October 17, 2018

Via Electronic Mail

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
Docket No. R–1608; RIN 7100–AF 06

Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090
File No. S7–14–18

Robert E. Feldman, Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, DC 20429
RIN: 3064–AE67

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street SW, Suite 3E-218, Mail Stop 9W-11
Washington, DC 20219
Docket ID OCC–2018–0010

Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington, DC 20581
RIN: 3038–AE72

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 Bank Policy Institute[1] ("**BPI**") is pleased to comment on the notice of proposed rulemaking (the "**NPR**")[2] issued by the Board of Governors of the Federal Reserve System, the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission regarding the agencies' proposed

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1 BPI is a nonpartisan public policy, research and advocacy group, representing the nation's leading banks and their customers. Our members include universal banks, regional banks and the major foreign banks doing business in the United States. Collectively, our members employ almost 2 million Americans, make nearly half of the nation's small business loans, and are an engine for financial innovation and economic growth.

2 83 Fed. Reg. 33432 (July 17, 2018).

amendments (the "**Proposed Rule**") to the current rule (the "**Final Rule**") implementing Section 13 of the Bank Holding Company Act (the "**BHC Act**"), commonly referred to as the "**Volcker Rule**."[3]

We appreciate the agencies' efforts to "simplify and tailor the [Final Rule], where possible, in order to increase efficiency, reduce excess demands on available compliance capacities at banking entities, and allow banking entities to more efficiently provide services to clients, consistent with the requirements of the statute."[4] We support a number of the agencies' proposed reforms. However, we believe additional steps are necessary to improve the Final Rule and appropriately tailor its application to the activities and risks of banking entities and to give effect to the plain statutory language of the Volcker Rule.

The recommendations in this letter focus on proposals and questions in the NPR that are particularly relevant to commercial banks.[5] Our recommendations have two primary objectives: (i) preserving the ability of banking entities to perform asset-liability management ("**ALM**") and commercial banking activities that have long been regarded as promoting the safety and soundness of banking entities, and to provide credit and other services to customers, and (ii) implementing the Volcker Rule in a manner that focuses on preventing banking entities from engaging in impermissible speculative, high-risk trading or investment strategies.

Most critically, the agencies should not adopt the Proposed Rule's so-called "accounting prong" (the "**Accounting Prong**").[6] Instead, we recommend that the agencies retain an amended version of the Final Rule's existing "trading account" definition that applies the market risk capital rule prong (the "**MRC Prong**")[7] and a modified dealer prong (the "**Dealer Prong**")[8] to banking entities subject to the

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3 The Volcker Rule was added to the BHC Act by Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**"). References and citations herein to the "**Final Rule's Preamble**" are to the Federal Register version of the supplementary information issued by the agencies other than the CFTC in connection with their issuance of the Final Rule. *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 79 Fed. Reg. 5535 (Jan. 31, 2014).

Our comments in this letter are limited to the Proposed Rule. We note that statutory changes to the Volcker Rule were recently enacted (see Pub. L. No. 115-174, 132 Sat. 1296, Sections 203 and 204 (2018)), and expect that amendments to the Final Rule to effect that legislation will be subject to a separate notice and comment process, and as to which we may have separate comments.

4 NPR at 33434–35.

5 We also refer the agencies to the comments submitted by The Clearing House Association, L.L.C. to OCC's Proprietary Trading and Certain Interests in and Relationships with Covered Funds; Request for Public Input (the "**OCC RFI**"), 82 Fed. Reg. 36692 (Aug. 7, 2017) (the "**TCH Response to the OCC RFI**"), *available at* https://www.theclearinghouse.org/-/media/tch/documents/tch-weekly/2017/20170921_tch_-_comment_letter_to_occ_volcker_request_for_comment.pdf.

6 *See* Proposed Rule § _.3(b)(3).

7 *See* Final Rule § _.3(b)(1)(ii).

8 *See* Final Rule § _.3(b)(1)(iii).

market risk capital rule,[9] and a revised short-term intent prong (the "**Short-Term Intent Prong**") and the modified Dealer Prong to banking entities that are not subject to the MRC rule. We believe, as described in this letter, that this approach would be consistent with Congressional intent and the agencies' stated objectives, while also avoiding the adverse consequences of the Accounting Prong. The Accounting Prong would expand the "trading account" well beyond what is contemplated by the statute or established in the Final Rule.[10] It would also import accounting standards that have no relation to the Volcker Rule's objectives and are developed by an organization that has no bank regulatory focus, and has discretion to change those standards at any time without needing to consider how the changes could affect the Volcker Rule's definition of "trading account." The practical effect of implementing the Accounting Prong would be to impose significant constraints on firms' ability to engage in ALM activities, provide traditional commercial banking services and make otherwise permissible longer-term investments.

After careful consideration, we have concluded that the best solution to the flaws of the Accounting Prong is not to retain it and provide an expanded list of exclusions and exemptions. A broad prohibit-and-exclude approach would be inimical to the very goal of objectivity and simplicity that the Accounting Prong is intended to achieve. The interpretation of multiple exclusions and exemptions is likely to require considerably more, rather than less, debatable analysis by both banking entities and the agencies alike.

We also suggest targeted revisions to the covered funds provisions. The recommendations in this letter are intended to address the current "covered fund" definition's overbreadth and the prescriptive nature of certain of the Final Rule's other covered funds provisions, which have negatively impacted certain traditional commercial banking and asset management activities that foster economic growth. Among other things, we propose: (i) revising the foreign public fund exclusion to minimize disparate extraterritorial impact and reduce the inequitable treatment of non-U.S. funds that are substantially similar to U.S. registered investment companies; (ii) adopting exclusions from the "covered fund" definition for client facilitation structures and family wealth management vehicles to enable banking entities to accommodate client needs; (iii) amending the "ownership interest" definition to allow banking entities greater flexibility and certainty in providing traditional commercial banking and client-facilitation services; and (iv) revising the "banking entity" definition to exclude non-consolidated entities that a banking entity has limited or no practical ability to direct or control as well as family wealth management vehicles, public welfare and community development funds and employees' securities companies.

We also support appropriate changes to the Proposed Rule that are discussed in a comment letter being submitted by the Securities Industry and Financial Markets Association ("**SIFMA**"), specifically with regard to the proposed amendments to the underwriting and market-making exemptions and the metrics requirements, and the proposed exclusion for tender option bonds.

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9 *See* 12 C.F.R. Part 324, Subpart F (FDIC); 12 C.F.R. Part 217 (Federal Reserve), Subpart F; 12 C.F.R. Part 3, Subpart F (OCC).

10 *See* discussion *infra* Section II.A.1–2.

I. Executive Summary

BPI supports the agencies' objectives of simplifying the Final Rule and "provid[ing] banking entities with greater clarity and certainty about what activities are prohibited [under the Volcker Rule]."[11] However, we believe that certain of the Proposed Rule's amendments, such as the proposed Accounting Prong, would in fact undermine these objectives and exacerbate the compliance burden associated with the Final Rule. Accordingly, the recommendations in this letter focus on modifying several aspects of the Proposed Rule and/or Final Rule to improve and simplify the implementation of the Volcker Rule as it relates to ALM, traditional commercial banking services, risk management, asset management and other activities that are critical to banking entities' safety and soundness, the quality of customer service and the overall strength of the U.S. financial system.

This letter is organized as follows:

- Section II identifies the following key recommendations regarding the proprietary trading provisions in the Proposed Rule and/or Final Rule:
    - The Accounting Prong is an over-inclusive test that, contrary to statutory intent, inappropriately captures ALM activities, long-term investments and other traditional commercial banking activities that are not currently included in the "trading account." Therefore, the agencies should not adopt the Accounting Prong and should amend the current definition to better tailor the activities that are for the "trading account" in a manner consistent with the statute and without adversely impacting banking entities' safety and soundness;
    - We support the Proposed Rule's amendment of the liquidity management exclusion to include foreign exchange forwards, swaps and physically settled cross-currency swaps. The exclusion should also be amended to allow banking entities to conduct *bona fide* ALM and liquidity management activities more efficiently within the scope of the exclusion;
    - We welcome the proposed changes to the risk-mitigating hedging exemption. However, the agencies can further reduce the costs and uncertainty associated with relying on this exemption by removing its redundant enhanced documentation requirements and providing that banking entities can rely on analyses and documentation prepared for other existing processes to demonstrate compliance with the exemption; and
    - We support the agencies' proposal to add an exclusion from the definition of "proprietary trading" for loan-related swaps to provide banking entities with greater certainty that these transactions would not be viewed to be impermissible proprietary trading.
- Section III discusses the following key recommendations to the covered funds provisions:
    - To reduce the inequitable disparity in treatment between foreign public funds and U.S. registered investment companies, the foreign public fund exclusion should be revised to:

[11] NPR at 33434–35.

(i) cover expressly (a) any non-U.S. fund that is qualified to be offered to non-U.S. retail investors in one or more jurisdictions in which it is subject to substantive disclosure and retail investor protection regulation or (b) that is listed on an internationally-recognized exchange; (ii) amend the home jurisdiction requirement to allow foreign funds to qualify for the exclusion if they are authorized to be publicly offered only in jurisdictions other than their jurisdictions of organization; (iii) eliminate the burdensome "predominance" requirement; (iv) eliminate the director/employee ownership limitation; and (v) align the ownership interest limitation in sponsored foreign public funds with the registered investment company limits;

- The agencies should exclude from the definition of "covered fund" a single investor structure (or structures for a single group of affiliated investors) from the definition of "covered fund" to provide banking entities with greater flexibility when structuring transactions on behalf of clients;

- The agencies should provide for an exclusion from the definition of "covered fund" for family wealth management vehicles because these entities do not implicate the types of activities or risks that the Volcker Rule was intended to restrict;

- The agencies should revise the loan securitization exclusion to permit a limited holding of non-loan assets to enable banking entities to provide traditional securitization products and services that are demanded by the market;

- The Final Rule's definition of "ownership interest" is overly broad and unduly constrains traditional bank investments and client-facilitation services. Therefore, the definition should be revised to explicitly exclude certain instruments that do not have any equity-like features;

- The agencies should revise Super 23A to include the exemptions and quantitative limits provided under Section 23A of the Federal Reserve Act and Regulation W for purposes of interpreting Super 23A, which would promote banking entities' provision of a wide range of traditional asset management services to clients;

- We support the agencies' proposal to allow a banking entity to acquire an ownership interest in a covered fund as a risk-mitigating hedge for clients and believe that this modification will facilitate client activity;

- The agencies should expressly confirm the previous staff guidance regarding the seeding period for RICs and FPFs in the commentary of the amended Final Rule; and

- We support the proposal to remove the Final Rule's requirement that banking entities include covered fund ownership interests held in a permissible underwriting or market-making capacity in the aggregate fund limit and Tier 1 capital deduction.

➢ Section IV provides recommendations with respect to the Final Rule's "banking entity" definition, namely that the agencies should the exclude from the definition non-consolidated entities that a banking entity has limited or no practical ability to direct or control, as well as public welfare and community development funds, family wealth management vehicles and employees' securities companies.

- Section V addresses the Proposed Rule's categorization of banking entities by trading assets and liabilities ("**TALs**") and proposes that:

  - The agencies should increase the proposed TALs thresholds for the different banking entity categories to reflect amounts that are more appropriate for designating firms as having "significant," "moderate" or "limited" trading activity;

  - The agencies should clarify that banking entities moving into a higher TALs category will have two years to comply with the higher category's requirements and provide a buffer to address fluctuations above the TALs thresholds; and

  - The agencies should clarify the reference to "trading assets and liabilities" that is used in the definitions of banking entities with significant, moderate and limited TALs.

- Section VI identifies two ways in which the Proposed Rule's compliance requirements can be further tailored:

  - The agencies should (i) at a minimum incorporate a knowledge qualifier in the CEO attestation requirement regarding Volcker Rule compliance and (ii) limit the attestation requirement to banking entities with significant TALs; and

  - The agencies' reservation of authority to assign banking entities with limited or moderate TALs a higher compliance category should be revised to include the notice and response procedures specified under the presumption of compliance for banking entities with limited TALs.

- Section VII discusses the following additional proposals in respect of the Final Rule or the Proposed Rule:

  - The agencies should take steps to improve interagency coordination with respect to interpreting the Volcker Rule and providing guidance to banking entities;

  - We support the agencies' confirmation that transactions to correct *bona fide* trade errors are not considered proprietary trading;

  - The agencies should revise the permitted trading in domestic and foreign government obligation exemptions to permit a wider range of financial instruments;

  - We support providing an exclusion from the "covered fund" definition for venture capital funds;

  - BPI supports the efforts of the agencies to improve the trading outside of the United States exemption;

- We support the Proposed Rule's changes in respect of covered fund activities and investments outside the United States; and

- The agencies should codify the guidance related to foreign excluded funds in the amended Final Rule.

II. Proprietary Trading Provisions

We support the agencies' efforts to streamline and clarify the Final Rule's proprietary trading provisions, but believe that the Accounting Prong undermines these efforts and that various other changes are needed to align the Proposed Rule with the plain language and clear intent of the statute. Specifically, prohibited proprietary trading should be more clearly defined to focus on short-term trading or short-term profit intent, consistent with the statute, and should not be defined in a way that captures transactions in furtherance of ALM and liquidity management objectives or traditional commercial banking activities.

A. The Accounting Prong is an over-inclusive test that, contrary to statutory intent, inappropriately captures ALM activities, long-term investments and other traditional commercial banking activities that are not currently included in the "trading account." Therefore, the agencies should not adopt the Accounting Prong and should amend the current definition to better tailor the activities that are for the "trading account" in a manner consistent with the statute and without adversely impacting banking entities' safety and soundness.[12]

The Proposed Rule includes a new Accounting Prong of the "trading account" definition that captures any account that is used by a banking entity to purchase or sell one or more financial instruments if the financial instrument is recorded at fair value on a recurring basis under applicable accounting standards.[13] The Accounting Prong would expand the Final Rule's "trading account" definition[14] to include a significant number of financial instruments that are not currently subject to the proprietary trading prohibition under the Final Rule. Examples of financial instruments that would be captured by the Accounting Prong include debt securities recorded as available-for-sale ("**AFS**"),[15] derivatives, equity securities with a readily determinable fair value, non-marketable equity investments for which the "measurement alternative" has not been adopted[16] and financial instruments that a banking entity elects to

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12 This section is responsive to Questions 23–35, 37 and 39–41 in the NPR.

13 Proposed Rule § _.3(b)(3).

14 Dodd-Frank Act § 619(h)(6) (defining "trading account" to mean "any account used for acquiring or taking positions in the securities and instruments . . . principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements), and any such other accounts as the [agencies] may, by rule as provided in subsection (b)(2), determine.").

15 *See infra* note 22.

16 Financial instruments recorded at cost without a readily determinable fair value for which a banking entity uses the "measurement alternative" under the Financial Accounting Standards Board's ("**FASB**") ASU 2016-01, *Financial Instruments—Overall (Subtopic 825-10): Recognition and Measurement of Financial Assets and Financial Liabilities* ("**ASU 2016-01**"), should not be regarded as being recorded "at fair value on a recurring basis" such that they are subject to the Accounting Prong.

account for at fair value under the Fair Value Option ("**FVO**").[17] Moreover, because of the Accounting Prong's lack of a temporal limitation, many of the newly-captured longer-term activities could effectively become *prohibited* because the Final Rule's exclusions and exemptions generally relate to short-term trading or hedging and, therefore, often will not be available for longer-term activities.

Although we appreciate the agencies' goal[18] of proposing a test that is simpler and easier to apply than the short-term intent prong[19] (the "**Short-Term Intent Prong**"), the Accounting Prong will not achieve that goal.

1. Fair value accounting is not a proxy for whether a position is purchased or sold principally for the purpose of selling in the near term or profiting from short-term price movements. Adopting the Accounting Prong would be inconsistent with the statutory definition of "trading account."

Fair value accounting standards, which were not developed with the Volcker Rule in mind, apply to a wide range of assets and liabilities that do not involve the type of short-term principal trading that Congress intended to prohibit under the Volcker Rule.[20] According to FASB, "fair value is a market-based measurement [that] is measured using the assumptions that market participants would use when pricing the asset or liability, including assumptions about risk . . . [a]s a result, *a reporting entity's intention to hold an asset or to settle or otherwise fulfill a liability is not relevant when measuring fair value*."[21] In many cases, accounting standards *require* that positions be recorded at fair value even if they are not held for trading purposes or purchased or sold with short-term trading intent. To the extent that the accounting rules permit discretion, banking entities may choose to account for instruments at fair value for a number of reasons, including to reflect changes in market values immediately in financial statements as a way to promote transparency and facilitate risk management processes. Accordingly, fair

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17 Although some financial instruments for which the FVO is elected would qualify for the risk-mitigating hedging exemption, in certain circumstances, there may not be an available exclusion or exemption covering the relevant FVO position, such as FVO elections in connection with certain long-term equity and debt security investments other than domestic government obligations, or consolidated variable interest entities.

18 *See* NPR at 33447–48 ("The proposal's inclusion of this prong in the definition of 'trading account' is intended to give greater [] clarity to banking entities about what financial instruments would be included in the trading account, because banking entities should know which instruments are recorded at fair value on their balance sheets.").

19 *See* Final Rule § _.3(b)(i).

20 *See*, *e.g.*, 156 Cong. Rec. S5894–96 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("The term 'trading account' is intended to cover an account used by a firm to make profits from relatively short-term trading positions, as opposed to long-term, multi-year investments . . . . In designing this definition, we were aware of bank regulatory capital rules that distinguish between short-term trading and long-term investments, and our overall focus was to restrict high risk proprietary trading . . . . Linking the prohibition on proprietary trading to trading accounts permits banking entities to hold debt securities and other financial instruments in long-term investment portfolios.").

21 FASB, ASC 820-10-05-1C (emphasis added).

value accounting is by definition not an appropriate indicator of short-term trading or short-term profit intent.

The stark disconnect between fair value accounting rules and Congress's focus on short-term trading and short-term profit intent is demonstrated by the treatment of AFS positions under the Accounting Prong. Classifying a security as AFS generally means, from an accounting perspective, that the security is *not* purchased and held principally for the purpose of sale in the short term.[22] In other words, a security that is, in fact, not purchased for the purposes proscribed by Section 13 of the BHC Act would nonetheless be treated as if it were. This anomalous result should alone be sufficient to conclude that the Accounting Prong should not be adopted.

It is noteworthy, and in our view determinative, that the NPR nowhere indicates how the Accounting Prong is consistent with the objectives of the Volcker Rule or explains how the statutory proprietary trading prohibition could be construed to capture long-term investments. We recognize the agencies' attempt to simplify trading account determinations, but even if the Accounting Prong achieved such simplification, which we do not believe it does, that result would not justify a rulemaking that is inconsistent with statutory intent.

2. Many fair value positions that are not acquired or sold for the purpose of selling in the near term or profiting from short-term price movements would be captured by the Accounting Prong.

The over-inclusive nature of the Accounting Prong is demonstrated by the wide variety of investments, derivatives,[23] and AFS positions that may be fair valued and, therefore, in the "trading account" under the Accounting Prong, even where banking entities purchase or sell the financial

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22 For example, short-term trading positions are generally designated as "trading" under GAAP. "Trading securities" are defined as "securities that are bought and held principally for the purpose of selling them in the near term and therefore held for only a short period of time . . . [t]rading generally reflects active and frequent buying and selling, and trading securities are generally used with the objective of generating profits on short-term differences in price." FASB, ASC 320-10-20 (Investments – Debt and Equity Securities) ("**ASC 320**"); *see also* FASB, Statement of Financial Accounting Standards No. 115, *Accounting for Certain Investments in Debt and Equity Securities* (1993).

"AFS securities," however, are defined as "investments *not* classified as either trading securities or held-to-maturity ("**HTM**") securities." *See* ASC 320 (emphasis added). AFS treatment is often utilized when a banking entity intends to hold a position for an extended period of time, but not necessarily to maturity—an intent clearly outside the statutory "trading account" definition. Not only is the Accounting Prong's "fair value on a recurring basis" standard significantly more expansive than the statute, it is also broader than analogous accounting concepts governing short-term principal trading activities.

