Company Act of 1956, as amended (12 U.S.C. 1841 et seq.).

(e) *Banking entity* means any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity, but shall not include any registered investment company, covered fund or any portfolio company or, solely with respect to subsection 13(d)(1)(G)(vi) of the Bank Holding Company Act, any sponsor or investment adviser of a covered fund that is not a bank holding company or an insured depository institution. For purposes of this paragraph, the term "insured depository institution" does not include an institution that functions solely in a trust or fiduciary capacity, if—

(1) All or substantially all of the deposits of such institution are in trust funds and are received in a bona fide fiduciary capacity;

(2) No deposits of such institution which are insured by the Federal Deposit Insurance Corporation are offered or marketed by or through an affiliate of such institution;

(3) Such institution does not accept demand deposits or deposits that the depositor may withdraw by check or similar means for payment to third parties or others or make commercial loans; and

(4) Such institution does not—

(A) Obtain payment or payment related services from any Federal Reserve bank, including any service referred to in section 11A of the Federal Reserve Act (12 U.S.C. 248a); or

(B) Exercise discount or borrowing privileges pursuant to section 19(b)(7) of the Federal Reserve Act (12 U.S.C. 461(b)(7)).

(f) *Carried interest* means incentive compensation paid or allocated to the investment manager or adviser of a covered fund on the basis of a share of capital gains upon or capital appreciation of the assets or any portion of the assets of the covered fund.

(g) *Company* has the same meaning as in section 3(b) of the Bank Holding Company Act.

(h) *Control* has the meaning set forth in section 3(a)(2) of the Bank Holding Company Act.

(i) *Covered fund* means any hedge fund or private equity fund, including any issuer that shall have been designated as a similar fund under this subpart, except for any—

(1) issuer that qualifies for any exemption from the definition of investment company, as defined in the Investment Company Act, other than section 3(c)(1) or 3(c)(7) of that Act, even if it also qualifies for an exemption under section 3(c)(1) or 3(c)(7), and has not been designated as a similar fund;

(2) subsidiary of a banking entity that qualifies for an exemption from the definition of investment company, as defined in the Investment Company Act, under section 3(b)(3) of that Act;

(3) joint venture subsidiary;

(4) acquisition vehicle;

(5) credit fund;

(6) securitization vehicle;

(7) properly operated fund;

(8) appropriately regulated foreign investment company; or

(9) bank or corporate owned life insurance policy that meets the requirements of supervisory guidance issued by the banking entity's appropriate Federal financial regulator and each separate account related to such policy.

(j) *Covered transaction with a covered fund* means any covered transaction as defined in section 223.3(h) of the Board's Regulation W (12 C.F.R. Part 223) as if the covered fund were the affiliate, except that such term shall not include—

(1) any equity, partnership or other ownership interest in the covered fund;

(2) any transaction that qualifies for an exemption from the quantitative limits or collateral requirements of section 23A of the Federal Reserve Act under subpart E of the Board's Regulation W (12 C.F.R. Part 223); and

(3) any transaction that would be treated as a covered transaction with respect to a covered fund solely by reason of section 23A(a)(2) of the Federal Reserve Act or section 223.16 of the Board's Regulation W (12 C.F.R. Part 223).

(k) *Credit fund* means any issuer that—

(1) is predominantly engaged in originating loans and other extensions of credit (as defined in section 5200 of the Revised Statutes of the United States (12 U.S.C. 84)) or purchasing loans and other extensions of credit in primary debt originations;

(2) is predominantly funded with equity capital or long-term debt;

(3) has an intent to hold such instruments to maturity;

(4) does not—

(A) trade or otherwise buy loans or other extensions of credit with the intent to profit from short-term price movements; or

(B) except in the management of a problem credit, purchase or sell synthetic securities (including total rate of return swaps or credit default swaps), or hedge or otherwise transfer the borrower's credit risk; and

(5) satisfies the following additional criteria—

(A) Any banking entity that sponsors such credit fund does not, and will disclose to all investors in the fund that it will not, guarantee the obligations of the fund or otherwise provide financial support or assistance to investors in the fund in connection with their investment in the fund;

(B) Any activity of the fund other than as described in (j)(1) consists solely of—

(i) purchases of loans or other extensions of credit in the secondary market with the intention to hold such instruments to maturity; and

(ii) purchasing or holding warrants or equity-like instruments for which the fund has made a contemporaneous extension of credit

consistent with both clause (1) and any restrictions in the Bank Holding Company Act other than section 13 thereof;

(C) The fund has policies and procedures that require it to follow prudent credit underwriting standards, real estate appraisal standards and other credit standards, such as diversification requirements and concentration limits, reasonably designed to ensure the fund is operated in a safe and sound manner, which may include syndication of loans or other extensions of credit pursuant to clause (1); and

(D) The governing documents of the fund include terms and conditions designed to require the fund to comply with the conditions of this definition.

