INVESTMENT COMPANY INSTITUTE

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

June 3, 2016

Robert deV. Frierson, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551
E-mail: regs.comments@federalreserve.gov

Re: Single-Counterparty Credit Limits for Large Banking Organizations; Proposed Rule (RIN 7100-AE 48)

Dear Mr. Frierson:

The Investment Company Institute ("ICI")[1] appreciates the opportunity to comment on the proposal ("Proposal") that the Board of Governors of the Federal Reserve System ("Board") has issued to implement Section 165(e) of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The proposal would establish single-counterparty credit limits ("SCCL requirements") for domestic and foreign bank holding companies with $50 billion or more in total consolidated assets ("covered companies").[2]

On behalf of our member funds – which are both issuers of securities and major investors in the financial markets around the world – ICI has engaged actively with policymakers on a broad range of legislative and regulatory issues emanating from the global financial crisis. Our members have a strong interest in efforts, such as the Proposal, to promote a strong and well-regulated global financial system. To this end, we support the Proposal's goals of strengthening covered companies' monitoring and management of counterparty and concentration risks. At the same time, we have concerns about the

[1] The Investment Company Institute ("ICI") is a leading, global association of regulated funds, including mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and unit investment trusts ("UITs") in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's U.S. fund members manage total assets of $17.8 trillion and serve more than 90 million U.S. shareholders. Members of ICI Global, the international arm of ICI, manage total assets of $1.5 trillion.

[2] *Single-Counterparty Credit Limits for Large Banking Organizations*, 81 Fed. Reg. 14328 (Mar. 16, 2016). The Proposal builds on earlier proposed rules to establish SCCL requirements for large domestic and foreign banking organizations. *See Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies,* 77 Fed. Reg. 593 (Jan. 5, 2012) ("2011 Proposal"); *Enhanced Prudential Standards and Early Remediation Requirements for Foreign Banking Organizations and Foreign Nonbank Financial Companies,* 77 Fed. Reg. 76627 (Dec. 28, 2012).

potential implications of the Proposal's treatment of regulated funds.[3] Our comments focus in that area.

More specifically, we discuss why:

- The final rules should not treat regulated funds as subsidiaries or otherwise part of covered companies;
- The final rules should not treat regulated funds as part of a counterparty due to a sponsor or adviser relationship;
- Regulated funds should be excluded from the "control relationship" standard;
- Large covered companies should not be required to "look through" to the portfolio investments of regulated funds; and
- A large covered company that invests in a regulated fund should not be required to recognize a second, equivalent exposure to the fund's manager or any other service provider.

I. The Final Rules Should Not Treat Regulated Funds as Subsidiaries or Otherwise Part of Covered Companies

Under the Proposal, the aggregate net credit exposure of a covered company and all of its "subsidiaries" to any unaffiliated counterparty may not exceed 25 percent of the covered company's eligible capital base.[4] The Board proposes to define a "subsidiary" of a covered company as a company that is "directly or indirectly controlled" by the covered company for purposes of the Bank Holding Company Act ("BHC Act").[5] In the preamble, the Board explains that "[i]f an investment fund . . . is not controlled by a covered company, the exposures of such fund . . . to its counterparties would not be aggregated with those of the covered company" for purposes of the SCCL requirements.[6] As applied to regulated funds that a covered company sponsors or advises, we agree with the Board's intended result.

---

[3] The term "regulated funds" includes "regulated U.S. funds," which are comprehensively regulated under the Investment Company Act of 1940 ("Investment Company Act"), and "regulated non-U.S. funds," which are organized or formed outside the U.S. and substantively regulated to make them eligible for sale to retail investors (*e.g.*, funds domiciled in the European Union and qualified under the UCITS Directive ("UCITS")).

[4] This limit is reduced to 15 percent if a covered company and its counterparty are considered "major counterparties," which would include global systemically important banks. Proposal § 252.72. For convenience, this letter uses citations to the portion of the Proposal applicable to U.S. covered companies.

[5] Proposal § 252.71(cc); 81 Fed. Reg. at 14331. Under the BHC Act, a company "controls" another entity if: (1) it directly or indirectly or acting through one or more other persons owns, controls, or has power to vote 25 per centum or more of any class of the entity's voting securities; (2) it controls in any manner the election of a majority of the entity's directors or trustees; or (3) the Board determines, after notice and opportunity for hearing, that the company directly or indirectly exercises a controlling influence over the management or policies of the entity. *See* 12 U.S.C. 1841(a)(2).

[6] 81 Fed. Reg. at 14331.

