Arnold & Porter

David F. Freeman, Jr.
+1 202.942.5745 Direct
David.Freeman@arnoldporter.com

July 17, 2018

Legislative and Regulatory Activities Division
Office of the Comptroller of the Currency
250 E Street, S.W., Mail Stop 2-3
Washington, D.C. 20210

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

Christopher Kirkpatrick
Secretary of the Commission
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, N.W.
Washington, D.C. 20581

Robert E. Feldman
Executive Secretary
Attention: Comments/Legal ESS,
Federal Deposit Insurance Corporation
550 17th Street, N.W.
Washington, D.C. 20551

Brent J. Fields
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549-1090

Re: Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships with, Hedge Funds and Private Equity Funds OCC: 12 C.F.R. Part 44, Docket No. OCC-2018-0010, RIN: 1557-AE27; Federal Reserve: 12 C.F.R. Part 248, Docket No. R-1608, RIN: 7100-AF 06; FDIC: 12 C.F.R. Part 351, RIN 3064-AE67; SEC: 17 C.F.R. Part 255 Release No. BHCA-3, File No. S7-14-18 RIN: 3235-AM10; CFTC: 17 C.F.R. Part 75 RIN: 3038-AE72

Ladies and Gentlemen:

We appreciate the opportunity to submit a comment letter on behalf of our client, Federated Investors, Inc., and its subsidiaries ("Federated"),[1] in response to the request for

[1] Federated has over 45 years of experience in the business of managing pooled cash investment funds (including money market mutual funds, local government investment pools, and liquidity funds). Federated has served the cash management and investment needs of millions of individual and institutional investors of all sizes, including banking entities, insurance companies and securities firms. Federated is a

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public comments on the joint rulemaking of the Board of Governors of the Federal Reserve System, Federal Deposit Insurance Corporation, Office of the Comptroller of the Currency, Commodity Futures Trading Commission and U.S. Securities and Exchange Commission[2] (the "Agencies") to revise the rules that implement the "Volcker Rule" restrictions on proprietary trading by banking entities and certain relationships between banking entities and hedge funds and private equity funds (the "Volcker Implementing Rules"). The statutory Volcker Rule is codified as Section 13 of the Bank Holding Company Act ("BHC Act"), 12 U.S.C. § 1851, and the Volcker Implementing Rules are codified at 12 C.F.R. §§ 44, 248, 351 and 17 C.F.R. §§ 75, 255.

Our comments are addressed solely at the status of liquidity funds as "covered funds" under the Volcker Implementing Rules, and questions 160 through 171 of the Release, which ask whether the Volcker Implementing Rules should be revised to tailor the "covered funds" definition by using a characteristics-based exclusion. In particular, the Release asks "whether the covered fund definition should exclude funds that are not hedge funds or private equity funds, as defined in Form PF. This would exclude other types of funds from the covered fund definition (such as venture capital, real estate, securitized asset, liquidity, and all other private funds, as those terms are defined in Form PF)."[3]

In Federated's view, "liquidity funds" as defined in Form PF[4] should be excluded from the definition of "covered funds." For purposes of this letter and amendments to the Volcker Implementing Rules, we use this term to cover all liquidity funds whether

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"Section 3" liquidity funds reporting entity because it manages both MMFs and liquidity funds with combined assets in excess of $1 billion. Federated also manages money market assets through individually managed accounts for corporate and state government treasurers. Federated has participated actively in the money market as it has developed over the years.

[2] *Proposed Revisions to Prohibitions and Restrictions on Proprietary Trading and Certain Interests in and Relationships with, Hedge Funds and Private Equity Funds*, 83 Fed. Reg. 33432 (July 17, 2018) (the "Release").

[3] Release at 33545.

[4] Form PF (for "private fund") is filed with the SEC by private fund managers, including private liquidity funds, and includes data on assets under management and categories of fund holdings.

organized under U.S. or non-U.S. laws, regardless of whether they are privately offered in the United States, and also include offshore MMFs if they are not excluded as "foreign public funds" by the Volcker Implementing Rules.

Liquidity funds are different from other types of private funds because:

- Liquidity funds are "cash equivalents" for accounting purposes. Other private funds are not.

- Liquidity funds are simply an efficient means for prudent short term management of liquid assets. Liquidity funds' portfolios are limited to very short-term, highly liquid, investment quality, money market instruments. Other private funds' portfolios are not limited in this manner.

- Liquidity funds' portfolios generally are restricted to "national bank eligible" money market instruments. Most other private funds are not. Investments in liquidity funds were eligible investments for national banks prior to the adoption of the Volcker Implementing Rules. Most other types of private funds were not.

- Liquidity funds are eligible investments for SEC-registered money market mutual funds.[5] Other private funds are not.

- Liquidity funds do not make material use of leverage. Not true of most other types of private funds.

- Liquidity funds do not make material use of derivatives. Not true of most other types of private funds, except for venture funds.

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[5] *See* 17 C.F.R. § 270.12d1-1(b)(2); SEC, *Fund-of-Fund Investments; Final Rule*, 71 Fed. Reg. 36640, 36642-36643 (June 27, 2006) (permitting MMFs to invest in registered MMFs and in unregistered MMFs (*e.g.*, liquidity funds) under conditions set forth in Rule 12d1-1).

- Liquidity funds do not invest in equity securities, real estate or other assets that are illiquid or subject to significant risks of fluctuation in value or loss. Not true of most other types of private funds.

- Liquidity funds do not have the balance sheet or liquidity risks of hedge funds, private equity funds or most other types of private funds.

- Liquidity funds do not provide an opportunity for speculative gains. Not true of most other types of private funds.

- Liquidity funds seek to maintain a stable net asset value ("NAV") per unit. They do this by restricting their portfolio to very short term, high credit quality, very liquid, money market assets. Other private funds do not.

