American Bankers Association
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**VIA ELECTRONIC MAIL**

Alastair Fitzpayne
Deputy Chief of Staff and Executive Secretary
Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

**Re:** Information on the FSOC Notice 2010-0002: Request for Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds

Dear Mr. Fitzpayne:

The American Bankers Association (ABA) appreciates the opportunity to provide comments for the study to be undertaken by the Financial Stability Oversight Council (FSOC) to make recommendations implementing the "Volcker Rule." The "Volcker Rule" is set forth in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act which, among other things, prohibits banking entities from engaging in proprietary trading and from investing in and sponsoring hedge funds and private equity funds.[1] This letter addresses only the latter restrictions.

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 trust or custody services for corporate and institutional clients and may be affected by any rule implementing Section 619. As of year-end 2009, banks held $76 trillion in trust and custody accounts.[2]

Recognizing the potential for unintended consequences, Congress mandated the FSOC to study the effect of the Volcker Rule in order to avoid harming the long-standing traditional banking activities that benefit customers. In this letter we limit our focus to what we believe to be unintended, consequences of the Volcker Rule to the trust and asset management industry that could occur unless appropriate clarifications are made through the study and regulatory process. In particular, we have concerns that certain definitions could be read so broadly that they impact traditional banking activities, while not addressing the intended focus of the Volcker Rule to reach situations where there are significant conflicts of interest. While we have limited the scope of these comments, we anticipate that there will be many other issues that will continue to arise

[1] The Volcker Rule was added as new Section 13 to the Bank Holding Company Act of 1956, as amended (the "BHCA").
[2] December 2009 FDIC Call Report Data.

throughout the study and rulemaking process, and we look forward to a continuing dialogue on the many other issues raised by the Volcker Rule.

Definition of "Sponsor"

Paragraph (h) (5) of new Section 13 defines the term "sponsor" to mean acting as a general partner, managing member, or trustee of a fund.[3] If interpreted too broadly, this definition of "sponsor" would capture situations where the banking entity acts as a directed trustee, among other situations. In a directed trust, the grantor of the trust delegates the authority to manage, acquire, or dispose of the assets of the plan to one or more third-party investment managers, while the directed (non-discretionary) trustee performs services that are more akin to administrative functions. The role of directed trustee is quite different from, and should not be equated with, the more substantive involvement that a trustee with investment discretion has with a fund.

Recognizing this difference, the Department of Labor (DOL) has determined that the appropriate standard of care for a directed trustee is quite different from that of a discretionary trustee. In Department of Labor Field Assistance Bulletin 2004-03, the DOL states that a directed trustee is a fiduciary, although its duties are significantly narrower than those of a discretionary trustee.[4] A directed trustee does not have an obligation to duplicate or second-guess the work of the plan fiduciaries that have investment discretionary authority over the management of plan assets and does not have a direct obligation to determine the prudence of any transaction that the third-party investment adviser recommends or effects for the plan. Thus, the DOL has expressly acknowledged that there are meaningful, substantive differences between the responsibilities of a discretionary and non-discretionary trustee.

The DOL also considered the difference between directed and discretionary trustees in the employee benefit plan context when it studied fees paid by mutual funds to a bank servicing the plan. If a bank acts in the role of a directed trustee and is directed to invest in a mutual fund that pays the bank a servicing fee, then the DOL has determined that the investment would not be considered a conflict of interest, because the trustee is not considered to be dealing with the assets of the plan for its own account, and the bank would therefore not be in violation of the prohibited transaction rule.[5] This is a key distinction to consider, because it is our understanding

[3] Dodd Frank Act, Public Law 111-203, Section 619 (h)(5). The term "sponsor" is also used in various provisions of the Investment Company Act of 1940, although it is not a defined term. In context, the SEC staff has usually taken the position that a person serving as a "sponsor" is tantamount to the investment adviser or principal underwriter of a registered investment company in order to impose the prohibitions on conflicts of interest in Section 17 of the Investment Company Act upon a "sponsor" of a registered investment company. In that situation the investment adviser, which is usually an affiliated person of the principal underwriter, has formed and organized the investment company and will have investment discretion over the registered investment company's investment portfolio. In contrast, we are addressing the situation where the grantor of the trust, not the bank, has dictated the terms of the relationship and has elected to have the bank serve as directed trustee with administrative but not investment responsibilities. Instead a third-party investment adviser will be responsible for investment discretion.