Regulated U.S. Funds Are Not Controlled By Their Sponsors or Advisers

We note that for regulated U.S. funds, long-standing Board precedents indicate that an advisory or sponsor relationship, on its own, does not constitute "control" of such a fund.[7] Therefore, and appropriately in our view, the Proposal generally would not require covered companies to aggregate exposures of any sponsored or advised regulated U.S. funds with their own exposures. This result properly recognizes the relationship between regulated funds and their covered company sponsor or adviser. Most notably:

- Each fund is a separate legal entity, distinct from its sponsor or adviser.
- The sponsor/adviser does not own and has no claim on fund assets; it may not use such assets to benefit itself.
- The fund's sponsor or adviser does not absorb the fund's investment risks; fund shareholders bear those risks and have no recourse against the adviser (absent wrongdoing on the part of the adviser).
- Acting as agent under a contract with the fund, the adviser manages the fund's portfolio as a fiduciary in accordance with the fund's investment objectives and policies as stipulated in the fund's prospectus.
- The fund's own board of directors—generally required to have at least a majority of independent members—oversees the management and operations of the fund.
- In addition to carrying out various specific responsibilities, the independent directors are charged with safeguarding the interests of the fund and its shareholders against potential conflicts with the adviser or its affiliates.
- Although rarely exercised, a fund board has the authority to terminate the adviser's contract and engage a new adviser for the fund.

Regulated Non-U.S. Funds Warrant Similar Treatment

Regulated non-U.S. funds share many of the characteristics listed above, including an independent oversight mechanism. Based on local legal regimes or custom and practice, however, some of these funds operate under organizational or governance structures that do not include an independent board of directors.[8] As a result, these funds cannot rely on the Board precedents mentioned above, and the sponsor or adviser might be deemed to "control" (as defined in the BHC Act) a fund's governing body. Under the Proposal, such a fund would fall within the definition of

---

[7] *See, e.g., Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships with, Hedge Funds and Private Equity Funds*, 79 Fed. Reg. 5536, 5676 (Jan. 31, 2014) ("Volcker Adopting Release") ("The Board's regulations and orders have long recognized that a bank holding company may organize, sponsor and manage a mutual fund such as a registered investment company, including by serving as investment adviser to [a] registered investment company, without controlling the registered investment company for purposes of the BHC Act.").

[8] UCITS, for example, must appoint a depositary that is independent of the fund and its sponsor/adviser.

"subsidiary" and a covered company sponsor or adviser would be required to aggregate the fund's exposures with its own exposures. Given the defining characteristics of these funds, this treatment is not necessary to achieve the purposes of the Proposal.

Board staff has recognized in the context of the Volcker Rule that the organizational structure or governance arrangements of regulated non-U.S. funds should not be viewed as meaning that such funds should be treated as "controlled" by their sponsor or adviser for all purposes.[9] The same recognition is appropriate here.

One way to achieve this result would be to adopt the bright-line definition of "subsidiary" the Board chose to use in the 2011 Proposal—*i.e.,* any entity that a covered company (1) owns, controls, or holds power to vote 25 percent or more of a class of voting securities; (2) owns or controls 25 percent or more of the total equity; or (3) consolidates for financial reporting purposes. In the preamble to the 2011 Proposal, the Board indicated that "a simpler, more objective definition of control is more consistent with the objectives of single-counterparty credit limits."[10] The Board has requested comment on whether it should revert to this definition (which also is the standard it proposes to use for purposes of identifying exposures that must be aggregated with a covered company's exposure to a given counterparty). We would support such a change.

Treatment of Regulated Funds Should Not Change During Temporary Seeding Period

It is common practice for an adviser or sponsor to hold more than 25 percent of the voting shares of a regulated fund during the temporary seeding period for the fund. During this period, the sponsor or adviser needs to hold more than 25 percent of a new fund's shares to execute the fund's contemplated investment strategy and seek to amass a track record that is credible to investors and meets investor needs and expectations. The seeding period also allows time for successful public marketing and distribution of fund shares.

In our view, the treatment of a sponsored or advised regulated fund for purposes of the SCCL requirements should not be different during the fund's seeding period. The features we enumerated above that define the relationship between regulated funds and their covered company sponsor or adviser, which make aggregation of exposures unnecessary and inappropriate, are present during the seeding period. Moreover, given the temporary nature of the seeding period and the fact that funds at this stage of their existence are likely to be small, the burdens of requiring aggregation of sponsored or

---

[9] *See* Volcker Rule FAQ #14, available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#14 (recognizing that "unlike in the case of U.S. registered investment companies, sponsors of foreign public funds in some foreign jurisdictions select the majority of the fund's directors or trustees, or otherwise control the fund for purposes of the BHC Act by contract or through a controlled corporate director," but nevertheless determining that such a fund should not be deemed a "banking entity" that is subject to the Volcker Rule).

