Defending Liberty
Pursuing Justice

AMERICAN BAR ASSOCIATION

740 Fifteenth Street, NW
Washington, DC 20005-1022
(202) 662-1000
FAX: (202) 662-1032

November 8, 2010

The Honorable Timothy Geithner
Chairman
Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

Re: Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds; Docket ID: FSOC 2010-0002; Response to Questions 3, 4(ii), 4(iii) and 12

Dear Mr. Chairman:

On behalf of the American Bar Association ("ABA"), which has almost 400,000 members, we are pleased to submit these comments in response to the Notice and Request for Information (the "Notice") issued by the Financial Stability Oversight Council ("FSOC") entitled "Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds", Docket ID FSOC 2010-0002. The Notice was issued in connection with the provisions of Section 619(b) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Dodd-Frank Act") that require the FSOC to study and make recommendations on the implementation of the Volcker Rule. As Co-Chairs of the ABA Task Force on Financial Markets Regulatory Reform ("Task Force")[1], we have been authorized to express the ABA's views on this important topic.

The comments expressed in this letter were prepared in conjunction with the Committee on Federal Regulation of Securities and the Committee on Securitization and Structured Finance of the ABA Section of Business Law.[2] Our comments also are based on the principles for financial markets

[1] The ABA Task Force is comprised of 16 prominent financial services lawyers who have served in the top levels of government and private practice. The Task Force includes former general counsels of the U.S. Securities and Exchange Commission, the Federal Deposit Insurance Corporation and the Treasury Department, as well as members and liaisons who have held high-level positions with the Board of Governors of the Federal Reserve System, the Office of the Comptroller of the Currency, and the U.S. Securities and Exchange Commission. Other members of and liaisons to the Task Force include a founder of Public Citizen Litigation Group and leading academics in the law relating to financial entities and administrative law. A complete Task Force roster is available at: http://www.abanet.org/buslaw/committees/CL116000pub/materials/publicroster.pdf

[2] The ABA's comment letter was principally prepared by a drafting committee comprised of the following leading members of the two ABA Business Law Section committees: Eric Marcus, Chair; J. Paul Forrester; Carol A. Hitselberger; Jason H.P. Kravitt; Ellen L. Marks; Kenneth P. Morrison; Keith F. Oberkfell; Vicki O. Tucker; Amy Williams; Craig A. Wolson; and Christopher J. Young.

regulatory reform developed by our Task Force and then formally approved by the ABA House of Delegates in August 2009 as the official policy of the ABA.[3]

The ABA thanks the FSOC for this opportunity to comment on certain questions posed by the FSOC in the Notice. We apologize that we were not able to submit this letter within the timeframe set forth in the Notice, but we hope the FSOC will nonetheless be willing to consider the issues discussed herein.

Background

Section 619 of the Dodd-Frank Act, which is commonly referred to as the Volcker Rule, adds a new Section 13 to the Bank Holding Company Act entitled "Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds." New Section 13 provides, among other things, that (a) the terms "hedge fund" and "private equity fund" are defined as an issuer that would be an investment company but for the Section 3(c)(1) or 3(c)(7) exemptions from the Investment Company Act (the "'40 Act"); (b) banks and their affiliates are prohibited from sponsoring a hedge fund or a private equity fund; and (c) banks and their affiliates that sponsor or advise a hedge fund or private equity fund are prohibited from entering into Federal Reserve Act Section 23A covered transactions with the fund (covered transactions include loans to the fund and purchases of assets from the fund).

Our comments on the Volcker Rule in this letter relate solely to the possible inclusion (which we believe was not intended) of certain securitization vehicles within the defined terms "hedge fund" and "private equity fund." In our view, in connection with its implementation recommendations required by Section 619 of the Dodd-Frank Act, the FSOC should consider the following:

ABCP Conduits

Virtually all asset-backed commercial paper conduits[4] (referred to herein as "ABCP conduits") rely on either the Section 3(c)(1) or 3(c)(7) exemption from the '40 Act. Accordingly, these ABCP conduits would fall within the definition of "hedge fund" and "private equity fund" in new Section 13.

