FINANCIAL SERVICES FORUM

March 11, 2020

VIA ELECTRONIC SUBMISSION

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551
Docket No. R–1694; RIN 7100–AF70

Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, D.C. 20581
RIN 3038–AE93

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429
RIN 3064–AF17

Chief Counsel's Office
Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219
Docket ID OCC–2020–0002

Vanessa A. Countryman, Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549-1090
File No. S7–02–20

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Ladies and Gentlemen:

The Financial Services Forum (the "Forum")[1] appreciates the opportunity to submit this letter to the Board of Governors of the Federal Reserve System (the "FRB"), the

[1] The Financial Services Forum is an economic policy and advocacy organization whose members are the chief executive officers of the eight largest and most diversified financial institutions headquartered in the United States. Forum member institutions are a leading source of lending and investment in the United States and serve millions of consumers, businesses, investors, and communities throughout the country. The Forum promotes policies that support savings and investment, deep and liquid capital markets, a competitive global marketplace, and a sound financial system.

Commodity Futures Trading Commission (the "CFTC"), the Federal Deposit Insurance Corporation (the "FDIC"), the Office of the Comptroller of the Currency (the "OCC"), and the Securities and Exchange Commission (the "SEC," and collectively with the FRB, the FDIC, the CFTC, and the OCC, the "Agencies") on the notice of proposed rulemaking (the "Proposal") for revisions to the Agencies' regulations (the "Implementing Regulations") implementing section 13 of the Bank Holding Company Act of 1956 (the "BHC Act"), commonly referred to as the "Volcker Rule."[2] The proposed changes are applicable to all of our member institutions, the U.S. global systemically important bank holding companies.

***Summary of Recommendations*.**

We believe the Proposal thoughtfully strikes the right balance between fostering safety and soundness and financial stability, on the one hand, with a regulatory framework that facilitates credit intermediation, financing, capital formation and, ultimately, economic growth and job creation. For this reason, we support the Proposal and believe it would achieve a more efficient implementation of the Volcker Rule and continue to reflect the letter and spirit of the law — to keep banking entities focused on "their central mission of serving their customers."[3] Indeed, the Proposal reflects common-sense revisions that would help banking entities serve customers by providing debt and equity financing and other forms of financial intermediation, yet at the same time incorporates robust safety and soundness protections.

As outlined below, we believe that a few targeted adjustments would be consistent with the broader theme of the Proposal and should be made to eliminate complexity that is not necessary to achieve the Agencies' policy objectives. We also support the comment letter submitted by the Securities Industry and Financial Markets Association, including with respect to matters not covered in this letter, such as in relation to the loan securitization and family wealth management vehicle exclusions.

Covered Funds Exclusions.

- The Agencies should adopt the Proposal's new exclusion for credit funds that invest in loans and other debt instruments with a few adjustments. (See page 7.)
    - The Agencies should clarify that a credit fund is not prohibited from engaging in activities that are explicitly excluded or otherwise permitted under the proprietary trading provisions, so long as the fund

[2] 85 Fed. Reg. 12120 (Feb. 28, 2020).

[3] President Barack H. Obama, *Remarks by the President on Financial Reform* (Jan. 21, 2010), https://obamawhitehouse.archives.gov/the-press-office/remarks-president-financial-reform.

is otherwise operating within the requirements of the credit fund exclusion (such as the proposed restrictions on holding interest rate or foreign exchange derivatives).

- The Agencies should permit a qualifying credit fund to have a separate and distinct 25 percent bucket for assets that are *not* related or incidental to the loans or debt instruments (or otherwise permitted under the credit fund exclusion as proposed), including preferred and other equity securities, provided that the assets would be permissible for the banking entity to acquire and hold directly.

- In response to Question 29, we recommend that no limit apply to holding related or incidental non-loan and non-debt assets, including equity securities or rights to acquire equity securities received on customary terms in connection with the loans or debt instruments.

- In response to Question 38, we recommend that the credit fund and loan securitization exclusions exist as two separate exclusions.

- The Agencies should adopt the Proposal's new exclusion for qualifying venture capital funds, but, as with credit funds, should clarify that the qualifying venture capital fund would not be prohibited from engaging in activities that are explicitly excluded or otherwise permitted under the proprietary trading provisions of the Implementing Regulations, so long as the fund is otherwise operating within the requirements of the venture capital fund exclusion. (See page 9.)

  - In response to Question 44, we recommend that a revenue limit not be incorporated as a requirement of the exclusion because it is unnecessary to ensure the fund is a bona fide venture capital fund and could unnecessarily limit the scope of qualifying venture capital funds in which banking entities can invest.

  - In response to Question 45, we recommend that the requirement on the fund's holdings in qualifying investments remain at 80 percent, as is required under Investment Advisers Act of 1940 Rule 203(1)-1(a)(2).

- The Agencies should adopt the Proposal's new exclusion for customer facilitation vehicles, but should allow 0.5 percent of the vehicle's ownership interests to be held by a third-party, in addition to the banking entity and its affiliates. (See page 12.)

  - In response to Question 66, we recommend the exclusion not require the banking entity and its affiliates to comply with Super 23A, as doing so would render the exclusion effectively unavailable.

- The Agencies should exclude from the definition of covered fund vehicles engaged in qualifying long-term banking entity-permissible activities and investments that would not be qualifying venture capital funds, subject to the same or enhanced safeguards applicable to qualifying venture capital funds (*Question 50*). (See page 14.)

- The Agencies should adopt, with certain adjustments, the Proposal's revised exclusion for foreign public funds ("FPFs"). (See page 16.)

    - The Agencies should eliminate the condition, for U.S. banking entities, that 85 percent or more of the fund's ownership interests be sold to non-affiliated entities and persons who are not directors or senior executive officers. Instead, as with registered investment companies ("RICs"), a sponsoring banking entity and its affiliates should be limited to holding less than 25 percent ownership after a multi-year seeding period without separate restrictions on investment by directors or senior executive officers.

    - The Agencies should confirm that a fund meets the standards necessary to qualify for the FPF exclusion if the fund is listed on an internationally-recognized exchange that permits trading for retail investors.

- The Agencies should make clear that FAQs Nos. 5, 14 and 16 continue to apply and have not been modified by the FRB's recently finalized control regulation.[4] Specifically, the Agencies should clarify: (1) that pursuant to these FAQs, the activities and investments of a RIC or FPF would not be attributed to the banking entity for purposes of the Implementing Regulations where a banking entity does not hold 25 percent or more of the voting shares of the RIC or FPF after the seeding period and provides advisory, administrative and other services to the fund; and (2) that these FAQs provide a multi-year seeding period, "without setting any maximum prescribed period."[5] Further, the Agencies should clarify that FAQs Nos. 5, 14 and 16 apply to seeding a third-party exchange-traded fund ("ETF") or exchange-traded product ("ETP") by a banking entity that is an authorized participant. (See page 18.)

- As suggested by the Agencies, we recommend that the final rule clarify that funds that qualify for Community Reinvestment Act ("CRA") credit *per se* fall within the exclusion for public welfare investments (*Questions 19 and*

[4] 85 Fed. Reg. 12398 (Mar. 2, 2020).

[5] 83 Fed. Reg. 33432, 33443 (July 17, 2018).

20). In addition, the Agencies should expand the exclusion, or create a new exclusion, to include rural business investment companies ("RBICs") (*Question 21)* and qualified opportunity funds ("QOFs") (*Question 22)*. (See page 20.)

Parallel Investments.

- The Agencies should adopt the proposed rule of construction regarding parallel investments and co-investments with covered funds, which clarifies that banking entities may make investments that are otherwise permissible under current law. (See page 21.)

Super 23A.

