



February 13, 2012

Ms. Jennifer J. Johnson
Secretary
Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Mr. Robert E. Feldman
Executive Secretary
Attention: Comments
Federal Deposit Insurance
Corporation
550 17th Street, NW.
Washington, DC 20429

Office of the Comptroller of the Currency
250 E Street, SW.
Mail Stop 2-3
Washington, DC 20219

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange
Commission
100 F Street NE.
Washington, DC 20549-1090

Re: Comments on Volcker Rule Proposed Regulations

Ladies and Gentlemen:

The Securities Industry and Financial Markets Association (“SIFMA”)¹ appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve (the “Board”), the Federal Deposit Insurance Corporation (the “FDIC”), the Office of the Comptroller of the Currency (the “OCC”) and the Securities and Exchange Commission (the “SEC” and, together with the Board, the FDIC and the OCC, the “Agencies”) regarding the Agencies’ notice of proposed rulemaking² (the “Proposal”) to implement Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Volcker Rule”).

This comment letter focuses specifically on (i) municipal securities and (ii) tender option bonds, which are a specific type of transaction described herein

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. For more information, visit www.sifma.org.

² Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68,846 (Nov. 7, 2011) (“Proposal”).

that involves the repackaging of municipal securities that is common in the marketplace. Separate [comment letters](#) are being submitted by SIFMA with respect to other issues relating to the Proposal.

As further discussed herein, we respectfully request that the Agencies:

(1) interpret the permitted activity in the statute provided by clause (a)(1)(iii) of Section __.6 to include all municipal securities as defined in clause (c)(9) of Section __.3 of the Proposal and securities issued in connection with tender option bond programs,

(2) exempt tender option bond transactions from the definition of “covered fund” as defined clause (b)(1) of Section __.10 of the Proposal, and

(3) amend Section __.3(b)(2)(iii) to explicitly provide that an account shall not be deemed a trading account for purposes of paragraph (b)(2)(i) of Section __.3 to the extent that such account is used to acquire securities issued pursuant to a tender option bond transaction.

I. Volcker Rule and municipal securities

The Volcker Rule generally prohibits any banking institution from engaging in certain proprietary trading activities or from acquiring or retaining an ownership interest in, sponsoring, or having certain relationships with “hedge funds” and “private equity funds.” Certain permitted activities to the general prohibition are included in Section 13(d) of the Bank Holding Company Act (the “BHC Act”), including “. . . the purchase, sale, acquisition or disposition of . . . obligations of any State or of any political subdivision thereof.”³ The Proposal correctly exempts from its scope obligations of any State or of any political subdivision thereof. However, the Agencies’ narrow reading, as expressed in footnote 165 of the Proposal, of the scope of permitted activity excludes a substantial portion of the municipal securities that are issued in the market today. The actual percentage of municipal securities that will be subject to the Proposal can only be calculated after examining the legal incorporation of tens of thousands of municipal issuers; however, the Municipal Securities Rulemaking Board estimates, based on information from Thompson Reuters, that, in calendar year 2011, 41.4% of municipal securities were issued by agencies and authorities.⁴ We believe that the narrow reading is improper, and that there exists statutory precedent for a broader interpretation of the definition of political subdivision.⁵ Further, we are not aware of any evidence that Congress intended

³ 12 U.S.C. §1851(d)(1)

⁴ See page 2 of letter dated January 31, 2012 submitted by the Municipal Securities Rulemaking Board Re: Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds (the “MSRB Comment Letter”).

⁵ See pages 5 – 7 of the MSRB Letter for numerous statutory interpretations of the definition of political subdivision.

to treat certain municipal securities differently than other municipal securities under the Volcker Rule.

We request that all municipal securities be exempted from the Proposal's proprietary trading prohibition. As we describe in this letter, trading municipal bonds and conducting a tender option bond business are activities that lead to a more liquid and sound market for municipal securities.

