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Statement of the Investment Company Institute
Hearing on "Examining the Impact of the Volcker Rule on Markets, Businesses, Investors and Job Creation"
Subcommittee on Capital Markets and Government Sponsored Enterprises
Subcommittee on Financial Institutions and Consumer Credit
Committee on Financial Services
United States House of Representatives

January 18, 2012

The Investment Company Institute[1] is pleased to provide this written statement in connection with the hearing on Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act—commonly known as the "Volcker Rule." This provision was enacted to restrict banks from using their own resources to trade for purposes unrelated to serving clients. Section 619 was not directed at U.S. mutual funds and other registered investment companies ("registered funds"), which manage total assets of $12.47 trillion and serve over 90 million shareholders. Unfortunately, the current proposal to implement the Volcker Rule ("Proposal") nonetheless raises deep concerns for the U.S. registered fund industry.

If adopted in its current form, the Proposal would reach much farther than Congress ever intended. For example, the Proposal would treat many registered investment companies as hedge funds—a result that contradicts the plain language that Congress passed. In part one of our statement, we discuss this and other ways in which the proposed implementation of the Volcker Rule would impede the organization, sponsorship and normal activities of registered funds.[2]

The Proposal, as currently drafted, could also restrict banks from playing their historic role as market makers buying and selling securities—despite the fact that Congress specifically designated "market making related activity" as a "permitted activity" for banks under the Volcker Rule. If banks cannot provide these services, particularly in the less liquid fixed income and derivatives markets and the less liquid portions of the equity markets, registered funds and other investors could face wider spreads, higher transaction costs, and diminished returns. The Proposal also could greatly impair the U.S. financial markets by imposing stringent restrictions that go well beyond what is necessary to effectuate Congress' intent in enacting the Volcker Rule, potentially hurting our broader economy and impacting job creation and investments in U.S. businesses overall. In part two of our statement, we describe this and other ways in which the financial markets would be affected.

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.47 trillion and serve over 90 million shareholders.

[2] The Proposal's overreach extends beyond U.S. borders, negatively impacting investors, funds, and global markets. A separate statement by our new voice overseas, ICI Global, discusses these issues.

Finally, part three of our statement describes ways in which the Proposal, as currently drafted, could limit investment opportunities for registered funds and their shareholders.

The issues highlighted below will be discussed in greater detail in ICI's comment letter on the Proposal, which we plan to file by the February 13 deadline.

I. The Proposal Would Impede the Organization, Sponsorship and Normal Activities of Registered Funds

Section 619 of the Dodd-Frank Act, which adds new Section 13 to the Bank Holding Company Act, generally prohibits banking entities from engaging in proprietary trading and from having certain relationships with hedge funds and private equity funds. In enacting Section 13, Congress sought to reduce the potential negative consequences that certain types of speculative risk-taking by, and conflicting relationships of, banking entities—which benefit from federal deposit insurance and access to the Federal Reserve discount window—could have on banks, taxpayers, or U.S. financial stability.[3] There is no indication that Congress intended to restrict a banking entity's activities with and relationships to registered funds, or to impede the normal operations of registered funds themselves. Yet in several ways, the Proposal would do just that. It is important, therefore, that the Proposal be modified to avoid improperly affecting registered funds and their long-permitted relationships with banking entities.

A. <u>The Proposal Should Clarify That a Registered Fund is Not a "Covered Fund"</u>

Section 619 generally prohibits a banking entity from having an ownership interest in, or acting as sponsor to, a hedge fund or private equity fund. The statute defines "hedge fund" and "private equity fund" as "any issuer that would be an investment company, as defined in the Investment Company Act of 1940, but for Section 3(c)(1) or 3(c)(7) of that Act," or "such similar funds" as the regulators may determine by rule. The Proposal refers to these investment vehicles as "covered funds" and includes within "covered fund" any investment vehicle that is considered a "commodity pool" as defined in the Commodity Exchange Act ("CEA"). The CEA broadly defines "commodity pool" to include "any investment trust, syndicate or similar form of enterprise operated for the purpose of trading in commodity interests."

