SUBMITTED ELECTRONICALLY

October 17, 2018

Jerome H. Powell, Chairman
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, D.C. 20551

Joseph M. Otting, Comptroller
Office of the Comptroller of the Currency
400 7th Street, SW
Suite 3E-218, Mail Stop 9W-11
Washington, D.C. 20219

J. Christopher Giancarlo, Chairman
Commodity Futures Trading Commission
1155 21st Street, NW
Washington, D.C. 20551

Jay Clayton, Chairman
Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549

Jelena McWilliams, Chairman
Federal Deposit Insurance Corporation
550 17th Street, NW
Washington, D.C. 20429

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

Dear Chairmen Powell, Giancarlo, McWilliams, and Clayton; and Comptroller Otting:

The American Investment Council (the "AIC") appreciates the opportunity to submit this letter to the Board of Governors of the Federal Reserve System (the "Federal Reserve"), the Commodity Futures Trading Commission, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, and the Securities and Exchange Commission (collectively, the "Agencies") on the notice of proposed rulemaking (the "Proposal") on revisions to the Agencies' regulations (the "Final Regulations") implementing section 13 of the Bank Holding Company Act of 1956 (the "BHC Act"), commonly referred to as the "Volcker Rule."[1]

The AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation and economic

[1] 83 Fed. Reg. 33432 (July 17, 2018).

growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes and distributes information about the private equity and growth capital industry and its contributions to the U.S. and global economy. Established in 2007 and formerly known as the Private Equity Growth Capital Council, the AIC is based in Washington, D.C. The AIC's members are the world's leading private equity and growth capital firms united by their commitment to growing and strengthening the businesses in which they invest. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

Although our member private equity and growth capital funds ("private equity funds") are not directly subject to the Final Regulations, the Final Regulations have affected our members by making it more difficult for us to raise funds from investors – such as non-U.S. banks investing from abroad and U.S. banks investing in third-party funds – that were not intended to be limited by the Volcker Rule. To this end, we appreciate the Agencies' goal to simplify and tailor the Final Regulations by eliminating or modifying requirements that are not necessary to implement the statute's mandate and requirements. We also believe the Proposal can be further revised to more efficiently achieve the Agencies' policy objectives and, in turn, eliminate unnecessary burdens for private equity funds and their investors. In this letter, we describe why we support certain proposed modifications that would remove unnecessary barriers to investment and provide recommendations for ways the Proposal should be revised further to appropriately align the Final Regulations with the congressional intent in adopting the Volcker Rule and the Agencies' policy objectives.

I. Covered Fund Definition

We appreciate the Agencies' request for input on ways the Agencies could revisit the covered fund definition and on whether the definition is appropriately tailored to align with the purposes of the Volcker Rule. The AIC supports the Agencies' consideration of such tailoring. We believe that such tailoring ought to take place and should be guided by three core principles. By refocusing the covered fund provisions along these principles, the covered fund definition not only would accord with the plain language of the statute (which we acknowledge uses the term "private equity fund"), but also would better align with congressional intent as well as the Agencies' safety and soundness objectives.

A. The Agencies Should Revise the Final Regulations in a Manner Consistent with Three Core Principles.

We ask the Agencies to keep the following principles in mind as they determine how to revise the covered fund definition:

- *First*, revisions to the Final Regulations should ensure consistent treatment of funds with long-term investment strategies where investors do not have redemption rights. Consistent treatment is necessary to maintain a level playing field and avoid one type of fund being arbitrarily, or even unintentionally, favored over another, which would create market dislocations and incentives for unwarranted regulatory arbitrage. For example, and as the Agencies recognized in the past,[2] it makes no sense to draw an artificial line between private equity and venture capital funds—both of which pursue the same long-term investment strategies. Creating such a distinction, and drawing on regulatory definitions that, for other purposes, may divide these two types of funds, would be a poor policy choice.

