ARNOLD & PORTER LLP

David F. Freeman, Jr.
David.Freeman@aporter.com

202.942.5745
202.942.5999 Fax

555 Twelfth Street, NW
Washington, DC 20004-1206

January 31, 2014

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
400 7th Street, S.W., Suite 3E-218
Mail Stop 9W-11
Washington, DC 20219
Docket No. OCC–2013–0016

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, DC 20429
RIN 3064-AE04

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551
Docket No. R-1466

Re: Liquidity Coverage Ratio: Liquidity Risk Measurement, Standards, and Monitoring. FDIC RIN 3064-AE04. OCC Docket ID OCC-2013-0016. Federal Reserve Docket No. R-3064-AE04

Ladies and Gentlemen:

I am writing on behalf of a client bank to provide comments on the above-referenced joint proposed liquidity coverage ratio ("LCR") rule ("Proposed LCR Rule") published by the Office of the Comptroller of the Currency, the Board of Governors of the Federal Reserve System, and the Federal Deposit Insurance Corporation (collectively, "the Agencies") in the Federal Register on November 29, 2013.[1]

We appreciate the opportunity to comment on the Proposed LCR Rule. Our comments will focus on the following topics:

[1] *Liquidity Coverage Ratio: Liquidity Risk Management, Standards, and Monitoring*, 78 Fed. Reg. 71818 (Nov. 29, 2013). The Proposed LCR Rule, when adopted, will be codified at 12 C.F.R. §§ 50, 249 and 329.

(i) the outflow rates applicable to deposits of non-regulated funds, in particular the definition of the terms "private equity" and "hedge" funds that are not defined in the Proposed LCR Rule, the outflow rates for private equity, venture capital, real estate and other closed-end funds that do not issue shares that are redeemable at the option of the holder in the normal course, the treatment of operating accounts of private funds, the treatment of deposits of non-financial portfolio companies owned by private funds, and good faith reliance by a bank on available information and estimates on the filing status of a private fund under Form PF (which is not publicly available information);

(ii) the treatment of unused borrowing capacity under Federal Home Loan Bank ("FHLB") lines of credit;

(iii) the treatment of investment-grade municipal bonds as a high-quality liquid asset ("HQLA");

(iv) the outflow rates for the insured portions of deposits with total amounts in excess of FDIC deposit insurance limits;

(v) the outflow rates for sweep deposits in excess of FDIC deposit insurance limits that originate with an affiliate of the bank;

(vi) the treatment of HQLAs under the leverage capital rules;

(vii) requesting a longer phase-in period for the final rule; and

(viii) a request for clarification of certain points in the final rule, including the mechanics of reporting LCR to regulators, the triggering event for being subject to LCR reporting, the status of time deposits that are not subject to early withdrawal, and the treatment of non-brokered deposits held by a custodian, fiduciary or nominee for the benefit of others.

Our comments address the modified LCR requirement proposed for smaller banking firms.

I. Outflow Rates Applicable to Deposits of a "Non-Regulated Fund"

The Proposed LCR Rule would treat deposits of "non-regulated funds" as subject to 100% outflow rates (or 70% under the modified version proposed for smaller banking firms), citing the "interconnectedness of financial institutions."[2] The Financial Stability Oversight Council ("FSOC") and other agencies have enunciated broad theories of interconnectedness among financial institutions[3] that, even if accepted as valid, would not appear to suggest any meaningful interconnectedness between certain categories of private investment funds or their subsidiaries as depositors on the one hand, and banks and the greater financial system, on the other. These private funds, which would fall within the definition of a "non-regulated fund" in the Proposed LCR Rule, do not operate in a fashion by which their deposit relationships with banks could serve as a means of transmission of risk into the banking system. These include closed-end private funds generally, as well as non-financial portfolio companies owned by funds and real estate projects owned by real estate funds. We would request that the definition of a "non-regulated fund" be crafted more precisely to exclude those entities whose deposit relationships cannot transmit risk into the financial system.

The term "non-regulated fund" is defined in the Proposed LCR Rule to include "any hedge fund or private equity fund whose investment adviser is required to file Securities and Exchange Commission ("SEC") Form PF (Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors), and any consolidated subsidiary of such fund, other than a small business investment company as defined in section 102 of the Small Business Investment Act of 1958 (15 U.S.C. §§ 661 *et seq.*)."[4] The terms "hedge fund" and "private equity fund" are left undefined in the Proposed LCR Rule. SEC Form PF must be filed by SEC-registered investment advisers that have $150 million or more in "private funds" under management, in respect of those "private funds." SEC Form PF is not required to be filed by state-registered investment advisers, by banks or trust companies that manage private investment funds but are not SEC-registered, or by SEC-registered investment advisers that have less than $150 million in "private funds" under management. "Private funds"

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[2] The release accompanying the Proposed LCR Rule expresses concern that a "higher outflow rate is associated with the elevated refinancing or roll-over risk in a stressed situation and the interconnectedness of financial institutions." 78 Fed. Reg. at 71841.

