sifma

Invested in America

February 13, 2012

**Re:** Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds: **Application to Securitization and Insurance-Linked Securities Transactions**

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to provide the agencies (the "**Agencies**")[1] charged with issuing rules implementing new Section 13 of the Bank Holding Company Act of 1956 (the "**Volcker Rule**") with our comments on the Agencies' October 2011 proposed rulemaking regarding the Volcker Rule (the "**Proposed Rules**").[2] The Volcker Rule was added by Section 619 of the Wall Street Reform and Consumer Protection Act of 2010 (the "**Dodd-Frank Act**"). This comment letter relates solely to certain provisions of the Proposed Rules that affect the treatment of asset-backed securities[3] and insurance-linked securities.[4] SIFMA is submitting separately in other letters

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[1] The Agencies are the Office of the Comptroller of the Currency (the "**OCC**"), the Board of Governors of the Federal Reserve System (the "**Board**"), the Federal Deposit Insurance Corporation (the "**FDIC**"), the Securities and Exchange Commission (the "**SEC**") and the Commodity Futures Trading Commission (the "**CFTC**"). The respective rule identifiers are Docket No. R-1432, RIN 7100-AD82 (Board), RIN 3064-AD85 (FDIC), Docket No. OCC-2011-0014, RIN 1557-AD44 (OCC), File Number S7-41-11, RIN 3235-AL07 (SEC), RIN 3038-AD05 (CFTC).

[2] 76 Fed. Reg. 68,846 (Nov. 7, 2011).

[3] As used herein, "**asset-backed security**" means a fixed-income or other security collateralized by any type of financial asset (including a loan or other extension of credit referred to herein, a lease, a mortgage, or a secured or unsecured receivable) that allows the holders of the security to receive payments that depend on the cash flow from the asset, and also includes asset-backed commercial paper and synthetic asset-backed securities. The definition is also intended to cover securities issued by so-called "repack" special purpose vehicles, which issue asset-backed securities that may be exposed primarily to corporate debt assets, but may be collateralized (directly or indirectly) by commercial real estate or corporate loan assets or certain nonfinancial assets such as aircraft, storage containers, equipment or other hard assets.

[4] As used herein, "**insurance-linked security**" means a fixed-income or other security that allows the holder to receive payments that depend on the occurrence or non-occurrence of a natural disaster, catastrophe, pandemic or other similar event but that do not primarily depend on the cash flow from assets that collateralize the security.

comments on the general proprietary trading and covered funds provisions of the Proposed Rules and provisions of the Proposed Rules that impact municipal securities and tender option bonds.[5]

## I. Background and Summary of Recommendations

The Volcker Rule generally prohibits any "banking entity"[6] from: (i) acquiring or retaining any "ownership interest" in or "sponsoring" a "hedge fund" or "private equity fund"; (ii) entering into Federal Reserve Act Section 23A "covered transactions" (including loans, guarantees or purchases of securities or assets) with any "hedge fund" or "private equity fund" for which it serves as sponsor, investment manager or investment adviser (a prohibition which we hereafter refer to as "**Super 23A**") and (iii) engaging in "proprietary trading."[7]

Although the Volcker Rule is intended to address issues relating to sponsorship and ownership by banking entities of hedge funds and private equity funds and not securitization issuers, new Section 13 defines "hedge fund" and "private equity fund" as any "issuer that would be an investment company under the Investment Company Act of 1940 … but for section 3(c)(1) or 3(c)(7) of that Act, or such similar funds as the appropriate Federal banking agencies, the Securities and Exchange Commission, and the Commodity Futures Trading Commission may, by rule, as provided in section (b)(2), determine."[8] Even though they are not hedge funds or private equity funds, many issuers of asset-backed securities and insurance-linked securities rely upon Section 3(c)(1) or 3(c)(7) for an exemption from the Investment Company Act of 1940 (the "**1940 Act**"). Accordingly, reading the Section 13 definition of "hedge fund" and "private equity fund" in isolation, such issuers could be viewed as being "hedge funds" or "private equity funds" merely by virtue of relying upon such exemptions. This construction would prohibit banking

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[5] SIFMA has previously submitted the following comment letters in connection with the Volcker Rule: (i) a comment letter dated November 5, 2010 to the Financial Stability Oversight Council ("**FSOC**") in connection with its study mandated under the Dodd-Frank Act and recommendations to the Agencies regarding the Volcker Rule's implementation as it relates to hedge funds and private equity funds, (ii) a comment letter dated November 5, 2010 to the FSOC in connection with the FSOC Study as it relates to proprietary trading, (iii) a comment letter dated December 27, 2010 to the Board of Governors of the Federal Reserve System on implementation of the Volcker Rule, and (iv) a comment letter dated April 14, 2011, as supplemented by a supplemental comment letter dated May 9, 2011, from SIFMA's asset management group to the Agencies on implementing the private funds portion of the Volcker Rule. In addition to this letter, SIFMA is submitting four additional letters regarding other aspects of the Volcker Rule: (i) proprietary trading ban, (ii) private funds restrictions, (iii) municipal securities, and (iv) investor perspectives on the proprietary trading ban. SIFMA also is separately submitting a comment letter to the SEC's proposed rules implementing Section 27B of the Securities Act of 1933 (the "**Securities Act**").

[6] "**Banking entity**" is defined in Volcker Rule Section 13(h)(1) and includes any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company under the International Banking Act, and any affiliate or subsidiary of any of the foregoing.

[7] Volcker Rule Sections 13(a)(1), 13(f).

[8] *Id.*, Section 13(h)(2).

entities from sponsoring or retaining an ownership interest in such issuers (subject to the limited exemptions in the Proposed Rules). In addition, Super 23A would prohibit a banking entity that serves as sponsor, investment manager or investment adviser of such an issuer from extending loans to, purchasing assets from or entering into other "covered transactions" with such issuer which, as further discussed below, would significantly limit, and in many cases prevent, banking entities from securitizing their assets.

Recognizing the crucial role that securitization plays in financing credit, Congress sought to avoid these results by specifying in Section 13(g)(2) of the Volcker Rule that the rule is not to be "construed to limit or restrict the ability of a banking entity or nonbank financial company … to sell or securitize loans…" (the "**Securitization Exclusion**").[9] Notably, the plain language of the Securitization Exclusion requires that the Volcker Rule not be "construed to *limit* or *restrict* the *ability*" (emphasis added) to sell or securitize loans, and not just that it not be construed to *prohibit* or *unduly* limit or restrict such activities.[10] Rulemaking that renders such activities impractical, despite the plain language of the Securitization Exclusion, would therefore fail the clear requirement of the Securitization Exclusion.

In the FSOC Study mandated under the Dodd-Frank Act, the FSOC describes Section 13(g)(2) as "an inviolable rule of construction [designed to ensure] that the economically essential activity of loan creation is not infringed upon by the Volcker Rule" and recommends that the Agencies be guided by the exclusion in crafting the Proposed Rules.[11] The FSOC further observes that "Congress determined that none of the restrictions of the Volcker Rule, nor the 'backstop' restrictions on permitted activities, will apply to the sale or securitization of loans."[12] Recognizing that a broad spectrum of legal entities that are not hedge funds or private equity funds structure transactions to rely on Sections 3(c)(1) and 3(c)(7), the FSOC also recommends that, in devising the Proposed Rules, the Agencies carefully evaluate the range of such entities with a view to narrowing the statutory definitions of "hedge fund" and "private

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[9] *Id.*, Section 13(g)(2).

[10] *Id.*

[11] Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships With Hedge Funds and Private Equity Funds (January 2011) (the "**FSOC Study**"), at 47. (The FSOC further emphasizes that "[t]he creation and securitization of loans is a basic and critical mechanism for capital formation and distribution of risk in the banking system. While these activities involve the assumption of principal risk, the broader benefits to the economy reflect the intent of federal borrowing subsidies and protections.").

[12] *Id.*

equity fund" where appropriate.[13] Section 13(b)(2)(A) of the Volcker Rule expressly requires the Agencies to consider the findings of the FSOC Study when crafting implementing rules.[14]

Despite the Securitization Exclusion and the FSOC Study recommendations, the Agencies have chosen not to exclude issuers of asset-backed securities ("**ABS Issuers**") from the Proposed Rules' definition of "covered funds."[15] Although the Agencies have included exemptions in the Proposed Rules for loan securitizations and for ownership interests retained in order to comply with the credit risk retention requirements of new Section 15G of the Securities Exchange Act of 1934 (the "**Exchange Act**"), as further discussed below they have crafted these exemptions too narrowly to achieve the Securitization Exclusion's intended purpose. Moreover, the Proposed Rules provide for banking entities that sponsor securitization issuers pursuant to those exemptions to be subject to Super 23A with respect to their loans to, asset purchases from, and other "covered transactions" entered into with such issuers.[16] For the reasons discussed below, this will effectively render such exemptions useless, in contravention of the Securitization Exclusion mandate that the Volcker Rule not be construed to limit or restrict the ability of banking entities to securitize loans.

Consistent with the Securitization Exclusion, the Agencies have long recognized the critical role asset securitization plays in ensuring the availability of credit and non-governmental bank funding in the real economy and in promoting bank safety and soundness and financial stability.[17] We acknowledge the Agencies' good faith efforts to effectuate the Securitization

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[13] *Id.*, at 62.

[14] The FSOC's recommendation, coupled with the requirement in Volcker Rule Section 13(b)(2)(A) that the Agencies consider the findings of the FSOC Study in crafting their implementing regulations, forms a statutory basis (separate from the Securitization Exclusion) for the Agencies to exclude ABS Issuers from the definition of "covered funds." The statutory definition of "hedge fund" and "private equity fund" as issuers that would be investment companies but for Section 3(c)(1) or 3(c)(7) of the 1940 Act "*or*" (emphasis added) such similar funds as the Agencies may by rule determine is disjunctive rather than conjunctive and provides another statutory basis for the Agencies to adopt a definition of covered fund that is more reflective of the common meaning of "hedge fund" and "private equity fund."