- *Second*, revisions to the Final Regulations should create mechanisms that make it easier for banking entities to make permissible investments in third-party sponsored vehicles. For example, under the Volcker Rule, non-U.S. banks are permitted to make investments, from outside the United States, into private funds; the Final Regulations' barriers to such investments should, wherever possible, be eliminated. Similarly, because U.S. and non-U.S. banking entities that have elected financial holding company status can make merchant banking investments (and thereby directly acquire portfolio companies), the Final Regulations should permit investments in private equity and other funds that make those very same investments. As discussed below, we do not believe that Congress intended the Agencies to restrict investments by banking entities in third-party sponsored private equity funds, and doing so makes no sense from a safety and soundness perspective (given that the Federal Reserve has long recognized the benefits of investing in pooled vehicles, as opposed to making direct portfolio company investments).

- *Third*, revisions to the Final Regulations should seek to minimize interference with, and compliance burdens imposed on, non-bank fund sponsors, which were never intended to be affected by the Volcker Rule. For example, the Final Regulations limit non-U.S. bank investment in private equity funds, special purpose entities or other vehicles that are not offered to U.S. investors (so-called "foreign excluded funds") because such vehicles could become "banking entities" that are, then, made subject to the Volcker Rule. These limits are not warranted.

[2] *See* 79 Fed. Reg. 5536, 5704 (Jan. 31, 2014) ("Many key structural and operational characteristics of venture capital funds are substantially similar to those of hedge funds and private equity funds, thereby making it difficult to define venture capital funds in a manner that would not provide banking entities with an opportunity to evade the restrictions of section 13 of the BHC Act.").

Applying these principles helps respond to a number of the questions that the Agencies have asked with respect to the covered fund portions of the Final Regulations. For example, we do not believe the Agencies should use Form PF to define "private equity fund."[3] Doing so would not adhere to the first core principle, because it would create distinctions among funds that pursue identical long-term investment strategies. Moreover, Form PF was not designed for Volcker Rule purposes, and its use would not ensure adherence to the policy objectives that Congress had in mind in adopting the covered fund provisions.[4]

B. Third-Party Sponsored Funds Are Not the Proper Focus of the Final Regulations.

The restrictions on fund activities in the Volcker Rule were, at core, designed to ensure that banks (1) do not engage in prohibited proprietary trading activities indirectly through funds (essentially, an anti-evasion objective) and (2) do not "bail-out" or support their sponsored private funds.[5]

To our view, the Final Regulations go far beyond what is necessary to achieve the congressional purpose in the Volcker Rule. We believe the congressional objectives to curtail evasion of the proprietary trading restrictions of the Volcker Rule and limit bail-outs by banks can be met by refocusing the Final Regulations to bank investments in and dealings with (1) funds they sponsor or advise, rather than banking entity investments in <u>third-party</u> sponsored vehicles, and (2) funds that engage in trading strategies that implicate the Volcker Rule's proprietary trading restrictions.

Stretching the Volcker Rule to prevent banking entities from investing in third-party sponsored vehicles that engage in long-term investment activities does not further the covered fund provisions' policy objectives. Where a banking entity does not sponsor

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[3] *See* 83 Fed. Reg. at 33478 (Question 163). Form PF defines private equity fund as "[a]ny private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund and does not provide investors with redemption rights in the ordinary course."

[4] Form PF is designed for private fund data collection purposes. The definitions used in the form were not adopted with the distinctions and requirements of the Volcker Rule in mind, nor should they be used in that way.

[5] *See* 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Merkley) (expressing support for the covered fund 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 "a financial firm will often feel compelled by reputational demands and relationship preservation concerns to bail out clients in a failed fund that it managed or sponsored, rather than risk litigation or lost business").

or act as investment adviser to a fund, the bail-out risks are not evident. And, where the fund does not engage in short-term trading, the fund is not a vehicle that can be used to evade the proprietary trading limits of the Volcker Rule.[6]