- Liquidity funds by definition have portfolios and capital structures, as well as readily measurable risk and return metrics, that are so different in character from other types of private funds as to preclude opportunities for evading the Volcker Rule by gaming the label to masquerade a different type of private fund as a liquidity fund.

What Are Liquidity Funds?

As defined by the SEC in Form PF, a "liquidity fund" is any "private fund" that seeks to generate income by investing in a portfolio of short-term obligations in order to maintain a stable NAV per unit and minimize principal volatility for investors.[6] Private funds, including liquidity funds, are exempt from the definition of "investment company" either under Section 3(c)(1) (for funds with no more than 100 beneficial owners) or 3(c)(7) (funds beneficially owned solely by persons that, at the time of acquisition, are "qualified purchasers") of the Investment Company Act of 1940, depending on their ownership structure. They are not required to register as investment companies under the Investment Company Act.

[6] SEC Form PF, Glossary of Terms, definition of "liquidity fund;" SEC, Form ADV, Instructions to Part 1A, Item 7B additional instruction (e)(2) definition of "liquidity fund."

The SEC recognizes liquidity funds as being functionally similar to MMFs.[7] They are functionally grouped together for Form PF reporting purposes.[8] When the SEC amended MMF Rule 2a-7 in 2014, it amended Form PF to impose enhanced reporting requirements for investment advisers to liquidity funds parallel to those applicable to registered MMFs.[9]

Liquidity funds seek to maintain a stable NAV, generally $1.00 per share, by operating in a manner consistent with the portfolio "risk limiting conditions" in the SEC's Rule 2a-7(d). In particular, most liquidity funds generally seek to:

- Maintain daily liquid assets of at least 10% and weekly liquid assets of at least 30% of portfolio assets (and may in practice set higher liquidity requirements based on the needs of the fund's investors);
- Maintain a weighted average maturity ("WAM") of 60 days or less;
- Maintain a weighted average life ("WAL") of 120 days or less;
- Limit investments to those determined to present minimal credit risks;
- Hold no more than 5% of illiquid portfolio assets; and
- Hold no more than 5% of their interests in a single issuer, other than U.S. government securities.

As a result of these restrictions, liquidity funds invest primarily in a diverse portfolio of high-quality, dollar-denominated, fixed-income assets that are issued by banks, corporations and the U.S. government, and that mature in 397 days or less.

Unlike money market funds, however, liquidity funds: (i) may use the amortized cost method to value portfolio assets without restricting beneficial owners of the shares to natural persons (as is required for MMFs under 2014 SEC amendments that went into effect in October

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[7] *See* 79 Fed. Reg. 47863-47864, 47867; SEC, *Fund of Fund Investments; Final Rule*, 71 Fed. Reg. 36640, 36643 (June 27, 2006).

[8] *See* SEC Form PF, Section 3 (Section 3 liquidity funds are funds with enhanced Form PF reporting requirements based on fund manager having at least $1 billion in MMF and liquidity fund assets under management).

[9] SEC, *Money Market Fund Reform; Amendments to Form PF: Final Rule*, 79 Fed. Reg. 47736 (Aug. 14, 2014).

2016); and (ii) are not required to reserve the right to impose a liquidity fee or to suspend redemptions temporarily in accordance with the 2014 SEC amendments.

In addition, private liquidity funds voluntarily follow the portfolio standards in Rule 2a-7(d), but are not required to do so. Liquidity funds follow this portfolio investment strategy to provide daily liquidity and maintain a stable net asset value per share even in stressed markets and economic conditions, and to provide investors an effective means to manage large cash balances. A 2015 Office of Financial Research ("OFR") staff analysis of Form PF data confirms that liquidity funds are invested in short-term, relatively low-risk portfolio assets. According to the OFR:

> "Liquidity funds' largest investments include . . .
>
> - U.S. Treasury securities (26 percent),
> - bank certificates of deposit (CDs) (16 percent),
> - unsecured commercial paper (15 percent), and
> - U.S. Treasury and agency security repos (14 percent).
>
> Approximately half of the assets in liquidity funds have maturities of 30 days or less (31 percent of assets have maturities of 7 days or less and an additional 16 percent have maturities between 8 and 30 days) while the other half have maturities of 31 to 397 days."[10]

The OFR staff found that "Treasuries or CDs represent 59 percent of assets managed by liquidity funds with maturities greater than 30 days, while 20 percent are commercial paper."[11] The OFR staff also found that "liquidity funds have relatively low leverage levels" and that "[d]erivative positions accounted for a negligible percentage of fund assets."[12]

An SEC Staff white paper published in 2017 found that "while most liquidity funds... did not formally commit themselves to rule 2a-7 risk limits ... the vast majority of them held

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[10] D. Johnson, *Private Fund Data Shed Light on Liquidity Funds*, U.S. Treasury Department Office of Financial Research Brief Series 15-05 at 3 (Jul. 9, 2015).

[11] *Id.* at 4.

[12] *Id.* at 5.

portfolios that were consistent with those limits.[13] The white paper also noted that private liquidity funds tended to hold more daily liquid assets than required by Rule 2a-7 and more than typically held by MMFs.[14]

The SEC in 2017 enhanced its reporting on aggregated Form PF data to provide more granular data on, among other things, portfolios and operations of "Section 3" private liquidity funds (those managed by investment advisers that manage a total of at least $1 billion in liquidity funds and MMFs) and required these liquidity funds to report detailed portfolio information in Section 3 of Form PF. Section 3 liquidity funds represented 98.9% of total liquidity fund assets as of September 30, 2017.[15] This SEC data provides insights into the average portfolio holdings, liquidity and maturity of these liquidity funds.

