Davis Polk

Volcker Rule Materials
Hedge and Private Equity Funds

November 5, 2010

SIFMA FSOC Study Comment Letter

November 5, 2010

By electronic submission to www.regulations.gov

Financial Stability Oversight Council
c/o United States Department of the Treasury
Office of Domestic Finance
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships With Hedge Funds and Private Equity Funds (the "Study")

Docket Number FSOC 2010-0002

Comment Letter on the Portion of Study Related to Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**")[1] appreciates the opportunity to provide the Financial Stability Oversight Council (the "**FSOC**") with our comments regarding the FSOC's Study. This comment letter relates solely to the portion of the Study related to hedge funds and private equity funds. SIFMA is writing a separate letter on the proprietary trading portion of the Study.

SIFMA believes that the issues arising out of the proprietary trading portion of the Volcker Rule are very different from those arising out of the funds portion. The proprietary trading provisions are based on vague definitions. These definitions require the agencies to exercise considerable discretion and judgment in implementing them, and this discretion should be exercised in a manner that preserves the effective functioning of the markets and access to capital while achieving the objectives of the statute. As a result, SIFMA has urged the FSOC to adopt a careful, staged approach to implementation of the proprietary trading restrictions with a

[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.

firm grounding in market realities. The reasons for this recommended approach, and the recommendations for carrying it out, are contained in SIFMA's separate letter on proprietary trading.

In contrast, the provisions in the Volcker Rule relating to hedge funds and private equity funds do not generally suffer from excessive vagueness. Instead of lacking specificity, the key definitions in this portion of the Volcker Rule are generally overbroad: they sweep in entities and vehicles that Congress never intended to be treated as hedge funds or private equity funds and which Congress expected the implementing agencies to exclude from the general definition through the exercise of their regulatory discretion. In addition, the interaction of defined terms and other provisions in this portion of the Volcker Rule contain internal contradictions, produce absurd results or generate unintended consequences that the implementing agencies will need to correct through use of the Supreme Court's canons of statutory construction. SIFMA therefore asks the FSOC to recommend that the implementing agencies 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 identified in this letter.

Implementation of the funds portion of the Volcker Rule should also be done in light of the context of global financial markets, recognizing the risk that funds activity may migrate to the unregulated shadow banking system or to foreign financial centers such as Hong Kong, Singapore, London, Frankfurt, Paris or Zurich, and the resulting adverse effects on the strength and competitiveness of the United States as a global financial center.

While we do not address in this letter whether the activities prohibited by the Volcker Rule caused the financial crisis, we believe there are cogent arguments that they did not. We ask that the FSOC and regulators consider these arguments when implementing the Volcker Rule.

Background

The Volcker Rule, which is contained in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"), amends the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) by adding a new Section 13. This new section 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. It also requires the FSOC to conduct the Study and make recommendations for the section's implementation within 6 months after the date of its enactment.

The agencies responsible for implementing the Volcker Rule are required to issue regulations within 9 months of the Study. They are also required to consider the FSOC's findings

and recommendations in issuing regulations. Although the Board of Governors of the Federal Reserve System (the "**Board**") is generally the exclusive agency responsible for implementing the Bank Holding Company Act, new Section 13 is required to be implemented by the Board, the Office of the Comptroller of the Currency (the "**OCC**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Securities and Exchange Commission (the "**SEC**") and the Commodity Futures Trading Commission (the "**CFTC**" and together with the Board, the OCC, the FDIC and the CFTC, the "**Regulatory Agencies**") with respect to the companies for which they are the primary financial regulatory agencies as set forth on Annex A.[2] The Treasury Secretary, as chairperson of the FSOC, is responsible for coordination of the regulations issued under Section 619.

The purpose of the prohibitions on certain relationships with hedge funds and private equity funds is to prevent banking entities from establishing or maintaining what have been deemed to be inappropriate relationships. A principal goal is to eliminate the temptation of banking entities to bail out investors in sponsored hedge funds and private equity funds, which otherwise might expand a banking entity's losses during a financial crisis. However, the exemptions to the general prohibitions also reflect a decision to balance these considerations with the recognition that appropriate asset management, traditional lending activities and other corporate or investment activities should not be prohibited. These activities, which contribute to "spurring innovation, creating jobs and growing companies,"[3] are critical to the nation's economic recovery. Implementation of the Volcker Rule in a manner that unduly restricts these activities would have a detrimental effect on the availability of capital and credit to American businesses, job creation and the recovering economy. The Volcker Rule must be implemented in a way that restricts certain relationships between banking entities and private funds, without triggering adverse economic consequences that Congress did not intend.

To this end, SIFMA requests that the FSOC make the principal findings and recommendations in its Study regarding sponsorship of and investment in private equity and hedge funds that are described in the body of this comment letter. Annex B contains SIFMA's responses to the specific requests for information contained in the FSOC's notice and request for information, but only as they relate to hedge funds and private equity funds, and not proprietary trading, which is discussed in SIFMA's separate comment letter on proprietary trading.

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[2] Although the Office of Thrift Supervision (the "**OTS**") will continue to be the appropriate Federal banking agency for federal savings associations and FDIC-insured state-chartered savings associations until July 21, 2011 (with a possible six-month extension), the date on which the OCC and the FDIC will assume the OTS's powers with respect to federal savings associations and insured state-chartered savings associations, the chart in Annex A assumes that this merger will have been completed by the time the Regulatory Agencies issue their rules under subsection (b)(2).

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

I. Because the general definition of hedge fund and private equity fund is overbroad, the FSOC should recommend that the Regulatory Agencies clarify that certain entities will not be treated as hedge funds or private equity funds even if they fall within the literal scope of the general definition

The Volcker Rule defines the terms "hedge fund" and "private equity fund" with a single definition, despite the very real differences between these two types of funds, and between both of these types of funds and the many other investment vehicles and corporate structures that are included within the literal scope of the definition. It defines "hedge fund" and "private equity fund" as any "issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) (the "**1940 Act**"), but for section 3(c)(1) or 3(c)(7) of that Act" (the "**general definition**"). The Volcker Rule supplements this general definition by providing that each term also includes "such similar funds" as the Regulatory Agencies "may, by rule, as provided in subsection (b)(2), determine" (a "**similar fund designation**").[4]

The 1940 Act contains a very broad definition of the term "investment company" and a series of exemptions. Sections 3(c)(1) and 3(c)(7) of the 1940 Act contain two of the most commonly used exemptions.[5] The reason these two exemptions are the most common is that they can be used to exempt any investment company regardless of how it invests or what it invests in so long as it satisfies certain limits on the number or financial characteristics of its investors. They are therefore the exemptions relied upon in the vast majority of cases, even for entities that have never been considered to be hedge funds or private equity funds because they do not have the attributes generally associated with traditional hedge funds or private equity funds.[6]

After drafting the general definition for the terms hedge fund and private equity fund in the Volcker Rule, Congress recognized that it was overbroad because it swept in many

[4] The "similar funds" portion of the definition contains a technical error – it does not contain a specific reference to the Board even though subsection (b)(2) identifies the Board as the implementing regulator with respect to the companies next to its name on Annex A, which is a more expansive list than the firms for which it is defined as the appropriate Federal banking agency under Section 3(q) of the Federal Deposit Insurance Act (12 U.S.C. 1813(q)). The FSOC should recommend that the Regulatory Agencies interpret this provision as if the missing reference to the Board were included because this was clearly a clerical error. Under the Supreme Court's canons of statutory construction, statutes are supposed to be interpreted to correct clerical errors. *See* W. Eskridge, P. Frickey & E. Garrett, LEGISLATION AND STATUTORY INTERPRETATION 267-71, 390 (2d ed. 2006).

[5] Section 3(c)(1) exempts any issuer that is beneficially owned by 100 or fewer persons that does not make a public offering. Section 3(c)(7) exempts any issuer that is beneficially owned exclusively by "qualified purchasers" and does not make a public offering.

[6] See the responses to Questions 4.(b) and 4.(c) in Annex B for a description of the attributes that SIFMA believes should be used to define traditional hedge funds or private equity funds for purposes of the Volcker Rule.

investment vehicles and other corporate structures that have never been considered to be hedge funds or private equity funds. As discussed more fully below, Congress intended for the Regulatory Agencies to correct this overbreadth by granting exemptions for issuers that are not properly treated as hedge funds or private equity funds, such as acquisition vehicles, joint ventures, properly operated venture capital funds, finance subsidiaries, employee pension funds, credit funds and many other entities or vehicles.

It is not surprising that Congress adopted this overbroad general definition. The SEC and other regulatory agencies have never been able to agree upon precise definitions for hedge funds and private equity funds.[7] Part of the reason for this difficulty is that the characteristics and activities of these funds, especially hedge funds, have evolved and expanded significantly since these types of vehicles were first created and are likely to continue to evolve significantly in the future. It is virtually impossible to define a moving target with a static definition.[8]

When a statutory term is particularly difficult to define, it is common practice for Congress to adopt an overbroad definition and then either create a series of appropriate statutory exemptions or rely on regulatory agencies to do so, or both. For example, Congress took this approach in defining the term "investment company" in the 1940 Act. It adopted an overbroad general definition, and then created a series of statutory exemptions to narrow the definition to a more appropriate target and also relied on the SEC to grant further appropriate exemptions. It was easier to identify what was not an investment company than to come up with a more precise definition of exactly what it is.