23 For example, numerous derivative hedging programs established in accordance with FASB's ASC 815 (Derivatives and Accounting) ("**ASC 815**") are not currently subject to the Volcker Rule for various reasons (*e.g.*, programs that hedge loans typically do not fall within the "trading account" as defined in the Final Rule). *See also* Financial Accounting Statement No. 133, *Accounting for Derivative Instruments and Hedging Activities* (June 1998). The Accounting Prong would capture these types of derivatives, thereby subjecting banking entities to an increased regulatory burden relating to hedging activities and further complicating already complex risk management practices, potentially increasing risk to the institution.

instruments without any short-term trading or short-term profit intent. These financial instruments include:

- longer-term investments in bank-eligible debt securities[24] held in the banking book (in some cases, pursuant to the OCC's 12 C.F.R. Part 1 (Investment Securities)), including for liquidity and interest rate risk management purposes;[25]

- longer-term equity investments, including strategic investments and investments in public welfare vehicles and other types of entities in which Congress specifically authorized banking entities to invest—for example, investments in various government-sponsored enterprises ("**GSEs**"), small business investment companies, rural business development companies, renewable fuel capital investment companies and public welfare investments that are mandated by the Community Reinvestment Act ("**CRA**");[26]

- investments in funds that banking entities are expressly permitted under the Final Rule to organize and seed capital investments in registered investment companies ("**RICs**") and foreign public funds ("**FPFs**") that are required to be held at fair value under investment company accounting rules as well as long-term static hedges of these investments;

- investments made on behalf of a banking entity's employees, such as investments related to deferred compensation, stock bonus, profit-sharing and pension plans;

- hedge positions that qualify under applicable hedge accounting standards; and

- longer-term hedge positions that are not actively managed;

- derivatives and other instruments that are recognized as credit risk mitigants under applicable capital rules;

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24 These include so-called (i) "Type III" securities (*e.g.*, investment-grade corporate and municipal bonds that do not qualify under the other categories of investment securities); (ii) "Type IV" securities (*e.g.*, certain small-business-related securities, commercial and residential mortgage-related securities ("**CMBS**" and "**RMBS**," respectively) and other investment-grade asset-backed securities ("**ABS**") as well as structured products such as collateralized loan obligations ("**CLOs**")); and (iii) "Type V" securities (*e.g.*, marketable securities, backed by small business loans, credit card receivables and car loans). *See* 12 C.F.R. § 1.2; *see generally* Federal Reserve, *Trading and Capital-Markets Activities Manual* (Section 3000.1 (Investment Securities and End-User Activities)) (January 2009).

25 These securities are integral to liquidity risk management, including as collateral to the Federal Home Loan Bank system or to the Federal Reserve.

26 Banking entities may make equity or debt investments to support a variety of activities that are designed primarily to promote the public welfare, including certain investments in community development loan funds aimed at benefitting low- and moderate-income individuals and areas as well as equity and near-equity lending for start-up and expanding businesses. Subjecting these investments to the Volcker Rule may have a chilling effect on banking entities' provision of these services and may, therefore, adversely impact their ability to meet the credit needs of the communities in which they operate as well as CRA performance and balance sheet diversification strategies.

- positions to hedge structural interest rate and foreign exchange ("**FX**") risks that are not held for short-term principal trading or short-term profit intent, including positions often used to hedge accumulated other comprehensive income risk.

In many cases, these financial instruments are, appropriately, not in the "trading account" under the Short-Term Intent Prong and the 60-day rebuttable presumption (the "**60-Day Rebuttable Presumption**")[27] (or otherwise captured by the MRC Prong or the Dealer Prong) due to their medium- to longer-term nature.

The adverse consequences of the Accounting Prong demonstrate why concepts that are unrelated to the Volcker Rule's objectives should not be imported into the Final Rule's definitional framework. Another key example is provided by Section 13 of the BHC Act and the Final Rule in defining "covered fund" by reference to the Investment Company Act of 1940 (the "**Investment Company Act**").[28] The incorporation of Investment Company Act standards into that definition has had the effect of capturing entities that bear no meaningful resemblance to the private equity funds and hedge funds that Congress intended to target.[29] It has required the creation of a large number of exemptions to the covered funds prohibition, which have proven to be inadequate and subject to considerable compliance burden, confusion and uncertainty.[30] Adopting an accounting-based standard that covers all financial instruments recorded at fair value on a recurring basis would create the same problem for the proprietary trading definition. Using accounting-based standards to define the scope of the "trading account" would inappropriately expand a basic definition that should, instead, focus, as Congress intended, on short-term principal trading and short-term profit intent.

3. The Accounting Prong would negatively impact the ability of banking entities to conduct *bona fide* ALM, liquidity management and traditional commercial banking activities.

Capturing the types of positions and activities described above would greatly complicate, restrict and increase costs associated with ALM, liquidity management and traditional commercial banking activities, thereby impairing market liquidity and constraining banking entities' credit origination and financial intermediation activities.

Moreover, the Accounting Prong would have a significant impact on other risk management strategies, such as using derivatives to manage the duration risk related to loans and fixed-rate debt. These activities would in many cases be covered under the Accounting Prong notwithstanding that these strategies are not intended to produce short-term gains and are subject to ongoing supervision by

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27 *See* Final Rule § __.3(b)(2).

28 15 U.S.C. 80a-1 et seq.

29 *See* discussion in *infra* note 54.

30 *See, e.g.*, U.S. Department of the Treasury, *A Financial System That Creates Economic Opportunities: Banks and Credit Unions*, at 77 (June 2017) (the "**Treasury Report**") (discussing how the Final Rule's definition of "covered funds" is not well-tailored to the objectives underlying the statutory prohibition), *available at* https://www.treasury.gov/press-center/press-releases/Documents/A%20Financial%20System.pdf.

regulators. Counter to the agencies' objectives,[31] therefore, the Accounting Prong may potentially impede banking entities' prudent risk management practices.

i. ALM and Liquidity Management Activities

ALM activities are critical to bank safety and soundness[32] and to the stability of the U.S. and global financial systems. The Financial Stability Oversight Council (the "**FSOC**"), in its study regarding the Volcker Rule,[33] recognized that the appropriate treatment of ALM activities is "one of the more significant scope issues" under the Volcker Rule and concluded that the Volcker Rule should not prohibit ALM activities:

> All commercial banks, regardless of size, conduct asset-liability management . . . that help[s] the institution manage to a desired interest rate and liquidity risk profile. This study recognizes that ALM activities are clearly intended to be permitted activities, and are an important risk mitigation tool. . . . A finding that these are impermissible under the Volcker Rule would adversely impact liquidity and interest rate risk management capabilities as well as exacerbat[e] excess liquidity conditions. These activities also serve important safety and soundness objectives.[34]

ALM activities are not speculative in nature and the objective of ALM transactions is not to acquire financial instruments principally for the purpose of selling in the near term or to benefit from short-term price movements. This is evidenced by the fact that ALM positions typically are not treated as trading assets under accounting classifications or within the trading book for regulatory capital purposes.

ALM is the holistic and structural risk management of liquidity, market risk and interest rate sensitivity,[35] and capital embedded in a bank's core deposit and lending businesses. A firm's treasury ALM function is responsible for efficiently allocating resources, such as balance sheet capacity, liquidity and capital, in order to meet funding needs while also planning for future growth and maintaining

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31 *See* NPR at 33466 (discussing intent to make beneficial risk-mitigating activity more efficient and effective). Additional information as to why the risk-mitigating hedging exemption would be unavailable for many of these activities is set out below in Section II.A.4.

32 *See, e.g.*, OCC Bulletin 2004-29 (July 1, 2004) ("It is critical that bank managers fully understand their institution's interest rate risk exposures and ensure that their risk management framework incorporates the controls and tools necessary to conduct asset/liability management activities in a safe and sound manner.").

33 *See* FSOC, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds at 47 (Jan. 2011) (the "**FSOC Study**").

34 FSOC Study at 47. FSOC recognized that active trading can occur in an ALM portfolio, but stated that the agencies "should consider whether to verify as part of their ordinary supervisory activity that there is no prohibited proprietary trading occurring in ALM portfolios." *Id.*

35 *See, e.g.*, Federal Reserve, *Commercial Bank Examination Manual* § 4090.1 (Interest-Rate Risk Management) (noting that "[m]aterial sources of IRR include the mismatch, basis, and option risk exposures of the institution. In many cases, the interest-rate characteristics of a bank's largest holdings will dominate its aggregate risk profile").

adequate stress buffers. Differences in the behavioral characteristics of business activity (*e.g.*, interest rate sensitivity, term structure and convexity) and in growth rates can create meaningful structural risk. For example, when deposit growth exceeds loan growth, a bank's structural interest rate sensitivity may increase. The ALM function of a banking entity hedges firmwide structural risk on a medium- to longer-term basis.

If the agencies adopt the Accounting Prong, many banking entities will face increased challenges in implementing the types of ALM activities that regulators consider essential to promote safety and soundness. Fair value instruments, including bank-eligible AFS debt securities and derivatives, are critical components of ALM. These financial instruments are used to hedge interest rate risk on a medium- to long-term basis, invest excess liquidity, and satisfy liquidity coverage ratio ("**LCR**") requirements.[36] For example, derivatives are used to manage mismatches in interest rate risk between assets and liabilities, such as between floating rate loans and fixed-rate debt. These derivatives are typically designated as hedges under ASC 815 or International Financial Reporting Standard ("**IFRS**") 9 (Financial Instruments),[37] which both require rigorous documentation and effectiveness testing.[38] AFS

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36 *See* 12 C.F.R. Part 329 (FDIC); 12 C.F.R. Part 249 (Federal Reserve); 12 C.F.R. Part 50 (OCC). The costs and burdens of the LCR requirement may also be affected because banking entities would be encouraged to hold high-quality liquid assets as HTM instead of AFS. Many banking entities prefer to hold their stock of high quality liquid assets ("**HQLA**") as AFS instead of HTM in order to maintain necessary flexibility in managing their portfolios of HQLA. Although certain long-term investments can be booked as HTM, many medium-term, ALM- or liquidity-related investments would not qualify as HTM because banking entities generally need the flexibility to exit the investment in a manner that the accounting rules would not permit for HTM classification. *See, e.g*., ASC 320-10-25-3,-10-25-25,-10-35-9 (noting that HTM investments generally cannot be sold prior to their maturity absent an extraordinary event and there are consequences of the sale prior to maturity of an asset booked as HTM, including a potential periodic prohibition on the reliance of HTM accounting treatment); *see also* OCC, *Detecting Red Flags in Board Reports: A Guide for Directors* at 31 (Sept. 2013) (discussing that a bank's HTM designation may reduce managerial flexibility because the bank has stated its intent to hold the securities to maturity and, further, explaining that "[the] [s]ale of an HTM security, for reasons other than credit and other limited 'safe harbors,' may call into question the appropriateness of the HTM designation for other securities and may result in a required reclassification to AFS and the use of mark-to-market, as opposed to historical cost, accounting for these securities."); OCC, *Bank Accounting Advisory Series* at 4–5 (August 2017) (discussing the ramifications of selling debt securities that have been classified as HTM in circumstances outside ASC 320's limited HTM safe harbor exemptions).

37 For banking entities that have not yet converted to the International Accounting Standards Board's IFRS 9, the relevant hedge accounting standards are those described in International Accounting Standards ("**IAS**") 32 (Financial Instruments: Presentation) and IAS 39 (Financial Instruments: Recognition and Measurement).

38 For example, to qualify for hedge accounting under ASC 815, a banking entity must have formal documentation of the following at the inception of the hedge:

- *Documentation requirement applicable to fair value hedges, cash flow hedges, and net investment hedges*: The (1) hedging relationship and (2) entity's risk management objective and strategy for undertaking the hedge, including identification of certain information such as the: (i) hedging instrument; (ii) hedged item or transaction; (iii) nature of the risk being hedged; (iv) method that will be used to retrospectively and prospectively assess the hedging instrument's effectiveness in offsetting the exposure to changes in the hedged item's fair value (if a fair value hedge) or hedged transaction's variability in cash flows (if a cash flow hedge) attributable to the hedged risk debt securities can qualify as HQLA and satisfy LCR requirements, and can be used to manage structural interest rate risk and diversify risk exposures. Investing in non-HQLA investment-grade securities is also an important liquidity management strategy used to hedge imbalances in the growth of deposits and loans and fund medium-term growth. An AFS debt securities portfolio including both HQLA and non-HQLA therefore provides firms with liquidity resources that can be used in the face of certain stressed economic scenarios, including those in which interest rates and inflation rise.

- The important role that bank investment securities portfolios play as buffers[39] to changing economic and credit conditions is apparent when comparing domestically-chartered commercial bank deposit and loan growth against Non-Federal Debt Securities (as defined below) growth. When deposit growth exceeds loan demand, banks may invest the excess funds, in part, in debt securities[40] other than domestic government obligations, such as corporate bonds, RMBS, CMBS, CLOs and ABS backed by credit cards, auto loans and student loans ("**Non-Federal Debt Securities**"). Conversely, when loan demand exceeds deposit growth, banks may sell these debt securities to fund the provision of credit to the market. Therefore, if banking entities are not able to hold these types of debt securities in their AFS portfolios due to the adoption of the Accounting Prong, there may be significant negative consequences, including: (i) the diversion of capital from the private sector to government securities exempted from the proprietary trading prohibition; (ii) greater reliance

(including a reasonable basis for how the entity plans to assess the hedging instrument's effectiveness); and (v) method that will be used to measure hedge ineffectiveness.

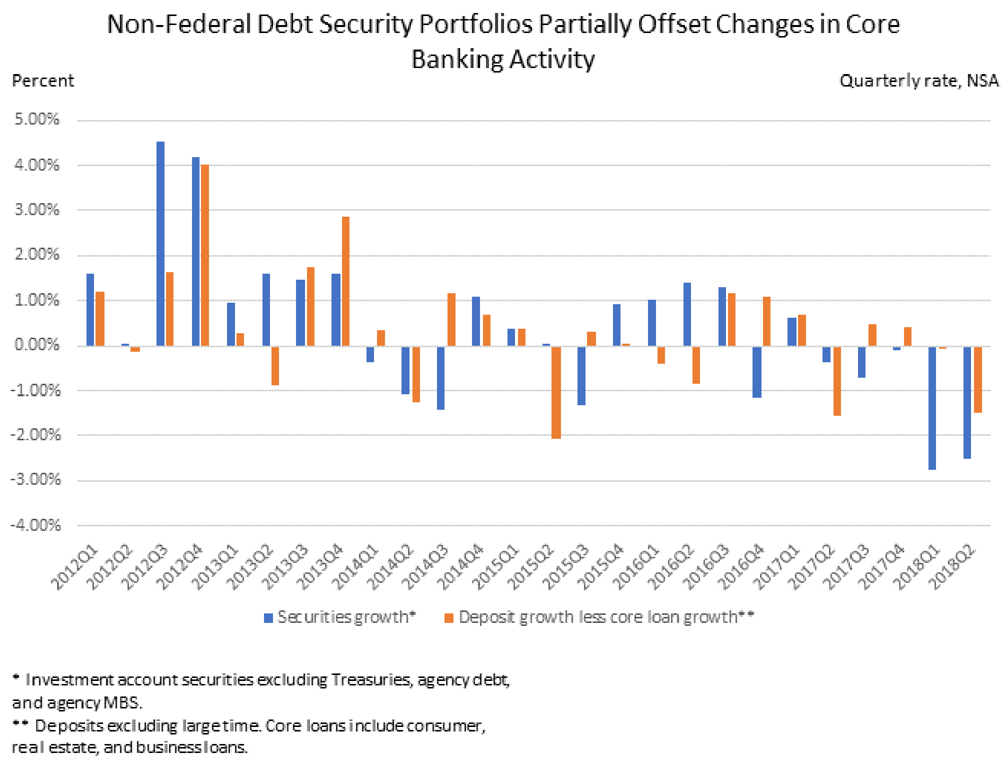
- *Documentation requirement applicable to fair value hedges only*: For a fair value hedge of a firm commitment, a reasonable method for recognizing in earnings the asset or liability representing the gain or loss on the hedged firm commitment.

- *Documentation requirement applicable to cash flow hedges only*: For a cash flow hedge of a forecasted transaction, documentation shall include all relevant details, including information concerning, among other things, the: (i) date on or period within which the forecasted transaction is expected to occur; (ii) specific nature of asset or liability involved (if any); and (iii) specification of either (x) the exact amount of foreign currency being hedged or (y) the number of items or units of measure encompassed by the hedged forecasted transaction.

39 *See*, *e.g.*, James Vickery, Angela Deng & Tara Sullivan, *Available for Sale? Understanding Bank Securities Portfolios*, FEDERAL RESERVE BANK OF NEW YORK – LIBERTY STREET ECONOMICS (Feb. 11, 2015) (discussing how banks use debt securities to (i) deal with imbalances between "their access to deposit finance or other low-cost funding and their profitable lending opportunities," which could be the result of shocks to credit demand or deposits or other factors; (ii) manage liquidity risk because securities can be "sold more easily and with lower price impact than loans, for which the secondary market is less active"; and (iii) diversify or mitigate risk exposures), *available at* http://libertystreeteconomics.newyorkfed.org/2015/02/available-for-sale-understanding-bank-securities-portfolios.html (last visited October 16, 2018).

40 *See* Matthew C. Plosser, *Bank Heterogeneity and Capital Allocation: Evidence from "Fracking" Shocks*, FEDERAL RESERVE BANK OF NEW YORK STAFF REPORT No. 693 at 18–19 (Feb. 2015) (empirical study finding that banks allocate approximately 75% of deposit inflows and outflows unrelated to changes in loan balances to investments in liquid assets, the largest category of which is securities).

by banks on wholesale funding[41] rather than core deposits to address mismatches between deposit growth and loan growth; and (iii) increases in the volatility of lending rates and deposit rates as a result of banking entities using these rates to recalibrate loan and deposit mismatches.



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41 The agencies have noted previously the negative consequences that arise from excessive reliance on wholesale funding in the banking sector. *See*, *e.g.*, William C. Dudley, former President and CEO of the FEDERAL RESERVE BANK OF NEW YORK, *Remarks at the Workshop on the Risks of Wholesale Funding* (Aug. 13, 2014) ("The extensive use by financial firms of short-term wholesale funding was one critical factor in the crisis. Not only did this reliance on short-term funding create the potential for a firm to fail in an extraordinarily rapid manner when faced with a loss of market confidence, but it also served as a channel through which the effects of those failures were widely propagated throughout the broader financial system."); *Safety and Soundness – Liquidity*, OCC – COMPTROLLER'S HANDBOOK (June 2012) at 5 (discussing how excessive reliance on wholesale and market-based funding sources elevates a bank's liquidity risk profile, exposing banks to heightened interest rate and credit sensitivity); *Net Stable Funding Ratio: Liquidity Risk Measurement Standards and Disclosure Requirements*, 81 Fed. Reg. 35124, 35127 (discussing how the LCR and net stable funding ratio requirements are aimed at addressing the risks arising from excessive reliance on unstable funding, such as short-term wholesale funding, that decreases banks' resilience to short-term economic and financial stress).

- The above graph demonstrates this relationship, subject to limitations in data availability.[42] The graph shows the quarterly percentage changes in the Non-Federal Debt Securities held by U.S. commercial banks in their investment accounts and the difference between the growth in domestic deposits and core loans. As can be seen, securities growth tends to increase when deposit growth exceeds loan demand, and vice versa.

- As proposed, we estimate that the Accounting Prong would bring over $400 billion in non-Federal AFS debt securities investments into the Volcker Rule "trading account."[43] In the case of non-Federal AFS debt securities that are funding loans to households (*e.g.*, auto loans, student loans and credit card receivables), commercial banks' share of these credit markets equals approximately 10% to 15% of the outstanding ABS market.[44] If the Accounting Prong were adopted, banking entities would face a choice between re-designating positions as HTM, which would reduce a firm's flexibility to respond to changing conditions,[45] or divesting them, which could materially increase the costs to consumers of financing these loans.

Existing supervisory tools are sufficient to monitor whether balance sheet positions, including AFS debt securities portfolios, are used in a manner inconsistent with the Volcker Rule, and it is not necessary to adopt the Accounting Prong to achieve that objective. The MRC rule's requirements[46] and ordinary course supervisory processes, including examinations relating to that rule, provide appropriate oversight mechanisms to prevent banking entities from improperly including "trading securities" in an AFS portfolio.[47] For firms that are not subject to the MRC rule, supervisory oversight of reporting on

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42 The data shown here is gathered from non-seasonally adjusted quarterly data published in the Federal Reserve's H8 Report (Assets and Liabilities of Commercial Banks in the U.S.), *available at* https://www.federalreserve.gov/releases/h8/.

43 This figure reflects publicly reported data for all U.S. BHCs as of the first quarter of 2018. S&P Global Market Intelligence (as of October 15, 2018).

44 For the number of total outstanding U.S. ABS and CMBS as of the end of 2017, *see* SIFMA, *Bond Market Chart*, *available at* https://www.sifma.org/resources/archive/research/us-abs-issuance-and-outstanding/.

45 *See* discussion in *supra* note 36.

46 *See supra* note 9.