In addition, the Final Regulations hinder banking entities' ability to invest in third-party private equity funds that make the same investments that banking entities can make directly on their balance sheet, a result that is incongruous and demonstrates the miscalibration of the covered fund provisions. Indeed, under "merchant banking" authority, qualifying banking entities—generally, those non-U.S. banks and bank holding companies that elect to be treated as "financial holding companies"—may make direct private equity investments in companies engaged in non-financial activities.[7] Further, the Federal Reserve has made clear that merchant banking authority is available for direct investments in companies, as well as investments in funds that "pool the firm's capital with capital provided by third-party investors."[8] In permitting this flexibility to make merchant banking investments, the Federal Reserve recognized that investments in private equity funds alongside third-party investors present lower risks than direct investment activity because third-party investors and sponsors monitor and help control the risk exposures of such investments; as a result, the Federal Reserve provides certain compliance benefits (*e.g.*, streamlined reporting and recordkeeping provisions) for investments in, or held through, private equity funds.[9]

Thus, permitting banking entities to invest more freely in third-party sponsored private equity and other funds would be consistent with the objectives of the Volcker Rule (and consistent with the second of our core principles described above).[10] We

[6] To the same end, we believe the Agencies should narrow the scope of the "banking entity" definition to exclude private funds that may control depository institutions, including industrial loan companies, but not be deemed bank or thrift holding companies. We do not believe that the Volcker Rule was intended to apply to the pooled vehicles (and their sponsors) that may come to own and control such depository institutions. Therefore, we ask the Agencies to distinguish between bank and thrift holding companies and their affiliates, which would be encompassed in the term "banking entity," and other owners of depository institutions, which are not subject to the BHC Act and, thus, should not be included in the Volcker Rule's scope.

[7] *See* 12 U.S.C. § 1843(k)(4)(H).

[8] 66 Fed. Reg. 8466, 8475 (Jan. 31, 2001).

[9] *See id*.

[10] In addition, some banking entities—including many smaller and mid-sized firms—do not sponsor their own funds and, for this reason, are not able to avail themselves of provisions in the Final Regulations that allow banking entities to invest in their own sponsored funds. We believe that allowing these entities to invest in third-party sponsored funds is consistent with the Volcker Rule and would allow these smaller firms to make investments that help grow the economy of their local communities.

agree with Federal Reserve Chairman Jerome Powell's statement that such activities do not threaten safety and soundness and should be accommodated in the Final Regulations.[11] Doing so would reduce risks to financial stability and enhance safety and soundness of banking entities by allowing a lower-risk fund investment activity rather than forcing banking entities to make direct merchant banking investments in portfolio companies. Taking this step also would be consistent with the Volcker Rule, because it would continue to apply limits on private equity funds that are sponsored and advised by banking entities—consistent with the plain language of the statute.

II. Codification of Existing Guidance on the Marketing Restriction.

The Final Regulations include an exemption for non-U.S. banking entities and their investments in covered funds outside the United States so long as no ownership interest is "offered for sale or sold to a resident of the United States" and any acquisition, retention or sponsorship is conducted "solely outside of the United States" (the "SOTUS" exemption).[12] Under the Final Regulations as currently written, the requirement that an ownership interest may not be "offered for sale or sold to a resident of the United States" (the "marketing restriction") was not clear whether it only applied to the investing non-U.S. banking entity (so that the entity could not market fund shares into the United States) or more broadly to third-party sponsors such as our members (in which case, non-U.S. banking entities would not be able to invest in funds that were offered also to U.S. investors).

After significant time and effort spent by AIC and other industry members to communicate on this issue, the Agencies' staff issued a helpful "frequently asked question" ("FAQ") #13 to clarify that the marketing restriction only applies to the activities of a foreign bank and not of unaffiliated third-party sponsors. Thus, this guidance enables foreign banks to invest in covered funds alongside U.S. investors. The FAQ also notes that non-U.S. banking entities that sponsor or serve as investment manager, investment adviser, commodity pool operator or commodity trading advisor to a covered fund would be deemed to participate in an offer or sale of ownership interests to U.S. residents.

