PRIVATE EQUITY GROWTH CAPITAL COUNCIL

SUBMITTED ELECTRONICALLY

November 5, 2010

The Honorable Timothy F. Geithner
Secretary, United States Department of the Treasury
Chairman, Financial Stability Oversight Council
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Financial Stability Oversight Council Request for Public Input for the Study Regarding Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds – FSOC-2010-0002

Dear Secretary Geithner:

These comments are submitted by the Private Equity Growth Capital Council (the "PEGCC"). The PEGCC is an advocacy, communications and research organization and resource center established to develop, analyze and distribute information about the private equity and growth capital investment industry and its contributions to the national and global economy. Established in 2007 and formerly known as the Private Equity Council, the PEGCC is based in Washington, D.C. The members of the PEGCC are 32 of the world's best-known and most respected private equity and growth capital firms, united by their commitment to growing and strengthening the businesses in which they invest.[1]

The PEGCC appreciates the opportunity to submit comments for consideration by the Financial Stability Oversight Council (the "FSOC") members with respect to the Request for Public Input for the Study Regarding Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds as provided for in Section 619 of the recently enacted Dodd-Frank Wall Street

[1] The members of the PEGCC are: American Securities; Apax Partners; Apollo Global Management LLC; Avista Capital Partners; Bain Capital Partners; The Blackstone Group; Brockway Moran & Partners; The Carlyle Group; Crestview Partners; Genstar Capital; Global Environment Fund; GTCR; Hellman & Friedman LLC; The Jordan Company; Kelso & Company; Kohlberg Kravis Roberts & Co.; KPS Capital Partners; Levine Leichtman Capital Partners; Madison Dearborn Partners; MidOcean Partners; New Mountain Capital; Permira; Providence Equity Partners; The Riverside Company; Silver Lake; Sterling Partners; Sun Capital Partners; TA Associates; Thomas H. Lee Partners; TPG Capital (formerly Texas Pacific Group); Vector Capital; and Welsh, Carson, Anderson & Stowe.

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Reform and Consumer Protection Act (the "Dodd-Frank Act"). All Section references herein are to the Dodd-Frank Act, unless otherwise indicated.

Although the PEGCC's members are not themselves directly subject to the Volcker Rule, the PEGCC has concerns regarding (*1*) the potential application of the Volcker Rule to bank-affiliated feeder funds and pension plans, insurance company general accounts and separately managed accounts, and non-U.S. banking entities; and (*2*) the transition period for compliance with the Volcker Rule.

Framework for Our Responses to the Request for Public Input

Section 619 amends the Bank Holding Company Act of 1956 (12 U.S.C. 1841 et seq.) (the "BHC Act") by adding a new Section 13, which is commonly known and referred to herein as the "Volcker Rule" and which is to be implemented by the Board of Governors of the Federal Reserve System (the "Federal Reserve Board"), the Office of the Comptroller of the Currency, the Federal Deposit Insurance Corporation, the Securities and Exchange Commission and the Commodity Futures Trading Commission (collectively, the "Regulatory Agencies"). The Volcker Rule generally restricts banking entities from engaging in proprietary trading and from investing in private equity funds and hedge funds. Our comments focus on the Volcker Rule's restrictions on investments in private equity funds.

Before responding below to individual questions in the request for public input, the PEGCC wishes to propose the following overarching framework, which guides its responses:

(1) The purpose of the Volcker Rule is not to limit the ability of the private equity industry to raise and invest capital, but to promote the safety and soundness of banking entities and to reduce conflicts of interest between banking entities and their customers. The Volcker Rule should be applied to the extent necessary to ensure the safety and soundness of the banking system and to reduce such conflicts of interest, while avoiding an overbroad application that could unnecessarily impede private investment and economic growth.

(2) Banks and insurance companies provide a wide range of intermediary services to clients. Congress did not intend to prohibit these intermediary services, and the Volcker Rule should not be construed to restrict private equity investment where a banking entity serves as an intermediary.

(3) Under the Volcker Rule, a foreign banking entity with a U.S. presence is allowed to invest in a private equity fund "solely outside of the United States," provided that no interest in such private equity fund is offered for sale or sold to U.S. residents and the foreign banking entity is not controlled by a U.S. banking entity. Such foreign banking entities should not be prohibited from investing in a private equity fund that is

established outside of the United States, the interests of which are not offered or sold to U.S. residents, even if such private equity fund may invest in U.S. assets and/or such private equity fund is advised, managed and/or controlled, directly or indirectly, by a U.S. entity (such as a U.S. private equity firm) that is not a banking entity.