47 Further, for larger banking organizations, capital risks associated with the AFS debt portfolio are subject to supervisory and company-run stress tests. The Dodd-Frank Annual Stress Testing ("**DFAST**"), which assesses whether firms are sufficiently capitalized to absorb losses during stressful market conditions, incorporates scenarios of significant volatility of securities portfolios, particularly in non-government assets, to examine whether firms maintain adequate capital to support stress and volatility from market dislocation. *See* §§ 165(i)(1)–(2) of the Dodd-Frank Act; 12 C.F.R. Part 252. The annual Comprehensive Capital Analysis and Review ("**CCAR**"), which includes a quantitative assessment of firms' capital plans based on the supervisory and company-run DFAST stress tests, is an important tool used to monitor firms' sources and uses of capital under stressed economic and financial market conditions and requires that firms provide detailed methodology documentation regarding projections of losses/gains on AFS securities portfolios over a nine-quarter horizon. *See* 12 C.F.R. §§ 225.8, 225.153(e)(2)(ii). CCAR will become an even stronger regulatory oversight mechanism with the expected implementation of the stress capital buffer, as ongoing capital requirements will be tied to outcomes under the Federal Reserve's supervisory

Form FR Y-9C allows regulators to monitor whether smaller entities are misreporting their trading assets and liabilities so as to not be subject to the MRC rule.

For the reasons discussed above, if fair valued AFS debt securities and derivatives were brought into the "trading account" as a result of the Accounting Prong's adoption, banking entities would have far less flexibility to prudently diversify their portfolios[48] to accommodate the multifaceted risks addressed by a sound ALM and risk management program.

ii. Traditional Commercial Banking Products

The Accounting Prong's expansion of the "trading account" would also impair banking entities' ability to provide traditional commercial banking products. Specifically, the Accounting Prong would prohibit banking entities from providing clients a variety of long-term equity and debt financings involving securities that are fair valued on a recurring basis, including for example in the health care, non-profit and infrastructure sectors and the closed-end mutual fund industry.

Clients may prefer to structure their long-term financing arrangements using securities for a variety of tax, market liquidity, local market practice and other considerations. For example, in the context of closed-end municipal bond funds, equity represents the only viable method of financing to achieve tax-exempt status for both the issuer as well as the investor. In connection with financing long-term infrastructure projects, clients may wish to structure their financings using debt securities to accommodate changes to circumstances over of the life of the project and provide for flexible refinancing options. Moreover, in many jurisdictions outside the United States, client financings are conducted using equity and debt securities due to local regulatory and tax considerations.

Serving long-term client financing needs in a flexible manner may require banking entities to use the AFS classification for debt securities and fair valuation for equity securities. Because the Accounting Prong would bring these types of instruments within the "trading account," banking entities would generally be prohibited from providing these types of financing products to clients, resulting in potential market disruption.[49]

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stress tests. *See Amendments to the Regulatory Capital, Capital Plan and Stress Test Rules*, 83 Fed. Reg. 18160 (Apr. 25, 2018).

48 *See* Basel Comm. on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and liquidity risk monitoring tools* at para. 44 (Jan. 2013) (discussing how a bank's stock of HQLA should be "well diversified within the asset classes themselves . . . . [a]lthough some asset classes are more likely to remain liquid irrespective of circumstances, ex-ante it is not possible to know with certainty which specific assets within each asset class might be subject to shocks ex-post. Banks should therefore have policies and limits in place in order to avoid concentration with respect to asset types, issue and issuer types, and currency [] within asset classes."); Basel Comm. on Banking Supervision, *Principles for Sound Liquidity Risk Management and Supervision* at paras. 65–66 (Sept. 2008) (noting that a bank "should diversify available funding sources in the short-, medium- and long-term" and that "as a general liquidity management practice, banks should limit concentration in any one particular funding source or tenor.").

49 Similarly, due to the fair value treatment of certain statutorily authorized investments, banking entities may no longer be able to make investments in or provide financing to entities for which Congress has granted specific authority, such as small business investment companies.

4. The Volcker Rule's existing exclusions and exemptions would not accommodate a wide variety of ALM (among other traditional commercial banking activities) and longer-term investment activities that would be newly captured by the Accounting Prong.

We are particularly concerned about the Accounting Prong's over-inclusiveness because the Final Rule's existing exclusions and exemptions would not accommodate many of the ALM and longer-term investment activities that would be subject to the "trading account" as a result of the Accounting Prong.[50] With regard to ALM activities, the existing liquidity management exclusion and the risk-mitigating hedging exemption may not be, individually or in combination, broad enough to accommodate the multiple risk management objectives and strategies that can form part of a robust ALM process. Even taking into account the changes included in the Proposed Rule, the liquidity management exclusion[51] may be unavailable for many ALM activities because the exclusion (i) focuses on near-term funding risks and not the entirety of ALM risks, which encompass longer-term interest rate and credit risk sensitivities as well as balance sheet growth and stress scenario impacts (all of which can be managed with a mix of medium to longer-term investments in AFS investment-grade debt securities) and (ii) does not include the full range of assets utilized for ALM activities (*e.g.*, other investment securities under 12 C.F.R. Part 1). Likewise, the risk-mitigating hedging exemption, which is designed to capture hedging of discrete risks,[52] will in many cases not be available for ALM activities designed to address multidimensional risks on a holistic basis (taking into account, for instance, liquidity, interest rate and macroeconomic risk). Further, the risk-mitigating hedging exemption has been interpreted by the agencies not to cover certain structural interest rate exposures.

Certain types of currently permissible investment activities that are beneficial from an interest rate risk, liquidity or commercial banking perspective would also be limited under the Accounting Prong because of the lack of an available exemption or exclusion. Permissible investments in AFS debt securities that may be affected include: (i) "Type II" securities (international and multilateral development bank bonds for the investment securities portfolio); (ii) "Type III" securities (investment-grade corporate and sovereign bonds); (iii) "Type IV"/ "Type V" securities (CMBS, RMBS and other investment-grade ABS as well as structured products, such as CLOs); and (iv) foreign government obligations[53] held pursuant to Regulation K. Although certain of these newly-captured instruments may qualify for an exclusion or exemption under the Final Rule, relying on the available exemption or exclusion would entail additional burdens, including the production and monitoring of metrics. Any

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[50] Although various exemptions and exclusions under the Final Rule could cover certain of these activities and positions, there would be substantial uncertainty as to the scope of coverage. This uncertainty means that the Accounting Prong creates complexity rather than simplification.

[51] Proposed Rule § _.3(e)(3).

[52] Final Rule § _.5 and Proposed Rule § _.5. *See* 79. Fed. Reg. at 5693 ("Moreover, hedging of aggregated positions under this exemption must be related to identifiable risks related to specific positions, contracts, or other holdings of the banking entity. . . . The risks in this context are not intended to be more generalized risks that a trading desk or combination of desks, or the banking entity as a whole, believe exists based on non-position-specific modeling or other considerations.").

[53] *See* 12 C.F.R. Part 211.4 (Permissible activities and investments of foreign branches of member banks).

position that would be captured by the Accounting Prong and that would not qualify for an exclusion or exemption, would need to be divested.

The Accounting Prong would also capture many long-term investments, such as strategic equity investments recorded at fair value and seed capital and co-investments in investment funds that are currently and appropriately held outside the "trading account." Even if the exclusions and exemptions to the proprietary trading prohibition are revised as recommended in this letter, these long-term positions would not have an available exclusion or exemption notwithstanding that these activities do not constitute short-term speculative trading.

Although we appreciate that the agencies could attempt to limit the overreach of the Accounting Prong through exclusions and exemptions, we respectfully submit that this is fundamentally a flawed approach. We generally believe that a prohibition that Congress imposed on a particular category of activities should not be implemented through a regulatory framework that intentionally captures activities that were not meant to be prohibited and then seeks to permit the activities that are inappropriately captured through carve-outs and exemptions.[54] The defects in this approach are amply demonstrated by the interpretive difficulties the industry and regulators have had under the Final Rule, which the agencies acknowledge and attempt to address in the NPR and their guidance regarding the Final Rule.[55] In the first place, it is virtually certain that exclusions and exemptions will fail to anticipate all circumstances in which activities that are intended to be permitted are inappropriately captured by the overbroad definition. Second, this approach creates unnecessary uncertainty and administrative burden for both banking entities and the regulatory staff that must interpret—and implement or examine compliance programs that take into account—not only the prohibition but also the numerous exceptions. Third, and relatedly, as interpretive uncertainty and complexity increase, the risk of inadvertent violation and disparate regulatory outcomes increases. The agencies should not adopt a "trading account" definition that replicates these very same problems.

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54 For example, banking entities have faced significant challenges in interpreting and applying the large number of exclusions from the Final Rule's definition of "covered fund." As discussed in Section III, Congress did not intend for the Volcker Rule to restrict certain activities, such as investments in and relationships with sponsored non-U.S. funds that are substantially similar to U.S. RICs or loan securitizations. These activities, among others, remain unduly limited by the overbroad "covered fund" definition because the relevant exclusions contain overly prescriptive requirements that limit their utility and, therefore, fail to cure the over-inclusiveness of the definition.

55 *See generally* NPR at 33434–35 ("The Agencies have now had several years of experience implementing the [Final Rule] and believe that supervision and implementation of the [Final Rule] can be substantially improved. The Agencies acknowledge concerns that some parts of the [Final Rule] may be unclear and potentially difficult to implement in practice. Based on experience since adoption of the [Final Rule], the Agencies have identified opportunities, consistent with the statute, for improving the rule, including further tailoring its application based on the activities and risks of banking entities . . . . The data collected in connection with the [Final Rule], compliance efforts by banking entities, and the Agencies' experience in reviewing trading and investment activity under the [Final Rule], have provided valuable insights into the effectiveness of the [Final Rule]. These insights highlighted areas in which the [Final Rule] may have resulted in ambiguity, overbroad application, or unduly complex compliance routines."); *see also* staff guidance issued via Frequently Asked Questions (last updated Mar. 4, 2016), *available at* https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm.

5. Basing the "trading account" definition on accounting standards would increase unpredictability for banking entities as those standards may be modified at any time without consideration of the impact on the Volcker Rule.

The agencies have acknowledged previously that importing accounting-based standards into the Volcker Rule framework is problematic because those standards could change at any time in the future.[56] The Accounting Prong suffers from this fundamental flaw and would potentially increase unpredictability for banking entities. Accounting standards are developed by accounting professionals who have the ability to change those standards without needing to consider how the changes could affect the Volcker Rule. For example, FASB's pursuit of its mission—namely, to "establish and improve financial accounting and reporting standards to provide useful information to investors and other users of financial reports and educate stakeholders on how to most effectively understand and implement those standards"—does not require FASB to consider the safety and soundness of the U.S. financial system or to promote consistency in the regulation of banking entities.[57]

If FASB were to modify the definitions of "trading securities," "AFS securities" or "fair value" under GAAP in the future or revise accounting requirements such that the instruments that must be recorded at fair value on a recurring basis changes, the scope of financial instruments captured by the "trading account" could change. As a result, formerly permissible activities could become impermissible and the divestiture of additional long-term holdings could potentially be required. Moreover, with each modification to the relevant accounting classifications, banking entities could be required to undertake extensive analyses regarding the financial instruments covered and the availability of exclusions or exemptions and to restructure their compliance programs to accommodate the accounting changes.

6. If the Accounting Prong is adopted, the compliance burden associated with the "trading account" definition would increase.

Adopting the Accounting Prong would undermine the agencies' objective "to simplify and tailor the implementing regulations, where possible, in order to increase efficiency, reduce excess demands on available compliance capacities at banking entities, and allow banking entities to more efficiently provide services to clients."[58] Rather than reducing the compliance burden and enhancing efficiency, the Accounting Prong's adoption would require banking entities to completely overhaul their Volcker Rule compliance and monitoring practices. To implement the Accounting Prong, banking entities would have to undertake a highly technical, fact-specific legal analysis of a wide range of additional activities and positions to determine whether they are permitted under an exemption or exclusion, including in cases where the underlying position is clearly unrelated to the types of short-term principal trading activities intended to be addressed by the statutory proprietary trading prohibition. Even if the agencies expand an exclusion or exemption as we recommend in this letter, to continue engaging in the newly-captured

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[56] 79 Fed. Reg. 5549 ("The Agencies continue to believe that formally incorporating accounting standards governing trading securities is not appropriate because . . . these accounting standards could change in the future without consideration of the potential impact on section 13 of the BHC Act and these rules"); *see also* Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846, 68859 n.101 (Nov. 7, 2011) (same).

[57] FASB, *FASB Mission*, *available at* https://www.fasb.org/facts/ (last visited October 16, 2018).

[58] NPR at 33435.

activities banking entities would nevertheless need to implement the documentation, reporting and compliance requirements associated with the applicable exclusions and exemptions, including in some cases, the production of metrics.

As just one example, static hedging activity involving long-term positions held for longer than 60 days currently falls outside the "trading account" definition, but would be captured by the Accounting Prong. These hedging positions are not "covered positions" or "trading positions" from a MRC rule perspective and are not typically held by a broker-dealer or swap dealer in a capacity for which dealer registration is required. Therefore, to remain permissible, this activity could be required to be conducted pursuant to the risk-mitigating hedging exemption, subject to all of its associated compliance requirements.

Supervisors' and examiners' resources devoted to Volcker Rule compliance would also increase as banking entities would need to seek a number of ad hoc approvals to hold longer-term investments. The agencies' resultant need to establish standards for, and provide consistency in, reviewing such requests may prove to be challenging.

7. The Accounting Prong may impact banking entities' FVO elections.

The Accounting Prong may influence whether banking entities elect to account for instruments under the FVO where they have the option, but are not required, to use fair value accounting, potentially reducing transparency into banking entities' financial reporting and frustrating risk management practices that are based on the FVO. FASB introduced the FVO in an effort to improve financial reporting by allowing banks and other companies to represent more faithfully the actual economics of certain transactions by eliminating the earnings mismatch that sometimes arises from the mixed attribute accounting system under GAAP.[59] A banking entity's election to account for an instrument at fair value under the FVO does not require the conclusion, or even suggest, that the instrument is held by the banking entity for short-term principal trading purposes. Nonetheless, as described above,[60] certain FVO positions, such as long-term equity and debt security investments other than domestic government obligations, generally will not qualify for any available exclusion or exemption from the proprietary trading prohibition. Because the Accounting Prong would result in automatically requiring that FVO positions be in the trading account (in effect prohibiting the activity unless an exclusion or exemption is available), banking entities would have strong incentives not to elect the FVO. This is a negative and perverse consequence of the Accounting Prong, given that FVO elections often help to enhance transparency in financial reporting and risk management practices.

The Accounting Prong would also create a potential for disparate "trading account" treatment among two banking entities holding the same financial instrument with the same objective solely because one banking entity elected the FVO. For the banking entity electing the FVO, the financial instrument would be included in the "trading account" and, therefore, prohibited (absent an available exclusion or exemption), and for the other banking entity, the financial instrument would be permissible (assuming it

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59 *See* FASB, ASC 825-10 (Financial Instruments – Objectives (Fair Value Option); *see also* FASB, *FASB Standard Establishes Fair Value Option for Financial Assets and Liabilities – Standard Seeks to Reduce Complexity and Improve Relevance of Financial Statements* (Feb. 15, 2007), *available at* https://www.fasb.org/news/nr021507.shtml (last visited October 16, 2018).

60 *See supra* note 17.

were not otherwise recorded at fair value on a recurring basis) and not subject to the proprietary trading prohibition because it chose a different accounting treatment. The deterrent effect of the Accounting Prong could also negatively impact banking entities' risk management practices because in some cases the FVO is elected because the underlying financial instruments are risk-managed on a fair value basis.

8. The proposed P&L presumption would not provide banking entities with any meaningful relief from the adverse effects of the Accounting Prong.

The agencies have proposed a "one-size-fits-all" $25 million absolute daily profit and loss presumption (the "**P&L Presumption**")[61] for trading desks that are not covered by the MRC or Dealer Prongs.[62] The requirement in the P&L Presumption to both calculate and monitor unrealized gains or losses in long-term investment positions newly-captured by the Accounting Prong, regardless of the length for which they are held, runs directly counter to the statutory focus on capturing short-term trading activities. Moreover, the P&L Presumption may actually increase the compliance burden for any banking entity that could rely on it because the presumption adds a new and complex daily calculation requirement that must reflect realized and unrealized gains and losses since the previous business day for all financial assets recorded at fair value on a recurring basis (including those that are not typically subject to daily profit-and-loss calculations), based on the banking entity's fair value for financial instruments for the preceding 90-calendar-day period.

The P&L Presumption also is unlikely to be available in practice due to its arbitrary and impractically low threshold. For example, a trading desk engaged in ALM activities for the bank that is not subject to the MRC or Dealer Prongs may wish to avail itself of the P&L Presumption for activities newly captured by the Accounting Prong. However, the P&L Presumption is unlikely to be available for even moderately-sized institutions because it is not appropriately calibrated to accommodate an institution's ALM activities and the associated value fluctuations that would be generated by ordinary course volatility in interest rates or credit spreads, which also could cause the book to cross the $25 million threshold on a regular basis.

Historical analysis of movements in basic securities illustrates the extent to which the P&L Presumption is unworkable. Our analysis of the data demonstrates that a modest portfolio of approximately $235 million of 5-year U.S. Treasuries (a portfolio smaller than almost all banking organizations subject to the Volcker Rule would maintain) would exceed the $25 million threshold

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61 Proposed Rule § __.3(c).

62 NPR at 33449 ("The Agencies propose to include a presumption of compliance with the proposed rule's proprietary trading prohibition based on an objective, quantitative measure of a trading desk's activities . . . [T]he presumption of compliance would limit the expansion of the definition of 'trading account' to include—unless the presumption is rebutted—only the activities of a trading desk that engages in a greater than de minimis amount of activity (unless the presumption is rebutted) . . . . The proposed presumption would not be available for trading desks that purchase or sell positions that are within the trading account under the market risk capital prong or the dealer prong. The Agencies are not proposing to extend the presumption of compliance to activities of banking entities that are included under the market risk capital prong or the dealer prong because, based on their experience implementing the 2013 final rule, the Agencies believe that these two prongs are reasonably designed to include the appropriate trading activities.").

approximately 50% of the time in a rolling 90-day calendar period.[63] Similarly, credit spread movements in a rolling 90-calendar-day period would also cause a portfolio of approximately $570 million of 5-year floating rate investment grade AFS debt securities to exceed the $25 million threshold 50% of the time.[64] This threshold clearly was not developed with reference to the size of the securities portfolios that would be captured by the Accounting Prong or the role that these portfolios play in managing structural interest rate risk.

9. Rather than adopt the Accounting Prong, the agencies should revise the Final Rule's "trading account" definition to be more consistent with the underlying policy objectives of the statute.

Although we understand and appreciate the desire for a simple and bright-line measure for determining purchases and sales of financial instruments that are for the "trading account," the benefits of a bright-line and simple test in the present case are outweighed by the significant negative consequences of the Accounting Prong's overbreadth. We, therefore, urge the agencies not to adopt the Accounting Prong.

Instead, to better serve the underlying purposes of the statute and the agencies' goal of simplification in applying the Final Rule, the agencies should revise the "trading account" definition to more directly address the differences among banking entities and the ease with which trading account determinations could be made in light of other bank regulatory requirements to which they are subject. We believe that it is appropriate to distinguish among banking entities based on whether or not they are subject to the MRC rule. Specifically, the agencies should amend the "trading account" definition to apply only the MRC Prong and the Dealer Prong (modified as described below) to banking entities that are subject to the MRC Rule.

For banking entities that are not subject to the MRC rule, we recommend the adoption of a two-part "trading account" definition. First, these banking entities would be subject to the same version of the Dealer Prong that applies to MRC firms. For the second prong applicable to non-MRC firms, we propose two alternatives. The first alternative is a modified version of the Short-Term Intent Prong that: (i) eliminates in its entirety the 60-Day Rebuttable Presumption; (ii) incorporates a presumption that financial instruments held for longer than 60 days or, in the case of financial instruments that have an original maturity or remaining maturity upon acquisition of fewer than 60 days, to their stated maturities will not be treated as for the "trading account" (the "**Revised Presumption**"); and (iii) for financial instruments held for fewer than 60 days, provide for a consultative process as described below. The second alternative is a test that incorporates the Revised Presumption and the consultative process, and encompasses only purchases and sales of financial instruments for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits (the "**Trading Position Prong**"). Each of these alternatives is described in more detail below.

Regardless of the approach the agencies decide to take, we believe that any third prong of the "trading account" definition included in the amended Final Rule should incorporate definitions and standards that are determined by the agencies themselves and not a third party, such as FASB, as well as

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63 Based on publicly available data on Bloomberg.com over a 15-year lookback period.