The most recent data (as of September 30, 2017) show "Section 3 liquidity funds" owning total portfolio assets of $279 billion and having "gross portfolio exposures" of $354 billion (there is "double counting" in Form PF Section 3 data due largely to repurchase agreements held in portfolio).[16] These portfolio totals consist of $79.7 billion in bank deposits (28.5% measured as a percentage of portfolio assets, 22.5% measured as a percentage of gross portfolio exposures), $62.1 billion in "other" investments a category defined in Form PF Section 3 to mean cash and cash equivalent items, including MMF shares and interests in other liquidity funds (22.3% of portfolio assets, 17.5% of gross portfolio exposures), $55.3 billion of U.S. Treasury securities (19.8% portfolio assets, 15.6% of gross portfolio exposures), $45.2 billion in commercial paper (16.2% of portfolio assets, 12.8% of gross portfolio exposures), $32.5 billion in repurchase agreements with U.S. government securities collateral (11.6% of portfolio assets, 9.2% of gross portfolio exposures), $48.8 billion in repurchase agreements with other collateral (17.5% of portfolio assets, 13.8% of gross portfolio exposures), $23.9 billion in asset-backed securities (8.6% of portfolio assets, 6.7% of gross portfolio exposures), $5.8 billion in other U.S.

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[13] Hiltgen, *Private Liquidity Funds: Characteristics and Risk Indicators* at 1 (Jan. 27, 2017 and modified Mar. 7, 2017), https://www.sec.gov/files/2017-03/Liquidity%20Fund%20Study.pdf.

[14] *Id.* at p 12.

[15] *See* SEC Division of Investment Management Risk and Examinations Office, *Private Fund Statistics, Third Calendar Quarter 2017* at 5 (Apr. 12, 2018); https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2017-q3.pdf

[16] *Id* at 5, 47.

government debt instruments (2.1% of portfolio assets, 1.6% of gross portfolio exposures), and $1.1 billion in municipal debt (0.4% of portfolio assets, 0.3% of gross portfolio exposures).[17]

The asset-weighted average WAM of the Section 3 liquidity funds was under 40 days, asset-weighted average WAL was approximately 70 days, weekly liquid assets were roughly 60% of assets and daily liquid assets were above 40% of total assets at September 30, 2017.[18] These Section 3 liquidity fund WAL, WAM and daily liquid asset averages are more conservative than required for MMFs by SEC Rule 2a-7.

As of year-end 2014, there were 69 liquidity funds with total net assets of $271 billion reported on SEC Form PF.[19] Those stood at $288 billion as of March 31, 2015,[20] and $282 billion as of September 30, 2017.[21] Any liquidity fund advised by a bank or by a non-SEC registered investment adviser not subject to reporting on Form PF is not included in these totals.

Liquidity Funds, Unlike other Private Funds, Do Not Use Meaningful Amounts of Leverage or Derivatives

The following charts from the SEC's Form PF statistics show use of leverage and derivatives by various categories of private funds.[22] Liquidity funds' balance sheets are very distinct from those of other types of private funds on these two charts.

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[17] *See* SEC Division of Investment Management Risk and Examinations Office, *Private Fund Statistics, Third Calendar Quarter 2017* at 47 (Apr. 12, 2018); Instructions to Form PF, Section 3.

[18] *Id.* at pp 43-45.

[19] SEC Division of Investment Management Risk and Examinations Office, *Private Fund Statistics, First Calendar Quarter 2015* at 4-5 (Dec. 30, 2015, https://www.sec.gov/divisions/investment/private-funds-statistics/private-funds-statistics-2015-q1-accessible.pdf.

[20] D. Johnson, *Private Fund Data Shed Light on Liquidity Funds*, U.S. Treasury Department Office of Financial Research Brief Series 15-05 (Jul. 9, 2015).

[21] SEC Division of Investment Management Risk and Examinations Office, *Private Fund Statistics, Third Calendar Quarter 2017* at 5 (Apr. 12, 2018).

[22] SEC Division of Investment Management Risk and Examinations Office, *Private Fund Statistics, Third Calendar Quarter 2017* Table 5 at p. 8, table 21 a p. 19 (Apr. 12, 2018).

Table 5: Aggregate Borrowings (Percent of Aggregate GAV)
As reported on Form PF, Questions 8, 12, and 43 (Third Month).

Fund Type	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3
Securitized Asset Fund	50.7	48.9	48.7	48.4	50.7	49.5	48.8	48.4
Qualifying Hedge Fund	38.1	39.1	38.2	39.9	39.7	41.0	42.0	41.6
Hedge Fund	35.6	36.8	36.3	38.1	37.3	38.4	39.2	39.5
Real Estate Fund	13.3	13.3	13.4	13.3	13.9	12.9	12.7	12.8
Private Equity Fund	4.8	4.8	4.9	4.9	5.1	5.0	5.0	5.0
Section 4 Private Equity Fund	3.4	3.4	3.4	3.4	4.0	4.0	4.0	4.1
Other Private Fund	2.3	2.2	2.2	2.1	2.8	2.7	2.7	2.7
Venture Capital Fund	0.4	0.4	0.4	0.4	0.4	0.4	0.5	0.5
Liquidity Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Section 3 Liquidity Fund	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Many categories of private funds make extensive use of leverage or derivatives. Derivatives can be used to hedge and mitigate portfolio downside risk, but can also be used by funds to greatly magnify risk and potential returns. Venture funds are low on both leverage and derivatives. But at liquidity funds, *neither* is used to *any* meaningful degree. Leverage increases volatility and both downside risk and potential upside returns on equity interests in funds because debtholders must be paid a set amount regardless of whether portfolio asset values go up or down.

Table 21: Aggregate Derivative Value (Percent of Aggregate NAV)
As reported on Form PF, Questions 9, 13, and 44 (Third Month).