(l) *Customer* means any person with which a banking entity (including any of its affiliates) has established a substantive pre-existing relationship.

(m) *Directed trustee* means any person acting in the capacity of a trustee of a covered fund that exercises solely administrative, ministerial or custodial functions with respect to the covered fund and has no investment discretion with respect to the covered fund's investments, including a trustee subject to the direction of another fiduciary as described in section 403(a)(1) of the Employee's Retirement Income Security Act (29 U.S.C. 1103(a)(1)) of the covered fund.

(n) *Hedge fund* means any issuer that—

(1) 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;

(2) is not a private equity fund.

(o) *Infrastructure fund* means any issuer that is predominantly engaged in investing in instruments that provide financing to infrastructure projects, such as roads, bridges and other projects that promote the public welfare.

(p) *Investment Company Act* means the Investment Company Act of 1940, as amended (15 U.S.C. 80a-1 et seq.).

(q) *Joint venture subsidiary* means any company that is owned by two or more other companies and is controlled or jointly controlled by each such other company.

(r) *Ownership interests* of a banking entity means any equity, partnership or other ownership interest of the banking entity in a covered fund, but shall not include:

(1) any equity, partnership or other ownership interests in a covered fund acquired by the banking entity in satisfaction of a debt previously contracted in good

faith subject to the conditions in section 4(c)(2) of the Bank Holding Company Act as if such interests were shares;

(2) notwithstanding section 2(g)(2) of the Bank Holding Company Act, any equity, partnership or other ownership interests in a covered fund acquired or retained by a qualified plan or qualified trust as those terms are used in section 401 of the Internal Revenue Code of 1986 (26 U.S.C. 401); and

(3) any carried interest in a covered fund, except any carried interest that is available to be paid or distributed to the banking entity and that—

(A) the banking entity has the contractual right to withdraw from the covered fund;

(B) the banking entity does not promptly withdraw from the covered fund; and

(C) participates *pro rata* in all of the profits and losses of the covered fund.

(s) *Portfolio company* means any company in which any covered fund or any registered investment company has an investment.

(t) *Predominantly engaged* means, with respect to a fund, that at least 85% of the fund's assets are attributable to a specified set of activities or investments;

(u) *Private equity fund* means any issuer that—

(1) would be an investment company, as defined in the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act;

(2) is predominantly engaged in investing in portfolio companies that are not publicly traded and holding those investments for the purpose of long-term price appreciation; and

(3) does not trade or otherwise buy securities or other financial instruments with the intent to resell in order to profit from short-term price movements.

(v) *Properly operated fund* means any fund, including any venture capital, infrastructure, or tracking fund, that is sponsored by a banking entity or in which a banking entity acquires or has any equity, partnership or other ownership interest if the primary financial regulatory agency of the banking entity has determined that any activities with respect to such fund are conducted by the banking entity in a manner that would promote and protect the safety and soundness of the banking entity and the financial stability of the United States.

(w) *Provision of investment advisory services* by a banking entity includes acting directly or indirectly through an affiliate as the investment adviser of a covered fund that is organized and offered by the banking entity.

(x) *Registered investment company* means any investment company that is registered as such under the Investment Company Act with the Securities and Exchange Commission.

(y) *Securities Act* means the Securities Act of 1933, as amended (15 U.S.C. § 77a et seq.).

(z) *Securitization vehicle* means any company that is predominantly engaged in the securitization of loans or other extensions of credit (as defined in section 5200 of the Revised Statutes of the United States (12 U.S.C. 84)) or any financial instruments that directly or indirectly derive their value exclusively from such loans or other extensions of credit, including the origination, purchase or sale of such loans or extensions of credit or financial instruments in connection with their securitization.

(aa) *Select or control a majority of the directors, trustees, or management of a fund* by a banking entity shall not apply to the selection or control of the initial directors, trustees, or management of a newly established covered fund, provided that a majority of such initial directors, trustees or management is independent of such banking entity.

