October 17, 2018

By Electronic Submission

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
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Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

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

Brent J. Fields, Secretary
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549-1090

Christopher Kirkpatrick, Secretary
Commodity Futures Trading Commission
1155 21st Street NW
Washington, DC 20581

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds: Tender Option Bond Vehicles

Ladies and Gentlemen,

The Board of Governors of the Federal Reserve System ("Board"), the Federal Deposit Insurance Corporation, the Office of the Comptroller of the Currency, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the "Agencies") have requested comments on the Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with Hedge Funds and Private Equity Funds (83 Fed. Reg. at 33432) ("Proposal") that would amend the regulations implementing Section 13 of the Bank Holding Company Act ("BHC Act").

Section 13 of the BHC Act contains certain restrictions on the ability of a banking entity, and a nonbank financial company supervised by the Board, to engage in proprietary trading and have certain interests in, or relationships with, a hedge fund or private equity fund.

The Securities Industry and Financial Markets Association ("SIFMA")[1] appreciates the opportunity to comment on the Proposal and commends the Agencies for their work on this issue. The Proposal encourages commenters to identify the specific question to which they are responding. This letter is limited to SIFMA's comments on Question 182 of the Proposal (relating to municipal securities tender option bond ("TOB") vehicles). For additional comments on the Proposal, please see our letter dated October 17, 2018.

This letter assumes that the reader is generally familiar with the structural features of municipal securities TOB vehicles. For convenience, the Agencies' description of a municipal securities TOB vehicle is set forth in footnote 2 below.

1. Background

The final Volcker Rule does not provide a specific exclusion from the definition of the term "covered fund" for an issuer that is a municipal securities TOB vehicle.[2] The final Volcker Rule requires that tender option bond activities be conducted in the same manner as with other covered funds.[3] To the extent that a TOB vehicle is a covered fund, then, § __.10 prohibits a banking entity from, as principal, directly or indirectly, acquiring or retaining any ownership interest in or sponsoring a covered fund unless an exemption applies. Prior to restructuring in response to the final Volcker Rule, municipal securities TOB vehicles met the definition of the term "covered fund" and the floaters and residual certificates constituted "ownership interests" in such covered fund.

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[1] SIFMA is the voice of the US securities industry. We represent the broker-dealers, banks and asset managers whose nearly one million employees provide access to the capital markets, raising over $2.5 trillion for businesses and municipalities in the US, serving clients with over $18.5 trillion in assets and managing more than $67 trillion in assets for individual and institutional clients including mutual funds and retirement plans. SIFMA, with offices in New York and Washington, DC, is the US regional member of the Global Financial Markets Association. For more information, visit www.sifma.org.

[2] See Proposal, Question 182 ("In the preamble to the 2013 final [Volcker Rule], the Agencies noted commenters' description of a "typical tender option bond transaction" as consisting of "the deposit of a single issue of highly-rated, long-term municipal bonds in a trust and the issuance by the trust of two classes of securities: a floating rate, puttable security (the "floaters"), and an inverse floating rate security (the "residual") with no tranching involved. According to commenters, the holders of the floaters have the right, generally on a daily or weekly basis, to put the floaters for purchase at par. The put right is supported by a liquidity facility delivered by a highly-rated provider (in many cases, the banking entity sponsoring the trust) and allows the floaters to be treated as a short-term security. The floaters are in large part purchased and held by money market mutual funds. The residual is held by a longer-term investor (in many cases the banking entity sponsoring the trust, or an insurance company, mutual fund, or hedge fund). According to commenters, the residual investors take all of the market and structural risk related to the tender option bonds structure, with the investors in floaters taking only limited, well-defined insolvency and default risks associated with the underlying municipal bonds generally equivalent to the risks associated with investing in the municipal bonds directly. According to commenters, the structure of tender option bond transactions is governed by certain provisions of the Internal Revenue Code in order to preserve the tax-exempt treatment of the underlying municipal securities." See 79 Fed. Reg. at 5702."). See also the text following note 2037 of the "Supplementary Information" issued with in the final Volcker Rule.

[3] See Proposal, Question 182; 79 Fed. Reg. at 5703.

The Agencies have requested comments on three specific issues related to TOB vehicles –

(1) What role do banking entities play in creating the tender option bond trust and how have the restrictions on "covered transactions" affected the continuing use of this financing structure?

(2) Why should tender option bond vehicles sponsored by banking entities be viewed differently than other types of covered funds sponsored by banking entities?