[4] DOL FAB 2004-03, "Fiduciary Responsibilities of Directed Trustees", 2004.

[5] DOL Advisory Opinion 97-15A

that the Volcker Rule is intended to impose restrictions on situations where there are significant conflicts of interest.

Accordingly, we believe that, where a banking entity is a directed trustee, as outlined above, that specific set of activities should not be governed by the provisions of the Volcker Rule. Otherwise, one consequence could be that the intended prohibition on "sponsoring" hedge funds would accidentally (and inappropriately) apply to certain state statutory investment trusts (Delaware and New Hampshire) which often rely on the exclusion in Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 (see infra ) and as to which the banking entity serves as a directed trustee. These types of investment vehicles pose nominal risk to the banking entity, because these assets are held in trust and the banking entity is directed in its largely administrative actions. However, since these funds often rely on either the Section 3(c)(1) or 3(c)(7) exclusion and the bank acts as a directed trustee, the fund could be deemed to be a "sponsored" "hedge fund" or "private equity fund" even if the fund is managed by an unaffiliated third-party manager. We believe that it would be appropriate, and consistent with the intent of the Volcker Rule, for banking entities to continue to be allowed to act as a directed trustee for these types of statutory investment trusts without subjecting them to the prohibitions in the Volcker Rule, and we urge the Council consider in its study recommending the same position.

Definition of "Hedge Fund", "Private Equity Fund," and "Such Similar Funds"

Paragraph (h)(2) of new Section 13 defines the term "hedge fund" and "private equity fund" not by the nature of the investment activities in which they are engaged but instead by reference to the Sections in the Investment Company Act of 1940 which excludes them from the definition of "investment company." Investment vehicles that are excluded from the definition of "investment company" are not required to register with the SEC under the Investment Company Act. We are concerned that the definition is overbroad and encompasses investment vehicles that are beyond the intended scope of the Volcker Rule. The purpose and public policy concerns underlying those exclusions from the definition of "investment company" (i.e., whether or not there is any Federal interest in requiring such funds to register with the SEC) are very different from the focus of the Volcker Rule. Accordingly, we believe that there are many investment vehicles and other corporate structures that rely on the Section 3(c)(1) and 3(c)(7) exclusions that have never been considered to be a hedge fund or private equity fund and have few, if any, of the typical characteristics of "hedge funds" and "private equity funds" that the Volcker Rule was intended to restrict. "Hedge funds" and "private equity funds" share certain common characteristics, including often being organized as blind pooled investment vehicles managed by a professional investment manager that would be registered investment companies but for Sections 3(c)(1) or 3(c)(7); having an investment manager with sole discretion for investment and reinvestment; being formed not for the purpose of making a specific investment, but instead to make a large number of investments; and having numerous investors that are subject to high investment minimums.

In addition, substantially all "hedge funds" utilize a number of different sophisticated investment techniques, such as significant leverage, short selling, and derivatives to enhance returns. In the case of private equity funds, they generally all make equity or equity-type investments, and their

