American Bankers Association
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Phoebe Papageorgiou
Senior Counsel
Center for Securities, Trust and Investments
202-663-5053
phoebep@aba.com

VIA ELECTRONIC MAIL

Monday, January 10, 2011

Jennifer J. Johnson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Conformance Period for Entities Engaged in Prohibited Proprietary Trading or Private Equity Fund or Hedge Fund Activities, 75 Federal Register 72741 (Friday, November 26, 2010).

Dear Ms. Johnson:

The American Bankers Association (ABA) appreciates this opportunity to comment on the proposed rule of the Board of Governors of the Federal Reserve System (Board) implementing the conformance period for entities affected by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act). ABA represents banks of all sizes and charters and is the voice for the nation's $13 trillion banking industry and its two million employees. Many of our member institutions provide fiduciary and custody services for institutional, charitable, government and individual clients, including sponsoring or serving as trustee or manager of pooled investment vehicles, and may be affected by the various rules implementing Section 619. As of year-end 2009, banks held $76 trillion in fiduciary and custody accounts.[1]

ABA urges the Board to exercise its discretion to extend the conformance deadline for Section 619 in a way that minimizes disruptions to long-standing and valuable banking activities, as well as the industry and economic growth in general. Towards this end, we recommend that important terms, such as "illiquid assets," "principally invested," and "contractual obligation," be defined in a manner that is consistent with the statute and avoids unintended consequences.

[1] FDIC Quarterly Banking Profile, Fourth Quarter 2009, Table VIII, *available at* http://www2.fdic.gov/qbp/2009dec/qbp.pdf.

Background on the Volcker Rule

Section 619, commonly referred to as the Volcker Rule (Rule, or Section), generally prohibits banking entities from engaging in proprietary trading or from investing in, sponsoring, or having certain relationships with "hedge funds" or "private equity funds." Banking entities must come into conformance with the Volcker Rule two years after the earlier of one year after the issuance of final rules under the Section or two years after enactment. The Section gives the Board the authority to extend this conformance period for up to three years if consistent with the purposes of the Section and not detrimental to the public interest. In addition, the Board may extend the conformance period for up to five years for holdings of illiquid funds "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010."[2] The Board must issue these conformance period rules within six months of enactment, i.e., January 21, 2011.

ABA appreciates and understands the need to release a timely rule in order to give the affected entities enough time and opportunity to arrange their affairs and come into conformance with the Volcker Rule. Nonetheless, due to the significant ramifications of these new requirements, we strongly urge the Board to take a measured approach, with the assumption that any rule issued will be periodically revisited and revised as needed. This concern is especially pressing given the intertwined nature of this proposal with the as-yet-unreleased Financial Stability Oversight Council's (Council) Volcker Rule study and the coordinated rulemaking of the Federal banking agencies, the Securities and Exchange Commission, and the Commodities Futures Trading Commission. In particular, the coordinated rulemaking may address such vital issues as the scope of the terms "banking entity," "hedge fund," and "private equity fund." Given these uncoordinated deadlines, it is extremely difficult to foresee and comment on all the concerns that may arise with the conformance period proposal when it operates in conjunction with the other not-yet-issued implementing rules.

Intent of Congress

Recognizing the potential for unintended consequences of such a profound new rule, Congress, through the mechanism of the Council study, sought to identify potential concerns and avoid

[2] 12 U.S.C. 1841 (c)(2).

rulemaking that may harm long-standing and valuable traditional banking activities. This approach seeks to facilitate an orderly transition over sufficient time for affected entities in order to minimize disruptions to the industry, to our clients and customers, and to the broader economy. That is to say, such an approach seeks to allow for the liquidation of long-term interests without hurting the safety and soundness of the very institutions the Volcker Rule seeks to protect or harming the clients of the banking entities and the investors in the funds.

Congress clearly intended for the agencies to engage in thoughtful deliberation when implementing the Volcker Rule, as evidenced by the significant authority vested in the Board under the Rule to consider and grant applications for extensions of the conformance period. However, by proposing to define terms in the statute too narrowly, the Board will undermine the utility of such extensions. In order to implement the rule consistent with the purposes of the Section and in the public interest, ABA believes the Board should preserve its statutory authority and more broadly define the important terms in the statute.

Definitions in the Extended Transition for Illiquid Funds

Given the complex and long-term nature of many investments in "hedge funds" and "private equity funds," Congress appropriately gave the Board authority to grant additional extensions for interests in "illiquid funds"[3] "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010."[4] ABA is concerned that the Board has interpreted this statutory language too narrowly and perhaps not in keeping with the intent of Congress, thereby unnecessarily limiting the important means for avoiding unintended consequences.

Definition of Illiquid Asset

Under the proposal, an illiquid asset is one that is not a "liquid asset" as defined in the proposal (e.g., not cash, an asset traded on an exchange or market, or an asset with a ready market, etc.) or one that because of statutory or regulatory restrictions may not be sold to a person unaffiliated with the

[3] The proposal, closely following the statute, defines illiquid funds as: "a hedge fund or private equity fund that as of May 1, 2010: (1) Was principally invested in illiquid assets; or (2) Was invested in, and contractually committed to principally invest in, illiquid assets; and (3) Makes all investments pursuant to, and consistent with, an investment strategy to principally invest in illiquid assets."

