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March 31, 2020

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20th Street and Constitution Avenue, NW
Washington, DC 20551

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Washington, DC 20429

Office of the Comptroller of the Currency
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Washington, DC 20219

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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

Japanese Bankers Association

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds: Federal Reserve Docket No. R-1694 and RIN 7100-AF70, OCC Docket ID OCC-2020-0002 and RIN 1557-AE67, FDIC RIN 3064-AF17, SEC File no. S7-02-20 and RIN 3235-AM70, and CFTC RIN 3038-AE 93

The Japanese Bankers Association (the "JBA")[1] appreciates the opportunity to provide 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 (the "Proposal") published on February 28, 2020, by the Board of Governors of the Federal Reserve System ("FRB"), the Office of Comptroller of the Currency ("OCC"), the Federal Deposit Insurance Corporation ("FDIC"), the Securities and Exchange Commission ("SEC"), and the Commodity Futures Trading Commission ("CFTC") (collectively, the "Agencies").

I. General comments

The JBA appreciates the efforts of the Agencies to improve and streamline the covered fund provisions of the Volcker Rule and to mitigate some of the extraterritorial impact of the Volcker Rule on non-U.S. funds. In particular, the JBA supports the proposed revisions to the requirements of the foreign public fund ("FPF") exclusion and the proposed relaxation of limitations on relationships with covered funds (so-called "Super 23A"). These aspects of the Proposal are generally consistent with requests made previously by the JBA and other industry participants, and would help mitigate certain extraterritorial impacts of the Volcker Rule and reduce some of the operational burdens on non-U.S. banking entities

[1] The Japanese Bankers Association (JBA) is the leading trade association for banks, bank holding companies and bankers associations in Japan. As of March 31, 2020, JBA has 117 Full Members (banks), 3 Bank Holding Company Members (bank holding companies), 73 Associate Members (banks & bank holding company), 58 Special Members (regionally-based bankers associations) and 1 Sub-Associate Member for a total of 252 members. Several of its largest member banks are active participants in the U.S. financial markets.

without compromising the objectives of safety and soundness or U.S. financial stability.

On the other hand, certain elements of the Proposal contain ambiguities that could limit the overall effectiveness of the proposed amendments and, in some cases, undermine the objectives of streamlining and bringing greater clarity to the Volcker Rule's fund-related provisions. In particular, the JBA believes that the Proposal does not fully address concerns raised previously (by the JBA and others) regarding the excessive extraterritorial impact of the Volcker Rule on certain non-U.S. funds that might potentially be treated as banking entities ("BEs"). The JBA believes that the Proposal should be further revised on this point, as set out below in Part II.

In addition to further revising the treatment of non-U.S. funds potentially treated as BEs, the JBA also recommends further revisions and clarifications to certain other aspects of the Proposal, including the definition of "covered fund", the definition of "ownership interest", the requirements of the loan securitization exclusion, and the effective date/transition period for the proposed covered fund amendments. These additional issues are discussed below in Part III.

The JBA believes that these additional revisions will further promote the safety and soundness of non-U.S. banking entities subject to the Volcker Rule, while substantially reducing the risk that the fund-related provisions of the Volcker Rule might undermine non-U.S. regulatory schemes or the stability of global markets. Further, the JBA believes that these changes can be made without presenting any incremental risk to U.S. financial stability or principles of competitive equity.

II. Comments and Recommendations Regarding Qualifying Foreign Excluded Funds

The JBA appreciates the Agencies' efforts to resolve the longstanding issues associated with foreign excluded funds that might potentially be regarded as BEs under the Volcker Rule, and to do so on a permanent basis as opposed to relying on additional time-limited relief. The JBA has long regarded the extraterritorial impact of the Volcker Rule on non-U.S. fund activities as among the most problematic aspects of the regulation, and has previously requested "that the Rule be clarified so as to ensure that the funds owned by non-U.S. BEs, that are organized and offered exclusively outside of the United States and that do not otherwise qualify as 'covered funds' are not deemed to be BEs by virtue of the non-U.S. BE's investment in or governance arrangements with the fund."[2]

While the JBA agrees that "proprietary trading" activities and "covered fund" investments by qualifying foreign excluded funds ("QFEFs") should not be restricted in any way by the Volcker Rule, the manner in which the Proposal achieves this objective could be improved in several ways.