By treating all "commodity pools" as "covered funds," the Proposal would greatly expand the reach of the Volcker Rule—even to the extent of sweeping in some *registered funds*.[4] This result would

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[3] *See, e.g.*, Financial Stability Oversight Council, Study & Recommendations on Prohibitions on Proprietary Trading & Certain Relationships with Hedge Funds & Private Equity Funds (January 2011), at 15-16.

[4] A registered investment company might use commodity futures, commodity options or swaps in varying ways to manage its investment portfolio, including for reasons wholly unrelated to speculation or providing exposure to the commodity markets. Uses of these instruments include, for example, hedging positions, equitizing cash that cannot be immediately invested in direct equity holdings (such as if the stock market has already closed for the day), managing cash positions more generally, adjusting portfolio duration (*e.g.*, seeking to maintain a stated duration of seven years as a fund's fixed income

be contrary to Congressional intent. A plain reading of Section 619 indicates that Congress did not intend for the Volcker Rule to be applied to registered funds. Put simply, a registered fund is not "similar" to a hedge fund or private equity fund. Registered funds are subject to comprehensive, substantive regulation under the Investment Company Act, which focuses first and foremost on investor protection, and such funds are designed to be publicly offered to investors "of all stripes."[5] Hedge funds and private equity funds, on the other hand, are identified in Section 619 by two sections of the Investment Company Act that keep those funds *outside* that Act's regulatory protections. In addition, shares of a hedge fund or private equity fund cannot be offered publicly but rather only to a limited number of investors (in the case of a Section 3(c)(1) fund) or to sophisticated investors (in the case of a Section 3(c)(7) fund).

Moreover, the legislative history of the Dodd-Frank Act does not support a broad reading of the term "similar fund." To the contrary, former Senator Christopher Dodd (D-CT), Representative Barney Frank (D-MA) and other members of Congress appear to have been concerned that the Section 619 definition of hedge fund and private equity fund could be interpreted too broadly. As the legislative record reflects, members engaged in colloquies in order to clarify that references to the Section 3(c)(1) and 3(c)(7) exclusions under the Investment Company Act should not be read broadly for fear of sweeping in subsidiaries, joint ventures, venture capital funds and other structures that rely on those exclusions but "will not cause the harms at which the Volcker rule is directed."[6] These efforts by legislators to constrain the scope of the Volcker Rule have been undermined by the regulators' inclusion of "commodity pools" in the definition of "covered fund."

Based on the foregoing, ICI strongly recommends that the regulators modify the Proposal's definition of "covered fund" by including an express statement that any registered fund is ***not*** a covered fund.

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securities age or mature), managing bond positions in general (*e.g.*, in anticipation of expected changes in monetary policy or the Treasury's auction schedule), or managing the fund's portfolio in accordance with the investment objective stated in the fund's prospectus (*e.g.*, an S&P 500 index fund that tracks the S&P 500 using a "sampling algorithm" that relies in part on S&P 500 or other futures).

[5] *See, e.g.*, 2011 Investment Company Fact Book, Core Principles Underlying The Regulation of U.S. Investment Companies, available at http://www.icifactbook.org/fb_appa.html#core.

[6] *See, e.g.*, 156 Cong. Rec. S5904 (daily ed. July 15, 2010) (colloquy between Sens. Dodd and Boxer).

B. The Proposal Should Expressly Exclude Registered Funds from the Definition of "Banking Entity"

The Volcker Rule's prohibition on proprietary trading and restrictions on activities involving hedge funds and private equity funds apply to "banking entities."[7] A registered fund such as a mutual fund would fall within the definition of "banking entity" if it were considered a subsidiary or affiliate of a banking entity (*e.g.,* its sponsor or investment adviser). In this event, the registered fund itself would be subject to all of the requirements of the Volcker Rule, as implemented by the Proposal. There is no indication that Congress intended this result.