- The Agencies should adopt the Proposal's revisions to Super 23A, which are more appropriately aligned with section 23A of the Federal Reserve Act and the FRB's Regulation W thereunder and would permit a banking entity to provide ordinary course, low-risk services to clients in a safe and sound manner without undermining the Volcker Rule's policy objectives. The Agencies should nonetheless clarify that by incorporating the Regulation W exemptions, the Agencies intended to include all transactions in section 223.42, including those with a securities affiliate, notwithstanding that the covered fund with which the banking entity enters into the transaction is not a securities affiliate. (See page 22.)

Ownership Interest.

- The Agencies should adopt the Proposal's revisions to the definition of ownership interest, which clarify that certain ordinary debt instruments would not be treated as ownership interests, and should clarify that the condition on fixed principal payments allows for amortization or acceleration provisions. (See page 25.)

Underwriting and Market-Making in Sponsored and Advised Covered Funds.

- The Agencies should eliminate the investment limits and capital deduction requirement for underwriting and market-making in sponsored and advised covered funds. (See page 25.)

Compliance.

- The Agencies should permit banking entities to voluntarily comply early with the revised final rule, in whole or in part, as was permitted in the 2019 final rule. (See page 27.)

I. Covered Fund Exclusions.

We generally support the proposed revisions to existing exclusions and new exclusions from the definition of covered fund. As the Agencies acknowledged when finalizing the Implementing Regulations in 2013, the "covered fund" definition is overly broad and, therefore, exclusions are necessary to tailor the definition to focus on vehicles "used for the investment purposes that were the target of section 13."[6] Indeed, the covered fund provisions are meant to limit banking entities' ability to evade the proprietary trading prohibitions through investments with covered funds and to reduce the incentive to bail out related covered funds,[7] while "permitting banking entities to continue to provide, and to manage and limit the risks associated with providing, client-oriented financial services that are critical to capital generation . . . and that facilitate liquid markets."[8] The experience of our member institutions with the Implementing Regulations has been that the covered fund definition is not appropriately tailored to achieve these objectives.

Accordingly, we support the Agencies' proposal to add new exclusions "to address the potential over-breadth of the covered fund definition."[9] We also support the proposed modifications to several existing exclusions, which would "provide clarity and simplify compliance with the requirements of the implementing regulations."[10] Adoption of the proposed new exclusions, and revisions to certain existing exclusions, would help ensure banking entities have the flexibility necessary to continue to provide critical financing that encourages capital formation and economic growth, consistent with the Agencies' policy objectives. Further, and importantly, we believe the Agencies have proposed appropriate limits and restrictions designed to support safety and soundness and financial stability.

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6 79 Fed. Reg. 5536, 5671 (Jan. 31, 2014).

7 *See* 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Merkley) (expressing support for the covered funds restrictions in the Volcker Rule because "[c]learly, if a financial firm were able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund, the prohibition on proprietary trading would be easily avoided, and the risks to the firm and its subsidiaries and affiliates would continue" and because "setting limits on involvement in hedge funds and private equity funds is critical to protecting against risks arising from asset management services").

8 79 Fed. Reg. at 5541.

9 85 Fed. Reg. at 12123.

10 *Id.*

A. The Agencies should adopt the Proposal's new exclusion for credit funds with a few adjustments.

We support the Agencies' new exclusion for credit funds that invest in loans and other debt instruments. The new exclusion would enable banking entities to engage in the types of activities that are the most traditional and fundamental activity in which a banking entity engages — credit intermediation and credit provision to the real economy. The current overbroad covered fund definition creates a competitive disadvantage for our member institutions compared to non-bank credit fund sponsors. As a result, the Implementing Regulations are driving traditional lending activities toward non-bank entities, which should not be a desired result and is not called for by the letter or spirit of the Volcker Rule. Accordingly, we agree with the Agencies that "the proposed credit fund exclusion would (1) address the application of the covered fund provisions to the credit-related activities in which banking entities are permitted to engage directly and (2) be consistent with and effectuate Congress's intent that section 13 of the BHC Act not limit or restrict banking entities' ability to sell loans."[11]

The proposed exclusion for credit funds incorporates specific limiting criteria and should address any concerns about safety and soundness or evasion. In particular, we agree with the Agencies that, as proposed, the credit fund exclusion "would prevent a banking entity [from] having any incentive to bail out such funds in periods of financial stress or otherwise expose the banking entity to the types of risks that the covered fund provisions of section 13 were intended to address."[12] For example, a qualifying credit fund would be permitted to hold certain rights or assets besides loans or debt instruments, but only those that are *related* or *incidental* to the loans or debt instruments. In addition, the credit fund would be permitted to hold certain interest rate or foreign exchange derivatives, but only those related to the loans or other assets held and only to *reduce* the interest rate and/or foreign exchange risks related to these holdings. Importantly, the credit fund would not be permitted to engage in any proprietary trading (subject to our suggested revision below).

Moreover, the credit fund exclusion includes several restrictions on the banking entity's relationship with the credit fund. For example, the proposed exclusion prohibits the banking entity from guaranteeing, assuming, or otherwise insuring the obligations or performance of the fund, requires application of Super 23A, and requires that the banking entity's investment in and relationship with the fund be conducted in compliance with all applicable banking laws and regulations, including applicable safety and soundness standards. The proposed exclusion would also apply the Implementing Regulations' prudential backstop provisions, which guard against the banking entity using the exclusion to engage in a high-risk trading strategy or

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[11] 85 Fed. Reg. at 12132; *see also* 12 U.S.C. § 1851(g)(2).

[12] 85 Fed. Reg. at 12133.

hold high-risk assets. The exclusion also includes certain provisions to ensure that the activities and holdings of the credit fund are limited to those activities and assets that the banking entity could engage in or hold directly. Accordingly, with these limits, we believe the Agencies have struck a reasonable balance that mitigates any potential evasion concerns while also permitting banking entities to provide financing through a fund structure.

As noted above, as proposed, an excluded credit fund would not be permitted to engage in any proprietary trading. Although we agree this is a helpful safeguard, the proposed condition refers only to the definition of proprietary trading pursuant to the short-term intent test without reference to the various exclusions and exemptions from the Volcker Rule proprietary trading provisions. We believe the Agencies should clarify that a credit fund is not prohibited from engaging in activities that are explicitly excluded or otherwise permitted under the proprietary trading provisions, so long as the fund is otherwise operating within the requirements of the credit fund exclusion (such as the proposed restrictions on holding interest rate or foreign exchange derivatives).[13]

Further, the Agencies should permit a qualifying credit fund to have a separate and distinct 25 percent bucket for assets that are *not* "related or incidental to acquiring, holding, servicing, or selling"[14] the loans or debt instruments, or otherwise permitted under the credit fund exclusion as proposed, including preferred and other equity securities, provided that the assets would be permissible for the banking entity to acquire and hold directly.[15] Credit funds, such as mezzanine funds, often invest across a borrower's capital structure in preferred or other equity securities as well as

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13 Such a clarification would be consistent with revisions made in the 2013 final rule, in which the Agencies clarified that, under the exemptions for underwriting and market making-related activities, and risk-mitigating hedging, the requirement regarding compensation arrangements would be "designed not to reward or incentivize *prohibited* proprietary trading" as opposed to all proprietary trading. *See* 79 Fed. Reg. at 5628; *e.g.*, *compare* § __.4(b)(2)(v) ("The compensation arrangements of persons performing the activities described in this paragraph (b) are designed not to reward or incentivize *prohibited* proprietary trading") (emphasis added) *with* 76 Fed. Reg. 68846, 68948 (Nov. 7, 2011) (proposing § __.4(b)(2)(vii), which provided "[t]he compensation arrangements of persons performing the market making-related activities are designed not to reward proprietary risk-taking.").