[15] In addition, although not explicitly specified in the Volcker Rule to be hedge funds or private equity funds, the Agencies have chosen to add to the Volcker Rule definition issuers that are organized or offer securities outside the United States and that would fall within the Volcker Rule definition if they were organized under the laws of, or offered securities to one or more residents of, the United States (the "**Non-U.S. Issuer Inclusion**"), a provision of uncertain scope that could be interpreted to encompass certain non-U.S. ABS Issuers. Proposed Rules Section .10(b)(1)(iii).

[16] *Id.*, Section .16.

[17] *See, e.g.*, the statement of the Office of the Comptroller of the Currency in proposing enhancements to the securitization provisions of its investment securities regulations: "The ability of banks to sell conventional bank assets through the issuance and sale of certificates evidencing interests in pools of the assets provides flexibility that can enhance banks' safety and soundness. Asset securitization provides an important source of liquidity by allowing

Exclusion in the Proposed Rules. However, such efforts do not go far enough and will result in the very effects on the credit and bank funding markets that the Securitization Exclusion was intended to avoid. Further, as the Joint Forum of the Basel Committee on Banking Supervision recently reiterated, "re-establishing sustainable securitization markets has been high on the agenda of the Group of Twenty (G20), the Financial Stability Board (FSB), and other international organizations and national governments since the onset of the [credit] crisis."[18] We are concerned that the way the Agencies have chosen to implement the Securitization Exclusion in the Proposed Rules risks undermining such agenda, not only in the United States but (because the Proposed Rules purport to apply to U.S. and non-U.S. banking entities on a worldwide basis) internationally as well.

In order to prevent these consequences, we recommend that the Agencies modify the Proposed Rules as follows:

(i) Because ABS Issuers are not hedge funds or private equity funds, the Agencies should, as intended by the Securitization Exclusion, exclude such issuers from the Proposed Rules' definition of "covered funds."

(ii) Further, because we do not believe issuers of insurance-linked securities ("**ILS Issuers**") were intended to be "covered funds" under the Volcker Rule, the Agencies should exclude ILS Issuers from such definition.

We believe that excluding ABS Issuers and ILS Issuers from the definition of "covered funds" is required to ensure the practical viability of banking entity securitization and insurance-linked securities transactions. We have also discussed with our members other modifications that could be made to the Proposed Rules to mitigate their negative impact if the Agencies decline to exclude ABS Issuers and ILS Issuers from the definition of "covered funds." We set forth our alternative recommendations in clauses (i) through (vii) of the following paragraph, but emphasize that we view these as imperfect substitutes that will add needless burden and complexity to securitization and insurance-linked securities transactions and will not address the

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banks to convert relatively illiquid assets into instruments with maturities and other features that investors are readily willing to purchase. Another important benefit is the increased credit available, due to the fact that a bank may make more loans with a given level of capital (when the assets are removed from the bank's balance sheet) and may diversify its lending into new markets without incurring undue risk. Also, a bank is less dependent on deposits to fund its loans, improving bank profitability, with positive implications for reducing bank failure rates and minimizing draws on the deposit insurance funds." 60 Fed. Reg. 66,152, at 66,155 (Dec. 21, 1995).

[18] The Joint Forum, Basel Committee on Banking Supervision, Report on Asset Securitization Incentives (July 2011); *see also* Financial Stability Board, Progress Since the Washington Summit in the Implementation of the G20 Recommendations for Strengthening Financial Stability – Report of the Financial Stability Board to G20 Leaders (Nov. 2010) (stating that "re-establishing securitization on a sound basis remains a priority in order to support provision of credit to the real economy and improve banks' access to funding in many jurisdictions.").

entire scope of unintended consequences and other potential adverse outcomes that could be prevented by simply excluding ABS Issuers and ILS Issuers from the definition of "covered funds" as requested above.

That said, for the reasons set forth below, if the Agencies decline to exclude ABS Issuers and ILS Issuers from the definition of "covered funds," we recommend that the Agencies:

(i) modify the exemptions set forth in Sections .13(d) and .14(a)(2)(v) of the Proposed Rules for loan securitizations (the "**loan securitization exemptions**") to provide that ABS Issuers that issue asset-backed securities backed by or referencing any type of credit extension (including bonds, other debt securities, asset-backed securities, variable funding notes and securities lending agreements, repurchase agreements, reverse repurchase agreements and other similar extensions of credit) that a banking entity could hold or deal in directly come within such exemptions;

(ii) modify the exemption set forth in Section .14(a)(2)(iii) of the Proposed Rules (the "**risk retention exemption**") to permit, in addition to risk retention required to be maintained under Section 15G of the Exchange Act, risk retention retained under any other law or regulation (including, without limitation, the Federal Deposit Insurance Corporation's Securitization Safe Harbor Rule,[19] Article 122a of the European Capital Requirements Directive[20] and corresponding rules applicable to European credit institutions and other regulated investors[21]) and to allow for the retention of more than the minimum required risk retention;

(iii) add a separate exemption in Section .14 for ILS Issuers;

(iv) exempt transactions between a banking entity and an ABS Issuer or ILS Issuer from Super 23A;

(v) clarify the terms "sponsor" and "ownership interest" in the Proposed Rules as they relate to ABS Issuers and ILS Issuers and provide that the prohibition on ownership interests and Super 23A do not cover ownership interests relating to underwriting or market-making activities;

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[19] "Treatment of financial assets transferred in connection with a securitization or participation," 12 C.F.R. 360.6 (the "**FDIC Securitization Safe Harbor Rule**").

[20] Directive 2006/48/EC, as amended by Directive 2009/111/EC.

[21] *See, e.g.*, Directive 2009/138/EC Article 135(2) (insurance and reinsurance undertakings), Directive 2011/61/EU Article 17 (alternative investment fund managers), Article 65 (amending Directive 2009/65/EC (Undertakings for Collective Investment in Transferrable Securities)). Note that the European rules require economic risk retention by the originator, sponsor or original lender as a condition to the capital treatment of an investment by the regulated investor, not as a direct mandate to the originator, sponsor or original lender. The exemption needs to be broad enough to include these requirements.

(vi) if the Agencies determine not to exempt ABS Issuers and ILS Issuers from the definition of "covered fund," exempt ABS Issuers and ILS Issuers from the compliance and reporting requirements under the Proposed Rules; and

(vii) exempt asset-backed securities and insurance-linked securities transactions and issuers in existence prior to the effective date of the Volcker Rule from its prohibitions.

Regardless of whether the Agencies exclude ABS Issuers and ILS Issuers from the definition of "covered fund," as we urge them to do, or pursue an alternative approach we recommend that, in addition, the Agencies modify the Proposed Rules as follows:

(i) modify the Proposed Rules to exclude ABS Issuers and ILS Issuers from the definition of "banking entities;"

(ii) pursuant to the FSOC Study[22] and the Securitization Exclusion, modify the Proposed Rules to provide that the Volcker Rule "backstop" restrictions on permitted activities do not apply to asset-backed securities transactions. However, if they are applied to such transactions, modify the provisions of the Proposed Rules governing conflicts of interest to allow that any securitization that satisfies the conflicts of interest provisions under Rule 127B, as amended as suggested in our comment letters to the SEC, be deemed to satisfy any applicable conflict of interest provisions under the applicable sections of the Volcker Rule;

(iii) modify the definition of "covered financial position" to make clear that it does not include any asset-backed security that would be eligible for the loan securitization exemptions (modified as provided herein) to the Proposed Rules' covered fund ownership and sponsorship prohibition; and

(iv) modify the Proposed Rules to clarify that transactions that are incidental to securitizations do not constitute impermissible proprietary trading.

We discuss each of these recommendations in detail below.

We have organized our discussion as follows: Sections II and III below detail why it is essential to exclude ABS Issuers and ILS Issuers from the definition of "covered funds." Sections IV through IX below suggest alternatives for mitigating the negative impact of the Proposed Rules on securitization and insurance-linked securities transactions if the Agencies decline to exclude ABS Issuers and ILS Issuers from the definition of "covered funds." We emphasize again that we do not believe such alternatives will adequately address the extremely adverse consequences (including certain of those described below) that could be prevented by simply excluding ABS Issuers and ILS Issuers from the definition of "covered funds." Sections X through XIII below set forth recommendations that address the Proposed Rules' definition of

[22] *See* fn 11, *supra*.

"banking entity," prohibition on proprietary trading and conflicts of interest and other "backstop" restrictions as they relate to securitization and insurance-linked securities transactions.

## II. ABS Issuers Should Not Be Considered to Be "Covered Funds"

Consistent with the Securitization Exclusion and the FSOC's recommendations, and in marked contrast to how the Agencies have regarded bank sponsorship and ownership of hedge funds and private equity funds, the Agencies have long regarded sponsorship of ABS Issuers and ownership of asset-backed securities as an essential part of the business of banking.[23] Courts considering the issue have similarly characterized such activities.[24] Thus, even under the Glass-Steagall Act (which, among other things, generally restricted the ability of banks to sponsor and own hedge funds and private equity funds), the Agencies and the courts deemed sponsorship of ABS Issuers and ownership of interests therein to be a permissible banking activity.[25]

Moreover, market participants do not view asset-backed securities issued by ABS Issuers as posing the same risks as securities issued by hedge funds and private equity funds or other ownership interests therein. Historically, the Agencies have similarly recognized this distinction, and have therefore treated asset-backed securities differently in their regulations (including their legal investment regulations) from securities of such funds.[26]

We believe that the Dodd-Frank Act does not disturb this distinction or mandate that the Agencies apply an approach different from historical practices, but rather reaffirms the separateness of the securitization regulatory regime from that applicable to hedge funds and

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[23] *See, e.g.*, 12 C.F.R. 1.3(g) (providing that "[a] national bank may securitize and sell assets that it holds, as part of its banking business. The amount of securitized loans and obligations that a bank may sell is not limited to a specified percentage of the bank's capital and surplus."); OCC Interpretive Letter No. 1133 (pursuant to 12 C.F.R. 1.3(g), a national bank may securitize both assets it originates and assets it acquires from others); 12 C.F.R. 1.2(1) and (m) (authorizing national banks to invest in residential mortgage-related securities, commercial mortgage-related securities, small business-related securities and asset-backed securities); and 12 C.F.R. 1.3(h) (a national bank may purchase and sell shares in pooled investment vehicles whose assets consist exclusively of assets that the bank may purchase and sell for its own account).