[3] *See* Office of Financial Research, Asset Management and Financial Stability (Sept. 2013); Financial Stability Board, Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014); Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012). We note that these theories of interconnectedness diverge from those specified by Congress in Title I of the Dodd-Frank Act and have been subject to significant criticism. *See, e.g.*, comment letters on file with SEC on OFR Report, avail. at http://www.sec.gov/comments/am-1/am-1.shtml.

[4] 78 Fed. Reg. at 71858.

are defined for purposes of SEC Form ADV and Form PF to include investment funds that rely on Sections 3(c)(1) (privately-placed funds with fewer than 100 beneficial owners) or 3(c)(7) (privately placed funds beneficially owned exclusively by institutional and high-net worth "qualified purchasers") of the Investment Company Act for an exemption from that Act.

It is not clear from the Proposed LCR Rule how the Agencies plan to interpret the terms "hedge fund" and "private equity fund." It is possible that the Agencies will look by analogy to the Volcker Rule (12 U.S.C. § 1851(h)(2)), which defines those terms to include any issuer that relies on Sections 3(c)(1) or 3(c)(7) for an exemption from the Investment Company Act. It is also possible that the Agencies will look to the instructions to SEC Form ADV and Form PF, which more narrowly define "hedge fund" and "private equity fund" in such a way as to exclude real estate funds, venture capital funds and various other categories of private funds that rely on Sections 3(c)(1) or 3(c)(7).[5]

We respectfully suggest that the Proposed LCR Rule be revised to remove this ambiguity and to focus the higher outflow treatment exclusively on the types of "non-regulated funds" that are most likely to withdraw deposits in a period of stress. In particular, we suggest that closed-end funds that do not issue redeemable securities, which would include most private equity funds, venture capital funds,[6] real estate funds, and a variety of other funds, be excluded from the definition of "non-regulated funds" and more broadly from the "financial sector entity" categorization.

The definition of a "non-regulated fund" should also exclude portfolio companies that are consolidated subsidiaries of private funds. Moreover, the final rule should permit a bank to rely, in good faith, on publicly available information in determining whether a fund is a "non-regulated fund."

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[5] SEC Form PF, Glossary of Terms; SEC Form ADV, Instructions to part 1A. The private fund categories defined in the SEC Forms are hedge funds (including commodity pools), liquidity funds, private equity funds, real estate funds, securitized asset funds, venture capital funds, and "other" private funds.

[6] Some advisers to venture capital funds operate within the "venture capital" exemption from registration as an investment adviser (Investment Advisers Act § 203(l) & 17 C.F.R. § 275.203(l)-1, which has no maximum size limit), and thereby also are exempt from filing Form PF, although they may be required to file parts of Form ADV as "exempt reporting advisers." Other advisers to venture capital funds are registered with the SEC as investment advisers and are subject to filing Form PF.

It is important to define a "non-regulated fund" appropriately to correlate higher presumed outflow rates in the final LCR rule to those types of private funds that, due to their nature, may need to raise significant amounts of cash in short order during a crisis to pay redemptions or meet similar liquidity needs. The Proposed LCR Rule would apply the same outflow rates to the deposits of a "non-regulated fund" as are applicable to financial sector firms, such as banks and broker-dealer firms that are interconnected through the banking system and that are subject to short-term funding risks that can cause them to withdraw deposits and other short-term funding from banks in a crisis. Such outflow rates are much higher than those applicable to non-financial companies. Closed-end funds, real estate funds and non-financial portfolio companies of private equity funds do not present the "run risk" and consequent liquidity issues (and risk transmission issues) that the banking regulators have associated with banks, brokerage firms, insurance companies, and open-end funds. We therefore respectfully request that the Agencies revise this definition as outlined below.

A. Exclude Closed-end Private Funds from Non-Regulated Funds Treatment

We suggest that the definition of "non-regulated fund" exclude any fund that does not issue redeemable securities that provide investors with redemption rights in the ordinary course.[7] Closed-end funds should be excluded from this treatment without regard to which exemption from the registration requirements of the Investment Company Act such a fund relies on or whether the investment adviser to the fund is required to file SEC Form PF.

The purpose of the higher liquidity requirements for deposits of investment companies and non-regulated funds under the Proposed LCR Rule is to cause banks to hold greater liquidity and have cash available to pay out withdrawals of deposits by funds in the event of a financial crisis, thereby preventing an investor "run" on an investment fund from being transmitted to a liquidity crisis at banks with which the fund provides deposits and other short-term funding.[8]

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[7] SEC Forms PF and ADV, together with 17 C.F.R. § 275.203(l), define venture capital funds, real estate funds and private equity funds as funds that do not issue shares generally redeemable at the option of a holder. Although not specified by the Forms, securities issued by securitization funds also generally are not redeemable at the option of a holder.