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.[8] This language is helpful, but without an express exclusion in the rule text, it is possible that some registered funds could become subject to all of the prohibitions and restrictions in the Volcker Rule. 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/adviser, the mutual fund could be considered an affiliate of the banking entity, and thus subject to the Volcker Rule in its own right. This could have the perverse effect of essentially barring banking entities from sponsoring the most highly regulated type of investment vehicle and, thereby, limiting important investment options for retail investors. Further, it would ban banking entities from engaging in an activity that is permitted under the Bank Holding Company Act and other federal banking laws and that was never intended to be affected by the Volcker Rule.

Providing an express exclusion for registered funds from the definition of "banking entity" would avoid this result without thwarting in any way the policy goals of the Volcker Rule. Even during the post-launch period when a banking entity owns all or nearly all of a fund's shares, the registered fund must be operated in accordance with the comprehensive regulatory regime administered by the Securities and Exchange Commission ("SEC") under the Investment Company Act and other federal securities laws. Of particular significance in this context, registered funds are subject to oversight by an independent board of directors,[9] strong conflict of interest protections through prohibitions on

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[7] The Proposal generally defines "banking entity" to include: (1) an insured depository institution; (2) a company that controls an insured depository institution; (3) a company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978; and (4) subject to certain exceptions, an affiliate or subsidiary of any of the foregoing.

[8] 76 Fed. Reg. at 68856.

[9] *See* Section 10(a) of the Investment Company Act (requiring a board of directors at least 40 percent of which must be independent directors). Importantly, certain exemptive rules under the Investment Company Act upon which nearly all registered funds rely require as a condition of reliance that at least a majority of a fund's directors must be independent directors. *See, e.g.,* Rule 17a-7 under the Investment Company Act. As a practical matter, most registered fund boards have a far higher percentage of independent directors than the Investment Company Act requires. As of year-end 2010, independent directors made up three-quarters of boards in more than 90 percent of fund complexes. Independent Directors Council and Investment Company Institute, *Overview of Fund Governance Practices, 1994–2010* (October 2011). A small

affiliated transactions,[10] and strict restrictions on leverage.[11]

C. The Ability of Banking Entities to Serve as Authorized Participants for Registered Exchange-Traded Funds Should Not be Constrained

The proposing release asks whether "particular markets or instruments, such as the market for exchange-traded funds, raise particular issues that are not adequately or appropriately addressed" in the Proposal.[12] In fact, the proprietary trading provisions of the Proposal call into question whether banking entities could continue to serve as Authorized Participants ("APs") for registered exchange-traded funds ("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 transactions (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. How these transactions must take place, and the substantial market disclosures that the ETF must make to facilitate them, are spelled out in the SEC order pursuant to which the ETF operates.[13]

APs may trade in ETF shares as traditional market makers, on behalf of their own clients, or for their own accounts. In all of these cases, AP transactions with an ETF are a unique and controlled form of arbitrage trading, and such transactions have the effect of minimizing differences between the market price for ETF shares and the underlying net asset value of those shares. The SEC views AP trading as 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.

Many of the leading APs in the ETF market are banking entities. As currently drafted, the Proposal creates substantial uncertainty regarding the extent to which an AP's trading would come within the permitted trading exemptions discussed below. If left unchanged, these uncertainties would create substantial risks that banking entities would cease to serve as APs to ETFs. It is therefore important that the Proposal be revised or clarified to avoid this result.

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number of ETFs are structured as unit investment trusts, a form of registered investment company that has no board of directors or investment adviser.

[10] *See* Section 17(a) of the Investment Company Act; Section 23A of the Federal Reserve Act.

[11] *See* Section 18 of the Investment Company Act.

[12] 76 Fed. Reg. 68873 (Question 91).

[13] For a detailed discussion of ETFs, including how they trade, *see* 2011 Investment Company Fact Book, Exchange-Traded Funds, available at http://www.icifactbook.org/fb_ch3.html.