14 Proposal § __.10(c)(15)(i)(C) (proposing that the credit fund exclusion permit the fund to hold assets composed of such related or incidental rights and other assets, including "an equity security (or right to acquire an equity security) received on customary terms in connection with such loans or debt instruments").

15 As an example, the credit fund would be permitted to include in its 25 percent bucket equity securities that are not related or incidental to the loans or debt instruments. By contrast, rights or other assets that are related or incidental to the loans or debt instruments, such as certain warrants received on customary terms in connection with loans or debt instruments, could be held by the credit fund *without* limit and would *not* count towards the 25 percent bucket.

in the borrower's debt securities, and often at the borrower's request. Accordingly, this 25 percent bucket would enable a credit fund to hold a moderate amount of non-loan and non-debt assets in response to customer and market demand, while still predominantly engaging in lending.

The Agencies ask whether the credit fund exclusion should include a quantitative limit on permissible non-loan and non-debt assets, with a specific reference to equity securities (or rights to acquire equity securities) received on customary terms in connection with the loans or debt instruments (*Question 29*). We recommend that no limit apply to holding related or incidental non-loan and non-debt assets, including equity securities or rights to acquire equity securities.[16] Such an approach would be consistent with OCC regulations, which permit a national bank to take stock warrants as consideration for a loan.[17] The holding of equity securities (or rights to acquire equity securities) does not raise concerns that banking entities may use credit funds to evade the Volcker Rule given that the equity securities may be held only when received on customary terms in connection with a loan or other credit investment and that proprietary trading also will be restricted.

The Agencies also request comment on whether the credit fund exclusion should be combined with the exclusion for loan securitizations (*Question 38*). We believe that, consistent with the Proposal, the credit fund and loan securitization exclusions should exist as two separate exclusions. In our view, the types of vehicles the exclusions cover are sufficiently different that tailored treatment is warranted. For example, loan securitizations issue asset-backed securities whereas credit funds do not. In addition, merging the two exclusions would result in unnecessary compliance uncertainty, cost and complexity, as banking entities have developed policies and procedures, and established and invested in vehicles, in accordance with the existing exclusion for loan securitizations.

B. The Agencies should adopt the Proposal's new exclusion for qualifying venture capital funds with a clarification of its conditions.

The Agencies should adopt the Proposal's new exclusion for qualifying venture capital funds. The exclusion for venture capital funds would help promote investments in and financing to small businesses and start-ups in a broad range of geographic areas, industries and sectors. In particular, we agree with the Agencies that the proposed exclusion "could allow banking entities with a presence in and knowledge of the areas where venture capital and other types of financing are less

16 *See* Proposal §__.10(c)(15)(i)(C).

17 *See* 12 CFR 7.1006 (permitting a national bank to take stock warrants as consideration for a loan, provided that the bank does not exercise the warrants).

readily available to businesses to provide this type of financing in those areas."[18] Moreover, permitting banking entities to invest in early-stage companies through venture capital funds as well as directly would "allow banking entities to share the costs and risks of their permissible investment activities with third-party investors,"[19] thereby reducing risk and promoting safety and soundness. In these ways, the proposed venture capital fund exclusion would support economic growth and innovation while simultaneously promoting safety and soundness and financial stability.

The proposed exclusion also would be consistent with congressional intent that the Volcker Rule "not restrict the activities of venture capital funds"[20] but rather preserve the ability of banking entities to sponsor and invest in venture capital funds that create jobs, foster innovation and promote financial stability. As acknowledged in the Proposal's preamble, during the passage of the Dodd-Frank Act, several members of Congress made statements indicating that the intent of the Volcker Rule was not to restrict investment activities that serve the public interest, including venture capital investments.[21] For example, in recognition of the valuable role that venture capital funds play in providing capital to technology start-ups, the legislative history notes that "properly conducted venture capital investment will not cause the harms at which the Volcker [R]ule is directed."[22]

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[18] 85 Fed. Reg. at 12137.

[19] *Id*.

[20] 85 Fed. Reg. at 12134.

[21] *See* 156 Cong. Rec. E1295 (daily ed. July 13, 2010) (statement of Rep. Eshoo) ("the purpose of the Volcker Rule is to eliminate risk-taking activities by banks and their affiliates while at the same time preserving safe, sound investment activities that serve the public interest…Venture capital funds do not pose the same risk to the health of the financial system. They promote the public interest by funding growing companies critical to spurring innovation, job creation, and economic competitiveness. I expect the regulators to use the broad authority in the Volcker Rule wisely and clarify that funds…such as venture capital funds, are not captured under the Volcker Rule and fall outside the definition of 'private equity.'"); 156 Cong. Rec. S6242 (daily ed. July 26, 2010) (statement of Sen. Scott Brown) ("One other area of remaining uncertainty that has been left to the regulators is the treatment of bank investments in venture capital funds. Regulators should carefully consider whether banks that focus overwhelmingly on lending to and investing in start-up technology companies should be captured by one-size-fits-all restrictions under the Volcker [R]ule. I believe they should not be. Venture capital investments help entrepreneurs get the financing they need to create new jobs. Unfairly restricting this type of capital formation is the last thing we should be doing in this economy.").

[22] 156 Cong. Rec. S5905 (daily ed. July 15, 2010) (statement of Sen. Dodd); *see also* 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (statement by Sen. Boxer recognizing the "crucial and unique role that venture capital plays in spurring innovation, creating jobs and growing companies" and that "the intent of the rule is not to harm venture capital investment.").

As with the proposed exclusion for credit funds, the proposed exclusion for qualifying venture capital funds would incorporate specific criteria and activity restrictions that address any concerns about safety and soundness or evasion, striking the right balance of "giv[ing] effect to the language and purpose of [the Volcker Rule] without allowing banking entities to evade the requirements of [the Volcker Rule]."[23] First, by incorporating the definition of "venture capital fund" from the SEC, the exclusion is narrowly tailored to include only bona fide venture capital funds. The SEC definition also incorporates characteristics that limit the risks that a venture capital fund could pose to a banking entity; for example, the Agencies in the preamble to the Proposal point to "the smaller role of leverage financing and a lesser degree of interconnectedness with public markets."[24]

Second, the Proposal would require similar restrictions on qualifying venture capital funds as would be applicable to credit funds. The proposed exclusion prohibits the banking entity from guaranteeing, assuming, or otherwise insuring the obligations or performance of the fund, requires application of Super 23A, and requires that the banking entity's investment in and relationship with the fund be conducted in compliance with all applicable banking laws and regulations, including applicable safety and soundness standards. The proposed exclusion also would apply the Implementing Regulations' prudential backstop provisions, which guard against the banking entity using the exclusion to engage in a high-risk trading strategy or hold high-risk assets.

In addition, qualifying venture capital funds would be prohibited from engaging in proprietary trading. As with credit funds, we recommend that this condition be revised to clarify that the qualifying venture capital fund would not be prohibited from engaging in activities that are explicitly excluded or otherwise permitted under the proprietary trading provisions of the Implementing Regulations, so long as the fund is otherwise operating within the requirements of the venture capital fund exclusion (such as the proposed restrictions on the fund incurring leverage).[25]

The Agencies request comment on whether an additional proposed revenue requirement should be added to the exclusion to help ensure that the investments made by excluded venture capital funds are truly made in small and early-stage companies (*Question 44*). We recommend that a revenue limit not be incorporated as a requirement of the exclusion because it is unnecessary to ensure the fund is a bona fide venture capital fund and could unnecessarily limit the scope of venture capital

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[23] 85 Fed. Reg. at 12137.

[24] 85 Fed. Reg. at 12168.