(bb) *Sharing a name for marketing purposes* does not include disclosing or otherwise using the name of any banking entity that is affiliated with a covered fund or family of covered funds or disclosing or using the relationship between the banking entity with such covered fund or family of covered funds in any marketing materials, provided that the marketing materials contain the disclosures required by section 13(d)(1)(G)(viii) of the Bank Holding Company Act.

(cc) *Similar fund* means any issuer that is not a hedge fund or private equity fund but that has substantially all of the characteristics of a traditional hedge fund or a traditional private equity fund, as the appropriate Federal banking agencies, the Board, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in section 13(b)(2) of the Bank Holding Company Act, determine.

(dd) *Sponsor* means, with respect to a covered fund, (i) to serve as a general partner, managing member, or trustee of a covered fund, (ii) in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a covered fund; or (iii) to share with a covered fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name, but shall not include any directed trustee.

(ee) *Subsidiary* has the same meaning as in section 3(d) of the Bank Holding Company as if a banking entity were a bank holding company.

(ff) *Substantive pre-existing relationship* means the "substantive pre-existing relationship" standard as defined by the SEC that is required to be met in order for an offering of securities in the United States to be exempt from the registration requirements of the Securities Act under section 4(2) of that Act and any regulations promulgated thereunder.

(gg) *Tracking fund* means any issuer that—

(1) is exclusively engaged in an investment strategy to generate returns equal to or in excess of the returns on a recognized market index or other benchmark; and

(2) does not—

(A) engage in short-selling;

(B) use borrowed funds to leverage any of its investments; or

(C) pay, or is not contractually obligated to pay, any carried interest or incentive fee to its investment manager or investment adviser.

(hh) *Traditional hedge fund* means any hedge fund that (i) has a substantial number of investors each of which is a qualified purchaser for purposes of the Investment Company Act or an accredited investor for purposes of the Securities Act; (ii) invests in or has an investment strategy to invest in a substantial number of companies or financial instruments; and (iii) has substantially all of the following additional characteristics:

(1) the offer and sale of ownership interests in the hedge fund qualify for an exemption under section 4(2) of the Securities Act from the registration requirements of that Act;

(2) its investors are not entitled to the protections of the Investment Company Act or other comparable laws, including requirements that apply to the management and operations of the hedge fund, including the independence of the directors or similar persons on its board of directors or other governing body, limitations on leverage and short sales and investment restrictions and restrictions on any transactions or other activities;

(3) it is advised by a professional investment manager that has the sole discretion to invest and reinvest its cash and otherwise manage its portfolio in accordance with investment guidelines agreed to between its investment manager and its investors;

(4) it trades for its own account in securities, derivatives or other 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) it employs material leverage to enhance the returns on its investments as part of its investment strategy;

(6) its investors have the right to cause it to redeem their investments in whole or in part at specified times, but not the right to daily redemptions, and such redemption rights may be further restricted or suspended if, as a result of market conditions or otherwise, the securities or instruments in its portfolio become illiquid or independent valuations are not readily available; and

(7) the investment manager earns a management fee based on the net asset value of the total assets under management and a carried interest that is performance-based, subject to measures such as a high water mark or hurdle rate.

(ii) *Traditional private equity fund* means any private equity fund that (i) has a substantial number of investors each of which is a qualified purchaser for purposes of the Investment Company Act or an accredited investor for purposes of the Securities Act; and (ii) has substantially all of the following additional characteristics:

(1) the offer and sale of ownership interests in the private equity fund qualify for an exemption under section 4(2) of the Securities Act from the registration requirements of that Act;

(2) its investors are not entitled to the protections of the Investment Company Act or other comparable laws, including requirements that apply to the management and operations of the private equity fund, including the independence of the directors or similar persons on its board of directors or other governing body, limitations on leverage and short sales and investment restrictions and restrictions on any transactions or activities;

(3) the purpose of the private equity fund is to generate significant investment returns by (i) investing in privately held, established operating companies (other than start-ups or venture capital companies), (ii) primarily acquiring the unregistered equity or equity-like securities of such companies for which there is no public market and for which third-party valuations are not readily available, (iii) holding those investments long-term, and (iv) realizing on such investments and distributing the proceeds thereof to investors before the end of the private equity fund's life;

(4) it is advised by a professional investment manager that has the sole discretion to invest and reinvest its cash and otherwise manage its portfolio in accordance with investment guidelines agreed to between its investment manager and its investors;

(5) it has a limited life, such as ten years with a limited number of one-year extensions;