II. The Proposal Could Greatly Impair the Financial Markets

Section 619 of the Dodd-Frank Act prohibits a banking entity from engaging in proprietary trading of any security, derivative, and certain other financial instruments for its own account. Notwithstanding this broad prohibition, the statute provides exemptions for a banking entity to engage in certain "permitted activities." Exemptions are provided for positions taken in connection with market making activities, risk-mitigating hedging activities, and trading in certain U.S. government securities.[14]

ICI supports the overall goals of the Volcker Rule's proprietary trading prohibition, particularly the need to address concerns surrounding the impact on the markets of truly speculative proprietary trading. We do not believe, however, that the Proposal's proprietary trading restrictions, as currently drafted, will achieve these goals. Instead, they may adversely impact the financial markets and the ability for registered funds and other investors to participate in the markets.[15] The implications of the Proposal for the markets may actually be inconsistent with the goals of Section 619 by increasing—not decreasing—systemic risk.

A. Sufficient Liquidity and Efficient Markets are Important for Registered Funds

For registered funds, the availability of sufficient liquidity is a critical element of efficient markets. Banking entities are key participants in providing this liquidity, promoting the orderly functioning of the markets as well as the commitment of capital when needed by investors to facilitate trading.

We are deeply concerned that the Proposal would decrease liquidity, particularly for markets that rely most on banking entities to provide liquidity, such as the fixed-income and derivatives markets and the less liquid portions of the equities markets. A reduction of liquidity would have serious implications for registered funds, leading to, among other things, wider spreads, increased market fragmentation, and ultimately the potential for higher costs for fund shareholders. Sufficient liquidity is particularly important in the everyday operations of mutual funds, which typically continuously offer

[14] Exemptions also are provided for trading "on behalf of customers," activities conducted solely outside of the United States by certain non-U.S. banking entities, underwriting activities, and trading by regulated insurance companies.

[15] A recent study by Oliver Wyman estimates the harm to investors from the proposed implementation of the Volcker Rule. For example, the study suggests that based on current holdings of U.S. corporate bonds ($7.7 trillion), investors may lose between $90-315 billion in immediate value in those securities due to decreased liquidity. Ongoing transaction costs for this asset class could further impair investor returns by $1-4 billion. Oliver Wyman, *The Volcker Rule restrictions on proprietary trading, Implications for the US corporate bond market*, December 2011. As of year-end 2010, registered funds held approximately $1.5 trillion in corporate bonds or 13% of the corporate bond market. *See* 2011 Investment Company Fact Book, Role of Investment Companies in Financial Markets, available at http://www.icifactbook.org/fb_ch1.html#role. As a result, the shareholders in those funds likely would face immediate and ongoing losses of a very substantial amount.

their shares and are required under the Investment Company Act to issue "redeemable securities."[16] Mutual funds must have efficient markets to invest cash they receive when investors purchase fund shares as well as to meet investor redemption requests on a daily basis. There is also a high likelihood that the Proposal will affect the manner in which non-U.S. banking entities interact with registered funds. For example, if such entities outside the United States are reluctant to provide liquidity to U.S. entities, an important source of liquidity for registered funds will dry up. Finally, adequate liquidity in the markets also helps dampen volatility; the impact of volatility on the costs of trading for investors, as well as investor confidence overall, cannot be discounted. Given the volatility experienced by the financial markets in the past year, ensuring adequate liquidity is that much more important. Banking entities providing market making functions therefore play an important role for registered funds and their millions of shareholders.

B. The Complexity of, and Difficulties Complying with, the Exemptions from the Proprietary Trading Prohibition Threaten Market Liquidity

Much of the concern surrounding the effect of the Proposal on liquidity arises from the complexities of several of the exemptions from the proprietary trading prohibition and uncertainty about how the exemptions will be applied. So complex are the conditions that must be met by a banking entity that the exemptions effectively are unworkable. Moreover, they simply do not reflect the manner in which the financial markets operate.