[25] *See* 17 CFR § 275.203(l)-1(a)(3), which incorporates a leverage limitation in the definition of "venture capital fund", which is incorporated into the proposed exclusion for qualifying venture capital funds.

funds in which banking entities can invest. When it adopted the definition of venture capital fund in Investment Advisers Act Rule 203(l)-1, the SEC considered whether to impose revenue and other requirements on venture capital funds that seek to ensure that such funds' investments would be limited to "small" companies or businesses. The SEC, however, declined to adopt any such requirements, noting, among other things, the lack of consensus for defining a "small" investment and a concern that imposing standardized metrics such as net income, number of employees or another single factor test would ignore the complexities of doing business in different industries or regions and could inadvertently restrict venture capital funds from funding otherwise promising young small companies.[26] For these same reasons, a revenue limit would inappropriately limit the scope of qualifying venture capital funds in which banking entities could sponsor and invest.

The Agencies also request comment on whether the exclusion should require that 100 percent of the fund's holdings (other than short-term holdings) be in qualifying investments (*Question 45*). We recommend that the requirement on the fund's holdings in qualifying investments remain at 80 percent, as is required under Rule 203(1)-1(a)(2). The SEC, in adopting Rule 203(l)-1, considered whether to require that all of a venture capital fund's assets be invested in qualifying investments but ultimately declined to adopt such an approach. The SEC did so because it recognized that providing a venture capital fund with some flexibility in its investments, coupled with the Rule's other requirements relating to the nature and character of a venture capital fund, would result in an appropriate balance without expanding the scope of the Rule.[27]

C. The Agencies should adopt the Proposal's new exclusion for customer facilitation vehicles and permit 0.5 percent of the vehicle's ownership interest to be held by a third-party.

The Agencies should adopt the Proposal's new exclusion for customer facilitation vehicles, subject to certain technical revisions described below. The Proposal defines a customer facilitation vehicle as an issuer that is formed by or at the request of a customer of the banking entity for the purpose of providing such customer (and one or more of its affiliates) with exposure to a transaction, investment strategy, or other service provided by the banking entity. Currently, the Implementing Regulations restrict banking entities from utilizing a variety of customer-driven and customer-facing structures that banking entities establish as a convenience to accommodate the customer's counterparty risk, collateral segregation, and legal and other considerations. We believe the proposed exclusion would appropriately address the over-breadth of the current covered fund definition by providing banking entities

[26] 76 Fed. Reg. 39646, 39649 (July 6, 2011).

[27] *Id.* at 39650.

with flexibility to meet customer needs and "provide traditional customer-facing banking and asset management services."[28]

The proposed exclusion for customer facilitation vehicles incorporates various conditions, including that all of the ownership interests in the vehicle must be held by the customer (and its affiliates) for whom the vehicle was created, other than a 0.5 percent ownership interest that may be held by the banking entity or its affiliates. We recommend that the proposed exclusion be revised to permit 0.5 percent of the vehicle to be held by a third-party in addition to the banking entity and its affiliates. This change would accommodate certain customary structures that require a third-party service provider or designee, such as a charity, to hold an interest in the vehicle rather than the banking entity.

The Agencies request comment on whether the proposed exclusion should require the banking entity and its affiliates to comply with all the requirements of § __.14. In our view, the exclusion should not require compliance with all of § __.14, as doing so would eliminate the utility of the exclusion. As acknowledged in the preamble to the Proposal, many customers seek special purpose vehicles for their trading and lending activities in order to satisfy reasonable and legitimate legal, accounting, or risk management objectives.[29] In a common example, a customer may purchase a collateralized note issued by such a structure that then enters into a swap with a banking entity to obtain the exposure sought by the customer. If banking entities were required to comply with all of § __.14, they would not be able to enter into swaps and other covered transactions with the customer facilitation vehicle to provide the customer with the desired exposure, thus defeating the purpose of the exclusion.

Moreover, the exclusion, as proposed, already includes safeguards that are adequate to avoid the risk of bailout or other evasion concerns. In particular, the proposed exclusion would prohibit the banking entity from guaranteeing, assuming, or otherwise insuring the obligations or performance of the fund, would require application of the market terms requirements in Super 23B, and would apply the Implementing Regulations' prudential backstop provisions, which guard against the banking entity using the exclusion to engage in a high-risk trading strategy or hold high-risk assets. In addition, the proposed exclusion would prevent the banking entity from purchasing a low-quality asset from the vehicle. Accordingly, we agree with the Agencies' assessment that "the conditions on the proposed exclusion should help to ensure that customer facilitation vehicles would be used for customer-

[28] 85 Fed. Reg. at 12141.

[29] *Id*.

oriented financial services provided on arms-length, market terms, and should help to prevent evasion of the requirements of [the Volcker Rule]."[30]

D. The Agencies should exclude from the definition of covered fund vehicles engaged in qualifying long-term banking entity-permissible activities and investments that would not be qualifying venture capital funds.

Because of the over-breadth of the covered fund definition, banking entities face restrictions on their ability to invest in or sponsor fund vehicles that are engaged in activities that are permissible for the banking entity to engage in directly for its own account, on its balance sheet. When enacting the Dodd-Frank Act, which includes the Volcker Rule, Congress did not modify the merchant banking or other authorities in BHC Act section 4, leaving these authorities available.[31] There is no discernible policy benefit from limiting investments in funds, which are a form of risk syndication, that engage in the same activity that a banking entity is permitted to engage in directly on its balance sheet without any risk syndication.[32] To emphasize, the lack of a policy benefit is clear because a banking entity may have full exposure to such an investment made directly on its balance sheet, but the Implementing Regulations limit the ability to have indirect exposure to such an investment made through a fund above the *de minimis* levels permitted by the Implementing Regulations.[33]

In response to such concerns, the Agencies request comment on whether to exclude from the definition of covered fund long-term investment funds that would not be qualifying venture capital funds (*Question 50*). We believe such an exclusion would be appropriate and consistent with the goal of reducing the over-breadth of the Implementing Regulations, while at the same time keeping banking entities focused on serving customer needs. Put differently, a long-term investment funds exclusion would avoid the result of restricting a banking entity from investing in or sponsoring a fund that engages in activity the banking entity is permitted to engage in directly.

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[30] 85 Fed. Reg. at 12142.

[31] *See, e.g.*, BHC Act Section 4(k)(4)(H) (permitting a financial holding company to make merchant banking investments in companies engaged in non-financial activities).

[32] The risk syndication nature of fund structures arises because the risk of any single investment is borne by (syndicated to) all investors in the fund.

[33] As one example of the customer-driven nature of these types of investments, merchant banking authority has been recognized as an important tool to provide financing across a client's capital structure. *See* H.R. Rep. No. 106-434, at 154 (1999) (Conf. Rep.) (noting that merchant banking authority "is designed to recognize the essential role that these activities play in modern finance" and that merchant banking authority is intended to allow investments made directly or "on behalf of one or more entities (e.g., as an adviser to a fund, regardless of whether the FHC is also an investor in the fund), including entities that the FHC controls").

In addition, an exclusion for long-term investment funds would achieve purposes similar to those of the proposed exclusion for qualifying venture capital funds by enabling banking entities to provide capital to companies; thus, the rationale for excluding qualifying venture capital funds extends to long-term investment funds as well.

Our member institutions have found the overly broad current covered fund definition has captured investments that should not be restricted by the Volcker Rule. For example, certain start-ups and venture-type companies in some instances will fail the Investment Company Act's 40 percent test[34] due to the company's structure or asset composition and therefore be treated as covered funds. In particular, a start-up incubator's minority holdings in the underlying companies it incubates by providing consulting and intellectual experience could cause the operating company to fail the 40 percent test due to the minority interests in such underlying companies. Similarly, a parent company of a start-up that is applying its proprietary technology to underlying portfolio companies could fail the 40 percent test if with respect to one of those underlying companies the parent is a minority owner and that particular company experiences a significant rise in value.