A. <u>Banking Entity Exclusion Approach v. Permitted Activities Approach</u>

First and most fundamentally, the JBA believes that the objectives of the Proposal in relation to QFEFs would be better served by establishing a specific exclusion from the definition of "banking entity" for QFEFs, rather than treating proprietary trading and covered fund investments (and sponsorship) by QFEFs as a form of permitted activity. While the approach taken in the Proposal (i.e., of treating the trading and covered fund activities of QFEFs as permitted activities) represents a welcome step in the right direction, this approach is incomplete insofar as it would result in QFEFs being treated as BEs in

[2] *See* JBA Comment to the Agencies on Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds (Oct. 17, 2018); JBA Comment to the OCC on Notice Seeking Public Input on the Volcker Rule (Sep. 21, 2017); JBA Requests related to the Volcker Rule submitted to the Agencies (Mar. 7, 2016; May 21, 2015; Nov. 20, 2014).

all other respects. Most importantly, the JBA is concerned that QFEFs under the Proposal would be required to establish a Volcker Rule compliance program to the same extent as other BEs. Such a requirement would often be difficult to satisfy, given that QFEFs are established outside the United States and operated in accordance with applicable home country regulations in the relevant jurisdiction. At a minimum, imposing a Volcker Rule compliance screen over the activities of QFEFs—which presumably would need to account not only for the conditions of the proprietary trading and covered fund permitted activities exemptions, but also compliance with Super 23A by the QFEF (i.e., as potential counterparty to a covered fund) and with the "backstop" provisions related to conflicts of interest and high-risk assets and trading strategies—would impose substantial costs and burdens on QFEFs that are not shared by other non-U.S. asset management vehicles. Thus, QFEFs and their banking entity sponsors would remain at a competitive disadvantage as compared to similarly situated non-U.S. vehicles and managers that are not subject to the Volcker Rule. In the JBA's view, this approach would therefore continue to undermine the stated objectives of the QFEF exemption.

In addition to the foregoing, the JBA notes that there are various non-U.S. fund structures where a vehicle might be characterized as a QFEF as a result of being controlled by a non-U.S. BE, but the non-U.S. BE lacks the authority to compel the vehicle to adopt a Volcker Rule compliance program. For example, contract-type investment trusts offered as part of asset management activities in Japan do not issue securities or other instruments that correspond to "voting securities" under the U.S. Bank Holding Company Act. Rather, these investment trusts are managed based on the investment policy specified in the trust contract entered into between the settlor and trustee and thus are not controlled by the investor. Therefore, it generally is not possible for a BE that is an investor in such a vehicle (even one that holds a greater than 1/3 interest and may be involved in marketing/advising the vehicle as part of its asset management business) to establish a compliance program for the management and operation of each contract-type investment trusts (and compel the trustee to implement such a program).

Based on the foregoing, the JBA recommends that a more streamlined and efficient approach to achieving the objectives of the QFEF exemption would be to exclude QFEFs entirely from the scope of the BE definition. If the Agencies determine that such an exclusion is not feasible, then the JBA recommends two alternatives to mitigate the impacts noted above: (i) expressly exempting QFEFs from the Volcker Rule compliance program requirements, provided that a non-U.S. BE investing in or sponsoring the fund confirms that the QFEF requirements are satisfied; or (ii) clarifying that it is unnecessary to establish compliance program by treating proprietary trading and covered fund investments/activities conducted by a QFEF as activities excluded from the Volcker Rule, rather than permitted activities. If the Agencies elect to require QFEFs to establish any form of Volcker Rule compliance program, the final rule should clarify the Agencies' expectations in this regard (including that compliance program expectations for a QFEF are substantially more limited than for other BEs).

Other than the example above, the JBA also notes that there are some type of foreign excluded funds that are not characterized as QFEFs and could not substantially be controlled by a non-U.S. BE since such entity cannot exercise voting right. These funds might be treated as BEs under the Proposal, however, the JBA also recommends that these funds be excluded from the scope of the BE definition, given that the non-U.S. BE have no control influence.

B. <u>Definition of QFEF – Anti-Evasion Language</u>

The Proposal indicates that a QFEF is generally intended to have the same meaning as in the FRB's 2017 and 2019 policy statements. However, the language of the Proposal differs in a small but important way that suggests (perhaps inadvertently) that BEs could be required to "police" the activities of other, unaffiliated BEs in a way that is not commercially reasonable. Specifically, policy statements have provided previously that "a 'qualifying foreign excluded fund' means, with respect to a foreign banking entity, an entity that ... [i]s not operated in a manner that enables the foreign banking entity to evade the requirements of section 13 or implementing regulations" (emphases added). The corresponding provision in the Proposal, however, imposes a requirement that the QFEF "is not operated in a manner that enables any other banking entity to evade the requirements of section 13 of the BHC Act or this part" (emphasis added). The JBA believes this reference to "any other banking entity" requires amendment, as it is not feasible for a non-U.S. BE sponsor of a QFEF to ensure that no other BE (including one not controlled by the sponsoring BE) is somehow using the QFEF evade the requirements of section 13. This aspect of the QFEF definition should be amended in a manner consistent with the policy statements (or otherwise in a way that clarifies the reference to "any other banking entity" means only the sponsoring BE and its affiliates).