1. Market Making Exemption

The Proposal's implementation of Section 619's market making exemption contains numerous conditions that must be met by a banking entity.[17] These conditions, as currently drafted, make the exemption extremely complex and so difficult to comply with as to be effectively unworkable in a number of key financial markets or for a significant number of financial instruments. For example, the Proposal would require banking entities to ensure that their market making activities generate revenues primarily from fees, commissions, bid/ask spreads or other income that is not attributable to appreciation in the value of covered financial positions held as inventory. Market making in many fixed-income instruments, however, simply does not function in that way. Moreover, this condition ignores the likelihood that market makers holding inventory may generate revenue and profit from the

[16] *See* Section 2(a)(32) of the Investment Company Act (generally defining "redeemable security" as "any security . . . under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled . . . to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof.").

[17] These conditions include, among other things: establishing an internal compliance program; ensuring that the trading desk that makes a market in a covered financial position holds itself out as being willing to buy and sell the covered financial position, for its own account, on a regular or continuous basis; ensuring that market making-related activities are designed not to exceed the reasonably expected near term demands of clients, customers, or counterparties; ensuring that market making-related activities generate revenues primarily from fees, commissions, bid/ask spreads, or other income that is not attributable to appreciation in the value of covered financial positions held as inventory or their hedges; and that compensation arrangements for employees performing market making-related activities must be designed not to reward proprietary risk-taking.

appreciation of the covered financial position during the time the position is held in inventory. Similarly, in less liquid markets where trades are infrequent and customer demand is hard to predict, it may be difficult for a market maker to satisfy the condition that its activity must be "designed not to exceed the reasonably expected near-term demands of clients, customers, or counterparties." In addition, given the difficulties of overcoming the Proposal's rebuttable presumption that an account held by a banking entity will be a "trading account" for purposes of the Volcker Rule, market makers understandably will be highly reluctant to provide liquidity with respect to any instrument they are not reasonably confident they can resell immediately.

2. Risk Mitigating Hedging Exemption

The ability of banking entities to hedge their positions and manage the risks taken in connection with their market making activities is a critical part of a liquid and efficient market. It is therefore imperative to ensure that banking entities can appropriately hedge their positions to allow them to effectively provide needed services to registered funds. The exemptions provided for hedging under the Proposal appear to raise a number of potential concerns for the activities of banking entities and overall market liquidity. In particular, the uncertainty faced by banking entities as to whether a specific hedge fulfills the requirements of the exemption will adversely impact their ability to conduct market making functions. We therefore recommend that the risk mitigating hedging exemption be flexible enough to allow banking entities to manage appropriately all possible risks and facilitate hedging against overall portfolio risk.

3. Government Obligations Exemption

One of the permitted activities specified in Section 619 is trading in certain government obligations, including obligations of any State or political subdivision.[18] The language of the permitted activity provision, however, does not extend to transactions in obligations of an *agency* of any State or political subdivision. The Proposal carries forth this statutory language into the proposed government obligations exemption.

Some believe that excluding obligations of an agency of a State or political subdivision will subject more than half of the securities currently outstanding in the municipal securities market to the proprietary trading prohibition.[19] Banking entities currently play a significant role in facilitating a

[18] Specifically, new Section 13(d)(1)(A) of the Bank Holding Company Act (added by Section 619 of the Dodd-Frank Act) includes as one of the permitted activities the "purchase, sale, acquisition, or disposition of obligations of the United States or any agency thereof, obligations, participations, or other instruments of or issued by the Government National Mortgage Association, the Federal National Mortgage Association, the Federal Home Loan Mortgage Corporation, a Federal Home Loan Bank, the Federal Agricultural Mortgage Corporation, or a Farm Credit System institution … **and obligations of any State or of any political subdivision thereof.**" (Emphasis added.)