[8] *See* Office of Financial Research, Asset Management and Financial Stability, at 9-13, 23 (Sept. 2013); Financial Stability Board, Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions at 29 (Jan. 8, 2014); Financial Stability

Closed-end private funds do not issue redeemable securities and are not subject to investor "runs," or the resulting need to liquidate assets to pay redeeming fund shareholders. Common examples of funds that do not issue securities that are redeemable by investors in the ordinary course include private equity funds, venture capital funds and real estate funds. For these types of funds, profits are distributed and investment capital is slowly returned by the fund to investors over time, as portfolio assets are sold and the fund is slowly liquidated. No investor has the right to redeem shares in advance of liquidation. Such funds should not be considered, or subject to the punitive outflow rates associated with, "financial sector entities." Hedge funds, in contrast, typically issue securities to investors that can be redeemed by the investor on a quarterly or annual basis, subject to an advance notice requirement and a potential for a hold-back by the fund of some of the proceeds of the redemptions.

Because they have no need to suddenly liquidate portfolio assets to pay shareholders, closed-end funds cannot be a means of transmission of financial instability caused by shareholder runs to banks and others to which they provide funding. Deposits of closed-end funds are no less stable than those of other businesses. Accordingly, we respectfully suggest that closed-end funds that do not issue securities that are redeemable by investors in the ordinary course, should not be subject to higher presumed rates of withdrawal reserved for "financial sector entities" under the final LCR rule.

B. Exclude Real Estate Funds from "Non-Regulated Funds" Treatment

We suggest that the definition of "non-regulated fund" also exclude any fund that invests primarily in real estate and real estate-related assets, regardless of which exemption from the registration requirements of the Investment Company Act such a fund relies on or whether the investment adviser to the fund is required to file SEC Form PF.

Due to the illiquid nature of their portfolio assets, real estate funds typically do not issue redeemable securities,[9] and therefore are not generally subject to the type of investor "runs" that would cause the fund to redeem its deposits from a bank during a financial crisis. Instead, like other non-financial issuers, the deposit withdrawal patterns

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Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455, 69460 (Nov. 19, 2012).

[9] *See* SEC, Instructions to Form ADV Part 1A at page 11 (definition of "real estate fund" requires that it not provide investors with redemption rights in the ordinary course).

of real estate funds typically are driven by the operating cash needs of the fund and its properties. Cash tends to come in from the sale of a real estate property or when new investors are brought into the fund, and cash goes out when new properties are purchased or developed, existing properties are built out or renovated, loans are paid off, or distributions are made to shareholders. At the operating partnership level, cash comes in from rent or other revenues and goes out to pay the operating costs of the property.

It is especially difficult to know whether a real estate fund is subject to a Form PF filing requirement. As the Agencies have noted, many real estate funds are excluded from the definition of an "investment company" in Section 3(a) of the Investment Company Act because they invest primarily in physical real estate. Depending on a complex analysis of the structure of investments, funds that invest in real estate through majority-owned subsidiaries may or may not be excluded from the definition of an "investment company" in Section 3(a).[10] Other real estate funds may be exempt under Section 3(c)(5)(C) if they invest primarily in mortgages and other real-estate related assets.[11] It is difficult for real estate fund managers to be certain that their real estate fund is excluded from the definition of "investment company" or exempted by Section 3(c)(5)(C) and thus many real estate funds that likely are excluded nonetheless rely upon Sections 3(c)(1) or 3(c)(7) as a "back up" exemption in case the SEC or a court were to determine, based upon their facts, that the real estate funds are within the definition of an "investment company" in Section 3(a) of the Investment Company Act and not excluded by Section 3(c)(5)(C) of that Act.

Moreover, the SEC permits investment managers of real estate funds to voluntarily treat the real estate fund as invested primarily in "securities" even though real estate is not a "security" and thereby reach the $100 million AUM threshold required to qualify for federal registration as an investment adviser.[12] A real estate manager may

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[10] Two-Tiered Real Estate Partnerships, SEC ICA Rel. No. 8456 (Aug. 9, 1974). Some real estate funds seek an exemptive order from the SEC pursuant to Section 6(c) of the Investment Company to resolve the ambiguity, *see e.g., WNC Tax Credits 40, LLC et al.*, SEC ICA Rel. No. 29742 (Aug. 2, 2011), while others rely upon an analysis of the statute and guidance issued by the SEC to others.

[11] Capital Trust, Inc, SEC Staff Letter (avail. Feb. 3, 2009) (interpreting Section 3(c)(5)(C) exemption).

[12] *See* SEC, Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, 76 Fed. Reg. 39,646, 39,668 (July 6. 2011); 17 C.F.R. § 275.203(m)-1(d)(5) ("For purposes of this section, an investment adviser may treat as a private fund an issuer that qualifies for an exclusion from the definition of an 'investment company,' as defined in section 3 of the Investment Company Act of 1940 (15 U.S.C. § 80a–3), in addition to those provided by section 3(c)(1) or 3(c)(7) of that Act (15 U.S.C. § 80a–3(c)(1) or 15 U.S.C. § 80a–

choose to do so in order to avoid state investment adviser registration, or in order to attract investment from governmental entities and pension plans. Pension plan trustees commonly rely upon a safe harbor permitting prudent delegation to investment advisers and therefore often require fund managers -- including otherwise exempt real estate fund managers -- to be registered with the SEC as investment advisers as a condition to making the investment.