[24] *See Securities Industry Association v. Clarke*, 885 F. 2d 1034 (2d Cir. 1989), *cert. denied*, 493 U.S. 1070 (1990) (sale by banks of securities backed by bank-eligible assets are within the business of banking and therefore do not violate the Glass-Steagall Act (upholding OCC Interpretive Letter No. 388, which had reached the same conclusion)). *See also* letter from William W. Wiles, Secretary of the Federal Reserve Board, to Robert J. Unruh, Executive Vice President, Meridian Bancorp, Inc., dated Jan. 17, 1995 (concluding that the underwriting of mortgage-backed securities is a traditional banking activity (*i.e.*, the sale of the bank's own assets) that is permitted notwithstanding the Glass-Steagall Act).

[25] *Id.*

[26] *See, e.g.*, 12 C.F.R. Part 1 (distinguishing between securities of asset-backed securities issuers whose underlying investments are eligible for investment for the bank's own account and securities of other issuers).

private equity funds. Congress expressly included in the Dodd-Frank Act a broad new regulatory framework (separate from the Volcker Rule and not applicable to hedge funds or private equity funds) governing asset-backed securities, through which it intended to address the manner in which banking entities and others engage in securitizations.[27] In light of the separate Dodd-Frank Act securitization framework and other regulations squarely addressing securitization,[28] and Congress' explicit desire to insulate loan securitization activities from any unintended consequences resulting from the broad definition of covered funds, it is clear that Congress did not intend for the Volcker Rule be used to regulate the securitization activities of banking entities.

Consistent with the foregoing, in promulgating regulations under the Dodd-Frank Act, the Agencies have thus far been careful to distinguish ABS Issuers from hedge funds and private equity funds. Thus, for example, although the Dodd-Frank Act requires advisers registered with the SEC and managing one or more private funds that rely upon the Section 3(c)(7) exemption to file reports with respect to such funds with the SEC, in its implementing regulations the SEC wisely excluded "securitized asset funds" (which it defines as funds "whose primary purpose is

[27] *See, e.g.*, Section 15G of the Exchange Act added by Section 941 of the Dodd-Frank Act and rules to be implemented (mandating credit risk retention with respect to asset-backed securities (as defined in new Section 3(a)(77) of the Exchange Act ("**Exchange Act ABS**")); Section 942(b) of the Dodd-Frank Act (disclosure requirements for Exchange Act ABS); Rule 15Ga-1 under the Exchange Act and Items 1104(e) and 1121 of Regulation AB implementing Section 943 of the Dodd-Frank Act (disclosure of repurchase demand activity with respect to asset-level representations and warranties in offerings of Exchange Act ABS); Rule 193 under the Securities Act and revised Item 1111 of Regulation AB implementing Section 7(d) of the Securities Act added by Section 945 of the Dodd-Frank Act (due diligence and related disclosures in registered offerings of Exchange Act ABS); Section 27B of the Exchange Act added by Section 621 of the Dodd-Frank Act and rules to be implemented (conflicts of interest relating to Exchange Act ABS and synthetic asset-backed securities); Rule 17g-7 under the Exchange Act implementing Section 943 of the Dodd-Frank Act (disclosure of comparison by rating agencies of the representations and warranties made and enforcement mechanisms in an offering of Exchange Act ABS against market standards); and Section 15E(s)(4)(A) of the Exchange Act added by Section 932 of the Dodd-Frank Act and rules to be implemented (requiring rating agencies, issuers and underwriters to make public the findings and conclusions of any due diligence reports prepared by a third-party service provider in an Exchange Act ABS transaction). Although we note the ability of the Agencies to regulate securitizations by means of these and other laws and regulations, this letter relates solely to the Proposed Rules and is not intended to express any view on the proper or permissible scope of any other regulation.

[28] For example, the SEC has proposed changes to its Regulation AB (which currently applies only to public offerings of Regulation AB "asset-backed securities" and therefore has no direct effect on offerings by ABS Issuers that rely on Section 3(c)(1) or 3(c)(7)) that would impose requirements on private placements of "structured finance products" (including Exchange Act ABS and synthetic asset-backed securities) if the private placement is conducted pursuant to Rule 506 of the SEC's Regulation D or the SEC's Rule 144A. *See* SEC Release No. 33-9117 and SEC Release No. 33-9244.

to issue asset-backed securities and whose investors are primarily debt-holders") from such requirements even though they also rely upon the Section 3(c)(7) exemption.[29]

If an ABS Issuer were deemed to be a "covered fund," then if a banking entity sponsors, manages, or advises such ABS Issuer, it will be prohibited by Super 23A from entering into "covered transactions" with the issuer, including purchasing assets from or extending credit or issuing guarantees to such ABS Issuer.[30] For example, the banking entity would be unable to repurchase assets from the ABS Issuer for breaches of representations or warranties made in connection with its sales of assets into the related securitization or to make servicing advances to, or provide liquidity facilities or guarantees in respect of, such securitization,[31] all of which are customary, and in most cases necessary, structural features for a securitization to be viable ("**securitization related transactions**").[32] This would be true even when the banking entity was acting as sponsor of the issuer pursuant to one of the loan securitization exemptions (discussed below), because Super 23A contains no applicable exemption with respect to transactions with a covered fund in such case.[33] Indeed, the Agencies appear to take the position that the Volcker Rule limits their ability to provide exemptions from Super 23A-prohibited covered transactions with a company, once the company is deemed to be a "covered fund."[34] Typically a banking entity that sponsors an ABS Issuer would be expected to engage in one or more securitization-

[29] Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, 76 Fed. Reg. 71,128 (Nov. 16, 2011).

[30] Proposed Rules Section .16.

[31] Beginning in July 2012, Section 608 of the Dodd-Frank Act adds derivatives transactions with affiliates to the list of Section 23A covered transactions to the extent they result in credit exposure to a bank. Accordingly, banking entities would also be prohibited from entering into such derivatives with an ABS Issuer.

[32] Securitization-related transactions include core transaction features that have evolved over time in multiple securitization transactions. Many of these features, including repurchase obligations for breaches of representations and warranties in asset-backed securities transactions, are now subject to regulation, including rules implemented pursuant to Title IX of the Dodd-Frank Act.

[33] The Proposed Rules' sole exemptions from Super 23A are for the acquisition or retention of ownership interests in securities issued by a related covered fund in accordance with the requirements of Subpart C of the Proposed Rules and for prime brokerage transactions with such fund. *See* Proposed Rules Section .16(a)(2). As noted in fn 34, *infra*, the Agencies appear to believe they are limited in granting any other exemptions.

[34] The Agencies apparently view Super 23A as operating "as an independent prohibition and set of limitations on the activities of banking entities," and accordingly the Agencies believe they are limited in granting exemptions therefrom, even with respect to activities that the Proposed Rules exempt pursuant to new Volcker Rule Section 13(d)(1)(J). *See* Proposed Rules, fn 313. However, this interpretation clearly would result in Super 23A "limiting" or "restricting" the activity of entities in the sale or securitization of loans in contravention of the plain language of the Securitization Exclusion.

related transactions with such ABS Issuer.[35] As a consequence, deeming ABS Issuers to be "covered funds" will, as a practical matter, prevent banking entities from sponsoring ABS Issuers, in contravention of the Securitization Exclusion (which prohibits the Agencies from construing the Volcker Rule to limit or restrict loan securitizations).

Given the definition of "banking entity" and the scope of the Proposed Rules, deeming ABS Issuers to be "covered funds" will lead to a host of other extremely adverse consequences that cannot have been intended by Congress in enacting the Volcker Rule. For example, a manufacturer (*e.g.*, an automobile manufacturer) or other non-financial company (even one that is organized overseas) that is a banking entity solely because it is affiliated with a small U.S. depository institution would be subject, potentially on a worldwide basis, to the Proposed Rules' prohibition on sponsoring or having an ownership interest in an ABS Issuer (even one that was organized outside the United States) and to Super 23A. Accordingly, it would need to undertake a burdensome and potentially costly analysis of whether each securitization it contemplates that relies on Section 3(c)(1) or 3(c)(7) would comply with the Volcker Rule and, in some cases, would be prevented by the Volcker Rule from sponsoring the securitization. Further, as a result of the Non-U.S. Issuer Inclusion,[36] such a company might have to undertake such analysis, and could be precluded from issuing securitizations through a non-U.S. ABS Issuer that does not rely upon Section 3(c)(1) or 3(c)(7) of the 1940 Act, but which would need to rely upon such exemption if it were a U.S. ABS Issuer.

As another example, a foreign banking entity (even one with a relatively minor U.S. banking presence) that seeks to sponsor a non-U.S. securitization, some of whose securities might potentially be sold into the United States or to U.S. residents, would need to undertake a similar analysis each time it considers engaging in such a securitization, and could similarly be precluded from sponsoring the securitization. This would be true even when the reason such a securitization issuer is relying (or might hypothetically need to rely) on Section 3(c)(1) or 3(c)(7), rather than another 1940 Act exemption, is entirely technical. For example, because the securitization is foreign-based, it might use a non-U.S. bank as trustee and therefore be unable to

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[35] For example, a banking entity sponsoring an asset-backed commercial paper conduit (which may rely on Section 3(c)(1) or 3(c)(7) for its 1940 Act exemption) customarily will provide liquidity support and/or credit enhancement to the commercial paper holders through liquidity facilities, guarantees and/or letters of credit, among other things. In addition, a banking entity determined to be a sponsor of a covered fund that is acting as a trustee for the covered fund customarily will perform ministerial duties for the related ABS Issuer but also may be obligated to engage in securitization related transactions including, for example, if it assumes the duties of a servicer pending appointment of a successor or liquidates collateral held by the ABS Issuer. Further, a banking entity sponsoring a covered fund and acting as securitizer under Section 15G of the Exchange Act may seek or be obligated to retain risk in excess of the minimum permitted under Section .14(a)(2)(iii), which as a technical matter would not fall within the exceptions under Section .16(a)(2) of the Proposed Rules. *See* fn 66, *infra*.