(4) Given the illiquid nature of private equity fund investments, the difficulty of transferring interests in private equity funds and the significant percentage of private equity fund interests that are owned by banking entities, the deadline for banks to dispose of interests in private equity funds should be extended to the maximum extent allowable. Such an approach would serve to enhance the safety and soundness of banks that currently own private equity interests and minimize disruption in the marketplace more generally.

<u>Our Responses to the Request for Public Input</u>

1. Commenters are invited to submit views on ways in which the implementation of the Volcker Rule can best serve to:

[Text of (i)–(v) deleted.]

(vi) Appropriately accommodate the business of insurance within an insurance company, subject to regulation in accordance with the relevant insurance company investment laws, while protecting the safety and soundness of any banking entity with which such insurance company is affiliated and of the United States financial system; and

Please see our response to question 3 below.

(vii) Appropriately time the divestiture of illiquid assets that are affected by the implementation of the prohibitions under the Volcker Rule.

Please see our response to question 11 below.

3. What are the key factors and considerations that should be taken into account in making recommendations on implementing the provisions of the Volcker Rule that restrict the ability of banking entities to invest in, sponsor or have certain other covered relationships with private equity and hedge funds?

The key considerations in implementing the Volcker Rule restriction on the ability of banking entities to invest in private equity funds should be as set forth in the introduction above, namely, complying with the letter and intent of the Volcker Rule while not unduly impairing banking entities and the U.S. economy. The PEGCC believes

that this approach generally should result in the restrictions of the Volcker Rule being interpreted and construed narrowly. For example, the PEGCC believes that the following activities were not meant to be prohibited by the Volcker Rule, and suggests that the FSOC recommend such treatment to the Regulatory Agencies:

(1) Fiduciary Funds. Under the Volcker Rule, banking entities are allowed to sponsor private equity funds, subject to certain restrictions, pursuant to Section 619(d)(1)(G) (a "Fiduciary Fund"). The Volcker Rule imposes no restrictions on the types of assets that a Fiduciary Fund may acquire. The PEGCC is concerned that the definition of "banking entity" could be inappropriately construed so as to prohibit Fiduciary Funds from investing in private equity funds that are controlled and/or managed by private equity firms (such as the PEGCC's members) that are not affiliated with the banking entity sponsoring the Fiduciary Fund ("Third-Party Funds").[2]

Section 619(h)(1) defines "banking entity" as "any insured depository institution…and any affiliate or subsidiary of any such entity."[3] A Fiduciary Fund is likely to be a subsidiary of the sponsoring bank[4] such that, as a technical matter, each Fiduciary Fund could be deemed to be a "banking entity," and thereby be prohibited from investing in Third-Party Funds. Such a prohibition would contradict the clear intent of Section 619(d)(1)(G), would not advance the goals of the Volcker Rule and would serve only to limit the access of bank clients to the economic benefits of being associated with leading Third Party Funds.

Congress did not limit the asset classes in which a Fiduciary Fund may invest under the Volcker Rule, and an overly technical reading of the "banking entity" definition

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[2] We note that some banks have units that form, administer and/or control feeder vehicles to facilitate investment by the bank's high net worth private banking or other clients in Third Party Funds. These feeder vehicles reduce the administrative burden on investors and enable banks to provide their clients with access to leading Third Party Funds.

[3] The full definition is: "The term 'banking entity' means any insured depository institution (as defined in Section 3 of the Federal Deposit Insurance Act (12 U.S.C. 1813)), any company that controls an insured depository institution, or 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 such entity." Section 619(h)(1).

[4] The BHC Act defines "subsidiary" as, with respect to a specified bank holding company, "(1) any company 25 per centum or more of whose voting shares (excluding shares owned by the United States or by any company wholly owned by the United States) is directly or indirectly owned or controlled by such bank holding company, or is held by it with power to vote; (2) any company the election of a majority of whose directors is controlled in any manner by such bank holding company; or (3) any company with respect to the management or policies of which such bank holding company has the power, directly or indirectly, to exercise a controlling influence, as determined by the Board, after notice and opportunity for hearing."

should not impose such a limit. The PEGCC respectfully requests that the FSOC recommend that the Regulatory Agencies permit Fiduciary Funds to invest in any asset classes, including Third-Party Funds.