Thus, compared with other types of investment funds, real estate funds pose a special challenge in terms of determining from publicly-available documentation whether a real estate fund manager has filed a Form PF on a particular real estate fund. Requiring a bank to make such a determination would impose an undue burden, particularly in light of the low risk that the real estate fund will withdraw funds from the bank in a financial crisis.

Further, real estate funds serve as an important source of liquidity to real estate markets during a financial crisis by continuing to purchase and sell properties when other participants are withdrawing from the markets. They are an important source of funding for housing and economic growth through all economic cycles. Imposing an unfavorable treatment on banks that hold deposits of real estate funds creates an incentive for banks to shun such deposits and ultimately could lead to increased economic fragility during a crisis, rather than increased stability.

C. Exempt Deposits in Operating Accounts of Investment Funds and Reserve Accounts of Real Estate Funds from Higher Outflow Rates

An investment fund maintains operating accounts at banks for the ongoing operations of the fund as a business (which are distinct from "operational deposits" as defined in the Proposed LCR Rule required for a bank to provide operational services to the depositor). Such accounts are generally opened in the name of a general partner or management company for the investment fund. Inflows into the accounts are typically management fees and interest. Outflows from the accounts are fund-level business expenses, such as salaries, rent, utilities, and legal expenses. In the case of a real estate fund, separate operating accounts are set up at the property or project level to hold rent payments and other property-related cash inflows. Outflows from the property or project-level deposit accounts occur to pay for improvements, third-party property management fees, and property expenses not covered by tenants. Deposits in operating

3(c)(7)), provided that the investment adviser treats the issuer as a private fund under the Act (15 U.S.C. § 80b) and the rules thereunder for all purposes.").

accounts are stable and not subject to abnormal withdrawal in a stress scenario because the depositors need to keep funds in these accounts to meet ongoing business needs. Furthermore, such operating accounts are typically associated with a set of ancillary bank products and services, such as automatic transfers, online bill payment, account analysis, recurring wires and lockbox collection, which further ensure the stability of the deposits.

Additionally, a real estate fund also often will establish a reserve account to hold funds regularly set aside for capital expenditures associated with properties in its portfolio. Examples of such expenditures include building improvements and ongoing repairs. Deposits in the reserve account are stable because they are earmarked for business operations, much like deposits of non-financial businesses.

Deposits in operating accounts of investment funds and reserve accounts of real estate funds are not held to provide liquidity to redeeming investors. They are held to provide cash for the day-to-day operations of the fund and its projects and must be stable to meet intended business purposes. As a result, such deposits should be subject to the same outflow rates as deposits of non-financial sector entities.

D. Do Not Subject Deposits of Non-Financial Portfolio Companies that are Owned by Private Funds to the Higher Outflow Rates Applicable to Non-Regulated Funds

We suggest that a consolidated subsidiary of a "non-regulated fund" not be treated as a "non-regulated fund." Many portfolio companies of private equity funds operate outside the financial sector. They include manufacturers, retailers, and technology companies in which venture capital or private equity funds may be controlling investors, and real estate subsidiaries owned by a real estate fund that is the subject of a Form PF filing. Some of these subsidiaries may be consolidated subsidiaries, but the fact that they are controlled by private funds does not make them behave differently from other manufacturers, retailers, and technology companies, for example, in terms of their liquidity needs and their inclination to withdraw bank deposits in a financial crisis. Furthermore, the deposits of such portfolio companies generally serve the same purposes as deposits in operating accounts (described in Section I.C. above) and, as such, are stable.

Although the controlling fund may be a financial entity, the portfolio company is not. The deposits of a portfolio company controlled by a non-regulated fund should not be subject to the higher outflow rate assumptions applicable to a financial company.

E. Permit Good Faith Reliance on Information Regarding Absence of a Form PF Filing

The Proposed LCR Rule would require a bank to ascertain whether the investment adviser of a hedge fund or private equity fund client is required to file SEC Form PF in order to determine if such client is a "non-regulated fund" whose deposits are subject to higher outflow rates. That information is not, however, publicly available.

A bank may be able to make an educated guess as to whether a private fund is likely to be the subject of a Form PF filing, based upon whether the private fund's adviser is shown on the IARD system as registered with the SEC under the Advisers Act and the information contained in Schedule D to an investment adviser's Form ADV as reported on the IARD System. Because, however, the SEC does not make investment advisers' Form PF filings publicly available (nor does it make publicly available any information contained in or regarding those filings, including whether a private fund is covered by a Form PF filing), a bank would have no reliable means to verify whether in fact the adviser of a hedge fund or private equity fund is required to file SEC Form PF. Therefore, we would ask that the Agencies clarify that a bank may (i) rely in good faith on a private fund client's representation as to whether or not its investment adviser is required to file SEC Form PF in respect of that private fund, unless the bank knows that the representation is false, or (ii) make a good faith judgment based upon the information published in Schedule D to a private fund's investment adviser's Form ADV, regarding whether a particular private fund is likely to be the subject of a Form PF filing.