[36] *See* fn 15, *supra*.

use the exemption in SEC Rule 3a-7 under the 1940 Act,[37] which requires that a U.S. bank act as trustee.[38] Such results are particularly troublesome because, while undermining securitization on a worldwide basis, they have no meaningful relationship to the concerns relating to hedge funds and private equity funds that prompted the Volcker Rule.

Conversely, a company that is not a banking entity would be able to sponsor ABS Issuers and engage in "covered transactions" to obtain less costly funding without violating the Volcker Rule, putting banking entities at a competitive disadvantage and causing securitization activity to shift to the shadow banking system where it may be more difficult for the Agencies to regulate.

In addition, many existing asset-backed securities that could be affected by the Volcker Rule have scheduled maturities that exceed the Proposed Rules' conformance and extension periods.[39] Deeming ABS Issuers to be covered funds could, in cases where the loan securitization exemptions (as currently drafted) may not be available or Super 23A may prohibit the fulfillment of certain contractual commitments, put such ABS Issuers in the untenable position of having either to violate the prohibitions of the Volcker Rule after such periods or to breach their contractual obligations under such securitizations.[40]

Further, as the Agencies have themselves acknowledged,[41] even if banking entities are contractually able to divest themselves of ownership interests in, and end relationships with, such ABS Issuers within the conformance and extension periods, doing so could cause significant market disruption and result in selling pressures that may have a severe and adverse effect on market prices or otherwise result in higher price volatility, which could negatively impact all investors in asset-backed securities. In addition, since banking entities (a particularly large universe of investors because "banking entities" include all affiliates of a banking entity, whether

[37] SEC Rule 3a-7 under the 1940 Act exempts from its definition of "investment company" certain issuers of asset-backed securities, subject to satisfaction of certain conditions.

[38] Rule 3a-7(a)(4)(i).

[39] Proposed Rules Part 44.

[40] For example, banking entities may be prohibited by Super 23A from engaging in securitization related transactions as described above. Moreover, it is not clear whether securitization participants would be able to satisfy all conditions to amend the transaction documentation, including any investor and securitization participant consent requirements, to take advantage of a 1940 Act exemption other than Section 3(c)(1) or 3(c)(7) or otherwise conform the transaction documentation to the requirements of the Volcker Rule. Failure to satisfy all conditions to amend a transaction without breaching transaction covenants may have corresponding consequences, including default. Default on the securities could leave banking entities exposed to significant damages claims, result in loss to investors, and/or reduce the market value or liquidity of securities held (including securities held by third-party investors).

[41] *See*, 78 Fed. Reg. 68,846, at 68,931 (Nov. 7, 2011).

U.S. or non-U.S.) may no longer be able to invest in such securities, there will be fewer potential investors, which will significantly reduce liquidity in the securitization market.

Including ABS Issuers in the definition of "covered fund" will also leave banking entities vulnerable to changes in the SEC's 1940 Act rules and regulations. For example, while some ABS Issuers are currently eligible to rely upon SEC Rule 3a-7 or Section 3(c)(5) for an exemption from the 1940 Act, the SEC has indicated that it is reexamining the terms of such exemptions.[42] If such terms were to change, issuers that previously relied upon these exemptions could be forced to rely (if they are able) upon Section 3(c)(1) or 3(c)(7) in order to continue to be exempted from the 1940 Act, and as a result could become subject to the Volcker Rule, even with respect to their pre-existing securitizations. The specter of such events could cause many banking entities to refrain from issuing securitizations until the SEC finalizes any changes to Rule 3a-7 and its interpretation of Section 3(c)(5) and may even deter issuance thereafter (because future changes in the exemptions would still be possible).

Including ABS Issuers in the definition of "covered fund" would also result in banking entities being subjected to the Proposed Rules' reporting and compliance requirements with respect to "covered funds," which as currently drafted are designed for dealings with hedge funds and private equity funds (rather than ABS Issuers), and would add unnecessary burden and expense with respect to the securitization process.

## III. ILS Issuers Should Not Be Deemed to Be Covered Funds

We further urge the Agencies to exclude ILS Issuers, organized for the purpose of issuing insurance-linked securities, from the definition of "covered fund."

By way of background, insurance-linked securities were first developed in the 1990s to enable insurance companies to manage their insurance risk relating to natural disasters (such as earthquakes and hurricanes) by issuing securities. In the typical structure, an ILS Issuer (organized as a special purpose vehicle) enters into a reinsurance or similar contract ("**reinsurance contract**") with an insurance or other company ("**insurance company**") that covers the company's risk with respect to one or more natural disasters, catastrophes, pandemics, or similar events (be they natural events or man-made). In order to fund its obligations under the reinsurance contract, the ILS Issuer issues bonds or other debt instruments (insurance-linked securities), generally in a private placement structured to rely on the resale exemption under SEC Rule 144A or in sales outside of the United States pursuant to SEC Regulation S, to sophisticated

[42] *See* SEC Release No. IC-29779. In the release, the SEC has requested comment on (i) the treatment of securities under Rule 3a-7, whether the ratings requirements in Rule 3a-7 should be changed and whether other modifications to that rule may be appropriate, and (ii) whether Section 3(c)(5) of the 1940 Act should be amended by Congress to exclude certain asset-backed securities issuers or whether the SEC should limit the use of Section 3(c)(5) by certain issuers of asset-backed securities.

investors, and invests the proceeds of such securities in high quality and highly liquid instruments ("**eligible investments**") that the ILS Issuer pledges to the insurance company to secure the ILS Issuer's payment obligations under the reinsurance contract. The ILS Issuer uses the investment income on the eligible investments, together with premiums received from the insurance company under the reinsurance contract, to pay interest on the insurance-linked securities to investors. The natural disaster or other catastrophic event that triggers ILS Issuer payments to the insurance company under the reinsurance agreement is defined in the transaction documents. If the disaster occurs, the ILS Issuer uses cash proceeds of the eligible investments to make such payments, resulting in losses to the holders of the insurance-linked securities.

Typically, ILS Issuers rely upon Section 3(c)(7) for an exemption from the 1940 Act. Accordingly, without an exclusion, they could fall within the Proposed Rules' definition of "hedge fund" or "private equity fund." However, ILS Issuers bear no resemblance to hedge funds and private equity funds. ILS Issuers are simply vehicles through which insurance companies can obtain the economic equivalent of reinsurance where reinsurance contracts might otherwise be more expensive or unavailable. They also bear no resemblance to ABS Issuers because the performance of their securities is tied to the potential occurrence or non-occurrence of such natural disasters or other catastrophic events, rather than to the performance of the underlying (high quality and highly liquid) financial assets held by the ILS Issuer.

Unless ILS Issuers are exempted from being covered funds, an insurance company that was also a banking entity (*e.g.*, by virtue of being affiliated with a depository institution) would be unable to "sponsor" such an issuer. In addition, in many transactions the insurance company retains a portion of the risk of the natural disaster covered by the transaction, which gives market participants confidence that the insurance company's interests are aligned with investors, *i.e.*, it has "skin in the game." If the ILS Issuer were deemed to be a covered fund and such retained risk were deemed to be an "ownership interest," the insurance company could be prohibited from doing so. Further, if such insurance company were deemed to be a sponsor, adviser or manager of an ILS Issuer, it would be subject to Super 23A with respect to its covered transactions with such issuer, which might prohibit not only such risk retention but also other transactions with such issuer. Any of the foregoing could cause the insurance company to be unable to mitigate its risk through insurance-linked securities transactions, a result we are certain was not intended by Congress in enacting the Volcker Rule. Moreover, if ILS Issuers were deemed to be "covered funds" and their insurance-linked securities to represent "ownership interests," banking entities that were otherwise legally permitted to invest in such securities would be prohibited from doing so, which could dramatically reduce the market for and liquidity of such securities and needlessly increase costs in the insurance industry. Those increased costs would ultimately be passed along to businesses and consumers. Accordingly, the Agencies should exclude such issuers from the definition of "covered fund."

## IV. If the Agencies Decline to Exempt ABS Issuers from the Definition of "Covered Fund," the Loan Securitization and Risk Retention Exemptions Should Be Modified to Better Effect the Intent of the Securitization Exclusion

The Proposed Rules set forth three exemptions that directly address securitizations:

(i) the Section .13(d) exemption for loan securitizations, which appears to be aimed at permitting securitizations by a banking entity of its own "loan" assets;

(ii) the Section .14(a)(2)(v) exemption that, although worded almost identically with the Section .13(d) exemption, appears to be aimed at permitting acquisition of asset-backed securities by a banking entity which did not sponsor such securities (together with the Section .13(d) exemption, the "**loan securitization exemptions**"); and

(iii) the Section .14(a)(2)(iii) exemption, which permits a banking entity to retain an amount or value of ownership interests in an issuer of an "asset-backed security" in order to comply with the "minimum" risk retention requirements of new Section 15G of the Exchange Act and any implementing regulations thereunder (the "**risk retention exemption**").

Although the Securitization Exclusion (and Section 13(d)(1)(J) of the Volcker Rule) provide broad flexibility for the Agencies to exempt loan securitizations from the prohibitions of the Volcker Rule, in crafting the loan securitization and risk retention exemptions the Agencies have taken a narrow approach that will prevent such exemptions from serving their intended purpose. We therefore urge that, if the Agencies decline to exempt ABS Issuers from the definition of "covered fund," they modify those exemptions as suggested below.