Congress seems to have had as much difficulty as the SEC and other regulatory agencies in agreeing upon a precise definition of hedge fund or private equity fund. As a result, Congress appears to have used the same statutory drafting technique as it did in the 1940 Act for the definition of investment company, adopting an overbroad definition of the terms hedge fund and private equity fund, and then relying on the Regulatory Agencies to create exemptions.

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[7] *See, e.g.,* Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, September 2003 at 3 (Stating that the term "hedge fund" "has no precise legal or universally accepted definition"); *see also* Testimony of Federal Reserve Governor Kevin Warsh Before the House Committee on Financial Services, July 11, 2007, at 2 ("[T]here is no precise legal definition [of hedge fund] . . ."); Testimony of Former SEC Chairman David S. Ruder Before the House Committee on Oversight and Government Reform, November 13, 2008, at 2 ("[T]here is no universally accepted definition of hedge funds . . .").

[8] See the responses to Questions 4.(b) and 4.(c) in Annex B, however, for a description of the attributes that SIFMA believes should be used to define traditional hedge funds or private equity funds for purposes of the Volcker Rule.

The legislative history of the Dodd-Frank Act is consistent with this conclusion. During the House and Senate debates about the Dodd-Frank Act, a number of representatives and senators expressed concern about the overbreadth of the general definition. Colloquies in the House and Senate support the view that Congress understood that the general definition was overbroad and intended for the Regulatory Agencies to grant exemptions for issuers that are not properly treated as hedge funds or private equity funds. For example, House Financial Services Chairman Barney Frank (D-MA) engaged in the following colloquy with Representative Jim Himes (D-CT):

> "**Mr. Himes**. Madam Speaker, I rise to enter into a colloquy with Chairman Frank. I want to clarify a couple of important issues under section 619 of the bill, the Volcker Rule. The bill would prohibit firms from investing in traditional private equity funds and hedge funds. Because the bill uses the very broad Investment Company Act approach to define private equity and hedge funds, it could technically apply to lots of corporate structures, and not just the hedge funds and private equity funds. I want to confirm that when firms own or control subsidiaries or joint ventures that are used to hold other investments, that the Volcker Rule won't deem those things to be private equity or hedge funds and disrupt the way the firms structure their normal investment holdings.
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> **Mr. Frank**. . . . The point the gentleman makes is absolutely correct. We do not want these overdone. We don't want there to be excessive regulation. And the distinction the gentleman draws is very much in this bill, and we are confident that the regulators will appreciate that distinction, maintain it, and we will be there to make sure that they do."[9]

Similarly, Senate Banking Committee Chairman Christopher Dodd (D-CT) engaged in the following colloquy with Senator Barbara Boxer (D-CA):

> "**Mrs. Boxer**. Mr. President, I wish to ask my good friend, the Senator from Connecticut and the chairman of the Banking Committee, to engage in a brief discussion relating to the final Volcker rule and the role of venture capital in creating jobs and growing companies. . . . I know the chairman recognizes, as we all do, the crucial and unique role that venture capital plays in spurring innovation, creating jobs and growing companies. I also know that the authors of this bill do not intend the Volcker Rule to cut off sources of capital for America's technology startups, particularly in this difficult economy. . . .

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[9] 156 CONG. REC. H5226 (daily ed. June 30, 2010).

> I believe the intent of the rule is not to harm venture capital investment. Is my understanding correct?
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> **Mr. Dodd**. Mr. President, I thank my friend, the Senator from California, for her support and for all the work we have done together on this important issue. Her understanding is correct.[10]
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> . . . [P]roperly conducted venture capital investment will not cause the harms at which the Volcker rule is directed. 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)."

The Frank-Himes and Dodd-Boxer colloquies indicate that these congressional leaders believed that Congress intended to reach traditional hedge funds and private equity funds,[11] and to rely on the Regulatory Agencies to carve out "subsidiaries," "joint ventures" and other "corporate structures" that are not properly treated as hedge funds or private equity funds.

On the basis of this record, it appears that Congress deliberately adopted an overbroad general definition and expected the Regulatory Agencies to grant appropriate exemptions from the general definition for investment vehicles and other corporate structures that are not properly treated as hedge funds or private equity funds, such as acquisition vehicles, joint ventures, properly operated venture capital funds, finance subsidiaries, employee pension funds, credit funds and many other entities or vehicles. SIFMA recommends that the FSOC find this to be the case, and on the basis of this finding, recommend that the Regulatory Agencies identify the types of companies that should not be treated as hedge funds or private equity funds and exclude them from the general definition or exercise their discretion under subsection (d)(1)(J) to exclude such companies.

II. The FSOC should recommend that if the Regulatory Agencies make "similar funds" designations they do so based on whether a fund is similar to a traditional hedge fund or private equity fund, and adopt an appropriate transition period for any funds so designated

The 1940 Act contains a number of statutory exemptions from the definition of investment company other than Sections 3(c)(1) or 3(c)(7). The SEC has also created additional

[10] 156 CONG. REC. S5904 (daily ed. July 15, 2010).

[11] See the responses to Questions 4.(b) and 4.(c) in Annex B for a description of the attributes that SIFMA believes should be used to define traditional hedge funds or private equity funds for purposes of the Volcker Rule.

exemptions pursuant to its general exemptive authority under the statute. 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, it does not reach issuers that fall outside the definition of "investment company" or qualify for one of the many exemptions from that term under the 1940 Act. Nor should it reach issuers that the Regulatory Agencies exclude from the general definition of hedge funds or private equity funds as requested in Section I of this comment letter.

For example, the general definition does not reach SEC-registered investment companies. Nor should it reach a foreign regulated investment company. Nor should investments in hedge funds or private equity funds made by life insurance companies in connection with bank- or company-owned life insurance ("**BOLI/COLI**") policies be attributed to the banking entities that are the holders of the life insurance policies.

To prevent banking entities from evading the restrictions on sponsoring or investing in hedge funds or private equity funds offered and sold in the United States through creative structuring, the statute grants the Regulatory Agencies the power to treat such funds as hedge funds or private equity funds by designating them as "similar funds." This power to treat similar funds as hedge funds or private equity funds is not self-executing. The statute does not say that all funds will be treated as similar funds if they have any characteristics in common with hedge funds or private equity funds, but only funds that are designated as similar funds by affirmative agency rulemaking action. Congress therefore did not require the Regulatory Agencies to designate any fund as a similar fund; it merely gave them permissive authority to do so to prevent evasion. The statute does, however, mandate the process that must be followed in designating a fund as a similar fund. The Regulatory Agencies are authorized to do so only by formal rulemaking; they are not permitted to do so by order, staff interpretation or other non-rulemaking action. This requirement ensures that the similar funds designation process will be subject to the public notice and comment requirements of the Administrative Procedure Act.

In exercising its similar funds authority, the Regulatory Agencies should not, absent evasion, designate any entity or vehicle offered and sold in the United States as a similar fund if it qualifies for any of the statutory or regulatory exemptions from the 1940 Act other than Sections 3(c)(1) or 3(c)(7). Indeed, the Regulatory Agencies should announce that all such entities or vehicles enjoy a nonexclusive safe harbor from a similar funds designation. In the absence of such a pronouncement, the market will operate under substantial uncertainty as to whether a particular entity or vehicle might at some point in the future be designated as a similar fund. Such uncertainty will impair the efficiency of the United States capital and credit markets at a time when more capital and credit are needed to revive our unhealthy economy.

Moreover, in contrast to the procedural hurdles the Volcker Rule imposes on a similar funds designation, the statute leaves the Regulatory Agencies free to create safe harbors from a similar fund designation through any number of means, including rulemaking or any formal or informal agency action. The Regulatory Agencies may use this authority to provide certainty to the markets that a particular type of fund will not be designated as a similar fund.

Although the statute mandates that a similar funds designation must be done by formal rulemaking, it does not mandate the standards or the basis upon which a similar fund designation is to be made. As a result, the standards for determining what constitutes a similar fund are within the discretion of the Regulatory Agencies. Under *Chevron v. Natural Resources Defense Council*,[12] courts would be required to defer to any reasonable interpretation by the Regulatory Agencies, unless the interpretation is arbitrary or capricious.

Because the Volcker Rule does not expressly state what the Regulatory Agencies must compare a fund to, in order to determine whether the fund is similar, it is within their discretion to make their comparisons by reference to a traditional hedge fund or traditional private equity fund, rather than to the overbroad general definition. Moreover, the Regulatory Agencies need not agree on precise definitions for traditional hedge funds or traditional private equity funds to carry out this approach. They may base their similar fund analysis and safe harbor determinations on their concepts of what a traditional hedge fund or traditional private equity fund is. Not only would such an approach be entitled to *Chevron* deference, but it would also be more consistent with congressional intent, as evidenced by the Frank-Himes and Dodd-Boxer colloquies reproduced above.

While those colloquies were focused on the general definition, rather than the similar funds analysis, they show that the chairmen of both key committees of Congress recognized that the general definition was overbroad and indicated that Congress intended for the Volcker Rule to apply to traditional hedge funds and private equity funds. They did not intend for the Volcker Rule to apply to funds that are merely similar to other corporate structures that would be investment companies but for Sections 3(c)(1) or 3(c)(7), such as acquisition vehicles, joint ventures, properly operated venture capital funds, finance subsidiaries, employee pension funds, credit funds and many other entities or vehicles that have never been treated as hedge funds or private equity funds. Nor did they intend for the Volcker Rule to apply to SEC-registered investment companies, to foreign regulated investment companies, such as funds that qualify as Undertakings for the Collective Investment of Transferable Securities ("**UCITS**"), or to investments made by insurance companies pursuant to BOLI/COLI policies that provide insurance coverage to a banking entity.