64 Based on publicly available data on Bloomberg.com over a 15-year lookback period. Analysis used the spread over UST of the investment grade credit JULI 5-7yr index.

the Revised Presumption and consultative process for financial instruments held for fewer than 60 days. In particular, the Revised Presumption is critical to ensuring that whatever "trading account" definition the agencies adopt is correctly limited to the short-term trading activities contemplated by Section 13 of the BHC Act.

i. Proposal for MRC Firms

a. The MRC Prong

The agencies should retain the Final Rule's MRC Prong, which applies to the purchase or sale of financial instruments that are both covered positions and trading positions under the MRC rule.[65] As the agencies observed in the Final Rule's Preamble, the MRC prong is appropriate because it "reinforces the consistency between governance of the types of positions that banking entities identify as 'trading' for purposes of the [MRC rule] and those that are trading for purposes of the [Final Rule]" and reduces the "compliance burden on banking entities with substantial trading activities by establishing a clear, bright-line rule for determining that a trade is within the trading account."[66] We agree with the agencies that the MRC Prong is reasonably designed to include the trading activities that Congress intended the Volcker Rule to capture and that, since the adoption of the Final Rule, the interpretation of the MRC Prong has been relatively straightforward and clear in practice for most banking entities.[67] We, therefore, support retaining the Final Rule's MRC Prong for those banking entities subject to the MRC rule, consistent with the Proposed Rule.

b. The Dealer Prong

The agencies should also retain the Dealer Prong for banking entities subject to the MRC rule, but clarify that certain activities are not considered to be entered into by a banking entity in its capacity as a dealer and, therefore, are not captured by the Dealer Prong. Under the Dealer Prong, a financial instrument is considered for the "trading account" if it is purchased or sold by a banking entity that is registered as a broker-dealer, municipal securities dealer, government securities dealer, swap dealer or security based-swap dealer, to the extent that the financial instrument is purchased or sold in connection with activities that require registration.[68] This has been interpreted in some cases to require an analysis of every position booked to a dealer entity's balance sheet, regardless of trading or investment purpose or the length of time for which the dealer has held the investment. This reading of the Dealer Prong could require, in effect, a time-consuming and costly analysis of whether financial instruments that a dealer holds would require it to be registered. This is not an analysis done in the ordinary course for any other purpose, and in some cases, there is not an exemption or exclusion from dealer registration that clearly accommodates certain positions. Likewise, outside the United States, where dealing and commercial

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65 79 Fed. Reg. 5535, 5548. *See also supra* note 46.

66 79 Fed. Reg. at 5548–49.

67 NPR at 33438, 33449.

68 Proposed Rule § _.3(b)(2).

banking activities can occur within a single foreign bank, the analysis of whether an investment position is subject to the Dealer Prong is complicated if U.S.-related standards are required to be applied.[69]

To more appropriately tailor the Dealer Prong to the statute's focus on short-term principal trading, the agencies should clarify that only those financial instruments or activities that are required to be held or conducted by a registered dealer and held as part of, or to hedge risks associated with, its dealing inventory, are included in the definition of "trading account" under the Dealer Prong (*e.g*., dealing and underwriting positions). Examples of financial instruments or activities that are not conducted by a banking entity in its capacity as a dealer can include: (i) stock that a dealer is required to own as a member of an exchange and (ii) long-term investment activities that can be conducted by a dealer entity without a license outside its broker-dealer (including long-term investments by foreign banks in their capacity of providing financing to customers).

ii. Proposal for Non-MRC Firms

a. The Revised Short-Term Intent Prong

We believe that the most appropriate additional "trading account" prong for banking entities that are not subject to the MRC rule is a modified Short-Term Intent Prong as described below. The Short-Term Intent Prong[70] generally aligns with the statutory definition of "trading account" and is based on the purpose of a purchase or sale being for short-term principal trading or profiting from short-term price movements. Although there have been difficulties applying the Short-Term Intent Prong,[71] its direct alignment with the purpose of the statute make it far preferable to the Accounting Prong. In addition, banking entities and examiners have had several years of experience in applying the Short-Term Intent Prong and, therefore, are familiar with "trading account" determinations under this prong.

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69 In many jurisdictions, the predominant form of financing is done in the form of debt securities rather than bank loans due to market practice, legal restrictions or tax laws. Foreign banks, which are also permitted to deal in securities under foreign banking laws, can be primary investors in debt securities in their capacity as lenders. These investment purchases undergo a credit analysis in a manner comparable to loan underwriting and are held for the purpose of extending credit to clients and not for short-term principal trading or short-term profit intent. Although these purchases represent a core commercial banking activity (*i.e*., the provision of financing to a client), due to the Dealer Prong's overbreadth they have to be analyzed on a case-by-case basis to confirm whether they are for the "trading account" under the Dealer Prong. Moreover, this analysis can be further complicated if the firm, in a separate function, is acting in a trading capacity.

70 Final Rule § _.3(b)(1)(i).

71 NPR at 33438 ("In the experience of the Agencies, determining whether or not positions fall into the short-term intent prong of the trading account definition has often proved unclear [] and, consequently, may result in ambiguity or added costs and delays.").

(1) The 60-Day Rebuttable Presumption and the Revised Presumption

Consistent with the Treasury Report recommendation, the 60-Day Rebuttable Presumption should be eliminated in its entirety.[72] Experience has shown that the 60-Day Rebuttable Presumption is an over-inclusive test for whether a financial instrument should be in the trading account under the Short-Term Intent Prong.[73] In particular, the 60-Day Rebuttable Presumption has been problematic in that it has constrained a variety of *bona fide* ALM and commercial banking activities, such as risk management activities related to mortgage pipelines, FX swaps related to commercial lending and tender option bond liquidity purchases, that otherwise would not be captured by the Short-Term Intent Prong.[74] The 60-Day Rebuttable Presumption also inappropriately captures instruments that have original maturities of fewer than 60 days or are acquired within 60 days of their maturity date. Even if the trade does not otherwise implicate any short-term principal trading or short-term profit concerns, the transaction would nevertheless trigger the 60-Day Rebuttable Presumption. Furthermore, notwithstanding guidance provided in the Final Rule's Preamble,[75] in general, the agencies have not permitted banking entities to rebut the 60-Day Rebuttable Presumption for a group of related transactions or to develop policies and procedures to systematically rebut transactions. The regulatory uncertainty regarding the conditions and process for reliance on the 60-Day Rebuttable Presumption has resulted in some institutions placing artificial restraints on the dynamic management of hedges designed to manage the longer-term risks associated with the institution's balance sheet.

For these reasons, we recommend that the agencies eliminate the 60-Day Rebuttable Presumption and adopt a Revised Presumption for purchases and sales of financial instruments captured by the Short-Term Intent Prong. This would mean that financial instruments held for longer than 60 days or, in the case of financial instruments that have an original maturity or remaining maturity upon acquisition of fewer than 60 days, to their stated maturities are presumed to not be for the "trading account." Consistent

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72 *See* Treasury Report at 74.

73 Treasury Report at 74–75 ("[T]he regulations create a rebuttable presumption that any position held for fewer than 60 days constitutes proprietary trading . . . . The 60-day presumption places the burden on firms to justify the permissibility of their trading, creating undue pressure on compliance programs and leading to excessive conservatism in firms' trading activities. The proprietary trading prohibition should be revised by eliminating the regulations' rebuttable presumption that financial positions held for fewer than 60 days constitute proprietary trading."); NPR at 33510 (noting that "[m]any financial positions are scoped into the trading account automatically due to the 60-day presumption, and banking entities routinely conduct detailed and lengthy assessments of transactions to document that these positions should not be included in the trading account . . . . [E]xperience indicates that there is no clear set of analyses that may be conducted to rebut the presumption and a clear standard for successfully rebutting the presumption has been difficult to establish in practice.").

74 For additional discussion of this issue, please see the TCH Response to the OCC RFI at 10–12, Annex A (Section I).

75 *See* 79 Fed. Reg. 5550, n.166 ("To reduce the costs and burdens of rebutting the [60-Day Rebuttable Presumption], the Agencies will allow a banking entity to rebut the presumption for a group of related positions . . . [t]he Agencies believe this should help address commenters' concerns about the burdens associated with rebutting this presumption.").

with the agencies' stated goals,[76] the Revised Presumption would provide banking entities with greater certainty about which activities are restricted under the proprietary trading prohibition. Unlike the 60-Day Rebuttable Presumption, the Revised Presumption would not capture longer-term and other activities, which do not involve the types of risks that the statutory proprietary trading prohibition was intended to restrict.[77] Moreover, the Revised Presumption would not place an affirmative burden on firms to justify the permissibility of their longer-term trading activities; rather, absent a showing that a banking entity entered into a transaction for a prohibited purpose, a transaction meeting the Revised Presumption's requirements would be permitted.

(2) Consultative Process with Onsite Examination Teams

For financial instruments purchased or sold within 60 days, the agencies should adopt a procedure that provides banking entities the opportunity to consult their primary onsite examination team (or their functional regulator's appropriate supervisory arm) for a determination that certain financial instruments or classes of financial instruments are or were not purchased or sold with short-term principal trading or short-term profit intent and are therefore outside the "trading account." The agencies acknowledged in the NPR that there is a broad range of transactions that banking entities may enter into within a 60-day window to meet regulatory requirements or manage the banking entities' risk that are unlikely to have been executed with any short-term principal trading or short-term profit intent.[78] In conjunction with the adoption of the Revised Presumption, establishing a formal consultative procedure between banking entities and their examiners, and empowering examiners to make these decisions, would significantly reduce the uncertainties with which many banking organizations grapple when analyzing transactions under the Short-Term Intent Prong.

b. The Trading Position Prong

If the agencies determine that the shortcomings of the Short-Term Intent Prong are so problematic as to be fatal, our alternative recommendation for the second prong of the "trading account" definition applicable to non-MRC firms is a test that covers only purchases and sales of financial instruments for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits. This Trading Position Prong would allow non-MRC firms to make their "trading account" determinations based on a standard that is reasonably designed to include the trading activities that Congress intended the Volcker Rule to capture. In addition, for the same reasons stated above, the Trading Position Prong should incorporate the Revised Presumption and the consultative process described above in Sections II.A.9.ii.a(1) and II.A.9.ii.a(2), respectively.

c. The Dealer Prong

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[76] *See supra* note 11.

[77] NPR at 33447 (discussing how the current "trading account" definition with the 60-Day Rebuttable Presumption "may scope in activities that do not involve the types of risks or transactions the statutory definition of proprietary trading appears to have been intended to cover . . . ").

[78] NPR at 33446.

We believe that it is appropriate to apply the revised version of the Dealer Prong described above to banking entities that are not subject to the MRC rule because it would apply in an equivalent manner to all dealer banking entities subject to the Volcker Rule.

B. The agencies should amend certain of the Final Rule's exclusions and exemptions to better align with the policy objectives of the statute.

In addition to modifying the definition of "trading account" as described above, the agencies should refine the existing exclusions and exemptions and adopt additional exceptions from the definition in order to focus the Final Rule's applicability to the type of impermissible short-term trading intended to be prohibited by the statute.

1. We support the Proposed Rule's amendment of the liquidity management exclusion to include FX forwards, swaps and physically settled cross-currency swaps. The exclusion should also be amended to allow banking entities to conduct *bona fide* ALM and liquidity management activities more efficiently within the scope of the exclusion.[79]

We support the Proposed Rule's amendment of the liquidity management exclusion to include FX forwards, FX swaps and physically settled cross-currency swaps because this change recognizes that there are instruments other than securities that are used for *bona fide* liquidity management purposes.[80] However, the exclusion as proposed to be revised continues to be too limited in a number of ways. The revisions described in this section are necessary to permit a broader range of interest rate risk and liquidity management activities than can be conducted in reliance on the exclusion under the Final Rule.

To accommodate the full range of tools that appropriately can be used for liquidity and interest rate risk management, certain of the exclusion's requirements should be clarified or eliminated to enhance the ability of a banking entity to manage risk more efficiently and effectively. First, the agencies should revise the liquidity management exclusion to include (i) all interest rate and FX derivatives, including non-deliverable FX forwards and (ii) investment-grade debt securities permitted under 12 C.F.R. Part 1 and corresponding state authorities that are used for liquidity and interest rate risk management. Using these types of instruments enables banking entities to manage liquidity and interest rate risks in a safe and sound manner.

Second, the exclusion's requirement that the financial instruments purchased and sold by a banking entity in connection with its liquidity management plan be tied to the entity's "near-term funding needs" does not accommodate prudent risk management practices. Liquidity and interest rate risk management is conducted within a broader ALM function that enables a banking organization to meet its on- and off-balance-sheet obligations during both normal and stress periods over short-, medium- and longer-term horizons. For example, as interest rates, credit spreads and other factors change, firms often seek to rebalance their liquidity and credit portfolios to reduce overall risks. Although these purchases and sales may not directly correspond with a banking entity's near-term funding needs, they are nevertheless conducted in connection with a firm's prudent risk management of a liquidity portfolio. The

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79 This section is responsive to Questions 50–51 in the NPR.

80 Proposed Rule § _.3(e)(3).

agencies should, therefore, eliminate this requirement, which would advance the agencies' objective of enabling banking entities to implement risk management policies that promote safety and soundness.

Third, the exclusion's requirement that any position taken for liquidity management purposes be "limited to financial instruments the market, credit and other risks of which the banking entity does not reasonably expect to give rise to appreciable profits or losses as a result of short-term price movements" is a difficult standard to apply and audit. It is unclear how a banking entity could demonstrate that a short-term profit or loss on a position could not have been reasonably expected to occur. Therefore, the agencies should replace this requirement with a requirement that the financial instruments held under the exclusion are not acquired for the purpose of generating appreciable profits or losses as a result of short-term price movements.

Finally, the agencies should eliminate the compliance-related requirements for the liquidity management exclusion and permit banking entities to design and manage their liquidity management function according to their existing internal compliance frameworks, which would be consistent with the agencies' goal of providing banking entities with greater flexibility with regard to Volcker Rule compliance requirements. Similar to the challenges created by Appendix B's overly prescriptive requirements, the liquidity management exclusion's independent testing, analysis and internal controls requirements have proven to be inefficient and duplicative of banking entities' existing compliance regimes and risk management programs. Moreover, the exclusion's requirements present difficulties for banking entities that manage liquidity at both the line-of-business and firmwide levels. Banking entities should be able to design their liquidity management function according to the structure and activities of their organizations rather than the exclusion's prescriptive requirements.

2. We welcome the proposed changes to the risk-mitigating hedging exemption. However, the agencies can further reduce the costs and uncertainty associated with relying on this exemption by removing its redundant enhanced documentation requirements and providing that banking entities can rely on analyses and documentation prepared for other existing processes to demonstrate compliance with the exemption.[81]

The requirements associated with the Final Rule's risk-mitigating hedging exemption have been widely recognized as being overly prescriptive, cumbersome and unnecessary for sound and efficient risk management.[82] We support the Proposed Rule's (i) eliminating the current requirement that the hedging

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[81] This section is responsive to Questions 120–121 in the NPR.

[82] *See, e.g.*, Treasury Report at 76 ("The Volcker Rule appropriately exempts risk-mitigating hedging transactions from the proprietary trading prohibition. However, the compliance program and documentation requirements that banks must comply with under the regulations to avail themselves of the exemption are unnecessarily burdensome . . . . [B]anks should be required to monitor risks as part of their standard business practice and should be responsible for taking reasonable action to mitigate material new risks that develop over time including from existing positions. Further, the requirement to maintain documentation of the specific assets and risks being hedged is overly burdensome and should be eliminated."); SIFMA Response to the OCC RFI, at A-16 (Sept. 21, 2017) ("The approach to the permitted activities taken by the Volcker Agencies has contributed to the chilling effect on financial intermediation and [the] negative impact on liquidity [] and [] significant compliance costs []. The exemptions in the implementing regulations are unnecessarily complex and limiting . . . . Risk-mitigating hedging activity should include

activity "demonstrably reduces" or otherwise "significantly mitigates" risks, (ii) eliminating the existing requirement that banking entities conduct correlation analyses regarding their hedges and (iii) streamlining the requirements with respect to banking entities with moderate or limited TALs.[83]

With regard to the exemption's documentation requirements,[84] rather than merely reducing the requirements associated with documenting risk-mitigating hedging transactions conducted by one desk to hedge positions at another desk with pre-approved types of instruments within preset hedging limits as the NPR suggests,[85] the agencies should eliminate the enhanced documentation requirements altogether as these are unnecessary in light of the Proposed Rule's robust compliance framework. To further enhance the exemption's utility and help ease the compliance burden associated with it, the agencies should clarify in the commentary to the Final Rule that banking entities may rely on analyses and documentation that demonstrates hedge effectiveness prepared in connection with other internal processes to demonstrate compliance with the risk-mitigating hedging exemption.

3. We support the agencies' proposal to add an exclusion from the definition of "proprietary trading" for loan-related swaps to provide banking entities with greater certainty that these transactions would not be viewed to be impermissible proprietary trading.[86]

Loan-related swaps are client-driven transactions in which a banking entity enters into a swap with a client in connection with the client's loan from the banking entity and then hedges the related risks, including through a back-to-back swap with a third party. As a result, the client achieves its preferred economics (*e.g.*, a fixed-rate rather than floating-rate loan) and the banking entity offsets the market risk associated with the client-facing swap.[87] As noted in the NPR, a banking entity's "decision to enter into loan-related swaps tends to be situational and dependent on changes in market conditions, as well as the interaction of a number of factors specific to the banking entity, such as the nature of the client relationship."[88] Given that banking entities, particularly those with less trading activity,[89] in practice

any activity through which a banking entity hedges or mitigates existing or anticipated specific risks, on an individual or portfolio basis, as it reasonably deems appropriate. Satisfaction of this requirement is sufficient proof that the activity is legitimate hedging. The remainder of the requirements in the implementing regulations for [] risk-mitigating hedging permitted activities that go beyond these core components should be removed.").

83 NPR at 33465–67.

84 Proposed Rule § _.5(c).

85 NPR at 33465–67.

86 This section is responsive to the agencies' request for comment in the NPR at 33534 and Questions 101 and 104 in the NPR.

87 NPR at 33462–63.

88 NPR at 33463.

89 NPR at 33464, n.123 ("The Agencies understand that [] loan-related swaps present a particular challenge for smaller banking entities that are neither subject to the market risk rule nor registered as dealers. On the other hand, such swaps typically do not present the same challenges for banking entities that are subject to

primarily make a market in these swaps only in one direction,[90] some banking entities have faced uncertainty as to whether client loan-related swaps and offsetting hedging swaps would be permissible under the exemption for market-making related activities—specifically, whether this activity could satisfy the exemption's requirement that the trading desk using the exemption routinely stands ready to purchase and sell the relevant type of financial instrument, in commercially reasonable amounts and throughout market cycles on a basis appropriate for the liquidity, maturity, and depth of the market for the type of financial instrument. These entities have also faced uncertainty as to whether they may rely on the market-making exemption when providing derivative products to customers only upon request or in limited volumes. Accordingly, we support the agencies' proposal to adopt an exclusion for loan-related swaps to accommodate the issues some banking entities face in connection with their customer lending activities and customer-driven derivative transactions and related hedges.

If an exclusion for loan-related swaps is not adopted, the agencies should revise the market-making exemption[91] to clarify that these activities are permitted under that exemption, including in connection with the establishment of a new trading desk or business. In the Final Rule's Preamble, the agencies stated that, in adopting the market-making exemption, they strived to balance "two goals of section 13 of the BHC Act: [t]o allow market making, which is important to well-functioning markets as well as to the economy, and simultaneously to prohibit proprietary trading, unrelated to market making or other permitted activities, that poses significant risks to banking entities and the financial system."[92] The agencies also stated that a "flexible approach to this exemption is appropriate because the activities a market maker undertakes to provide important intermediation and liquidity services will differ based on the liquidity, maturity, and depth of the market for a given type of financial instrument . . . [t]he statute specifically permits banking entities to continue to provide these beneficial services to their clients, customers, and counterparties."[93] Although these loan-related swaps infrequently occur in both directions because of how they are typically used by market participants, these transactions are nevertheless beneficial to (and are directly requested by) clients, and banking entities that seek to rely on this exemption would stand ready to execute loan-related swaps upon an appropriate client request and otherwise meet the conditions of the exemption.

III. Covered Funds Provisions

This section discusses the changes to the covered funds provisions that we believe are necessary in order to foster economic growth and mitigate negative impacts on commercial banking and asset

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the market risk rule or are registered as dealers because the availability of the market-making exemption is apparent.").

90 NPR at 33463. ("[T]he Agencies note that a banking entity may also infrequently enter into loan-related swaps in both directions because of how those swaps are commonly used by market participants. For example, providing a floating to fixed swap is common in connection with a floating rate loan [], but the reverse (i.e., seeking to convert from a fixed rate to a floating rate) is much less common.").

91 Proposed Rule § _.4(b).

92 79 Fed. Reg. at 5576.

93 79 Fed. Reg. at 5576.

management activities.[94] We agree with the Treasury Report's statement that the Final Rule's covered fund provisions "are not well-tailored to meet [the] objectives" of the Volcker Rule[95] and welcome the opportunity to comment on many aspects of the covered funds provisions that the agencies highlighted in the NPR.