Moreover, the circumstances of a private fund may change during the course of a year without any public notice. For example, the adviser to a private fund may cross the threshold of $150 million in private funds under management and become subject to Form PF filing requirements during the course of a year, or may become subject to Advisers Act registration (or elect to become federally registered) based upon growth or a change in the types of its clients. A bank will not immediately know of the change in Form PF filing status, may not learn of the change for some time, and often may discern the change well after the fact only through periodic diligence on existing clients. Because a private fund that previously was not the subject of a Form PF filing may subsequently become subject to a Form PF filing, a bank should be permitted to rely in good faith upon the prior status of the private fund for a period of twelve months after there has been a change in the filing status of the private fund under Form PF.

II. Recognize Unused FHLB Borrowing Capacity, with Haircut, in the LCR Ratio

Unused FHLB borrowing capacity provides a reliable source of liquidity that a bank may access in a liquidity crunch. Since the FHLB System was established in 1932, it has served as a stable source of funds for residential mortgages, meeting the liquidity needs of member institutions during numerous economic downturns, including the savings and loan crisis of the 1980s and again throughout the recent financial crisis. Indeed, the FHLB System was a primary source of liquidity to banks during the recent financial crisis, providing over $1 trillion in funding to the U.S. banking system (which is more liquidity than was provided to U.S. banks by the Federal Reserve System during this period).[13]

Under the Proposed LCR Rule, a commitment from an FHLB, which has been as good as cash even in times of market crisis, would not count as liquidity. By contrast, a security issued or guaranteed by certain other government sponsored enterprises would be treated as a type of liquid asset. Unlike other GSEs, the FHLBs weathered the recent financial crisis well and were an important source of funding to banks during that period. The less favorable treatment accorded FHLB commitments in the Proposed LCR Rule would not accurately reflect the proven availability of liquidity to a bank.

To recognize the continued viability of the FHLB System and the access to liquidity it provides, we would respectfully request that the Agencies allow a bank to include at least 50% of the unused borrowing commitments from an FHLB in the HQLA amount. This would recognize that such commitments are at least as reliable as high-quality corporate bonds as a source of liquidity in a financial crisis, as they have been for over 80 years. Alternatively, and at a minimum, we would request that the Agencies allow a bank to increase its inflow amounts and thus decrease the denominator of the ratio by an amount equal to at least 50% of the unused borrowing commitments from an FHLB.

Importantly, the availability of FHLB lines serves as a proxy for the credit quality of the assets that are pledged by a member bank to support the lines, and is an indicator of the access that the bank has to stable funding to support its balance sheet in times of

[13] Federal Reserve Bank of New York, Staff Report No. 357 at pages 28-29 (Nov. 2008); The Federal Home Loan Bank System, The Basel III Liquidity Framework: The Unintended Consequences Impacting Members of the Federal Home Loan Bank System and the U.S. Financial System at Large (Dec. 9, 2011).

need. The collateral required to be pledged by a bank on its FHLB lines must meet stringent asset quality standards established by the FHLBs, and is subject to collateral valuation analysis, market-based collateral haircuts, and advance rates. If the Agencies do not recognize unused FHLB borrowing capacity as a source of liquidity, the Agencies would effectively suggest that banks that make good loans (and are thus able to provide the high-quality collateral that the FHLBs require) have the same liquidity as those that make bad loans. This would create perverse incentives, discouraging banks from focusing on asset quality, which is key to liquidity.

By requiring a bank to hold a large amount of low-yield assets to meet liquidity requirements, the Proposed LCR Rule would also increase the pressure for a bank to seek higher yield on its other assets, which could lead the bank to make riskier loans and purchase riskier assets. Essentially the Proposed LCR Rule as drafted, by imposing very substantial liquidity haircuts (in many cases 100%) on relatively liquid, high quality assets (such as high quality, real-estate secured loans that are readily pledgable or saleable) that are comparable to haircuts imposed on higher risk, illiquid (but higher yielding) portfolio assets, creates a strong economic incentive for banks to have a "bar-bell" shape to the liquidity and credit quality in their portfolios. This would result in bank portfolios having greater concentrations than currently seen both in very liquid assets with low yields that are accorded favorable treatment under the Proposed LCR Rule, and in illiquid, higher risk, higher yield assets that are not treated less favorably under the proposal than other more liquid, higher quality assets.

It is important that the final LCR rule mitigate this negative impact by rewarding high-quality assets beyond the narrow definition in the Proposed LCR Rule. A bank's FHLB borrowing capacity serves as a proxy for the quality of the bank's assets, particularly its loans, because such capacity depends on the quality of the assets that the bank is able to pledge as collateral. Thus, by recognizing unused borrowing capacity, even with a conservative haircut, in the calculation of the LCR, the Agencies would encourage banks to make good loans and maintain a portfolio of high-quality assets rather than taking additional credit risk in order to offset the cost of its lower-yielding liquidity portfolio.