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[12] 467 U.S. 837 (1984).

On the basis of this record, SIFMA believes that the FSOC should recommend that any entity or vehicle offered and sold in the United States that falls outside the definition of "investment company," qualifies for one of the many exemptions from that term under the 1940 Act, or is excluded by the Regulatory Agencies from the general definition of hedge funds or private equity funds as requested in Section I of this comment letter should not be designated as a similar fund absent evasion, and that any other similar fund designation should be based on whether such fund is similar to a traditional hedge fund or a traditional private equity fund.[13]

SIFMA also believes the Council should recommend that if and when the Regulatory Agencies designate a fund as a "similar fund," they should adopt an appropriate transition period in order to preserve and promote fundamental fairness. Fundamental fairness requires that the Regulatory Agencies provide appropriate transition periods to permit banking entities to bring the operations of newly designated similar funds into compliance upon such a designation. It is virtually impossible for banking entities to predict in advance what sort of funds the Regulatory 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. If the Regulatory Agencies determine to make a similar fund designation, banking entities should be given sufficient time to conform any such newly designated similar fund to the restrictions contained in the Volcker Rule.

III. The FSOC should recommend that the Regulatory Agencies confirm that credit funds not be treated as hedge funds or private equity funds, if their credit activities are conducted in a safe and sound manner in accordance with sound underwriting and other standards applicable to banking entities

As discussed above, SIFMA believes that Congress expects the Regulatory Agencies to exercise their discretion to exclude from the general definition any investment vehicles that are clearly not hedge funds or private equity funds as commonly understood.

One type of fund that is clearly not a hedge fund or private equity fund is a fund that primarily extends credit, *i.e.*, makes loans or engages in other extensions of credit ("**credit funds**"). Credit funds engage in activities that are at the core of the activities that are permissible for banking entities under applicable banking laws – lending money on a long-term basis to companies and providing support, liquidity and stable credit for capital formation needs, such as government infrastructure projects. Credit funds strengthen the overall economy and promote job

[13] See the responses to Questions 4.(b) and 4.(c) in Annex B for a description of the attributes that SIFMA believes should be used to define traditional hedge funds or private equity funds for purposes of the Volcker Rule.

creation by providing credit to companies, many of which are not able to access the public markets.

Banking entities are permitted to engage directly in prudent lending and should not be limited in their ability to do so through a fund structure. Using a fund structure facilitates investment by third-party investors, which creates a broader and deeper pool of capital available for lending. Investors in credit funds, such as pension funds and governmental entities, represent a significant amount of capital that might otherwise not be available to the United States lending market.

The activities of credit funds can be operated in a safe and risk-controlled manner. Using third-party investor capital in lending activities in a fund structure or joint venture with clients is inherently more prudent because it allows the banking entity to pre-syndicate its lending exposure and more efficiently manage its capital at risk. This reduces overall risk within the United States banking system.

Moreover, the credit and other financing activities of these funds can be conducted in compliance with Federal banking law standards. These include underwriting standards, diversification requirements, concentration limits, real estate appraisals and other safety and soundness standards. Accordingly, these funds can be operated in substantially the same manner as the banking entities that can engage in similar credit and other financing activities themselves – a prudent manner that would serve the public interest and promote the safety and soundness of the banking entity and the financial stability of the United States. In addition, the funds can be operated subject to the "no bailout" and affiliate provisions of new Section 13.

SIFMA believes that the FSOC should recommend that the Regulatory Agencies clarify that credit funds will not be treated as hedge funds or private equity funds for purposes of new Section 13, provided that their activities are conducted in a safe and sound manner consistent with the underwriting and other standards applicable to banking entities.

IV. The FSOC should recommend that the Board construe any terms defined in Section 2 of the Bank Holding Company Act or Section 23A of the Federal Reserve Act so that they do not produce any internal contradictions, absurd results or unintended consequences in the Volcker Rule

As noted above, the Volcker Rule is an amendment to the Bank Holding Company Act; it is new Section 13 of that Act. As such, it appears to incorporate various terms such as "company," "affiliate," "subsidiary" and "control" that are defined in Section 2 of the Bank

Holding Company Act.[14] It also incorporates by reference the term "covered transaction" as defined in Section 23A of the Federal Reserve Act.[15] However, these terms were developed, and have been construed by the Board, for very different provisions with very different purposes. If used without exception or modification in the Volcker Rule, they will produce internal contradictions, absurd results or other consequences that Congress could not possibly have intended.

Under the Supreme Court's canons of statutory construction, statutes are supposed to be construed to avoid such internal contradictions, absurd results or unintended consequences.[16]

To illustrate how the use of these definitions without exception or modification can produce internal contradictions, absurd results or unintended consequences in the Volcker Rule, consider the following six examples.

A. Internal contradiction unless the terms "affiliate" and "subsidiary" exclude hedge funds and private equity funds for purposes of the definition of "banking entity" in the Volcker Rule

First, consider the internal contradiction that would exist unless the Board construed the terms "affiliate" and "subsidiary" to exclude hedge funds and private equity funds for purposes of the definition of banking entity in new Section 13 of the Bank Holding Company Act. The term "banking entity" is defined in the Volcker Rule as "any insured depository institution (as defined in section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), any

[14] Section 2 defines "company" very broadly to include any corporation, partnership, business trust and many other trusts. It defines "subsidiary" of any company as any company that is directly or indirectly controlled by the first company. It defines "affiliate" of any company as any company that directly or indirectly controls, is directly or indirectly controlled by, or is under common control with the first company. It defines "control" of a company as the ownership or control of 25% or more of any class of voting securities of the company, controlling in any manner the election of a majority of the directors or similar body of the company or having a controlling influence over the management or policies of the company. The Board has consistently treated a fund as under the control of a banking holding company and as the bank holding company's subsidiary and affiliate if the bank holding company directly or indirectly controls: the general partner of the fund if organized as a limited partnership, the managing member of the fund if organized as a limited liability company, or the trustee of the fund if organized as a business trust. Finally, Section 2(g)(2) of the Bank Holding Company provides that shares held or controlled directly or indirectly by a pension trust for the benefit of a company's employees (whether exclusively or not) shall be deemed to be controlled by such company, unless the Board determines that such treatment is not appropriate.

[15] The term "covered transaction" as defined in Section 23A of the Federal Reserve Act includes any "purchase of or investment in any securities issued by an affiliate."

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

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 [the "**IBA**"],[17] and any ***affiliate*** or ***subsidiary*** of any such entity." (Emphasis added). Unless the Board construes 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 controlled by a bank holding company or any of its direct or indirect subsidiaries.[18] Such a controlled fund would be treated as the direct or indirect subsidiary of a bank holding company and as an affiliate of the bank holding company and all of its other direct or indirect subsidiaries, and subject to the restrictions of the Volcker Rule.

If the terms "banking entity" and "affiliate" include controlled funds, such funds would be prohibited from making any investment in another fund unless they organized and offered the other fund in accordance with subsection (d)(1)(G). They would also be prohibited from making controlling investments in funds they organized and offered. Consequently, as a practical matter, banking entities could not operate a fund of funds business where the fund of funds invested in third party funds, nor could the fund of funds make controlling investments in other funds. It also means use of the traditional master-feeder structure, which is a mainstay of the funds business, would no longer be permissible for banking entities. This would significantly impact the ability of banking entities to meet the needs of their customers for these investment products. Moreover, the text and legislative history of the Volcker Rule plainly contemplate that hedge funds and private equity funds that are controlled by a banking entity are permitted to make both controlling and non-controlling investments in other funds. This is the sort of internal contradiction that must be avoided under the Supreme Court's canons of statutory construction.

The best example of text and legislative history that plainly contemplates that funds controlled by a banking entity are permitted to make controlling and non-controlling investments in both affiliated and unaffiliated funds is contained in subsections (f)(1) and (f)(3) of the Volcker Rule ("**Super 23A**") and a related colloquy between Senators Merkley and Levin, the principal authors of the Volcker Rule. Super 23A plainly contemplates that a fund that is managed, advised, sponsored, or organized and offered by a banking entity or any of its affiliates (a "**covered fund**"), including a controlled fund, would be permitted to make and retain both controlling and non-controlling investments in other funds, including investments by feeder funds

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[17] Section 8 of the IBA provides that any foreign bank with a branch, agency or commercial lending subsidiary in the United States, and any company that directly or indirectly controls such foreign bank, will be treated as a bank holding company. The Board has extended this treatment by regulation to any foreign bank that controls an Edge Act corporation acquired after March 5, 1987. See 12 C.F.R. 211.22(o)(1)(iii).

[18] For a discussion of the definition of "control" under the Bank Holding Company Act, including control of a fund as to which a bank holding company or its subsidiary serves as the fund's general partner, managing member or trustee, please see footnote 14 above.

into master funds. This follows from the language of subsection (f)(1), which generally prohibits any "banking entity" from entering into any covered transactions with:

1. any hedge fund or private equity fund that is managed, advised, sponsored or organized and offered by the banking entity or any affiliate, or

2. "**any other hedge fund or private equity fund that is controlled by such fund**." (Emphasis added.)