We support the Proposal's codification of FAQ #13 because it would provide greater clarity and certainty for non-U.S. banks to make investments in third-party sponsored funds in reliance on the SOTUS exemption, consistent with the principles we outline above. As we have stated previously, codification would provide complete

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[11] Federal Reserve Chairman Jerome H. Powell, Testimony Before H. Comm. on Fin. Services (July 18, 2018). *See also* Letter from Sens. Crapo et al. to the Agencies (Oct. 1, 2018) (noting that these activities themselves are "subject to a comprehensive regulatory framework that imposes various requirements and limitations to address inherent risks").

[12] *See* Final Regulations §§ _.13(b)(1)(iii), (iv).

confidence to our members (and non-U.S. bank investors) that this interpretation is here to stay and long-term strategies will be able to rely on this guidance.

III. Foreign Excluded Funds

We appreciate that the Proposal seeks to address the extraterritorial impact of the Final Regulations. We agree with this objective of the Agencies. Currently, the Final Regulations permit non-U.S. banking entities to rely on the SOTUS exemption to invest in non-U.S. funds that are not covered funds (so called "foreign excluded funds"). However, the significant issue that has emerged is that a foreign excluded fund, if it is 25% or more owned by a banking entity, may be treated as an affiliate of the investing banking entity and, therefore, would be subject to the limits and restrictions of the Volcker Rule.[13]

This treatment is untenable for many funds and at odds with their core purpose to invest in financial instruments and other assets. As a result, non-U.S. banks' investments in foreign excluded funds and other non-U.S. vehicles may be artificially and unnecessarily limited and/or needless compliance burdens may be foisted on fund sponsors (which need to ensure that funds comply with the Volcker Rule's limits) and costs imposed on other fund investors. This treatment achieves no legitimate policy purpose and merely thwarts the Volcker Rule's clear objective of seeking to avoid disruptions to non-U.S. banking entities' non-U.S. investment activities.

This issue is avoided for covered funds because the Final Regulations expressly carve out those funds from the banking entity definition.[14] We urge that foreign excluded funds be treated similarly to prevent possible regulation as a banking entity.

Currently, foreign excluded funds benefit from no-action relief that states the Agencies would not take action through July 21, 2018, against a non-U.S. banking entity based on attribution to the non-U.S. banking entity of the activities and investments of qualifying foreign excluded funds or against such a fund itself as a banking entity. We appreciate that the Agencies have extended this relief through July 21, 2019, to accommodate the pendency of the Proposal.

In that relief, the Agencies stated the relief was necessary to provide the Agencies with time to address any possible "unintended consequences" of the Final Regulations. We agree with the statement that the treatment of foreign excluded funds as banking entities is an unintended consequence of the Final Regulations. To avoid this consequence, foreign excluded funds should be treated similarly to covered funds so that non-U.S. banking entities may invest in such funds without

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[13] *Id.* at § _.2(a) (referencing the BHC Act definition of affiliate, 12 U.S.C. § 1841(k)).

[14] *Id*. at § _.2(c)(2)(i).

adverse Volcker Rule implications. Such relief is necessary to avoid imposing burdens and limits on private equity fund sponsors, which burdens and limits serve no apparent policy purpose. Further, this treatment would be consistent with the Agencies' stated efforts to "limit the extraterritorial application" of the Final Regulations.

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Thank you for considering these comments. We strongly believe that adherence to the three principles we describe will more efficiently achieve the Volcker Rule's purposes: (1) ensure consistent treatment of funds with long-term investment strategies where investors do not have redemption rights; (2) create mechanisms to make it easier for banking entities to make permissible investments in third-party sponsored vehicles; and (3) minimize interference with, and compliance burdens imposed on, non-bank fund sponsors. To that end, we support revisions that would refocus the Final Regulations' covered fund provisions to bank-affiliated funds, codify the marketing restriction, and ensure foreign excluded funds are not treated as banking entities.

If you have any questions or would like additional information, please feel free to contact me at [redacted].

Respectfully submitted,

Jason Mulvihill

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American Investment Council