MANAGED FUNDS ASSOCIATION
The Voice of the Global Alternative Investment Industry
WASHINGTON, DC | NEW YORK

February 13, 2012

Via Electronic Filing:

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 Corp.
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

Mr. David A. Stawick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: MFA Comments on Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds

Dear Ladies and Gentleman:

Managed Funds Association ("MFA")[1] appreciates the opportunity to provide comments to the Office of the Comptroller of the Currency, Treasury; the Board of Governors of the Federal Reserve System; the Federal Deposit Insurance Corporation; the Commodity Futures Trading Commission; and the Securities and Exchange

[1] MFA is the voice of the global alternative investment industry. Its members are professionals in hedge funds, funds of funds and managed futures funds, as well as industry service providers. Established in 1991, MFA is the primary source of information for policy makers and the media and the leading advocate for sound business practices and industry growth. MFA members include the vast majority of the largest hedge fund groups in the world who manage a substantial portion of the approximately $2.0 trillion invested in absolute return strategies. MFA is headquartered in Washington, D.C., with an office in New York.

Commission (together the "Agencies") on the Agencies' proposed rulemaking (the "Proposed Rule") to implement section 619 of The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). Section 619 of the Dodd-Frank Act imposes certain prohibitions on banking entities from engaging in proprietary trading and maintaining certain relationships with private investment funds (the "Volcker Rule"). Section 619 of the Dodd-Frank Act charges the Agencies to adopt rules to implement the Volcker Rule.

Summary of Comments

Our letter focuses on three key aspects of the Proposed Rule:

(i) whether covered entities may continue to engage in legitimate market making activities;

(ii) whether covered entities may continue to engage in legitimate distribution activities; and

(iii) whether foreign banks may continue to invest in offshore funds sponsored and managed by U.S. non-banking entities.

Private investment funds are the customers of and counterparties to banks and broker-dealers and we provide our comments regarding market making and distribution activities in that context. We encourage the Agencies to implement the Volcker Rule in a manner that does not impede two important intermediary functions of banks and broker-dealers, *i.e.*, market making functions in various assets and markets and distribution platforms for customers to invest in third-party private investment funds. We believe that both of these activities are outside of the scope of the intended limitations and prohibitions in the Volcker Rule, and we urge the Agencies to finalize the Proposed Rule in a manner that does not unintentionally limit these important market intermediary functions. We further encourage the Agencies to amend the Proposed Rule to ensure that the presence of U.S. residents in an offshore fund managed by a U.S. non-banking entity does not preclude foreign banks from investing in that fund.

Market Making

Banks and broker-dealers play a critical role as market makers in our capital markets. Private investment funds, along with all other investors and market participants, rely on market makers to ensure that there is sufficient liquidity in markets to engage in trading activities. To ensure that markets continue to have sufficient liquidity, we believe that it is critical for banks and broker-dealers to continue to be able to maintain sufficient levels of inventory and engage in appropriate hedging activities in connection with their market making functions. Maintaining appropriate inventory levels and engaging in hedging activities are both dynamic in nature and require some degree of flexibility in application.

For example, in determining the appropriate levels of inventory needed to meet customer demands, market makers must anticipate not only current demand, but reasonably anticipated demand. The ability to maintain reasonable levels of inventory to meet customer demand is particularly important for entities that act as market makers in illiquid instruments, such as fixed income instruments, derivatives, and structured products. Market makers also must be able to facilitate large block trades for institutional customers. In order to facilitate customer trades in illiquid markets and large block trades, market makers may be required to hold assets in their inventory for a period of time. Holding assets for these market making purposes may from time to time generate profits and losses on those assets; however, maintaining appropriate inventory is critical to ensure that customers' demands can be met in a timely manner. To the extent an entity maintains inventory for purposes of meeting customer needs, we believe that such activities are appropriate and beyond the intended scope of the Volcker Rule's ban on proprietary trading. Accordingly, we encourage the Agencies to adopt final rules that take into account these important aspects of market making in different markets and asset classes and that do not unintentionally inhibit activities undertaken in connection with legitimate market making functions.

Further, with respect to hedging activities, it is critical that banks and broker-dealers be able to utilize imperfect hedges as part of their legitimate hedging activities, as it is not always possible to establish a perfect hedged position. We also note that the appropriate level of flexibility with respect to hedging activities is likely to vary depending on the particular asset class and market. Unless the rules provide for reasonable flexibility in implementation, market makers may construe the rules narrowly, unduly harming the liquidity of markets for all investors.