If a covered fund were not permitted to make a controlling investment in other funds the second element of Super 23A would make no sense.

Similarly, subsection (f)(3) of Super 23A creates an exemption to the general prohibition in subsection (f)(1) for prime brokerage transactions between a banking entity and "**any hedge fund or private equity fund in which a hedge fund or private equity fund managed, sponsored or advised by such banking entity has taken an equity, partnership or other ownership interest**." (Emphasis added.) Because the general prohibition in subsection (f)(1) only applies to funds in which a covered fund makes a controlling investment, subsection (f)(3) is only necessary if the ownership interest is a controlling one. Otherwise, subsection (f)(1) would not prohibit a covered transaction with the lower-tier fund in the first place.

Senators Merkley and Levin confirmed this reading in their colloquy and also confirmed that covered funds are permitted to invest in unaffiliated funds. According to Senator Merkley:

> "Subsection (f), paragraph (3) permits the Board to allow a very limited exception to paragraph (1) for the provision of certain limited services under the rubric of 'prime brokerage' between the banking entity and a **third-party advised fund** in which the fund managed, sponsored, or advised by the banking entity has taken an ownership interest. Essentially, it was argued that a banking entity should not be prohibited, under proper restrictions, from providing limited services to **unaffiliated funds**, but in which its own advised fund may invest." (Emphasis added.)[19]

To eliminate this internal contradiction, SIFMA requests that the FSOC recommend that the Board construe the terms "subsidiary" and "affiliate" to exclude hedge funds and private equity funds for purposes of the Volcker Rule.

[19] 156 CONG. REC. S5898 (daily ed. July 15, 2010).

B. Internal contradiction unless the terms "affiliate" and "subsidiary" exclude hedge funds and private equity funds for purposes of "Super 23A" in the Volcker Rule

Next, consider the internal contradiction that would exist unless the Board construed the terms "affiliate" and "subsidiary" to exclude hedge funds and private equity funds for purposes of the prohibition in subsection (f)(1) of the Volcker Rule on "covered transactions" as defined in Section 23A between a banking entity and a fund that is managed, advised, sponsored or organized and offered by a banking entity or any of its affiliates. As discussed above, Super 23A contemplates that a covered fund would be permitted to make controlling investments in another fund. If a covered fund makes such an investment, however, it would be prohibited from entering into any "covered transaction" with that fund. This is confirmed by the Merkley-Levin colloquy.

But the term "covered transaction" is defined in Section 23A to include any "investment in securities issued by an affiliate." The term "affiliate" is defined in both the Bank Holding Company Act and Section 23A of the Federal Reserve Act to include any company controlled by another company. Thus, if a covered fund makes a controlling investment in another fund, that other fund would become an affiliate of the covered fund, and the investment in the affiliated fund would be prohibited by Super 23A.

Accordingly, unless modified, the Volcker Rule would both permit and prohibit controlling investments by a covered fund in another fund. This is another example of the sort of internal contradiction that must be avoided under the Supreme Court's canons of statutory construction.

To eliminate this internal contradiction, SIFMA requests that the FSOC recommend that the Board construe the terms "subsidiary" and "affiliate" to exclude hedge funds and private equity funds for purposes of the Volcker Rule.

C. Absurd result unless the terms "affiliate" and "subsidiary" exclude hedge funds and private equity funds for purposes of prohibition on name-sharing in the Volcker Rule

Third, consider the following absurd result if the Board does not construe the terms "affiliate" or "subsidiary" to exclude hedge funds or private equity funds for purposes of new Section 13. Subsection (d)(1)(G)(vi) provides that a fund that otherwise complies with the conditions of that subsection is prohibited from sharing the same name or a variation of the same name with a banking entity. But if the terms "affiliate" and "subsidiary" were construed to include controlled hedge funds and private equity funds for purposes of new Section 13, then every fund in a family of controlled funds would be treated as a banking entity and an affiliate of

each other, as well as of any investment advisory affiliate. Each would therefore be required to have a unique name. They could not satisfy subsection (d)(1)(G)(vi) merely by avoiding the same name or a variation of the same name of their parent bank holding company or any insured depository institution affiliate.

For example, suppose that Brand Name bank holding company, which controls Brand Name bank, directly or indirectly sponsors a family of funds that it wants to name after its wholly owned investment advisory affiliate, ABC Asset Management. Because ABC Asset Management and each controlled fund would be a banking entity and an affiliate of each other, they would be prohibited from sharing the name ABC or a variation on that name. Thus, the banking group would be prohibited from choosing the names ABC Fund 1, ABC Fund 2 and so forth and would instead be required to choose a unique name for each fund (e.g., DEF Fund, XYZ Fund, etc.). Congress could not possibly have intended such an absurd result.

To eliminate this absurd result, SIFMA requests that the FSOC recommend that the Board construe the terms "subsidiary" and "affiliate" to exclude hedge funds and private equity funds for purposes of the Volcker Rule.

D. Unintended consequences unless investments by employee pension funds are exempted from the rule attributing them to banking entities for purposes of the Volcker Rule

Fourth, consider the unintended consequences that would result unless the Board determined that investments in a hedge fund or private equity fund made by an employee pension fund will not be attributed to the employer-company for purposes of the Volcker Rule. Section 2(g)(2) of the Bank Holding Company Act provides that any shares held or controlled directly or indirectly by a pension trust for the benefit of a company's employees (whether exclusively or not) shall be deemed to be controlled by such company, unless the Board determines that such treatment is not appropriate. In effect, a bank holding company's employee pension fund would be treated as if it were a subsidiary of the bank holding company for purposes of the Volcker Rule. But if the pension fund were so treated, it would not be permitted to make or retain investments in a hedge fund or private equity fund without complying with the Volcker Rule.

Employee pension funds are highly regulated. Their trustees have extensive fiduciary duties under the Employee Retirement Income Security Act ("**ERISA**"). They are required to invest pension assets in a manner that is in the best interest of the employees. If the best interest of the employees would be served by allocating a portion of the fund assets to investments in hedge funds or private equity funds, the trustees should be allowed to do so. Pension funds for the employees of both banking entities and non-banking entities currently invest a portion of their portfolio in hedge funds or private equity funds as a means of diversification, asset allocation and portfolio management. It is inconceivable that Congress intended for the

Volcker Rule to interfere with such investment activities and to uniquely penalize employees of banking entities by doing so.

To eliminate this unintended consequence, SIFMA requests that the FSOC recommend that the Board determine that hedge funds and private equity funds owned by employee pension funds should not be attributed to a banking entity for purposes of the Volcker Rule.

E. Unintended consequences unless the terms "affiliate" and "subsidiary" exclude portfolio companies of hedge funds and private equity funds for purposes of the definition of "banking entity" in the Volcker Rule

Fifth, consider the unintended consequences unless the Board construed the terms "affiliate" and "subsidiary" to exclude companies controlled by hedge funds and private equity funds ("**portfolio companies**") for purposes of the definition of "banking entity" under the Volcker Rule. As noted above, unless the Board construes 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 controlled by a bank holding company or any of its direct or indirect subsidiaries. Such a controlled fund would be treated as the direct or indirect subsidiary of a bank holding company and as an affiliate of the bank holding company and all of its other direct or indirect subsidiaries.

Similarly, unless the Board construes the terms "affiliate" and "subsidiary" to exclude the portfolio companies of such controlled hedge funds or private equity funds for purposes of the definition of "banking entity" under the Volcker Rule, any portfolio company in which the controlled fund has a controlling investment will also be treated as a banking entity for purposes of the Volcker Rule. These portfolio companies are merely investments by the fund and could be engaged in any sort of commercial or other activity. The definition of "control" under Section 2 of the Bank Holding Company Act, however, is quite broad (and created for another purpose) and would cause such portfolio companies, depending on the level of ownership and other factors, to become "subsidiaries" of the bank holding company and therefore "banking entities" for purposes of the Volcker Rule.[20] Absent modification, this means that they would be subject to the Volcker Rule's prohibitions on proprietary trading and sponsoring or investing in hedge funds or private equity funds. 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.

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[20] See footnote 14 for the definition of control under Section 2 of the Bank Holding Company Act.

To eliminate this unintended consequence, SIFMA requests that the FSOC recommend that the Board construe the terms "subsidiary" and "affiliate" to exclude portfolio companies of hedge funds and private equity funds for purposes of the Volcker Rule.

F. Unintended consequences unless the terms "affiliate" and "subsidiary" exclude registered investment companies for purposes of the definition of "banking entity" in the Volcker Rule

Sixth, consider the unintended consequences that would result unless the Board construed the terms "affiliate" and "subsidiary" to exclude SEC-registered investment companies for purposes of the definition of the term "banking entity" in the Volcker Rule. SEC-registered investment companies fall outside the general definition of the term hedge fund and private equity fund, and were not intended to be designated as similar funds. But if a banking entity controls a registered investment company, the company would be treated as the banking entity's subsidiary and thus a banking entity itself. This would mean that any registered investment company directly or indirectly controlled by a bank holding company would be prohibited from investing any of its assets in hedge funds or private equity funds. Yet, SEC-registered investment companies are permitted and often do invest a portion of their assets in hedge funds and, to a lesser extent, in private equity funds as an asset allocation, diversification and fund management matter. It is inconceivable that Congress intended to prohibit SEC-registered investment companies from investing a portion of their assets in hedge funds or private equity funds solely because they would be treated as subsidiaries of a bank holding company for other purposes under the Bank Holding Company Act.