Finally, we would respectfully note that the Basel III accord permits a nation, in implementing the liquidity requirements, to tailor them to circumstances and financial structures within the country. The FHLB System is a federal liquidity source that is unique to the United States and is precisely the type of arrangement that Basel III contemplates can be addressed in the way in which the global liquidity standards are implemented in the United States.

III. Include Investment Grade Municipal Securities in High-Quality Liquid Assets

Investment grade municipal securities are liquid and readily marketable. In fact, they are pledged at the Federal Reserve discount window with a 2% to 5% haircut. Other commenters have provided data demonstrating that:[14]

- Investment grade municipal securities experience less price volatility than investment grade corporate bonds, which are proposed to be Level 2B liquid assets.
- Trading volumes on municipal securities are comparable to trading volumes on corporate and GSE bonds. According to data from the Securities Industry and Financial Markets Association ("SIFMA"), the municipal market trades 0.31% of its total outstanding par every day, while the corporate bond market trades 0.20% per day and the GSE debt market trades 0.33% per day.
- There are deep, diverse, and well-developed secured funding markets for municipal securities. In addition, the Federal Reserve accepts all U.S. municipal bonds as collateral at a 2% to 5% haircut, depending on maturity. These are the same haircuts that the Federal Reserve applies to U.S. agency and GSE securities. By comparison, the Federal Reserve accepts U.S. AAA corporate bonds at a 3% to 6% haircut and all other investment grade corporate bonds at a 5% to 8% haircut.
- The municipal market has a deep and diverse composition of buyers, sellers, and dealers.

We would therefore respectfully request that a bank be allowed to include as HQLAs at least 50% of the market value of investment grade municipal bonds less the market value of any such bonds pledged with any counterparty other than the Federal Reserve.

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[14] *See* Letter from Citigroup Global Markets Inc. (Dec. 27, 2013).

IV. Apply Lower Outflow Rates to Insured Portions of All Deposits

The Proposed LCR Rule would apply the same higher outflow rates to both the insured and uninsured portions of a deposit with a total amount that exceeds the applicable FDIC insurance limit. The Agencies should apply the same lower outflow rates to the insured portion of such a deposit as they apply to a fully insured deposit. The insured portion of a large deposit is protected by FDIC insurance to the same extent as a smaller deposit not exceeding FDIC insurance limits. In a flight to safety triggered by a financial crisis, investors would seek out the safety of FDIC-insured deposits, as they did in the recent financial crisis. We believe that, by applying higher outflow rates to insured portions of large deposits, the Proposed Rule would be overstating liquidity requirements of covered banks..

V. Apply a Lower Outflow Rate to Brokered Sweep Deposits that are Not Entirely Insured and that Originate with a Covered Company or an Affiliate of a Covered Company

For brokered sweep deposits that are entirely covered by deposit insurance, the Proposed LCR Rule would apply a 10% outflow rate (7% for the modified LCR) to those originating with a covered company or an affiliate of a covered company, compared with a 25% outflow rate (17.5% for the modified LCR) to those not originating with a covered company or an affiliate of a covered company. However, for brokered sweep deposits that are not entirely covered by deposit insurance, the Proposed LCR Rule would apply the same 40% outflow rate (28% for the modified LCR) whether or not the deposits originate with a covered company or an affiliate of a covered company.

We also note that deposits swept within a bank are not "brokered deposits" and that the term "brokered sweep deposits" is defined in the Proposed LCR Rule to mean assets swept from a *different* financial institution to the bank. Intra-bank sweep deposits swept from accounts of customers of the bank or its subsidiaries should not be viewed as either brokered deposits or "brokered sweep deposits" under the final LCR rule, but instead simply as deposits of the bank. This is consistent with the concepts that (i) deposits for which the customer relationship is owned by the bank (or its operating subsidiaries) are less likely to be withdrawn in a crisis (regardless of the balance) as compared to sweep deposits where the relationship resides with a third party institution, and (ii) the customer relationships are part of the core franchise value of the bank, and, unlike third-party sweep deposits, have value as a continuing deposit funding source when sold to a purchaser bank in the event of a receivership of the bank.

The Agencies should apply no more than a 20% outflow rate (14% for the modified LCR) to brokered sweep deposits that are not entirely insured and that originate with a covered company or an affiliate of a covered company. The FDIC has found that sweep deposits originating with an affiliate are stable. In its 2011 Study on Core Deposits and Brokered Deposits, it concluded: "[S]weep deposits from affiliates . . . may not leave when a bank is under stress."[15]

VI. Exempt High-Quality Liquid Assets from Leverage Ratio Calculation

We request that the Agencies consider excluding the amount of HQLAs from the denominator in calculating a bank's leverage ratio. HQLAs, by design, are low in credit risk and market risk. Accordingly, banks should not be required to hold Tier 1 capital for HQLAs for leverage ratio purposes given that leverage is based on average assets rather than risk-weighted assets.