[10] 77 Fed. Reg. at 614.

advised fund exposures with a covered company's exposures during the seeding period almost certainly would outweigh any possible benefits.

For these reasons, and consistent with positions the Board and its staff adopted in implementing the Volcker Rule, we recommend that the Board clarify that an adviser's or sponsor's ownership of more than 25 percent of the voting shares of a regulated (U.S. or non-U.S.) fund for a reasonable seeding period would not require aggregation of the fund's exposures with those of its covered company sponsor or adviser.[11]

The Board Should Not Depart From Well-Established Precedent Regarding Regulated Funds

The Board has asked for comment on whether the Proposal's definition of "subsidiary" should be expanded to include funds and vehicles that a covered company sponsors or advises and whether the definition of covered company should expressly include such funds and vehicles.[12] We strongly believe that the final rules should *not* treat sponsored or advised regulated funds as subsidiaries of or otherwise part of a covered company and we therefore oppose making either of these changes.

Treating sponsored or advised regulated funds as subsidiaries or otherwise part of a covered company would be at odds with the Board precedents we cite above. The Board does not discuss any policy rationale that would explain its question about whether this rule should depart from this well-established approach. Presumably, the Board has in mind the same issue it highlighted in the preamble to the 2011 Proposal. There, the Board similarly noted that "[i]f a fund or vehicle is not controlled by a covered company, the exposures of such fund or vehicle to its counterparties would not be aggregated with those of the covered company."[13] It went on to state: "Such arm's length treatment, however, may be at odds with the support that some companies provided during the financial crisis to the funds they advised and sponsored."[14] In seeking comment on whether the rule should include funds or vehicles that a covered company sponsors or advises as part of the covered company, the Board theorized that "a

---

[11] *See* Volcker Rule FAQ #16, available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#16 (recognizing that a banking entity may own a significant portion of the shares of a U.S. registered investment company or foreign public fund during a temporary period (*e.g.,* three years), but nevertheless determining that such a fund should not be deemed a banking entity that is subject to the Volcker Rule during that period). *See also* Volcker Adopting Release, *supra* note 7, at 5676-77 ("[C]onsistent with the Board's precedent regarding bank holding company control of and relationships with funds, a seeding vehicle that will become [a regulated U.S. fund] would not itself be viewed as" subject to the Volcker Rule during the seeding period); Volcker Rule FAQ #5, available at http://www.federalreserve.gov/bankinforeg/volcker-rule/faq.htm#5 (concluding that similar treatment is appropriate for a seeding vehicle that will become a foreign public fund).

[12] 81 Fed. Reg. at 14331.

[13] 77 Fed. Reg. 594, 614 (Jan. 5, 2012).

[14] *Id.* The Board pointed to the experience of money market funds in particular.

covered company may have strong incentives to provide support in times of distress" to such funds and vehicles.[15]

We strongly disagree with this premise. In this regard, we recently had occasion to explain the many reasons why regulated funds sponsored by banks or bank affiliates—both regulated money market funds and regulated stock and bond funds—are unlikely to present "step-in risk" (i.e., the risk that a bank may provide financial support to an entity beyond or in the absence of contractual obligations, should the entity experience financial distress).[16] Those reasons, detailed in the attached letter, likewise support our recommendation that the Board should not treat sponsored or advised regulated funds as subsidiaries or otherwise part of a covered company for purposes of the SCCL requirements.[17]

Treating Regulated Funds as Subsidiaries of Their Sponsor/Adviser Would Create Conflicts of Interest

If the Board were to change its approach and treat regulated funds sponsored or advised by covered companies as subsidiaries or otherwise part of covered companies, this would put the funds' advisers in an untenable position. Namely, an adviser would face a conflict of interest if—when making investment decisions on behalf of a regulated fund—it had to take into consideration credit exposures of affiliated companies that are subject to the rule's credit limits. The adviser's fiduciary duty requires that it make those decisions based solely on the interests of the fund and its shareholders.

Ordinarily, an adviser might attempt to resolve such a conflict by giving the fund precedence in utilizing the credit limit for any counterparty and curtailing proprietary credit transactions to the extent that they might interfere with the fund's 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 proprietary investments whenever necessary to allow the a fund to invest, which could result in losses for the covered company.