To eliminate this unintended consequence, SIFMA requests that the FSOC recommend that the Board construe the terms "subsidiary" and "affiliate" to exclude SEC-registered investment companies for purposes of the Volcker Rule.

G. Conclusion

On the basis of this record, SIFMA believes that the FSOC should recommend that the Board construe any terms defined in Section 2 of the Bank Holding Company Act or Section 23A of the Federal Reserve Act so that they do not produce any internal contradictions, absurd results or unintended consequences in the Volcker Rule.

V. <u>The FSOC should recommend that the Regulatory Agencies grant an exemption for investments in hedge funds or private equity funds acquired in satisfaction of debts previously contracted</u>

Section 4 of the Bank Holding Company Act generally prohibits a bank holding company from owning or controlling any shares of any company other than a bank or bank

holding company. One of the exemptions from this general prohibition is an exemption for shares acquired in satisfaction of a debt previously contracted in good faith ("**DPC**"). Bank holding companies are generally permitted to hold such shares for an initial two-year period, with extensions at the discretion of the Board. The purpose of this exemption is to promote the safety and soundness of bank holding companies by permitting them to foreclose on securities collateral or to accept debt-for-equity swaps if that is the best available means for maximizing collections on a troubled credit.

Although the Volcker Rule does not contain a similar exemption for DPC acquisitions of ownership interests, we believe that the FSOC should recommend that the Regulatory Agencies create such an exemption pursuant to their exemptive authority in subsection (d)(1)(J). Banking entities should be able to take and retain interests in hedge funds or private equity funds in satisfaction of debts previously contracted in good faith without being subject to the restrictions in the Volcker Rule. The power to foreclose on collateral or take equity in satisfaction of a debt obligation is one of the most basic incidents of the power to extend credit. Requiring a banking entity to analyze the Volcker Rule implications as a condition of foreclosing on collateral or doing a debt-for-equity exchange would disrupt traditional lending activities. For example, a banking entity might conclude that it would not be permitted to foreclose on a block of shares in a company engaged in activities prohibited by the Volcker Rule or might be required to sell the shares immediately after foreclosure at a depressed price. SIFMA believes that the proposed exemption would promote and protect the safety and soundness of banking entities and the financial stability of the United States by giving banking entities the means to maximizing collections on a troubled extension of credit to a hedge fund or private equity fund or to investors in a fund.

VI. The FSOC should recommend that the Board construe the term "covered transaction" in Section 23A of the Federal Reserve Act so that it includes all appropriate exemptions for purposes of the Volcker Rule

Super 23A applies to all "covered transactions" as defined in Section 23A of the Federal Reserve Act. It is not clear whether that defined term includes the exemptions contained in Section 23A or Regulation W (the Board's regulation that implements Section 23A). The exemptions in Section 23A or Regulation W include 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.[21] These exemptions are just as necessary to prevent Super 23A from having unintended consequences as they are in actual Section 23A. The FSOC should recommend that the Board

[21] 12 U.S.C. § 371c(d)(4); 12 C.F.R. § 223.42(c), (l).

define the term "covered transaction" as defined in Section 23A of the Federal Reserve Act to include any appropriate exemptions from that definition, to the extent the definition is used in the Volcker Rule, including the exemptions identified in the previous sentence.

VII. **The FSOC should recommend that the Regulatory Agencies treat carried interest as incentive compensation, and not an ownership interest, for purposes of the 3% limit on total ownership interests in a fund under the Volcker Rule**

Subsection (d)(1)(G) provides that a banking entity is permitted to make *de minimis* investments in a hedge fund or private equity fund that the banking entity organizes and offers, subject to certain conditions and limits, including that the banking entity reduce its investment to not more than 3% of the total ownership interests in the fund after a seeding period. The managers of hedge funds and private equity funds typically receive incentive compensation in the form of a carried interest as part of their arrangement with the funds they manage. Such incentive compensation typically entitles the managers to receive 20% of the gains on a fund's investments after a specified minimum return has been achieved for the other investors. Any carried interest earned before a private equity fund's liquidation is typically required to be returned to the other investors if the fund's cumulative returns do not exceed the cumulative minimum return at the time of liquidation.

The FSOC should recommend to the Regulatory Agencies that incentive compensation in the form of carried interest should not be treated as an ownership interest in the fund, for purposes of calculating the 3% limit on total ownership interests in the fund.

VIII. **The FSOC should recommend that the Regulatory Agencies calculate the 3% ownership limit as of the end of the permitted seeding period**

As noted above, subsection (d)(1)(G) provides that a banking entity may make *de minimis* investments in a hedge fund or private equity fund that the banking entity organizes and offers, subject to certain conditions and limits, including that the banking entity reduce its investment to not more than 3% of the total ownership interests in the fund after a seeding period. It is not clear from either the text or legislative history whether the 3% limit is supposed to be measured at the end of the seeding period time or whether it is a continuing requirement that permits a banking entity to top up its investment if it falls below 3% as a result of being diluted by new third-party investments, or requires reduction of the investment if it exceeds the 3% limit because of third-party redemptions.

SIFMA requests that the FSOC recommend that the Regulatory Agencies clarify that the 3% limit is measured as of the end of the seeding period. That approach will be more consistent with how the Board has interpreted the ownership limits and reporting requirements for

investments in hedge funds and private equity funds under Section 4(k)(4)(H) of the Bank Holding Company Act and the Merchant Banking Rule that implements Section 4(k)(4)(H).[22] If a hedge fund increases in value or investors contribute additional capital, the banking entity would have no reason to increase its investment in the fund to attract additional investors. If a hedge fund loses value or investors withdraw capital, a banking entity would face both practical and fiduciary issues if it were required to withdraw capital to stay below the 3% limit. The redemption of the banking entity's investment could actually exacerbate a fund's declining value, potentially create a race to redeem and potentially push the banking entity's redemption ahead of other redeeming investors.

IX. The FSOC should recommend that the Regulatory Agencies construe the 3% of Tier 1 capital limit to be calculated on a consolidated basis at the ultimate parent company level of any banking entity

Subsection (d)(1)(G) provides that a banking entity may make *de minimis* investments in a hedge fund or private equity fund that the banking entity organizes and offers, subject to certain conditions and limits, including that the "aggregate of all of the interests of the banking entity in all such funds [may not] exceed 3 percent of the Tier 1 capital of the banking entity."

SIFMA believes that the 3% of Tier 1 capital 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.

The alternative interpretation, that the 3% of Tier 1 capital limit applies at the level of each specific affiliate that organizes and offers a fund could not possibly reflect congressional intent. If that interpretation were adopted, it would make subsection (d)(1)(G) a dead letter because the specific affiliates are typically special purpose vehicles that have almost no capital independent of their bank holding company parent. Nor are they otherwise required or have the systems to calculate their own Tier 1 capital.

Indeed, a colloquy between Senators Merkley and Levin, the principal authors of new Section 13, confirms the view that the Tier 1 capital limit is supposed to be calculated on a consolidated basis at the level of the ultimate parent bank holding company. In commenting on the 3% of Tier 1 capital limit, Senator Merkley refers to the "firm and its affiliates" rather than to the specific banking entity affiliate that is investing in a fund, and says that the limit applies to the "firm's" Tier 1 capital:

[22] 12 C.F.R. Part 225, Subpart J.

> "Fifth, the ***firm or its affiliates*** cannot make or maintain an investment in the fund, except in compliance with the limited fund seeding and alignment of interest provisions provided in paragraph (4) of subsection (d).
>
> . . . These "de minimis" investments are to be greatly disfavored, and subject to several significant restrictions. First, a firm may only have, in the aggregate, an immaterial amount of capital in such funds, but in no circumstances may such positions aggregate to more than 3 percent of the ***firm's*** Tier 1 capital." (Emphasis added.)[23]

On the basis of this record, SIFMA believes that the FSOC should recommend that the Regulatory Agencies construe the 3% of tier 1 capital limit to be calculated on a consolidated basis at the ultimate parent company level of any banking entity.

* * * * * * *

[23] 156 CONG. REC. S5901 (daily ed. July 15, 2010).