Comment was specifically requested as to whether the exemption from the proprietary trading prohibition should be expanded to include all municipal securities.⁶ In addition, comment was requested as to whether the definition of municipal security in Section 3(a)(29) of the Securities Exchange Act of 1934 (the "1934 Act") would be helpful in determining the scope of the exemption from the Volcker Rule.⁷ We strongly believe that the exemption from the proprietary trading prohibition should be expanded to include municipal securities as defined in Section 3(a)(29) of the 1934 Act. Doing so will clearly exclude all municipal securities from the proprietary trading prohibition under the Volcker Rule, which will result in a more liquid, stable and sound municipal market.

Failure to exclude all municipal securities from the Volcker Rule will create tremendous confusion in the municipal market.

Municipal securities are the source of financing for a wide range of governmental projects, including essential infrastructure at the state and local level, non-profit healthcare facilities, student loan programs and affordable housing programs. These securities are issued by a wide range of issuing entities, including states, agencies, authorities or instrumentalities of states, municipal corporations, cities, counties, and political subdivisions thereof. Depending on the law of a particular state, municipal securities for the same purpose may be issued by different entities. For example, an affordable housing bond in one state might be issued by the state or an agency of the state, whereas in a different state a bond for the same purpose might be issued by a county or a municipal corporation. Accordingly, under the Proposal there will be no consistency as to the types of municipal securities that are exempt from the proprietary trading prohibition under the Volcker Rule. This disparate result will lead to immense confusion in the municipal market. In particular, market liquidity for securities

⁶ Question 120 reads: "Should the Agencies adopt an additional exemption for proprietary trading in State or municipal agency obligations under section 13(d)(1)(J) of the [BHC Act]? If so, how would such an exemption promote and protect the safety and soundness of banking entities and the financial stability of the United States? 76 Fed. Reg. 68846, 68878.

⁷ Question 124 reads: "Are the definitions of 'government security' and 'municipal security' in sections 3(a)(42) and 3(a)(29) of the Exchange Act helpful in determining the proper scope of the exemption? If so, please explain their utility and how incorporating such definitions into the exemption would be consistent with the language and purpose of section 13 of the [BHC Act]." 76 Fed. Reg. 68846, 68878.

issued by state agencies or authorities will be directly and materially harmed by the prohibition on proprietary trading.

Further, the exclusion of certain municipal securities from the proprietary trading prohibition under the Proposal does not appear to have been arrived at based on a difference between the credit underlying the municipal securities. Distinguishing between municipal securities based on the type of issuer is inappropriate in the context of the Volcker Rule, as different issuers may offer securities that offer the same credit exposure to investors. As noted above, an affordable housing bond issued in one state may qualify for exclusion from the proposed proprietary trading prohibition, whereas an affordable housing bond issued in another state, because the bond is issued by a state agency or authority, may not qualify for exclusion from such prohibition, yet the programs financed by the different securities may be of the same creditworthiness.

Furthermore, the Proposal's treatment of municipal securities is inconsistent with precedent under banking law. The National Bank Act permits “. . . dealing in, underwriting, or purchasing securities . . . issued on behalf of any State or political subdivision of a State, including any municipal corporate instrumentality in 1 or more States, or any public agency or authority of any State or political subdivision of a State . . .” by national banks provided that the bank is well capitalized. Interpreting the permitted activities in a manner that creates an inconsistency between the treatment of municipal securities under the National Bank Act and under the Proposal will result in market uncertainty which will have a negative effect on the banking system. In order to avoid inconsistencies and in order to ensure that banks and their affiliates can continue to engage in activities that bank regulators have previously deemed appropriate and which serve a valuable public policy purpose, the Proposal should be interpreted to provide for a broad exclusion of municipal securities consistent with existing definitions of municipal securities rather than creating a new standard under the Volcker Rule.

The Volcker Rule will reduce liquidity and will increase price volatility in the municipal market.

