sifma | asset management group

October 20, 2014

Scott G. Alvarez, Esq.
General Counsel
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Volcker Rule Interpretations Regarding Foreign Public Funds and Foreign Non-Covered Funds that May Be Banking Entities

Dear Mr. Alvarez:

The Securities Industry and Financial Markets Association ("SIFMA")[1] writes to request that the staffs of the agencies ("Agencies") charged with implementing section 13 of the Bank Holding Company Act ("BHC Act") (commonly referred to as the "Volcker Rule") provide public guidance that (1) in certain circumstances, as described below, foreign public funds and foreign non-covered funds (as each term is described below) will not be treated as "banking entities" under the final regulations ("Final Rule") implementing the Volcker Rule and (2) extensions of the initial one-year seeding period for foreign public funds will be available in a streamlined manner.

In addition, we ask the Federal Reserve Board ("Federal Reserve") to grant a one-year extension of the conformance period with respect to all foreign funds as promptly as practicable. This extension would help alleviate concerns arising out of the current lack of clarity with respect to the Volcker Rule treatment of foreign fund structures, provide the Agencies with sufficient time to consider and act on this request and give industry participants near-term certainty as they implement their conformance strategies.

This letter (1) provides background on foreign public funds and foreign non-covered funds, (2) explains why these categories of funds should not be treated as banking entities, (3) explains why a streamlined process for extensions of the initial one-year seeding period for foreign public funds is important and (4) asks the Federal Reserve to grant an extension of the Volcker Rule conformance period with respect to all foreign funds to allow sufficient time for the Agencies to resolve the issues discussed below.

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[1] SIFMA brings together the shared interests of hundreds of securities firms, banks and asset managers. SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

Wide-ranging Impact. The issues discussed in this letter have a wide-ranging impact across the industry, potentially affecting hundreds of thousands of funds. To this end, we understand that the Institute of International Bankers conducted a survey of its members and found that over 5,000 foreign public funds and over 2,300 foreign non-covered funds could be considered banking entities for the reasons discussed below. An informal survey of SIFMA's membership – which includes not only internationally headquartered banks, but also U.S.-based banks and other financial institutions – bears out the same point. For example, three of SIFMA's U.S. headquartered members have informed us that the issues identified in this letter adversely affect more than 1,200 foreign public funds. These numbers represent a very small sampling of the industry; we anticipate that banking entities will seek extensions for many thousands of additional funds.

Given the size of the problem and interpretive uncertainty, we respectfully suggest the Agencies address the issues promptly and that, in the interim, the Federal Reserve grant an industry-wide extension of the Volcker Rule conformance period for all foreign funds as a critical first step to provide interim certainty to banking entities. Such an extension also would permit the Agencies sufficient time to consider the relevant issues in more detail. Extensions will be necessary not only for the thousands of foreign public and non-covered funds mentioned above but also for other funds. For example, we understand that many SIFMA members have been in discussions with the Agencies regarding the need for interpretive guidance regarding funds offered in reliance on the "solely outside the United States" ("SOTUS") exemption. Four of SIFMA's members have informed us that they intend to seek extensions for more than 2,000 funds that, depending on the interpretations that the Agencies may offer, may or may not fall within either the foreign non-covered fund exemption or the SOTUS exemption.

Agencies Can Provide Relief Through Interpretive Guidance. The guidance we are requesting in this letter can be provided by the Agencies through an interpretive process and should not require revisions to the Final Rule, because the guidance would be consistent with the Final Rule's text, the regulatory preamble and the Agencies' clear intent, as we describe in more detail below. For example, the Agencies could provide guidance through the informal FAQ process that has been used to address other Volcker Rule issues (and that the Federal Reserve has used to address other issues under its regulations implementing the Dodd-Frank Act) to clarify that controlled foreign public funds and foreign non-covered funds will not be regarded by the Agencies as banking entities. We understand the Agencies have received proposals from industry participants and counsel regarding different approaches for addressing these issues. If helpful, we would be happy to confer with the Agencies and to share SIFMA members' view as the Agencies consider avenues for guidance.

I. Foreign Public Funds and Foreign Non-Covered Funds Should Not Be Treated as Banking Entities

As you know, the Volcker Rule generally prohibits "banking entities" from engaging in proprietary trading and investing in "covered funds."[2] As relevant to this letter, the Final Rule excludes two categories of foreign funds from the otherwise applicable definition of covered funds: (1) so-called foreign public funds and (2) in the case of foreign banking entities, certain foreign private funds (which we refer to as "foreign non-covered funds").[3]

Foreign Public Funds. Foreign public funds are defined as funds that (1) are organized outside the United States, (2) are authorized to sell ownership interests to retail investors in the fund's home jurisdiction and (3) sell ownership interests "predominantly" through one or more public offerings outside of the United States.[4] (U.S. banking entities are permitted to sponsor foreign public funds but are subject to additional limits on the holding of ownership interests in any such sponsored funds, as discussed in more detail in Section II below.)