(3) The Agencies are requesting comment about whether to incorporate into § __.14's limitations on covered transactions the exemptions provided in section 23A of the Federal Reserve Act and the Board's Regulation W. Would incorporating some or all of these exemptions address any challenges banking entities that sponsor tender option bond trusts have faced with respect to subsequent and ongoing covered transactions with such tender option bond vehicles?[4]

This letter addresses each of these questions and, consistent with our prior submissions,[5] recommends that the Agencies exclude TOB vehicles from the definition of the term "covered fund."

1. The Role of Banking Entities in the TOB market.

As background, TOB vehicles play an important role in the municipal markets – to the banking entities and their clients who are investors, and to the issuers of municipal securities who may indirectly benefit from the TOB market through improved liquidity and lower finance costs. The final Volcker Rule prohibits proprietary trading by banking entities but provides an exemption for trading in obligations of the United States, certain Agencies of the United States, and obligations of any State or political subdivision, including any municipal security.[6] The rationale for providing these exemptions is that they allow banking entities to provide liquidity to the market which reduces the yield and transaction costs for those securities. This benefit inures to the issuers of those securities through reduced borrowing costs. The Agencies previously have acknowledged that the final Volcker Rule could impose an economic burden on municipalities as a result of a decrease in demand for the types of securities issued by municipal securities TOB vehicles, and therefore, the potential negative effects on the depth and liquidity of the municipal securities market.[7]

To provide liquidity to investors and issuers, banking entities need to finance trading positions in the most cost-effective manner. For taxable investments such as Treasury and Agency Securities, this is largely accomplished in the repurchase agreement ("repo") market. Treasury and Agency Securities are pledged as collateral to lenders, who provide short-term, low cost funding. The lenders in these markets tend to be money market funds, banking entities and other financial institutions that choose to lend available funds without taking interest rate risk or credit risk and, in exchange, demand a low rate of interest.

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[4] Id.
[5] See SIFMA letter to the Agencies dated September 21, 2017.
[6] See § __.6 of the final Volcker Rule.
[7] See the text accompanying footnotes 2058 and 2059 of the "Supplementary Information" issued with the final Volcker Rule.

The ability of banking entities to access low cost funding via the repo market allows those entities to make markets in Treasury and Agency Securities, which results in reduced long term yields and tighter bid / offer spreads. Such market-making activities are permissible under the final Volcker Rule.[8] If the repo market did not exist, banking entities would need to factor in increased funding costs when they traded Treasury and Agency Securities. The net effect would be higher transaction costs, less liquidity, and a reduction of investment options for those banking entities, funds and other institutions with excess cash.

The repo market for municipal securities is limited and inefficient due to tax law constraints. In addition, interest earned by the lender in a repo transaction is, in general terms, taxable income and interest expense paid by the borrower in a repo transaction is nondeductible for tax purposes.[9] This inefficiency imposes additional cost on municipal securities investors. TOB vehicles fill that gap, by providing low cost, efficient financing of municipal securities. TOB vehicles economically resemble repo transactions, albeit for municipal securities, rather than Treasury and Agency Securities. Further, the OCC has previously determined that banking entities may invest in the securities issued by TOB vehicles.[10]

In very general terms, the TOB market can be divided into two different segments. First, a banking entity can use TOB vehicles to efficiently finance such banking entity's existing portfolio of municipal securities. The market sometimes refers to this segment as bank TOBs. This activity should be a permitted activity under the Volcker Rule because Section 13(d)(1)(A) of the BHC Act allows banking entities to own and dispose of municipal securities directly, municipal securities TOB vehicles "engage" in the same activities that banking entities could perform directly, and TOBs are functionally and economically equivalent to repos but documented as a legal entity for securities and tax law purposes.

In the case of bank TOBs, banking entities act as sponsor of the TOB vehicle and purchase the residual certificate. A banking entity is almost invariably also acting as the remarketing agent and the liquidity provider. Finally, a banking entity may provide a letter of credit or similar credit enhancement to guarantee the payments of principal and interest on the underlying municipal security to obtain a higher rating (and therefore, a lower interest rate) on the floating rate certificates sold to third party investors.

For bank TOBs, the "covered fund" limitation in the final Volcker Rule has dramatically impacted the TOB market. The Agencies decision to "include" a municipal securities TOB vehicle within the definition of a "covered fund" has caused certain banking entities and other market participants to structure bank TOB vehicles in compliance with another 1940 Act exemption, typically Rule 3a-7. This has led to varying structures in the marketplace. These structures are unnecessarily complex, burdensome to investors, and impair liquidity.