[19] *See* Citigroup Global Markets, US Municipal Strategy Special Focus, *Volcker Rule – Potentially Negative Implications for Municipals*, November 20, 2011.

secondary market for municipal securities. These instruments represent one of the more conservative asset classes in the capital markets, and registered funds are significant investors in these securities. If trading in these instruments is restricted, registered funds could face reduced liquidity and wider bid-ask spreads. The fixed-income market as a whole is more dependent on market makers than other markets; the municipal securities market arguably is even more dependent on market makers than the other parts of the fixed-income market. Institutional investor involvement is lower in the municipal securities market as compared to other fixed-income markets and banking entities therefore play an increased role as liquidity providers.[20] We recommend that the permitted activity exemption for government obligations 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.[21]

C. The Proprietary Trading Prohibition Will Impact the Structure and Operation of the Financial Markets

The proprietary trading prohibition could have negative implications for the overall structure and operation of the U.S. financial markets. For example, this prohibition may negatively impact overall capital formation in the markets. 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. We therefore believe the stringent restrictions of the Proposal, which go well beyond what is necessary to effectuate Congress' intent in enacting Section 619 of the Dodd-Frank Act, could hurt our broader economy, impacting job creation and investments in U.S. businesses overall.

1. Impact on Capital Formation

As currently drafted, the proprietary trading prohibition likely will impact overall capital formation. Registered funds and other investors are dependent on adequate liquidity in the secondary markets to trade the instruments in which they invest. If registered funds cannot transact effectively in the secondary markets due to a lack of liquidity, they may be reluctant to invest in these instruments at all.

Banking entities also play a critical role in initial capital formation, often providing companies with the capital necessary to go public. If banking entities find that the restrictions contemplated by the Proposal prohibit or greatly impede their serving this role, the availability of investments for registered funds will decline. Similarly, if issuers and dealers face increased costs in the capital formation process due to the Proposal, this too could restrict access for registered funds to suitable investments, particularly in the fixed-income markets.

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[20] As of September 2011, retail investors held about half of all tax-exempt debt directly and another 23 percent of tax-exempt debt through registered funds (Sources: Flow of Funds Accounts published by the Federal Reserve and ICI).

[21] The Securities Exchange Act of 1934 defines "municipal securities" as "securities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, **or any agency or instrumentality of a State or any political subdivision thereof,** or any municipal corporate instrumentality of one or more States, ..." (Emphasis added.) Exchange Act Section 3(a)(29).

2. Changes to the Adequacy and Availability of Liquidity Providers

If banking entities currently serving as market makers are unable to continue to provide necessary services to registered funds and other investors, or are forced to exit the market making business altogether, the non-banking entity market makers that remain may be unable to provide the liquidity necessary for funds to conduct trades efficiently in the markets. We are skeptical that other entities that purport to conduct market making activities will be able to replace banking entities that currently provide needed services to funds, particularly in less liquid markets. It is not clear that other entities will be able to step in to replace market makers that may exit the business due to an aggressive implementation of the Volcker Rule. Even if they do, this likely will not occur immediately. It may take some time for a new trading environment to evolve, following a period of potentially significant market dislocation. We urge careful consideration of whether a more nuanced implementation of the Volcker Rule could avoid or mitigate this upheaval and its attendant costs (*i.e.*, wider spreads and diminished shareholder confidence).

III. The Proposal Could Limit Investment Opportunities for Registered Funds and their Shareholders

A. The Foreign Trading Exemption Should Be Revised To Avoid Adverse Effects on U.S. Registered Funds' Investments in Certain Foreign Securities

As noted above, trading outside of the United States is a "permitted activity," evidencing Congressional recognition that there should be limits on the extraterritorial reach of the Volcker Rule. The Proposal greatly limits the utility of this exemption, however, by departing—without explanation—from an existing and well-understood U.S. securities regulation that governs whether an offering takes place outside of the United States and therefore is not subject to U.S. registration requirements.[22] If adopted as proposed, the Proposal would have negative consequences for registered funds and their shareholders.

