The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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ICI and Members Meet with Federal Agencies on Implications of Risk Retention Re-Proposal for TOBs and ABCP

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TO: FIXED-INCOME ADVISORY COMMITTEE No. 26-13
MONEY MARKET FUNDS ADVISORY COMMITTEE No. 35-13
MUNICIPAL SECURITIES ADVISORY COMMITTEE No. 34-13 RE: ICI AND MEMBERS MEET WITH FEDERAL AGENCIES ON IMPLICATIONS OF RISK RETENTION RE-PROPOSAL FOR TOBs AND ABCP

On December 19, 2013, ICI and several of our members met with representatives of the Securities and Exchange Commission ("SEC"), the Board of Governors of the Federal Reserve, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation ("Agencies"), regarding the implications of the risk retention re-proposal ("Proposal") [1] for tender option bond programs ("TOBs") and asset-backed commercial paper programs ("ABCP"). The meetings, which ICI had requested in order to discuss our concerns about the treatment of these asset classes under the Proposal, are summarized below.

Meeting on TOBs

The meeting on TOBs was a joint meeting of the Agencies; ICI; ICI member representatives from BlackRock, Fidelity, and Nuveen; a representative from SIFMA; representatives from the law firm Ashurst; and representatives from several bank clients of Ashurst that are significant sponsors of TOB programs – Citibank, Deutsche Bank, and JP Morgan. [2] At the meeting, we explained to the Agencies that the reason we were meeting with them jointly was to emphasize that we all were seeking an approach on risk retention for TOBs that takes into account the ways in which TOBs are different than traditional asset-backed securities, that acknowledges the existing mechanisms for aligning interests inherent in the TOB program structure, and that works in the real world given the full scope of the TOB market. We explained why TOBs are important to the municipal markets and to registered investment companies ("funds"). We explained how TOB programs operate, and the role they serve in the markets, emphasizing that they are more similar to a repurchase

financing than to a traditional asset-backed security transaction. At the outset, we acknowledged that this meeting was not about the recently adopted Volcker rule.

The Agency representatives asked numerous questions throughout this portion of the meeting about the technical operation of TOB programs, the scope of the TOB market, and other matters. In the context of a discussion of whether the risk retention option should extend to taxable TOBs, an SEC representative explained that the Agencies were trying to provide a risk retention option for existing products, although it appeared possible that this could encompass taxable TOBs to the extent the underlying assets were municipal securities.

We discussed the key concerns raised in the October 30 ICI and Ashurst comment letters, [3] acknowledging that the Agencies tried to provide tailored risk retention options for TOBs, but that technically some aspects of the Proposal do not work. We raised the issue that residual holders should be able to satisfy risk retention obligations under the rule whether or not they are sponsors (i.e., by serving as third-party purchasers). We also explained that the first TOB risk retention option in the Proposal does not work as a technical matter, [4] that the Agencies should deem the rule's five percent risk retention obligation to be satisfied as long as a residual interest represents five percent of the market value of the trust at inception and bears all of the market risk, as well as a pro rata share of the credit risk in the event of a TOTE. We also made the point that multiple fund residual holders should be able to satisfy the five percent risk retention obligation.

The bank representatives explained that the definition of "qualified tender option bond entity" under the Proposal is too narrow for several reasons, including the restrictions tied to current rule 2a-7 under the Investment Company Act of 1940 ("Investment Company Act"). They explained that the proposed amendments to rule 2a-7 would change some of the restrictions under the Proposal, which in any event are irrelevant to risk retention. While the Agency representatives seemed to understand the concerns, they seemed very hesitant to dispense with these restrictions, particularly the 30 day limit on notice of a holder's election to tender, which Ashurst has recommended be replaced with a 397 day limit.