(6) it seeks representation on the boards of directors of the operating companies in which it invests, enhanced information rights or access to the management of the operating companies in which it invests;

(7) it can admit new investors to, or permit existing investors to increase their investment in, the private equity fund only during an initial start-up period, after which the private equity fund is closed;

(8) investors are not permitted to withdraw or redeem their investments in the private equity fund;

(9) the investment manager earns a management fee based on the net asset value of the total assets under management and a carried interest that is performance-based, subject to measures such as a high water mark or hurdle rate

(10) the investment manager is entitled by contract to a management fee based on the total capital commitments or invested capital and a carried interest that is performance-based taking into account the performance of all of the private equity fund's investments over the life of the private equity fund; and

(11) its constituent documents include a "clawback" obligation pursuant to which the investment manager is required to return carried interest if it is determined, at the end of the life of the private equity fund, to have received carried interest in excess of what it is entitled to receive in light of the performance of all of the private equity fund's investments.

(jj) *Ultimate parent* of a banking entity means a banking entity that is not the direct or indirect subsidiary of any other banking entity.

(kk) *Venture capital fund* has the meaning set forth in Rule 203(l)-1 under the Investment Advisers Act of 1940 (15 U.S.C. 80b-3(l)).

II. Clarifying Regulations

(a) **Calculation of investment limits**. In determining whether a banking entity is in compliance with the investment limits in section 13(d)(4)(B)(ii) of the Bank Holding Company Act—

(1) with respect to the per-fund limit in section 13(d)(4)(B)(ii)(I), any equity, partnership or other ownership interests of a banking entity in a covered fund will be calculated on the basis of invested capital of the banking entity in such covered fund, with the numerator being the invested capital of the banking entity in the covered fund and the denominator being the total amount of the invested capital of all investors in the covered fund;

(2) with respect to the aggregate limit in section 13(d)(4)(B)(ii)(II), the aggregate equity, partnership or other ownership interests of a banking entity in all

covered funds will be calculated on the basis of the consolidated invested capital of its ultimate parent in all covered funds, with the numerator being the consolidated invested capital of its ultimate parent in all covered funds and the consolidated Tier 1 capital of such ultimate parent; and

(3) employee and director investments in a covered fund made in compliance with section 13(d)(1)(G)(vii) will not be treated as ownership interests of the banking entity in the covered fund.

(b) **Timing of calculations**. A banking entity's ownership interests with respect to any covered fund for purposes of determining such banking entity's compliance with the investment limits in section 13(d)(4)(B)(ii) of the Bank Holding Company Act shall—

(1) with respect to the per fund investment limit in section 13(d)(4)(B)(ii)(I) of the Bank Holding Company Act, be equal to the total of the banking entity's ownership interests in the covered fund measured as a percentage of the total ownership interests in the covered fund as of the later of—

(A) the last day of the period during which the banking entity is permitted to hold ownership interests in the covered fund in excess of 3 percent of the total ownership interests in the covered fund; and

(B) such subsequent date as the banking entity acquires additional ownership interests in the covered fund; and

(2) with respect to the investment limit calculated as a percentage of the Tier 1 capital of the ultimate parent of the banking entity in section 13(d)(4)(B)(ii)(II) of the Bank Holding Company Act, be equal to the total of the banking entity's ownership interests in all covered funds measured as a percentage of the Tier 1 capital of the ultimate parent of the banking entity, calculated as of the last day of each calendar quarter.

(c) **Permitted risk-mitigating hedging activities**. The prohibitions or other limits on acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, a covered fund shall not apply to the acquisition or retention of any equity, partnership or other ownership interest in the covered fund that is made in compliance with section 13(d)(1)(c) of the Bank Holding Company Act.

(d) **Permitted SBIC investments**. The prohibitions or other limits on acquiring or retaining any equity, partnership or other ownership interest in, or sponsoring, a covered fund shall not apply to the acquisition or retention of any equity, partnership or other ownership interest in, or the sponsorship of:

(1) Any small business investment company, as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. 662); and

(2) Investments designed primarily to promote the public welfare, of the type permitted under paragraph (11) of section 5136 of the Revised Statutes of the United States (12 U.S.C. 24), including the welfare of low- and moderate-income communities or families (such as providing housing, services, or jobs) such as in community and economic development entities and community development venture and equity capital funds as defined in 12 C.F.R. Part 24 (or any successor regulation), to the extent otherwise permissible under applicable Federal or State law.