INVESTMENT COMPANY INSTITUTE

1401 H Street, NW, Washington, DC 20005-2148, USA
202/326-5800 www.ici.org

April 30, 2012

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

Re: Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies (RIN 7100-AD-86)

Dear Ms. Johnson:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposal that the Board of Governors of the Federal Reserve System ("Board") has issued to implement Sections 165 and 166 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] Those provisions concern enhanced prudential standards (Section 165) and early remediation requirements (Section 166) for bank holding companies with at least $50 billion in total consolidated assets ("large BHCs") and nonbank financial companies designated for supervision by the Federal Reserve Board ("SIFIs").

On previous occasions, ICI has expressed its strongly held view that SIFI designation would not be appropriate for registered investment companies ("registered funds")[3] or their investment advisers because, among other things, they do not present the risks that such designation is intended to address.[4] We are hopeful that the Financial Stability Oversight Council ("FSOC"), to the extent that it evaluates any registered funds or advisers to registered funds for possible designation, will reach the same conclusion. Nevertheless, because no SIFIs have been named yet and the precise scope of SIFI

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[1] The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $13.3 trillion and serve over 90 million shareholders.

[2] *See* Board of Governors of the Federal Reserve System, *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 Fed. Reg. 594 (Jan. 5, 2012)("Proposal").

[3] References to "registered funds" in this letter mean investment companies registered with the Securities and Exchange Commission under the Investment Company Act of 1940 ("Investment Company Act").

[4] *See* Letters from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010 and Feb. 25, 2011, available at http://www.ici.org/pdf/24696.pdf and http://www.ici.org/pdf/24994.pdf, respectively.

designations remains an open question, we are commenting on the application of the Proposal to SIFIs. In addition, our comments address an issue the Proposal raises that is of concern to money market funds[5] sponsored by large BHCs.[6]

Summary of Comments

As discussed more fully in Part I of this letter, ICI continues to believe that SIFI designation would be inappropriate for registered funds and their advisers, a conclusion the Proposal only strengthens. Further, it is premature to apply the Proposal to SIFIs, which have yet to be identified. Without knowing which entities will be subject to enhanced prudential standards, the Board cannot comply with its statutory obligations under Section 165. In particular, in prescribing enhanced standards, the Board is required to take into account differences among SIFIs and large BHCs based on specified considerations. The Proposal fails to make any such distinctions. Notwithstanding some references in the preamble to tailoring the application of the standards, the overall approach of the Proposal is to apply the "same set" of enhanced prudential standards to all SIFIs and large BHCs , which is inconsistent with what the statute requires. Moreover, applying a bank-oriented regulatory framework to *all* covered companies, as the Proposal does, disregards Congressional recognition that for purposes of prescribing enhanced prudential standards under Section 165, one size *does not* fit all. For the foregoing reasons, ICI recommends that the Board exclude SIFIs from the Proposal and propose for public comment a process for prescribing appropriate enhanced standards and requirements for SIFIs that takes into account the characteristics and risks of those entities so designated.

In Part II of this letter, we address an issue related to the proposed single counterparty credit limits, which would be applied to a covered company together with its subsidiaries. Under the Proposal, a registered fund would not be a "subsidiary" if the covered company does not own more than 25 percent of the fund's voting securities. The Board poses a question in the preamble, however, as to whether money market funds or other funds or vehicles that a covered company sponsors or advises should be included as part of the covered company and whether the Proposal's definition of "subsidiary" should be expanded to include any investment fund or vehicle advised or sponsored by a covered company or any other entity. As we explain below, sponsored or advised registered funds, including money market funds, do not meet any of the standard indicia of a subsidiary. Treating registered funds as subsidiaries of their covered company sponsor or adviser will not further the purpose of the single counterparty credit limits, and will unnecessarily disrupt the operations of the funds while creating potential conflicts of interest between the funds and their covered company adviser. Moreover, such treatment could create the inaccurate perception that support from a fund's adviser or sponsor is likely—a result directly contrary to the Board's objective.

[5] References to money market funds in this letter mean U.S. registered investment companies that comply with Rule 2a-7 under the Investment Company Act.

[6] Large BHCs will be subject to the Proposal even if the Board follows our recommendation below to revise the Proposal to exclude SIFIs.