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 for trading outside of the United States may 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

[22] *See* Regulation S (Rules Governing Offers and Sales Made Outside of the United States without Registration under the Securities Act of 1933), 17 C.F.R. §§230.901-230.905. *See also* Offshore Offers and Sales, Securities Act Release No. 6863 (Apr. 24, 1990) ("Regulation S Adopting Release") (noting that, under Regulation S, "where a non-U.S. person makes investment decisions for the account of a U.S. person, that account is not treated as a U.S. person"). By contrast, the Proposal provides that a "resident of the United States" includes "any discretionary or non-discretionary account . . . held by a dealer or fiduciary for the benefit or account of a resident of the United States."

comport fully with well-established and widely understood standards under the U.S. securities laws.[23] As a result, U.S. registered funds' access to non-U.S. counterparties could decrease significantly. By limiting the counterparties with which non-U.S. banking entities may effect securities transactions, the Proposal's approach also may reduce liquidity in some markets. There is no indication that Congress intended to create a new or different standard for determining when a securities transaction takes place outside of the United States. We therefore urge that the Proposal expressly conform to the approach under existing U.S. securities laws so as to avoid the highly undesirable results described above.

B. The Proposal Should Provide Sufficient Exemptions for Asset-Backed Commercial Paper and Tender Option Bond Programs

The Proposal would adversely 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.[24] This would have significant negative implications for issuers of these financing vehicles and their investors, many of which are ICI members.

Under the Proposal, ABCP and TOB programs would fall within the definition of "covered fund" because they are typically issued by special purpose trusts or corporations that rely on Section 3(c)(1) or 3(c)(7) of the Investment Company Act. Similarly, an ABCP or TOB program would fall within the definition of "banking entity" if it were considered a subsidiary or affiliate of a banking entity (*e.g.,* because the banking entity is acting as sponsor of that ABCP or TOB program), subjecting the program itself to all of the requirements of the Volcker Rule and the Proposal. Even in circumstances where an ABCP or TOB program is not necessarily viewed as part of the banking entity, the proprietary trading rules could be construed to impede these securitization activities by preventing banking entities from engaging in transactions with ABCP or TOB programs.

There is no indication, however, that Congress intended to include ABCP or TOB programs within the scope of the Volcker Rule. Quite the opposite—the Volcker Rule was intended to constrain

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[23] Indeed, the SEC specifically indicated when it adopted Regulation S that if an authorized person employed by a U.S. registered fund or its investment adviser places a buy order outside the United States on behalf of the registered fund, the requirement that the buyer be outside the United States will be met. *See* Regulation S Adopting Release. By contrast, in these circumstances the Proposal would treat the U.S. registered fund as a "resident of the United States," and thus would preclude a non-U.S. bank counterparty relying on the foreign trading exception from trading with the U.S. registered fund.

[24] ABCP programs are issued by a special purpose trust or corporation established by the program's sponsor, which is often a major commercial bank, that own, or have security interests in, multiple pools of various types of receivables from a wide variety of corporations, such as manufacturers, banks, finance companies, and broker-dealers, looking to obtain low-cost financing for a diverse range of trade and financial receivables, including manufacturing account receivables, commercial loans, equipment loan and lease receivables, consumer loans, auto loans and leases, and student loans. TOB programs are created by a sponsor bank that deposits one or more high-quality municipal bonds into a trust that issues two classes of tax-exempt securities: a short-term security that is supported by a liquidity facility and an inverse floating rate security. TOBs provide an important source of demand for municipal bonds, which benefit municipalities with funding needs.

certain types of risk taking by banking entities but specifically sought to avoid "interfer[ing] inadvertently with longstanding, traditional banking activities that do not produce high levels of risks or significant conflicts of interest."[25] 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 any type of 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 Proposal be revised to provide sufficient exemptions for ABCP and TOB programs.

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We thank the Subcommittees for this opportunity to outline ICI's significant concerns regarding this Proposal to implement the Volcker Rule. While focused on the specific ways in which the Proposal could negatively affect registered funds and their shareholders, our comments echo the same overarching theme that has been voiced by many stakeholders—this Proposal would reach farther than Congress ever intended and could greatly impair the U.S. financial markets. We urge the regulators to modify the Proposal to avoid such outcomes.

[25] S. Rep. No. 111-176, at 91 (2009).