### *A. Recommended Modifications to the Loan Securitization Exemptions*

As presently drafted, the Proposed Rules' loan securitization exemptions would permit a banking entity to acquire or retain an ownership interest in, or act as sponsor of, a covered fund that is an issuer of "asset-backed securities" (not defined in the exemptions), the assets or holdings of which are comprised of:

(1) "loans,"

(2) contractual rights or assets directly arising from those loans supporting the asset-backed securities, and

(3) interest rate or foreign exchange derivatives that (A) materially relate to "the terms of such loans or contractual rights or assets and (B) are used for hedging purposes with respect to the securitization structure" (the "**derivative use limitation**").[43]

The Proposed Rules define "loan" as "any loan, lease or extension of credit, or secured or unsecured receivable."[44] In the preamble to the Proposed Rules (the "**preamble**"), the Agencies state that "the proposed definition of loan is intended to be expansive, and include a broad array of loans and similar credit transactions."[45] However, they state that such definition would not encompass an asset-backed security that is issued in connection with a loan securitization or is otherwise backed by loans, an interpretation which would effectively exclude many asset-backed securities issuers (such as asset-backed commercial paper conduits that hold such securities and issuers of resecuritizations) from falling within the exemption.[46] Further, the Proposed Rules do not make clear that other types of securities (such as ordinary debt securities) that the Agencies have traditionally viewed as "extensions of credit" fall within the "loan" definition.[47] In addition, the Agencies indicate that the derivative use limitation is intended to limit derivatives to those whose notional amount is tied to the principal balance of loans backing the security that includes the derivative.[48] Further, the limitation's requirement that derivatives be used for hedging purposes means that they must be used solely to hedge the risk that results from a material mismatch between the loans and the related asset-backed securities, and would not allow the use of credit default swaps.[49]

Given the intent behind the Securitization Exclusion, as discussed above, these conditions are unduly restrictive and will prevent the exemptions from serving their intended purpose. Accordingly, we urge the Agencies to make the following changes and clarifications:

(i) The definition of "loan" should be modified to make clear that "loan" includes any type of credit instrument, obligation or other similar asset that the banking entity could own or deal in, including banking entity-eligible debt securities, asset-backed securities, variable funding notes and securities lending agreements, repurchase agreements, reverse repurchase agreements and other similar extensions of credit. Such

[43] Proposed Rules Sections .13(d) and .14(a)(2)(v).

[44] *Id.*, Section .2(q).

[45] 76 Fed. Reg. 68,846, at 68,864 (Nov. 7, 2011).

[46] *Id.*

[47] *See* Proposed Rules Question 61.

[48] 76 Fed. Reg. 68,846, at 68,912 (Nov. 7, 2011).

[49] *Id.*

modification would effectuate the intent behind the Securitization Exclusion that the Proposed Rules not interfere with the credit extension activities of banking entities. As the Agencies have long recognized, banking entities appropriately engage in "extensions of credit" not only by making loans, but through originating, investing and dealing in a variety of other credit instruments and obligations, including debt securities and asset-backed securities.[50] Further, the Agencies and the courts have long regarded asset-backed securities as being "legally transparent" (*i.e.,* as simply another way for banking entities to buy and sell the loans or other assets underlying such securities) and therefore traditionally look through such securities to such loans or assets when characterizing them.[51]

(ii) For similar reasons, asset-backed securities transactions, such as resecuritizations and asset-backed commercial paper conduits, which are supported by intermediate asset-backed securities or beneficial interests in auto lease securitization titling trusts[52] should be treated as securitizations of the loans, leases or other assets backing such intermediate securities.[53]

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[50] Consistent with such view, the Agencies have generally defined "loan" and "extension of credit" in their regulations to include not only conventional loans, but also other obligations including debt securities. *See* 12 C.F.R. Part 223 (implementing Sections 23A and 23B of the Federal Reserve Act and defining "extension of credit" to include "the acquisition by purchase, discount, exchange or otherwise of a note or other obligation, including commercial paper or other debt securities."). *See also,* 12 U.S.C. Section 84(b) (the term "loan" includes "any direct or indirect advance of funds to a person made on the basis of *any* obligation of that person to repay the funds or repayable from specific property pledged by or on behalf of that person") (emphasis added); 12 C.F.R. 32.2 (broadly defining "loan and extension of credit" for purposes of the national bank lending limit regulation to include any direct or indirect advance of funds); OCC Interpretive Letter No. 834 (a bank may purchase a debt security as a loan); and OCC Interpretive Letter No. 1027 (indicating that national banks' general lending authority is derived from 12 U.S.C. Section 24(7)'s express authorization for national banks to conduct the business of banking by "discounting and negotiating promissory notes, drafts, bills of exchange, and other evidences of debt" and "loaning money on personal security," and as such extends to purchasing certain debt-like equity securities).

[51] *See Securities Industry Ass'n v. Clarke, supra* at fn 24 (certificates representing undivided interests in pooled bank assets should be viewed as substantially the same as the underlying assets for purposes of the Glass-Steagall Act (upholding OCC Interpretive Letter No. 388, which had reached the same conclusion)).

[52] *See* Proposed Rules Question 301. We do not believe that the issuance of a special unit of beneficial interest in a titling trust holding the leases and cash flow thereon and related vehicles would in and of itself constitute a securitization. Rather it is a pass-through financing transaction executed for a limited purpose.

[53] Were the Agencies to adopt a different interpretation with respect to asset-backed commercial paper conduits and auto lease securitizations, they would be making it impossible for banking entities to act as sponsor for many asset-backed commercial paper conduits and auto lease securitizations because (i) asset-backed commercial paper conduits frequently hold variable funding notes and other securities issued by securitization vehicles, and (ii) in auto lease securitizations the asset-backed security issued to investors is backed by a beneficial interest in a titling trust or similar entity which is created to hold title to the vehicles and leases, neither of which types of securitizations would

(iii) To effectuate the Securitization Exclusion, the Agencies should modify the loan securitization exemptions to allow banking entities to sponsor and retain ownership interests in issuers of synthetic asset-backed securities whose reference assets are credit instruments or other obligations the banking entity could originate or invest or deal in directly, including tranched or untranched credit linked notes exposed to the credit risk of such reference assets through a credit default swap or other credit derivative entered into by the related ABS Issuer.[54] Such issuers, like issuers of traditional asset-backed securities, enable banking entities economically to transfer or sell loans or interests therein[55] and accordingly should be included in the exemption. For a similar reason, assets of traditional securitizations (such as collateralized loan obligations) should be able to include synthetic asset-backed securities or interests whose reference assets consist of such credit instruments or obligations.

(iv) ABS Issuers should not be limited by the derivative use limitation, but should instead be able to use any derivative, including a credit default swap, as and to the extent a banking entity could use such derivative in managing its own investment portfolio.[56]

(v) The Agencies should clarify that assets of issuers eligible for the loan securitization exemptions may include other types of guarantees and liquidity arrangements, including liquidity and asset purchase agreements, and third party credit enhancements such as guarantees and letters of credit, that a banking entity could use to

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fall within the loan securitization exemption as currently drafted. They would therefore be making it impossible for banking entities to engage in their normal banking entity business by means of such entities.

[54] In the release accompanying its Regulation AB, the SEC described synthetic asset-backed securities as securities the payment of which "… can primarily or entirely comprise or include payments based on the value of a reference asset which is unrelated to the value of or payments on any actual assets in the pool. Payment is therefore by reference to an asset not in the pool instead of primarily from the performance of a discrete pool of financial assets that by their terms convert into cash and are transferred to a separate issuing entity." 70 Fed. Reg. 1,506, at 1,514 (Jan. 7, 2005). The Agencies have historically viewed the issuance of such securities as falling within the business of banking. *See* OCC Bulletin 99-43, Federal Reserve SR Letter 99-32 (Nov. 15, 1999) and OCC Bulletin 2002-22, Federal Reserve SR Letter 2002-16 (May 23, 2002).

[55] For this reason, the Agencies treat synthetic asset-backed securitizations (which they define as transactions which transfer all or a portion of the credit risk of one or more underlying exposures to third parties through the use of credit derivatives or guarantees) and traditional loan securitizations identically for purposes of assessing risk-based capital charges under their capital rules. *See, e.g.,* 12 C.F.R. Part 3, Appendix C, Section 43.

[56] *See, e.g.,* OCC Investment Securities Manual (1990), at 5 (indicating that pooled investment funds eligible for national bank investment may also use various derivative instruments as part of their portfolio management strategies so long as such instruments would be acceptable for use by the national bank in managing its own portfolio).

provide liquidity to, or credit enhance, its own assets. ABS Issuers should also be able to hold pre-funding accounts (consisting of cash or other assets that would permit the issuer to acquire additional assets during a specified pre-funding period), and collection, reserve and other accounts and associated investments which are customarily employed in securitization transactions.

(vi) For purposes of the "loan securitization exemptions," "asset-backed security" should be defined to include any asset-backed security (as defined herein).[57]

### *B. Recommended Modifications to the Risk Retention Exemption*

As currently drafted, the risk retention exemption permits a banking entity to retain an amount or value of ownership interests in an issuer of "asset-backed securities" in order to comply with the "minimum" risk retention requirements of new Section 15G of the Exchange Act and any implementing regulations thereunder. New Section 15G generally requires that securitizers retain an unhedged economic interest in not less than 5% of the credit risk of any assets that the securitizer, through the issuance of the asset-backed security, transfers to a third party, subject to certain exceptions. In March 2011, the regulatory agencies issued joint proposed rules to implement this requirement which have not yet been finalized.[58]

In what may have been an unintentional oversight, Section .14(a)(2)(iii) does not contain a similar exemption for acquisition and retention of ownership interests that are required to comply with, or obtain the benefit of, laws other than new Section 15G. For example, as a condition to a bank obtaining the benefit of the FDIC Safe Harbor Securitization Rule, which provides comfort with regard to the legal isolation of assets backing asset-backed securities sponsored by FDIC-insured depository institutions, a bank is required to retain "at least" 5% of the credit risk of the assets transferred into the securitization.[59] Article 122a of the European Union Capital Requirements Directive requires that for credit institutions to receive more favorable capital treatment such credit institutions may invest only in securitizations in which, among other things, the originator, sponsor, or original lender of the securitization retains a material net economic interest of at least 5%.[60] Corresponding rules will apply to other types of

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[57] *See* fn 3, *supra*. The definition of "asset-backed security" under Regulation AB is considerably narrower than the definition contained herein, and would be the wrong definition to use. Its purpose is to limit the types of asset-backed securities that are eligible to be publicly offered under a registration statement on Form S-3, which involves significantly different considerations than those that apply to defining the types of securities an ABS Issuer should be able to issue consistent with the purpose of the loan securitization exemptions.

[58] 76 Fed. Reg. 24,090 (Apr. 29, 2011). SIFMA previously submitted a comment letter dated August 1, 2011 regarding the proposed risk retention rules under Section 15G of the Exchange Act.

[59] 12 C.F.R. 360.6.

[60] Fn 20, *supra*.