Including HQLAs in the denominator of the leverage ratio could undermine the quality of bank assets. Banks must pay for Tier 1 capital, but the yield they earn on HQLAs is low. As a result, banks would have an incentive to seek a high yield on the rest of its portfolio of assets, which would lead to higher risk. Further, lending to creditworthy businesses and consumers could suffer, because such loans would neither qualify as HQLAs nor yield high returns.

VII. Delay the Implementation of the Rule by 12 Months and Allow a Longer Transition Period

The Proposed LCR Rule would phase in the LCR requirement over a two-year period, beginning on January 1, 2015. Assuming that the Agencies will finalize the LCR rule in mid-2014, providing approximately just six months to implement at 80%, we would remind the Agencies that this rate may have a profound impact on the balance sheets of many banks and, in addition to requiring the purchase of significant instruments, may necessitate the raising of additional capital. Furthermore, rushed purchases of large amounts of eligible securities over such a short time frame may also cause disruptions in the markets for such securities. For example, excess demand and a tight deadline to complete purchases may drive down yields on eligible securities,

[15] Federal Deposit Insurance Corporation, Study on Core Deposits and Brokered Deposits, at 55 (July 8, 2011).

causing banks to have even lower yielding HQLA portfolios and unnecessarily impairing earnings over future periods.

We request that implementation of the final LCR rule begin no earlier than January 1, 2016, with a phase-in period of at least three years. We note that the Basel Committee's LCR requirement, with a four-year phase-in period, will not be fully implemented until January 1, 2019. The final LCR rule will represent the first time the Agencies have adopted a specific quantitative liquidity requirement. Banks will need to make operational changes to comply with the new requirement, and some will need to adjust their asset composition significantly. A later starting date for implementation and a longer phase-in period than proposed would help to avoid (a) distortions in the financial markets, which could occur if banks were to rush to sell certain assets and acquire others to achieve an asset composition that meets the LCR requirement, and (b) disruptions to banks' operations.

The Proposed LCR Rule is being proposed against the background of an improving U.S. economy and the unprecedented unwinding of the Federal Reserve's quantitative easing policies. Short-term funding markets are operating normally. This should allow the Agencies to adopt a final rule that ensures a smooth transition and maintains the competiveness of U.S. banks.

VIII. Requests for Clarification

A. What are the Mechanics for Reporting the LCR to the Regulators?

We would request that the Agencies clarify the mechanics for calculating the LCR and reporting it to the regulators. Would a bank with more than $50 billion but less than $250 billion in total assets be required to calculate the LCR daily, as banks with at least $250 in total assets would? Would a bank be required to report its LCR in its FR Y-9C or Call Report, or would a new regulatory report be required? What would be the reporting deadline?

B. When must a Company Start Meeting the LCR Requirement Under the Modified LCR Rule?

The Proposed LCR Rule would apply a modified LCR requirement to a "covered depository institution holding company domiciled in the United States that has total consolidated assets equal to $50 billion or more, based on the average of the Board-regulated institution's four most recent FR Y-9Cs." The Agencies should clarify when such a company is required to start meeting the LCR requirement. Is it the day on which the company files the fourth FR Y-9C that shows the company has total consolidated assets of at least $50 billion over the four most recent quarters, is it the first day of the quarter following the filing of such a FR Y-9C, or is it another date?

C. *Treatment of Time Deposits that are Not Subject to Early Withdrawal*

Bank time deposits come in two contractual varieties: those which a depositor can withdraw prior to the contractual maturity date (often subject to a penalty or loss of interest), and those which the depositor cannot withdraw absent death or a determination of incompetence. It appears that the Proposed LCR Rule would treat the former category for purposes of calculating outflow rates as being short-term deposits, regardless of the contractual maturity of such deposits, while it would deem the latter category to have maturities that corresponds to their contractual maturity dates. Please confirm this in the final LCR rule.

D. *Treatment of Deposits Held Through a Custodian Bank or Broker*

The Proposed LCR Rule leaves ambiguous the treatment of deposits that are held through a custodian, fiduciary or other nominee that do not constitute "brokered deposits." Examples include clients of an investment adviser that generally are required to be held in custody at a broker-dealer or bank if they do not constitute "brokered deposits."[16] The nominees are generally regulated financial services firms whose own deposits as principal are accorded unfavorable treatment under the Proposed LCR Rule. The unfavorable treatment accorded to deposits belonging to the intermediary as principal should not be accorded to deposits that it holds in a custodial, nominee, fiduciary, or agency capacity on behalf of depositors that would qualify for more favorable treatment were the deposits held directly.

Under the Federal Deposit Insurance Act ("FDI Act") and FDIC rules, deposits held through certain types of intermediaries are not treated as "brokered deposits."[17] These non-brokered deposits held through a conduit account are recognized by Congress

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[16] 17 C.F.R. § 275.206(4)-2. *See* FDIC Interp. Letter 05-02 (2005).

