Deutsche Bank

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Department of the Treasury
Office of Domestic Finance
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20520

Board of Governors of the Federal
Reserve System
20th Street and Constitution Avenue, N.W.
Washington, D.C. 20551

Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20429

Office of the Comptroller of the Currency
250 E Street, S.W.
Washington, D.C. 20219

Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Commodity Futures Trading Commission
1155 21st Street, N.W.
Washington, D.C. 20551

Re: Notice of Proposed Rulemaking Implementing the Volcker Rule - Impact on Fund-Linked Products

Federal Reserve Docket No. R–1432 and RIN 7100 AD 82
FDIC RIN 3064–AD85
OCC Docket ID OCC–2011–14
SEC File No. S7–41–11
CFTC RIN 3038–AD05

Dear Sirs/Mesdames:

Deutsche Bank AG (together with its affiliates, "**Deutsche Bank**") appreciates the opportunity to provide comments to the Board of Governors of the Federal Reserve System ("**Board**"), the Office of the Comptroller of the Currency ("**OCC**"), the Federal Deposit Insurance Corporation ("**FDIC**"), the Commodity Futures Trading Commission ("**CFTC**") and the Securities and Exchange Commission ("**SEC**") (collectively, the "**Agencies**") with respect to the Agencies' notice of proposed rulemaking ("**Proposed Rules**") to implement new Section 13 of the Bank Holding Company Act of 1956 ("**BHC Act**"), commonly referred to as the Volcker Rule.

This letter addresses the potential impact of the Proposed Rules on Deutsche Bank's customer-driven fund-linked products business. Deutsche Bank is submitting a separate comment letter that addresses the potential impact of the Proposed Rules on our role in arranging repackaging transactions for clients.

We are concerned that the hedging exemption for acquiring and retaining ownership interests in covered funds in Section __.13(b) of the Proposed Rules would severely limit the ability of Deutsche Bank and other banking organizations to effectively manage the risks arising from the fund-linked products we enter into with customers. Many of the restrictive conditions in Section __.13(b) of the Proposed Rules have no basis in the broad statutory hedging exemption. Nor is there a statutory basis for implementing by regulation a separate hedging exemption for covered fund activities that is significantly narrower than the hedging exemption for proprietary trading activities.

We recommend that, consistent with the statute, the final rules provide for a single hedging exemption applicable to both the proprietary trading and covered funds portions of the Volcker Rule. This single exemption should not contain any of the restrictive conditions in Section __.13(b) of the Proposed Rules that undermine the ability of banking entities to use effective, industry standard hedging strategies to mitigate risks arising from customer-driven fund-linked products and other transactions.[1]

In addition to the recommendations contained in this letter, Deutsche Bank strongly supports the views expressed and recommendations made by the Securities Industry and Financial Markets Association, the American Bankers Association, the Financial Services Roundtable and The Clearing House Association (collectively, the "**Trade Associations**") in their joint comment letter on the covered funds portion of the Proposed Rules ("**Trade Associations Joint Funds Letter**"). Deutsche Bank also strongly supports the comment letters submitted by the International Swaps and Derivatives Association ("**ISDA**"), the American Securitization Forum ("**ASF**"), the Association of German Banks (Bundesverband deutscher Banken) and the German Investment and Asset Management Association (BVI Bundesverband Investment und Asset Management e.V.) regarding the Proposed Rules. In addition, we strongly support the comments submitted by the Institute of International Bankers ("**IIB**") regarding the extraterritorial application of the Volcker Rule.

In particular, Deutsche Bank agrees with the Trade Associations that the definition of "covered fund" should be narrowed and should focus on the characteristics of traditional hedge funds and private equity funds identified in that letter. Deutsche Bank also supports the recommendations in the Trade Associations Joint Funds Letter regarding the appropriate implementation of Section 13(f) of the BHC Act (so-called "**Super 23A**"), as their proposed approach would mitigate the unintended consequences of that provision.

Deutsche Bank also agrees with the IIB that the Agencies should limit the extraterritorial scope of the Volcker Rule and provide clear guidance regarding its cross-border application. Specifically, we support the IIB's recommendation that the Agencies limit the extraterritorial application of Super 23A. For example, Super 23A should not prohibit covered transactions between a foreign bank or any of its foreign

[1] Alternatively, if the Agencies decide to adopt separate hedging exemptions for proprietary trading and covered funds activities, they should, at a minimum, address the concerns raised in this letter regarding those conditions in Section __.13(b) of the Proposed Rules that could prevent Deutsche Bank and other banking organizations from effectively hedging risks arising from fund-linked products and other transactions.

affiliates, *acting from outside the United States*, and a covered fund that the foreign bank or any of its foreign affiliates sponsors, advises or organizes and offers.