The exclusions to the definition of "covered fund" are too narrowly drawn to avoid capturing many vehicles that are used by banking entities to offer traditional commercial banking, asset management and custodial services to customers. Therefore, our recommendations in this Section III focus on targeted revisions to certain of the Final Rule's exclusions from the "covered fund" definition and certain other covered funds-related provisions that would permit these activities and align the Volcker Rule more closely with its intended purposes.[96]

A. The agencies should refine certain of the Final Rule's existing exclusions and exemptions from the "covered fund" definition and provide for additional ones to enable banking entities to engage in permissible activities that are not intended to be captured by the Volcker Rule's covered funds prohibition.[97]

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94 *See*, *e.g*., NPR at 33545 ("[T]he covered fund definition in the implementing rules is broad, and some have argued that the rules currently in place may limit the ability of banking entities to conduct traditional asset-management activities and to promote capital formation."); *see also* OCC RFI at 36696 (recognizing that the covered fund definition "may apply more broadly than necessary to achieve the Volcker Rule's purposes" and acknowledging that "[s]ome have suggested that, notwithstanding the exclusions currently provided, the [definition of 'covered fund'] continues to include within its scope many issuers that were not intended to be covered by [the Volcker Rule]."), *available at* https://www.gpo.gov/fdsys/pkg/FR-2017-08-07/pdf/2017-16556.pdf.

95 Treasury Report at 77.

96 In determining the ultimate scope of what is captured in the "covered fund" definition, it is important to note that we disagree with the agencies' statement that the Volcker Rule "contemplates that the covered fund definition would include funds that make longer-term investments" because of the statute's inclusion of an extended transition period for illiquid funds. NPR at 33479. The "illiquid funds" provision was not adopted for the purpose of defining the scope of the "covered fund" definition; rather, it was included in the statute to allow banking entities to appropriately time the divestiture of investments in, or the conformance of activities involving, certain private equity or similar funds in accordance with Volcker Rule requirements before the scope of the definition of covered funds was known fully. We respectfully believe that the illiquid funds provision should not serve as a substitute for the agencies' need to carefully tailor the covered funds provisions.

97 This section is responsive to Questions 132–133 and 136 in the NPR.

1. To reduce the inequitable disparity in treatment between FPFs and U.S. RICs, the FPF exclusion should be revised to: (i) cover expressly (a) any non-U.S. fund that is qualified to be offered to non-U.S. retail investors in one or more jurisdictions in which it is subject to substantive disclosure and retail investor protection regulation or (b) that is listed on an internationally-recognized exchange; (ii) amend the home jurisdiction requirement to allow foreign funds to qualify for the exclusion if they are authorized to be publicly offered only in jurisdictions other than their jurisdictions of organization; (iii) eliminate the burdensome "predominance" requirement; (iv) eliminate the director/employee ownership limitation; and (v) align the ownership interest limitation in sponsored FPFs with the RICs limits.[98]

The Final Rule excludes from the definition of "covered fund" any "foreign public fund," but significantly limits the exclusion by imposing a number of conditions, some of which are overly narrow or difficult to apply. A FPF must be organized or established outside the United States and the ownership interests of the fund must be (i) authorized to be offered and sold to retail investors in the issuer's home jurisdiction and (ii) sold "predominantly" through one or more public offerings outside the United States.[99] "Public offering," in turn, is limited to a distribution of securities in "any jurisdiction outside the United States to investors, including retail investors, provided that: (A) [t]he distribution complies with all applicable requirements in the jurisdiction in which such distribution is being made; (B) [t]he distribution does not restrict availability to investors having a minimum level of net worth or net investment; and (C) [t]the issuer has filed or submitted, with the appropriate regulatory authority in such jurisdiction, offering disclosure documents that are publicly available."[100] In addition, the Final Rule provides that the exclusion is not available to a U.S. banking entity with respect to a FPF that it sponsors unless the fund's interests are sold "predominantly" to persons other than the sponsoring banking entity, the issuer, and their affiliates, directors and employees.[101]

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98 This section is responsive to Questions 140–141, 144–147 and 150–153 in the NPR.

99 Final Rule § _.10(c)(1).

100 Final Rule § _.10(c)(1)(iii).

101 Final Rule § _.10(c)(1)(ii).

Contrary to the agencies' stated rationale underlying this exclusion[102] and their intent to minimize disparate extraterritorial impact,[103] certain non-U.S. funds that are substantially similar to U.S. RICs may nonetheless be treated as covered funds because of these overly prescriptive requirements of the current FPF exclusion. This disparate treatment creates market disruption and a competitive imbalance for no apparent policy reason. Even where a FPF is in fact eligible for the exclusion, banking entities have been required to engage in costly diligence on factors that are unrelated to the underlying fund's eligibility in order to reach this determination.

To increase the utility of the FPF exclusion, enhance consistency in the treatment of U.S. RICs and foreign retail funds under the Volcker Rule and provide clearer guidance on the scope of the FPF exclusion, the exclusion should be modified in the following ways:

- Scope: In order to align the conditions imposed on FPFs with those applicable to U.S. RICs, the FPF exclusion should be extended to non-U.S. funds that are qualified to be offered to retail investors in one or more non-U.S. jurisdictions in which the fund is subject to substantive requirements and regulation under retail investor protection and disclosure laws. Moreover, non-U.S. funds that are listed on an internationally-recognized exchange should be presumed to qualify for the exclusion. These types of bright-line standards would help to eliminate uncertainty surrounding the exclusion's availability to foreign funds that are similar to U.S. RICs and that should, therefore, benefit from the same clear exclusion.[104]

- Home Jurisdiction Requirement: The exclusion's "home jurisdiction" requirement[105] is problematic because a fund that is otherwise similar to a U.S. RIC and meets all other conditions of the exclusion nevertheless may not rely on the exclusion if the fund is authorized to be publicly offered only in jurisdictions other than its home jurisdiction of organization. As the agencies recognize, however, in practice it is not unusual for foreign retail funds to be organized in one jurisdiction and be authorized under local law to be sold to

102 The Final Rule's Preamble and multiple FAQs demonstrate that the agencies intend for FPFs to be treated similarly to U.S. RICs. 79 Fed. Reg. 5535, 5673 (the FPF exclusion was "designed to prevent . . . the definition of covered fund from including foreign funds that are similar to U.S. registered investment companies"); 79 Fed. Reg. 5535, 5678 ("the foreign public fund exclusion is designed to treat foreign public funds consistently with similar U.S. funds"); FAQ #14 (the FPF exclusion's requirements "were designed to mirror the characteristics of U.S. mutual funds that are outside the applicability of [the Volcker Rule] . . . . [b]y referring to characteristics common to publicly distributed foreign funds rather than requiring that foreign public funds organize themselves identically to U.S. mutual funds or other types of U.S. regulated investment companies, the [Final Rule] recognized that foreign jurisdictions have established their own frameworks governing the details for the operation and distribution of foreign public funds.").

103 79 Fed. Reg. 5678 (the agencies explained that the FPF exclusion was "designed to treat foreign public funds consistently with similar U.S. funds and to limit the extraterritorial application of [the Volcker Rule], including by permitting U.S. banking entities and their foreign affiliates to carry on traditional asset-management businesses outside of the United States.").

104 *See* Final Rule § _.10(c)(12).

105 Final Rule § _.10(c)(1)(i)(B).

retail investors in other jurisdictions.[106] For example, a fund may be domiciled in the Cayman Islands due to tax considerations and qualify for registration and distribution in other jurisdictions, such as Japan, where market interest is greater and the fund is seeking investors, or be domiciled in an EU jurisdiction where it is eligible for passporting rights so that it has flexibility to make distributions in multiple markets. The home jurisdiction limitation, therefore, greatly reduces the utility of the exclusion for many FPFs that should qualify for the exclusion but are not authorized to be sold to retail investors in their home jurisdiction due to structural and other client-driven preferences.

The agencies indicated that one of the core rationales underlying this limitation is that retail investors should benefit from "the full protection of securities laws in the home jurisdiction of the fund."[107] A fund that is authorized under local law to be sold to retail investors in other jurisdictions, however, must comply with those other jurisdictions' securities laws and, therefore, investors in those other jurisdictions should benefit from those protections. Requiring a fund to be registered in its home jurisdiction even if the fund is not authorized to be sold to retail investors in that jurisdiction serves no investor protection rationale. If a foreign retail fund conducts its public offerings consistent with local securities laws and otherwise complies with the FPF exclusion's requirements, then denying such a fund the benefit of the FPF exclusion undermines the agencies' goal of excluding funds that are sufficiently similar to U.S. RICs from the covered fund definition.[108]

- <u>"Predominance" Requirement</u>: The requirement that a FPF be sold "predominantly" through one or more public offerings outside the United States poses a range of compliance and monitoring challenges.[109] A banking entity may have limited visibility into the historical distribution strategy of a fund or the composition of its investor pool and may not be able to monitor how these facts could change in the future, in particular where a fund is sponsored by a third party and/or is listed on an exchange. Even in the case of a banking entity's sponsored fund, interests in such funds are customarily sold through third-party intermediaries and

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106 *See* NPR at 33474–75 ("The Agencies understand that some funds may be formed under the laws of one non-U.S. jurisdiction, but offered to retail investors in another. For example, Undertakings for Collective Investment in Transferable Securities [] funds and investment companies with variable capital, or SICAVs, may be domiciled in one jurisdiction in the European Union, such as Ireland or Luxembourg, but may be offered and sold in one or more other E.U. member states. In this case a foreign fund could be authorized for sale to retail investors, as contemplated by the FPF exclusion, but fail to satisfy this condition.").

107 79 Fed. Reg. 5678.

108 *See supra* note 102.

109 The agencies stated in the Final Rule's Preamble that they generally expect that an offering is made predominantly outside the United States if 85% or more of the FPF's interests are sold to investors that are not residents of the United States. 79 Fed. Reg. at 5678; *see also* NPR at 33475 ("The Agencies understand that some banking entities have faced compliance challenges in determining whether 85 percent or more of the fund's interests are sold to investors that are not residents of the United States. Where foreign funds are listed on a foreign exchange, for example, it may not be feasible to obtain sufficient information about a fund's owners to make these determinations. The Agencies understand that banking entities also have experienced difficulties in obtaining sufficient information about a fund's owners in some cases where the foreign fund is sold through intermediaries.").

distributors, and the precise pattern of distribution will depend on investor interest and market trends. The sponsoring banking entity therefore may not have the practical ability to quantify the extent to which the fund was actually sold in non-U.S. public offerings rather than private placements. This is also true of many U.S. RICs—however, the covered fund exclusion for RICs[110] imposes no such requirements to monitor the manner of distribution of U.S. RICs or assess, either retrospectively or prospectively, the extent to which the fund was sold in private placements in any particular jurisdiction. Therefore, the exclusion's "predominance" requirement should be eliminated to create the parity that the agencies sought.

- <u>Employee & Director Ownership Limitations</u>: The 15% limit on ownership of interests in a U.S. banking entity-sponsored FPF by the banking entity's directors and employees (including their immediate family members) is inconsistent with the treatment of U.S. RICs. This requirement has proven to be extremely difficult to monitor because, like U.S. RICs, FPFs are often offered through dispersed networks of third-party intermediaries and distributors and sometimes exchange-traded. By contrast, a U.S. banking entity and its affiliates generally may own up to 25% of a RIC that it sponsors with no restriction placed on director or employee investment.[111] The agencies should therefore eliminate the employee and director ownership requirement to alleviate the monitoring challenges described above. Removing this requirement would also reduce inconsistencies between the agencies' stated intent[112] and the current exclusion, which creates unwarranted disparity between the treatment of U.S. RICs and FPFs without furthering any meaningful policy objective and places U.S. banking entities at a competitive disadvantage relative to non-U.S. banking entities.

- <u>Align with RIC Ownership Limits</u>: The exclusion also creates disparity between FPFs and RICs because a U.S. banking entity can own up to 25% of a RIC after the seeding period, but only 15% of a FPF that it sponsors. This outcome is inconsistent with the objective of according similar treatment to FPFs and RICs and creates a competitive disadvantage for U.S. banking entities subject to this 15% ownership limitation. The agencies should provide that a FPF would not be considered to be an affiliate of a banking entity so long as the banking entity owns less than 25% of the fund's interests after the permissible seeding period.

Adopting these proposed changes would help to make banking entities' investments in and sponsorship of FPFs subject to the same requirements under the Volcker Rule as RICs. These modifications would reduce disparate extraterritorial impact and compliance burden while still accomplishing the Final Rule's purpose.

2. The agencies should exclude from the definition of "covered fund" a single investor structure (or structures for a single group of affiliated investors)

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110 Final Rule § _.10(c)(12).

111 Investment in RICs by the employees of the investment manager is expressly contemplated under U.S. securities laws and is acknowledged as a means of promoting incentive alignment, to the benefit of investors. *See, e.g.*, SEC, *Disclosure Regarding Portfolio Managers of Registered Management Investment Companies*, 69 Fed. Reg. 52788, 52792 (Aug. 27, 2004) (observing that disclosure of a portfolio manager's ownership provides "a direct indication of his or her alignment with the interests of shareholders in that fund.").

112 *See supra* note 102.

from the definition of "covered fund" to provide banking entities with greater flexibility when structuring transactions on behalf of clients.

The agencies should provide an exclusion from the covered fund definition for structures established by banking entities for a client. Because of the Final Rule's broad definitions of "covered fund," "sponsor" and "ownership interest," and the application of Super 23A, a banking entity's flexibility to structure transactions to accommodate clients' commercial preferences is severely limited under the Final Rule. These structures are used to create client-facing products that a banking entity could offer to the client directly. If a banking entity is (or could be) deemed to sponsor, advise or manage, or hold an ownership interest in, a client facilitation structure, the Final Rule could proscribe or restrict the client's desired trading or lending transaction, even though the entity structure is used to facilitate a transaction that could have been provided to the client directly.

As an example, many clients, in particular non-U.S. clients, prefer to face an entity structure rather than a banking entity to facilitate their trading and lending transactions for a variety of legal, counterparty risk management and accounting reasons. A client may desire, for example, to face a counterparty whose sole assets are the collateral for the transaction or a counterparty within a specific jurisdiction for tax or foreign investment restrictions purposes. Similarly, to obtain a desired exposure, a client may prefer to receive a note issued by a structure (that in turn enters into a swap transaction with a banking entity) rather than entering into a swap directly with a banking entity. In cases where an entity (rather than a separate account) is used, it also provides clients with a unitized pool of assets with a single net asset value, which allows for aggregate performance monitoring when a client does not have the operational infrastructure or expertise to monitor or analyze classes of securities held in a separate account. In contrast to hedge funds or private equity funds, these structures are not offered to a broader set of investors as an investment product; rather they are used to facilitate a transaction with a single client (or a single group of affiliated clients), which is a standard means of investing in certain markets, such as Brazil, Germany, Hong Kong and Japan, among others.

The legislative history of the Volcker Rule and the agencies' statements in connection with implementing the statute make clear that the rule was not intended to disrupt client services.[113] Providing traditional commercial banking services in a structure to facilitate the client's objectives does not implicate the restrictions that Congress sought to impose in enacting the Volcker Rule—namely, the restriction of banking entities' ability to engage, as principal, in proprietary trading and investing in and

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113 *See, e.g.*, 156 Cong. Rec. H5224 (daily ed. June 30, 2010) (statement of Rep. Perlmutter) ("[The Volcker Rule] strikes a good balance in banning proprietary trading without disrupting client services and asset-management."); *see also* Final Rule's Preamble at 5541 ("The Agencies have designed the final rule to achieve the purposes of section 13 of the BHC Act, which include prohibiting banking entities from engaging in proprietary trading or acquiring or retaining an ownership interest in, or having certain relationships with, a covered fund, *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 for businesses of all sizes, households and individuals, and that facilitate liquid markets. These client-oriented financial services, which include underwriting, market making, and asset management services, are important to the U.S. financial markets and the participants in those markets*.") (emphasis added).

engaging in certain relationships with hedge funds and private equity funds.[114] The provision of ordinary course, client-driven commercial banking products does not involve any prohibited proprietary trading or investment by the banking entity nor does the banking entity face reputational harm of the type that could arise if the banking entity's sponsored investment fund were to suffer losses. In addition, a banking entity may hold a non-economic interest in a customer facilitation structure solely to enforce protective provisions, such as veto rights to protect the structure's collateral and, therefore, face uncertainty as to whether it holds an impermissible ownership interest. In effect, the banking entity is executing the same type of trade that the client could do directly but for the client's preference to use this type of structure. These structures would, therefore, not raise bail out concerns any more than a banking entity offering commercial banking products to clients directly. Moreover, the fact that these structures sometimes have an asset composition that could trigger the application of the Investment Company Act and, thereby, the Volcker Rule (and, in particular, its Super 23A provisions),[115] is not a result of banking entities' attempt to evade the proprietary trading restrictions, but rather reflects client preferences and client-driven formation and capitalization activities.

Imposing limitations on the activities of these types of structures by treating them as covered funds serves only to limit the products and services that clients may obtain from banking entities without furthering the statutory purposes of the Volcker Rule. The agencies should, therefore, provide for an exclusion from the covered fund definition for structures for a single investor (or a single group of affiliated investors). Moreover, the exclusion could incorporate conditions that are factually representative of how client facilitation structures operate in practice, such as requiring that a banking entity not guarantee or insure expressly the entity or its obligations in any way that would legally require the banking entity to "bail out"[116] the client facilitation structure and that the banking entity observe the market terms requirement of Section 23B of the Federal Reserve Act[117] when transacting with the client facilitation structure.

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114 *See*, *e.g.*, 156 Cong. Rec. S5895 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("The new Bank Holding Company Act section 13 also restricts investing in or sponsoring hedge funds and private equity funds. Clearly, 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.").

115 For example, there is uncertainty as to whether a banking entity may be deemed to sponsor or act as an adviser to a client facilitation structure where it serves as a trustee or organizes a structure at the client's request. Therefore, even in cases where banking entities are clearly acting at the request of a client, they face uncertainties as to the Super 23A status of certain client facilitation structures that may frustrate the entire purpose of the structure.

116 It should nevertheless be clarified that a banking entity's provision of ordinary course market risk products at the request of a client to achieve the client's desired risk exposure should not be deemed to implicate any bail out concerns.

117 *See* 12 U.S.C. § 371c–1 ("A member bank and its subsidiaries may engage in any [permissible transaction] only [] (A) on terms and under circumstances, including credit standards, that are substantially the same, or at least as favorable to such bank or its subsidiary, as those prevailing at the time for comparable transactions with or involving other nonaffiliated companies, or (B) in the absence of comparable transactions, on terms and under circumstances, including credit standards, that in good faith would be offered to, or would apply to, nonaffiliated companies.").

3. The agencies should provide for an exclusion from the definition of "covered fund" for family wealth management vehicles because these entities do not implicate the types of activities or risks that the Volcker Rule was intended to restrict.[118]

Family wealth management vehicles are a valuable tool for many clients seeking to make independent financial decisions and informed choices in the marketplace, save for retirement, achieve estate planning objectives and build individual and family wealth. Banking entities may assist clients in achieving these objectives by providing family wealth management vehicles with investment advisory and related services, as well as ordinary course extensions of credit, including on an intraday basis for the settlement and clearance of securities transactions.

There is, to our knowledge, no evidence of any statutory or regulatory intent that the Volcker Rule should restrict the provision of ordinary course banking transactions and related services in the context of a family wealth management business. Rather, it is clear from the legislative history that the Volcker Rule was intended to accommodate banking entities' traditional asset management business.[119, 120]

Nevertheless, as the agencies acknowledged in the NPR, the Final Rule has left uncertainty as to whether certain family wealth management vehicles may be covered funds and, therefore, whether a banking entity that serves as a family wealth management vehicle's investment adviser, investment manager or sponsor (*e.g.*, by acting as trustee with investment discretion) may be prohibited under Super 23A from engaging in any "covered transaction" with the vehicle.[121] As a result of this uncertainty, the options available to a family wealth management vehicle that seeks investment advisory services and other services related to the facilitation of its investment activities could be restricted by a rule that is intended to restrict banking entities' activities with respect to hedge funds and private equity funds. A family wealth management vehicle treated as a covered fund could, absent an exclusion or exemption, be restricted from obtaining various types of ordinary course services and transactions from a banking entity that serves as investment adviser to the vehicle. These include, for example: (i) borrowing from an

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118 *See supra* notes 113–114. This section is responsive to Questions 155–159 in the NPR.

119 *See* S. Comm. on Banking, Hous., and Urban Affairs, *The Restoring American Financial Stability Act* 74 (Mar. 22, 2010) ("It is not the intent of [the Volcker Rule] to interfere inadvertently with longstanding, traditional banking activities that do not produce high levels of risk or significant conflicts of interest."); 156 Cong. Rec. S5889 (daily ed. July 15, 2010) (statement of Sen. Hagan) (noting with approval that the bill draft reported out of the conference committee had been "modified to permit a banking entity to engage in a certain level of traditional asset-management business").