SIFMA thanks the FSOC for the opportunity to comment on the Study. If you have any questions, please do not hesitate to call me at 212-313-1114, or SIFMA's 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

Annex A

<table>
<tr><th>Regulatory Agency</th><th>Banking Entity</th></tr>
<tr><td rowspan="4">Federal Reserve Board</td><td>company that controls an insured depository institution, including a bank holding company</td></tr>
<tr><td>foreign bank that has a branch, agency or commercial lending company subsidiary in the United States, and any company that directly or indirectly controls such a foreign bank</td></tr>
<tr><td>subsidiary of any of the foregoing, except for any subsidiary as to which another federal agency is the primary financial regulatory agency as listed below</td></tr>
<tr><td>FDIC-insured bank that is incorporated under State law and a member of the Federal Reserve System</td></tr>
<tr><td rowspan="4">OCC</td><td>national banking association</td></tr>
<tr><td>federal savings association (after July 21, 2011)</td></tr>
<tr><td>FDIC-insured bank operating under the Code of Law of the District of Columbia</td></tr>
<tr><td>FDIC-insured federally licensed branch or agency of a foreign bank</td></tr>
<tr><td rowspan="3">FDIC</td><td>FDIC-insured bank that is incorporated under State law and is not a member of the Federal Reserve System</td></tr>
<tr><td>FDIC-insured savings association that is incorporated under State law (after transfer date)</td></tr>
<tr><td>FDIC-insured state licensed branch or foreign bank with an FDIC-insured state licensed branch</td></tr>
<tr><td colspan="2">Any of the following but only if it is a subsidiary or affiliate of any of the foregoing:</td></tr>
<tr><td rowspan="7">SEC</td><td>registered broker or dealer</td></tr>
<tr><td>registered investment company</td></tr>
<tr><td>registered investment adviser</td></tr>
<tr><td>registered transfer agent</td></tr>
<tr><td>registered securities information processor</td></tr>
<tr><td>registered security-based swap execution facility, swap data repository, swap dealer or major security-based swap participant</td></tr>
<tr><td>other specified companies[1]</td></tr>
<tr><td rowspan="6">CFTC</td><td>registered futures commission merchant</td></tr>
<tr><td>registered commodity pool operator</td></tr>
<tr><td>registered commodity trading adviser</td></tr>
<tr><td>registered swap execution facility, swap data repository, swap dealer or major swap participant</td></tr>
<tr><td>other registered entity</td></tr>
<tr><td>other specified companies[2]</td></tr>
</table>

[1] These include any registered clearing agency, nationally recognized statistical rating agency, registered national securities exchange, registered national securities association and the Municipal Securities Rulemaking Board.

[2] These include any registered derivatives clearing organization, board of trade designated as a contract market, registered futures association or registered retail foreign exchange dealer.

Annex B

Note: *The comments below are limited to hedge funds and private equity funds, and do not address proprietary trading. SIFMA has submitted a separate comment letter on proprietary trading.*

Solicitation for Comments on the Volcker Rule Study

1. Commenters are invited to submit views on ways in which the implementation of the Volcker Rule can best serve to:

(a) Promote and enhance the safety and soundness of banking entities;

The Volcker Rule can best achieve this purpose by striking the right balance between prohibiting certain relationships with hedge funds and private equity funds and preserving appropriate asset management and other corporate and investment activities. It will promote and enhance the safety and soundness of banking entities if the Volcker Rule is implemented so as to:

- clarify the types of companies that should not be treated as hedge funds or private equity funds, such as acquisition vehicles, joint ventures, properly operated venture capital funds, finance subsidiaries, employee pension funds, credit funds and other entities or vehicles;
- create clear guidance as to the application of the term "similar funds," including non-exclusive safe harbors for investment vehicles and other corporate structures that are not similar to traditional hedge funds or private equity funds and therefore should not be treated as "similar funds";
- permit banking entities to continue to engage in socially useful lending activities and extensions of credit, whether on their own balance sheet or through investment vehicles or funds;
- ensure that the rules clearly and predictably distinguish between prohibited and permitted activities;
- ensure that the rules do not unduly restrict entities that are not operationally part of an insured depository institution;
- mitigate the likelihood of significant disruption to third-party investors and the business, activities or capital of banking entities by providing clear and appropriately flexible transition rules; and
- maintain the international competitiveness of the United States financial services industry in light of the extent to which other countries with a significant financial

services industry have established corresponding regimes for proprietary trading or sponsoring or investing in hedge funds or private equity funds to mitigate threats to financial stability of the economy posed by financial companies.

(b) Protect taxpayers and consumers and enhance financial stability by minimizing the risk that insured depository institutions and the affiliates of insured depository institutions will engage in unsafe and unsound activities;

See our response to Question 1.(a) above.

(c) Limit the inappropriate transfer of federal subsidies from institutions that benefit from deposit insurance and liquidity facilities of the federal government to unregulated entities;

Sections 23A and 23B of the Federal Reserve Act impose strong limits on any inappropriate transfer of the benefits of deposit insurance and federal liquidity facilities from insured depository institutions to unregulated entities. The 23A/23B provisions in subsections (f) and (d)(1)(G)(iv) of the Volcker Rule, the anti-guarantee provision in Subsection (d)(1)(G)(v) of the Volcker Rule, the existing limits on access to the Federal Reserve's discount window and the new limits imposed by the Dodd-Frank Act on Section 13(3) of the Federal Reserve Act and the FDIC's powers to provide credit support under the Federal Deposit Insurance Act impose appropriate limits on the transfer of federal subsidies to unregulated entities.

(d) Reduce conflicts of interest between the self-interest of banking entities and nonbank financial companies supervised by the Board[1], and the interests of the customers of such entities and companies;

The conditions in subsection (d)(1)(G), as well as appropriate disclosure and consent requirements, such as those that exist in the Investment Advisers Act, appropriately address any conflicts of interest in sponsoring or investing in hedge funds or private equity funds that are offered to customers.

(e) Limit activities that have caused undue risk or loss in banking entities and nonbank financial companies supervised by the Board, or that might reasonably be expected to create undue risk or loss in such banking entities and nonbank financial companies supervised by the Board;

See our response to Question 1.(a) above.

[1] The term "nonbank financial companies supervised by the Board" refers to those nonbank financial companies that may be designated by the FSOC under section 113 of the Dodd-Frank Act to be supervised by the Board and subject to enhanced prudential standards.

(f) Appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system; and

SIFMA does not have a view on this subject.

(g) Appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under the Volcker Rule.

The FSOC should recommend that the Regulatory Agencies construe the transition provisions in the Volcker Rule to give banking entities sufficient time to conform their activities with respect to illiquid funds so that the economic impact on banking entities and on third-party clients invested in those funds is minimized.

Please see our responses to Questions 4.(b) and 11 for additional information about the appropriate timing of any required divestiture or restructuring of illiquid funds.

2. What are the key factors and considerations that should be taken into account in making recommendations on implementing the proprietary trading provisions of the Volcker Rule?

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.

3. What are the key factors and considerations that should be taken into account in making recommendations on implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds?

The key factors and considerations that should be taken into account in making recommendations include the need to:

- preserve appropriate client-focused asset management, traditional lending activities and other corporate and investment activities that the Volcker Rule is intended to preserve, while prohibiting certain relationships with hedge funds and private equity funds;

- protect the banking system from expanded losses arising from bailouts of investors in affiliated funds;

- construe the definition of "hedge fund" and "private equity fund" so that it does not extend to corporate structures or entities that Congress did not intend to cover, as indicated by the Frank-Himes and Dodd-Boxer colloquies; the current definition includes many corporate structures or entities that have never been considered to be hedge funds or private equity funds; Congress intended for the Regulatory Agencies to exempt any companies not properly treated as hedge funds or private equity funds;

- recognize that the "similar funds" provision is not self-executing; the Regulatory Agencies are authorized to designate an investment vehicle as a "similar fund" only by formal rulemaking action; in contrast, they are free to create non-exclusive safe harbors from a similar fund designation by rulemaking or any other formal or informal action;

- construe any terms, such as "subsidiary," "affiliate" and "covered transaction," as defined in Section 2 of the Bank Holding Company Act and Section 23A of the Federal Reserve Act, so that they do not produce any internal contradictions, absurd results or unintended consequences in the application of the Volcker Rule;

- ensure that the availability of capital and credit to American businesses, vital to job creation and the recovering economy, is not impeded;

- provide legal certainty to the markets for matters relating to transition periods and other open issues; and

- preserve the international competitiveness of U.S. banking entities.

4. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should inform decisions on the definitions of:

(a) "Banking entity" [§619(h)(1)];

See Section IV of our comment letter.

(b) "Hedge fund" [§619(h)(2)];

As noted in our comment letter, the SEC and other regulatory agencies have never been able to agree upon a precise definition for a hedge fund.[2] The Volcker

[2] *See* Implications of the Growth of Hedge Funds, Staff Report to the United States Securities and Exchange Commission, September 2003 at 3 (Stating that the term "hedge fund" "has no precise legal or universally accepted definition"); *see also* Testimony of Federal Reserve Governor Kevin Warsh Before the House Committee on Financial Services, July 11, 2007, at 2 ("[T]here is no precise legal definition [of hedge fund] . . ."); Testimony

Rule defines a "hedge fund" as any "issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.) (the "**1940 Act**"), but for section 3(c)(1) or 3(c)(7) of that Act." As discussed in greater detail in our comment letter, SIFMA notes that this general definition is overbroad and as a result sweeps in corporate structures and entities, such as acquisition vehicles and other limited or single purpose structured finance vehicles or entities, joint ventures, properly operated venture capital funds, finance subsidiaries, credit funds, employee pension funds and other entities that Congress never intended to treat as hedge funds. As set out in our comment letter, SIFMA believes that such structures and entities should be identified and excluded from the general definition by the Regulatory Agencies, exercising the discretion granted to them in the Volcker Rule.

SIFMA recognizes that one reason for the difficulty of arriving at a more precise definition of a "hedge fund" is that the characteristics and activities of hedge funds have evolved and expanded significantly since these types of vehicles were first created and are likely to continue to evolve significantly in the future.