The alternative would be to limit regulated funds' investment opportunities in a manner that bears no relationship to fund shareholders' interests or to the risks those shareholders expect the fund to take based on its disclosed objectives and policies. Such a limitation would be detrimental to fund shareholders if it forced the fund to forego profitable investment opportunities or avoid useful

---

[15] *Id.*

[16] *See* Letter from Dan Waters, Managing Director, ICI Global, to Basel Committee on Banking Supervision, dated March 17, 2016 (regarding its consultation on identification and measurement of step-in risk), available at https://www.bis.org/bcbs/publ/comments/d349/iciig.pdf. A copy of the letter is attached.

[17] *See also* Letter from Stefan M. Gavell, Executive Vice President and Head of Regulatory, Industry and Government Affairs, State Street, to Basel Committee on Banking Supervision, dated March 17, 2016, at 4-5 (discussing limits on the ability and incentives of a bank to provide financial support to a sponsored or advised fund).

diversification of the fund's portfolio. Further, as discussed above, applying the credit limits to the fund's exposures would seem to be premised on the theory—with which we disagree—that a covered company is likely to provide financial support to the fund that it is not legally obligated to provide (*i.e.*, assuming that the fund's credit exposures are tantamount to exposures of the covered company). Thus, any prudential benefit of applying the limit in this manner would be entirely speculative. Said differently, treating regulated funds as subsidiaries of covered companies would force the funds' shareholders to share in the burdens of the credit limits and would impose other compliance and economic costs, with no assurance of any corresponding benefit.

II. The Final Rules Should Not Treat Regulated Funds as Part of a Counterparty Due to a Sponsor or Adviser Relationship

The Proposal defines "counterparty" to include a company and any person with respect to which the company (i) owns, controls, or holds with power to vote 25 percent or more of a class of voting securities; (ii) owns or controls 25 percent or more of the total equity; or (iii) consolidates for financial reporting purposes.[18] Normally, an adviser or sponsor would not hold this level of ownership in a regulated fund. As noted above, however, during a seeding period, the adviser or sponsor may have a 25 percent or greater stake in the fund's voting securities. Thus, during such a seeding period, a regulated fund could be aggregated with its sponsor or adviser for purposes of determining credit limits. The Board has asked for comment on whether and under what circumstances funds or vehicles that a counterparty sponsors or advises should be expressly included as part of the counterparty.[19]

As we explained above, regulated funds should not be treated as controlled by their sponsor or adviser, including during a seeding period, or otherwise treated as part of a covered company. We described specific characteristics of regulated funds that justify this approach, as well as relevant Board precedents.[20] We also outlined certain conflicts of interest that such treatment would raise. For all of the same reasons, we urge the Board to clarify that it will not treat a regulated fund as part of a counterparty as a result of a sponsor or adviser relationship, including when a sponsor or adviser has an equity investment in a fund during a permitted seeding period.

III. Regulated Funds Should Be Excluded from the "Control Relationship" Standard

The Proposal would require covered companies to assess whether any counterparties are connected by certain control relationships, including: (i) the presence of voting agreements; (ii) the ability of one counterparty to significantly influence the appointment or dismissal of another counterparty's administrative, management or governing body, or the fact that a majority of members

---

[18] Proposal § 252.71(e).

[19] 81 Fed. Reg. at 14332.

[20] In addition, we referenced the attached letter explaining why it is unlikely that either regulated money market funds or regulated stock and bond funds would present "step-in risk."

of such body have been appointed solely as a result of the exercise of the first counterparty's voting rights; and (iii) the ability of one counterparty to exercise a controlling influence over the management or policies of another counterparty.[21] If so, covered companies would have to aggregate their exposures to those counterparties for purposes of applying the SCCL requirements.

The preamble provides an example in which a covered company has exposure to a bank and to a fund sponsored by the bank. It indicates that because the bank has the ability to appoint a majority of the fund's directors, the above standard would require the covered company to aggregate its exposure to the bank with its exposure to the fund for purposes of determining compliance with the SCCL requirements. The requirement to aggregate counterparty exposures based on this standard would appear to extend to some regulated non-U.S. funds. As discussed above, such a fund's governing body may be controlled by the sponsor or adviser pursuant to local legal regimes or custom and practice. Board staff has recognized in the context of the Volcker Rule that such arrangements should not be viewed as meaning that a regulated fund should be treated as "controlled" by its sponsor or adviser for all purposes.[22]

The same conclusion is appropriate here. Even though the relationship between a regulated fund and its sponsor or adviser potentially could fall under the "control relationship" standard, aggregation would not be appropriate or serve the Proposal's policy objective. Of particular relevance are the regulatory and structural characteristics that separate and distinguish a regulated fund from its sponsor/adviser and make it unlikely that (1) the fund would experience material financial "distress" and (2) the fund's sponsor or adviser would feel compelled to provide financial support in the absence of any legal obligation to do so. For these reasons, we urge the Board to exclude regulated funds from the control relationship standard.