Furthermore, Deutsche Bank supports the recommendation in the Trade Associations Joint Funds Letter that the statutory exemptions for underwriting, market-making related activities and risk-mitigating hedging should apply equally to both the covered funds and the proprietary trading portions of the Volcker Rule.

I. Executive Summary

- ❖ Consistent with the statute, the final rules should provide for a single hedging exemption applicable to both the proprietary trading and covered funds portions of the Volcker Rule.
- ❖ Fund-linked products closely resemble other structured products and are hedged using similar strategies. Regulators have a long-standing practice of allowing banks the flexibility to hedge structured products in the way the banks, given their risk management expertise, deem most appropriate. The Volcker Rule should preserve this approach with respect to hedging strategies that involve acquiring interests in "covered funds."
- ❖ This single hedging exemption should <u>not</u> include those restrictive conditions in Section __.13(b) of the Proposed Rules that undermine the ability of Deutsche Bank and other banking organizations to effectively risk manage fund-linked products entered into with clients.
- ❖ Specifically, Deutsche Bank is concerned that: (i) the "profits <u>and</u> losses" requirement in Section __.13(b) of the Proposed Rules is inconsistent with the customized economic exposure offered by many fund-linked products; (ii) the "specific customer request" condition is inconsistent with modern banking practices; (iii) the "same amount of ownership interest" requirement is inconsistent with portfolio and dynamic hedging strategies and (iv) the "riskless principal" concept in the preamble of the Proposed Rules is inconsistent with the broad hedging exemption in the statutory text of the Volcker Rule.
- ❖ There is no statutory basis for any of the above restrictions, nor is there a basis for adopting a separate and narrower hedging exemption for covered fund activities than for proprietary trading activities.
- ❖ Any risk that a banking entity would abuse the hedging exemption should be addressed directly through the anti-evasion authority or supervisory processes rather than indirectly through narrowing the scope of the hedging exemption.

II. Business Overview

A fund-linked product provides sophisticated clients with a return linked to the performance of one or more investment funds, including traditional hedge funds. Deutsche Bank's fund-linked products business delivers customized investment products to our institutional and high-net-worth clients.

Like other banking organizations that operate fund-linked products businesses, Deutsche Bank acts as counterparty to our clients on fund-linked products. We also hedge our risk exposure on fund-linked products in the same way we would for other structured products – often by acquiring interests in the reference assets which, in the case of certain fund-linked products, are covered fund interests. As described below, banking organizations employ a number of industry standard risk management strategies, including transaction-specific, portfolio and dynamic hedging, to minimize their risk exposure on fund-linked products.

1. Fund-linked Products and their Benefits to Clients

As a result of increasing demand by sophisticated investors for exposure to alternative investments which provide diversification to traditional portfolios, fund-linked products have emerged as important financial instruments. Deutsche Bank observes that the global fund-linked products market is significant and developed and is increasing year-on-year as sophisticated investors seek greater exposure to alternative asset classes such as hedge funds to diversify their investment portfolios. The benefits of fund-linked derivatives to clients are further described below.

Customized Exposure: Fund-linked products allow sophisticated investors to customize their exposure to one or more funds to match their unique risk appetite or investment horizon. For example, a call option linked to the returns of one or more reference funds limits an investor's loss to the premium paid on the option and generates a profit to the extent the return exceeds the strike price of the option. A principal protected note linked to the returns of one or more reference funds promises the return of the principal amount paid by an investor while allowing the investor to benefit from some or all of the fund's upside performance. Fund-linked products also permit sophisticated clients to incorporate various risk mitigants into their overall exposure, such as foreign exchange hedging.

Diversification and Accessibility: To invest in a hedge fund directly, an investor must typically make a minimum investment of between $1 million and $5 million. A fund-linked product can provide the investor with exposure to more reference funds at the same investment level, and obviates the need to make significant investments in each fund. Diversification tends to lower the overall risk in a portfolio of funds.

Liquidity: Through the provision of various fund-linked products, Deutsche Bank and other banking organizations are able to offer clients better liquidity relative to the underlying assets.

2. Types of Fund-linked Products Offered to Clients

As with equity, fixed income, interest rate or commodities-linked derivatives, Deutsche Bank and other banking organizations offer a variety of different fund-linked products to sophisticated investors, including swaps, options and notes. We typically issue or enter into fund-linked products directly with customers. In other words, a Deutsche Bank entity acts as counterparty to its clients on the swaps and options and serves as the issuer with respect to notes. Please refer to **Annex A** for an illustrative overview of certain fund-linked products that Deutsche Bank and other banking organizations enter into with clients: swaps, options and notes.