Type	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3
Hedge Fund	244.7	269.7	272.7	269.1	263.3	284.1	280.0	302.3
Qualifying Hedge Fund	269.3	302.5	302.5	299.9	288.8	312.4	308.0	322.9
Other Private Fund	11.4	11.3	11.0	11.1	11.5	11.0	11.0	11.3
Private Equity Fund	2.9	2.8	2.8	2.8	1.8	1.8	1.8	1.8
Section 4 Private Equity Fund	3.1	3.1	3.1	3.1	2.3	2.3	2.3	2.3
Liquidity Fund	***	***	***	***	***	***	***	***
Section 3 Liquidity Fund	***	***	***	***	***	***	***	***
Real Estate Fund	6.7	6.6	6.6	6.6	4.8	4.8	4.7	4.8
Securitized Asset Fund	8.3	7.9	7.7	7.4	9.8	9.8	9.4	9.2
Venture Capital Fund	***	***	***	***	***	***	***	***
Total	123.2	134.9	135.8	135.0	127.4	138.6	138.8	152.4

Even a child could see from these charts that, to paraphrase the old ditty from Sesame Street, "one of these things is not like the others, one of these things just doesn't belong" in the Volcker Implementing Rules' definition of "covered funds."

Liquidity Funds Are Historically "National Bank Eligible" Investments

The instruments in which national banks may invest, including for liquidity management purposes, are limited by Federal statutory law, regulation, and interpretive guidance from the Office of the Comptroller of the Currency ("OCC"). Similarly, the Federal Deposit Insurance

Act and its implementing regulations generally restrict permissible investments for FDIC-insured state banks to instruments which would be permissible for a national bank.[23] The list of permissible investments for national banks includes loans, leases, cash, bank deposits, some securitizations, U.S. government securities, municipal securities, investment grade marketable debt instruments, repurchase agreements, bankers' acceptances, and bank-eligible money market funds, among other instruments.[24] OCC regulations permit national banks to purchase and sell for their own accounts investment company shares provided that (1) the underlying portfolio of the investment company consists exclusively of assets that the bank may purchase and sell for its own account (in other words, the underlying portfolio instruments are bank-eligible), and (2) the bank's holdings of the shares do not exceed permissible limits when aggregating the underlying portfolio securities held by the investment company with any direct holdings of the bank.[25]

Private liquidity funds can readily be operated to meet these investment requirements. Such "bank-eligible" private liquidity funds are managed to ensure that the portfolio only contains instruments in which banks are permitted to invest, in addition to observing the investment restrictions that would apply under Rule 2a-7. The portfolio of a bank-eligible private liquidity fund is made up of short-term U.S. Treasury securities, short-term U.S. Treasury and agency repurchase agreements, other repurchase agreements, bank demand deposit accounts, certificates of deposit, and similar instruments, unsecured and asset-backed commercial paper, short-term loans and loan participations, and cash and cash equivalents. Prior to the compliance date of the Volcker Implementing Rules, at September 30, 2014, banks and thrifts owned $19 billion in liquidity fund interests, representing 6.8% of total liquidity fund beneficial ownership.[26]

Section 203 of the Economic Growth Act,[27] enacted in May 2018, exempts banking organizations with less than $10 billion in aggregate assets from the Volcker Rule, including the

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[23] 12 U.S.C. § 1831a; 12 C.F.R. § 362. State bank investments further must be permissible under the laws of the chartering state.

[24] Section 24(Seventh) of the National Bank Act, 12 U.S.C. § 24(Seventh); 12 C.F.R. § 1; Office of the Comptroller of the Currency, *Activities Permissible for a National Bank, Cumulative* (April 2012).

[25] 12 C.F.R. §§ 1.3(h), 1.4(e).

[26] SEC Division of Investment Management Risk and Examinations Office, *Private Fund Statistics, First Calendar Quarter 2014* at 14 (Dec. 30, 2015).

[27] S.2155, 115th Cong., 2d Sess. (2018).

prohibition on ownership of covered funds. With the statutory amendment to the Volcker Rule, we anticipate community banking organizations will once again invest in liquidity funds. The potential amendments to the definition of "covered fund" in the Volcker Implementing Rules that are discussed in the Release could allow larger depository institutions and their affiliates to do so as well.

Liquidity Funds are "Cash Equivalents" for Accounting Purposes

Accounting standards define "cash equivalents" to mean short-term highly liquid assets that can be converted by the owner to known amounts of cash with insignificant risk of change in value.[28] They must be high credit quality and very liquid. SEC-registered MMFs,[29] as well as offshore (not SEC-registered) MMFs,[30] and exempt state government equivalents, known as "cash pools" or "local government investment pools",[31] are all specifically recognized by the relevant accounting bodies as "cash equivalents." The accounting standards do not include SEC registration under the Investment Company Act as a factor in the definition of "cash equivalents." Liquidity funds, which operate as functional equivalents of MMFs and with substantially similar portfolio requirements, risk parameters and liquidity, are "cash equivalents" as that term is defined for accounting purposes.[32]

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[28] *See* FASB, ASC 305-10-20; International Accounting Standard 7, Statement of Cash Flows ¶¶ 6, 7; Statement No. 9 of Governmental Accounting Standard Board, *Reporting Cash Flows of Proprietary and Nonexpendable Trust Funds and Governmental Entities That Use Proprietary Fund Accounting*, at pp 4-5 (Sept. 1989) ("GASB 9").

[29] SEC, *Money Market Fund Reform; Amendments to Form PF: Final Rule*, 79 Fed. Reg. 47736, 47785 (Aug. 24, 2014).

[30] IFRIC, Meeting Staff Paper, *IAS-7 Statement of Cash Flows - Determination of cash equivalents* (May 2009); Richard Norval, *Money Market Funds as Cash Equivalents* (2009) (article by IMFFA Treasurer summarizing IFRIC decision and IMMFA guidance on status of European money market fund as cash equivalents).