Foreign Non-Covered Funds. The Final Rule includes in the covered funds definition certain non-U.S. funds, but only with respect to U.S. banking entities. For non-U.S. banking entities, funds that do not offer interests to U.S. persons and that, therefore, do not rely on sections 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 ("ICA") are not covered funds (and we refer to such funds as "foreign non-covered funds").[5]

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[2] "Banking entities" include full-service insured depository institutions and their affiliates, as well as any company that is a bank holding company ("BHC") for purposes of section 8 of the International Banking Act of 1978 ("IBA") and such company's affiliates. Final Rule § _.2(c). For purposes of the Volcker Rule, an "affiliate" is defined by reference to the BHC Act's definition of such term, which in turn relies on the BHC Act's definition of "control." Final Rule § _.2(a). Thus, throughout this letter, references to "control" are made with respect to the definition set forth in the BHC Act. *See* 12 U.S.C. § 1841(a)(2).

[3] Final Rule § _.10(b)(iii) (defining "U.S. banking entity" as "any banking entity that is, or is controlled directly or indirectly by a banking entity that is, located in or organized under the laws of the United States or of any State.") Accordingly, a "non-U.S. banking entity" is any banking entity that is not a U.S. banking entity.

[4] Final Rule § _.10(c)(1).

[5] A foreign fund that does not rely on 3(c)(1) or 3(c)(7) potentially could be a covered fund under the commodity pool prong of the covered funds definition. Final Rule § _.10(b)(1)(ii). In addition, as noted above, a broader range of funds are considered "covered funds" for U.S. banking entities. Specifically, for a U.S. banking entity (but not a non-U.S. banking entity) the definition of "covered fund" includes a fund if (1) the fund is organized or established outside the United States, (2) the ownership interests of the fund are offered and sold solely outside the United States, (3) the fund is, or

Interaction of Banking Entity and Covered Funds Definitions. Under the Final Rule, the banking entity definition excludes covered funds.[6] Thus, a banking entity may control a covered fund and, despite that control relationship, the fund would not be treated as an affiliate of the banking entity and thereby subject to the Volcker Rule's prohibitions at the fund level.

Because foreign public funds and foreign non-covered funds are specifically excluded from the definition of "covered fund," these categories of funds may fall under the banking entity definition, if they are controlled by a banking entity (by virtue of the banking entity's ownership stake in the fund, the banking entity's control of the election of a majority of the directors or trustees of the fund or for other reasons that constitute control under the BHC Act). In turn, any such funds that are banking entities would be subject to the Final Rule's prohibitions on proprietary trading and investing in covered funds. These restrictions are untenable for most funds, which are vehicles whose core purpose is to invest in securities and other assets. Although many funds have long-term investment time horizons and may not engage in short-term trading, their investment strategies often allow them to buy and sell securities without regard to how long a security is held.

The Agencies recognized the issues presented by treating funds as banking entities. For example, in proposing regulations to implement the Volcker Rule, the Agencies noted that treating covered funds as banking entities "would be inconsistent with the purpose and intent of the statute."[7] The Agencies thus determined to provide a blanket exclusion for covered funds from the banking entity definition in the Final Rule because, otherwise, covered funds would be prohibited from investing in other covered funds or trading financial instruments on a short-term basis. This outcome would have prevented covered funds from engaging in the very activities contemplated by the Volcker Rule.[8] Similarly, the Agencies contemplated the issue of banking entity control of U.S. registered investment companies ("RICs"), explained that banking entities ordinarily do not possess

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holds itself out as being, an entity or arrangement that raises money from investors primarily for the purpose of investing in securities for resale or other disposition or otherwise trading in securities and (4) the fund could not rely on an exclusion or exemption from the definition of "investment company" under the ICA other than the exemptions contained in Sections 3(c)(1) and 3(c)(7) of that Act, if the fund was subject to U.S. securities laws.

6 Final Rule § _.2(c)(2).

7 76 Fed. Reg. 68846, 68856 (Nov. 7, 2011).