(2) Bank-Affiliated Pension Plans. Many banking enterprises organize, sponsor and maintain tax-qualified pension plans for their own employees ("Bank Pension Plans"). These plans are subject to the Employee Retirement Income Security Act of 1974 ("ERISA"), which sets forth a statutory framework to ensure that a pension plan's assets are invested for the exclusive benefit of its participants and beneficiaries.[5] Because Bank Pension Plans may be deemed to be controlled by or affiliated with insured depository institutions, there is a risk that they would be deemed to be "banking entities" for Volcker Rule purposes. Similarly, under Section 2(g)(2) of the BHC Act, shares held or controlled, directly or indirectly, by pension plan trustees for the benefit of the employees of a company may be deemed to be controlled by the company. As a result, even if a Bank Pension Plan were not deemed to be a "banking entity," investments made by the Bank Pension Plan could be attributed to the affiliated bank, which would limit the investments the Bank Pension Plan could make to those which the affiliated bank itself is able to make.

Either of these technical readings would apply a drastic and unintended blanket prohibition on Bank Pension Plans investing in Third-Party Funds, which would unduly deny Bank Pension Plans the diversification and return potential afforded by such investments. Moreover, additional restraints on fiduciaries to Bank Pension Plans are not necessary due to ERISA's carefully delineated legislative framework. Given the restrictions already imposed by ERISA, fiduciaries of Bank Pension Funds would be better served if they had the same array of investment options as other prudent investment professionals managing pension monies. Finally, the investments of Bank Pension Plans do not create any of the conflicts of interest that the Volcker Rule seeks to eliminate. For all these reasons, the PEGCC therefore respectfully requests that the FSOC recommend that the Regulatory Agencies clarify that the Volcker Rule does not prohibit a Bank Pension Plan from investing in Third-Party Funds.

(3) Insurance Company General Accounts. Insurance companies investing their general accounts regularly invest a portion of their general accounts in private equity

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[5] ERISA imposes on plan fiduciaries duties that are commonly understood to be "the highest known to the law" including: (*1*) the "prudent man" standard, which requires that a fiduciary invest plan assets under the same standard as a prudent investment professional managing retirement monies; (*2*) the requirement to diversify so as to minimize the risk of large losses (unless under the circumstances it is clearly prudent not to do so); and (*3*) the exclusive benefit rule, which requires that a fiduciary act solely in the interest of the participants and beneficiaries. ERISA also prohibits a fiduciary from dealing with the assets of a plan for its own benefit. Under this statutory framework, while in general a pension plan may invest in private equity funds, such investments are not permitted when they are made to further the business objectives of the sponsor bank or its clients.

funds. Private equity investments are particularly valuable for insurance companies in that they have a low historical correlation to the stocks and bonds that comprise the bulk of insurance companies' investment portfolios and the relatively long-term horizon of private equity funds represent a good portfolio fit for long-dated liability products.

All insurance company investments are subject to extensive state insurance laws, which impose both qualitative and quantitative limits on insurance companies. In light of this stringent state framework, throughout the Dodd-Frank Act, Congress often declined to impose new federal laws on insurance companies (including those that are "banking entities" under the Volcker Rule). Recognizing the importance of giving flexibility to insurance companies to invest their general accounts, Congress included Section 619(d)(1)(F), which allows a regulated insurance company investing the general account of the insurance company to acquire "any security" as described in Section 619(h)(4).

The PEGCC respectfully requests that the FSOC recommend that the Regulatory Agencies clarify that interests in private equity funds are a "security" covered by Section 619(h)(4), to eliminate any confusion that might exist due to the fact that Section 619(h)(4) is titled "Proprietary Trading." Such clarification would ensure that the state laws to which insurance companies are subject are respected and that insurance companies have the flexibility to invest in alternative assets intended by Section 619(d)(1)(F).

(4) Insurance Company Separate Accounts. A separate account is a traditional product established on the books of an insurance company, whereby funds received by the insurance company from a customer under an insurance contract are invested in securities that are earmarked for such customer. Any gains or losses attributable to the securities are for the account of such customer. The customer does not own the underlying assets, but instead owns an insurance contract under which the insurance company's payment obligations are determined based on the investment performance of the underlying assets. Separate accounts are used to support a broad range of insurance products.