3. Reference Funds and the Managed Account Platform

Many fund-linked products offered by Deutsche Bank are linked to the performance of one or more hedge funds on Deutsche Bank's Managed Account Platforms. A Managed Account Platform comprises a series of segregated portfolio funds or unit trusts established by Deutsche Bank (each a "**Platform Fund**"). Each Platform Fund's assets are managed by a separate third party hedge fund manager ("**Trading Advisor**"), frequently pursuant to the strategy they employ in their own pre-existing benchmark fund.

Platform Funds exclusively employ strategies that are sufficiently liquid to permit a minimum weekly liquidity profile, thereby offering regular liquidity rights. The Trading Advisors are unaffiliated with Deutsche Bank and are generally well-established hedge fund managers with established track records. Certain Managed Account Platforms issue derivatives or notes linked to one or more of these benchmark funds while other Managed Account Platforms offer fund units directly to sophisticated clients.

In addition, affiliates of Deutsche Bank provide administrative, custodial, corporate governance, and risk monitoring functions in order to mitigate many of the operational or conflict of interest risks traditionally associated with hedge funds, such as custody, liquidity, style drift and valuation risk. In essence, the Managed Account Platform provides clients with the same protections as a managed account arrangement pursuant to which a hedge fund manager manages the portfolio directly through a brokerage account maintained by Deutsche Bank. Therefore, in addition to the customization and diversification potentials inherent in all fund-linked products, those fund-linked products that reference Platform Funds are particularly attractive to clients due to the enhanced and independent monitoring and scrutiny of Platform Funds.

III. How Banks Hedge Their Risk Exposure on Fund-linked Products Entered into with Customers

Upon entering into a fund-linked product with a client, a banking organization such as Deutsche Bank would hedge its risk exposure on that transaction similar to the way it would hedge exposures arising from derivatives such as equity options, index-linked options or other traditional bank asset classes. The sole purpose of the hedging strategies employed by Deutsche Bank's Global Fund

Derivatives business unit is to minimize Deutsche Bank's risk exposure and not to take speculative positions. The business unit primarily employs the following three hedging strategies.

1. Transaction-specific Hedging

Generally, Deutsche Bank hedges its exposure on swaps and certain other fund-linked products by making a one-for-one investment in the reference fund(s). Deutsche Bank adjusts its hedge on an ongoing basis so that the investment materially matches Deutsche Bank's notional exposure to the fund as a result of the fund-linked product. From time to time, Deutsche Bank may own slightly more or less of the reference fund than its exact notional exposure due to: (1) fees paid on the fund or (2) transaction costs and operational hurdles related to redeeming or investing *de minimis* amounts.

2. Portfolio Hedging

In addition to transaction-specific hedging, Deutsche Bank and other banking organizations use portfolio hedging to risk manage portions of their fund-linked products portfolios. Portfolio hedging is a well-established technique that many banks use to hedge their equity, fixed income, commodities and fund portfolios. Portfolio hedging is attractive because it minimizes the bid-offer spread and other transaction costs encountered when hedging transactions individually. For example, rather than hedging each fund-linked product on a transaction-specific basis, Deutsche Bank may invest in hedge fund indices to manage risks across its fund-linked products portfolio.

The attractiveness of portfolio hedging has been recognized by bank regulators. For example, the OCC has written that portfolio hedging has the following advantages: "Portfolio hedging can provide a more cost effective means of managing risks arising from derivative activities than perfectly matching transactions because it reduces transactional costs and operational risks. Rather than offset each individual derivative transaction, the bank can determine its net positions and hedge only the residual risk in its book of business."[2]

3. Dynamic Hedging of Option Exposures

In the preamble to the Proposed Rules, the Agencies recognized the importance of permitting dynamic hedging with respect to the proprietary trading aspect of the Volcker Rule.[3] Dynamic hedging is equally important to effectively risk manage a banking entity's exposures on fund-linked products, particularly fund-linked call options and principal protected notes.

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[2] OCC Interpretive Letter No. 1064 (Jul. 13, 2006).

[3] 76 Fed. Reg. at 68,875 ("[A] banking entity may need to engage in dynamic hedging, which involves rebalancing its current hedge position(s) based on a change in the portfolio resulting from permissible activities or from a change in the price, or other characteristic, of the individual or aggregated positions, contracts, or other holdings.").