European regulated investors, such as insurance companies, investment banks and regulated investment funds.[61] Ownership interests retained in accordance with these provisions or other governmental credit risk retention requirements or provisions[62] should be permitted under Section .14(a)(2)(iii).

The risk retention exemption should also be modified to allow banking entities to retain risk in excess of the minimum amount required.[63] As the Agencies have stated, the purpose of the risk retention requirements is to incentivize securitizers to monitor and ensure the quality of the assets they securitize so as to better align their interests with the interests of investors.[64] Limiting the amount of permitted risk retention to the minimum amount required undermines this purpose. Further, as the Agencies themselves acknowledge, the market may require that a securitizer retain risk in excess of such minimum.[65] For example, a securitizer may, in order to meet credit enhancement requirements specified under rating agencies' ratings criteria, maintain a horizontal retained interest for a securitization transaction in an amount that exceeds 5% of the credit risk of the assets. Thus, limiting the risk retention to the minimum requirement may reduce or eliminate investor demand for a securitization and make it more expensive or impossible to issue. We also note that in some securitizations certain forms of risk retention (*e.g.*, a seller's interest in a credit card securitization) may be maintained in excess of the minimum requirement to avoid breaching such requirement if fluctuations in the asset pool cause a reduction in the securitization's size. In addition, if a banking entity in the capacity of securitizer for a transaction were to retain risk, for example, in accordance with the horizontal, vertical or L-shaped options set forth in the proposed rules under Section 15G of the Exchange Act, such banking entity may be entering into a covered transaction prohibited under Super 23A with respect to such retention in excess of the minimum.[66] Accordingly, the Agencies should

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[61] Fn 21, *supra*.

[62] For example, although in light of Section 15G of the Exchange Act the SEC has dropped its previous proposal to condition eligibility for shelf registration of asset-backed securities on other risk retention requirements, it has indicated that it may reconsider whether to do so after regulations implementing Section 15G of the Exchange Act are finalized. 75 Fed. Reg. 47,948, at 47,950 (Aug. 5, 2011).

[63] Further, the Agencies should clarify that when (as permitted under the proposed risk retention regulations under Section 15G) a banking entity acting as securitizer has the option to hold the retention in any of several forms (*e.g.*, horizontal, vertical, L-shaped or representative sample forms) the Proposed Rules' risk retention exemption does not require that it use the form of retention that exposes it to the least first loss risk.

[64] 76 Fed. Reg. 24,011, at 24,101 (Apr. 29, 2011).

[65] 76 Fed. Reg. 68,846, at 68,931 (Nov. 7, 2011).

[66] Proposed Rule Section .16(a)(2)(i) provides for an exception to Section .16(a)(1) for the acquisition of an ownership interest in a covered fund permitted under Subpart C of the Proposed Rules. The purchase of securities in excess of the minimum risk retention requirements under Section 15G of the Exchange Act would not be permitted under Section .14(a)(2)(iii) of Subpart C and therefore would be prohibited under Section .16(a)(1).

modify the risk retention exemption so that the amount of the ownership interest that may be retained is not limited to the minimum amount required.

## V. Exemption for ILS Issuers

For the reasons set forth above, we believe that ILS Issuers should be excluded from the definition of "covered fund." However, if they are not so excluded, the Agencies should separately exempt them from the Proposed Rules' sponsorship and ownership prohibitions.

## VI. Super 23A Should Not Apply to Transactions of an ABS Issuer or ILS Issuer Whose Securities Are Issued Pursuant to an Exemption

As discussed above, if an ABS Issuer or ILS Issuer is deemed to be a "covered fund," then under the Proposed Rules' Super 23A provisions a banking entity that sponsors or serves as an investment manager or investment adviser to such issuer will be prohibited from entering into "covered transactions" with it, even when it sponsors such issuer pursuant to one of the Proposed Rules' exemptions. As discussed above, this will effectively render the loan securitization and other exemptions useless, which would be in clear contravention of the Securitization Exclusion requirement that the Volcker Rule not be construed to "limit" or "restrict" the ability of banking entities to securitize loans. Accordingly, if the Agencies do not exempt ABS Issuers and ILS Issuers from the "covered fund" definition, they should exempt transactions between banking entities and such issuers from Super 23A.

## VII. The Definitions of "Ownership Interest" and "Sponsor" Should Be Modified to Effectuate the Purpose of Such Terms

### *A. Definition of Ownership Interest*

Under the Proposed Rules, a banking entity is generally prohibited from acquiring or retaining an "ownership interest" in a covered fund. The Proposed Rules, like the Volcker Rule, define "ownership interest" to mean "any equity, partnership, or similar interest (including without limitation, a share, equity security, warrant, option, general partnership interest, limited partnership interest, membership interest, trust certificate, or other similar interest) in a covered fund, whether voting or non-voting, or any derivative of such interest."[67]

In the preamble, the Agencies indicate that the "ownership interest" definition is intended to focus "on the attributes of the interest and whether it provides a banking entity with economic exposure to the profits and losses of the covered fund, rather than its form" and, further, that the Agencies could consider debt securities possessing such attributes to be "ownership interests."

[67] Proposed Rules Section .10(b)(iii).

However, the Agencies specifically solicit comment on how "ownership interest" should be defined in the securitization context.[68]

Classifying debt asset-backed securities as ownership interests which banking entities could not invest in and would have to divest under the Volcker Rule would be a surprising result, with significant adverse effects on the asset-backed securities market. Debt asset-backed securities are not typically viewed as having economic exposure to profits and losses of an ABS Issuer. Moreover they share few of the other characteristics that the Agencies have associated with equity "ownership interests" when seeking to distinguish equity from debt securities, *i.e.*, perpetual life with broad voting rights, appreciation in the market value of the issuer and non-cumulative dividends, and subordination to the claims of debt holders if the issuer fails.[69] Rather, debt asset-backed securities typically have a limited life, periodic fixed or fluctuating cumulative payments, and are senior to equity of the issuer should the issuer fail. While holders of debt asset-backed securities may be accorded certain limited voting rights (such as the rights to replace a servicer or manager), such rights are protective in nature and similar to voting rights that accompany securities (including securities formally structured as equity) that the Agencies have traditionally classified as debt securities under their legal investment and other regulations.[70] Accordingly, we see no justification for classifying debt asset-backed securities as "ownership interests" for purposes of the Volcker Rule.

Nor do we believe that many equity asset-backed securities should be viewed as "ownership interests" under the rule. In this regard, we note that notwithstanding the general prohibition on banks investing in equity securities,[71] the Agencies have long taken the position that national banks may invest in equity securities with debt-like characteristics as debt securities.[72] Many equity securities of securitization issuers (such as owner trust certificates and pass-though securities) have such characteristics. Further, the Agencies have not generally regarded the voting or non-voting equity securities of securitization issuers as equity ownership interests for purposes of the Bank Holding Company Act provisions that require Federal Reserve

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[68] 76 Fed. Reg. 68,846, at 68,899 (Nov. 7, 2011).

[69] *See, e.g.*, OCC Interpretive Letter No. 1047, at 9-10.

[70] *See, e.g.,* OCC Interpretive Letter No. 1086 (permitting bank investment in preferred stock convertible into common stock as a permitted investment in a "debt security," notwithstanding voting rights designed to protect the interests of holders in the securities).

[71] 12 U.S.C. Section 24(7) generally prohibits banks from investing in stock, a prohibition which similarly applies to state member banks (12 U.S.C. 335) and to state nonmember banks (12 U.S.C. 1832a). However, such prohibitions do not apply to depository holding companies and other banking entities.

[72] *See, e.g.*, OCC Interpretive Letter No. 781 (national bank may invest in money market preferred stock as a debt security); and OCC Interpretive Letter No. 777 (trust preferred stock deemed to be a "debt-like" security and therefore eligible for purchase by a national bank).

Board approval prior to certain acquisitions of equity securities by banking entities that are financial holding companies and bank holding companies. Moreover, the Agencies' current regulations provide that investment in the equity securities of securitization issuers whose underlying assets and activities consist of assets and activities that a bank could invest or engage in directly should, for this purpose, be regarded as investments in the assets held by such issuers rather than as equity ownership interests in the issuer.[73] The Agencies have also long held that a bank may retain equity interests that arise from a securitization which it itself originates on the basis that such retention is "part of, or incidental to, the bank's general lending authority, and its ability to securitize."[74] In short, although an interest in a securitization issuer might take the form of equity for state law, accounting or tax purposes, the Agencies have not generally regarded such interest as an equity interest for banking law purposes.

### *B. The Prohibition on Ownership and Super 23A Should Not Apply to Ownership Resulting from Underwriting and Market-Making Activities*

Broker-dealer and other affiliates of banks are significant underwriters of asset-backed securities and insurance-linked securities and frequently act as market makers in connection with such securities. In such capacity they purchase securities from an ABS Issuer or ILS Issuer or affiliates for resale to investors or from investors for resale to other investors. Read strictly, the ownership restrictions of the Proposed Rules and Super 23A may, in certain cases, be construed to prohibit such activities, a result we do not believe was intended.[75] Further, the inability of banking entities to serve as underwriters or market makers of asset-backed securities would severely undermine the primary and secondary markets for such securities in contravention of the intent behind the Securitization Exclusion. Accordingly, the Agencies should clarify that the ownership and Super 23A restrictions under the Proposed Rules do not prohibit ownership or retention of asset-backed securities or insurance-linked securities in connection with underwriting or market-making activities.[76]

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[73] *See*, fn 51, *supra*.

[74] OCC Interpretive Letter No. 1035, at 5.

[75] The Agencies have included underwriting and market-making exemptions to the Proposed Rules' prohibition on proprietary trading, but have not included similar exemptions from the ownership or Super 23A restrictions under the Proposed Rules. *See* Proposed Rules Sections .4(a) and (b). By its terms, the exemption in Volcker Rule Section 13(d) for underwriting and market-making activities applies to both proprietary trading and the ownership interest prohibitions contained in Volcker Rule Section 13(a). Accordingly there is no justification for such omission. Further, as the absence of such exemption would significantly limit and restrict loan securitizations, the Securitization Exclusion serves as an independent basis for such an exemption with respect to such securitizations.