8 *Id.* (noting that if the Agencies did not exclude covered funds from the banking entity definition, the funds would be prohibited from conducting activities that the Volcker Rule "specifically contemplates").

such control and, thus, determined that RICs ordinarily would not be subject to the restrictions of the Volcker Rule.[9]

Capturing foreign public funds and foreign non-covered funds within the definition of banking entity, we believe, was the unintended consequence of the Final Rule, and, specifically, of the Agencies' entirely appropriate efforts to tailor the definition of "covered fund."[10] As described in more detail below, foreign public funds and foreign non-covered funds rightly were excluded from the covered funds definition, respectively, to provide parity of regulatory treatment for similarly situated U.S. and non-U.S. funds and to limit the Final Rule's extraterritorial reach. This exclusion results, perversely, in these funds potentially being treated as banking entities, which would severely restrict these funds' activities and render the Final Rule's exclusions essentially meaningless given the realities of the marketplace.

We believe that the Agencies should issue guidance that foreign public funds and foreign non-covered funds will be treated as excluded from the definition of "banking entity" for Volcker Rule purposes. The proposed treatment would place foreign public funds and foreign non-covered funds on equal footing with RICs and covered funds, respectively. This treatment also would put bank-affiliated asset managers on an equal footing with third-party asset managers. Finally, the proposed treatment would avoid needless costly and otherwise unnecessary restructurings that will have market impacts in foreign funds markets, as described in more detail below.

A. Foreign Public Funds Should Not Be Treated as Banking Entities

As noted above, RICs are not covered funds under the Final Rule, and the Final Rule excludes foreign public funds from the covered funds definition in an attempt to provide regulatory parity between these funds and their U.S. RIC analogues.

Even though RICs are not covered funds, the Agencies made clear their expectation that a RIC would not be treated as a banking entity by virtue of a banking

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9 Prohibitions and Restriction on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 79 Fed Reg. 5535, 5676 (Jan. 31, 2014).

10 See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, § 619(h)(2), 124 Stat. 1376, 1630 (2010); 79 Fed. Reg. at 5671 (noting that the Agencies exercised their statutory authority to adopt "a tailored definition of covered fund in the final rule that covers issuers of the type that would be investment companies but for section 3(c)(1) or 3(c)(7) of the Investment Company Act with exclusions for certain specific types of issuers in order to focus the covered fund definition on vehicles used for the investment purposes that were the target of section 13").

entity providing advisory, administrative or other services to the RIC.[11] Banking entities providing the very same services to foreign public funds, on the other hand, may not be able to rely on the non-control precedents the Federal Reserve has developed with RICs in mind because these foreign funds employ structures that vary from those used by RICs. This result, whereby foreign public funds are treated as banking entities but RICs are not, is inconsistent with the Agencies' intent to treat foreign public funds and RICs the same under the Final Rule.

This disparate treatment problem is not merely hypothetical. In a number of foreign jurisdictions, the sponsors of and advisers to public funds could be viewed as "controlling" the fund because of legal requirements in the local jurisdiction, the evolution of local industry practice or the demands of third-party retail investors. We provide a few examples to illustrate the scope and breadth of the problem and the real market impacts that result:

- In the United Kingdom, the prevalent market practice is for UCITS to have an "authorized corporate director" or "authorized trust manager," which effectively are management companies that perform the function of a board of directors.[12] The authorized corporate directors and authorized trust managers generally are affiliates of the bank sponsoring the fund, which could result in a banking entity controlling the UCITS for BHC Act purposes.

- In addition, even where a UCITS has a board of directors (which is often the case in Ireland and Luxembourg), a majority of the directors often are affiliated with the sponsoring banking entity as a result of market practice. Further, UCITS without a board structure are run by management companies controlled by banking entity sponsors, as in the United Kingdom.

- In Europe, funds that are sold within a particular jurisdiction almost always are organized under local regulatory regimes (as opposed to the EU-wide UCITS regime). In France, such a fund is called a "*fond commun de placement*," or FCP; in Spain, these funds are called "*fondos de inversión*,"

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[11] 79 Fed. Reg. at 5676 (stating that for purposes of the Volcker Rule, "a financial holding company may own more than 5 percent (and less than 25 percent) of the voting shares of a registered investment company for which the holding company provides investment advisory, administrative, and other services and has a number of director and officer interlocks, without controlling the fund for purposes of the BHC Act").

[12] A UCITS is a fund organized under the European Union's Undertakings for Collective Investment in Transferable Securities Directive.

or FIs. FCPs and FIs are not separate corporate entities, are run by asset managers affiliated with a sponsoring banking entity and, therefore, likely are banking entities themselves.