[31] GASB Implementation Guide No. 2015-1 at pp. 58-59 (June 2015).

[32] The instructions to Form PF in the last reporting boxes in section 2a question 26, section 2b question 30, and section 3 question 56, treat MMFs and liquidity funds as cash equivalents for portfolio reporting purposes. Questions 26 and 30 reference liquidity funds as "Investments in funds for cash management purposes (other than *money market funds*)" and group them together with MMFs and other money market instruments under the heading "cash and cash equivalents." Question 56 requires liquidity funds to report

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In contrast, hedge funds, private equity funds and the other categories of private funds listed in Form PF are *not* "cash equivalents" and have very different credit risk, volatility and liquidity characteristics than liquidity funds. The portfolios and capital structures of liquidity funds, as well as their risk and return metrics, are characteristics so distinctive and different from other private funds as to preclude opportunities for evasion of the Volcker Rule if liquidity funds were excluded from the definition of "covered funds."

Conclusion

The agencies have authority pursuant to Subsection (d)(1)(J) of the Volcker Rule to amend the Volcker Implementing Rules to exclude liquidity funds from the definition of "covered funds" or otherwise exempt banking entities' investments in liquidity funds from the covered funds ownership prohibition of the Volcker Rule.[33]

The term "covered fund" in the Volcker Implementing Rules should be revised to exclude "liquidity funds." The excluded category of "liquidity funds" should provide an exemption for all liquidity funds whether organized under U.S. or non-U.S. laws, regardless of whether they are privately offered in the United States, and also include any offshore MMFs that are not excluded as "foreign public funds" by the Volcker Implementing Rules. Liquidity funds provide an efficient, cost effective means for banking entities to manage short term cash positions, and do not present the balance sheet and liquidity risks of private equity and hedge funds or other types of "covered funds." They can readily be managed to operate as "bank eligible" investment funds, and many

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portfolio investments in other liquidity funds under the heading "Other instruments" together with investments in MMFs and other types of cash equivalents that are not specifically scheduled in that section of Form PF. That this reporting line item for "other instruments" is meant to mean *other cash equivalents* is clear in the formatting of question 56 to the original instructions to Form PF adopted by the SEC and CFTC in 2011. CFTC & SEC, *Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF; Final Rule,* 76 Fed. Reg. 71128, 71220 (Nov. 16, 2011). The 2014 amendments to question 56 in Form PF in 2014 do not appear to have changed the intended grouping of portfolio assets.

[33] 12 U.S.C. § 1851(d)(1)(J).

are. They were a common investment for banking entities prior to effective date of the Volcker Implementing Rules in 2015, and they are once again a permitted investment for banking organizations with under $10 billion in assets. There is no risk reduction objective furthered by prohibiting investment by larger banking organizations in liquidity funds.

Federated's responses to Release questions 160 through 171 are contained in the attached Appendix.

We appreciate the opportunity to submit this comment on the proposed amendments to the Volcker Implementing Rules and thank you for your consideration of these comments. If you have any questions or wish to discuss them further, please do not hesitate to contact me at (202) 942-5745.

Respectfully submitted,

David F. Freeman, Jr.

Appendix/Responses to Questions 160-171

Set forth below are a portion of the discussion and questions 160-171 from pages 33477-33479 of the Release, with the questions in bold and indented below and our responses follow each question.

v. Fund Characteristics

> **As the Agencies stated in the preamble to the 2013 final rule, an alternative to the 2013 final rule's approach of defining a covered fund would be to reference fund characteristics. In the preamble to the 2013 final rule, the Agencies stated that a characteristics-based definition could be less effective than the approach taken in the 2013 final rule as a means to prohibit banking entities, either directly or indirectly, from engaging in the covered fund activities limited or proscribed by section 13.**[169]
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> **The Agencies also stated that a characteristics-based approach could require more analysis by banking entities to apply those characteristics to every potential covered fund on a case-by-case basis and could create greater opportunity for evasion. Finally, the Agencies stated that although a characteristics-based approach could mitigate the costs associated with an investment company analysis, depending on the characteristics, such an approach could result in additional compliance costs in some cases to the extent banking entities would be required to implement policies and procedures to prevent issuers from having characteristics that would bring them within the covered fund definition.**
>
> **As the Agencies consider whether to further tailor the covered fund definition, the Agencies invite commenters' views and request comment on whether it may be appropriate to exclude from the definition of "covered fund" entities that lack certain characteristics commonly associated with being a hedge fund or a private equity fund:**

[169] *See* 79 FR at 5671.

> **Question 160. Should the Agencies exclude from the definition of "covered fund" entities that lack certain enumerated traits or factors of a hedge fund or private equity fund? If so, what traits or factors should be incorporated and why? For instance, the SEC's Form PF defines the terms "hedge fund" and "private equity fund," as described below.[170] Would it be appropriate to exclude from the definition of "covered fund" an entity that does not meet either of the Form PF definitions of "hedge fund" and "private equity fund"? If the Agencies were to take this approach, should we, for example, modify the 2013 final rule to provide that an issuer is excluded from the covered fund definition if that issuer is neither a "hedge fund" nor a "private equity fund," as defined in Form PF, or should the Agencies incorporate some or all of the substance of the definitions in Form PF into the 2013 final rule?**

Yes, the Agencies should exclude from the definition of "covered fund" one or more categories of private funds, specifically liquidity funds. Liquidity funds have very distinctive portfolio traits and factors that distinguish them not only from hedge funds and private equity funds, but also from all other types of private funds. We do not mean to discount the strong statutory and public policy arguments in favor of excluding credit securitizations and venture capital funds from the definition of "covered funds" in the Volcker Implementing Rules. But liquidity funds stand alone when measured by their distinctive portfolio and capital structure traits, risk and return characteristics and lack of shelter for label gaming and evasion efforts, as compared to private equity funds and hedge funds, as discussed in our attached comment letter and summarized at pages 3-4 of that letter.