The municipal market is composed of approximately 50,000 different issuing entities and at least 1.1 million different CUSIPs (separately identifiable securities). The corporate equity market is composed of 5,700 public companies which list their equity securities on major U.S. exchanges⁸ and approximately 22,000 different CUSIPs. The municipal market is accordingly quite fragmented given the tens of thousands of different municipal issuers, the number of municipal CUSIPs and the relatively small average size of individual municipal issuance. Further, approximately half of all municipal securities are held by individuals in relatively small amounts. As a result, retail investor trading of

⁸ United States Government Accountability Office Report to Congressional Committees, January 2012, Municipal Securities, Overview of Market Structure, Pricing and Regulation. Page 6.

municipal bonds does not occur in large blocks of common CUSIPs (as it does in the corporate bond and equity market), and liquidity for the municipal market is created by the trading desks of banking institutions making markets in a variety of municipal securities. The role of trading desks in creating liquidity is critical to maintaining a functioning municipal market.⁹ The Proposal would make much of the ordinary and necessary market making activity of the municipal market impermissible proprietary trading of banking institutions in the municipal market, and the result will be a material and adverse effect on the liquidity of and price volatility within the municipal market. Investors will face wider bid-ask spreads on municipal securities, and municipal issuers will have reduced access to low cost financing for essential governmental projects.

The exemption for market-making activities is not workable.

Investors and issuers expect banking institutions to make markets in municipal securities and provide a reliable source of liquidity. This essential activity would be severely curtailed by the Proposal.

The full [comment letter](#) submitted by SIFMA on the Proposal sets forth in detail concerns regarding the market making provisions of the Proposal, and participants in the municipal market affirm the concerns raised in that comment letter.

Participants in the municipal market further note that it will be costly and burdensome for banking institutions to implement compliance procedures with respect to the market making exception unless all municipal securities are exempt from the proprietary trading prohibition under the Proposal. Unlike any other markets, banking institutions will be required to review each municipal issuer to determine whether or not its securities are exempt from the Proposal, and the answer may not always be clear from the offering documents, which will then require banking institutions to pursue additional analysis or to assume that the Proposal applies. Banking institutions will need to develop compliance procedures in order to track which municipal securities are subject to trading restrictions under the Volcker Rule and then will need to ensure that the banking institution's trading of the municipal securities not subject to the proprietary trading prohibition under the Proposal satisfy the exemption for market making activities. We submit that the required compliance will be excessively burdensome on the municipal market with little, if any, benefit.

⁹ United States Government Accountability Office Report to Congressional Committees, January 2012, Municipal Securities, Overview of Market Structure, Pricing and Regulation, on page 7, states, "The fact that the average municipal security is traded infrequently indicates that generally ready buyers and sellers are not available. Thus, some broker-dealers provide liquidity for their investors by committing capital to maintain their own inventories."

Volcker Rule should exempt all municipal securities.

The proposed municipal securities exemption provided for in the Proposal Rule is under-inclusive. Request is respectfully made that the Agencies interpret the permitted activity in the statute provided by clause (a)(1)(iii) of Section __.6 to include all municipal securities as defined clause (c)(9) of Section __.3 of the Proposal.

II. Volcker Rule and tender option bonds

Structure of tender option bonds.

Tender option bonds represent a repackaging of long term municipal obligations into a money market eligible class of floating rate securities, which may be tendered at par plus accrued interest, and a residual certificate. Tender option bond offerings are private placements, sold primarily to institutional buyers.

Tender option bond transactions involve the creation of a trust which owns municipal securities (typically a single series of a highly rated municipal bond) and issues two classes of certificates. One class distributes interest based on a short-term floating rate (the “floaters”) and is highly rated; the other class receives the interest paid on the bond, less the interest paid to the floaters and less the payment of fees (the “residual certificate”) and, if rated, carries the rating of the underlying municipal bond. The holders of the floaters have the right to tender their floaters for purchase at par plus accrued interest, and the payment of the tender price is supported by a liquidity facility delivered by a highly rated liquidity provider, which is often a bank. This structure causes the floaters to have interest rates similar to and to trade like ordinary short-term municipal securities. The trust engages a broker-dealer to serve as remarketing agent for any floaters that are tendered by holders. The main role of the remarketing agent is to establish the interest rate for the floaters and to facilitate sales of floaters between investors. The remarketing agent may, but is not obligated to, purchase floater certificates. To the extent that the remarketing agent is unable to remarket tendered floaters, the floaters are purchased by the liquidity provider.