We believe that, without appropriate flexibility in the application of the Volcker Rule's prohibition on proprietary trading, market liquidity will be impaired, to the detriment of investors and our capital markets. Again, we believe that market making activities are not intended to be subject to the limitations in the Volcker Rule, and we encourage the Agencies not to adopt overly restrictive definitions or limitations on activities that could unintentionally constrain the important market making role played by banks and broker-dealers.

Distribution Functions

Many banks and broker-dealers establish distribution platforms that allow their customers to invest in private investment funds sponsored and managed by third parties. In this structure, the bank or broker typically establishes a pooled investment vehicle that will invest substantially all of its assets in the third-party private investment fund. The risks associated with this type of bank-managed feeder fund are borne entirely by the customers of the bank who are the investors in that feeder fund.[2] This type of distribution

[2] In some circumstances, the bank may invest a *de minimis* amount of money as seed capital when it sets up the feeder vehicle. To the extent the feeder vehicle is a covered fund for purposes of the Volcker Rule, a bank would be precluded from investing more than a *de minimis* amount.

platform provides an important way for bank customers to invest in third-party private investment funds, without placing the bank's assets at risk. This distribution model also is important to many private investment funds that are owned and operated independently of banks or broker-dealers. We believe this distribution function is outside the scope of the type of activities intended to be subject to the Volcker Rule and we encourage the Agencies to adopt final rules that do not unintentionally impair this important function.

Offshore Exemption

The Proposed Rule also imposes limitations on the ability of "banking entities" to sponsor or invest in covered funds.[3] A key issue on which we would like to comment arises under § __.13(c) of the Proposed Rule (the "Offshore Exemption"), which permits foreign banks to invest in offshore funds as long as certain requirements are met, including that the investment occur solely outside the United States. Because of the expansive nature of the Proposed Rule and the way in which the Offshore Exemption is drafted, U.S. asset managers completely unaffiliated with any banking entity (*i.e.*, U.S. non-bank managers) that are not otherwise subject to the Proposed Rule are materially impacted.

The Offshore Exemption seeks to implement section 13(d)(1)(I) of the Volcker Rule by establishing the conditions pursuant to which foreign banking entities can invest in offshore (*i.e.*, non-U.S.) covered funds sponsored and advised by U.S. non-bank managers. As drafted, the Proposed Rule could make it difficult, if not impossible, for a foreign banking entity to invest in these offshore funds. From a policy perspective, this result is anomalous and, we believe, unintended by Congress. As noted in the following floor statement by Senator Merkley, one of the principal authors of the Volcker Rule provisions in the Dodd-Frank Act, the intent underlying section 13(d)(1)(I) was to prevent U.S. banking entities from evading the prohibition simply by setting up a foreign entity and to prevent foreign banks from offering their funds to U.S. persons.

> Subparagraphs (H) and (I) recognize rules of international regulatory comity by permitting foreign banks, regulated and backed by foreign taxpayers, in the course of operating outside of the United States to engage in activities permitted under relevant foreign law. However, these subparagraphs are not intended to permit a U.S. banking entity to avoid the restrictions on proprietary trading simply by setting up an offshore subsidiary or reincorporating offshore, and regulators should enforce them accordingly. In addition, the subparagraphs seek to maintain a level playing field by prohibiting a foreign bank from improperly

[3] "Covered fund" is generally meant to include hedge and private equity funds, as the Proposed Rule defines "covered fund" in relevant part as an issuer that would be an investment company, as defined in the Investment Company Act of 1940 (the "ICA"), but for section 3(c)(1) or 3(c)(7) of that Act, as well as any issuer, as defined in section 2(a)(22) of the ICA, that is organized or offered outside of the United States that would be a "covered fund", were it organized or offered under the laws, or offered to one or more residents, of the United States or of one or more States. §__.10(b)(1).

> offering its hedge fund and private equity fund services to U.S. persons when such offering could not be made in the United States.[4]

Accordingly, we do not believe that section 13(d)(1)(I) was intended to apply to circumstances in which foreign banks invest in offshore funds sponsored and managed by U.S. non-banking entities, even if those funds do have U.S. investors. Therefore, as discussed in more detail below, we do not believe the Proposed Rule should preclude U.S. non-bank managers from accepting foreign banks as investors in their offshore funds, or potentially eliminate investment options for U.S. tax-exempt investors, in order to allow U.S. non-bank managers to accept investments from foreign banks.