> **Question 161. If the Agencies were to incorporate the substance of the definitions of hedge fund and private equity fund in Form PF, should the Agencies make any modifications to these definitions for purposes of the 2013 final rule? Also, Form PF is designed for reporting by funds advised by SEC-**

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[170] **See Form PF, Glossary of Terms. Form PF uses a characteristics-based approach to define different types of private funds. A "private fund" for purposes of Form PF is any issuer that would be an investment company, as defined in section 3 of the Investment Company Act, but for section 3(c)(1) or 3(c)(7) of that Act. Form PF defines the following types of private funds: hedge funds, private equity funds, liquidity funds, real estate funds, securitized asset funds, venture capital funds, and other private funds. See infra at note 167.**

> **registered advisers. Would any modifications be needed to have the characteristics-based exclusion apply to funds not advised by SEC-registered advisers, in particular foreign funds with non-U.S. advisers not registered with the SEC?**

We believe the definitions in Form PF are basically fine as they are. The "liquidity funds" definition used in the Volcker Implementing Rules exemption should, however, provide an exemption for all liquidity funds whether organized under U.S. or non-U.S. laws, regardless of whether they are privately offered in the United States, and should also expressly exempt from treatment as "covered funds" any offshore MMFs that are not otherwise exempted as "foreign public funds" by the Volcker Implementing Rules. However, Section C of the SEC's "Form PF Frequently Asked Questions" indicates that some "liquidity funds" also fit the definition of "hedge fund" and should be reported as "other" funds on Form PF. We doubt that many funds meet both definitions and note the wealth of data on liquidity funds that are reported as such in the semiannual SEC reports of Form PF data. To the extent that there is any real ambiguity, we suggest that liquidity funds meeting a portfolio characteristics-based definitional requirement be excluded from the amended Volcker Implementing Rule definition of "hedge fund."

We suggest banks and exempt advisers to private funds that wish to be eligible for investment by banking entities be required to report on Form PF as a condition to their facilitating investment by banking entities under an exemption from the Volcker Implementing Rule. The federal banking agencies could adopt a version of Form PF and direct banks to voluntarily report that data through the SEC's Form PF reporting facility if they want their liquidity fund to qualify for the Volker Rule covered funds exclusion. The SEC could do the same for exempt advisers whether domestic or overseas.

> **Question 162. Form PF defines "hedge fund" to mean any private fund (other than a securitized asset fund): (a) with respect to which one or more investment advisers (or related persons of investment advisers) may be paid a performance fee or allocation calculated by taking into account unrealized gains (other than a fee or allocation the calculation of which may take into account unrealized gains solely for the purpose of reducing such fee or allocation to reflect net unrealized losses); (b) that may borrow an amount in excess of one-half of its net asset value (including any committed capital) or may have gross notional exposure in excess of twice its net asset value**

> **(including any committed capital); or (c) that may sell securities or other assets short or enter into similar transactions (other than for the purpose of hedging currency exposure or managing duration). If the Agencies were to incorporate these provisions as part of a characteristics-based exclusion, should any of these provisions be modified? If so, how? Additionally, Form PF's definition of the term "hedge fund" provides that, solely for purposes of Form PF, any commodity pool is categorized as a hedge fund.**[171]
>
> **If the Agencies were to define the term "hedge fund" based on the definition in Form PF, should the term include only those commodity pools that come within the "hedge fund" definition without regard to this clause in the Form PF definition that treats every commodity pool as a hedge fund for purposes of Form PF? Why or why not?**

We suggest the CFTC further clarify its definition of "commodity pool" and the *de minimis* exemptions thereto by rulemaking. Currently there are a range of private funds that rely on no-action relief or other guidance or exemptions from coverage as "commodity pools" in a way that creates uncertainty for investor banking entities.

> **Question 163. By contrast, Form PF primarily defines "private equity fund" not by affirmative characteristics, but as any private fund that is not a hedge fund, liquidity fund, real estate fund, securitized asset fund or venture capital fund, as those terms are defined in Form PF,**[172] **and that does not provide investors with redemption rights in the ordinary course. If the Agencies were to provide a characteristics-based exclusion, should the**

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[171] **Form PF defines "commodity pool" by reference to the definition in section 1a(10) of the Commodity Exchange Act. See 7 U.S.C. 1a(10).**

[172] **Form PF defines (i) "liquidity fund" to mean any private fund that seeks to generate income by investing in a portfolio of short term obligations in order to maintain a stable net asset value per unit or minimize principal volatility for investors; (ii) "real estate fund" to mean any private fund that is not a hedge fund, that does not provide investors with redemption rights in the ordinary course and that invests primarily in real estate and real estate related assets; (iii) "securitized asset fund" to mean any private fund whose primary purpose is to issue asset backed securities and whose investors are primarily debt-holders; and (iv) "venture capital fund" to mean any private fund meeting the definition of venture capital fund in rule 203(l)-1 under the Investment Advisers Act of 1940.**

> **Agencies do so by incorporating the definitions of these other private funds? If so, should the Agencies modify such definitions, and if so, how? Alternatively, rather than referencing the definition of private equity fund in Form PF in a characteristics-based exclusion, the Agencies could design their own definition of a private equity fund based on traits and factors commonly associated with a private equity fund. For example, the Agencies understand that private equity funds commonly (i) have restricted or limited investor redemption rights; (ii) invest in public and non-public companies through privately negotiated transactions resulting in private ownership of the business; (iii) acquire the unregistered equity or equity-like securities of such companies that are illiquid as there is no public market and third party valuations are not readily available; (iv) require holding investments long-term; (v) have a limited duration of ten years or less; and (vi) realize returns on investments and distribute the proceeds to investors before the anticipated expiration of the fund's duration. Are there other traits or factors the Agencies should incorporate if the Agencies were to provide a characteristics-based exclusion? Should any of these traits or factors be omitted?**