[3] The financial reform principles adopted by the ABA in August 2009 are available online at: http://meetings.abanet.org/webupload/commupload/CL116000/sitesofinterest_files/Report301.pdf

[4] As used in this letter, the term "ABCP conduit" means a special purpose entity that (i) issues highly-rated commercial paper, (ii) uses the proceeds thereof to acquire or finance financial assets, and (iii) has access to committed liquidity from one or more highly-rated liquidity provider(s) in an amount not less than the face amount (*i.e.*, principal plus interest through maturity) of all of its outstanding commercial paper. Most ABCP conduits are also supported by credit facilities from highly-rated providers, the sizes of which vary, but typically cover 5%-10% or more of the face amount of the programs' commercial paper outstanding from time to time. "ABCP conduit" as used in this letter is not intended to include issuers of commercial paper such as structured investment vehicles, market value CLOs or extendible commercial paper programs that do not have access to committed liquidity in support of the issuer's obligation to pay the commercial paper in full on its maturity date (although such commercial paper is also often referred to in the marketplace as "asset-backed commercial paper").

ABCP conduits would not be considered hedge funds or private equity funds, as those terms are normally defined. Hedge funds generally invest in a wide range of assets, including equity, debt and commodities, and often engage in trading, short-selling and derivatives transactions. Private equity funds are traditionally long-term investment vehicles which invest primarily in equity. By contrast, ABCP conduits only make investments in the types of assets (such as trade receivables, auto and equipment loans, dealer floorplan loans and other financial assets) that typically support secured loans or in asset-backed securities, in each case which could be made directly by the sponsoring bank as part of its normal banking activity. The ABCP conduits do not invest in stock or similar equity instruments. The ABCP conduit structure is used by many U.S. and foreign banks to facilitate commercial paper-based funding of secured loans or other debt instruments which could be made by the banks directly.

ABCP conduits could not continue to operate in their current form if the Volcker Rule were to apply to them. Many ABCP conduits are administered by a bank, which (in conjunction with the bank's customers) selects and structures the financial assets to be acquired by the conduit, administers the conduit's assets and enforces the conduit's rights and remedies thereunder, arranges for liquidity facilities and credit enhancement to support the conduit's commercial paper, and arranges for the conduit's commercial paper to be rated. The bank providing administration services is commonly referred to in the marketplace as the "sponsor" of the conduit, although the bank may or may not meet the terms of the statutory definition of "sponsor" contained in Section 619(h)(5) of the Dodd-Frank Act.[5] For purposes of this letter, the term "sponsor" is used to refer to the bank that administers the conduit, but this is not intended to mean that the bank constitutes a "sponsor" within the meaning of Section 619(h)(5).

Bank sponsors generally provide liquidity facilities and swingline facilities and frequently also credit enhancement facilities to their ABCP conduits, which take the form of either loans to the conduits or purchases of assets from the conduits, both of which would constitute Section 23A covered transactions under Section 619(f)(1) and would be prohibited. (Section 619(f)(1) prohibits a bank which sponsors or advises a hedge fund or private equity fund from entering into Section 23A covered transactions with the fund, regardless of whether the fund is an affiliate of the bank.) However, the liquidity facility provided by highly rated banks and covering 100% of the conduit's outstanding commercial paper is one of the defining features of ABCP and is absolutely necessary in order for the ABCP to obtain the high short-term ratings that enable the ABCP to be issued in the marketplace. Because ABCP conduits are a mechanism allowing bank sponsors to obtain capital markets funding for their customers, thereby permitting banks to finance their customers indirectly rather than directly, there is no policy reason for prohibiting liquidity lines and other covered transactions with the ABCP conduit. The ABCP conduit's operations directly benefit and support the sponsoring bank.

There is no other exemption available under the '40 Act which would allow ABCP conduits to continue to fund the types of assets that they currently fund within the structure presently utilized by ABCP conduits. The Section 3(c)(5) exemption would limit conduit assets to primarily accounts

[5] The equity of the ABCP conduit is generally not owned by the administering bank (although many banks are required to consolidate for accounting purposes the ABCP conduits which they administer, as a result of the recent adoption of Financial Accounting Standards 166 and 167, which emphasize control rather than equity ownership).

receivable, auto and equipment loans and mortgage loans. Many asset classes that are currently funded in conduits either would not qualify for this exemption or would be subject to significant additional restrictions. Rule 3a-7 is not an attractive alternative exemption for conduits because, like the exemption afforded by Section 3(c)(5), it restricts the types of assets a conduit can hold. The Rule's definition of "eligible assets" would exclude certain leases and potentially some ABS in the form of trust certificates or other ownership interests in special purpose entities. Moreover, Rule 3a-7 requires that the payments on securities issued must depend primarily on the cash flow of eligible assets. This may be a difficult test for ABCP conduits to satisfy, in that generally they allow their customers to prepay conduit loans or repurchase conduit assets, rather than requiring that the assets self-liquidate in all circumstances, and furthermore the conduits may decide to draw on liquidity lines. Additionally, two of the four conditions of Rule 3a-7 refer to ratings tests and it is not clear at this time how the Rule will be revised in light of the statutory mandate to remove ratings references.