The Agencies request comment on what safeguards, if any, the Agencies should impose if an exclusion for long-term investment funds is adopted (*Question 50*). We believe the Agencies could impose the same safeguards applicable to qualifying venture capital funds, including conditions that: (1) prohibit the banking entity from guaranteeing, assuming, or otherwise insuring the obligations or performance of the fund; (2) apply Super 23A; (3) require that the banking entity's investment in and relationship with the fund be conducted in compliance with all applicable banking laws and regulations, including applicable safety and soundness standards; and (4) apply the Implementing Regulations' prudential backstop provisions. In addition, as the Agencies suggest in the preamble, they could require that the funds: (1) make long-term investments that a banking entity could make directly; (2) hold themselves out as entities that make investments that they intend to hold for at least two years; and (3) have relevant offering and governing documents that reflect a long-term investment strategy. As a result, adding an exclusion for long-term investment funds would not give rise to any incremental risk relative to activities permissible for a banking entity under current law, and the long-term investment funds exclusion would enable banking entities to "promote the benefits of long-term investment that the agencies and Members of Congress have previously recognized."[35] At the same

[34] Under section 3(a)(1)(C) of the Investment Company Act of 1940, any company that is engaged in the business of investing, reinvesting, owning, holding or trading in securities and owns investment securities exceeding 40 percent of the company's total assets is required to register as an investment company if it does not qualify for an exception or exemption. Thus, an operating company that fails the 40 percent test risks being treated as an "inadvertent investment company" subject to certain exceptions and exemptions.

[35] 85 Fed. Reg. at 12137.

time, such an exclusion would not undermine the purposes of the Volcker Rule and would be in line with the Agencies' stated goal of facilitating "a more diverse array of long-term investments in a broader range of geographic areas, industries and sectors."[36]

Finally, we do not believe a qualifying long-term investment fund exclusion would run counter to the statutory language, as various types of funds colloquially known as private equity funds would continue to be covered by the prohibition. For example, banking entities that sponsor a fund would be able to choose whether to restrict the activities of the long-term investment fund in order to comply with the new exclusion or treat the long-term investment fund as a covered fund. In other words, a banking entity could choose whether to market the fund as a banking entity-permissible fund subject to a more restrictive investment mandate (*e.g.*, minimum and maximum holding periods). For such a fund, the banking entity would not be subject to the asset management exemption's investment limits. Alternatively, the banking entity could market a covered fund as having a more flexible investment mandate, but subject to the three percent per-fund limit, employee investing restriction and other asset management exemption restrictions. As a result of the varying preferences and risk appetite of investors, the universe of funds treated as covered funds will be driven primarily by investor preferences and will include funds styled as "private equity" funds. At bottom, the exclusion would rationalize the incongruity of the current rule and allow banking entities to meet different client preferences and needs and provide equity and debt financing through sponsored funds. In addition, hedge funds and other active trading funds would continue to be treated as covered funds.

E. The Agencies should adopt the Proposal's revisions to the FPF exclusion with certain adjustments.

The Agencies should adopt the Proposal's revisions to the FPF exclusion, subject to certain adjustments outlined below. The Agencies' proposed revisions would streamline the FPF exclusion and better align the treatment of FPFs with U.S. RICs, consistent with the Agencies' intent, and permit U.S. banking entities and their foreign affiliates to conduct traditional asset management businesses outside the United States without giving rise to Volcker Rule evasion concerns.

In particular, we support the Agencies' proposed revision to eliminate the requirement that ownership interests be sold "predominantly" through one or more public offerings outside of the United States. As the Agencies acknowledge in the preamble, in the case of FPFs, the use of third-party distributors often means that the sponsoring asset manager has "limited visibility" into the fund's distributions "and the precise pattern of distribution may be affected by market forces and changes in investor demand."[37] Thus, the asset manager may not be able to ensure that the

[36] *Id*.

[37] 85 Fed. Reg. at 12126.

ultimate distribution of the fund satisfies this predominance prong without undertaking a complex compliance endeavor. In practice, the complexity of that compliance endeavor often has rendered the FPF exclusion unavailable. We also support the Agencies' proposed revision to eliminate the "home jurisdiction" prong, recognizing that the prong is unduly restrictive and impractical, as it is typical for retail funds in non-U.S. jurisdictions to be registered for sale and sold primarily or exclusively in jurisdictions other than those in which they are domiciled.[38]

In addition, the Proposal would modify the definition of "public offering" to add a new requirement that the distribution be subject to substantive disclosure and retail investor protection laws or regulations. We agree with the Agencies that this requirement would "help ensure that funds qualifying for [the FPF] exclusion are sufficiently similar to U.S. [RICs]."[39] Finally, we support the proposed elimination of the limitation on U.S. banking entities' selling ownership interests to employees other than senior executive officers (although we think the Agencies should further relax the limitation applied to U.S. banking entities as discussed further below). We agree with the Agencies that this requirement "may be difficult for banking entities to monitor" for reasons similar to the third-party distribution issues discussed above, and that the elimination of this requirement would "help to align the treatment of [FPFs] with that of U.S. [RICs], as the exclusion for U.S. [RICs] has no such limitation."[40]

The Agencies request comment on whether the requirement that the fund's ownership interest be sold predominantly to persons other than the sponsoring banking entity or the issuer and certain affiliated persons is necessary, or whether that requirement should be deemed satisfied if 75 percent of the fund's interests are sold to persons other than the sponsoring banking entity or the issuer and their affiliated persons (*Question 11*). In our view, this requirement is unnecessary and inconsistent with the Agencies' goal to treat FPFs similarly to their U.S. RIC counterparts, which are not subject to such a condition. Indeed, the Agencies have consistently explained that the exclusion from the covered fund definition for FPFs is intended to be "consistent with" the exclusions for RICs.[41] Moreover, the Agencies expect that "a fund authorized to sell ownership interests to . . . retail investors [would] be of a type that is more similar to a U.S. registered investment company rather than to a U.S. covered fund."[42] Thus, to align treatment of FPFs with the

[38] *Id.* (acknowledging that "it is not uncommon for foreign retail funds to be organized in one jurisdiction and sold in another jurisdiction").

[39] 85 Fed. Reg. at 12127.

[40] *Id.*

[41] 79 Fed. Reg. at 5679.

[42] *Id.* at 5678; s*ee also* Implementing Regulations § __.10(c)(12)(i) (establishing an exclusion from the covered fund definition for U.S. registered investment companies).

treatment of RICs, the Agencies should eliminate the condition that our member institutions' non-U.S. funds can only qualify for the FPF exclusion if 85 percent or more of their ownership interests are sold to non-affiliated entities and persons who are not directors or senior executive officers. Instead, as with RICs, a sponsoring banking entity and its affiliates should be limited to holding less than 25 percent of a fund's voting shares after a multi-year seeding period without separate restrictions on investment by directors or senior executive officers.

Separately, we recommend that the Agencies clarify that a fund meets the standards necessary to qualify for the FPF exclusion if the fund is listed on an internationally-recognized exchange that permits trading for retail investors. For such funds, any purported benefits of applying the FPF exclusion's specific criteria would be unnecessary and impose unnecessary compliance costs, particularly for trading desks that may hold ownership interests in such funds in their market making or underwriting capacity. By contrast, a bright-line test would help simplify compliance efforts without creating undue risk, as funds listed on such an exchange would serve the purpose of excluding vehicles that are similar to RICs.

F. The Agencies should make clear that FAQs Nos. 5, 14 and 16 continue to apply and should clarify that FAQs Nos. 5, 14 and 16 apply to seeding a third-party exchange-traded product or exchange-traded fund by a banking entity that is an authorized participant.