I. Application of the Proposal to SIFIs

A. The Proposal Only Strengthens the Conclusion that SIFI Designation is Inappropriate for Registered Funds and Their Advisers

Many of our comments below focus on the need for the Board to adhere to statutory requirements and Congressional intent regarding tailored requirements for SIFIs, so as to avoid applying standards that will be ineffective and unworkable. It bears emphasizing, however, that the statutory provisions regarding tailoring can only go so far; they are *not* a substitute for the FSOC determining in the first instance that SIFI designation is "the right tool for the job." As ICI previously commented, this means, among other things, that the FSOC should have a reasonable expectation that the "remedies" that would flow from SIFI designation are necessary and will be effective to address the specific risk(s) that the FSOC seeks to minimize.[7]

The Proposal does nothing to change our view that SIFI designation would not be an appropriate regulatory tool for addressing any perceived risks that registered funds or their advisers might raise. To the contrary, by applying bank-oriented requirements to all covered companies, the Proposal only strengthens the conclusion that SIFI designation would be inappropriate in their case.

B. Application of the Proposal to SIFIs Is Premature

ICI submits that it is premature to apply the Proposal to SIFIs. As the Board acknowledges in the preamble, to date the FSOC "has not designated any nonbank financial company for supervision by the Board."[8] In fact, the FSOC just recently adopted the final rule and interpretive guidance establishing the criteria by which it intends to evaluate nonbank financial companies for possible SIFI designation.[9]

An important purpose of publishing proposed regulations for comment is to allow affected parties to weigh in on the application of those regulations to them. It is difficult, if not impossible, to achieve this purpose if those parties have not yet been identified. Asset management companies (some of which include investment advisers to registered funds) provide a good illustration of the inappropriate timing of the Proposal as regards SIFIs. In adopting the final SIFI designation rule and guidance, the FSOC indicated that it, its member agencies, and the Office of Financial Research are analyzing the extent to which there are any potential threats to U.S. financial stability arising from asset management companies. The FSOC further stated that this analysis "is considering *what threats exist,*

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[7] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated February 25, 2011, *supra* note 4, at 6.

[8] Proposal, *supra* note 2, at n.11 and n.12.

[9] *See* Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (April 11, 2012).

if any, and whether such threats can be mitigated by subjecting such companies to [Board] supervision and prudential standards, or whether they are better addressed through other regulatory measures." [10] ICI commends the FSOC for its deliberate approach. But the quoted statement underscores that at this time, no one knows whether any companies whose primary business is asset management will be subject to the requirements the Proposal seeks to implement.

Application of the Proposal to SIFIs also is premature because the Board cannot comply with its statutory obligations under Section 165 without knowing which entities will be subject to the enhanced prudential standards. For example, in prescribing prudential standards for SIFIs and large BHCs, the Board is *required,* among other things, to take into account differences among SIFIs and large BHCs based on enumerated considerations.[11] Fulfilling this requirement presupposes that there are SIFIs to analyze for this purpose.

C. The Proposal as Applied to SIFIs Is Inconsistent with Statutory Requirements

On a related point, the overall approach of the Proposal in its current form appears directly at odds with the statute. In particular, as stated in the preamble, the Proposal "would apply the *same set* of enhanced prudential standards to covered companies that are bank holding companies and covered companies that are nonbank financial companies."[12] This approach on its face violates the Board's statutory obligation to take into account differences among SIFIs and large BHCs based on enumerated considerations. It also ignores requirements under Section 165(b)(3) that the Board (1) take into account recommendations from the FSOC regarding the establishment and refinement of prudential standards for SIFIs, and (2) adapt the standards in light of the company's predominant line of business, including assets under management or other activities for which particular standards may not be appropriate.[13]

The preamble makes reference to some of the language in Section 165 that either directs or authorizes the Board to tailor the prudential standards for SIFIs in certain circumstances, based on specified considerations.[14] Unfortunately, the Proposal appears to mischaracterize the Board's obligations with respect to tailoring. For example, the preamble notes that "in applying" the enhanced prudential standards to covered companies, the Board may determine, on its own or in response to a

[10] 77 Fed. Reg. at 21644. While the FSOC indicated that it will analyze asset managers under the current guidance for now, it is evident that the FSOC is not satisfied with how some aspects of the guidance would apply to asset management companies. *Id.* at 21643.

[11] The considerations are: (1) the factors described in subsections (a) and (b) of Section 113 of the Dodd-Frank Act; (2) whether the company owns an insured depository institution; (3) nonfinancial activities and affiliations of the company; and (4) any other risk-related factors that the Board determines appropriate.