The definition of "liquidity fund" is clear enough. Whether the agencies choose to use "private equity funds" as a catch-all term for all undifferentiated private funds that remain as "covered funds" or carefully define "private equity funds" in terms, "liquidity funds" would not be private equity funds under any reasonable definition of those terms. Whether by exclusion from the private equity fund through incorporation by reference of the definitions of the other types of private funds, or by listing the characteristic traits, structure and portfolio attributes of private equity funds, liquidity funds should be excluded from the definition of "private equity fund."

We believe, however, that it would be far simpler to separately define the characteristics of each category of excluded fund, than to attempt to define the characteristics of private funds that are not excluded.

> **Question 164. A venture capital fund, as defined in rule 203(l)-1 under the Advisers Act, is not a "private equity fund" or "hedge fund," as those terms are defined in Form PF. In the preamble to the 2013 final rule, the Agencies explained why they believed that the statutory language of section 13 did not**

> **support providing an exclusion for venture capital funds from the definition of "covered fund."**[173]
>
> **If the Agencies were to adopt a characteristics-based exclusion based on the definition of private equity fund in Form PF, should the Agencies specify that venture capital funds are private equity funds for purposes of this rule so that venture capital funds would not be excluded from the covered fund definition? Do commenters believe that this approach would be consistent with the statutory language of section 13?**

Congress gave the agencies authority to adopt the Volcker Implementing Rules in order to address the fine details. The agencies should exercise that authority to tailor the Volcker Rule in such a way as to achieve the risk-limiting purposes of the Volcker Rule while not imposing unnecessary inefficiencies on the financial system.

> **Question 165. The Agencies request that commenters advocating for a characteristics-based exclusion explain why particular characteristics are appropriate, what kinds of funds and what kinds of investment strategies or**

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[173] *See* **79 FR at 5704 ("The final rule does not provide an exclusion for venture capital funds. The Agencies believe that the statutory language of section 13 does not support providing an exclusion for venture capital funds from the definition of covered fund. Congress explicitly recognized and treated venture capital funds as a subset of private equity funds in various parts of the Dodd-Frank Act and accorded distinct treatment for venture capital fund advisers by exempting them from registration requirements under the Investment Advisers Act. This indicates that Congress knew how to distinguish venture capital funds from other types of private equity funds when it desired to do so. No such distinction appears in section 13 of the BHC Act. Because Congress chose to distinguish between private equity and venture capital in one part of the Dodd-Frank Act, but chose not to do so for purposes of section 13, the Agencies believe it is appropriate to follow this Congressional determination.") (footnotes omitted). Section 13 also provides an extended transition period for "illiquid funds," which section 13 defines, in part, as a hedge fund or private equity fund that, as of May 1, 2010, was principally invested in, or was invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments. Congress appears to have contemplated that covered funds would include funds principally invested in venture capital investments.**

portfolio holdings might be excluded by the commenters' suggested approach, and why that would be appropriate.

If a characteristics-based exclusion from the definition of "covered funds" is adopted, liquidity funds present the strongest case for exclusion, due to their distinctive portfolio restrictions and capital structure, which allow easy identification of what is a liquidity fund and what is not, so as to prevent evasion. The defining portfolio characteristics of liquidity funds -- specific, diversified portfolio of very high quality, short term debt instruments, and overall short duration and portfolio life -- limit balance sheet risk and liquidity risk, and preclude their use for speculative gain.

The definition of a "liquidity fund" could be incorporated by a Form PF cross-reference in an exclusion in the Volcker Implementing Rules, or a version of it could be drafted in long form into the Volcker Implementing Rules. Variations of the defining portfolio characteristics appear in SEC Investment Company Act Rule 2a-7, OCC Rule 9.18(b)(4)(iii), and in GASB Statement No. 79, *Certain External Pools and Pool Participants* (June 2015). They all speak to permitted assets, credit quality, portfolio duration (measured by weighted average life ("WAL") and weighted average maturity ("WAM")), and portfolio diversification. However, the excluded category of "liquidity funds" should provide an exemption for all liquidity funds whether organized under U.S. or non-U.S. laws, regardless of whether they are privately offered in the United States, and also provide an express exemption for any offshore MMFs that are not excluded as "foreign public funds" by the Volcker Implementing Rules.

Question 166. If the Agencies were to provide a characteristics-based exclusion, should it exclude only funds that have none of the enumerated characteristics? Alternatively, are there any circumstances where a fund should be able to rely on a characteristics-based exclusion if it had some, but not most, of the characteristics?

The definition of "liquidity fund" in Form PF is characteristics based, and should be an affirmative definition for those funds they have the defining characteristics of a liquidity fund, which then should be excluded from the definition of a "covered fund." A liquidity fund should possess *all* of the portfolio characteristics in the definition, not merely *some* of them.

Question 167. Would a characteristics-based exclusion present opportunities for evasion? Should the Agencies address any concerns about evasion through other means, such as the anti-evasion provisions in § __.21 of the 2013 final rule, rather than by including a broader range of funds in the covered fund definition?

As discussed above, due to the specific and distinctive portfolio restrictions and capital structure of liquidity funds, it is easy to identify what is a liquidity fund and what is not, so as to prevent evasion. There can be murky boundaries in some cases between what is a hedge fund, a private equity fund and a venture capital fund. Not so for liquidity funds.