- As another example, in Canada, public funds often are organized as trusts where the sponsoring banking entity or an affiliate is the trustee of the public fund. As such, these Canadian public funds likely would be banking entities themselves under the Volcker Rule, subject to the Final Rule's prohibitions and restrictions.

- In Australia, managed funds are required to be administered and managed by "Responsible Entities." Responsible Entities are required by local law to have a governing board consisting of a majority of independent directors, but the independent board may be appointed by the bank that sponsors the funds or that controls the Responsible Entity. Thus, such funds are likely to be affiliates of the bank under the BHC Act and banking entities under the Volcker Rule.

In the situations described above, restructuring to avoid BHC Act control would be cost-prohibitive, confusing for foreign retail investors and, in many cases, contrary to local jurisdiction regulatory requirements. As an illustration of the cost and administrative difficulties, restructuring of the governance arrangements of foreign public funds could include negotiating new trust indentures, issuing notices to unitholders and conducting unitholder votes as well as requiring the approval or involvement of local market regulators. This result seems unnecessary to achieve the purposes of the Volcker Rule, as the foreign public funds at issue are not being used to evade the Volcker Rule's restrictions or to undertake otherwise prohibited activities. Instead, these funds are providing investment options for retail investors in foreign jurisdictions, just as RICs do in the United States. The result also has foreign market implications that the Agencies could not have intended.

The disparate treatment between RICs (U.S. public funds) and foreign public funds contravenes one of the primary purposes of the "asset management exemption" included in the Volcker Rule – namely, to allow banks and bank holding companies to continue to operate customer-facing asset management businesses. Treating foreign public funds as banking entities would have significant ramifications for bank-affiliated fund companies and asset managers well beyond what the Volcker Rule intended and would put those firms at a clear disadvantage relative to managers not affiliated with a bank.

The disparate treatment also contravenes the Final Rule's intent to limit the extraterritorial scope of the Volcker Rule and to treat foreign public funds similarly to U.S. registered funds. Thus, to resolve this disparity, the Agencies should provide public

guidance that clarifies that "controlled" foreign public funds will not be treated as banking entities under the Final Rule. The guidance could clarify, as the Agencies have done in the preamble to the Final Rule for RICs, that a banking entity may organize, sponsor, manage and have other relationships with a foreign public fund without that fund being deemed a Volcker Rule affiliate of the banking entity.

In addition, the Agencies should issue guidance addressing the disparate treatment between RICs and foreign public funds that arises as of result of the suggestion in the preamble that to qualify for the foreign public fund exemption, U.S. banking entities and certain related persons "generally [are] expect[ed]" to hold 15 percent or less of sponsored foreign public funds.[13] No such restriction applies to RICs for Volcker Rule purposes, and applying the restriction to foreign public funds would inhibit U.S. banking entities from competing in important foreign markets. For example, banking entities often hold more than 15 percent in sector-specific or other niche foreign public funds because a banking entity needs a significant amount of time to sell such a fund that does not represent a core portfolio asset class for most investors.[14]

B. Foreign Non-Covered Funds Should Not Be Treated as Banking Entities

Foreign non-covered funds are excluded from the definition of "covered fund" because the Agencies determined that prohibiting investments in these funds by non-U.S. banking entities would not advance the policy objectives of the Volcker Rule.[15] As noted above, this exclusion means that controlled foreign non-covered funds may become banking entities and therefore subject to the Final Rule's prohibitions and restrictions. In contrast, funds offered in reliance on the SOTUS exemption are not considered banking entities under the Final Rule because SOTUS funds are, in the first instance, covered

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[13] In order to qualify for the foreign public fund exemption, any such funds sponsored by a U.S. banking entity must be offered "predominately outside the United States" and to persons other than the sponsoring U.S. banking entity and its affiliates. Final Rule § _.10(c)(1). The Agencies stated that they "generally expect" these requirements would be met "if 85 percent or more of the fund's interests are sold to investors that are not residents of the United States. . . . to persons other than the sponsoring U.S. banking entity and certain persons connected to that banking entity." 79 Fed. Reg. at 5678.

[14] Of course, limits on ownership may apply for other (non-Volcker Rule) purposes, such as for BHC Act control purposes.