120 Moreover, the legislative record contains several references to the position that traditional asset-management and investment advisory services are banking activities that are consistent with safety and soundness and subject to fiduciary obligations inherent in those services. *See* 156 Cong. Rec. S6242 (daily ed. July 26, 2010) (statement of Sen. Brown) (commenting that the pre-conference bill draft "would have gone too far in preventing banks from offering appropriate investment services to their clients as a limited and safe part of their business model. . . . Even the Glass-Steagall law clearly permitted banks to serve as investment advisers, and yet the original Volcker rule language threatened the ability of banks to offer these services").

121 NPR at 33476-77. *See* Final Rule § _.14(a)(1).

investment advisory portfolio for temporary liquidity and other purposes; (ii) engaging in securities lending transactions; (iii) conducting transactions with the banking entity on a principal basis (for example, where a client seeks to sell a security to the banking entity); and (iv) seeking custodian or clearing agent services from the banking entity.

In an effort to accommodate client needs and continue to provide ordinary course family wealth management services, banking entities have been forced to conduct burdensome case-by-case Investment Company Act analyses for numerous vehicles.[122] As the agencies acknowledge in the NPR, family wealth management vehicles vary widely in their legal form, degree of complexity and operating history—in short, there is "no set of consistent standards that govern the characteristics of family wealth management vehicles or the manner in which they operate."[123] Banking entities have operated in an environment of significant interpretive uncertainties and logistical burdens with respect to such vehicles, and some firms have sought to manage these challenges by drawing legal conclusions as to the potential "covered fund" status of certain categories of family wealth management vehicles and communicating these conclusions to examiners in order to not impair the asset management services provided to their clients.

To help address these uncertainties and alleviate the compliance burden that the Final Rule has imposed on banking entities, the agencies should provide an express exclusion for family wealth management vehicles from the "covered fund" definition, which would provide a non-exclusive basis for banking entities to determine that family wealth management vehicles are not covered funds.

We note that, even if Super 23A were to be revised to incorporate Section 23A's exemptions (as we recommend in Section III.C), that would not be a sufficient solution to the problems affecting family wealth management vehicles, since many of the types of transactions that banking entities provide to family wealth management vehicles could continue to be captured as covered transactions. For example, certain ordinary course custodian or clearing agency services that banking entities regularly provide family wealth management vehicles, such as overnight extensions of credit, would not meet the requirements of any available exemption in Section 23A and Regulation W or the collateral conditions thereunder. Similarly, a revised Super 23A that substitutes Section 23A's quantitative limits for the current prohibition on covered transactions also would not provide an adequate solution. Banking entities would still be required to conduct entity-by-entity analyses, and further, would need to establish and maintain an infrastructure to monitor the amount of transactions with each family wealth management vehicle that is treated as a covered fund. Therefore, we propose the following exclusion:

_.10(c)([●]) Family wealth management vehicles.

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122 Although some family wealth management vehicles may not fall within the base definition of "covered fund," in practice, banking entities often cannot rely on clients of wealth management services to assist in Investment Company Act determination, as many clients either have not conducted the requisite analysis or do not have the practical ability to do so. Rather, such clients may presume compliance with the requirements of exemptions under Sections 3(c)(1) or 3(c)(7), as these exemptions can be relied upon without adverse consequence outside the Volcker Rule context.

123 NPR at 33476.

(i) Subject to paragraph (ii) below, any entity that is not, and does not hold itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities, and:

(A) if the entity is a trust, the grantor(s) of the entity are family customers; and

(B) if the entity is not a trust, all outstanding ownership interests of the entity are owned directly or indirectly by one or more family customers or up to 10 closely related persons.

(ii) A banking entity may rely on the exclusion in paragraph (c)([●])(i) of this section with respect to an entity only if the banking entity and its affiliates:

(A) do not acquire or retain, as principal, an ownership interest in the entity;

(B) provide bona fide trust, fiduciary, investment advisory, or commodity trading advisory services to the entity; and

(C) do not, directly or indirectly, guarantee, assume, or otherwise insure the obligations or performance of the entity.

(iii) For purposes of this paragraph (c)([●]) of this section, the following definitions apply:

(A) *Closely related* person means, with respect to any entity referred to in paragraph (c)([●])(i) of this section, a natural person (including the estate and estate planning vehicles of such person) who is:

(1) engaged in the day-to-day management and operations of such entity at the request of any family customer of such entity; or

(2) a close associate of, and has longstanding business or personal relationships with, any family customer of such entity.

(B) *Family customer* means, with respect to an entity referred to in paragraph (c)([●])(i) of this section:

(1) a family client, as defined in Rule 202(a)(11)(G)-1(d)(4) of the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1(d)(4)); or

(2) any natural person within the immediate family of any other person who is a family client by virtue of being a family member or a former family member, as defined in Rule 202(a)(11)(G)-1(d)(6) and (7) of the Investment Advisers Act of 1940 (17 CFR 275.202(a)(11)(G)-1(d)(6) & (7)).

(C) *Immediate family* has the same meaning as in section 225.41(b)(3) of the Board's Regulation Y (12 CFR 225.41(b)(3)).

As is the case with client facilitation vehicles, the fact that family wealth management vehicles are sometimes structured in a manner that could trigger the application of the Investment Company Act (and, thus, the Volcker Rule's "covered fund" definition) is not a result of banking entities' activities as principal, but rather reflects client preferences and market practice in the family wealth management space. Moreover, these vehicles do not raise the type of "bail out" concerns that Super 23A was designed to address[124] because banking entities: (1) have no any obligations to make fund holders whole in the event of portfolio losses; (2) do not maintain any ownership interests[125] in family wealth management vehicles; and (3) do not directly or indirectly guarantee or otherwise assume the obligations or performance of these entities.

4. The agencies should revise the loan securitization exclusion to permit a limited holding of non-loan assets to enable banking entities to provide traditional securitization products and services that are demanded by the market.[126]

Under the current exclusion,[127] an issuing entity for asset-backed securities can rely on the exclusion where its underlying assets and holdings are solely comprised of (i) loans; (ii) rights or assets designed to assure servicing or timely distribution of proceeds and rights or other assets; (iii) certain foreign interest rate or FX derivatives; and (iv) certain special units of beneficial interest and collateral certificates.[128]

Due to the narrow scope of this exclusion, banking entities are required to undertake costly and time-consuming reviews of each securitization deal to confirm whether it can qualify for the loan securitization exclusion, which have impacted banking entities' ability to participate in the securitization market and provide essential lending activity.[129] Moreover, because the qualified covered bond

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124 The view that Super 23A is intended to prevent bail outs of hedge funds and private equity funds (not limit asset management services) is also consistent with statements made during the conference committee debate. *See* House-Senate Conference Committee Holds Markup on HR 4173, CQ Congressional Transcript (June 24, 2010) (statement of Sen. Dodd) ("We make it even more clear under our proposal that a bank may not bail out a hedge fund or private equity fund in which it has invested.").

125 A banking entity would not, however, be restricted from acquiring an interest in connection with serving as general partner of a family wealth management vehicle at the client's request as long as the purpose was not for economic participation. In addition, a banking entity would not be prohibited from acquiring an ownership interest in connection with the ordinary course collection of a debt previously contracted in good faith, provided that the banking entity divests the ownership interest in the family wealth management vehicle as soon as practicable, and in no event does the banking entity retain the ownership interest for longer than such period permitted by the applicable agency. *See* Final Rule § _.10(a)(2)(iii).

126 This section is responsive to Questions 176–177 in the NPR.

127 *See* Final Rule § _.10(c)(8).

128 Final Rule § _.10(c)(8).

129 This is particularly true for lease securitizations, where the proportion of operating leases and finance leases in the collateral pool can affect the issuer's ability to qualify for exemptions other than Sections 3(c)(1) or 3(c)(7) of the Investment Company Act.

exclusion[130] relies on the loan securitization exemption, the burdensome reviews for loan securitization status also complicate banking entities' ability to evaluate covered bonds.

In addition, the current version of the loan securitization exclusion precludes the issuer from holding any securities or derivatives that do not meet certain prescriptive conditions,[131] significantly reducing a banking entity's ability to structure securitization products and services. The agencies should not constrain banking entities from engaging in such traditional commercial banking-related activity because doing so is inconsistent with the underlying statute, which contains a rule of construction providing that nothing in the Volcker Rule shall be construed to limit or restrict the ability of a banking entity to sell or securitize loans in a manner otherwise permitted by law.[132] To increase the utility of this exclusion and provide banks with "greater capacity to continuously provide financing and lending to their customers" at competitive prices,[133] the agencies should revise the conditions of the loan securitization exclusion to permit a limited amount (*i.e.*, 10% of total assets) of non-loan assets, such as debt securities, consistent with (but narrower than) the approach in Section 3(c)(5)(C) of the Investment Company Act with respect to non-real estate assets, and in Rule 3a-7 thereunder with respect to non-"eligible assets."[134]

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130 Final Rule § _.10(c)(10)(i).

131 "Permitted securities" under the loan securitization exclusion include "[c]ash equivalents for purposes of the rights and assets in paragraph (c)(8)(i)(B) of this section [*i.e.*, designed to assure the servicing or timely distribution of proceeds to holders of such securities and rights or other assets that are related or incidental to purchasing or otherwise acquiring and holding the loans]" and "[s]ecurities received in lieu of debts previously contracted with respect to the loans supporting the asset-backed securities." Final Rule § _.10(c)(8)(iii).

The exclusion limits the holding of derivatives by the issuing entity to interest rate or FX derivatives "the written terms of [which] directly relate to the loans, the asset-backed securities, or the contractual rights of other assets described in paragraph (c)(8)(i)(B)" and that "the interest rate and/or foreign exchange risks related to the loans, the asset-backed securities, or the contractual rights or other assets described in paragraph (c)(8)(i)(B)." Final Rule § _.10(c)(8)(iv).

132 12 U.S.C. § 1851(g)(2).

133 79 Fed. Reg. at 5688.

134 The Investment Company Act states that a person is not an investment company if the person "is not engaged in the business of issuing redeemable securities, face-amount certificates of the installment type or periodic payment plan certificates and . . . is *primarily* engaged in purchasing or otherwise acquiring mortgages and other liens on and interests in real estate." 15 U.S.C. §80a-3(c)(5)(C) (emphasis added). The SEC has taken the position that the exclusion in Section 3(c)(5)(C) of the Investment Company Act is available to an issuer if "at least 80% of its total assets consist of qualifying interests and real estate-type interests[] *and no more than 20% of its total assets consist of assets that have no relationship to real estate*." *See, e.g.*, Great Ajax Funding LLC, SEC Staff No-Action Letter (Feb. 12, 2018); Redwood Trust, Inc., SEC Staff No-Action Letter (Oct. 16, 2017).

Rule 3a-7 states adds that issuers who do not issue redeemable securities and are otherwise engaged in the business of holding eligible assets (such as mortgages, student and automobile loans) will not be deemed to be an investment company, provided that:

(1) The issuer issues fixed-income securities or other securities which entitle their holders to receive payments that depend primarily on the cash flow from eligible assets;

It is important to underscore that we believe that the 10% threshold reflects an appropriate balance between the interests of sell-side and buy-side participants in the industry that will ensure the smooth functioning of the securitization markets, while also ensuring that the securitization's underlying exposures are predominantly loans.

The expansion of the loan securitization exclusion to include a limited amount of non-loan assets is consistent with the agencies' previous recognition that, in administering a loan securitization transaction on an ongoing basis, banking entities need to "hold various assets other than the loans that support the asset-backed securities."[135] In practice, securitization vehicles in certain markets are typically expected to include assets other than "loans" as defined in the Final Rule,[136] such as a limited amount of securities, money market interests and cash and cash equivalents.

B. The Final Rule's definition of "ownership interest" is overly broad and unduly constrains traditional bank investments and client-facilitation services. Therefore, the definition should be revised to explicitly exclude certain instruments that do not have any equity-like features.

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(2) Securities sold by the issuer or any underwriter thereof are fixed-income securities rated, at the time of initial sale, in one of the four highest categories assigned to long-term debt or in an equivalent short-term category [] by at least one nationally recognized statistical rating organization that is not an affiliated person of the issuer or of any person involved in the organization or operation of the issuer, except that any fixed-income securities may be sold to accredited investors or qualified institutional buyers:

(3) The issuer acquires additional eligible assets, or disposes of eligible assets, only if: (i) the assets are acquired or disposed of in accordance with the terms and conditions set forth in the agreements, indentures, or other instruments pursuant to which the issuer's securities are issued; (ii) the acquisition or disposition of the assets does not result in a downgrading in the rating of the issuer's outstanding fixed-income securities; and (iii) the assets are not acquired or disposed of for the primary purpose of recognizing gains or decreasing losses resulting from market value changes; and

(4) If the issuer issues any securities other than securities exempted from the Securities Act of 1933, as amended by section 3(a)(3) thereof, the issuer: (i) appoints a trustee that is not, among other things, affiliated with the issuer or with any person involved in the organization or operation of the issuer; (ii) takes reasonable steps to cause the trustee to have a perfected security interest or ownership interest valid against third parties in those eligible assets that principally generate the cash flow needed to pay the fixed-income security holders; and (iii) takes actions necessary for the cash flows derived from eligible assets for the benefit of the holders of fixed-income securities to be deposited periodically in a segregated account that is maintained or controlled by the trustee consistent with the rating of the outstanding fixed-income securities.

135 79 Fed Reg. at 5687. The current exclusion, coupled with a patchwork of exclusions from the Investment Company Act, have led to a high compliance burden and have not sufficiently carved out foreign securitizations and certain U.S. securitizations from the covered funds prohibition. The loan securitization exclusion does not just apply to CLOs but to all loans as defined under the Final Rule, including mortgage, auto and student loans, and the securitizations backed by those loans. By expanding the exclusion to permit a limited amount of non-loan assets, the exclusion would become a true exemption for securitizations.

136 *See* Proposed Rule § _.2(u) (defining "loan" to mean "any loan, lease, extension of credit, or secured or unsecured receivable that is not a security or derivative").

Although the Proposed Rule does not make any changes to the existing definition of "ownership interest,"[137] we believe that additional guidance from the agencies on what constitutes an "ownership interest" is necessary to help banking entities distinguish more clearly between permissible and impermissible activities.

As a general matter, the agencies should clarify that loans and senior debt instruments without economic features associated with equity do not constitute "ownership interests." These changes are consistent with the statutory prohibition, which limits the ability to acquire or retain "any equity, partnership, or other ownership interest" in a covered fund.[138] The uncertainty concerning the status of these instruments has had a chilling effect on traditional bank investments (*e.g.*, debt investments in securitizations) and client-facilitation services. For example, banking entities traditionally purchase debt instruments offered by a wide range of issuers and these could be deemed to be "ownership interests" under the Final Rule due to the overbroad definition of "other similar interest."[139] Moreover, even where debt instruments are determined not to constitute an ownership interest for purposes of the Final Rule, the determination requires an in-depth fact-specific analysis. This has had a significant impact in the securitization context and has inhibited banking entities' ability to provide liquidity in the securitization markets.

Accordingly, given the clear statutory intent to include only equity-like instruments in the definition of ownership interest, the agencies should explicitly exclude from the definition: (1) any debt instruments that have: (i) a stated interest payment (whether fixed or linked to an external benchmark) and fixed payment at maturity (and for which non-payment constitutes an event of default) and (ii) no equity-like rights, such as warrants or earnings participations and (2) senior tranche instruments that contain no equity-like features other than voting rights.

C. The agencies should revise Super 23A to include the exemptions and quantitative limits provided under Section 23A of the Federal Reserve Act and Regulation W for purposes of interpreting Super 23A, which would promote banking entities' provision of a wide range of traditional asset management services to clients.[140]

Under the Final Rule's "Super 23A" provisions, banking entities are prohibited from entering into transactions with a covered fund if they serve as investment manager, adviser or sponsor to the covered fund.[141] These provisions were intended to prevent banking entities from engaging in relationships with

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[137] The Final Rule generally refers to "any equity, partnership, or other similar interest." Final Rule § __10(d)(5).

[138] 12 U.S.C. § 1851(a)(1)(B).

[139] Features associated with mezzanine and senior tranches of securitizations, in particular, have been the subject of uncertainty as to whether these issuances constitute an "other similar interest"—*e.g.,* by virtue of rights to remove a manager or trustee for cause, provisions for redirection of excess spread through the normal payment waterfall and provisions for tranche write-downs related to the normal attribution of losses.

[140] This section is responsive to Questions 198–199 in the NPR.

[141] Final Rule § _.14(a).

related funds that create a risk that the banking entities will "bail out" these funds.[142] The Volcker Rule was not intended to restrict ordinary course transactions and services provided to custody clients. However, by not applying the exemptions available under Section 23A of the Federal Reserve Act[143] ("**Section 23A**") and Regulation W,[144] the Final Rule has implemented Super 23A in a way that imposes significant costs and constraints on, and disrupts the long-standing functioning of, traditional trust and wealth management activities beyond Congress's intent for Super 23A—*i.e.*, "to prohibit banking entities from *bailing out* funds they manage, sponsor, or advise, as well as funds in which those funds invest."[145]

As a matter of statutory interpretation, reading the definition of "covered transaction" in Section 23A to include all of its exemptions is as logically necessary as reading the definition of "covered fund" to incorporate all of its exemptions. The agencies previously declined[146] to incorporate Section 23A's exemptions into Super 23A because they found no explicit evidence that Congress intended that the reference to the "covered transaction" definition in subsection (b)(7) of Section 23A be qualified by the exemptions in other relevant sections of Section 23A. However, reading the term "covered transaction" in isolation is contrary to fundamental principles of statutory construction that require the terms of a statute to be interpreted in context and in accordance with the statute as a whole.[147]

142 *See, e.g.*, 156 Cong. Reg. 5901 (daily ed. July 15, 2010) (statement of Sen. Merkley) ("[T]he intent of [Super 23A]" is "to prohibit banking entities from bailing out funds they manage, sponsor, or advise, as well as funds in which those funds invest[.]").

143 *See* 12 U.S.C. § 371c(d).

144 12 C.F.R. Part 223 (Subpart E).

145 156 Cong. Reg. 5901 (daily ed. July 15, 2010) (statement by Sen. Merkley) (emphasis added); *see also* NPR at 33548 (incorporating the exemptions under Section 23A of the Federal Reserve Act and Regulation W "would provide banking entities greater flexibility to provide . . . services directly to covered funds. If being able to provide custody, clearing, and other services to sponsored funds reduces the costs of these services, fund advisers and, indirectly, fund investors, may benefit from incorporating the exemptions . . . These changes would increase banking entities' ability to engage in custody, clearing, and other transactions with their covered funds and benefit banking entities that are currently unable to engage in otherwise profitable or efficient activities with covered funds they own or advise. Moreover, this could enhance operational efficiency and reduce costs incurred by covered funds, which are currently unable to rely on their affiliated banking entity for custody, clearing, and other transactions.").

146 *See* 77 Fed. Reg. at 5746 ("The final rule continues to apply the same definition of covered transaction as the proposal. Section 13(f) refers to a covered transaction, as defined in section 23A[]. Section 13(f) of the BHC Act does not incorporate or reference the exemptions contained in section 23A [] or the Board's Regulation W. Indeed, the exemptions for these transactions are not included in the definition of covered transactions in section 23A; the exemptions are instead in a different subsection of section 23A and provide an exemption from only some (but not all) of the provisions of section 23A governing covered transactions. Therefore, the final rule does not incorporate the exemptions in section 23A.").

147 *See, e.g.*, *Deal v. United States*, 508 U.S. 129, 132 (1993) (Scalia, J.) (it is a "fundamental principle of statutory construction . . . that the meaning of a word cannot be determined in isolation, but must be drawn from the context in which it is used."); *Green v. Bock Laundry Machine Co.*, 490 U.S. 504, 528 (1989) (Scalia, J., concurring in the judgment) (meaning of the words in a statute should be determined "on the

To properly reflect the core provisions of Section 23A and Regulation W, the agencies should revise Super 23A to incorporate the exemptions available thereunder, such as the exemptions for intraday extensions of credit that facilitate settlement, transactions that are fully secured by cash or U.S. government securities, correspondent banking deposits and transactions involving liquid or marketable securities.[148] These types of transactions with sponsored or advised covered funds pose little or no risk to the banking entity, and are a natural and necessary aspect of traditional commercial banking-related activities. For example, as part of commercial banks' traditional suite of ordinary course custodial and administrative services provided to corporate and institutional clients (including clients that are covered funds), banking entities may engage in intraday or short-term extensions of credit to facilitate securities settlement, contractual settlement, predetermined income or similar custody-related transactions and provide transaction accounts and checking accounts with overdraft protection. Further, some banking entities also act as securities lending agents for custodial clients, a traditional commercial banking-related activity that, as the OCC has stated, is "one of the most important value-added products custodians offer to their customers."[149] Indeed, because there is little or no risk for banking entities created by the exempted transactions, there is little or none of the bail out risk that concerned Congress.

