INVESTMENT COMPANY INSTITUTE

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ICI Files Comment Letter on "Volcker Rule" Proposal

[25909]

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TO: BOARD OF GOVERNORS No. 1-12
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SEC RULES MEMBERS No. 15-12
SMALL FUNDS MEMBERS No. 5-12
UNIT INVESTMENT TRUST MEMBERS No. 1-12 RE: ICI FILES COMMENT LETTER ON "VOLCKER RULE" PROPOSAL

ICI has filed a comment letter on the proposed rule ("Proposed Rule") jointly issued by the Securities and Exchange Commission, Federal Reserve Board, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the "Volcker Rule." [1] The letter asserts that, if adopted in its current form, the Proposed Rule would reach much farther than Congress ever intended and could greatly impair the financial markets. It identifies several areas of concern for U.S. registered investment companies ("registered funds"), despite the fact that the Volcker Rule was not directed at registered funds but at proprietary trading activities by banks and perceived conflicts of interest in certain bank transactions. [2] The letter recommends that the Agencies issue a revised proposal for comment before adopting any final rule, and that the Federal Reserve extend by two years (to July 2014) the conformance period for new activities to comply with the Volcker Rule. The letter is attached, and a summary of ICI's comments is provided below.

Organization, Sponsorship and Normal Activities of Registered Funds:

- The Rule Expressly Should Exclude All Registered Funds (and Their Non-U.S. Counterparts) from the Definition of “Covered Fund”. Section 619 of the Dodd-Frank Act prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund, private equity fund, or “similar fund” as the Agencies determine by rule—collectively defined in the Proposed Rule as “covered funds.” The Proposed Rule would include within “covered fund” any investment vehicle that is considered a “commodity pool” under Section 1a(10) of the Commodity Exchange Act. In so doing, the Proposed Rule would greatly expand the reach of the Volcker Rule, even to the extent of sweeping in some registered funds. ICI believes treating any registered fund as “similar” to a hedge fund or private equity fund for purposes of the Volcker Rule is contrary to Congressional intent. Providing an express exclusion for registered funds from the definition of “covered fund” would avoid this result. ICI further recommends that the Agencies expressly exclude non-U.S. retail funds from the definition of covered fund. Non-U.S. retail funds are not managed or structured like hedge funds or private equity funds, and excluding them from “covered fund” is consistent with Congressional intent to limit the extraterritorial impact of the Volcker Rule.
- The Rule Expressly Should Exclude All Registered Funds from the Definition of “Banking Entity”. The Proposing Release suggests that a mutual fund generally would not be considered a subsidiary or affiliate of the banking entity that sponsors or advises it. Without an express exclusion in the rule text, however, it is possible that some registered funds could become subject to all of the prohibitions and restrictions in the Volcker Rule—a result not intended by Congress. For example, during the period following the launch of a new mutual fund by a bank-affiliated sponsor, when all or nearly all of the fund’s shares are owned by that sponsor, the mutual fund could be considered an affiliate of the banking entity, and thus subject to the Volcker Rule in its own right. Providing an express exclusion for registered funds from the definition of “banking entity” would avoid this result (and, we believe, be consistent with the Agencies’ intent as expressed in the Proposing Release) without thwarting in any way the policy goals of the Volcker Rule.
- The Rule Should Not Limit the Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds and Conduct Related Activities. The proprietary trading provisions of the Proposed Rule call into question whether banking entities could continue to serve as Authorized Participants (“APs”) for exchange-traded funds registered under the Investment Company Act of 1940 (“ETFs”) and conduct related activities. ETFs are similar to mutual funds except that they list their shares on a securities exchange, thereby allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. APs alone transact directly with ETFs, in large amounts (typically involving 50,000 to 100,000 ETF shares) based not on market prices but on the ETF’s daily net asset value. AP transactions with an ETF are a unique and controlled form of arbitrage trading that, in the view of the SEC, is a critical component of maintaining efficient pricing in the ETF marketplace and protecting ETF investors. Some APs also may engage in traditional market making activities in the ETFs with which they participate. The Agencies should revise the Proposed Rule to ensure that APs can continue to fulfill these important roles.

Impact on the Financial Markets:

- Liquid and Efficient Markets are Important for Registered Funds. Banking entities are key participants in providing liquidity in the financial markets, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading. The Proposed Rule has the potential to decrease market liquidity, particularly for the fixed-income and derivatives markets, and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, leading to wider bid-ask spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders.
- The Complexity of, and Difficulties of Complying with, the Proposed Rule Threaten Market Liquidity and May Adversely Impact Registered Funds. Much of the concern surrounding the effect of the Proposed Rule on market liquidity arises from the complexity of the Proposed Rule and its exemptions from the proprietary trading prohibition. ICI supports suggestions to recast what appear to be rigid criteria defining permitted activities under the Proposed Rule as guidance that could be incorporated into banking entities' policies and procedures.