The legislative history of Section 619 (156 Cong Rec S 5895) describes hedge funds as "tend[ing] to be trading vehicles" and private equity funds as "tend[ing] to own entire companies." Neither of these characterizations applies to ABCP conduits, which hold assets consisting of secured loans and (in some cases) asset-backed securities. Moreover, ABCP conduits do not hold their assets for short-term trading purposes. The legislative history further states that the purpose of Section 619 was to "prohibit high-risk proprietary trading at banks," and the limitation on investing in or sponsoring funds was intended to foreclose a potential loophole by preventing a firm from being "able to structure its proprietary positions simply as an investment in a hedge fund or private equity fund" (156 Cong Rec S 5894-5895). Inasmuch as the assets held by ABCP conduits are for the most part collateral pools that would often secure traditional bank loans and do not arise from proprietary trading of securities and derivatives, the restrictions in the Volcker Rule on sponsoring and advising funds do not appear to have been intended to affect the operations of such securitization vehicles. We request that the FSOC recommend in its implementation study that ABCP conduits not be characterized as hedge funds or private equity funds under Section 619(h)(2) solely on the basis that they rely on the exemptions contained in Section 3(c)(1) or Section 3(c)(7) of the '40 Act. Alternatively, the same result might be achieved if sponsoring or advising an ABCP conduit were classified as a "Permitted Activity" pursuant to Section 16(d)(1)(J).[6]

ABCP conduits currently provide about $400 billion in financing for consumer and commercial assets, much of it for short-term, current activities. They are not a means of speculative investment. The ABCP conduits performed well during the recent financial crisis due to strong underwriting criteria, a diverse asset base and careful review by rating agencies and large institutional investors. We are aware of nothing in the legislative history of the Volcker Rule which suggests a desire to terminate ABCP conduit programs,[7] and we believe that there would be significant unintended

[6] As a technical matter, because the "Permitted Activity" classification appears to only override the sponsoring prohibition in new Section 13(a)(1), it would be necessary to also override the prohibition on covered transactions contained in new Section 13(f)(1). Another approach would be to request the Securities and Exchange Commission to craft a new '40 Act exemption rule (somewhat similar to Rule 3a-7) that could be used by ABCP conduits and that would not rely on ratings tests.

[7] Other rules issued by the Securities and Exchange Commission and Federal banking agencies expressly acknowledge and attempt to accommodate ABCP conduits, e.g. the proposed revisions to Regulation AB issued by the Securities and Exchange Commission on May 3, 2010 and the FDIC's Memorandum to the Board dated December 15, 2009 relating to the Final Rule regarding (among other things) Consolidation of Asset-Backed Commercial Paper Programs. See also the

(continued...)

adverse consequences for the economy and credit availability generally if the broad scope of the definitions in the Volcker Rule had the effect of disabling this type of vital financing.

CLOs

Collateralized loan obligations ("CLOs") usually rely on the Section 3(c)(7) exemption in the '40 Act and would therefore fall within the definition of "hedge fund" and "private equity fund" under new Section 13 of the Bank Holding Company Act.[8]

CLOs invest in loans or other debt instruments which could be made by banks directly, usually with a particular focus on senior secured loans. They do not invest in equity securities or engage in short selling, and trading of the related CLO portfolio is limited. For the same reasons as described above with respect to ABCP conduits, CLOs are not regarded by market participants to be hedge funds or private equity funds.

Historically, banks have used so-called "balance sheet" CLOs for portfolio management and regulatory capital efficiency. Generally, a "balance sheet" CLO is a CLO sponsored by a bank, usually managed by that bank and in which that bank will usually hold a significant equity/first loss position. Because of the prohibitions on sponsorship and equity ownership contained in new Section 13(a)(1), balance sheet CLOs would no longer be possible.