For similar reasons, we also support the incorporation of these quantitative limits into Super 23A.[150] Allowing banking entities to engage in limited covered transactions with their related funds would align Super 23A with the existing regime governing member banks' affiliate transactions and would provide banking entities with greater flexibility to provide traditional, ordinary course custodial and administrative services to their affiliates. Another way in which the agencies can enhance the ability of banking entities to provide important services to their related funds would be to specify that, to the extent a covered transaction does not meet the requirements of a particular exemption under Section 23A or Regulation W, the transaction with a related covered fund would nevertheless be allowed subject to quantitative limits. For example, if the quantitative limits are not incorporated into Super 23A, certain routine custody and clearing transactions, such as overnight extensions of credit in cases where there are delays or failures in trade settlements or credit transactions that are not fully backed by U.S. government securities, would be prohibited in connection with related covered funds even though banking entities are allowed to engage in these same transactions with their affiliates under Section 23A. If the agencies adopt this approach, the agencies should provide guidance clarifying that the quantitative limits for Super 23A purposes are entirely independent of the quantitative limits for Section 23A (unless the transaction is also a covered transaction with an insured depository institution), and include both the aggregate and individual limits applicable to the maximum amount of covered transactions that a banking entity may enter into with affiliates.

D. In addition to the recommendations discussed above, we also support certain of the Proposed Rule's amendments to the covered funds provisions.

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basis of which meaning is . . . most compatible with the surrounding body of law into which the provision must be integrated.").

148 *See* 12 U.S.C. § 371c(d); 12 C.F.R. § 223.42.

149 OCC, Comptroller's Handbook: Custody Services (Jan. 2002) at 26.

150 NPR at 33487 (Question 199).

1. We support the agencies' proposal to allow a banking entity to acquire an ownership interest in a covered fund as a risk-mitigating hedge for clients and believe that this modification will facilitate client activity.[151]

The Final Rule prohibits a banking entity from acquiring and retaining a covered fund ownership interest for risk-mitigating hedging purposes or market making-related hedging purposes.[152] However, the statute, which provides a broad exemption for risk-mitigating hedging, does not distinguish between risk-mitigating hedging in covered fund ownership interests versus other types of hedging instruments used by banking entities.[153] In practice, the restrictions upon banking entities' acquisition of ownership interests in a covered fund to hedge exposure in fund-linked derivative transactions has deprived banking entities of their ability to hedge their exposure in the most direct and effective way possible. Accordingly, we strongly support the agencies' proposal to allow a banking entity to acquire or retain an ownership interest in a covered fund as a risk-mitigating hedge when acting as an intermediary on behalf of a client that is not itself a banking entity to facilitate the exposure by the client to the profits and losses of the covered fund.

Consistent with the intent of the Volcker Rule, permitting banking entities to acquire ownership interests in covered funds as a hedge for client transactions will provide banking entities with the flexibility to utilize appropriate risk management strategies and facilitate client activity (including those that promote capital raising and economic growth). We agree with the commentary in the NPR that this activity is consistent with safety and soundness, as it would be subject to the requirements of the Final Rule as modified by the Proposed Rule.[154] Therefore, the agencies should adopt this provision as proposed to accommodate banking entities' client facilitation activities and risk management activities[155] and to align the covered fund provisions with the purpose and statutory text of the Volcker Rule.

Relatedly, we appreciate the clarity provided by the agencies' proposal because banking entities will be able to acquire and retain a covered fund ownership interest for hedging purposes to the same extent, and subject to the same conditions, that apply to other types of instruments that a banking entity may hold for hedging purposes under the Final Rule, including the risk-mitigating hedging exemption and

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151 This section is responsive to Questions 186–188 in the NPR.

152 Final Rule § __.10(a)(2).

153 *See* 12 U.S.C. § 1851(d)(1)(C).

154 NPR at 33483–84. *See also* 79 Fed. Reg. at 5737 (noting that risk-mitigating hedging activities do not represent a "high risk strategy that could threaten the safety and soundness of the banking entity").

155 NPR at 33547 ("The proposed amendments increase the ability of banking entities to facilitate customer-facing transactions while hedging their own risk exposure. As a result, this amendment may increase banking entity intermediation and provide customers with easier access to the risks and returns of covered funds. To the degree that banking entities' investments in covered funds to hedge customer-facing transactions may facilitate their engagement in customer-facing trades, customers of banking entities may benefit from greater availability of financial instruments providing exposure to covered funds and related intermediation. Access to covered funds may be particularly valuable when private capital plays an increasingly important role in U.S. capital markets and firm financing.").

the exemption for market making-related hedging activities, whether it relates to a transaction that is solicited by the banking entity or reverse inquiry from the client.

2. **The agencies should expressly confirm the previous staff guidance regarding the seeding period for RICs and FPFs in the commentary of the amended Final Rule.**[156]

Through the issuance of two FAQs, the agencies addressed certain questions regarding whether RICs or FPFs could potentially be treated as banking entities due to a sponsoring banking entity having "control" over these funds through its seeding period investment, which would result in these RICs and FPFs being subject to the Final Rule's restrictions on proprietary trading and covered fund investments in a way that could interfere with their businesses. The NPR confirms the guidance in FAQs #14 and #16 that RICs and FPFs should not be treated as a "banking entity" subject to the Volcker Rule's proprietary trading restrictions during the seeding period and that a three-year seeding period is an example of, and not a maximum length, of a permissible seeding period.[157] We appreciate the agencies' confirmation of these important points and would strongly request that the agencies further confirm this guidance in the commentary of the amended Final Rule.

3. **We support the proposal to remove the Final Rule's requirement that banking entities include covered fund ownership interests held in a permissible underwriting or market-making capacity in the aggregate fund limit and Tier 1 capital deduction.**[158]

We strongly support the agencies' proposal to eliminate the requirements to include ownership interests in third party-sponsored covered funds held in a permissible underwriting or market-making capacity in the calculation of the 3% aggregate funds limitations and Tier 1 capital deduction.[159] This proposal would reduce the compliance burden for banking entities engaged in these client-facing activities and would facilitate banking entities' permitted underwriting and marketing making

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156 This section is responsive to Question 13 in the NPR.

157 *See* NPR at 33443. In FAQ #14, the staffs addressed the "banking entity" status of FPFs sponsored by a banking entity, stating that they would not advise that the activities and investments of an excluded FPF be attributed to the sponsoring banking entity for purposes of the Volcker Rule so long as "the banking entity does not own, control or hold with the power to vote 25 percent or more of any class of voting shares of the fund (after the seeding period), and provides investment advisory, commodity trading, advisory, administrative and other services to the fund in compliance with applicable limitations in the relevant foreign jurisdiction." Federal Reserve, Volcker Rule Frequently Asked Questions (last updated Mar. 4, 2016), *available at* https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#14.

FAQ #16 addressed the treatment of FPFs and RICs during seeding periods, stating that the staffs would neither advise the agencies to treat a FPF or RIC as a banking entity solely on the basis of the level of ownership of the FPF or RIC by a banking entity during a seeding period of "for example, three years," nor "expect an application to the Board to determine the length of the seeding period." Federal Reserve, Volcker Rule Frequently Asked Questions (last updated Mar. 4, 2016), *available at* https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#16.

158 This section is responsive to Question 183 in the NPR.

159 NPR at 33482–83.

activities.[160] For similar reasons, we also propose that the agencies eliminate these requirements for covered funds that are advised, but not sponsored, by banking entities. Extending the proposal to these types of advised funds would not expose banking entities to greater risk because ownership interests acquired in such funds pursuant to the risk-mitigating hedging, market-making or underwriting exemptions would nevertheless be subject to the restrictions contained in those exemptions.

IV. Scope of "Banking Entity" Definition[161]

Consistent with the agencies' goals of simplifying and tailoring the Final Rule, the agencies should revise the definition of "banking entity" to exclude non-consolidated entities that a banking entity has limited or no practical ability to direct or control and, thus, allow banking entities to continue to make investments and establish relationships that are important from a strategic or risk management perspective.[162] Any "affiliate" or "subsidiary," as defined and interpreted under the BHC Act, of a banking entity, unless otherwise exempt under the Final Rule, is itself a "banking entity" subject to the extensive restrictions and compliance program requirements under the Final Rule.[163] These are difficult to apply to certain entities that are "affiliates" or "subsidiaries" as defined and interpreted under the BHC Act, such as deemed "controlled" investments and joint ventures, because the banking entity often lacks the practical control necessary to implement the detailed requirements of the Volcker Rule compliance program.[164] This problem is significantly exacerbated by the Federal Reserve's unduly broad definition

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160 *See* NPR at 33546 ("Under the proposed amendments, banking entities would be able to engage in potentially profitable market making and underwriting in covered funds they do not organize or offer without the per-fund and aggregate limits and capital deductions. SEC-registered banking entities are expected to benefit from this amendment to the extent they profit from underwriting and market-making activities in such covered funds. In addition, these benefits may, at least partially, flow through to funds and fund investors. Specifically, banking entities may become more willing and able to underwrite and make markets in covered funds, and provide investors with more readily available economic exposure to the returns and risks of certain covered funds.").

161 This section is responsive to Question 22 in the NPR.

162 *See* OCC RFI at 36694–95 (noting that, as a result of the broad definition of "banking entity" adopted in the Final Rule, the Volcker Rule's prohibitions and compliance program requirements extend to "many entities that may not pose systemic risk concerns . . . .").

163 *See* Final Rule §§ _.2(a) and (dd) (defining "affiliate" and "subsidiary" by reference to the BHC Act); Final Rule § _.2(c)(1) (defining "banking entity"). *See also* 12 U.S.C. § 1851(h)(1) (defining "banking entity" to mean "any insured depository institution (as defined in [Section 2 of the BHC Act]), any company that controls an insured depository institution, or that is treated as a bank holding company for purposes of section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any such entity," subject to carve-outs for insured depository institutions meeting certain conditions).

164 For purposes of the Volcker Rule, the term "affiliate" is defined by reference to Section 2(k) of the BHC Act to mean "any company that controls, is controlled by, or is under common control with another company." 12 U.S.C. § 1841(k). Under the BHC Act's "control" rules, a company is presumed to "control" another company where (i) the company owns, controls or has the power to vote 25% or more of any class of voting securities of the other company, (ii) the company controls in any manner the election of a majority of the directors or trustees of the other company or (iii) the Federal Reserve determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the other company. 12 U.S.C. § 1841(a)(2).

of "controlling influence."[165] Although the Federal Reserve has indicated that it will be reconsidering its guidance around controlling influence, we believe that a separate and distinct approach should be taken for defining "banking entities."

The agencies already have drafted the definition of "banking entity" to exclude similar types of affiliates, such as non-financial portfolio companies in which banking entities hold an equity interest under the merchant banking authority, and excluded them from the definition of "banking entity" in the Final Rule.[166] Under its merchant banking authority, a financial holding company may make investments in portfolio companies, which are not part of a holding company's core businesses.[167] The BHC Act restricts a financial holding company from managing these portfolio companies on a day-to-day basis, even if the banking entity may "control" the company for purposes of the BHC Act.[168] The Federal Reserve traditionally has not viewed merchant banking portfolio companies as "affiliates" under the BHC Act for purposes of activities restrictions and compliance and supervision.

Providing a carve-out from the "affiliate" and "subsidiary" concepts for similar non-consolidated and independently-managed entities is especially important in light of the Proposed Rule's compliance program requirements, which cannot practically be complied with in the absence of actual operational control and certainty as to what relationships would cause a company to be deemed to be a "banking entity" within a banking organization.[169] Excluding non-consolidated and independently managed entities from the "banking entity" definition would be consistent with the accommodation by Congress and the Federal Reserve of the realities of certain types of banking activities, such as merchant banking, where

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165 *See generally* Federal Reserve, § 225.144 Policy Statement on Equity Investments in Banks and Banking Companies (Sept. 2008).

166 Final Rule § _.2(c)(2)(ii).

167 Section 4(k)(4)(H) of the BHC Act and the Federal Reserve's related merchant banking regulations authorize financial holding companies to engage in the activity of investing in shares of companies not engaged in activities permissible under Section 4(k) in order to realize capital appreciation upon disposition of the investment. 12 C.F.R. § 225.170 *et seq*. These regulations require that merchant banking portfolio company investments be bona fide.

168 Section 4(k)(4)(H)(iv) of the BHC Act prohibits a financial holding company from using this merchant banking authority to engage in nonfinancial activities. *See* 12 U.S.C. § 1843(k)(4)(H)(iv); 12 C.F.R. § 225.171(a); Bank Holding Companies and Change in Bank Control, 65 Fed. Reg. 16,460, 16,463 (Mar. 28, 2000).

169 As the agencies have acknowledged in their guidance issued subsequent to the Final Rule, targeted carve-outs from the "banking entity" definition are appropriate under some circumstances. *See* Federal Reserve, Volcker Rule Frequently Asked Questions (last updated Mar. 4, 2016), *available at* https://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm, FAQ #14 n.24 (recognizing that the Federal Reserve's regulations and orders have long recognized that a BHC may organize, sponsor, and manage a RIC, including by serving as investment adviser to the RIC, without controlling the RIC for purposes of the BHC Act) and FAQ #16 (citing the Federal Reserve's guidance on the circumstances under which a BHC's seed investment in a RIC would not constitute "control" of the RIC for BHC Act purposes).

they have provided for an alternative definition of control while, concurrently, implementing related controls and restrictions to ensure these activities do not impact the entity's safety and soundness.[170]

In addition, certain funds that are not "covered funds" should be expressly excluded from the definition of "banking entity." Consistent with our proposal in Section III.A.3, we propose that the agencies also expressly exclude family wealth management vehicles from the "banking entity" definition. If these vehicles are excluded from the definition of "covered fund," under the Final Rule they would not be eligible for the exclusion from the definition of "banking entity" that is available for covered funds offered by a banking entity to its clients.[171] Consistent with the agencies' guidance in respect of FPFs,[172] we believe that certain corporate governance arrangements, such as trustee or general partner roles or the power to select the majority of an entity's directors, should not be determinative of whether a firm is deemed to control a family wealth management vehicle such that the vehicle is treated as a banking entity. Treating family wealth management vehicles as banking entities solely on the basis of governance structures would unduly restrict the types of assets that these vehicles can acquire and trade under the Volcker Rule, which in turn limits a firm's ability to engage in a traditional, customer-driven business and to provide a wide range of individuals and families with their desired exposure or services. Therefore, as with FPFs, the agencies should clarify that family wealth management vehicles that meet our proposed covered fund exclusion's conditions and in which banking entities do not hold an ownership interest for economic participation would not be banking entities and provide an express exclusion to that effect from the "banking entity" definition.[173]

We also believe that certain other categories of entities, such as public welfare and community development investment and similar funds[174] and employees' securities companies ("**ESCs**"), would be unduly restricted, without any meaningful policy benefit, if treated as "banking entities." For example, limited partnership investments in public welfare and community development investment funds, such as affordable housing partnerships, are held under a separate authority and are therefore not provided an exclusion from the definition of "banking entity." These funds are often managed by third-party sponsors over which banks have no practical control, making the application of the Volcker Rule's compliance requirements to these funds challenging, if not impossible. Moreover, treating public welfare and community development investment and similar funds as banking entities could unnecessarily limit the

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170 *See* 12 U.S.C. § 1843(k)(4) (codified by Section 103 of the Gramm-Leach-Bliley Act, Pub. L. No. 106-102, 113 Stat. 1338, 1342).

171 *See* Final Rule § _.2(c)(2).

172 *See* FAQ #14 cited in *supra* note 169.

173 The agencies acknowledged in the Final Rule's Preamble that common or collective investment funds that are investment companies under Section 3(c)(3) or 3(c)(11) of the Investment Company Act do not act as principal when conducting activities. Similarly, in the family wealth management business, these family wealth entities facilitate the provision of traditional commercial banking and asset management activities on behalf of customers and do not raise the concerns about evasive proprietary trading and, therefore, capturing them in the "banking entity" definition would serve no purpose. *See* Final Rule's Preamble at 5558, n. 282.

174 *See* Final Rule § _.10(c)(11) (small business investment companies and public welfare investment funds exclusion).

types of activities in which they can engage, which, in turn, may have a negative impact on the causes and communities they serve.[175]

Like family wealth management vehicles and public welfare and community development investment and similar funds, ESCs should also be expressly excluded from the "banking entity" definition. The agencies noted in the NPR that ESCs are "controlled by their sponsors and, if those sponsors are banking entities, may themselves be treated as banking entities . . . [which] may conflict with [ESCs'] stated investment objectives."[176] ESCs invest in covered funds in the interest of providing a sponsoring banking entity's employees with incentive compensation and not for the benefit of the sponsoring banking entity itself. Treating ESCs as banking entities would unnecessarily restrict the types of investments these entities can make without furthering any meaningful policy objective.

We, therefore, urge the agencies to revise the Final Rule to adopt a clear and easy-to-apply definition of "banking entity" to exclude non-consolidated entities that a banking entity has limited or no practical ability to direct or control, as well as public welfare and community development investment and similar funds, family wealth management vehicles and ESCs, as described above. As an alternative to providing express exclusions for these categories of funds from the "banking entity" definition, the agencies could also exempt them from both the proprietary trading and covered fund restrictions. However the agencies choose to implement these changes, it would permit banking entities to use corporate structures to make investments and establish relationships that are important from a strategic or risk management perspective, as well as facilitate client or employee investments, without imposing the costs and burdens of Volcker Rule compliance on these structures. Moreover, these proposed revisions are consistent with the language and purpose of the statute, and, therefore, the agencies have the authority to implement these modifications to the Final Rule.[177]

V. Modifications Relating to Trading Assets and Liabilities Categorization

A. The agencies should increase the proposed TALs thresholds for the different banking entity categories to reflect amounts that are more appropriate for designating firms as having "significant," "moderate" or "limited" trading activity.[178]

The Proposed Rule would establish three categories of banking entities based on their level of trading activity.[179] The first category is for banking entities with "significant" TALs, defined as those that, together with their affiliates and subsidiaries, have TALs (excluding obligations of or guaranteed by

175 Consistent with Congress's desire to enable banking entities to make investments "in a range of low-income community development and other projects," the agencies should also clarify that foreign investments similar to those under 12 U.S.C. Part 24 are permitted under the small business investment company and public welfare investment funds exclusion as these are low-risk investments and in the public interest. 156 Cong. Rec. S5896 (daily ed. July 15, 2010); *see* Final Rule § _.10(c)(11).

176 NPR at 33446.

177 *See* 12 U.S.C. § 1851(d)(1)(J).

178 This section is responsive to Questions 3–6 in the NPR.

179 NPR at 33437.

the United States or any agency of the United States) the average gross sum of which over the previous consecutive four quarters, as measured as of the last day of each of the four previous calendar quarters, equals or exceeds $10 billion.[180] The second category is for banking entities with "moderate" TALs, defined as those that, together with their affiliates and subsidiaries, have $1 billion or greater in TALs (determined in accordance with the methodology for calculating "limited" TALs), but less than $10 billion in TALs (determined in accordance with the methodology for calculating "significant" TALs).[181] The third category is for banking entities with "limited" TALs, defined as those that, together with their affiliates and subsidiaries on a worldwide consolidated basis, have TALs (excluding obligations of or guaranteed by the United States or any agency of the United States) the average gross sum of which over the previous consecutive four quarters, as measured as of the last day of each of the four previous calendar quarters, is less than $1 billion.[182]

Consistent with the agencies' objective to better tailor the application of the Final Rule based on a banking entity's size and level of trading activity,[183] we recommend that the thresholds for designating firms with "significant" and "limited" TALs be increased to $20 billion (from $10 billion) and $5 billion (from $1 billion), respectively. We believe that these amounts are more appropriate for designating banking entities as having "significant" or "limited" TALs than those included in the Proposed Rule.

The agencies believe that, as currently proposed, the TALs thresholds would capture:

- 18 firms in the "significant category," representing approximately 95% of the TALs in the U.S. banking system according to agencies' estimates;
- 40 firms in the "significant" and "moderate" categories, representing approximately 98% of the TALs in the U.S. banking system; and
- entities that have a relatively "small percentage" of the TALs in the U.S. banking system in the "limited" category.[184]

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180 Proposed Rule § _.2(ff). For banking entities that are foreign banking organizations or subsidiaries of foreign banking organizations, the significant TALs calculation would be based on the "trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) of the combined U.S. operations of the top-tier foreign banking organization (including all subsidiaries, affiliates, branches, and agencies of the foreign banking organization operating, located, or organized in the United States)." Proposal § __.2(ff)(3)(i). For all other banking entities, the significant TALs threshold would be measured based on "trading assets and liabilities (excluding trading assets and liabilities involving obligations of or guaranteed by the United States or any agency of the United States) on a worldwide consolidated basis." Proposal §__.2(ff)(2).