[15] *Id*. at 5672 ("This approach [of excluding foreign funds from the definition of "covered fund"] is designed to include within the definition of covered fund only foreign entities that would pose risks to U.S. banking entities of the type section 13 was designed to address.")

funds that benefit from an exemption under the Final Rule (as opposed to being excluded from the covered fund definition).[16]

Thus, a foreign banking entity may own, for example, up to 99 percent of the interests issued by a fund organized under Delaware law that qualifies for the SOTUS exemption without that fund being deemed to be an affiliate of the banking entity for purposes of the Volcker Rule. That same foreign banking entity may not, however, own 25 percent of a fund organized under the law of a foreign jurisdiction and that qualifies as a foreign non-covered fund (even though that fund may have no relationship to the United States whatsoever). In addition, some foreign non-covered funds are organized using the FCP and FI structures noted in the discussion of foreign public funds above and, therefore, these foreign non-covered funds could be controlled by a banking entity as a result of the FCP / FI structural issues described above.

This disparate treatment seems untenable. It does not serve any policy objective, in particular because SOTUS funds and foreign non-covered funds are essentially indistinguishable. More specifically, both SOTUS funds and foreign non-covered funds (1) may not be sponsored by or receive investments from U.S. banking entities (unless another exemption applies), (2) may not offer interests to U.S. persons, (3) may make U.S. investments, (4) may be managed by a U.S. person and (5) are equally subject to the anti-evasion provisions of the Final Rule.[17]

In fact, an interpretation that foreign non-covered funds will not be treated as banking entities would be supported by the policy goals of the Final Rule, particularly as they relate to restricting the extraterritorial reach of the Final Rule while limiting the risks that covered fund investments and activities pose to the safety and soundness of U.S. banking entities and the U.S. financial system. For example, the Agencies determined that foreign banking entities' activities under the SOTUS fund exemption "ensures the risk and sponsorship of the activity or investment occurs and resides solely outside the United States."[18]

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[16] A SOTUS fund is a fund that falls within the definition of "covered fund" but, with respect to investments by foreign banking entities, is exempt from the prohibition of the Volcker Rule. Final Rule § _.13(b).

[17] We understand that other industry participants may be separately liaising with the staff from the Agencies regarding issues raised by the SOTUS exemption. Although this letter does not address SOTUS, many of SIFMA's members believe the Agencies' staff should address a number of SOTUS-related issues.

[18] 79 Fed. Reg. at 5741.

Thus, given that foreign non-covered funds essentially are indistinguishable from SOTUS funds, and that investment in both types of funds is available exclusively to non-U.S. banking entities (unless another exemption applies), the Agencies should issue guidance that indicates that they will afford foreign non-covered funds the same regulatory treatment as SOTUS funds by treating foreign non-covered funds as excluded from the banking entity definition.

II. Banking Entities Should Be Allowed up to Three Years to Seed a Foreign Public Fund to Facilitate the Development of Track Records

The Agencies recently issued helpful guidance that confirms that seeding vehicles for foreign public funds will not be treated as covered funds during the seeding period, similar to the treatment for RICs under the Final Rule.[19] This guidance requires banking entities to develop and document a plan to convert a seeding vehicle into a foreign public fund in one year, which is the time period permitted for seeding under the Final Rule's so-called "asset management" exemption.

SIFMA urges the Agencies to clarify that, in ordinary circumstances, a banking entity would be able to extend the seeding period for a foreign public fund by up to two additional years (for a total seeding period of three years). A three-year seeding period is commonplace in many situations and is necessary to develop a track record for a fund. The Agencies also should make clear the process for granting extensions of the initial one-year seeding period and make this process as streamlined as possible (including, for example, by allowing the potential for a three-year seeding period to be documented in the initial plan to develop the foreign public fund).

III. The Federal Reserve Should Grant an Industry-Wide Extension of the Conformance Period for All Foreign Funds to Provide Near-Term Certainty

We recognize that addressing the issues we raise in this letter through a multi-agency process can be time consuming. We also acknowledge that the Agencies need to consider these issues carefully and fully.

Thus, to provide the Agencies sufficient time to review these issues thoroughly, and the industry with near-term certainty regarding the treatment of foreign funds under the Final Rule, we request that the Federal Reserve grant, as promptly as practicable, an industry-wide one-year extension to the conformance period for all foreign funds, inclusive of foreign public funds, foreign non-covered funds and funds offered under the SOTUS exemption.

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[19] Volcker Rule, Frequently Asked Questions, *available at* http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#5

In addition to granting the one-year conformance period extension, the Federal Reserve should provide a clear indication that a further one-year extension will be granted if these issues are not resolved by the Agencies in advance of July 2015, so that banking entities in all cases have sufficient time to make any changes to their business that ultimately may be necessary.

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Thank you for considering our requests. Please do not hesitate to contact SIFMA if we can be of assistance on these important issues. We would welcome any opportunity to discuss these issues with the staffs of the Agencies.

Sincerely,

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