Nevertheless, SIFMA believes that a ***traditional hedge fund*** for purposes of the Volcker Rule should be defined as an entity that (i) is a pooled investment vehicle that has a large number of sophisticated, third-party institutional and high net worth investors and that makes a large number of investments, (ii) would be an investment company (as defined in the 1940 Act) but for Section 3(c)(1) or 3(c)(7) of the 1940 Act,[3] and is not otherwise registered under the 1940 Act and (iii) has the following additional characteristics:

- the fund and its investment activities are not subject to regulatory restrictions or limitations; however, the nature and number of investors in the fund, and the manner in which the fund offers its interests to prospective investors, are subject to certain regulatory requirements or limitations;

- because it is exempt from the 1940 Act and other comparable laws, its investors are not entitled to the protections afforded by the 1940 Act or such other comparable laws, including requirements that apply to the management and operations of the fund (e.g., requirements relating to independent directors on the board of directors, limitations on leverage and short sales and certain investment restrictions and restrictions on certain types of transactions);

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of Former SEC Chairman David S. Ruder Before the House Committee on Oversight and Government Reform, November 13, 2008, at 2 ("[T]here is no universally accepted definition of hedge funds . . .").

[3] SIFMA believes that, as discussed in our comment letter, entities exempt from the 1940 Act pursuant to any other provision of the 1940 Act should not be treated as a "hedge fund," "private equity fund" or "similar fund" for purposes of the Volcker Rule.

- it is advised by a professional investment manager that has the sole discretion to invest and reinvest the vehicle's cash and to otherwise manage the vehicle's portfolio in accordance with investment guidelines proposed by the manager and agreed to by its investors;
- 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;
- as part of its stated investment strategy, it employs or is expected to employ material leverage to enhance the returns on its investments;
- investors have the right to redeem their investments in whole or in part at specified times, but do not have daily redemption rights, and such redemption rights may be further restricted or suspended indefinitely if, as a result of market conditions or otherwise, the securities or instruments in its portfolio become illiquid or third-party valuations are not readily available; and
- the investment manager earns a management fee (based on the NAV of total assets under management) and a carried interest that is performance-based (i.e., it is calculated taking into account the performance of the fund's entire portfolio over a specified period of time (such as a year), subject to various measures such as a "high water mark," "hurdle rate" or other adjustments).

(c) "Private equity fund" [§619(h)(2)];

As noted in our comment letter, the SEC and other regulatory agencies have found it difficult to agree upon a precise definition for a private equity fund. The Volcker Rule defines a "private equity fund" as any "issuer that would be an investment company, as defined in the Investment Company Act of 1940 (15 U.S.C. 80a-1 et seq.), but for section 3(c)(1) or 3(c)(7) of that Act." As discussed in greater detail in our comment letter, SIFMA notes that this general definition is overbroad and as a result sweeps in corporate structures and entities, such as acquisition vehicles and other limited or single purpose structured finance vehicles or entities, joint ventures, finance subsidiaries, credit funds, employee pension funds, regulated foreign funds and other entities that Congress never intended to treat as hedge funds or private equity funds. As set out in our comment letter, SIFMA believes that such structures and entities should be identified and excluded from the general definition by the Regulatory Agencies, exercising the discretion granted to them in the Volcker Rule.

SIFMA believes that a ***traditional private equity fund*** for purposes of the Volcker Rule should be defined as an entity that (i) is a pooled investment vehicle that has a large number of sophisticated, third-party institutional and high net worth

investors and that makes several investments, (ii) would be an investment company (as defined in the 1940 Act) but for Section 3(c)(1) or 3(c)(7) of the 1940 Act,[4] and is not otherwise registered under the 1940 Act and (iii) has the following additional characteristics:

- the fund and its investment activities are not subject to regulatory restrictions or limitations; however, the nature and number of investors in the fund, and the manner in which the fund offers its interests to prospective investors, are subject to certain regulatory requirements or limitations;
- because it is exempt from the 1940 Act and other comparable laws, its investors are not entitled to the protections afforded by the 1940 Act or such other comparable laws, including requirements that apply to the management and operations of the fund (e.g., requirements relating to independent directors on the board of directors, limitations on leverage and investments in illiquid equity securities and other instruments and restrictions on certain types of transactions);
- the purpose of the fund is to generate significant investment returns by (i) investing in several private, established operating companies (other than start-ups or venture capital companies), (ii) 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 fund's life;
- it is advised by a professional investment manager that has the sole discretion to invest the vehicle's cash and to otherwise manage the fund's portfolio in accordance with investment guidelines proposed by the manager and agreed to by its investors;
- it has a limited life, such as ten years with a limited number of one-year extensions;
- it seeks representation on the boards of directors of the operating companies in which it invests and/or enhanced information rights or access to the management of the operating companies in which it invests;

[4] SIFMA believes that, as discussed in our comment letter, entities exempt from the 1940 Act pursuant to any other provision of the 1940 Act should not be treated as a "hedge fund," "private equity fund" or "similar fund" for purposes of the Volcker Rule.

- it can admit new investors to, or permit existing investors to increase their investment in, the fund only during an initial start-up period, after which the fund is closed;
- investors are not permitted to withdraw or redeem their investments in the fund;
- the investment manager earns (i) a management fee (based on the total capital commitments and/or invested capital) and (ii) a carried interest that is performance-based (i.e., it is calculated taking into account the performance of all of the fund's investments over the life of the fund); and
- it provides for 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 fund, to have received carried interest in excess of what it is entitled to receive in light of the performance of all of the fund's investments.

(d) "Such similar funds" [§619(h)(2)];

See Section II of our comment letter. In particular, SIFMA believes that any regulated foreign funds, for example any fund that qualifies as an Undertaking for the Collective Investment of Transferable Securities ("**UCITS**") or any fund managed by managers required to comply with the EU's Alternative Investment Fund Managers Directive (the "**AIFM Directive**"), should not be treated as "similar funds".

(e) "Proprietary trading" [§619(h)(4)];

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.

(f) "Sponsor" [§619(h)(5)];

The FSOC should recommend that the Regulatory Agencies permit a banking entity to propose a board of directors upon the formation of a new fund without being deemed to "sponsor" the fund if a majority of such board is comprised of directors that are independent of the banking entity.

The FSOC should recommend that the Regulatory Agencies exclude directed trustees from the term "trustee" as used in the definition of "sponsor." 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.

(g) "Trading account" [§619(h)(6)];

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.

(h) "Short term" [§619(h)(6)];

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.

(i) "Illiquid fund" [§619(h)(7)];

SIFMA believes that an illiquid fund has the following characteristics:

- its assets are principally illiquid assets, i.e., a significant amount of its assets are assets for which there is no public market and for which valuation is based on internal models, rather than third-party valuations; and
- its investors are not permitted to withdraw or redeem their investments in the fund for an extended period of time.

The term "principally" should be interpreted the way that term has been interpreted by the Board of Governors of the Federal Reserve System in the context of other provisions of the U.S. banking laws, including former Section 20 of the Glass-Steagall Act or other banking provisions: i.e., it refers to a significant portion, which was interpreted in the Section 20 context to be more than 25% of revenues.

The term 'illiquid fund' should be interpreted in ways that do not interfere with fund sponsors' fiduciary obligations or the fiduciary duties of banking entities to their shareholders. The Volcker Rule provides for transition periods during which banking entities may bring their operations into compliance. It specifically addresses an extended period for illiquid funds. In interpreting the term "illiquid fund," the Regulatory Agencies should consider several fundamental factors: whether the fund has a significant amount of assets that are inherently illiquid, the ability of the fund investors to exit their investment, the fiduciary duties of the fund sponsor and the fiduciary duties of the banking entity to its shareholders.

Private equity funds have a lifetime of many years, during which investors are typically not permitted to transfer or redeem their interests. Such funds therefore are clearly the type that should be considered "illiquid funds." While many hedge funds trade in marketable securities, many hold some or all of their portfolios in securities or instruments that trade infrequently or in illiquid markets. For example, a hedge fund may be unable to sell or transfer its investments due to securities laws restrictions or

valuation challenges. Although hedge fund investors can generally make earlier and more frequent redemptions than private equity fund investors, they may nonetheless be constrained by contractual restrictions on redemption rights through side pockets, gates and staggered lock-up periods that typically exist due to the liquidity limitations of the hedge fund's portfolio. Premature asset sales by a fund in order to redeem the interest held by a banking entity could have severe adverse consequences to the banking entity and to the other investors in the affected fund, including the loss of economic value and adverse tax consequences.

Just as there may be limitations on the ability of a fund to sell or otherwise dispose of its investments, there may also be limitations on the ability of an investor in the fund to sell or otherwise dispose of its investment in the fund. Many banking entities hold significant positions, as investors, in the hedge funds and private equity funds that they have sponsored as well as hedge funds and private equity funds established by third-party managers. These positions were acquired prior to the enactment of the Volcker Rule. If banking entities are required to divest their interests in such funds, especially on an expedited or "fire sale" basis, such sales will likely be effected at prices far below the fair value of such interests and will result in a loss of value for the banking entities themselves as well as for the other investors in the affected funds who may also be seeking to transfer their interests in such funds for their own reasons.