[17] *See* 12 U.S.C. § 1831f(g)(2); 12 C.F.R. § 337.6. These definitions are incorporated by reference into the Proposed LCR Rule, which weighs in favor of a similarly favorable treatment being accorded these deposits under the outflow rates in the final LCR rule.

and the FDIC as more stable than brokered deposits. Examples include deposits gathered or held through the bank (for example, the trust department of the bank or an operating subsidiary) and deposits held through another bank's trust department or other agent or nominee whose primary purpose is not the placement of deposits with insured banks. These non-brokered deposits should receive *more* favorable outflow treatment under the final LCR rule than is accorded brokered deposits, and in any event should not receive *worse* treatment.

To illustrate, consider the trust department of a bank or a non-depository trust company, which invests and holds in custody customer investment portfolios consisting primarily of securities. In connection with those securities positions, a certain amount of cash is in the account from dividends, sales of securities and new money awaiting investment. The trust department or trust company must place that customer cash from its custody and fiduciary accounts somewhere pending investment or distribution to the beneficial owners. The trust department or trust company will often place that cash on deposit at another bank through an omnibus deposit account in the name of the trust department for the benefit of its fiduciary customers. Under the FDI Act and FDIC rules, these omnibus deposits by the trust department or a trust company for its fiduciary and custody client accounts at another bank more often than not are excluded from the definition of "brokered deposits."[18] Yet because these omnibus deposits are excluded from the definition of "brokered deposits" by the FDI Act, and are held in the name of a regulated financial entity, the Proposed LCR Rule leaves undefined the outflow rate applicable to them and might be read to subject them to the 100% outflow rates (70% for the modified LCR) applicable to unsecured wholesale funding from a regulated financial entity depositor.

The FDIC's deposit insurance rules provide for a look-through of a custodian, fiduciary or nominee as nominal owner of a deposit to the ultimate owners of the deposit for purposes of determining the amount of deposit insurance coverage on a "pass-through" basis.[19] The inclusion into the Proposed LCR Rule of deposit insurance coverage as a determinant in assessing outflow rates counsels in favor of applying a similar concept to deposits held by a nominee as agent or fiduciary for an ultimate depositor.

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[18] *See* 12 U.S.C. §§ 1831(f)(g)(2)(C), (F), (G) & (I); 12 C.F.R. §§ 337.6(a)(2), (5)(ii)(C), (F), (G) & (I). If the trust department places those deposits in the commercial side of itself bank, the omnibus deposits are even more clearly excluded from the definition of "brokered deposits." 12 U.S.C. §§ 1831(f)(g)(2)(A); 12 C.F.R. §§ 337.6(a)(2), (5)(ii)(A).

[19] 12 C.F.R. § 330.5.

The Proposed LCR Rule implicitly applies a similar concept in looking through conduit holders of certain types of deposits to the ultimate depositors for purposes of classifying outflow rates on the deposits. Examples in the Proposed LCR Rule include the treatment of "brokered deposits" (and its subcategories -- brokered sweep deposits and brokered reciprocal deposits). Similarly, assets of most types of investment funds are required to be held in custody at a bank or broker-dealer pursuant to the securities laws,[20] and yet the Proposed LCR Rule differentiates in its treatment of deposits of different categories of investment funds in applying outflow rates. As with brokered deposits, the Proposed LCR Rule implicitly looks through the custodian bank or broker-dealer to the nature of the custodied funds or client accounts to classify the outflow rate based upon the ultimate depositor rather than the nature of the custodian bank or broker dealer. This suggests that the intent of the Proposed Rule is to look through the conduit to the ultimate depositor for purposes of categorizing the outflow rates on the deposit. Otherwise, there might be no occasion to apply the outflow rates designated for the funds of such ultimate depositors.

We believe such a look through is consistent with the purposes of the proposal, is consistent with the "pass through" deposit insurance treatment accorded depositors under FDIC rules, and reflects an appropriate means of reconciling the rule with the actual manner in which the chain of ownership of deposits is held.

The Proposed LCR Rule and the release accompanying the rule do not, however, contain a clear statement to that effect. We respectfully request that the final rule and accompanying release from the Agencies contain a clear statement to the effect that deposits that are held in custody through a conduit financial entity, such as a broker-dealer, bank or trust company, for the benefit of its customers, under an arrangement by which the depositors would be eligible for deposit insurance on a pass-through basis under FDIC rules, should be categorized for LCR Rule purposes based upon the nature of the ultimate owners of the deposits. We further request that a bank be permitted to rely on written representations and data from the conduit financial institution on the nature and balances held on behalf of the ultimate depositors in calculating its compliance with the final LCR Rule.

[20] Investment Company Act § 17; 17 C.F.R. §§ 270.17f-1 through 17f-7; 17 C.F.R. § 275.206(4)-2.

We appreciate the opportunity to comment on the Proposed LCR Rule. If you would like to discuss any of our comments, please call me at 202-942-5745.

Respectfully submitted,

David F. Freeman, Jr.