

**MEMO# 25870**

February 6, 2012

## **Revised Draft ICI Letter on "Volcker Rule" Proposal; Your Comments Due Feb. 9th**

URGENT/ACTION REQUESTED

[25870]

February 6, 2012

TO: CLOSED-END INVESTMENT COMPANY COMMITTEE No. 6-12  
DERIVATIVES MARKETS ADVISORY COMMITTEE No. 6-12  
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 2-12  
ETF ADVISORY COMMITTEE No. 2-12  
EQUITY MARKETS ADVISORY COMMITTEE No. 3-12  
FIXED-INCOME ADVISORY COMMITTEE No. 5-12  
INTERNATIONAL COMMITTEE No. 4-12  
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 8-12  
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 4-12  
SEC RULES COMMITTEE No. 9-12  
SMALL FUNDS COMMITTEE No. 2-12 RE: REVISED DRAFT ICI LETTER ON "VOLCKER RULE"  
PROPOSAL; YOUR COMMENTS DUE FEB. 9TH

In late December, we circulated a draft comment letter on the proposal jointly issued by the Securities and Exchange Commission, Federal Reserve Board, Office of the Comptroller of the Currency, and Federal Deposit Insurance Corporation (the "Agencies") to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act, commonly known as the "Volcker Rule." [1] Shortly after we circulated the draft letter, the Agencies extended the comment deadline by one month, to February 13, 2012. We have prepared a revised draft letter, which is attached and summarized below.

To allow us to finalize the letter by the February 13 deadline, please provide comments on the revised draft by Thursday, February 9th by email to Rachel Graham at [rgraham@ici.org](mailto:rgraham@ici.org).

Besides the extension of the comment deadline, there have been several notable developments since we circulated our original draft. In January, the Commodity Futures Trading Commission separately issued its "Volcker Rule" implementation proposal. [2] Also, as we previously indicated, two Subcommittees of the House Financial Services

Committee held a hearing on the Volcker Rule, and ICI and ICI Global each submitted a statement for the record. [3] In addition, last week, ICI and several member representatives met with officials at the Treasury Department, the SEC, and the Federal Reserve Board to highlight concerns about the proposal's impact on registered investment companies ("registered funds") and their shareholders. [4] Taking into account these developments, we have substantially revised the format and much of the content of the original draft.

## Summary of Comments

### Organization, Sponsorship and Normal Activities of Registered Funds:

- The Proposed Rule Should Expressly Exclude Registered Funds 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.
- The Proposed Rule Should Expressly Exclude 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. Similar issues could arise where a banking entity involved in the underwriting of a closed-end fund or unit investment trust ("UIT") temporarily owns a controlling interest in the fund or UIT. 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 Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds Should Not be Constrained. 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"). ETFs are similar to mutual funds except that their shares are listed on a securities exchange, allowing retail and institutional investors to buy and sell shares throughout the trading day at market prices. ETFs transact directly with APs pursuant to contract, in large transaction amounts (typically involving 50,000 to 100,000 ETF shares) that are 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 from the risks of substantial and sustained discounts to net asset value. It is therefore important that the Proposed Rule be revised to allow APs to continue to fulfill this important role.

## **Impact on the Financial Markets:**

- Sufficient Liquidity 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 equity markets. A reduction of liquidity would have serious implications for registered funds, leading to wider spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders.
- The Complexity of, and Difficulties Complying with, the Proposed Rule Threaten Market Liquidity. 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.
  - Presumption of Prohibited Activity is Unwarranted. The process to rebut the Proposed Rule's presumption of prohibited activity appears extremely complex and onerous. A presumption of prohibited activity is unhelpful and prejudices the analysis from the outset.
  - Conditions of the Proposed Exemptions Do Not Reflect the Operation of the Financial Markets. The Proposed Rule has been tailored primarily for the operations of certain portions of the equity markets, which operate substantially differently from those of other markets. It does not reflect that market makers provide liquidity by acting as principal, and not as an agent, in the majority of the financial markets, and it does not take into account the need for flexibility and discretion by market makers to enter into transactions to build inventory. As a result, the proposed exemptions from the proprietary trading prohibition likely will be of very limited utility for banking entities.
  - Conditions of the Proposed Market Making Exemption are Impractical. The conditions under the market making exemption make the exemption extremely complex and so difficult to comply with as to be effectively unworkable in a number of financial markets and for a significant number of financial instruments.
  - Risk Mitigating Hedging Exemption Must be Flexible. The conditions provided under the proposed hedging exemption create uncertainty as to whether a specific hedge fulfills the requirements of the exemption and whether the exemption can be applied to hedging against overall portfolio risk.
  - Proposed Government Obligations Exemption Should be Expanded to Cover All Municipal Securities and Foreign Government Obligations. The proposed exemption for trading in certain government obligations does not extend to transactions in obligations of an agency 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 non-U.S. government obligations; such an exemption is consistent with limiting the extraterritorial reach of the Volcker Rule and would not undermine the purposes of the Volcker Rule.
- The Proprietary Trading Prohibition Will Impact the Structure of the Financial Markets and the U.S. Economy Overall. The proprietary trading prohibition could have

negative implications for the overall structure of the U.S. financial markets. For example, the prohibition may negatively impact overall capital formation in the markets. Banking entities play a critical role in initial capital formation; if they find that the restrictions contemplated by the Proposed Rule prohibit or greatly impede their serving this role, the availability of investments for registered funds will decline. Banking entities also may find it difficult to remain in the market making business, which could lead to a shift to less regulated and less transparent financial institutions. ICI therefore believes the stringent 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 Proposed Rule Should Include Sufficient Exemptions for Asset-Backed Commercial Paper and Tender Option Bond Programs. The Proposed Rule would impact 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 inadvertently 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 high-risk, conflict-ridden financial activities that Congress may have intended 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 provide sufficient exemptions for ABCP and TOB programs.

Frances M. Stadler  
Senior Counsel - Securities Regulation

[Attachment \(in .pdf format\)](#)

**endnotes**

[1] See ICI [Memorandum](#) No. 25741 (December 23, 2011). The Agencies' proposal ("Proposed Rule") is available on the SEC's website at <http://www.sec.gov/rules/proposed/2011/34-66057.pdf>.

[2] The CFTC's proposal, which is substantially similar to the proposal issued by the other agencies, is available on the CFTC's website at <http://www.cftc.gov/ucm/groups/public/@newsroom/documents/file/federalregister011112c.pdf>. We intend to submit one comment letter to all of the agencies, including the CFTC.

[3] See ICI [Memorandum](#) No. 25831 (January 25, 2012).

[4] Meetings with the OCC and FDIC will take place this week; ICI also expects to schedule a meeting with the CFTC.

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