assets primarily consist of unregistered and illiquid equity securities for which there is little or no market. As a result, the investors in hedge funds or private equity funds may have limited redemption rights due to liquidity, valuation, or marketability of the underlying portfolios. Rather than focusing on the exclusions on which hedge funds or private equity funds rely to avoid registration under the Investment Company Act, we urge the Council to identify the systemically important characteristics of the type of fund that the Volcker Rule is trying to reach while also removing those investment vehicles that are clearly not hedge funds or private equity funds in the traditional sense. Absent clarification, the current language could be read to sweep in investment vehicles and other entities that Congress never intended to treat as "hedge funds" or "private equity funds." Entities that are commonly utilized by banking entities to facilitate permissible activities include acquisition vehicles or joint ventures relating to a single underlying investment, finance subsidiaries, credit funds[6], employee pension funds, bank-owned life insurance policies, foreign funds regulated under the laws of other countries, and other entities. An additional issue for FSOC to study would be the merits of focusing on (i) whether the particular fund imposes restrictions on redemptions, (ii) whether or not it invests substantially in illiquid securities, and (iii) whether the fund makes use of significant leverage. For example, the definition of "hedge fund" and "private equity fund" could exclude those funds whose investment portfolio primarily consists of securities for which market quotations are readily available, are able to offer daily redemption rights at net asset value, and whose investment portfolio does not contain more than 15% in illiquid securities. This is the percent illiquidity standard currently used by the SEC for mutual funds.[7] By defining the term "hedge fund" or "private equity fund" in terms of the activities in which it would engage, banking entities could continue to offer funds that rely on Section 3(c)(7) for exclusion from registration but generally share certain investment and risk characteristics of mutual funds (and not hedge funds or private equity funds) without the risk of being subject to the restrictions in the Volcker Rule. Currently, banking entities give investment advice to investment vehicles that function much like a mutual fund but are not required to register because interests are offered and sold solely to "qualified purchasers" (as defined in Section 2(a)(51)(A) of the Investment Company Act) in non-public offerings and rely on the Section 3(c)(7) exclusion. For many institutional investors, offering them investment advice through a Section 3(c)(7) vehicle significantly reduces the regulatory and disclosure costs that they would have to bear if they were offered and sold interests in a registered investment company.

Another issue for FSOC to study would be the nature of the legal vehicles that hedge funds typically utilize. In the US, for tax efficiency, hedge funds and private equity funds are almost always organized as either Limited Partnerships or Limited Liability Companies. We would

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[6] Credit funds involve a fundamental banking activity - commercial lending and real estate, energy, and infrastructure financings. Such funds that make loans and extend credit are vehicles for lending activity which are captured within the definition of hedge fund because these funds often rely on Sections 3(c)(1) or 3(c)(7). A banking entity's ability to in engage in its core business of lending should not be limited if it chooses to do so through a fund structure. In fact a fund, with significant committed third party capital allows a bank to more efficiently manage its capital at risk.

[7] Fifteen percent limit recommended on the acquisition by an open-end fund of restricted securities or other assets not having readily available market quotations. *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992).

propose that a definition of "hedge fund" that limits the application of the rule to funds that rely on Sections 3(c)(1) and 3(c)(7) and that are organized as Limited Partnerships or Limited Liability Companies, would exclude from the application of the definition group trusts organized pursuant to IRS Revenue Rulings 81-100 and 2004-28 for the pooled investment of retirement plan assets.

Finally, the statutory definition contains a catch-all phrase "or such similar funds." In context, we believe that this phrase should be interpreted to mean "funds that are similar to hedge funds or private equity funds," not "other funds that might be excluded from the definition of "investment company" by virtue of Section 3(c) of the Investment Company Act." More specifically, there are fourteen sub-sections of section 3(c) (Section 3(c)(8) presently contains no content but has been reserved) that provide exclusions from the definition of "investment company," most of which are obviously inapposite. For example, Sections 3(c)(4) and (5) exclude entities which are involved in small loans, factoring, and real estate, Section 3(c)(6) excludes certain holding companies, Section 3(c)(9) excludes funds investing in oil and gas and other minerals, and Sections 3(c)(10) and (14) exclude charities and church plans. Banking entities rely on Sections 3(c)(3) and 3(c)(11) to offer interests in common trust funds and collective investment funds to personal estates and trusts and to certain qualified pension plans. As discussed briefly above, each of these exclusions exists because Congress has concluded that, for investor protection and public policy reasons relevant solely to the Investment Company Act, none of the entities relying on these exclusions needs to be registered with the SEC or subject to the investor protection provisions of the Investment Company Act. Nothing in the legislative history of the Dodd-Frank Act as it relates to the Volcker Rule suggests that Congress had the same public policies concerns about entities relying on other exclusions from the definition of "investment company" that it did with hedge funds, and there is no reason to believe that Congress wanted or expected the restrictions in the Volcker Rule to apply equally to entities, for example, relying on Sections 3(c)(4) or (5) of the Investment Company Act. Rather, we believe that, because Congress was unable to define hedge funds or private equity funds in meaningful words that aptly captured the exact nature of their investment activities, use of their investment company status under Sections 3(c)(1) and 3(c)(7) was simply a convenient place marker until FSOC through a study could gather more information on these funds and a careful rulemaking could take place.