Balance sheet CLOs are important to the financial industry for a number of reasons. A bank balance sheet CLO can be used by a bank for portfolio management, regulatory capital efficiency and, where a third-party is the related manager, outsourcing the management of the CLO portfolio to an independent and properly incentivized third-party manager. When used for portfolio management, the bank effectively transfers the risk on the related CLO portfolio (subject to any retained or acquired entity/first loss CLO investment) and thereby can take a credit view of particular obligors and industries and can better manage the asset/liability mismatch usually inherent in the bank's own balance sheet. When used for regulatory capital efficiency, a bank balance sheet CLO can free up capital otherwise required to support the CLO portfolio and redeploy this capital in new lending or other permissible bank activities. When used to outsource portfolio management, a bank balance sheet CLO permits a qualified and independent third-party manager (usually a specialist with respect to assets of the type contained in the related CLO portfolio – e.g. distressed loans) to manage the related CLO portfolio subject to specified CLO parameters and under an appropriate incentive compensation arrangement.

We also note that if any specific bank balance sheet CLO constitutes an "asset-backed security" as defined in Section 941(a) of the Dodd-Frank Act, the bank, as securitizer, may be required to retain a 5% credit risk retention pursuant to the regulations to be issued in accordance with Section 941(b) of

---

discussion of ABCP conduits in the Report to the Congress on Risk Retention issued by the Federal Reserve Board on October 19, 2010 pursuant to the Dodd-Frank Act.

[8] CLOs would probably not be able to utilize Rule 3a-7, because CLO structures generally permit a greater degree of asset management than is consistent with Rule 3a-7.

the Dodd-Frank Act.[9] The imposition of such risk retention provisions appears to be inconsistent with the Volcker Rule if the Volcker Rule is interpreted to prohibit bank balance sheet CLOs altogether.

Another example of possible "sponsorship" and "advising" that may inadvertently trigger the prohibitions of the new Section 13 of the Bank Holding Company Act are the typical warehouse arrangements required to compile a CLO-eligible portfolio. When a CLO is initiated, there is often a warehouse line of credit between a bank and the CLO, which enables the CLO to acquire loan assets directly from loan originators or through secondary market transactions pending completion of the issuance of the CLO's securities, in each case subject to investment parameters established by the lender under the warehouse facility. If the bank were regarded as a sponsor or adviser under the Volcker Rule, this line of credit would constitute a prohibited Section 23A covered transaction under the Volcker Rule. If such a line of credit could not be utilized, key aspects of the current functioning of this market would be impaired. Although other structures might be developed, they would likely not be as efficient or straight-forward as the warehouse line and would potentially limit the availability of CLO structures as a source of liquidity for the corporate loan market.

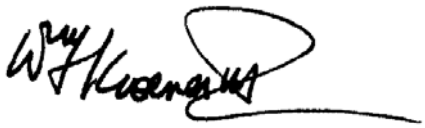
Based on the legislative history (discussed above), we do not believe that the Volcker Rule restrictions on sponsoring or advising funds were intended to impact CLOs, and we request the FSOC to recommend in its implementation study that CLOs not be characterized as hedge funds or private equity funds under Section 619(h)(2) solely on the basis that they rely on the exemption contained in Section 3(c)(7) of the '40 Act. Alternatively, the FSOC could recommend that sponsoring or advising a CLO be classified as a "Permitted Activity" pursuant to Section 16(d)(1)(J).

****

[9] CLOs are one of the nine asset classes which are discussed in the Report to Congress on Risk Retention issued by the Federal Reserve Board, which provides recommendations on risk retention requirements to the agencies charged with adopting regulations under the Dodd-Frank Act.

The ABA appreciates the opportunity to provide its comments on these important issues. If we can provide the FSOC or its staff with any additional information or if we can be of further assistance, please contact Jeffrey Rubin, the Chair of the ABA Business Law Section's Federal Regulation of Securities Committee, at (212) 918-8224 or Vicki Tucker, the Chair of the Section's Securitization and Structured Finance Committee, at (804) 788-8779.

Very truly yours,



William F. Kroner III

Giovanni P. Prezioso (by RLF)

Giovanni P. Prezioso

cc: Members of the Financial Stability Oversight Council
Jeffrey W. Rubin, Chair, Federal Regulation of Securities Committee, ABA Section of Business Law
Vicki O. Tucker, Chair, Securitization and Structured Finance Committee, ABA Section of Business Law
Thomas M. Susman, Director, ABA Governmental Affairs Office