Deutsche Bank and other banking organizations use dynamic hedging to manage their risk exposure on options, including fund-linked call options. The overall aim of dynamic hedging is to ensure that a banking organization's exposure on a fund-linked call option is largely neutralized notwithstanding upward or downward movements in the value of the reference fund(s) during the life of the option – a so-called "Delta Neutral" position – or movements in other transaction pricing factors such as interest and foreign exchange rates.

Dynamic hedging is based on standard option theory, which states that the value of a fund-linked option may be replicated at any time by ownership interests in the reference fund(s) plus a position in a risk-free bond such as Treasury bonds. This combination of assets, which constantly changes throughout the duration of the option, is called the "replicating portfolio." The precise composition of the replicating portfolio is determined by a hedging model based on the Black-Scholes methodology, which takes into account certain inputs, such as the time remaining until the maturity date of the option, the cost of use of cash during the intervening period, foreign exchange risk as well as the expected volatility of the reference fund(s). As these inputs change throughout the duration of an option, so does the composition of the replicating portfolio.

To effectively hedge a fund-linked call option, Deutsche Bank dynamically adjusts its ownership interests in the reference fund(s) and risk-free bond to match the composition of the replicating portfolio, as determined by the hedging model. These constant adjustments help ensure that Deutsche Bank maintains a Delta Neutral position. In this respect, Deutsche Bank's Managed Account Platforms facilitate dynamic hedging by providing sufficient liquidity to enable Deutsche Bank to adjust its ownership levels in one or more Platform Funds referenced by a fund-linked call option.

IV. Adverse Consequences of Inability to Effectively Hedge Exposures on Fund-linked Products

Effective hedging strategies are important to the safety and soundness of all banking entities. If regulations implementing the Volcker Rule restricted the ability of banking entities to effectively hedge their risk exposure on fund-linked products, they would be forced to exit or significantly reduce their fund-linked product activities at a time of increasing customer demand for these services. If this were to occur, sophisticated investors may have no choice but to enter into fund-linked products with unregulated "shadow" banking entities that carry greater counterparty credit and other risks. Moreover, banking entities that decide to offer fund-linked products on a reduced capacity going forward would incur significant risks due to their inability to effectively hedge such transactions. This would threaten their safety and soundness.

Inability to employ effective hedging strategies would also adversely affect the significant volumes of existing transactions that Deutsche Bank and other banking organizations have entered into with their customers. For example, the accumulation of unhedged risk exposures resulting from an overly restrictive implementation of the hedging exemption may compel banking entities to invoke change-of-law provisions in their contracts to terminate existing fund-linked products. This would be highly disruptive to customers and would have serious systemic consequences if widespread terminations were to occur.

There are no policy justifications for implementing the Volcker Rule in a way that would give rise to any of these unintended and disruptive outcomes. On the contrary, Section 13 of the BHC Act expressly requires that regulations implementing the Volcker Rule protect, rather than undermine, the safety and soundness of banking entities and the stability of the U.S. financial system.[4]

V. Concerns and Recommendations Regarding the Hedging Exemption in Section __.13(b) of the Proposed Rules

As described above, Deutsche Bank and other banking organizations use a number of risk management tools to hedge their exposure on the fund-linked products that they enter into with clients. These hedging strategies involve taking positions in reference funds, many of which would be "covered funds" under the Proposed Rules due to their reliance on the exemption in Section 3(c)(7) of the Investment Company Act.[5]

Deutsche Bank is concerned that the Agencies' interpretation and proposed implementation of the hedging exemption in Section 13(d)(1)(C) of the BHC Act would severely restrict the ability of banking organizations to employ industry standard, *bona fide* hedging strategies. The exemption in Section __.13(b) of the Proposed Rules is overly narrow and imposes a number of restrictive conditions that are not required by the statute, not contained in the proposed hedging exemption for proprietary trading activities and not consistent with the long-standing regulatory practice of allowing banks the flexibility to use hedging strategies that they, given their risk management expertise, deem most appropriate.

Deutsche Bank believes the overly narrow hedging exemption in Section __.13(b) of the Proposed Rules arises from a misunderstanding of how banks use interests in covered funds to effectively hedge their customer-driven transactions on a transaction-specific, portfolio or dynamic basis. The hedging strategies described in this letter are industry standard practices that are based on sophisticated risk management models, supported by empirical data and strengthened by regular back-testing and supervisory oversight. They are solely aimed at reducing a banking entity's risk exposure and are not disguised or evasive forms of proprietary risk-taking.

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[4] *See e.g.*, BHC Act § 13(b)(2) ("In developing and issuing regulations pursuant to this section, the [Agencies] shall consult and coordinate with each other, as appropriate, for the purposes of assuring, to the extent possible, that such regulations . . . protect the safety and soundness of banking entities and nonbank financial companies supervised by the Board.").