This type of intermediary activity is clearly not meant to be prohibited by the Volcker Rule. Congress included Section 619(d)(1)(D), which permits the "purchase, sale, acquisition, or disposition of securities and other instruments described in subsection (h)(4) on behalf of customers." As stated above, ultimately the investments by insurance companies with respect to separate accounts are made on behalf of customers. The PEGCC respectfully requests that the FSOC recommend that the Regulatory Agencies clarify that insurance company separate accounts are exempted from the Volcker Rule pursuant to Section 619(d)(1)(D).

10. How should the international context be considered when implementing the Volcker Rule? Are there any factors or considerations that should be taken into account regarding the application of the Volcker Rule to banking

entities or nonbank financial companies that operate outside the United States? What issues does implementation of the Volcker Rule present with respect to the following:

(i) Domestic banking entities that have access to foreign exchanges,

(ii) foreign affiliates of domestic banking entities, and

(iii) foreign non-bank financial companies

A foreign banking entity that has a U.S. banking presence is subject to restrictions under the Volcker Rule, but Section 619(d)(1)(I) allows such a foreign banking entity to acquire or retain an interest in a private equity fund "solely outside of the United States," provided that no ownership interest in such private equity fund is offered for sale or sold to a U.S. resident *and* that such foreign banking entity is not controlled by a U.S. banking entity (such foreign banking entity, a "Non-U.S. Banking Entity"). The PEGCC understands that this exemption permits a Non-U.S. Banking Entity to invest in any private equity fund that is formed under the laws of a country other than the United States so long as no interest in such private equity fund is offered for sale or sold to a U.S. resident (a "Non-U.S. Private Equity Fund"). The PEGCC respectfully requests that the FSOC recommend that the Regulatory Agencies clarify that a Non-U.S. Banking Entity may invest in a Non-U.S. Private Equity Fund even if such Non-U.S. Private Equity Fund (*1*) is advised, managed and/or controlled, directly or indirectly, by a U.S.-based investment manager and/or (*2*) invests in assets in the United States.

11. What timing issues are raised in connection with the divestiture of illiquid assets affected by the prohibitions of the Volcker Rule, and how might such issues be appropriately addressed?

Private equity funds generally invest in highly illiquid assets—typically unlisted securities of operating companies. Unlike investors in hedge funds, investors in private equity funds do not have redemption or withdrawal rights. There is no active secondary market for interests in private equity funds. Transfers of private equity fund interests are subject to GP approval and tend to be highly negotiated. Adding to the difficulty of selling a private equity fund interest is the fact that many of the likely purchasers are now covered by the Volcker Rule. Most private equity funds have terms of ten years, with potential extensions of one to three years with the consent of at least a majority in interest (by amount of capital commitments) of investors or the consent of an investor advisory committee. For private equity funds that had an initial closing in early 2010, investors' capital generally will be locked-up until 2021–2023.

Banks represent approximately 5% of investors in U.S. private equity funds and investments by banks represent approximately 9% of the capital invested in U.S. private

equity funds.[6] Given the size of investments in private equity by banking entities, it could threaten the safety and soundness of banking entities and create significant market disruption if banking entities are required to sell their interests in private equity funds prior to the end of the terms of the private equity funds in which they are now invested. In recognition of this threat, Section 619(c)(3) allows the Federal Reserve Board to extend the transition period for a banking entity by up to five years with respect to its interests in "illiquid funds." Given that many funds formed in early 2010 will not terminate until 2022 or 2023, the PEGCC respectfully requests that the FSOC recommend that the Federal Reserve Board clarify that any extended transition for illiquid funds granted under Section 619(c)(3) shall be in addition to any extension of the conformance period under Section 619(c)(2), which would allow the Federal Reserve Board the flexibility to grant extensions until the end of the term of most private equity funds that were formed before the Dodd-Frank Act was passed.

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The PEGCC appreciates the FSOC's consideration of our views, and is ready and available to respond to any questions that the FSOC may have concerning this letter or that otherwise may develop concerning the private equity industry.

Respectfully submitted,

Douglas Lowenstein
President
Private Equity Growth Capital Council

cc: Mr. Alastair Fitzpayne
Deputy Chief of Staff and Executive Secretary
United States Department of the Treasury

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[6] Source: Preqin press release, *Effects of Obama's Proposal on Alternatives Industry Significant* (January 22, 2010).