The floaters therefore have a significant level of protection in addition to the underlying municipal security held in the trust. The floaters are sold to short-term investors such as tax-exempt money market funds, and the residual certificates are sold to longer-term investors, such as banks, insurance companies, mutual funds or hedge funds, who use tender option bonds to reduce funding costs on an exposure to the municipal bond which it identifies for deposit in the trust. The holders of the residual certificate bear no greater risk than if they owned the underlying municipal bond; moreover, the low funding cost provided by the tender option bond structure provides a strong incentive for institutional investors to purchase long-term municipal securities, translating to lower borrowing costs

for issuers. In addition, tender option bonds provide for stability in the municipal securities market which results in a preservation of capital and increased liquidity.

Tender option bond programs are established by banking institutions as a means of satisfying the market demand for exposure to short-term municipal securities. The tender option bond market has existed for nearly twenty (20) years and there is nothing inherent in the tender option bond product that warrants the application of the Volcker Rule to this market. Tender option bonds performed well throughout the financial crisis and do not expose banking institutions to a higher risk profile. In fact, tender option bonds offer banking institutions a source of financing for municipal bonds and thus are a safe and sound resource that should be available to banking institutions. Tender option bonds are a common funding tool structured in order to preserve the tax-exempt nature of interest on municipal bonds, with a risk profile similar to repurchase agreements.

Tender option bonds should not be included within the definition of Covered Fund.

Because tender option bonds are effected through the creation of a trust that relies upon either Section 3(c)(1) or 3(c)(7) of the Investment Company Act of 1940 to avoid having the trust be classified as an “investment company,” tender option bond trusts will be captured in the definition of Covered Fund. There is no evidence in the legislative history of the Volcker Rule suggesting that Congress intended tender option bond transactions to be included in the scope of the Volcker Rule. Given that the Volcker Rule contains a specific exclusion for municipal securities it would be incongruous to apply the Volcker Rule to securities issued in tender option bond transactions when the securities represent an ownership interest in the very securities exempted from the Volcker Rule.

Further, by defining covered funds based solely on the exemption utilized under the Investment Company Act, the Volcker Rule captures certain types of banking activities that in no way introduce the same types of risks as imposed by private equity funds and hedge funds. Tender option bonds represent one such type of traditional banking transaction that is caught within this broad scope of the covered fund definition. We believe this is an unintended and incorrect result. To appropriately achieve the stated purpose of the Volcker Rule, we believe the definition of covered fund should focus on the characteristics of the relevant entity when determining whether the entity should constitute a covered fund rather than the specific exemption utilized under the Investment Company Act.

The Agencies should exempt tender option bond transactions from the definition of “covered fund” as defined in clause (b)(1) of Section __.10 of the Proposal.

Tender option bonds are economically similar to other arrangements that are exempt from the Volcker Rule, and tender option bonds should be one of the activities excluded from the definition of trading accounts.

Transactions such as repurchase agreements or securities lending transactions are excluded from the scope of the Volcker Rule. Tender option bonds are economically similar to repurchase agreements or securities lending transactions. Tender option bonds are, however, caught within the broad scope of Volcker due to the unique structure of tender option bonds. Tender option bonds are formed with trusts in order to maintain the exclusion from federal gross income for the interest on the municipal securities held in the trust. Comment was requested as to whether there are entities captured within the definition of “covered fund” that are inconsistent with the purpose of the statute.¹⁰

Capturing tender option bond programs within the definition of “covered fund” is inconsistent with the purpose of the Volcker Rule. Because tender option bonds are essentially traditional banking activities that are economically the same as other exempted secured financing arrangements, the Agencies should exempt tender option bonds from the Volcker Rule. The intent of the Volcker Rule was to prevent banking institutions from investing in and sponsoring hedge funds or private equity funds. Tender option bonds are not hedge funds or private equity funds. Furthermore, tender option bonds possess fundamental differences from those investment funds. Tender option bonds are not managed investment vehicles, do not involve the tranching of credit risk, and are not a speculative investment.

Comment was also requested regarding the proposed clarifying exclusions relating to trading accounts and whether other types of transactions should be excluded from the proposed definition of trading account.¹¹ Tender option bond programs do not operate based on expected or anticipated movements in the price of the bonds held in the tender option bond trust. Request is made to amend Section __.3(b)(2)(iii) to explicitly provide that an account shall not be deemed a trading account for purposes of paragraph (b)(2)(i) of Section __.3 to the extent

¹⁰ Question 225. Are there are entities captured by the proposed rule’s definition of “covered fund,” the inclusion of which does not appear to be consistent with the language and purpose of the statute? If so, which entities and why?