[12] 77 Fed. Reg. at 597 (emphasis added).

[13] In addition, under Section 165(b)(4), the Board is required to consult with each FSOC member that supervises a functionally regulated subsidiary or a depository institution subsidiary of a SIFI before imposing prudential standards or any other requirements pursuant to Section 165 that are likely to have a significant impact on such subsidiary.

[14] *See, e.g.,* Proposal, *supra* note 2, at nn. 13 -14 and accompanying text.

recommendation by the FSOC, to "tailor the application" of the enhanced standards to different companies on an individual basis or by category, taking into consideration their capital structure, riskiness, complexity, financial activities, size, and any other risk-related factors that the Board deems appropriate.[15] But the operative language in the statute does not speak in terms of tailoring the *application* of the standards. It provides that the Board may differentiate among companies on the basis of the above-listed factors "in *prescribing*" prudential standards under Section 165.

The preamble later correctly refers to the requirement to take into account differences among bank holding companies and SIFIs "in prescribing the enhanced standards under Section 165(b)(1)."[16] But immediately afterwards, it backtracks, indicating that after the FSOC designates a SIFI, "the Board would thoroughly assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards and early remediation requirements should apply." It further states that the Board "may, by order or regulation, *tailor the application* of the enhanced standards to designated nonbank financial companies on an individual basis or by category, as appropriate." The process described above does not meet the requirements of the statute. It also strongly suggests that the Board has not carefully considered the implications of applying the Proposal to SIFIs and therefore provides additional support for our recommendation, discussed below, that the Board exclude SIFIs at this time and address how they will be handled in a separate rule proposal.

Without any explanation as to why, the Proposal also would lump together all SIFIs regardless of their specific risk characteristics for purposes of the proposed single counterparty credit limits. In particular, all SIFIs (along with BHCs with total consolidated assets of at least $500 billion) would be treated as "major covered companies" and subjected to stricter limits on single counterparty exposures. Here again, the Board seems to disregard its responsibilities with respect to SIFIs. Section 165(e) calls for the Board to apply a 25 percent limit "or such lower amount as the [Board] may determine by regulation to be necessary to mitigate risks to the financial stability of the United States." The Proposal does not discuss how or why the Board determined that *all* SIFIs, regardless of their specific characteristics, should be subject to a 10 percent limit, or why they should be treated as presenting the equivalent level of risk to U.S. financial stability as a $500 billion BHC.

D. Application of a Bank-Oriented Regulatory Framework to All Covered Companies is Inappropriate

Quite apart from our technical concerns about the statutory requirements, ICI is very troubled that the Board is proposing to apply the bank-oriented prudential standards in the Proposal to *all* entities that ultimately may be covered companies. As provisions such as Section 165(b)(3) make clear, Congress recognized the likelihood that bank-oriented prudential standards would not be appropriate

[15] The preamble indicates that this authority will be particularly important in applying the enhanced standards to SIFIs that are organized and operated differently from banking organizations and may encompass a variety of business models, capital structures, and risk profiles.

[16] Proposal, *supra* note 2, at n. 26 and accompanying text.

for all SIFIs. By taking an approach that "would apply the same set of enhanced prudential standards" to all covered companies, the Board disregards Congressional intent. And in doing so, it risks reaching an ineffective and unworkable result.

The proposed enhanced risk-based capital and leverage requirements further illustrate this problem. Section 165(b)(1)(A)(i) provides that the Board, in consultation with the FSOC, may determine that risk-based capital requirements and leverage limits are inappropriate for a particular company because of the company's activities or structure. In such a case, the Board *must* apply "other standards that result in similarly stringent risk controls." But the Proposal makes no mention—in either the preamble or the rule text—of the possibility that for some companies, risk-based capital requirements and leverage limits may not apply in the same way or even at all. To the contrary, the Proposal would apply the specified requirements to any nonbank covered company "as if it were a bank holding company."[17]

It should go without saying that applying enhanced prudential standards that are inappropriate or unworkable will not further the policy goals underlying Section 165. Capital requirements are a good example because, while they are a tool of proven value for banks and broker-dealers, they simply do not make sense in all contexts, including in the case of registered funds and their advisers.[18]

E. <u>The Board Should Exclude SIFIs from the Proposal and Propose Separately a Process for Prescribing Enhanced Standards and Requirements for SIFIs</u>