The other TOB market segment involves purchasers of residual certificates that are not banking entities. The market refers to these programs as third party TOBs. These investors, which are frequently tax exempt mutual funds, are seeking to achieve the same financing objectives as the banking entities that

[8] See § _4(b) of the final Volcker Rule.
[9] See Internal Revenue Code of 1986, as amended Section 265.
[10] See OCC Interpretive Letter # 1070 October 2006.

sponsor bank TOB vehicles. Third party TOBs continue to rely on the exemption under Section 3(c)(1) or 3(c)(7) of the 1940 Act. The final Volcker Rule has had a significant impact on the third party TOB market because the final Volcker Rule generally prohibits banking entities from acting as sponsor, investor or liquidity provider. A banking entity typically acts as remarketing agent for third party TOBs, but the combination of the final Volcker Rule, regulatory capital and other regulatory burdens has made it difficult for banking entities to economically hold an inventory of floating certificates.

As described in greater detail below, SIFMA requests that the Agencies exempt TOB vehicles from the "covered fund" definition so that the market benefits from the certainty of a specific exemption from the Volcker Rule. The final Volcker Rule has resulted in unnecessarily complex, varying structures that create market inefficiencies and do not serve the intended purposes of Section 13 of the BHC Act. A single, unified Volcker Rule exemption for TOB vehicles from the definition of the term "covered fund" would reduce the overbreadth and complexity of the Volcker Rule and improve market liquidity for the securities issued by municipal securities TOB vehicles and municipal securities more generally.

2. TOBs are different than other types of covered funds.

TOB vehicles sponsored by banking entities and/or third parties are fundamentally different from hedge funds or private equity funds in at least five distinct ways. First, a TOB vehicle only owns municipal securities. In contrast, a hedge fund or private equity fund can acquire an almost limitless variety of underlying assets. Second, a TOB vehicle owns municipal securities of a single obligor. There is no credit diversification. TOB vehicles provide total transparency to the investors. Hedge funds and private equity funds can own a diversified portfolio of securities. Third, a TOB vehicle is passive. Unlike a hedge fund or private equity fund, the underlying municipal securities are not traded. There is no reinvestment of TOB vehicle assets.[11] Fourth, a TOB vehicle is not managed by a third party. The residual certificate investor typically decides whether to acquire, or dispose of, the municipal securities held by the TOB vehicle. Finally, there is virtually no risk that a banking entity sponsoring a TOB vehicle will be obligated to compensate a third-party investor for any loss on a TOB investment. The rights and remedies of an investor are clearly set forth in the underlying documentation.

The Volcker statute is intended to prevent banking entities from directly engaging in short term speculative proprietary trading and indirectly through funds that engage in such proprietary trading. The covered fund provisions of the final Volcker Rule capture a range of funds far broader than vehicles that engage in proprietary trading. A TOB vehicle is a passive fund that holds municipal securities, usually for a long time period. None of the elements of short term speculative proprietary trading are present. In fact, the only similarity between TOB vehicles and hedge funds and private equity funds is their reliance on Section 3(c)(1) or Section 3(c)(7) for an exemption from the 1940 Act.

[11] Internal Revenue Service, Rev. Proc. 2003-84, I.R.B. 2003-48 (December 1, 2003).

3. Impact of Section 23A and Reg. W.

We understand the Agencies are considering revising the definition of the term "covered transaction" for purposes of Super 23A so that it exempts the same transactions that are exempt from the definition of the term "covered transactions" under Section 23A of the Federal Reserve Act and Regulation W.

As stated above, banking entities have modified bank TOBs in a manner that complies with Rule 3a-7 and therefore outside of the final Volcker Rule and modified their activities to comply with the Volcker Rule for third party TOBs. Accordingly, we do not believe that incorporating some or all of the exemptions from the term "covered transactions" under Super 23A into Section 23A would benefit the TOB market or the municipal securities market generally.

2. Recommendation.

Under the final Volcker Rule, a banking entity is permitted to purchase and sell municipal securities—without limit or restriction—directly for its own balance sheet.[12] A restriction under the Final Volcker Rule treating a TOB vehicle—the underlying assets of which a banking entity could trade without restriction—as a covered fund is incongruous and unnecessary and restricts the ability of banking entities to sponsor, structure and purchase securities issued by TOB vehicles.

We recommend that the Agencies exclude municipal securities TOB vehicles from the definition of "covered fund". The addition of this exclusion would more effectively tailor the applicability of the covered fund provisions to the intended target (short term speculative proprietary trading by banking entities) and would mitigate the negative impact that the final Volcker Rule has had on banking entities and their clients.