Scope of Definition of "Banking Entity"

The scope of the term "banking entity" under the Volcker Rule should be more clearly defined. The Rule amends the Bank Holding Company Act to define a "banking entity" as "any insured depository institution,… any company that controls an insured depository institution,… and any affiliate or subsidiary of any such entity." The inclusion of the term "affiliate," which includes "subsidiary," as defined in the Bank Holding Company Act, implicates a group of entities that is significantly broader than the term "banking entity" itself would suggest. This implies that the term "banking entity" could be interpreted overly broadly in the context of the Volcker Rule. The term "banking entity" should capture a clearly defined and limited set of companies: a depository institution, its parent holding company, subsidiaries that are engaged in the permissible business of the depository institution and that are managed as part of the depository institution, and other financial subsidiaries of the holding company, such as an affiliated broker-

dealer, that are engaged in financial activities permitted by the Bank Holding Company Act. It should not apply to a banking entity's own pension plan, a fund of funds situation or portfolio management, among other examples.

In addition, if the term "banking entity" were read too broadly, it could lead to inconsistencies in the Dodd-Frank Act. Under a strict reading of the statute, a sponsored private equity or hedge fund of funds would be prohibited from making an investment in another fund. The purpose of a fund of funds is to invest in unrelated funds. If the sponsored fund of funds were considered a "banking entity," it would not generally be permitted to invest in other funds, or would be subject to the Rule's *de minimis* investment limits. This is inconsistent with the statute's intention to permit such activities.

Thus, to ensure a reasonable outcome, the Volcker Rule should apply to the insured deposit-taking institution and financial entities that the bank controls under the BHC Act, but it should *not* apply to nonfinancial affiliates or subsidiaries of the bank whose activities are operationally separate.

We also want to express concern that a broad definition of "banking entity" would have adverse consequences for investment advisers and non-depository trust companies that are affiliated with banking institutions, potentially putting put them at a disadvantage to their competitors that are not affiliated with a depository institution. As a result, it may actually hurt the safety and soundness of the banking institution. In many cases, a banking institution may have within its organization a separately branded fund management company that manages registered mutual funds and, for its institutional investors, "clones" of the mutual funds that are unregistered investment companies relying on Section 3(c)(7) because the fund is only offered privately to "qualified purchasers." Because the fund management company falls under the broad definition of "banking entity," the prohibition on "sponsoring," "hedge funds" and "private equity funds" (each of which is also broad in scope) has the potential to prohibit any bank-affiliated adviser, including one with a different name from the insured depository institution or the bank holding company, from sharing a common name with the unregistered funds that it manages. We believe the restrictions in Section 619(d)(1)(G)(v) and (viii) adequately address the use of a common name with the adviser/sponsor, particularly if the adviser/sponsor does not share a common name with the bank or its holding company parent.[8]

[8] Section 619(d)(1)(G)(v) and (viii) prohibit bailouts and guarantees and put fund investors on notice that they bear the risk of loss. Specifically, the provisions allow a banking entity to organize and offer such funds if "(v) the banking entity does not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the hedge fund or private equity fund or of any hedge fund or private equity fund in which such hedge fund or private equity fund invests;" and "(viii) the banking entity discloses to prospective and actual investors in the fund, in writing, that any losses in such hedge fund or private equity fund are borne solely by investors in the fund and not by the banking entity, and otherwise complies with any additional rules of the appropriate Federal banking agencies, the Securities and Exchange Commission, or the Commodity Futures Trading Commission, as provided in subsection (b)(2), designed to ensure that losses in such hedge fund or private equity fund are borne solely by investors in the fund and not by the banking entity."