[5] Please refer to Deutsche Bank's comment letter on repackaging transactions for our concerns and recommendations regarding the overly broad definition of "covered fund" in the Proposed Rules.

1. Agencies Should Adopt A Single Hedging Exemption for Proprietary Trading and Covered Fund Activities

Deutsche Bank recommends that the Agencies give effect to the statute by adopting a single hedging exemption applicable to both the proprietary trading and covered funds portions of the Volcker Rule.

The statutory text of the Volcker Rule provides a broad, single hedging exemption from both the proprietary trading and covered-fund related prohibitions and restrictions in Section 13(a) of the BHC Act. This single statutory exemption broadly permits a banking entity to engage in "[r]isk-mitigating hedging activities in connection with and related to individual or aggregated positions, contracts, or other holdings of a banking entity that are designed to reduce the specific risks to the banking entity in connection with and related to such positions, contracts, or other holdings."[6]

Construing Section 13 of the BHC Act in its entirety, it is clear that Congress intended the single hedging exemption to be interpreted and implemented similarly with respect to both proprietary trading and covered-fund related activities. In fact, where Congress intended a category of exemptions to apply differently to proprietary trading and covered fund activities, it enacted two different exemptions, as in the case of the offshore exemptions contained in Sections 13(d)(1)(H) (proprietary trading) and 13(d)(1)(I) (investing in and sponsoring covered funds) of the BHC Act. Notwithstanding this clear congressional mandate, the Agencies' proposed hedging exemption for covered fund activities is significantly narrower and more prescriptive than the hedging exemption for proprietary trading.

Not only is there no statutory basis for the Agencies' approach in Section __.13(b) of the Proposed Rules, requiring banking entities to modify existing, industry standard hedging strategies so that they qualify for this narrow exemption would harm the safety and soundness of banking entities, which is inconsistent with the central goal of the Volcker Rule and every major U.S. banking statute.[7]

Furthermore, as discussed below, the proposed regulatory treatment of hedging strategies that involve acquiring interests in "covered funds" departs from bank regulatory precedents with respect to the hedging of other structured products. This leads to absurd results where a fund-linked product and another structured product are economically equivalent and provide the same risk exposures but the former's reference to a "covered fund" would subject a banking entity's hedging activities to the restrictive conditions in Section __.13(b) of the Proposed Rules.

[6] BHC Act § 13(d)(1)(C).

[7] BHC Act § 13(b)(2)(B)(ii)("In developing and issuing regulations pursuant to this section, the [Agencies] shall . . . protect the safety and soundness of banking entities. . . .").

2. The Agencies Should Continue to Allow Banks to Have the Flexibility to Use Hedging Strategies that Banks Deem Most Appropriate

The prescriptive and restrictive hedging exemption in Section __.13(b) of the Proposed Rules is inconsistent with the Agencies' long-standing approach of allowing banks the flexibility to hedge risks using strategies that the banks, given their risk management expertise, deem most appropriate. The Volcker Rule should be implemented in a way that preserves this approach with respect to hedging of fund-linked products, which may involve acquiring interests in reference assets that are covered funds.

As the OCC recently stated: "banks are permitted, and indeed encouraged, to manage prudently the exposure arising out of bank activities and <u>they must be allowed the flexibility</u> to use the most suitable risk management tool."[8] Relying on this approach, banks currently employ a broad range of strategies (including portfolio hedging and cross-hedging) to minimize their exposures on customer-driven structured products that reference the performance of one or more investment funds, securities, securities indices, interest rates or other commodities.[9] These hedging strategies generally involve acquiring interests in the reference assets.

There is no policy justification for the Agencies' proposed departure from this long-standing regulatory practice. From a bank risk management perspective, there is no material difference between a fund-linked product and a structured product linked to the performance of other assets. Hence, Deutsche Bank and other banking organizations currently employ similar hedging strategies to minimize their risk exposure on fund-linked products and all other structured products. Yet, Section __.13(b) of the Proposed Rules would result in vastly different regulatory approaches to those hedging strategies that involve acquiring interests in covered funds and those that involve acquiring other reference assets.

This regulatory treatment would lead to particularly absurd results with respect to a covered fund that itself tracks the performance of another financial asset. From both a client and risk management perspective, a fund-linked product that references such a covered fund would offer the same economic exposure as a structured product that directly references the financial asset tracked by the fund. Yet, under the Proposed Rules, a banking entity that enters into the fund-linked product must modify its existing practices to qualify for the narrow and prescriptive exemption in Section __.13(b) while a banking entity that enters into the structured product directly referencing the asset would "be allowed the flexibility to use the most suitable risk management tool."