C. Definition of QFEF – Clarification Issues

As the JBA has expressed in previous comments, there are still certain ambiguities regarding the requirements for QFEFs that could undermine the objectives of a more streamlined approach to their treatment. In particular, the JBA believes that the requirements of sections 248.6(f)(3), (4), and (5) of the Proposal should be further clarified because specific identification methods and frequency are unclear. For instance, regarding the requirements of sections 248.6(f)(4), the Agencies should treat a fund as a QFEF in the case where a non-U.S. BE management company of the fund is approved by the home country regulator to perform fund management in accordance with the local law. Also, regarding the requirements of sections 248.6(f)(5), a fund should not be considered to evade the BHC Act in the case where a non-U.S. BE sponsor of the fund judges that its scheme, management method, etc. are in range of normal activity and thus there is no concern of evasion.

In addition, from the perspective of restricting excessive extraterritorial applications, the approach could be considered that the QFEFs requirements could be substituted by SOTUS requirements solely (as a sufficient condition of the QFEF exemption) and funds that meet SOTUS requirements could be defined as QFEFs.

III. Other issues

As discussed above, the JBA has additional comments and recommendations on the following aspects of the Proposal.

A. Definition of "Covered Fund"

The JBA supports the new covered fund exclusions included in the Proposal and appreciates the Agencies' efforts to more closely align the functional definition of "covered fund" with Congressional intent to address the risks posed by hedge funds and private equity funds. However, the JBA continues to believe—even with these additional proposed exclusions—that the definition of covered fund remains overbroad to the extent that it applies to any collective investment vehicle not possessing the risk characteristics of hedge funds and private equity funds.

As a result of this overbroad definition and the burdens associated with confirming (on a case-by-case basis) whether or not a particular fund falls under the definition of covered fund or meets the requirements of a particular exclusion, U.S. fund-related businesses continue to be limited by the Volcker Rule. Because the Proposal does not address the fundamental overbreadth of the approach taken in the Volcker Rule for defining covered funds, the Proposal would continue to limit the involvement of foreign bank-affiliated asset management companies in the United States and thereby hamper the sound competitive environment for asset management business.

Accordingly, the JBA continues to believe that a better approach would be to base covered fund status on the assessment of whether a particular fund demonstrates the typical risk appetite/characteristics of a hedge fund or private equity fund (based on readily apparent criteria, such as whether a performance fee is charged), with all funds not demonstrating these characteristics being excluded. The JBA believes this functional approach would more faithfully implement the objectives of the Volcker Rule and appropriately limit its scope.

B. Loan Securitization Exclusion

While the JBA appreciates the Agencies' proposal to allow loan securitization vehicles to hold a small amount of non-loan assets, the JBA believes it is not advisable to allow loan securitizations to hold non-loan assets that have materially different risk characteristics from loans. A contrary approach could cause complications and could make it difficult for investors to monitor each product. Accordingly, assuming this modification to the exclusion is retained, non-loan assets should be limited to securities that are not significantly different from loans in terms of risk characteristics. The JBA also requests that the Agencies clarify how to calculate 5 percent of the "aggregate value" of the issuer's assets for purposes of this exception (e.g., based on market value, par value, etc.).

C. Definition of Ownership Interest

The JBA supports the proposed amendment to the definition of "ownership interest" to clarify that participation in the removal of an investment manager for cause or nominating/voting on a replacement manager upon an investment manager's resignation or removal will not cause an interest to be treated as an ownership interest. However, the JBA believes that the "for cause" exception should be expanded beyond situations involving an event of default and, at least, should include the examples listed in Question 78, such as the occurrence of a "key person" event or a change in control with respect to an investment manager. Debt holders should not be treated as holding an ownership interest in a covered fund based on the rights listed in Question 78, given that those rights are generally provided to senior debt holders of a fund for the purpose of securing their debt (i.e., as opposed to providing control over the fund).

D. Effective Date/Transition Period

As the revised regulations announced in August 2019 are effective on January 1, 2020, and due for mandatory compliance on January 1, 2021,[3] the JBA suggests the Agencies also set adequate transition periods for the covered fund and QFEF amendments, which should be at least one year. Even if the Proposal is finalized as proposed and, on balance, is less restrictive than the current regulation, banking entities will still need to make changes to IT systems and operational processes to respond to the changes. The JBA would not object to a similar early "opt in" option as was taken in the amendments to the proprietary trading rules.

(End)

[3] *See* 84 FR 61974.