Prohibition on 23A Covered Transactions

The Volcker Rule prohibits a banking entity that serves, directly or indirectly, as the investment manager, investment adviser, or sponsor to a hedge fund or private equity fund, or that organizes and offers a hedge fund or private equity fund (or the affiliate of such entity) from entering into "a transaction with the fund, or with any other hedge fund or private equity fund that is controlled by such fund, *that would be a covered transaction, as defined in section 23A of the Federal Reserve Act (12 U.S.C. 371c), with the hedge fund or private equity fund, as if such banking entity and the affiliate thereof were a member bank and the hedge fund or private equity fund were an affiliate thereof. (emphasis added).* In taking some or all the requirements that apply to a member bank's transactions with its affiliates into the Volcker Rule, and then attempting to apply them to a banking entity's transactions with certain funds, it is important to proceed with care.

The Volcker Rule explicitly adopts the definition of covered transaction for the purposes of its prohibition, rather than importing the entire, very different, regulatory scheme contained within 23A. With only a few notable exceptions, Section 23A works by identifying, limiting, and mitigating risk in a bank's transactions with affiliates by identifying items as "covered transactions" and then subjecting them to appropriate limits. In contrast, the literal reading of the Volcker Rule appears to be an outright prohibition of risk. We would argue that the transactions that should be prohibited by the Volcker Rule should be the same as those defined as "covered transaction," in Section 23A, subject to the explicit exceptions to those covered transactions that are contained in Section 23A,and its implementing regulation, Federal Reserve Regulation W, *See* 12 U.S.C. 371c(b)(7) and (d). An example of this would include a loan by a member bank to an affiliate, which would be a covered transaction, but, if it were fully collateralized by obligations of the U.S. Government or cash (one of the explicit exemptions), the transaction would fall out of the calculation of covered transactions for purposes of the quantitative limits of Section 23A.

Custody Services

We believe that some attention needs to be given in any study of the Volcker Rule to the custodial services that are part of the relationship that a banking entity would have with a fund that may be covered by the Volcker Rule. It may be that some types of transactions that normally occur in such a relationship would run afoul of the Volcker Rule's prohibition on Section 23A covered transactions. We do not believe that this customary aspect of the typical provision of custodial services would have been intended to be caught up in the prohibition. These types of traditional activities include extensions of credit, overdrafts, and other short-term extensions of credit. These types of activities are an essential part of the orderly processing of the client's securities as part of the bank's custodial and trust services provided to clients, including employee benefit plans. Banks have established settlement policies and procedures to maximize the efficiency of the securities trading in institutional and corporate trust accounts. These settlement policies are intended to allow account holders reasonably to forecast and manage cash availability for investment and disbursement purposes.

An investment manager may instruct a bank to buy and sell a number of different securities concurrently. These transactions must be coordinated by the investment manager with directions to provide or receive cash or foreign currency necessary to complete such transactions. The market would suffer if a bank held up settlements to ensure that every sale scheduled to settle (thus generating funds necessary to effect subsequent transactions or disbursements) had in fact settled or that anticipated funds had indeed been received. Although most transactions settle on time, settlement problems may arise due to errors, unexpected delays by a counterparty or its agent, settlement failures by a counterparty or its custodian, broker failure, or inefficient markets. Cash reconciliation generally takes place after market close.

Events giving rise to these situations are generally inadvertent or outside the control of the bank. These extensions of credit may occur on an intra-day basis or extend overnight, and they are usually closed-out when cash comes into the client's account as a result of other securities settlement activity or cash management arrangements.

In the absence of allowances for extensions of credit, a purchase dependent on the proceeds of a failed trade (or provisionally settled assuming receipt of those proceeds) would also fail to settle, setting off a string of other settlement failures throughout the market. Such a result could disrupt the markets. Custodial services cannot function effectively in the absence of such allowances. If allowances are not made, it will make the role of custodians ineffective and inefficient, creating less control over operation and risks by involving third parties to extend credit. This will result in increased risk and more difficulty in managing such risk. A more viable approach would be to provide for such allowances so long as there is adequate collateralization, such credit extensions are short-term, and the terms are consistent with those extended to other unaffiliated clients.

Conclusion

We appreciate this opportunity to provide our comments to help the FSOC with its study to make recommendations implementing the Volcker Rule. We urge the FSOC to include in its recommendations allowances to ensure the continuation and stability of the trust and asset management business.

Please do not hesitate to contact the undersigned if you have any questions.

Sincerely,

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