[8] *See e.g.*, OCC, Interpretive Letter No. 1037 (Aug. 9, 2005) (emphasis added).

[9] *See e.g.*, OCC Interpretive Letter No. 1064 (Jul. 13, 2006) (A national bank may engage in customer-driven derivative transactions with payments tied to a broad range of assets, including below-investment grade debt, and hedge risks arising from those transactions through, among other things, physical positions in debt securities).

3. Concerns Regarding Specific Conditions in Section __.13(b) of the Proposed Rules

Deutsche Bank is concerned about several specific conditions in Section __.13(b) of the Proposed Rules because they restrict the ability of banking organizations to effectively hedge fund-linked products and other transactions. These conditions are not contained in the broad hedging exemption in Section 13(d)(1)(C) of the BHC Act, nor are they present in the hedging exemption for proprietary trading activities in Section __.5 of the Proposed Rules. Deutsche Bank believes that the single hedging exemption for proprietary trading and covered fund activities in the Agencies' final rules should not impose any of these restrictive conditions.

"Exposure by the customer to the profits and losses of the covered fund" Section __.13(b)(1) of the Proposed Rules restricts the hedging exemption to two situations, including when a banking entity is "acting as intermediary on behalf of a customer that is not itself a banking entity to facilitate the exposure by the customer to the profits and losses of the covered fund." While the fund-linked products business involves financial intermediation that facilitates customer exposure to investment funds including traditional hedge funds, products such as principal protected notes do not (or are designed not to) expose customers to the "losses" of these funds. The loss protection features in these products (which may be paired in some cases with a ceiling on performance upside) are highly attractive to clients in the uncertain economic climate.

Deutsche Bank is concerned that the "profits and losses" requirement in Section __.13(b) of the Proposed Rules could prevent effective hedging of its exposure on key fund-linked products, which would result in reduced product availability and higher costs that ultimately harm investors, including government and private sector pension funds. Like most other conditions in Section __.13(b) of the Proposed Rules, the "profits and losses" requirement is not mandated by statute, would hinder the ability of banks to manage their risks and thereby threaten the availability of beneficial investment products to the customers of Deutsche Bank and other banking organizations.

"In the same amount of ownership interest" Section __.13(b)(2)(ii)(B) requires greater equivalency between the reference asset and hedging instrument than the correlation required under the proposed hedging exemption for proprietary trading. Specifically, this section requires that the covered fund interest acquired or retained by a banking entity "[h]edges or otherwise mitigates an exposure to a covered fund through an offsetting exposure to the same covered fund and in the same amount of ownership interest in that covered fund that . . . arises out of a transaction conducted solely to accommodate a specific customer request with respect to . . . that covered fund."

Deutsche Bank is concerned that the prescriptive nature of this condition could undermine a banking entity's current flexibility to use the most suitable, efficient and effective hedging strategy with respect to its individual or aggregate exposure on fund-linked products. For example, the high level of equivalency effectively limits the types of hedgeable fund-linked products to solely pass-through or "delta one" products and is inconsistent with portfolio and dynamic hedging strategies. The broad language in Section 13 of the BHC Act expressly permits hedging "in connection with and related to individual or aggregated positions."[10] Moreover, U.S. bank regulators have traditionally permitted banks to use portfolio hedging strategies.[11] The strict correlation that Section __.13(b) appears to require would also increase transaction costs to the extent banking entities are required to make *de minimis* acquisitions or dispositions to precisely match their notional exposure to covered funds.

"Similar to acting as a riskless principal" The preamble to the Proposed Rules describes the condition in Section __.13(b)(1)(i)(A) of the Proposed Rules – "acting as intermediary on behalf of a customer . . . to facilitate the exposure by the customer to the profits and losses of the covered fund" – as being "similar to acting as a 'riskless principal.'"[12] Deutsche Bank is concerned that the reference to "riskless principal" (a concept that is defined elsewhere in the Proposed Rules[13]) suggests that the Section __.13 exemption has the effect of restricting hedging solely to "pass-through" or "delta one" products. Such a narrow approach would be inconsistent with the broad hedging exemption in Section 13(d)(1)(C) of the BHC Act and may prevent a banking entity from hedging on a portfolio or dynamic basis. Deutsche Bank believes a banking entity that enters into a fund-linked product with customer is more appropriately described as a "fully hedged counterparty."