In another recent rulemaking under the Dodd-Frank Act, the Board refrained from proposing requirements that would apply to SIFIs, offering the following explanation:

> The Board is not proposing at this time any additional capital requirements, quantitative limits, or other restrictions on nonbank financial companies pursuant to section 13 of the [Bank Holding Company] Act, as it believes doing so would be premature in light of the fact that the [FSOC] has not yet finalized the criteria for designation of, nor yet designated, any nonbank financial company.[19]

In the instant rulemaking, the Board refrained from applying the Proposal to foreign banking organizations because they are likely to require different treatment than domestic BHCs.[20] We urge the Board similarly to hold off on applying the Proposal to SIFIs, because while the FSOC has since finalized its SIFI designation rule and guidance, SIFIs have yet to be identified. As discussed above, to apply this Proposal to SIFIs not only would be inconsistent with what Section 165 expressly requires

[17] *See* proposed § 252.13(b)(1) and (b)(3).

[18] *See, e.g.*, Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., to Financial Stability Oversight Council, dated Dec. 19, 2011.

[19] *See* Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds, 76 Fed. Reg. 68846 (Nov. 7, 2011) at n.4.

[20] *See* 77 Fed. Reg. at 595 and 598.

and with Congressional intent, but also likely would result in ineffective and unworkable requirements for some companies. Instead, the Board should exclude SIFIs from the Proposal and propose for public comment a process for prescribing appropriate enhanced standards and requirements for SIFIs that takes into account the characteristics and risks of those entities so designated.

In this regard, we note the broad statement in the preamble that the Board "may, by order or regulation, tailor the application of the enhanced standards to designated nonbank financial companies on an individual basis or by category, as appropriate." Notwithstanding several references to "tailoring," this is the *only* mention of any process by which the Board intends to craft enhanced standards that make sense for particular SIFIs. Moreover, the rule text makes no provision whatsoever for tailoring.

Section 165 confers upon the Board significant and unprecedented regulatory authority with respect to entities not previously under its jurisdiction. And yet, the Proposal seems to treat these entities as an afterthought. We believe it is in the interests of all stakeholders, including the Board, to put in place a well-designed and reasonably transparent process for prescribing appropriate enhanced prudential standards for SIFIs, one that is consistent with statutory requirements and reflects careful consideration and input from the public. Developing this process through formal rulemaking will help ensure that it meets these criteria.

The process for developing enhanced standards must include close coordination with the FSOC's SIFI designation process. As noted above, SIFI designation should be based upon the FSOC's reasonable expectation that the "remedies" that would flow from SIFI designation are necessary and will be effective to address the specific risk(s) that the FSOC seeks to minimize.[21] The FSOC's analysis thus will be relevant to the Board's required considerations. In addition, the Board should address specifically how it will comply with applicable statutory requirements, including that the Board: (1) take into account differences among SIFIs and large BHCs based upon, among other things, the factors in Section 113 of the Dodd-Frank Act; (2) take into account recommendations from the FSOC regarding the establishment and refinement of prudential standards for SIFIs (Section 115); (3) adapt the standards in light of the company's predominant line of business, including assets under management or other activities for which particular standards may not be appropriate; and (4) consult with each FSOC member that supervises a functionally regulated subsidiary or a depository institution subsidiary of a SIFI before imposing prudential standards or any other requirements pursuant to Section 165 that are likely to have a significant impact on such subsidiary.

[21] The FSOC appears to be taking this approach with respect to its ongoing analysis of asset management companies. As mentioned above, the FSOC has indicated that it is "is considering what threats exist, if any, and whether such threats can be mitigated by subjecting such companies to [Board] supervision and prudential standards, or whether they are better addressed through other regulatory measures."

II. Application of Single Counterparty Credit Limits to Sponsors or Advisers of Registered Funds

The Proposal refers to SIFIs and large BHCs collectively as "covered companies." ICI urges the Board to exclude SIFIs from the Proposal and to develop, through formal rulemaking, a process for prescribing appropriate enhanced standards for them. Given that the Proposal still would apply to large BHCs, we address below an issue of concern to money market funds sponsored or advised by large BHCs (or by SIFIs, if they are not excluded from the Proposal).