Question 168. If the Agencies were to provide a characteristics-based exclusion, would any existing exclusions from the definition of "covered fund" be unnecessary? If so, which ones and why?

An exclusion for liquidity funds would not impact the other existing exclusions from the definition of "covered funds" other than in some narrow cases (*e.g.*, offshore liquidity funds in which foreign banks invest, insurance company banking entity-only separate account liquidity funds, and liquidity funds conformed to the loan securitization exemption) to create more than one available exemptions allowing a bank to invest.

Question 169. If the Agencies were to provide a characteristics-based exclusion, to what extent and how should the Agencies consider section 13's limitations both on proprietary trading and on covered fund activities? For example, section 13 limits a banking entity's ability to engage in proprietary trading, which section 13 defines as engaging as a principal for the trading account, and defines the term "trading account" generally as any account used for acquiring or taking positions in the securities and the instruments specified in the proprietary trading definition principally for the purpose of selling in the near term (or otherwise with the intent to resell in order to profit from short-term price movements).[174]

[174] *See* 12 U.S.C. 1851(h)(4) (defining "proprietary trading"); 12 U.S.C. 1851(h)(6) (defining "trading account").

> **This suggests that a fund engaged in selling financial instruments in the near term, or otherwise with the intent to resell in order to profit from short-term price movements, should be included in the covered fund definition in order to prevent a banking entity from evading the limitations in section 13 through investments in funds. The statute also, however, contemplates that the covered fund definition would include funds that make longer-term investments and specifically references private equity funds. For example, the statute provides for an extended conformance period for "illiquid funds," which section 13 defines, in part, as hedge funds or private equity funds that, as of May 1, 2010, were principally invested in, or were invested and contractually committed to principally invest in, illiquid assets, such as portfolio companies, real estate investments, and venture capital investments.[175] Trading strategies involving these and other types of illiquid assets generally do not involve selling financial instruments in the near term, or otherwise with the intent to resell in order to profit from short-term price movements.**

The short-term trading concept reflected in the Volcker Rule's prohibition on proprietary trading and the covered funds prohibition and restrictions, are different sets of concepts and should not be mixed. Private equity funds are illiquid buy-and-hold investments that invest in a long-term, illiquid portfolio of buy-and-hold assets. Transfer of both the interest in the fund and the portfolio assets are restricted under the securities laws and due to the absence of a trading market for them. In contrast, hedge funds tend to be active traders.

Interests in liquidity fund generally are restricted as to transfer. If you want your money back, you redeem your interests. And liquidity funds typically hold their portfolio assets to maturity (although the portfolio assets are very liquid and can be sold when appropriate). Due to the very short term nature of the portfolio assets, if not continually reinvested, liquidity fund portfolios would revert to cash in a matter of days or weeks.

Due to their nature as cash management vehicles, it would be appropriate to exclude purchases and redemptions or sales of interests in liquidity funds and MMFs from the

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[175] **12 U.S.C. 1851(c)(3).**

proprietary trading prohibitions based upon the liquidity management exemption in subsection __.3(d)(iii) of the Volcker Implementing Rules, and treat portfolio purchases and sales by any liquidity fund or MMF that is "controlled" by a banking entity as also within the "liquidity management" exemption.

> **Question 170. Should the Agencies therefore provide an exclusion from the covered fund definition for a fund that (i) is not engaged in selling financial instruments in the near term, or otherwise with the intent to resell in order to profit from short-term price movements; and (ii) does not invest, or principally invest, in illiquid assets, such as portfolio companies, real estate investments, and venture capital investments? Would this or a similar approach help to exclude from the covered fund definition issuers that do not engage in the investment activities contemplated by section 13? Would such an approach be sufficiently clear? Would it be clear when a fund is and is not engaged in selling financial instruments in the near term, or otherwise with the intent to resell in order to profit from short-term price movements? Would this approach result in funds being excluded from the definition that commenters believe should be covered funds under the rule? The Agencies similarly request comment as to whether a reference to illiquid assets, with the examples drawn from section 13, would be sufficiently clear and, if not, how the Agencies could provide greater clarity.**

Liquidity funds generally meet (i) above (depending on how it is drafted) and clearly meet (ii) above. We nonetheless believe a specific characteristics-based exclusion for liquidity funds and other excluded categories of private funds would be a simpler drafting exercise and far simpler and clearer to interpret and apply.

In passing, we note that equity real estate funds commonly are outside of the definition of "investment company" in Section 3(a)(1) of the Investment Company Act because they invest primarily in buildings and land rather than in "securities" and do not hold themselves out primarily as investing, reinvesting or trading in securities. Mortgage real estate funds and mixed-category real estate funds frequently are structured to fit within the Investment Company Act § 3(c)(5)(C) exclusion from the definition of "investment company", and consequently many are outside the definitions of "covered funds" in the Volcker Implementing Rules and "private fund" in Form PF.

Question 171. Rather than providing a characteristics-based exclusion, should the Agencies instead revise the base definition of "covered fund" using a characteristics-based approach?[176]

That is, should the Agencies provide that none of the types of funds currently included in the base definition—investment companies but for section 3(c)(1) or 3(c)(7) and certain commodity pools and foreign funds—will be covered funds in the first instance unless they have characteristics of a hedge fund or private equity fund?

As discussed above, we suggest a carve out from the definition of "covered funds" for specific categories of private funds, and in particular for liquidity funds, based upon their portfolio characteristics and capital structure. Trying to fold all disqualifying characteristics into definitions of "private equity fund" and "hedge fund" or into a master definition of "covered funds" would be a difficult drafting exercise and an even more difficult exercise in interpretation and compliance. We believe the simplest drafting approach would be to carefully define the characteristics of those specific types of private funds that are excluded from the definition of "covered funds."

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[176] ***See supra*** **Part III.C.1.a.i.**