Finally, the Regulatory Agencies should consider a banking entity's commitments to its investors that were made and disclosed at the time a particular fund was marketed to such investors. Fund investors often treat a banking entity's commitment to invest in a sponsored fund as a key consideration in deciding whether to invest in the fund. If the banking entity is prevented from fulfilling such a commitment as a result of the Volcker Rule, the investors will rightly feel that a material consideration that contributed to their investment decision is not being met. The Regulatory Agencies should recognize the importance of such a commitment to a fund's investors, and apply the extended transition period in a way that enables the expectations of the fund investors to be fulfilled.

Please see our response to Question 11 for further discussion of the transition period.

(j) A transaction "in connection with underwriting or market making related activities ... designed not to exceed the reasonably expected near-term demands of clients, customers or counterparties" [§619(d)(1)(B)];

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.

(k) "Risk-mitigating hedging activities" [§619(d)(1)(C)];

The FSOC should confirm that the natural reading of the permitted activity exemption for "risk-mitigating hedging activities" is correct, *i.e.*, that it provides a limited exemption from the general prohibition against acquiring or retaining ownership interests in hedge funds or private equity funds.

(l) "The purchase, sale, acquisition, disposition of securities or other instruments 'on behalf of customers'" [§619(d)(1)(D)];

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.

(m) Investments in "small business investment companies" and certain "public welfare" investments [§619(d)(1)(E)];

The FSOC should recommend that the Regulatory Agencies interpret this exemption broadly, as supported by a colloquy between Senators Merkley and Levin.[5] The Merkley-Levin Colloquy describes the exemption as permitting "investments of the type permitted under the paragraph of the National Bank Act enabling banks to invest in a range of low-income community development and other projects." By emphasizing the phrase "of the type," the colloquy should be read to treat as permitted activities public welfare investments that are of the same nature as those permitted under 12 USC § 24(Eleventh), even if not expressly permitted under that section.

(n) A permitted activity by an insurance company [§619(d)(1)(F)]; and

SIFMA does not have a view on this subject.

(o) Such other activities as "would promote and protect the safety and soundness of banking entities and the financial stability of the United States" [§619(d)(1)(J)];?

The FSOC should recommend that the Regulatory Agencies interpret their authority under this subsection to permit them the flexibility to exempt activities the prohibition of which results in internal contradictions within the Volcker Rule, absurd results or unintended consequences. See Section IV of our comment letter.

[5] 156 CONG. REC. S5896 (daily ed. July 15, 2010) (statement of Sens. Merkley and Levin).

5. With respect to proprietary trading and hedge fund and private equity fund activities, what factors and considerations should be taken into account as indicative that a transaction, class of transactions or activity:

(a) Would involve or result in a material conflict of interest between a banking entity (or a nonbank financial company supervised by the Board) and its clients, customers or counterparties;

With respect to hedge fund and private equity fund activities, SIFMA believes that the FSOC should recommend that the Regulatory Agencies address the Volcker Rule's material conflicts of interests provision by requiring banking entities to comply with appropriate disclosure and consent requirements with respect to clients, customers and counterparties. Investment advisers are subject to disclosure and consent requirements under section 206 of the Investment Advisers Act. In addition, every investor in a hedge fund or private equity fund is by definition sophisticated, able to understand conflict disclosure and to consent if doing so is in such investor's interest. The Volcker Rule's robust restrictions on transactions between a banking entity and any hedge fund or private equity fund that it sponsors, manages or advises, if implemented in conjunction with existing disclosure and consent requirements, should ensure that material conflicts of interest are appropriately addressed.

(b) Would result, directly or indirectly, in a material exposure by a banking entity (or a nonbank financial company supervised by the Board) to high-risk assets or high-risk trading strategies; or

With respect to hedge fund and private equity fund activities, SIFMA believes that the FSOC should encourage the Regulatory Agencies to make any such determination under an "all facts and circumstances" test as part of the supervisory process, taking into consideration the quality of an individual firm's risk management program. The Regulatory Agencies should also be encouraged to create regulatory safe harbors to provide transactional certainty.

(c) Would pose a threat to the safety and soundness of a banking entity (or a nonbank financial company supervised by the Board)?

With respect to hedge fund and private equity fund activities, SIFMA believes that the FSOC should encourage the Regulatory Agencies to apply their traditional standards of safety and soundness to any such determination as part of the supervisory process.

6. What factors and considerations should be taken into account in making recommendations on whether additional capital and quantitative limitations are appropriate to protect the safety and soundness of banking entities or nonbank financial companies supervised by the Board engaged in activities permitted under the Volcker Rule?

SIFMA believes that the FSOC should encourage the Regulatory Agencies to examine the impact of Basel III and the new generally applicable capital provisions introduced by the Dodd-Frank Act on banking entities and nonbank financial companies prior to determining whether additional capital and quantitative limitations are appropriate for Volcker Rule activities. The Dodd-Frank Act introduces a number of broadly applicable capital reforms, including requiring holding companies to observe risk-based capital and leverage capital standards currently applicable to U.S. insured depository institutions, and establishes a new systemic risk regime, which authorizes and mandates the Regulatory Agencies to subject covered firms to heightened prudential standards. The content of the new standards is likely to be influenced by the Basel III standards, expected to be released shortly. The FSOC should recommend that the Regulatory Agencies focus on implementing these capital standards before determining whether to supplement them with additional standards narrowly tailored to the Volcker Rule.

7. With respect to proprietary trading and hedge fund and private equity fund activities, which practices, types of transactions or corporate structures in general have historically accounted for or involved increased risks or may account for or involve increased risks in the future?

With respect to hedge fund and private equity fund activities, SIFMA recognizes that perspectives on this question may vary, and defers to the FSOC's judgment.

8. With respect to proprietary trading and hedge fund and private equity fund activities, what practices, policies or procedures have historically been utilized that may have mitigated or exacerbated risks or losses? What practices, policies or procedures might be useful in limiting undue risk or loss in the future?

With respect to hedge fund and private equity fund activities, SIFMA believes that the best approach to limiting undue risk or loss in the future is through a combination of robust risk management, internal controls and audits and appropriate regulatory oversight. The FSOC should encourage the Regulatory Agencies to work closely with banking entities to ensure that they are using best risk-management practices and internal controls to mitigate risks or losses.

9. What factors and considerations should be taken into account in making recommendations to safeguard against evasion of the Volcker Rule?

The FSOC should recommend that the Regulatory Agencies implement the Volcker Rule's anti-evasion provisions by requiring banking entities to establish and maintain policies and procedures reasonably designed to ensure compliance with the Volcker Rule's prohibitions. The Regulatory Agencies should test adherence to such policies and procedures in the course of the supervisory examination process. SIFMA looks forward to providing further recommendations with respect to evasion, should such input be sought, once the Regulatory Agencies issue the rules with which banking entities will comply.

10. How should the international context be considered when implementing the Volcker Rule? Are there any factors or considerations that should be taken into account regarding the application of the Volcker Rule to banking entities or nonbank financial companies that operate outside the United States? What issues does implementation of the Volcker Rule present with respect to the following:

(a) Domestic banking entities that have access to foreign exchanges,

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.

(b) foreign affiliates of domestic banking entities, and

The FSOC should recommend that the Regulatory Agencies give strong consideration to the international competitiveness of the United States financial services industry when determining the scope of the Volcker Rule's application to foreign affiliates of U.S. banking entities. In particular, the Regulatory Agencies should take into account the extent to which other countries with a significant financial services industry have established corresponding regimes for sponsoring or investing in hedge funds or private equity funds to mitigate threats to financial stability of the economy posed by financial companies. Flight of significant parts of the financial services sector to other markets would itself harm U.S. financial stability.

(c) foreign non-bank financial companies

SIFMA does not have a view on this subject.

11. What timing issues are raised in connection with the divestiture of illiquid assets affected by the prohibitions of the Volcker Rule, and how might such issues be appropriately addressed?

The FSOC should recommend that the Regulatory Agencies consider a fund sponsor's commitments to its investors regarding the expected holding period of portfolio investments

and the fiduciary duties of banking entities to their shareholders when writing rules to address divestiture of illiquid assets. Premature asset sales could have severe adverse consequences to investors, including the loss of economic value and adverse tax consequences. A banking entity that acts as a fund sponsor should be able to manage a fund and its activities in accordance with the terms of the offering to fund investors. Requiring sponsors to liquidate their funds prematurely could preclude them from carrying out their fiduciary duties to investors and could generate premature discounts on disposition.

The FSOC should also recommend that the Regulatory Agencies consider the practical necessity of providing banking entities with sufficient notice of the duration of the transition period as it applies to each of their illiquid funds. SIFMA believes that the Regulatory Agencies should strike an appropriate balance between their legislative mandate under the Volcker Rule and the need to avoid undue harm to investors and bank capital. The Regulatory Agencies should implement the Volcker Rule in a manner that encourages certainty and avoids fire sales that could unnecessarily reduce the capital of the U.S. banking industry.

Finally, the FSOC should confirm that the natural reading of subsection (c)(2) is correct, *i.e.*, that the Regulatory Agencies have the discretion to grant up to five years to conform an illiquid fund in addition to the total potential transition period for all funds.

12. Commenters are generally invited to submit views with respect to any qualitative or quantitative factors that should be considered in connection with the Council's study of the Volcker Rule, as well as any analogous areas of law, economics, or industry practice, and any factors specific to the commenter's experience. Please comment generally and specifically, and please include empirical data and other information in support of such comments, where appropriate and available.

As noted above, SIFMA has submitted a separate comment letter on proprietary trading. See that separate comment letter.