"Solely to accommodate a specific customer request" The "solely to accommodate a specific customer request" requirement in Section __.13(b)(2)(ii)(B) of the Proposed Rules also raises serious concerns to the extent it limits the hedging exemption to situations where fund-linked products are offered to customers on a "reverse inquiry" basis. In practice, Deutsche Bank and other banking entities do not passively wait for a specific customer request regarding a fund-linked product. Today's customers expect their banks to approach them with fund-linked products that match their investment profiles. Imposing a "reverse inquiry" requirement is divorced from market reality and inconsistent with the modern business of banking.

"Customer that is Not Itself a Banking Entity" Section __.13(b)(1)(i)(A) of the Proposed Rules limits a banking entity's ability to acquire an ownership interest in a covered fund as a permitted hedge to those situations where the customer is "not itself a banking entity." In practice, compliance with this condition would be highly problematic to the extent it requires a banking entity to determine whether each

[10] BHC Act § 13(d)(1)(C).

[11] *See e.g.*, OCC Interpretive Letter No. 892 (Sept. 13, 2000) (National banks may portfolio-hedge their permissible securities derivative transactions using either derivatives that settle in cash or by holding below-investment grade debt securities).

[12] 76 Fed. Reg. 68,852 *and* 68,908.

[13] Section __.6 (b)(2)(ii) of the Proposed Rules ("The covered banking entity is acting as riskless principal in a transaction in which the covered banking entity, after receiving an order to purchase (or sell) a covered financial position from a customer, purchases (or sells) the covered financial position for its own account to offset a contemporaneous sale to (or purchase from) the customer.").

counterparty is "controlled" by another banking entity.[14] The definition of "control" under the BHC Act includes the elusive concept of "exercis[ing] a controlling influence over the management or policies of [a] company," which must be determined in light of all the facts and circumstances.[15] In the face of uncertainty regarding the presence of control, a banking organization may be deterred from entering into fund-linked products with any entity that could be under the controlling influence of another a banking entity due to concerns about the availability of the hedging exemption. The stated aim of the "not itself a banking entity" requirement is to prevent evasion of the three percent ownership interest limitation under the so-called "asset management exemption."[16] However, as we argue below, the risk of evasion should be addressed directly through the Agencies' broad anti-evasion authority or through supervisory processes rather than indirectly through narrowing the scope of the hedging exemption.

The broad hedging exemption in Section 13(d)(1)(C) of the BHC Act does not impose any of the abovementioned requirements in the Proposed Rule. Moreover, there is no evidence to suggest that Congress intended the Volcker Rule to undermine a bank's ability to actively provide customer-driven products and services or to effectively hedge such activities using strategies that the bank, given its risk management expertise, deems appropriate.

4. Risk of Abuse or Evasion Should Be Addressed Directly and Not Through Narrowing the Hedging Exemption

The Agencies' concern for "potential abuse of the hedging exemption"[17] has resulted in a proposal that unduly constrains the important risk management function served by hedging strategies involving taking positions in covered funds. Even if the Agencies were able to produce evidence of abuse in specific cases, the application of an onerous and restrictive hedging exemption to all banking entities is not justified.[18] The significant costs arising from the inability of many banking entities to hedge their risks overwhelmingly outweigh any benefit arising from the possibility of preventing abuse.

[14] Section 13(h)(1) of the BHC Act defines "banking entity" to include any insured depository institution, any company that controls an insured depository institution, any company that is treated as a bank holding company for purposes of Section 8 of the International Banking Act of 1978, and any affiliate or subsidiary of any of the foregoing. Elsewhere in the BHC Act, the definitions of "affiliate" and "subsidiary" rely on the concept of control, defined in Section 2(a)(2) of the BHC Act.

[15] BHC Act § 2(a)(2); 12 CFR § 225.144.

[16] 76 Fed. Reg. at 68,908 n. 298.

[17] 76 Fed. Reg. at 68,875.

[18] Had the Agencies performed a cost-benefit analysis of the type required by recent judicial determinations, they would have concluded that the significant costs imposed by a restrictive hedging exemption overwhelming outweigh the benefits of reducing specific instances of abuse. *See Business Roundtable* v. *SEC*, 647 F.3d 1144 (D.C. Cir. 2011).

The risk that a banking entity could abuse the hedging exemption should be addressed directly through supervisory and enforcement processes or through compliance programs rather than indirectly through narrowing the scope of the exemption. For many years, U.S. prudential regulators have monitored the hedging strategies employed by banking entities with respect to their derivatives activities. This significantly reduces the likelihood that banks will misuse their hedging strategies to engage in proprietary risk-taking.[19] Moreover, the ability of regulators to police potential abuses of hedging practices are heightened under the Volcker Rule because Section 13(e) of the BHC Act provides the Agencies with broad powers to respond to specific instances of evasive behavior or "abuse of *any* permitted activity" on the basis of their reasonable belief.