In an effort to address single-counterparty concentration risk among large financial companies, Section 165(e) of the Dodd-Frank Act directs the Board to establish single-counterparty credit limits for covered companies in order to limit the risks that the failure of any individual firm could pose to a covered company. Under the Proposal, the aggregate net credit exposure of a covered company and all of its "subsidiaries" to any unaffiliated counterparty and its subsidiaries may not exceed 25 percent of the covered company's capital stock and surplus; this limit is reduced to 10 percent if a covered company and its counterparty are both either a bank holding company with $500 billion or more of total consolidated assets or a SIFI of any size. For this purpose, "subsidiary" is defined as a company that is "directly or indirectly controlled by" the specified company, and a company "controls" another company if it (i) owns, controls, or has power to vote 25 percent or more of a class of voting securities of the company, (ii) owns or controls 25 percent or more of the total equity of the company, or (iii) consolidates the company for financial reporting purposes.

Under the Proposal, a fund or other investment vehicle that is sponsored or advised by a covered company would not be considered a subsidiary of the covered company unless it was "controlled" by that covered company. Thus, unless the above control test is met, the credit exposure of a fund to a counterparty would not be aggregated with the credit exposure of the fund's sponsor or adviser to the same counterparty. The preamble notes, however, that this treatment may be at odds with the support that some money market funds received from their sponsors during the recent financial crisis to enable those funds to meet investor redemption requests without having to sell assets into then fragile and illiquid markets. The Board requests comment on whether money market funds or other funds or vehicles that a covered company sponsors or advises should be included as part of the covered company for purposes of this rule.[22] It also inquires whether the Proposal's definition of "subsidiary" should be expanded to include any investment fund or vehicle advised or sponsored by a covered company or any other entity.[23]

For the reasons discussed below, we strongly disagree that sponsored or advised funds,[24] including money market funds, should be included as part of a covered company or that the definition of "subsidiary" should be expanded to include any fund advised or sponsored by a covered company or

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[22] *See* Proposal, *supra* note 2, at 614-15 (Question 24).

[23] *Id.*

[24] While some of our arguments may apply broadly to various types of funds, our comments focus on registered funds.

any other entity.[25] Treating registered funds in this manner will not further the purpose of the proposed credit limits, and will unnecessarily disrupt the operations of the funds while creating potential conflicts of interest between the funds and their covered company adviser. Moreover, such treatment could create the inaccurate perception that support from a fund's adviser or sponsor is likely—a result directly contrary to the Board's objective.

A. Registered Funds Are Not Subsidiaries of Their Advisers or Sponsors

A registered fund is not a subsidiary of its sponsor/adviser. Rather, it is an independent legal entity, existing separate and apart from its sponsor/adviser. This legal relationship is well-grounded and a foundation of the Investment Company Act. To evidence this indicia of independence, consider the following examples:

- The fund is owned entirely by its shareholders. Except for shares in the fund held by the sponsor/adviser, the sponsor/adviser does not have any financial interest in the fund's assets or liabilities.
- The fund's assets are recorded on the fund's balance sheet, not the balance sheet of the fund's adviser.[26]
- Management of the fund is overseen by a separate board of directors, a majority of whom are independent sponsor/adviser.
- The investment advisory contract between a fund and its adviser must, by law, provide that it may be terminated at any time (by not more than 60 days written notice), without the payment of any penalty, by the fund's board, or by vote of a majority of the fund's outstanding voting securities.
- The fund's adviser must manage the fund's assets as a fiduciary and in accordance with the fund's own investment objectives and restrictions. The adviser thus cannot use the fund's assets for its own purposes.
- Shareholder recourse for losses is solely to the fund, and not its adviser (absent wrongdoing on the part of the adviser). Thus, losses incurred by the fund will not affect the sponsor's/adviser's financial condition or capitalization.

[25] While some of our arguments may apply broadly to various types of funds, our comments focus on registered funds.

[26] The Financial Accounting Standards Board is considering whether an investment adviser should consolidate the money market funds it manages for financial reporting purposes. *See* FASB Accounting Standards Update, *Consolidation (Topic 810) Principal versus Agent Analysis*. ICI believes that money market funds should not be consolidated by their investment advisers. *See* Letter from Gregory M. Smith, Director—Fund Accounting, Investment Company Institute, to Technical Director, Financial Accounting Standards Board (February 15, 2012), available at http://www.ici.org/pdf/25914.pdf. Even if accounting standards are modified at some future time to require such consolidation, for the reasons described herein, assets held in the funds should not be attributed to the covered company for purposes of an analysis under Section 165.