[76] In order to cover for the possibility of "sticky" deals where the banking entity is not able to immediately dispose of the securities purchased for resale as part of underwriting or market-making activities, the exemption should permit the securities to continue to be owned for a reasonable period of time after any such purchase. *Cf.* 12 C.F.R. Section 225.2(c)(1)(ii) (excluding from the definition of bank holding company in the Federal Reserve Board's

### *C. Definition of Sponsor*

Under the Volcker Rule, a banking entity is generally prohibited from acting as a "sponsor" of a covered fund. The term "sponsor" as defined in new Section 13 means "(A) to serve as a general partner, managing member or trustee of a fund; (B) in any manner to select or to control (or to have employees, officers, or directors, or agents who constitute) a majority of the directors, trustees, or management of a fund; or (C) to share with a fund, for corporate, marketing, promotional, or other purposes, the same name or a variation of the same name."[77] The Proposed Rules generally carry forward the Volcker Rule definition of "sponsor" but clarify that the term "sponsor" does not include a trustee that does not exercise investment discretion with respect to a covered fund.[78]

In the preamble, the Agencies indicate that the term "sponsor" is intended to capture entities with the ability to control the decision-making and operational functions of a covered fund and request comment on whether the "sponsor" (as defined in the SEC's Regulation AB) or a servicer of an asset-backed security should be treated as the "sponsor" for purposes of the Proposed Rules.[79]

Regulation AB defines "sponsor" as the person who organizes and initiates an asset-backed securities transaction by selling or transferring assets, directly or indirectly, to the issuing entity.[80] However, in the typical asset-backed securitization transaction, once such person transfers assets into the securitization it will not have the right to control the decision-making and operational functions of the issuer. The parameters for acquiring or disposing of assets will be set forth in the transaction documents for the securitization and will not typically provide the Regulation AB "sponsor" with any meaningful power to vary such parameters. Nor, for the same reason, would the servicer of a typical securitization (whether or not also the sponsor) have such control. For insurance-linked securities transactions, the Regulation AB definition would not apply. Accordingly, we believe that neither the Regulation AB sponsor nor the servicer should be viewed as the "sponsor" under the Proposed Rules merely as a result of acting in such capacities. Similarly, arrangers, structuring agents, placement agents and underwriters should not be deemed "sponsors" solely by virtue of acting in those roles.

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Regulation Y companies that control bank securities held for a reasonable period of time in connection with an underwriting).

[77] Volcker Rule Section 13(h)(5).

[78] Proposed Rules Section .10(b)(5).

[79] *See* 76 Fed. Reg. 68,846, at 68,898 (Nov. 7, 2011) and Proposed Rules Question 219.

[80] Regulation AB Item 1101(l).

The Agencies have also requested comment as to whether the investment manager, if any, of a securitization should be viewed as a "sponsor" under the Proposed Rules.[81] The discretion of an investment manager in a securitization can vary from transaction to transaction. However, consistent with the Agencies' intent to designate as "sponsor" the entity with the ability to control the operational functions of the fund, we believe that, at a minimum, when an investment manager does not (i) serve in one of the capacities specified in the Proposed Rules' definition of sponsor and is subject to being replaced at the discretion of one or more of the entities that serves in such capacity or with or without cause by the securityholders of such fund, or (ii) have the discretion to acquire or dispose of assets in the securitization for the primary purpose of recognizing gains or decreasing losses resulting from market value changes, it should not be considered to be the "sponsor" under the Proposed Rules.

Finally, as noted above, the Proposed Rules provide that the term "sponsor" does not include a trustee that does not exercise investment discretion with respect to a covered fund. The Agencies should clarify that this exclusion would exclude from the definition of "sponsor" the typical trustee in an asset-backed securities transaction, since such trustees do not exercise the type of investment discretion that should cause an entity to be viewed as a sponsor. Further, they should clarify that a trustee or other entity would not be deemed to be a sponsor of a covered fund by virtue of directing the investment of amounts held in transaction accounts in accordance with the applicable transaction documents.

## VIII. The Proposed Rules' Compliance and Reporting Requirements Should Not Apply to ABS Issuers and ILS Issuers

If ABS Issuers and ILS Issuers are deemed to be covered funds, banking entities should not be required to treat ABS Issuers as covered funds for purposes of the Proposed Rules' compliance and reporting requirements. As noted in Section II above, as currently drafted such requirements are designed for dealings with hedge funds and private equity funds (rather than ABS Issuers and ILS Issuers), and would only add unnecessary burden and expense with respect to the securitization process, which may be passed along to investors or to businesses and consumers as part of the origination process, without resulting in any meaningful regulatory benefit.

## IX. Banking Entities Should be Grandfathered with Respect to Sponsorship, Ownership and Other Relationships in Existence on the Effective Date of the Volcker Rule

As noted above, many existing asset-backed securities that could be affected by the Volcker Rule have scheduled maturities that exceed the Proposed Rules' conformance and extension periods. Deeming the issuers of such securities to be covered funds could, in cases where Super 23A would prohibit the fulfillment of certain contractual commitments or where the

[81] Proposed Rules Question 220.

loan securitization exemptions (as currently drafted) may not work as intended or be available at all, put such issuers in the untenable position of having to either violate the prohibitions of the Volcker Rule after such periods or breach their contractual obligations under such securitizations in order to bring their activities into compliance. The consequence of breaching contractual obligations could leave banking entities open to significant damage claims and could also result in significant losses to investors.[82] Accordingly, if the Agencies do not provide an exemption to such issuers from the covered fund definition, they should use their exemptive authority to grandfather banking entities as to sponsorship, ownership or other relationships with such issuers in existence (or which such banking entities are contractually obligated to enter into in the future) on the effective date for the Proposed Rules.

Sections IV through IX above present an alternative approach for the treatment of asset-backed securities and insurance-linked securities transactions should the agencies decline to exclude ABS Issuers and ILS Issuers from the definition of “covered funds.” As noted, while this alternative approach might lessen the negative impact of the Proposed Rules, it will not address all of the consequences and other potential adverse outcomes that could be prevented by excluding such issuers from the “covered fund” definition and will add needless burden and expense to such transactions. Sections X through XIII below (which address the Proposed Rules’ definition of “banking entity,” conflicts of interest and other “backstop” restrictions and prohibition on proprietary trading) generally address issues that are presented regardless of the revisions to the Proposed Rules requested above.

## X. ABS Issuers and ILS Issuers Should Not Be Deemed to Be “Banking Entities”

The Proposed Rules generally define a “banking entity” to include an affiliate or subsidiary of a banking entity, but exclude from such definition any affiliate that is a “covered fund” offered and held by the banking entity pursuant to the exemptions in the Proposed Rules.[83] Accordingly, if, as we recommend, ABS Issuers or ILS Issuers are exempted from the “covered fund” definition, they would become “banking entities” if they are affiliated with a “banking entity.”[84] As a result, such ABS Issuers or ILS Issuers would become subject to the requirements of the Proposed Rules relating to “banking entities,” including its prohibitions on ownership of covered funds, Super 23A, its prohibitions on proprietary trading, and its recordkeeping and reporting requirements. Moreover, ABS Issuers and ILS Issuers that are affiliated with a banking entity and that rely upon an exemption other than the Section 3(c)(1) or

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[82] Consequences of breaching contractual obligations may include the occurrence of events of default and early amortization or termination events.

[83] Proposed Rules Section .2(e).

[84] “Affiliate” is defined by reference to the definition of “affiliate” in Section 2(k) of the Bank Holding Company Act. *Id.*, at Section .2(a).

3(c)(7) exemptions from the 1940 Act would become subject to such prohibitions. We do not believe any of these results was intended by Congress, and they would only impose needless burden and expense in respect of such issuers. Accordingly, we urge the Agencies to modify the definition of "banking entity" to exclude ABS Issuers and ILS Issuers.

## XI. Consistent with the FSOC Study and the Securitization Exclusion, the Backstop Restrictions on Permitted Activities Should Not Be Applied to Asset-Backed Securities Transactions. If, Contrary to the FSOC Study and the Securitization Exclusion, the Backstop Restrictions on Permitted Activities Are Applied to Asset-Backed Securities Transactions, Proposed Rule 127B Under the Securities Act, Amended as We Have Recommended, Should Govern Securitization Conflicts of Interest Under the Volcker Rule

Section 13(d)(1) of the Volcker Rule specifies exemptions from the general prohibition on banking entities engaging in proprietary trading and acquiring an ownership interest in or sponsoring a hedge fund or private equity fund for certain "permitted activities."[85] Such exemptions for permitted activities are limited by the so-called "backstop" restrictions under Section 13(d)(1) of the Volcker Rule, including if a "transaction, class of transactions, or activity … (i) would involve or result in a material conflict of interest (as such term shall be defined by rule as provided in [Section 13(b)(2)]) between the banking entity and its clients, customers, or counterparties."[86]

In the FSOC Study, the FSOC observes that "Congress determined that none of the restrictions of the Volcker Rule, *nor the 'backstop' restrictions on permitted activities*, will apply to the sale or securitization of loans."[87] Consistent with the Securitization Exclusion and FSOC Study, the implementing provisions of the Proposed Rules[88] with respect to the "backstop" restrictions of the Volcker Rule should not apply to loan securitizations.

We note that Section 621 of the Dodd-Frank Act, which adds Section 27B to the Securities Act, and not the Volcker Rule and the implementing regulations, is intended to address material conflicts of interest in loan securitization transactions. Section 27B of the Securities Act prohibits certain material conflicts of interest between securitization transaction participants

[85] "Permitted activities" under the Volcker Rule include common bank trading activities such as market-making, risk-mitigating hedging and trading in government obligations.

[86] Volcker Rule Section 13(d)(2). The other "backstop" provisions limit permitted activities that would result in a material exposure by the banking entity to high-risk assets or high-risk trading strategies, or that would pose a threat to the safety and soundness of such banking entity or to the financial stability of the United States.

[87] FSOC Study, at 47 (emphasis added).