VI. Conclusion

Consistent with the statute, the Agencies should adopt a single hedging exemption for both the proprietary trading and covered funds portions of the Volcker Rule. This single exemption should not include any of the restrictive conditions in Section __.13(b) of the Proposed Rules that are identified in this letter.

Alternatively, if the Agencies do decide to adopt separate hedging exemptions for proprietary trading and covered fund activities, they should, at a minimum, address the concerns raised in this letter regarding those conditions in Section __.13(b) of the Proposed Rules that could prevent Deutsche Bank and other banking organizations from effectively hedging risks arising from fund-linked products and other transactions.

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[19] *See e.g.*, OCC Interpretive Letter No. 1064 (Jul. 13, 2006) (Holding that for a bank to "hedge risks arising from otherwise permissible derivatives activities, the [b]ank's risk measurement and management capabilities must be of appropriate sophistication to ensure that the activity can be conducted in a safe and sound manner, <u>for purposes of hedging and not as a proprietary trading business</u>. . . .").

Deutsche Bank appreciates the opportunity to provide the Agencies with the foregoing comments and recommendations regarding the Proposed Rules.

Respectfully submitted,

Ernest C. Goodrich, Jr.	Salvatore P. Palazzolo
Managing Director - Legal Department	Managing Director - Legal Department
Deutsche Bank AG	Deutsche Bank AG
212-250-7636	212-250-3003

<u>Annex A</u>

Overview of Certain Fund-Linked Products that Deutsche Bank Enters into with Customers

Fund-linked products offer sophisticated clients diversified and customized exposures to the performance of investment funds, including hedge funds, private equity funds and mutual funds ("**reference funds**"). Below is an illustrative overview of some fund-linked products that Deutsche Bank enters into with clients.

Fund-linked Swaps and Call Options: Just as investors buy swaps or call options linked to a single stock or a securities index, sophisticated investors can also purchase swaps or call options linked to the performance of one or more reference funds. Fund-linked swaps and options are structured in a similar manner to swaps and options on traditional equity securities or commodities.

Under a fund-linked swap, the investor generally receives the return of the reference fund(s) on a specified amount of notional exposure in exchange for making interest payments. Swaps generally pay the investor the return at termination.

Under a fund-linked call option, an investor pays a premium to Deutsche Bank in return for the amount by which the value of the reference fund(s) at the exercise date of the option exceeds a pre-determined "strike price," on specified amount of notional exposure. As with call options on other assets, fund-linked call options can generally be classified as American style (meaning they are exercisable at any time) or European style (meaning they are only exercisable at maturity). If the value of the reference fund(s) at the exercise date is below the strike price, the investor would not be paid and the option expires worthless.

Principal Protected Notes: Deutsche Bank offers principal protected notes linked to the performance of one or more reference funds. These products may offer investors full or partial downside protection so they can participate in the upside performance of the reference fund(s) while minimizing their potential losses. A principal protected note may be structured as: (i) a zero coupon bond plus a fund-linked call option, with the investor's exposure to each of the bond and option components being fixed at the outset or (ii) as a Constant Proportion Portfolio Insurance ("**CPPI**") note.

Under the first type of structure, the note issuer promises to return the initial principal amount to the investor at maturity and to pay an additional amount based on a pre-determined exposure to the positive performance (if any) of the reference fund(s). In other words, the investor's exposure to the reference fund(s) is constant and is not readjusted based on the funds' performance during the life of the note.

By contrast, a CPPI note employs a strategy that dynamically allocates assets, on a non-discretionary formulaic basis, between the fund-linked call option and the zero coupon bond components. This structure offers principal protection and attempts to maximize investor exposure to the positive performance of the reference fund(s). For example, if the reference fund(s) is performing well, the CPPI strategy will allocate more assets to the fund-linked call option component to provide investors with greater exposure to the fund(s). But if the reference fund(s) performs poorly, the CPPI strategy will reduce investor exposure to the fund(s) and allocate more assets to the zero coupon bond component.

Other Fund-linked Products: The products described above represent only a sample of the range of fund-linked products offered by Deutsche Bank and other banking organizations. Financial innovation, fueled by increasing investor demand for fund-linked products, has resulted in features such as coupons (guaranteed fixed payments over a given period), buffers (conditional protection of principal), “best of” options (linking return to the best performer in basket of reference funds), contingencies (returns conditioned on a reference fund not breaching one or more barriers), gearing (linking return to price movements over the term of a product). Banking organizations add these and other features to fund-linked products to customize client exposure to the reference fund(s) in a way that satisfies their specific investment and risk profiles.