The Offshore Exemption requires the satisfaction of several conditions, but our comments address our concerns with, and propose modifications to, the condition that no ownership interest[5] in such covered fund be offered for sale or sold to a resident of the United States.[6] This condition creates several issues as a result of the presence of U.S. residents in a typical managed fund structure. In connection with managing an offshore fund, a U.S. non-bank manager, or its affiliate, may hold an ownership stake, for example, as the general partner to the fund. To the extent that such an ownership stake represents anything more than a vehicle to receive a management fee or carried interest,[7] the fund could be considered to have sold an interest to a resident of the United States.[8] Additionally, many offshore funds include U.S. tax-exempt entities that would be U.S. residents under the Proposed Rule, such as pension plans and endowments. Under the Proposed Rule, a foreign banking entity would be precluded from investing in the same fund that contains U.S. tax exempt investors.[9]

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[4] *See, e.g.*, Statement of Sen. Merkley, 156 Cong. Rec. S5897 (daily ed. July 15, 2010).

[5] The Proposed Rule defines "ownership interest" in relevant part as "any equity, partnership, or other similar interest (including, without limitation, a . . . general partnership interest, limited partnership interest, membership interest. . . .) in a covered fund. . . ." but does not include a carried interest. §__.10(b)(3).

[6] In addition to including, *inter alia*, any business entity organized or incorporated under the laws of the United States or any State, a "resident of the United States" is defined to include "any person organized or incorporated under the laws of any foreign jurisdiction ***formed by or for a resident of the United States*** principally for the purpose of engaging in one or more transactions described in §__.6(d)(1) or §__.13(c)(1)." §__.2(t). (emphasis added)

[7] Carried interests are excluded from the definition of "ownership interest." See note 5.

[8] We note that a U.S. non-bank manager may form a non-U.S. entity to hold the general partner interest in an offshore fund. Although we do not believe that the non-U.S. general partner entity should be considered a resident of the United States because it is not being formed "principally for the purpose of engaging in" (see note 6) transactions otherwise prohibited by the Volcker Rule, we believe the final rule should confirm this.

[9] Excluding the U.S. tax-exempt residents by creating a separate offshore fund with only these investors may not be a practical solution under the Employee Retirement Income Security Act of 1974, as amended, or the "prohibited transaction" rules of Section 4975 of the Internal Revenue Code of 1986, as amended, because of the so-called "25% limit". Generally, to fit within the 25% limit, "benefit plan investors", in the aggregate, must hold less than 25% of the value of each "class" of equity interests issued by the hedge

We believe it would be consistent with the policy underlying the prohibition on offers and sales to U.S. residents to amend the Offshore Exemption to state explicitly that foreign banks may invest in an offshore fund that is sponsored and managed by a non-banking entity, even if that fund has residents of the U.S. as owners.[10]

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fund, excluding interests held by certain persons, including managers or investment advisers to the hedge fund and their affiliates.

[10] We would note that comment letters from foreign banking entities also address some of these concerns. *See, e.g.*, Volcker Rule Comment Letter, Japanese Banker Association, 15-16 (Jan. 13, 2012), noting in part that "even acquiring ownership interest in Japanese acquisition fund that invests in Japanese companies and is comprised of Japanese general partners (GP) could be subject to the rule if there are U.S. residents among other investors. However, this would constitute application of the rule outside the U.S. to an excessive degree and would not be the intention of the Volcker Rule."

Conclusion

MFA appreciates the opportunity to provide comments on the Agencies' Proposed Rule. Private investment funds are customers of and counterparties to banks and broker-dealers. In this context, we encourage the Agencies to implement the provisions of the Volcker Rule in a manner that does not impede two important intermediary functions of banks and broker-dealers, market making functions in various asset classes and distribution platforms for customers to invest in third-party private investment funds. We further encourage the Agencies to amend the provisions of the Offshore Exemption to avoid an overly broad prohibition on foreign banks investing in offshore funds managed by non-banking entities, a result that we believe is beyond the prohibitions Congress intended in enacting the Volcker Rule.

If you have any questions regarding any of these comments, or if we can provide further information with respect to these issues, please do not hesitate to contact Stuart J. Kaswell or me at (202) 730-2600.

Respectfully submitted,

/s/ Richard H. Baker

Richard H. Baker
President and CEO