The Agencies note that the Proposal would not modify or revoke any previously issued agency FAQs, unless otherwise specified. Consistent with this statement, the Agencies should make clear that FAQs Nos. 5, 14 and 16 and the Agencies' related commentary from the 2018 proposal[43] continue to apply, including that there is a multi-year seeding period and that the activities and investments of a RIC or FPF would not be attributed to the banking entity for purposes of the Implementing Regulations where a banking entity does not hold 25 percent or more of the voting shares of the RIC or FPF after the seeding period and provides advisory, administrative and other services to the fund.[44]

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[43] 83 Fed. Reg. at 33549 (noting that the staffs were not "setting any maximum prescribed period" for a RIC or FPF seeding period).

[44] *See* 12 CFR § 248.12(b)(1)(ii). *See also* 79 Fed. Reg. at 5732 ("[F]or purposes of section 13 of the BHC Act and the final rule, a registered investment company, SEC-regulated business development company, and a foreign public fund as described in §__.10(c)(1) of the final rule will not be considered to be an affiliate of the banking entity if the banking entity owns, controls, or holds with the power to vote less than 25 percent of the voting shares of the company or fund, and provides investment advisory, commodity trading advisory, administrative, and other services to the company or fund only in a manner that complies with other limitations under applicable regulation, order, or other authority").

Because a multi-year seeding period is necessary for banking entities to test the fund's investment strategy, establish a track record of performance, and attempt to distribute the fund's shares to unaffiliated investors, clarifying that these FAQs and the Agencies' related statements continue to apply is important to avoid disruptions in the market.

In addition, the Agencies should clarify that the guidance in these FAQs applies to a banking entity's seeding of third-party ETFs or ETPs when the banking entity acts as an authorized participant ("AP"). When a banking entity serves as AP for and seeds an ETF or ETP, it serves a critical role in promoting liquidity in ETF or ETP markets.[45] These activities can include, among others: (i) assisting the ETF/ETP sponsor or organizer in establishing the ETF/ETP and seeding newly created ETF/ETP or share classes of existing ETFs/ETPs; (ii) trading with the ETF/ETP issuer to create and redeem ETF/ETP shares on behalf of customers or the ETF/ETP issuer; and (iii) trading the ETF/ETP shares to reduce price dislocations between the ETF/ETP components and shares. For newly established ETFs/ETPs, APs often provide the necessary seed capital to establish the ETF/ETP or relevant share class to provide the necessary track record and market liquidity on behalf of the ETF/ETP issuer to attract customers. This type of seeding was recognized by the Agencies in the registered fund seeding provisions and the frequently asked questions (FAQ Nos. 5, 14 and 16). Once established, APs continue to serve a key role in ensuring market liquidity of the ETF/ETP. Because APs have direct access to the ETF/ETP issuer, customers often seek liquidity directly through the AP rather than the exchange. As such APs are required to stand ready to accept customer redemption or creation requests of any size as part of their service to the ETF/ETP issuer and its customers.

In light of the important role of banking entity-affiliated APs, it is critical that ETFs and ETPs are not treated as banking entities in order for ETFs and ETPs to engage in the activities they were established to conduct. Thus, we ask the Agencies to confirm that: (i) the seeding provisions and relevant FAQs (namely FAQ Nos. 5, 14, and 16) continue to be available for APs seeding newly launched ETFs and ETPs, including third-party ETFs and ETPs that rely on APs solely for seed capital, so that APs serving bona fide AP activity would not be required to treat the ETF or ETP as a banking entity; and (ii) APs providing market liquidity through creation, redemption, or block trading capacity by a market making or underwriting desk that complies with the relevant permitted activity criteria (*e.g.*, RENTD, market risk limits, etc.) would not cause the ETF or ETP to become a banking entity for purposes of the Volcker Rule due to the provision of the necessary services provided by the

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[45] *See* 79 Fed. Reg. at 5607-5608 (noting that a banking entity would be permitted to "seed" an ETF pursuant to the Volcker Rule's market-making exemption, as the Agencies recognized that banking entities "currently conduct a substantial amount of [authorized participant] creation and redemption activity in the ETF market and, thus, if the rule were to prevent or restrict a banking entity from acting as an AP for an ETF, then the rule would impact the functioning of the ETF market").

AP. Accordingly, seeding of a third-party ETF or ETP that has an AP warrants similar treatment to the permissible seeding of an advised RIC or FPF for Volcker Rule purposes.

G. The Agencies should expressly provide that the public welfare investments exclusion is available for any vehicle that qualifies for CRA credit and expand the exclusion to include RBICs and QOFs.

The Agencies request comment on whether investments that qualify for CRA credit explicitly should fall within the exclusion for public welfare investments (*Questions 19 and 20*). To provide additional clarity, we recommend that the Agencies explicitly provide that the exclusion for public welfare investments covers any vehicle that qualifies for CRA credit. This position, as acknowledged by the Agencies, is supported by the OCC's regulations implementing 12 U.S.C. 24 (Eleventh), which provide that investments that receive consideration as CRA-qualified investments also satisfy the requirements to be treated as public welfare investments.[46] Moreover, providing greater regulatory clarity regarding the treatment of CRA-qualified investments will help to ensure that public welfare investment activities are not unnecessarily chilled due to uncertainty or ambiguity around the applicability of the exclusion, and would reduce any associated compliance burdens.[47]

The Agencies also request comment on whether additional exclusions should be available for RBICs (*Question 21*) and QOFs (*Question 22*). We recommend that the Agencies expand the exclusion for public welfare investments explicitly to cover RBICs and QOFs, or provide separate exclusions for these vehicles. RBICs are companies licensed under a program "to promote economic development and job creation in rural communities by investing in companies involved in the production,

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[46] S*ee* 12 CFR 24.3 ("A national bank or national bank subsidiary may make an investment directly or indirectly under this part if the investment primarily benefits low- and moderate income individuals, low- and moderate income areas, or other areas targeted by a governmental entity for redevelopment, or the investment would receive consideration under 12 CFR 25.23 [the Community Reinvestment Act regulations] as a 'qualified investment.'"); 12 CFR 25.12(t) (A "qualified investment" is defined under the banking agencies' CRA regulations as a "lawful investment, deposit, membership share, or grant that has as its primary purpose community development."); *see also* 12 CFR 228.12(t) (same).

[47] Community development venture capital funds are one example of a type of fund that would benefit from a clarification that the exclusion of public welfare investments from the covered funds definition would include any vehicle that qualifies for CRA credit. In fact, the OCC, the FRB and the FDIC have previously issued guidance providing that "community development venture capital companies that promote economic development by financing small businesses" are examples of "qualified investments" for the purpose of meeting CRA obligations. 81 Fed. Reg. 48506, 48532 (July 25, 2016).

processing and supply of food and agriculture-related products."[48] QOFs are part of a program to promote long-term investing in designated economically distressed communities, and must have at least 90 percent of their assets in designated low-income zones. Explicitly excluding these vehicles from the definition of covered fund would be consistent with congressional intent to exclude public welfare investments from the scope of the Volcker Rule and would encourage banking entities to provide capital to projects that promote economic development in rural and low-income communities.[49] This approach would also reduce uncertainty as to whether these investments fall within the exclusion for public welfare investments and thereby reduce any associated compliance burdens.

II. Parallel Investments: The Agencies should adopt the Proposal's revisions regarding parallel investments and co-investments with covered funds.