Stated differently, a sponsor/adviser is a service provider to, rather than an owner of, the registered funds that it sponsors or advises.[27] Registered funds and their shareholders are therefore customers of the sponsor/adviser—not subsidiaries.[28]

B. The Proposed Credit Limits Already Would Limit the Support that a Sponsor/Adviser Could Provide to Registered Funds

Question 24 of the Proposal suggests that it might be appropriate to disregard the legal separation of a covered company from the funds that it sponsors or manages because of the possibility that the covered company could take on additional exposure to a counterparty by providing financial support to a fund. Even assuming that such support is likely (which we discuss below), support would only be of concern if it caused the covered company to exceed the maximum permitted net credit exposure to a counterparty. As we understand the proposed credit limits, they would effectively prohibit a covered company from providing support to such an extent.

Advisers to money market funds, on occasion, have provided support to a fund. Typically, the support has taken one of two forms: the adviser either (1) purchased portfolio securities from the fund in accordance with Rule 17a-9 under the Investment Company Act or (2) provided a guaranty, letter of credit, or other support agreement securing the value of the portfolio securities. Either form of support would constitute a "credit transaction" under the proposed credit limits (§ 252.92(n)(4)-(5)), which would be included in the covered company's gross credit exposure to the issuer of the supported portfolio securities (§ 252.94(a)(2) and (9)). A covered company therefore could provide support to a money market fund only to the extent that the resulting increase in the net credit exposure to the issuer of any supported securities did not exceed the applicable percentage of the consolidated capital stock and net surplus of the covered company specified in § 252.93.

[27] We also request that the Board not treat a registered fund during its seeding period as a subsidiary of the fund's sponsor under the Board's proposed definitions. The Board's Regulation Y allows financial holding companies to organize and sponsor mutual funds and, provided certain requirements are met, does not mandate that the sponsored fund comply with the investment and other restrictions of the BHC Act. 12 CFR 225.86(b)(2). As the Board has recognized in the Regulation Y context, a successful fund will lose its subsidiary status as it attracts outside investors. During its launch period, the fund needs to invest in securities that allow it to establish a favorable track record to attract investor interest. Application of the proposed counterparty credit limits to a fund during the launch period, therefore, may hinder the ability of sponsors to launch funds.

[28] This point also is relevant to footnote 98 in the Proposal, which seems to suggest that funds advised by a counterparty might be included in calculating a covered company's net credit exposure to the counterparty. This would limit a covered company's investment in registered funds with a common adviser, even though each fund is completely separate from every other fund and from the adviser. Section 17 and other provisions of the Investment Company Act shield registered funds from the risks of their adviser's business by, among other things, requiring independent custody of the funds' assets, prohibiting trading between the funds and their adviser, prohibiting the funds from investing in their adviser or engaging in joint enterprises with their adviser, and requiring the maintenance of a fidelity bond. These provisions insulate the funds from adverse developments in their adviser's financial condition. Thus, there is no reason to treat registered funds and their adviser as a single counterparty for purposes of the proposed credit limits.

Thus, the Board's proposed credit limits already deal with the risk of a covered company providing support to a registered fund. They would do so by limiting the covered company's capacity to provide support, rather than by limiting the funds' exposure to counterparties. This is clearly the preferable approach, for at least the following three reasons.

1. *The Proposed Credit Limits Should Not Presume that a Covered Company Will Provide Support to Sponsored or Advised Funds*

The Board appears to acknowledge that advisers have no legal obligation to provide any financial support to sponsored or advised funds, by noting that advisers may have other "strong incentives" to provide support. Even the strongest incentives are not immutable, and therefore may not produce the same results in every circumstance. Treating registered funds as subsidiaries of their adviser or sponsor has the effect of presupposing that support will always be forthcoming. This is not necessarily the case, and the Board should not adopt regulations that might encourage the inaccurate perception that such support is likely. It is better to deal with the potential risks of support at the time it is given and in light of the actual circumstances, than to place arbitrary constraints on registered funds to protect against eventualities that may never occur. Therefore, limiting the extent of support through credit limits (as the Proposal would do) would be preferable to treating registered funds as subsidiaries of their adviser/sponsor.

2. *Treating Registered Funds as Subsidiaries of Their Sponsor/Adviser Would Create Conflicts of Interest and Put Them at a Competitive Disadvantage.*

Treating registered funds sponsored or advised by a covered company as subsidiaries would have the effect of prohibiting the funds from making investments otherwise permitted by the Investment Company Act, the regulations thereunder (such as Rule 2a-7), and the funds' investment objectives, policies and limitations. A fund adviser that is or is part of a covered company could face a conflict of interest if it had to make investment decisions on behalf of a registered fund taking into consideration the extent of the covered company's net credit exposure to an issuer, rather than (in accordance with its fiduciary duty) based solely on the interests of the fund and its shareholders.