¹¹ Question 30. Are the proposed clarifying exclusions for positions under certain repurchase and reverse repurchase and securities lending transaction over- or under-inclusive and could they have unintended consequences? Is there an alternative approach to these clarifying exclusions broad enough to include *bona fide* arrangements that operate in economic substance as securitized loans and are not based on expected or anticipated movements in asset prices? Are there other types of arrangements, such as open dated repurchase arrangements, that should be excluded for clarity and, if so, how should the proposed rule be revised? Alternatively, are the proposed clarifying exclusions narrow enough to not inadvertently exclude from coverage any similar arrangements or transactions that do not have these characteristics?

that such account is used to acquire securities issued pursuant to a tender option bond transaction.

Tender option bond programs constitute a sizable portion of the municipal market, and a disruption of tender option bonds will disrupt the municipal market.

Tender option bonds serve at least three important public constituencies in the tax-exempt municipal market. First, they increase the demand for long-term municipal securities by enhancing market access for institutional investors and lowering financing costs for issuers of long-term tax-exempt municipal bonds and the related taxpayers. Second, as the relative size of the tender option bond market indicates (discussed below), tender option bonds provide municipal money market funds with a reliable supply of securities that meet the strictures of Rule 2a-7 of the Investment Company Act. Finally, tender option bonds allow investors in long-term tax-exempt municipal bonds to invest their capital more efficiently in the municipal bond market. The result of tender option bonds is increased capital base for long term municipal debt and increased stability in the municipal market.

Based on market estimates, the tender option bond market has historically represented between 25% and 30% of municipal money market fund assets. Accordingly, the tender option bond market composes a substantial portion of the short term municipal market. The Proposal will effectively prohibit tender option bond transactions and, as a result, disrupt the short term municipal market, as a substantial amount of liquid short duration high credit quality assets will simply disappear. Applying the Volcker Rule to tender option bond programs would be contrary to the stated purpose of the Volcker Rule, as tender option bond transactions are beneficial to the short term municipal market and promote the safety and soundness of the banking system by increasing liquidity in the market.

Request for exemption of tender option bonds from the Volcker Rule.

Tender option bonds are vital to a properly functioning and liquid municipal market and serve important public constituencies. Tender option bond transactions are not hedge funds or private equity funds. There is not multiple tranching of credit risk, and tender option bonds are not actively managed transactions. As noted above, the tender option bond transaction is economically similar to a repurchase agreement or securities lending agreement, both of which are exempt from the proprietary trading rules.

Tender option bond transactions should be recognized for what they are – an activity that promotes the safety and soundness of the banking system by (i) creating liquidity for municipal securities, (ii) providing short term municipal securities to investors, (iii) providing an investor source for municipal securities, and (iv) providing banking entities with a source of liquidity for municipal

securities. We urge that the Proposal be revised to clearly exclude tender option bonds from its scope, which we believe is entirely consistent with the proposed exclusion of repurchase agreements and securities lending transactions from the Volcker Rule.

III. Conclusion

We respectfully request that the Agencies:

(1) interpret the permitted activity in the statute provided by clause (a)(iii) of Section __.6 to include all municipal securities as defined clause (c)(9) of Section __.3 of the Proposal and securities issued in connection with tender option bond programs,

(2) exempt tender option bond transactions from the definition of “covered fund” as defined clause (a)(1) of Section __.10 of the Proposal, and

(3) amend Section __.3(b)(2)(iii) to explicitly provide that an account shall not be deemed a trading account for purposes of paragraph (b)(2)(i) of Section __.3 to the extent that such account is used to acquire securities issued pursuant to a tender option bond transaction.

* * * * *

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 you or with any member of the Agencies’ staff. Please feel free to contact the undersigned at (212) 313-1265 if you have any questions regarding this submission.

Very truly yours,



David L. Cohen
Managing Director
Associate General Counsel