We support, as proposed, the revisions regarding a banking entity's parallel investments and co-investments with covered funds. In particular, the proposed rule of construction would address ambiguity presented by the preamble discussion to the 2013 rule and clarify that banking entities may make investments that are permissible under current law. Specifically, the proposed rule of construction would clarify that a banking entity would not be restricted in the amount of any investment the banking entity makes alongside a covered fund, as long as the investment is made in compliance with applicable laws and regulations, including applicable safety and soundness standards. Indeed, as the Agencies note, "[n]either section 13(d)(4) of the BHC Act nor the text of the 2013 rule require that a banking entity treat an otherwise permissible investment the banking entity makes alongside a covered fund as an investment in the covered fund."[50]

The proposed revisions would not increase risks the Volcker Rule is intended to prevent because banking entities would be required to hold their investments in a manner consistent with the relevant BHC Act authorities and the associated risk management and other prudential and regulatory limits and controls, including stringent capital requirements for these types of investments. For example,

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48 85 Fed. Reg. at 12130.

49 *See* 79 Fed. Reg. at 5698. *See also* Press Release, SEC Amends Exemptions from Investment Adviser Registration for Advisers to Rural Business Investment Companies (Mar. 2, 2020), https://www.sec.gov/news/press-release/2020-51 (quoting SEC Chairman Jay Clayton as stating the SEC adopted certain amendments to its regulations to exempt investment advisers who advise RBICs to "implement congressionally-mandated exemptions to the Advisers Act that are intended to reduce regulatory burdens for advisers to RBICs" with a purpose to "encourage capital formation in rural areas where capital to form and grow a business all too often is more scarce than it should be").

50 85 Fed. Reg. at 12149.

investments in private, non-financial merchant banking portfolio companies in the form of common stock generally are assigned a risk weight of 400% under the simple risk-weight approach.[51] In addition, any direct investment made by a banking entity would need to comply with the Volcker Rule's proprietary trading restrictions.

In addition, the Proposal incorporates appropriate safeguards against the banking entity guaranteeing, assuming, or otherwise insuring the obligations or performance of the fund and addresses evasion concerns. Specifically, banking entities that rely on the proposed rule of construction to invest alongside an organized and offered covered fund would still be required to comply with all of the conditions under section § __.11, including the prohibition on the banking entity guaranteeing, assuming, or otherwise insuring the obligations or performance of the covered fund. We agree with the Agencies that, because of this prohibition, "the banking entity would not be permitted to make a direct investment alongside a covered fund that the banking entity organizes and offers for the purpose of artificially maintaining or increasing the value of the fund's positions."[52] Furthermore, the banking entity would need to comply with prudential backstops under section § __.15 for any direct investments alongside an organized and offered covered fund, which would prevent the banking entity from engaging in a high-risk trading strategy or investing in high-risk assets.

III. Super 23A: The Agencies should adopt the Proposal's revisions to the Implementing Regulations' so-called Super 23A limitations on banking entities' relationships with certain covered funds.

The Agencies should adopt, as proposed, the revisions to Super 23A that allow a banking entity to: (1) engage in covered transactions with a related covered fund that would be exempt from the quantitative limits, collateral requirements, and low-quality asset prohibition under section 23A of the Federal Reserve Act, in particular pursuant to the exemptions in 12 USC 371c(d) or section 223.42 of the FRB's Regulation W[53] and (2) enter into short-term extensions of credit with, and purchase assets from, a related covered fund in connection with payment transactions, settlement services, or futures, derivatives, and securities clearing. We believe these revisions would enable banking entities to provide ordinary course, low-risk services

[51] 12 CFR 217.52(b)(6). *See also* FRB, Guidance on Equity Investment and Merchant Banking Activities of Financial Holding Companies and Other Banking Organizations Supervised by the Federal Reserve, Supervision & Regulation Letter 00-9 (June 22, 2000) (describing "sound practices related to the equity investment activities of banking organizations that merit the attention of management, examiners, and other supervisory staff").

[52] 85 Fed. Reg. at 12149.

[53] These include exemptions for extending intraday credit, 12 CFR § 223.42(l), riskless principal transactions, 12 CFR § 223.42(m), and transactions fully secured by cash or U.S. government securities, 12 CFR § 223.42(c), among others.

to clients in a safe and sound manner without undermining the objectives of the Volcker Rule. Indeed, as the Agencies note, these types of transactions "generally do not present significant risks of loss, and serve important public policy objectives."[54] Further, these revisions would mitigate operational risks and other deleterious effects of the current Super 23A provisions and instead would "promote and protect the safety and soundness of banking entities and U.S. financial stability."[55]

First, incorporating the Section 23A and Regulation W exemptions into Super 23A would help to address the current overbreadth of the Super 23A provisions, which prohibit banking entities from engaging in certain routine, low-risk services to related covered funds, such as custodial or clearing services, ordinary course administrative services, or riskless principal transactions or transactions involving liquid or marketable securities without leverage. If adopted, the Proposal would address the significant limitation on banking entities' ability to provide traditional banking services due to the provision of such services possibly resulting in the banking entity engaging in a "covered transaction" prohibited under Super 23A.

In addition, incorporating the Regulation W exemptions into Super 23A would improve safety and soundness by reducing potential operational and third-party risk that may arise from the use of third-party service providers. Currently, due to Super 23A, a banking entity must regularly seek out an unaffiliated third party to serve as custodian or to provide intermediation services to a related covered fund, even if using a third party provides inferior services or pricing due to the third party's unfamiliarity with the fund. As the Agencies acknowledge,[56] operational and third-party risk arises because the involvement of an unaffiliated third party (or several unaffiliated third parties) can add a layer of operational complexity that is not present when using an affiliated service provider. Thus, the proposed revisions would help reduce contagion and financial stability risks presented by the fragmentation of services the current rule has created. Incorporating the Regulation W exemptions (which exemptions are designed to permit transactions that do not pose significant risks to banks), as recommended in the Proposal, into Super 23A would be a reasonable and appropriately tailored solution to address this issue and would work to "promote and protect U.S. financial stability by reducing interconnectedness among firms."[57]

Further, incorporating the Regulation W exemptions would not conflict with or undermine the policy objective of preventing banking entities from bailing out

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[54] 85 Fed. Reg. at 12144.

[55] *Id.* at 12125.

[56] *See id.* at 12145.

[57] *Id.*

related covered funds.[58] The types of low-risk transactions that the Regulation W exemptions would permit do not translate into bail-out risk, nor do those transactions implicate safety and soundness concerns. For example, as the FRB noted when it adopted Regulation W, "[i]ntraday overdrafts and other forms of intraday credit generally are not used as a means of funding or otherwise providing financial support for an affiliate" but rather they merely "facilitate the settlement of transactions … during the business day."[59] Similarly, the other Regulation W exemptions represent a narrow set of transactions that do not lead to bailout risk or pose risk to the safety and soundness of the banking entity and, instead, reflect financial intermediation (as compared to the provision of leverage or transactions that provide financial support for an affiliate).

We note that certain of the exemptions in section 223.42 of Regulation W apply to transactions between a member bank and a *securities* affiliate.[60] We believe the Agencies fully intended for these exemptions to be incorporated into Super 23A, as the Agencies in the Proposal cite generally to all of "12 CFR 223.42" and these exemptions, like the others, "do not present significant risks of loss, and serve important public policy objectives."[61] Accordingly, we recommend that the Agencies clarify that by incorporating the Regulation W exemptions into Super 23A, the Agencies intended to include all transactions in section 223.42, including those with a securities affiliate, notwithstanding that the covered fund with which the banking entity enters into the transaction is not a securities affiliate.

Second, the Agencies should adopt the Proposal's separate exemption for covered transactions that arise in connection with ordinary course payment transactions, settlement services, or futures, derivatives, and securities clearing activities to enable banking entities to provide low-risk services to related covered funds without undermining the objectives of the Volcker Rule. These transactions may often create short-dated exposures that would not be captured by an intraday exemption. For example, intraday extensions of credit sometimes may roll overnight or over the length of a settlement cycle (*e.g.*, T+5). These situations can arise due to time zone differences or settlement delays. In such cases, the banking entity's activities and the related risk is virtually identical to the situation in which the credit is settled within the same day, but the Regulation W exemptions on their own would not permit such

58 *See* 156 Cong. Rec. S5901 (statement of Sen. Merkley) (clarifying "the intent of subsection (f)'s [12 U.S.C. § 1851(f)] provisions to prohibit banking entities from bailing out funds they manage, sponsor, or advise").