Ordinarily, an adviser might attempt to resolve such a conflict by giving the funds precedence in utilizing the credit limit for any counterparty, and curtail its proprietary credit transactions to the extent that they might interfere with the funds' investments. This approach would not preclude potential conflicts of interest, however, unless the covered company abstained from credit transactions altogether, which would be completely impractical, or sold off proprietary investments whenever necessary to allow the funds to invest, which could result in losses for the covered company that would weaken its financial condition. Ultimately, in order to accommodate the net credit exposure taken by the funds, a covered company might have to raise additional capital in circumstances that would be disadvantageous to its shareholders.

The alternative would be to limit registered funds' investment opportunities in a manner that bears no relationship to the risks expected to be taken by the funds based on disclosed policies or to their shareholders' interests. Such a limitation would be detrimental to fund shareholders if it forced the fund to forego profitable investment opportunities. As the limitation would be premised on support that the covered company is not legally obligated to, and may never in fact, provide to the fund, any benefit to the shareholders resulting from such limitation would be entirely speculative. Thus, treating registered funds as subsidiaries of covered companies would force the funds' shareholders to share in the burdens of the credit limits with no assurance of any corresponding benefit.

Including sponsored and advised registered funds in the credit limits also could affect their dealings with counterparties. Most counterparties like to work with a single bank to arrange funding for important business activities, projects and investments. It is therefore important to them that the bank have the capacity to provide such funding without unnecessary delay. If a counterparty's bank is a covered company, and the counterparty realizes that securities held by sponsored and advised funds will reduce the covered company's capacity to fund the counterparty's important business objectives, the counterparty may refuse to deal with the funds altogether. As a result, registered funds sponsored and advised by covered companies may be put at a competitive disadvantage to other registered funds.

3. *Application of the Credit Limits to Registered Funds Is Not Workable*

Treating sponsored and advised registered funds as subsidiaries of a covered company would require the funds and the covered company to coordinate their credit transactions so as not to exceed the proposed credit limits. This would require the covered company to combine all of its trading and compliance systems so it could calculate the combined net credit exposures to each counterparty and the compliance of each proposed credit transaction with the credit limits. Apart from the expenses of combining these systems, this may create a breach in the information barrier normally maintained between trading systems that could give registered funds' advisers access to material non-public information (such as the pending negotiation of a credit facility that would be used to finance an as yet unannounced acquisition). This would further constrain the funds' ability to take advantage of attractive investment opportunities.[29]

In summary, the Proposal takes the right approach to regulating the possible impact of any support that a covered company might voluntarily provide to a registered fund that it manages. By limiting the amount of support that a covered company may provide, rather than limiting the net credit exposures taken by registered funds, the Board may avoid the perception that it anticipates covered companies will provide such support. The Board also will avoid the conflicts of interest and operational

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[29] Money market funds already must maintain a diversified portfolio. This requirement limits a fund's economic exposure to any single issuer. In general, money market funds may not invest more than 5 percent of their assets in the securities of any single issuer. Rule 2a-7 makes exceptions to the 5 percent limit for certain securities, including those issued by the federal government or its agencies. The limit is set at 0.5 percent if the issuer has received ratings in the second highest short-term rating category. Limiting the net credit exposures of money market funds to repurchase agreement counterparties would be particularly difficult. The rule includes an important exception for repurchase agreements, allowing funds to look through for diversification purposes to the underlying collateral securities, provided the collateral consists of cash and government securities and the fund evaluates the creditworthiness of the repurchase counterparty.

complexities inherent in requiring registered funds to coordinate their credit transactions with the covered company.

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If you have any questions regarding our comments or would like additional information, please feel free to contact me at 202/326-5815, Frances Stadler at 202/326-5822 or Jane Heinrichs at 202/371-5410. Thank you for your consideration of these comments.

Sincerely,

/s/

Karrie McMillan
General Counsel

cc: Ms. Eileen Rominger
Director, Division of Investment Management
U.S. Securities & Exchange Commission

Mr. Robert Plaze
Associate Director, Division of Investment Management
U.S. Securities & Exchange Commission