The Agencies clearly have the statutory authority to exclude municipal securities TOB vehicles from the definition of the term "covered fund"[13] and should do so here. The Agencies have previously exercised their authority by excluding 13 types of entities from the definition of "covered fund."[14] The Agencies expressly retained the ability to exclude additional types of entities from the definition of "covered fund" upon a joint determination that any additional exclusions are consistent with the purposes of Section 13.[15]

Congress intended for banking entities to trade obligations of any state government or one of its political subdivisions.[16] The Senate Report accompanying the Volcker Rule clearly shows that Congress was trying to prohibit or restrict certain types of high risk activities or activities which create significant conflicts of interest between banking entities and their customers. Municipal securities TOB vehicles do not involve high risk trading activities or create significant conflicts of interest. Owning a municipal security through a TOB vehicle poses no greater risk to the safety and soundness of a banking entity than direct

[12] Final Volcker Rule § __.6(a).
[13] 79 Fed. Reg. at 5670.
[14] See final Volcker Rule § __.10(c)(1) to (13).
[15] 79 Fed. Reg. at 5677.
[16] Section 13(d)(1)(A) of the BHC Act.

ownership. In fact, an efficient, unified TOB market is consistent with the purposes of Section 13 of the BHC Act and should not impair the safety and soundness of banking entities and the municipal securities markets.

We believe the "qualified tender option bond entity" ("QTOB") definition used by the Agencies in the final rules implementing the risk retention requirements of Section 15G of the Securities Exchange Act of 1934, as added by section 941 of Dodd Frank (the final Risk Retentions rules), is a useful and appropriate framework to develop an exclusion for TOB vehicles from the "covered fund" definition in the Volcker Rule. The final Risk Retention rules did not exempt TOB vehicles from risk retention, but the Agencies did provide additional risk retention options for sponsors of a limited universe of TOB vehicles described in the QTOB definition.

As such, we recommend that the Agencies adopt the same QTOB definition from the Risk Retention rules for purposes of creating a TOB vehicle exclusion from the definition of the term "covered fund." A single, unified exclusion will improve transparency, efficiency and certainty in the TOBs market, as well as provide the Agencies a known and recently developed framework from which to provide an exclusion for TOB vehicles. For ease of reference, the definition of QTOB is attached hereto as Exhibit A.

We would welcome the opportunity to discuss these comments with you or any member of the staff of the Agencies. Please contact myself (202 962 7300; mdecker@sifma.org) or John T. Lutz (212 547 5605; jlutz@mwe.com) of McDermott Will & Emery LLP if you have any questions.

Sincerely,

Michael Decker
Managing Director

EXHIBIT A

Qualified tender option bond entity means an issuing entity with respect to tender option bonds for which each of the following applies:

(i) Such entity is collateralized solely by servicing assets and by municipal securities that have the same municipal issuer and the same underlying obligor or source of payment (determined without regard to any third-party credit enhancement), and such municipal securities are not subject to substitution.

(ii) Such entity issues no securities other than:

(A) A single class of tender option bonds with a preferred variable return payable out of capital that meets the requirements of paragraph (b) of this section, and

(B) One or more residual equity interests that, in the aggregate, are entitled to all remaining income of the issuing entity.

(C) The types of securities referred to in paragraphs (ii)(A) and (B) of this definition must constitute asset-backed securities.

(iii) The municipal securities held as assets by such entity are issued in compliance with Section 103 of the Internal Revenue Code of 1986, as amended (the “IRS Code”, 26 U.S.C. 103), such that the interest payments made on those securities are excludable from the gross income of the owners under Section 103 of the IRS Code.

(iv) The terms of all of the securities issued by the entity are structured so that all holders of such securities who are eligible to exclude interest received on such securities will be able to exclude that interest from gross income pursuant to Section 103 of the IRS Code or as “exempt-interest dividends” pursuant to Section 852(b)(5) of the IRS Code (26 U.S.C. 852(b)(5)) in the case of regulated investment companies under the Investment Company Act of 1940, as amended.

(v) Such entity has a legally binding commitment from a regulated liquidity provider as defined in §244.6(a), to provide a 100 percent guarantee or liquidity coverage with respect to all of the issuing entity's outstanding tender option bonds.

(vi) Such entity qualifies for monthly closing elections pursuant to IRS Revenue Procedure 2003-84, as amended or supplemented from time to time.