59 Transactions Between Member Banks and Their Affiliates, 67 Fed. Reg. 76560, 76596 (Dec. 12, 2002).

60 *See, e.g.*, 12 CFR § 223.42(f) (certain marketable securities); 12 CFR § 223.42(g) (municipal securities); 12 CFR § 223.42(m) (riskless principal transactions).

61 85 Fed. Reg. at 12144.

transactions. The Proposal's exemption, which incorporates the restrictions applicable to intraday credit under Regulation W, is therefore a "necessary corollary to the exempt covered transactions that would allow banking entities to provide standard payment, clearing, and settlement services to related covered funds."[62]

IV. Ownership Interest Definition: The Agencies should adopt the proposed revisions to the definition of ownership interest subject to one clarification.

We support the proposed revisions to the "ownership interest" definition. In particular, the Proposal would include a safe harbor for ordinary debt interests by providing that senior debt interests that do not have equity-like features would not be treated as ownership interests. The Proposal also would clarify that a creditor's right to participate in the removal for cause or replacement of an investment manager upon the manager's resignation or removal would not be treated as an "other similar interest" and therefore would not be treated as an ownership interest. In our view, these changes help to provide clarity and predictability to better enable banking entities to make determinations as to whether an interest would be an ownership interest under the Implementing Regulations, thereby increasing transparency and reducing compliance costs without undermining the Volcker Rule's objectives.

Although we generally support the safe harbor for ordinary debt interests, we recommend the Agencies revise the condition requiring "[f]ixed principal payments on or before a maturity date" to clarify that the safe harbor would include debt instruments that have amortization or acceleration provisions. In such debt instruments, the payment received on or before maturity may not be "fixed," in the sense that the payment is not made in a schedule fixed in advance. This revision would clarify what was undoubtedly the intent of the safe harbor, namely that debt instruments, which commonly have such amortization or acceleration features, can be held in reliance upon the safe harbor.

V. Underwriting and Market Making in Sponsored and Advised Covered Funds: The Agencies should eliminate the investment limits and capital deduction requirement for underwriting and market making in sponsored and advised covered funds.

Under the 2019 final rule, banking entities are no longer required to include the value of ownership interests in third-party covered funds (*i.e.*, covered funds that the banking entity does not advise, sponsor or organize and offer) held as underwriting or market-making positions for purposes of the 3% aggregate limit or the capital deduction requirement. The elimination of these requirements, however, was not provided to sponsored or advised covered funds. In the preamble to the 2018 proposal, the Agencies requested comment on whether to eliminate these

62 *Id.* at 12145.

requirements for sponsored or advised covered funds as well, asking: "because the exemption for underwriting and market making-related activities under section 13(d)(1)(B), by its terms, is a statutorily permitted activity and an exemption from the prohibitions in section 13(a), is it necessary to continue to retain the per-fund limit, aggregate fund limit, and capital deduction where the banking entity engages in activity in reliance on § __.11(a) or (b)?"[63] In the 2019 final rule preamble, the Agencies reiterated that they would "continue to consider whether the approach being adopted in the final rule may be extended to other issuers, such as funds advised by the banking entity, and intend to address and request additional comment on this issue in the future proposed rulemaking."[64]

The Agencies, in our view, should extend this relief to sponsored and advised covered funds and eliminate application of the investment limits and capital deduction for several reasons. First, extending this relief to sponsored and advised covered funds would not expose banking entities to greater risk because the banking entity would still need to comply with the restrictions contained in the underwriting and market-making exemptions of the Volcker Rule. Moreover, the banking entity would still be subject to restrictions on transactions with the sponsored or advised covered fund pursuant to Super 23A and 23B, which adequately safeguard against the banking entity being exposed to the risks of the covered fund.

Second, as the Agencies have acknowledged,[65] the statutory exemption for underwriting and market-making-related activity does not require application of the investment limits or capital deductions applicable to funds sponsored under the asset management exemption and, thus, removing these restrictions would better align with the terms of the statute. In the preamble to the 2019 final rule, the Agencies explain that "Section 13(d)(1)(B) provides a statutory exemption for underwriting and market making activities and, by its terms, applies to both prohibitions in section 13(a), whether on proprietary trading or covered fund activities."[66] The Agencies continue, "Section 13 does not require any per-fund or aggregate limits, or capital deduction, with respect to covered fund ownership interests acquired pursuant to the underwriting and market making exemption in section 13(d)(1)(B)."[67] Rather, "[t]he quantitative limits and capital deduction requirements in 12 U.S.C. 1851(d)(4)(B) are required to apply only in the case of seeding investments and other *de minimis* investments made pursuant to 12 U.S.C. 1851(d)(4)(B)."[68] We concur with this

[63] 83 Fed. Reg. at 33483.

[64] 84 Fed. Reg. 61974, 62017 (Nov. 14, 2019).

[65] 83 Fed. Reg. at 33483.

[66] 84 Fed. Reg. at 62017.

[67] *Id.*

[68] *Id.* at 62017 n.575.

analysis. Further, removing the investment limit and capital deduction requirements here would be consistent with the approach taken by the Agencies to other exemptions that permit holding of covered fund ownership interests, such as the exemption for risk-mitigating hedging in covered fund ownership interests,[69] which does not include any such requirements.

Accordingly, extending the relief to sponsored and advised covered funds would be consistent with the terms of the statute, which provide that the investment limits and capital deductions apply only to banking entity activities respecting covered funds conducted in reliance on the asset management exemption. Finally, extending the same relief to underwriting and market making-related activities involving a sponsored or advised covered fund would streamline and reduce the compliance costs of the Implementing Regulations, as it did for third-party funds.[70]

VI. Compliance: The Agencies should permit banking entities to voluntarily comply early with the revised final rule, in whole or in part, as was permitted in the 2019 final rule.

The 2019 final rule adopted changes to the proprietary trading, certain covered fund, compliance, and metric provisions of the Volcker Rule's Implementing Regulations.[71] The Agencies set a compliance deadline of one year after the effective date of the final rule "[i]n order to give banking entities a sufficient amount of time to comply with the changes adopted."[72] At the same time, the Agencies gave banking entities the option to "voluntarily comply, in whole or in part" with the revisions to the rule "prior to the compliance date" (subject to an exception for metrics due to technological considerations).[73]

We recommend that the Agencies similarly permit banking entities to voluntarily comply, in whole or in part, with the revised final rule in advance of a future compliance deadline. As with the 2019 final rule, an extended compliance period would be appropriate to make sure banking entities have "a sufficient amount of time" to comply with the final covered fund changes. Permitting banking entities to

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[69] *See* Implementing Regulations § __.13(a).

[70] 83 Fed. Reg. at 33482 (describing the Agencies' expectation that the removal of this condition would "reduce compliance costs for banking entities that engage in these activities without exposing banking entities to additional risks beyond those inherent in underwriting and market making-related activities involving otherwise similar financial instruments as permitted by the statute").

[71] *See* 84 Fed. Reg. 61974.

[72] *Id.* at 61977.

[73] *Id.*

nonetheless comply early where possible would enable banking entities to more efficiently implement the Volcker Rule's requirements, and achieve the other benefits of the Proposal discussed above, as quickly as possible.

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Thank you for considering these comments. Please feel free to contact the undersigned (KFromer@fsforum.com) with any questions.

Respectfully submitted,

Kevin Fromer
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cc: The Honorable Steven T. Mnuchin, Secretary
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