[4] 12 U.S.C. 1841 (c)(2).

banking entity. The statute also refers specifically to "portfolio companies, real estate investments, and venture capital investments" as illiquid assets.

The proposal's definition does not accommodate assets that initially meet the definition of liquid but given the particular circumstances of the investment or market subsequently become illiquid. This may include, for example, the following:

- large holdings in the securities of one particular issuer that may prohibit the fund from selling the asset without material losses;
- assets (such as investments in another hedge fund) in which the fund is held to a particular redemption period or other contractual restriction even though the asset is readily valued or traded; and
- assets that have published market prices but nonetheless are not being traded in a genuine market.

The proposal should specify that other circumstances may exist that make a typically or historically liquid asset illiquid in the present circumstances.

Definition of Principally Invested

Under the proposal, an illiquid fund is "principally invested" in illiquid assets if at least 75 percent of the fund's consolidated assets are illiquid assets or related risk-mitigating hedges. Without citing any clear legislative history or pronouncement, the Board equates the modifier "principally" with "substantially" to arrive at the inappropriately high percentage in the proposal: "…Congress appears to have structured the extended transition period for these types of funds that are clearly focused on, and invest *substantially all* of their capital in, illiquid assets."[5] [Emphasis added.]

ABA urges the Board to consider a more moderate interpretation of the term "principally invested" that follows a straightforward reading of the statutory language. If Congress had wanted to focus on funds that were "substantially invested" in illiquid assets, it would have used such a term in the section instead of "principally." Therefore, we believe at a minimum the Board should reduce this threshold to a simple majority of the assets in the fund, if not a lower amount.

[5] 75 Federal Register 72741, 72745 (Friday, November 26, 2010).

Definition of Contractual Obligation

As required by the statute, the Board may extend the period for illiquid funds "to the extent necessary to fulfill a contractual obligation that was in effect on May 1, 2010." Significantly, the statute does not elaborate on nor does it *limit* what is a contractual obligation. However, the Board in its interpretation narrows the meaning of the term "contractual obligation" from the statutory language to mean only certain contractual obligations in which the banking entity is: (1) prohibited from redeeming or selling its interest; or (2) contractually obliged to provide additional capital; and (3) either prohibited from terminating the obligation or, if the obligation may be terminated, required to use "reasonable best efforts" to obtain consent to terminate.

Under common law and state statutes, all contracts may be amended or terminated upon the consent of all parties. In addition, many fund agreements have regulatory outs, allowing the investor to sell, not necessarily redeem, its interest before the redemption period if required by statute or regulation. Therefore, the proposal seemingly would force banking entities always to use "reasonable best efforts" to obtain consent to terminate their "contractual obligation," because that obligation may be terminable. The question is at what cost to the banking entity, which the Volcker Rule seeks to protect, must it use "reasonable best efforts" to obtain consent to terminate?

Banking entities should not be forced to sell their interest at a loss or to buyers who set the price of the interest in the fund at a value that takes advantage of the banking entity's predicament. This scenario is especially likely with illiquid funds where there is no ready market and the buyer may be aware of the banking entity's divestment requirement. It is important to keep in mind that the Volcker Rule was intended to reduce risk, not become a source of risk, and that implementing regulations and interpretations should embody that intention. A simpler reading of the term "contractual obligation," and one more in line with what Congress intended, would include *any* contractual obligation or agreement in effect on May 1, 2010, to "take or retain its equity, partnership, or other ownership interest in, or otherwise provide additional capital to, an illiquid fund."[6]

[6] 12 U.S.C. 1841(c)(3).

Additional Considerations for Bank Managed Funds

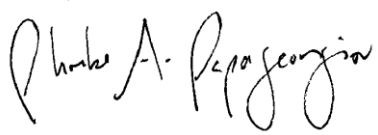
Banks routinely establish funds that potentially may fall within the broad definition of "hedge fund" or "private equity fund" for purposes of providing valuable investment opportunities to institutional, government, charitable, or trust customers. It is not uncommon for investors in these funds to expect that the sponsor of the fund invest side-by-side at least for the initial years of the fund – an expectation that may affect the investors' initial decision to invest and remain invested over time. This co-investment may be significant and larger than the three percent de minimis investment allowed as a permitted activity under the Rule.

The rule as proposed could require a bank to redeem its investment in the fund in a way that affects the other investors in the fund. For example, a bank may have to sell the more liquid assets in the fund, making the portfolio of the fund even more illiquid and perhaps leading to negative tax ramifications for the fund and its investors. Given the fiduciary and other obligations of a bank that is acting as trustee, general partner, or managing member, the Board should recognize as a factor governing its determinations these duties to the fund and its investors and not adopt rules or interpretations that in effect would not be in the best interests of the investors.

Conclusion

ABA appreciates this opportunity to comment on the conformance period. The importance and complexity—and the scope for unforeseen consequences—of the implementation of the Volcker Rule make the need for flexibility paramount. We strongly urge the Board to instill more flexibility into the rule so that it may consider a potentially wide variety of scenarios that legitimately need additional relief from the Volcker Rule. If you wish to discuss our comments further, please feel free to write or call the undersigned.

Sincerely,



Phoebe A. Papageorgiou
Senior Counsel