[88] *See* Proposed Rules Sections .8 and .17.

and investors, subject to exceptions for certain risk-mitigating hedging activities, liquidity commitments and *bona fide* market-making.[89] On September 19, 2011, the SEC proposed Rule 127B under the Securities Act. SIFMA previously submitted to the SEC a comment letter dated December 10, 2010 relating to Section 27B of the Securities Act in advance of proposed Rule 127B, and SIFMA is submitting comments on proposed Rule 127B in a separate comment letter. We believe that Rule 127B, amended as suggested in our comment letters to the SEC,[90] will adequately address conflicts of interest in the securitization context and, accordingly, that any securitization participant that satisfies such rule in connection with a securitization should not be deemed to be engaged in a transaction that would involve or result in a material conflict of interest under Sections .8 and .17 of the Proposed Rules (if applicable to a securitization).

## XII. The Definition of "Covered Financial Position" Should be Modified to Make Clear That it Does Not Include Any Asset-Backed Security That Would be Eligible for the Loan Securitization Exemptions to the Proposed Rules' Covered Fund Ownership and Sponsorship Prohibition

The Proposed Rules generally prohibit banking entities from engaging in proprietary trading[91] and define "proprietary trading" for this purpose to mean engaging as principal for the trading account of the banking entity in any purchase or sale of "covered financial positions."[92] "Covered financial position" is, in turn, defined as any long, short or other position in a security, derivative or certain commodity contracts, but excludes a position that is a "loan."[93] "Loan" for purposes of the exclusion is defined the same way as it is defined for purposes of the loan securitization exemptions to the Proposed Rules' covered fund ownership and sponsorship

[89] Section 27B(a) of the Securities Act states that "[a]n underwriter, placement agent, initial purchaser, or sponsor, or any affiliate or subsidiary of any such entity, of an asset-backed security… which for purposes of this section shall include a synthetic asset-backed security, shall not, at any time for a period ending on the date that is one year after the date of the first closing of the sale of the asset-backed security, engage in any transaction that would involve or result in any material conflict of interest with respect to any investor in a transaction arising out of such activity." Under Section 27B(b), the SEC is directed to issue rules implementing Section 27B(a).

[90] Separately, we propose in our comment letter regarding proposed Rule 127B, among other things, that the SEC grant a safe harbor from its conflicts of interest rules for securitization participants that have in place appropriately designed information barriers, and that it permit the use of disclosure to mitigate conflicts of interest. Such conflict-mitigating features are analogous to the type proposed in Sections .8 and .17 of the Proposed Rules.

[91] As discussed above, we are submitting our general comments regarding the proprietary trading provisions of Proposed Rules by separate letter. In this letter, we provide additional comments with respect to securitization transactions.

[92] Proposed Rules Section .3(a).

[93] *Id.*, at Section .3(b)(3).

prohibitions (*i.e.*, as "any loan, lease, extension of credit, or secured or unsecured receivable").[94] In the preamble, the Agencies indicate that the exclusion for loan positions "is intended to eliminate potential confusion by making clear that the purchase and sale of loans … are outside the scope of transactions to which the proprietary trading restrictions apply."[95] The Agencies emphasize that "the proposed definition of loan is intended to be expansive, and include a broad array of loans and similar credit transactions."[96] However, the Agencies state that the definition of "loan" "does *not* include any asset-backed security that is issued in connection with a loan securitization or otherwise backed by loans."[97]

As discussed above, the Agencies and courts have long regarded asset-backed securities backed by loans as merely another way for banks to buy and sell the loans backing such securities and therefore as legally transparent.[98] Thus, for example, they have not viewed them as "securities" for purposes of the various limitations on banks dealing and underwriting in securities, including those under the Glass-Steagall Act, but rather as purchases and sales of the underlying loans.[99]

Similarly, despite the Agencies' statement in the preamble, we believe that asset-backed securities that would be eligible for the loan securitization exemption from the ownership and sponsorship limitations of the Volcker Rule as articulated in the Proposed Rules, modified as we have suggested above, should be viewed as "loans" for purposes of the exclusion from the definition of "covered financial position" and accordingly that transactions in such securities should not be deemed to be within the scope of the Proposed Rules' proprietary trading restrictions.[100]

Such position not only reflects the views of the Agencies in the past, but is mandated by the Securitization Exclusion, which as the FSOC noted in its recommendations reflects a determination by Congress that "none of the restrictions of the Volcker Rule … will apply to the sale or securitization of loans."[101] Although the Agencies attempt to effectuate the Securitization

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[94] *Id.*, at Section .2(q).

[95] 76 Fed. Reg. 68,846, at 68,864 (Nov. 7, 2011).

[96] *Id.*

[97] *Id.*

[98] *See* fn 51, *supra*.

[99] *Id.*

[100] The Agencies should also make clear that other extensions of credit, such as banking entity-eligible debt securities, fall within the proprietary trading loan exclusion. *See* Section IV.A above.

[101] Fn 12, *supra*.

Exclusion with respect to the Proposed Rule's ownership and sponsorship provisions through the loan securitization exemptions,[102] they have not provided any parallel exemption from the Proposed Rules' prohibition on proprietary trading. To effectuate the Securitization Exclusion, they should do so.

Such an exemption is also important in order to provide parity under the Volcker Rule between mortgage-backed securities issued or guaranteed by the government-sponsored agencies and private label mortgage-backed securities. In this regard, the Proposed Rules create a blanket exemption from the prohibition on proprietary trading for mortgage-backed securities of or issued by the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation or the Government National Mortgage Association and for asset-backed securities issued by certain other government sponsored enterprises.[103] Without a parallel exemption for private label mortgage-backed securities, the mortgage-backed securities of such agencies will be accorded an unfair advantage over private label mortgage-backed securities. This would seriously impede the restart of the private mortgage securitization market and therefore undermine the intent of the Securitization Exclusion, which as the FSOC noted in its recommendations, is to support "the creation and securitization of loans … [as a] basic and critical mechanism for capital formation and the distribution of risk in the banking system."[104] In addition, narrowing the regulatory disparity between private label and government-sponsored enterprise mortgage securitization markets will reduce banks' dependency for liquidity on the government-sponsored enterprises (and, in turn, the U.S. government) and limit any uncertainty and potential market disruption as the private mortgage markets return as a primary source of liquidity in the residential mortgage markets.

Accordingly, the proposed loan exclusion from the definition of "covered financial position" should be broadened to cover asset-backed securities that would be eligible for the loan securitization exemption (modified as we have proposed) from the Proposed Rules' ownership and sponsorship limitations.

## XIII. The Proposed Rules Should Be Modified to Clarify that Transactions that Are Incidental to Securitizations Do Not Constitute Impermissible Proprietary Trading

The Proposed Rules provide that an account is a trading account for purposes of the proprietary trading prohibition merely because the banking entity using that account to take a

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[102] Proposed Rules Sections .13(d) and .14(a)(v).

[103] *Id.*, at Section .6(a)(iii). In the preamble, the Agencies indicate that the exclusion in Section .6(a)(iii) is intended to include "pass-though or participation certificates that are issued and guaranteed by one of [the] government-sponsored entities (*e.g.*, the Federal National Mortgage Association and the Federal Home Loan Mortgage Corporation) in connection with their securitization activities." 76 Fed. Reg. 68,846, at 68,878 (Nov. 7, 2011).

[104] Fn 11, *supra*.

covered financial position either is a regulated dealer or the covered financial position in the account is a market risk capital rule covered position.[105] Further, there is a presumption that an account is a trading account covered by the proprietary trading prohibition if the banking entity uses the account to acquire or take a covered financial position for a period of sixty days or less.[106]

We have separately commented on these provisions in our general comment letter on the Proposed Rules' proprietary trading prohibitions. In this letter we wish (i) to emphasize that the Securitization Exclusion prohibition on "limiting" or "restricting" securitizations was, among other things, intended to exempt certain customary transactions that are incidental to securitizations from the Volcker Rule prohibition on proprietary trading and (ii) to request that the Agencies separately exempt such incidental transactions from such prohibition. Such transactions include acquisition of assets and sales of such assets into a securitization, repurchases of assets out of a securitization pursuant to a "clean-up call" option or pursuant to obligations to repurchase assets that breach representations and warranties, or the deposit of cash or the purchase or sale of assets into or out of a collection account, reserve account, pre-funding account or similar securitization account (and investment of amounts held therein in cash and short-term high quality and highly liquid instruments). These transactions are necessary to accomplish most if not all securitizations.[107] Accordingly, deeming such transactions to result in "proprietary trading" would render the Securitization Exclusion meaningless. Deeming such transactions to result in proprietary trading would also create significant problems for banking entities that are contractually committed to engage in these transactions with respect to existing securitizations that have terms which extend beyond the Proposed Rules' extension and conformance periods.

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[105] Proposed Rules Sections .3(b)(2)(i)(B) and .3(b)(2)(i)(C).

[106] *Id.*, at Section .3(b)(2)(iii).

[107] A collection account generally refers to an account established at the closing of securitization that holds collections on underlying assets transferred by a banking entity (or an affiliate) in its capacity as servicer, manager or other agent to the securitization responsible for making collections. A pre-funding account generally refers to an account established at the closing of securitization that holds a portion of the proceeds of the issuance of asset-backed securities that a banking entity (or an affiliate) in its capacity as servicer, manager or other agent to the securitization will be obligated to withdraw over a period of time after closing to acquire assets that will serve as collateral for the asset-backed securities issued. A reserve account generally refers to an account that holds cash or cash equivalents and is used to pay transaction expenses or to provide liquidity or credit enhancement to the asset-backed securities, and which a banking entity (or an affiliate) may be obligated to replenish from time to time. Such an account may include a premium capture reserve account within the meaning of the proposed rules in connection with the credit risk retention requirements under new Section 15G of the Exchange Act, or a reserve account funded by a securitization sponsor to fund repurchases of mortgage loans subject to repurchase during the first year in the life of a transaction in compliance with the FDIC Securitization Safe Harbor Rule.

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We greatly appreciate your consideration of the views set forth in this letter, and we would be pleased to have the opportunity to discuss these matters further with the Agencies. If you have any comments or questions, please feel free to contact Richard Dorfman at (212) 313-1359 or rdorfman@sifma.org, Chris Killian at (212) 313-1126 or ckillian@sifma.org, or Daniel M. Rossner of Sidley Austin LLP at (212) 839-5533 or drossner@sidley.com.

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