The SEC representatives then asked further questions about how residual holders could satisfy the risk retention obligation, and whether they could meet the same restrictions as the sponsor. We made the point that, while fund residual holders could meet the obligations of a sponsor under the rule, we remained very concerned about fund residual holders being deemed sponsors because of the implications of being a sponsor under other Dodd-Frank Act rules, such as the proposed conflict of interest rule under Section 621 of the Dodd-Frank Act. [5]

At the end of our meeting, before our ABCP meeting started, an SEC representative told me and one of the ICI members that he did not think the concept of TOB third-party purchasers as a solution for fund residual holders was a viable option (and it sounded like this view was shared by the other Agencies). He indicated that they don't believe they have the statutory authority to provide for third-party purchasers in asset classes other than commercial mortgage backed securities, even though they are sympathetic to our concerns. He suggested that they were inclined to make fund residual holders "sponsors" for purposes of the rule. I reiterated that we were not particularly concerned about fund residual holders being deemed sponsors for purposes of the risk retention rule itself, but about being deemed sponsors under other rules, particularly the conflict of interest rule that has been proposed under section 621 of the Dodd-Frank Act. He suggested we consider writing

another comment letter to the SEC on that rule expressing our concerns. I requested that, at the least, if they proceed with that approach, they draft the provision as narrowly as possible, making it clear that the sponsor designation is for purposes of this rule only, so as to provide us with a basis to distinguish other rules as readily as possible. The SEC representative seemed sympathetic to that type of approach.

Meeting on ABCP

The meeting on ABCP was attended by the Agencies, ICI, and ICI member representatives from Fidelity and Vanguard. We thanked the Agencies for the extensive refinements they made to the ABCP risk retention options in the Proposal, and explained that our focus at this meeting was on some of the changes we believe are necessary so that the risk retention rules do not unnecessarily disrupt the ABCP markets.

The primary focus of the meeting was a recommendation, as included in ICI's October 30 comment letter, that the ABCP risk retention option be available to sponsors of partially-supported ABCP conduits. We argued that partially-supported ABCP combined with five percent program-wide first loss credit enhancement would meet the Agencies' risk retention regulatory objective, and that requiring full support is unnecessary to achieve that objective and would have detrimental effects on the ABCP market. ICI representatives asserted that, despite the Volcker rule's stipulation that ABCP conduits be fully supported to be exempt under that rule, it is still worthwhile for risk retention rules to reflect how investors view the allocation of risk in ABCP, and that fully supported and partially support programs should be treated the same within the ABCP option. They emphasized that partially-supported ABCP is likely to remain relevant as sponsors consider different ABCP structures that may not be subject to the Volcker rule.

The Agencies seemed very interested in the buy-side perspective provided by our members, and asked many questions. The SEC representatives stated, however, that they intentionally required full support as one of the conditions of the ABCP risk retention option in the Proposal, in addition to 100 percent liquidity coverage, and that they did so in response to a large number of letters from investors saying that they do not read ABCP disclosures or pay attention to the assets in the conduit. In response to a question from an ICI representative requesting flexibility in the rule to accommodate ABCP structures that may develop in the future, an SEC representative reiterated that the rule is intended to capture only existing market practices. Separately, in response to another question, the SEC representative explained that the Proposal does not permit first loss letters of credit as permitted risk retention mechanisms because it does not, for any asset class, permit unfunded risk retention mechanisms.

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endnotes

[1] On October 30, 2013, ICI filed a comment letter on the Proposal. See Letter to Ms. Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, et al., from Karrie McMillan, General Counsel, Investment Company Institute, dated Oct. 30, 2013, available at http://www.ici.org/pdf/27658.pdf ("ICI October Letter"). For a summary of the Proposal, see ICI Memorandum No. 27561 (Sept. 13, 2013), available at http://www.ici.org/my_ici/memorandum/memo27561.

[2] In 2012, ICI submitted a comment letter on TOBs to the Agencies jointly with Ashurst, these banks and others. See Letter to Office of the Comptroller of the Currency, et al., from Ashurst LLP, Citibank, N.A., Deutsche Bank AG, New York Branch, Société Générale, New York Branch, Wells Fargo Bank, N.A., Investment Company Institute, dated August 31, 2012.

[3] See Letter to Office of the Comptroller of the Currency, et al., from Ashurst LLP, et al., dated Oct. 30, 2013, available at http://www.sec.gov/comments/s7-14-11/s71411-407.pdf; ICI October Letter, supra note 1.

[4] This is the option that states that the sponsor may retain an interest that upon issuance meets the requirements of an eligible horizontal residual interest but that upon the occurrence of a "tender option termination event" ("TOTE") as defined in Section 4.01(5) of IRS Revenue Procedure 2003-84, as amended or supplemented from time to time will meet requirements of an eligible vertical interest. Please see our comment letter, supra, note 1, at 12, for a discussion of why this risk retention option does not work.

[5] See ICI October Letter, supra note 1, at 9-10.