181 Proposed Rule § _.2(v).

182 Proposed Rule § _.2(t).

183 NPR at 33436.

184 *See* NPR at 33440–41; Federal Reserve, Memorandum Regarding Draft Proposed Revisions to Rules Implementing the Proprietary Trading and Hedge Fund and Private Equity Fund Restrictions of Section 13 of the Bank Holding Company Act at 4 (May 25, 2018); Transcript of Federal Reserve Open Meeting

Firms that have $20 billion in TALs or more represent a significant portion of trading activities in the United States, whereas firms that have $5 billion in TALs or less constitute a very small segment of those activities.[185] Our proposed changes to the TALs thresholds would enable small- and midsize-banks, as well as larger banks with less significant trading activities, to have moderate, organic growth over time, in accordance with safety and soundness objectives, without being subject to an increased compliance burden that is not commensurate with their trading activity or necessary for the safety and soundness of the U.S. financial system. Moreover, to accommodate inflation, the agencies should provide for an upward adjustment of the TALs thresholds over time to adjust for inflation.

We also believe that our suggested thresholds will reduce the compliance burden on firms by providing firms in the "moderate" and "limited" categories with a wider TAL range within which they can manage their businesses without triggering new compliance requirements. TALs is not a metric that is typically managed by banking entities, and doing so would be challenging because banking entities cannot control market volatility or customer-driven demand. Hence, if there is higher volatility that requires banking entities to buy and sell financial instruments, the TALs for those entities may increase.

B. The agencies should clarify that banking entities moving into a higher TALs category will have two years to comply with the higher category's requirements and provide a buffer to address fluctuations above the TALs thresholds.

Whatever the thresholds the agencies ultimately adopt, the agencies should provide that when a firm crosses a threshold that will result in its moving into a higher TALs category, the firm will have a two-year conformance period during which to comply with the requirements of the new category. For a firm that moves into a lower TALs category, the agencies should provide that the firm may immediately comply with the requirements applicable for the new category. These two timing arrangements are not inconsistent because it requires substantial time to implement a new and more comprehensive compliance structure, but not to reduce an existing structure to a less comprehensive one.[186]

From a practical perspective, the agencies should revise the Proposed Rule to provide a buffer that addresses moderate fluctuations above the TALs thresholds. As discussed above, TALs is not a metric that is typically managed and, therefore, presents different challenges than metrics that can be

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regarding Notice of Proposed Rulemaking on Proprietary Trading and Hedge Fund and Private Equity Fund Restrictions of Section 13 of the Bank Holding Company Act (May 30, 2018).

185 Based on the aggregate TALs for top-tier U.S. BHCs, commercial banks, savings banks and savings and loan holding companies as reported on Call Reports and the Federal Reserve's Form FR Y-9C for the second quarter of 2018, we estimate that firms with $20 billion or more in TALs represented approximately 94.80% of total reported U.S. TALs and firms with $5 billion or less in TALs represented approximately 1.32% of total reported U.S. TALs. S&P Global Market Intelligence, Regulated Depositories Data Set (as of September 27, 2018). Note that these TALs figures do not exclude obligations of or guaranteed by the United States or any agency of the United States.

186 The proposed conformance period would be consistent with the original conformance period provided under statute, which provided banking entities with two years from the date on which the Volcker Rule requirements became effective to bring their activities and investments into compliance. *See* 12 U.S.C. § 1851(c)(2). Depending on the requirements in the amended Final Rule, some firms may need to completely reconstruct their Volcker Rule compliance and monitoring programs, which may not be feasible in only one year.

managed more holistically, such as total consolidated assets. For a banking entity that crosses a higher TALs threshold, we recommend the agencies adopt a limited cure period and provide that a banking entity will not be deemed to move into the moderate or significant TALs categories if (i) its TALs do not exceed more than 10% of the higher TALs threshold and (ii) within 180 days of initially exceeding the threshold, its TALs are once again below the relevant higher threshold. If, for example, a banking entity typically operates within the moderate TALs category, but due to an unusual uptick in customer-driven trading temporarily finds itself with $21 billion in TALs (using our proposed thresholds) as calculated over the previous consecutive four quarters, the entity would not automatically be subject to the heightened compliance requirements associated with the significant TALs category; rather, if within 180 days of initially exceeding the significant TALs threshold the banking entity once again has TALs of less than $20 billion as calculated over the previous consecutive four quarters, then it would remain in the moderate TALs category and retain its existing compliance framework. If, however, after the 180-day period expires the banking entity continues to maintain TALs in excess of $20 billion as calculated over the previous consecutive four quarters or the entity exceeds the 10% buffer, the entity would have a two-year conformance period during which to comply with the requirements of the significant TALs category.

C. The agencies should clarify the reference to "trading assets and liabilities" that is used in the definitions of banking entities with significant, moderate and limited TALs.[187]

To achieve consistency across banking entities and to provide clarity for banking entities that become subject to the rule in the future, the agencies should clarify that, with respect to banking entities required to file Form FR Y-9C, "trading assets and liabilities" as used in the definition of "significant trading assets and liabilities," "moderate trading assets and liabilities" and "limited trading assets and liabilities" refers to the TALs that are reported on Form FR Y-9C less relevant excluded items. The agencies should also clarify the standards that foreign banking organizations and other banking entities that do not file Form FR Y-9C should use to determine the applicable "trading assets and liabilities."[188]

VI. Compliance Program Requirements

A. The agencies should (i) at a minimum incorporate a knowledge qualifier in the CEO attestation requirement regarding Volcker Rule compliance and (ii) limit the attestation requirement to banking entities with significant TALs.[189]

Pursuant to the Final Rule's CEO attestation requirement, banking entities must attest annually in writing to the relevant agency that the banking entity has in place processes to establish, maintain, enforce, review, test and modify the compliance program established under the Final Rule in a manner "reasonably designed to achieve compliance" with the Section 13 of the BHC Act.[190] In the NPR, the

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187 This section is responsive to Question 4 in the NPR.

188 For example, foreign banking organizations could look to the "trading assets and liabilities" and "positive/negative market values from derivatives" standards on the IFRS balance sheet to determine the applicable "trading assets and liabilities."

189 This section is responsive to Questions 204, 206 and 208 in the NPR.

190 *See* Part III of Appendix B to the Final Rule.

agencies seek comment regarding whether (1) the CEO attestation requirement is redundant in light of existing business practices; (2) the scope of the requirement under the proposed three-tier scheme for banking entities is appropriate; and (3) whether incorporating the CEO attestation requirement would ensure that a strong governance framework is implemented with respect to compliance of the Volcker Rule.[191]

Although we do not see any compelling or even persuasive reason why the Volcker Rule should be treated differently from other federal bank regulatory compliance regimes, if the agencies nonetheless believe that attestation is important to the overall Volcker Rule compliance framework, we recommend retaining a revised version of the requirement. Specifically, we suggest incorporating a knowledge qualifier so that a CEO attests that a banking entity has in place processes reasonably designed to achieve compliance with the Volcker Rule to the *best of his or her knowledge* and *based on information* presented to the CEO during the attestation process. We believe that this is a more practical certification standard with which CEOs and banking entities can comply because it reflects the reality that, to make the attestation regarding firmwide compliance, CEOs of banking entities inevitably must rely on the representations of the individuals responsible for implementing and overseeing the policies and processes related to Volcker Rule effectiveness at the sub-unit level.

The agencies should also limit the requirement's application to firms with significant TALs. The Proposed Rule applies the attestation requirement to firms with moderate TALs, some of which previously were not subject to the attestation requirement, thereby increasing these entities' compliance burden, which is contrary to the agencies' stated intent to appropriately reduce the compliance burden for banking entities that engage in less trading activity and, thus, do not pose significant risk to U.S. financial system.[192]

B. The agencies' reservation of authority to assign banking entities with limited or moderate TALs a higher compliance category should be revised to include the notice and response procedures specified under the presumption of compliance for banking entities with limited TALs.[193]

The Proposed Rule includes a reservation of authority that would allow an agency to require a banking entity with limited or moderate TALs to apply any of the more extensive requirements that would otherwise apply if the banking entity had significant or moderate TALs, if the agency determines that the size or complexity of the banking entity's trading or investment activities, or the risk of evasion, warrants such treatment.[194]

The agencies should provide for notice and response procedures similar to those outlined in Section __.20(g)(2)(ii) of the Proposed Rule for agency determinations assigning a banking entity more

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191 NPR at 33489, 33493.

192 NPR at 33510 (requesting comment on "[w]hat steps could the Agencies take to appropriately reduce compliance burdens [] especially for banking entities that engage in less trading activity.") and 33526 (noting that firms in the "moderate" TALs category would be subject to "reduced requirements and an even more tailored approach in light of their smaller and less complex trading activities.").

193 This section is responsive to Question 209.

194 NPR at 33437; Proposed Rule § _.20(h).

extensive compliance requirements than are required by the entity's TALs category. If, for instance, an agency notifies a banking entity that it must establish a separate compliance program for its hedging activity under the risk-mitigating hedging exemption, the entity should at a minimum be provided with an explanation of the determination and a right to respond to the notice and request a meeting with the agency to discuss the determination. To the extent that a banking entity is finally determined to be required to comply with increased compliance requirements, the entity should be given a two-year conformance period to come into compliance with the additional requirements, consistent with the recommendation in Section V.B.

VII. Additional Issues

We also support the following proposals in respect of the Final Rule or the Proposed Rule, as applicable:

A. The agencies should take steps to improve interagency coordination with respect to interpreting the Volcker Rule and providing guidance to banking entities.[195]

The Volcker Rule requires the involvement of all five agencies, leading to interpretive and implementation uncertainties, coordination difficulties and substantial delay. In the NPR, the agencies recognize that "coordinating with respect to regulatory interpretations, examinations, supervision, and sharing of information is important to maintain consistent oversight, promote compliance with section 13 of the BHC Act and implementing regulations, and foster a level playing field for affected market participants" and that "coordinating these activities helps to avoid unnecessary duplication of oversight, reduces costs for banking entities, and provides for more efficient regulation."[196]

As highlighted in the Treasury Report, the current Volcker Rule oversight framework "results in fragmentation in responsibility and confusion for banks subject to the rule,"[197] which is exacerbated when multiple agencies are responsible for overseeing a single banking entity (*e.g.*, a national bank that is a CFTC-registered swap dealer) or one transaction (*e.g.*, where a trade and the related hedge are booked in different entities).[198] The agencies should, therefore, take steps toward enhancing regulatory coordination with respect to rulemaking, interpretation, examination and enforcement of the Volcker Rule.

The agencies should also establish interagency examination procedures and provide for information-sharing agreements to improve intra-agency and interagency consistency as well as enhance transparency by setting consistent, published expectations for the conduct of Volcker Rule examinations and interpretation.[199]

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[195] This section is responsive to Questions 1–2 in the NPR.

[196] NPR at 33436.

[197] Treasury Report at 73.

[198] Treasury Report at 73.

[199] The Federal Financial Institutions Examination Council's (the "**FFIEC**") Bank Secrecy Act/Anti-Money Laundering Examination Manual is one example where interagency coordination with respect to a multi-agency regulatory regime has been facilitated by the promulgation of interagency examination standards.

B. We support the agencies' confirmation that transactions to correct *bona fide* trade errors are not considered proprietary trading.[200]

The Proposed Rule adds a specific exclusion that confirms that for any purchase or sale of a financial instrument that was made in error by a banking entity "in the course of conducting a permitted or excluded activity or is a subsequent transaction to correct such an error"[201] is not prohibited proprietary trading. BPI agrees with the agencies that correcting error trades by or on behalf of clients is not conducted for the purpose of profiting from short-term price movements and welcomes the agencies' confirmation that firms can fix *bona fide* errors in the course of conducting a permitted or excluded activity by entering into a "subsequent transaction as principal to fulfill its obligation to deliver the customer's desired financial instrument position and to eliminate any principal exposure that the banking entity acquired in the course of its effort to deliver on the customer's original request."[202]

C. The agencies should revise the permitted trading in domestic and foreign government obligation exemptions to permit a wider range of financial instruments.

The agencies should revise the exemptions for permitted trading in government obligations in the following ways:

- <u>Zero Percent Risk-Weighted Government Obligations</u>: To preserve international comity and liquidity in non-U.S. sovereign bonds, the agencies should permit trading in government obligations that receive a zero percent risk weight under the Federal Reserve's, OCC's and FDIC's capital rules.[203] These types of obligations are the type utilized by banking organizations for risk-management purposes as demonstrated by their beneficial risk-weighting. In the Final Rule's Preamble, the agencies explained that they declined to allow trading in foreign government obligations if the obligations meet a particular condition on quality because they did not believe that such an approach "responds to the statutory purpose of limiting risks posed to the U.S. financial system by proprietary trading activities as directly as our current approach [(*i.e.*, the Final Rule)], which is structured to limit the exposure of banking entities, including depository institutions, to the risks of sovereign debt."[204] We believe these arguments are misguided because the purchases of foreign sovereign debt are generally undertaken for the same reasons as the purchases of U.S. government obligations. The risks associated with banking entities' sovereign debt-related financial instruments can be managed by using existing regulatory tools, such as risk-based capital and other prudential requirements, and, therefore, amending the foreign government obligations exemption to

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See FFIEC, *Bank Secrecy Act/Anti-Money Laundering Examination Manual* (2014), https://www.ffiec.gov/bsa_aml_infobase/documents/BSA_AML_Man_2014_v2.pdf.

[200] This section is responsive to Questions 52–54 in the NPR.

[201] Proposed Rule § _.3(e)(10).

[202] NPR at 33452.

[203] *See* 12 C.F.R. Part 324.32 (FDIC); 12 C.F.R. Part 217.32 (Federal Reserve); 12 C.F.R. Part 3.32 (OCC).

[204] 79. Fed. Reg. at 5644.

allow trading government obligations that receive a zero percent risk weight would not expose U.S. banking entities to undue risk.

- Jurisdictional Requirement: The Final Rule establishes a requirement that financial instruments traded pursuant to the foreign government obligations exemption must be "an obligation of, or issued or guaranteed by, the foreign sovereign under the laws of which" the applicable foreign entity is organized.[205] This jurisdictional condition should be eliminated because it is overbroad in that it does not recognize the benefit of centrally-managed ALM activities or that certain bonds may be fungible across jurisdictions, such as across multiple members of the Eurozone. Along with assisting in centralized risk management, removing this requirement would enhance the ability of U.S. banking entities affiliated with and operating foreign banking entities to benefit from international diversification and participation in global financial markets.

- Trading in Derivatives that Reference Government Obligations: The agencies should expand the exemptions for trading in domestic and foreign government obligations to permit trading in derivatives that reference the government obligations. In practice, desks that trade in government obligations also trade in futures, swaps and options referencing those obligations. Expanding the exemption in this way would allow banking entities to manage their government obligations portfolios and related hedges consistently and, as applicable, under a single trading desk in reliance on the government obligations exemptions. To enhance the effectiveness of firms' integrated government trading and hedging activities and to align with the Final Rule's use of the term "financial instruments,"[206] which is defined to include both securities and derivatives, banking entities should be allowed to engage in trading activity in government obligations not only through transactions with respect to the security itself, but also derivatives thereon.

D. We support providing an exclusion from the "covered fund" definition for venture capital funds.[207]

During legislative proceedings, a number of members of Congress highlighted the importance of keeping venture capital funds outside the scope of entities captured by the Volcker Rule's covered funds provisions.[208] We agree with these legislators' support for distinguishing venture capital funds based on

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205 Final Rule § _.6(b).

206 *See* Final Rule § _.3(d).

207 This section is responsive to Question 164 in the NPR.

208 *See, e.g.*, 156 Cong. Rec. S5904–05 (daily ed. July 15, 2010) (statements by Sen. Boxer recognizing the "crucial and unique role that venture capital plays in spurring innovation, creating jobs and growing companies" and Sen. Chris Dodd that "properly conducted venture capital investment will not cause the harms at which the Volcker rule is directed"); 156 Cong. Rec. S6242 (daily ed. July 15, 2010) (statement by Sen. Brown) ("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 rule. 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*.") (emphasis added); 156 Cong. Rec. S5896

the policy objectives furthered by venture capital investment—these funds are, by virtue of their investment strategy, long-term investment horizon and intermediation between portfolio companies in need of capital and institutional investors seeking to deploy capital in efficient ways, more likely to play a contributing role in capital formation, economic growth and efficient market function. We, therefore, recommend that the agencies adopt an exclusion from the definition of "covered fund" for venture capital funds.

E. BPI supports the efforts of the agencies to improve the trading outside of the United States exemption.

BPI appreciates the broad spirit of the changes in the Proposed Rule to simplify and streamline the Final Rule for all banking entities, including with respect to the extraterritorial impact of the Volcker Rule on foreign banking organizations. BPI supports the Proposed Rule's recognition of the reality of global trading through the proposed expansion of the exemption for trading by foreign banking entities. The revisions to § __.6(e) attempt to focus on where the economic risk of the trading activity resides.

F. We support the Proposed Rule's changes in respect of covered fund activities and investments outside the United States.[209]

The Proposed Rule codifies the agencies' previously issued FAQ guidance that, for purposes of the exemption for covered fund activities and investments conducted "solely outside the United States" (the "**SOTUS Exemption**"), an ownership interest in a covered fund is not "offered for sale or sold to a resident of the United States" if it is not sold, and has not been sold, pursuant to an offering that targets residents of the United States in which the banking entity relying on the exemption (or an affiliate) participates.[210] Furthermore, the Proposed Rule eliminates the Final Rule's requirement that no financing may be provided by any branch or affiliate of the banking entity in the United States for any sponsorship or investment conducted in reliance on this exemption.[211]

(daily ed. July 15, 2010) (statement by Sen. Merkley) ("In general, subparagraph (d)(1)(E) provides exceptions to the prohibition on investing in hedge funds or private equity funds, if such investments advance a ''public welfare'' purpose. It permits investments in small business investment companies, which are a form of regulated venture capital fund in which banks have a long history of successful participation. The subparagraph also permits investments 'of the type' permitted under the paragraph of the National Bank Act enabling banks to invest in a range of low-income community development and other projects."); *see also Monetary Policy and the State of the* Economy, H. Fin. Servs. Comm., 115th Cong. (July 18, 2018) (statements of Rep. Hultgren citing the congressional record as "clearly demonstrat[ing] . . . that investing in venture capital was never intended to be prohibited by the Volcker Rule when Section 619 was drafted by Congress.").

209 This section is responsive to Questions 189–192 in the NPR.

210 Proposed Rule § _.13(b); *see also* NPR at 33485.

211 Proposed Rule § _.13(b)(4); *see also* NPR at 33485.

We support these amendments and believe that the proposed changes will facilitate foreign banking entities' investment and sponsorship activities outside the United States and, more generally, promote international regulatory cooperation.

G. The agencies should codify the guidance related to foreign excluded funds in the amended Final Rule.[212]

In July 2017, the federal banking agencies released a policy statement indicating that they would not propose to take action, during the one-year period ending July 21, 2018, against a foreign banking entity based on attribution of the activities and investments of a "qualifying FEF" to the foreign banking entity, or against a qualifying foreign excluded fund ("**FEF**") as a banking entity, in each case, where the foreign banking entity's acquisition or retention of any ownership interest in, or sponsorship of, the qualifying FEF would meet the requirements of the SOTUS Exemption as if the qualifying FEF were a covered fund.[213] The NPR states that, in order to accommodate the pendency of the proposal, the agencies will extend the one-year stay of enforcement action for an additional year (*i.e.*, until July 21, 2019).[214] We agree with the staffs' guidance in respect of "qualifying FEFs" and believe that the agencies should codify in the amended Final Rule the policy statement and the enforcement stay related to their treatment and exclude qualifying FEFs from the definition of "banking entity."[215]

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212 This section is responsive to Questions 16–18 in the NPR.

213 Statement regarding Treatment of Certain Foreign Funds under the Rules Implementing Section 13 of the Bank Holding Company Act (July 21, 2017), *available at* https://www.federalreserve.gov/newsevents/pressreleases/files/bcreg20170721a1.pdf (last visited October 16, 2018).

214 NPR page 33444.

215 *See* NPR page 33444; *see also* Proposed Rule §__.13(b).

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BPI appreciates the opportunity to comment on the proposal. If you have any questions, please contact the undersigned by phone at [redacted] or by email at [redacted].

Respectfully submitted,

Gregg Rozansky

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cc: Joseph M. Otting, Comptroller of the Currency
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Honorable Jerome H. Powell, Chairman
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Honorable Jelena McWilliams, Chairman
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Honorable Jay Clayton, Chairman
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Honorable J. Christopher Giancarlo, Chairman
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