    - The Presumption of Prohibited Activity is Unwarranted. The Proposed Rule generally presumes that a banking entity's short-term principal trading activity is prohibited proprietary trading. This presumption of prohibited activity prejudices the analysis of a banking entity's trading activity from the outset. Moreover, the process to rebut the Proposed Rule's presumption would be extremely complex and onerous.
    - The Conditions of the Proposed Exemptions Do Not Reflect the Operation of the Financial Markets. The Proposed Rule appears tailored primarily for the traditional trading of equities on an agency-based "last sale" model, which differs substantially from how other markets operate. It does not reflect that market makers provide liquidity by acting as principal in the majority of the financial markets and it does not take into account the need to provide flexibility and discretion to market makers to enter into transactions to build inventory.
    - The Conditions of the Proposed Exemption for Market Making-Related Activities are Impractical. The conditions under the market making-related activities exemption are extremely complex and will be so difficult to comply with as to be effectively unworkable in a number of financial markets and for a significant number of financial instruments.
    - The Risk-Mitigating Hedging Exemption Must be Flexible. The conditions provided under the proposed risk-mitigating hedging exemption create uncertainty as to whether a specific hedge would fulfill the requirements of the exemption. The exemption should be made flexible enough to allow banking entities appropriately to manage all possible risks and to facilitate hedging against overall portfolio risk; it should not be a transaction-by-transaction analysis.
    - The Proposed Government Obligations Exemption Should be Expanded to Cover All Municipal Securities and Foreign Sovereign Obligations. The proposed exemption for trading in certain government obligations does not extend to transactions in obligations of an agency or instrumentality of any State or political subdivision. ICI recommends that the exemption be expanded to include all municipal securities, which would be consistent

with the current definition of municipal securities under the Securities Exchange Act of 1934. The Proposed Rule also should be expanded to provide an exemption for foreign sovereign obligations; such an exemption is consistent with Congressional intent to limit the extraterritorial reach of the Volcker Rule and with the purposes of the Volcker Rule.

- The Agencies’ Proposed Implementation of the Proprietary Trading Prohibition Would Impact the Structure of the Financial Markets and the U.S. Economy Overall. The Agencies’ proposed implementation of the proprietary trading prohibition could have negative implications for capital formation. Banking entities also may find it difficult to remain in the market making business, which could lead to less regulated and less transparent financial institutions performing these activities. The over-broad restrictions of the Proposed Rule, which go well beyond what is necessary to effectuate Congress’ intent in enacting the Volcker Rule, could hurt our broader economy, impacting job creation and investments in U.S. businesses overall.

Limiting Investment Opportunities for Registered Funds and Their Shareholders:

- The Foreign Trading Exemption Should Be Revised to Avoid Adverse Effects on U.S. Registered Funds’ Investments in Certain Foreign Securities. Although Congress intended that trading outside of the United States be a “permitted activity” under Section 619, the Proposed Rule narrowly defines which transactions would be considered to take place outside of the United States—and, in so doing, departs from an existing and well-understood U.S. securities regulation (Regulation S under the Securities Act of 1933) that governs whether an offering takes place outside of the United States. Many registered funds invest in securities, such as sovereign debt securities denominated in foreign currency, for which the primary and most liquid market is outside of the United States. These transactions often involve non-U.S. banking entities as counterparties. The narrow exemption in the Proposed Rule for trading outside of the United States may well cause some non-U.S. banking entities to avoid engaging in transactions with persons acting on behalf of U.S. registered funds, even when those transactions would comport fully with Regulation S. As a result, U.S. registered funds’ access to non-U.S. counterparties could decrease significantly, and liquidity in some markets could be reduced. Revising the Proposed Rule to conform to the existing approach under Regulation S would avoid these highly undesirable results.

- The Rule Should Exempt Asset-Backed Commercial Paper and Tender Option Bond Programs. The Proposed Rule would impair two particular types of securitization activities that are part of traditional banking activities—notes issued by asset-backed commercial paper (“ABCP”) programs and securities issued pursuant to municipal tender option bond (“TOB”) programs. This would have significant negative implications for issuers of these financing vehicles and their investors, many of which are registered funds. There is no indication, however, that Congress intended to include ABCP or TOB programs within the scope of the Volcker Rule; rather, Congress specifically sought to avoid interfering with longstanding, traditional banking activities. The provision of credit to companies to finance receivables through ABCP, as well as to issuers of municipal securities to finance their activities through TOBs, are both areas of traditional banking activity that should be distinguished from the types of financial activities that Congress sought to restrict under the Volcker Rule. Without liquid ABCP and TOB markets, credit funding for corporations and municipalities would be unduly and unnecessarily constrained. It is therefore important that the Proposed Rule be revised to exempt ABCP and TOB programs.

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General Counsel

Attachment

endnotes

[1] For a summary of the Proposed Rule, see ICI Memorandum No. 25634 (November 10, 2011). ICI's comment letter is addressed to those four regulatory agencies and to the Commodity Futures Trading Commission (collectively, "Agencies"), which issued a separate yet substantively similar proposal to implement the Volcker Rule. See Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Covered Funds (January 11, 2012) ("CFTC Release"), available at http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112c.pdf. ICI plans to file its comment letter with the CFTC once the CFTC Release has been published in the Federal Register.

[2] The Proposed Rule also raises issues of great concern for investors, funds, and markets outside the United States. Our overseas affiliate, ICI Global, discusses these issues in their comment letter on the Proposed Rule. See Letter from Dan Waters, Managing Director, ICI Global, to Agencies, dated February 13, 2012 ("ICI Global Letter"), available at www.iciglobal.org