IV. Large Covered Companies Should Not Be Required to "Look Through" to the Portfolio Investments of Diversified Regulated Funds

The Proposal would require covered companies with $250 billion or more in total consolidated assets or $10 billion or more in total on-balance sheet foreign exposures ("large covered companies") that invest in securitization vehicles, investment funds and other special purpose vehicles ("SPVs") to demonstrate that their gross credit exposure to each issuer of assets held by the investment fund or other vehicle is less than 0.25 percent of the covered company's eligible capital base.[23] If the large covered company is unable to do so, it would be required to calculate its exposure to each issuer of assets

---

[21] Proposal § 252.76(b).

[22] *See* Volcker Rule FAQ #14 (Recognizing that "unlike in the case of U.S. registered investment companies, sponsors of foreign public funds in some foreign jurisdictions select the majority of the fund's directors or trustees, or otherwise control the fund for purposes of the BHC Act by contract or through a controlled corporate director," but nevertheless determining that such a fund should not be deemed a "banking entity" that is subject to the Volcker Rule).

[23] Proposal § 252.75.

held by the investment fund or other vehicle and aggregate those various exposures with other exposures to the same issuers.[24] If the large covered company is unable to identify each issuer of assets held by the investment fund or other vehicle, it must attribute the gross credit exposure to a single unknown counterparty.[25]

The proposed look-through approach appears to pose considerable compliance challenges for large covered companies. It is unclear, for example, how a large covered company would determine the underlying issuers in an actively managed investment fund with the frequency that this Proposal expects. We are concerned that, if not made less burdensome, these requirements could discourage large covered companies from investing in diversified regulated funds.

All regulated U.S. funds are required by the federal tax laws to be diversified.[26] If a fund elects to be diversified for purposes of the Investment Company Act (and most do), the requirements are even more stringent—with respect to 75% of the fund's portfolio, no more than 5% may be invested in any one issuer. Regulated funds outside the U.S. typically adhere to similar concentration limits and/or diversification standards.[27] As a result, it is highly unlikely that a large covered company's investment in a diversified regulated fund—which investment already would be directly limited by the SCCL requirements—would materially increase the large covered company's exposure to any one underlying issuer.

We urge the Board to exclude diversified regulated funds from the Proposal's look-through approach. Such an exclusion would alleviate some of the costs and burdens of compliance for large covered companies without undermining the Board's regulatory policy objectives.

V. A Large Covered Company That Invests in a Regulated Fund Should Not Be Required to Recognize a Second, Equivalent Exposure to the Fund's Manager or to Any Other Service Provider

The Proposal would require large covered companies to recognize a gross credit exposure to each third party that has a contractual or other business relationship with a securitization vehicle, investment fund, or other SPV, in cases where failure or material financial distress of the third party would cause a loss in the value of the covered company's investment in or exposure to the investment fund.[28] The proposed rule text specifically identifies "fund managers" as potential third parties. Thus,

---

[24] Proposal § 252.75(b)(1).

[25] Proposal § 252.75(b)(2).

[26] Subchapter M of the Internal Revenue Code.

[27] *See, e.g.*, UCITS Directive Articles 52 and 56; National Instrument 81-102 *Mutual Funds* sections 2.1 and 2.2 (requirements applicable to Canadian mutual funds).

[28] Proposal § 252.75(c).

in the case of an investment fund, the large covered company would recognize an exposure to the investment fund and a second exposure of equal size to the fund manager or other third party if the "failure or distress" standard is met.

In its very brief description of this provision, the preamble focuses solely on SPVs. It states:

> For example, the value of an investment by the [large] covered company in an SPV might be reliant on various forms of credit support provided by a financial institution to the SPV. The failure or distress of the credit support provider would then lead to loss in the value of the investment of the [large] covered company in the SPV. Other examples of third parties whose failure or distress could potentially lead to a loss in the value of the [large] covered company's investment in the SPV are originators of assets held by the SPV, liquidity providers to the SPV, and (potentially) fund managers.[29]

The proposed rule text thus appears to cast a much wider net than is necessary to address the Board's stated concerns. For the reasons outlined below, we strongly urge the Board to narrow the rule text and otherwise make clear that this provision would not apply to a large covered company's investment in a regulated fund.

First, there are a host of regulatory and structural characteristics that sharply distinguish regulated funds—the most comprehensively regulated investment product in jurisdictions worldwide—from SPVs and securitization vehicles. These characteristics, which are described in some detail on pages 4-11 of the attached letter to the Basel Committee, include the separation between a regulated fund (whose gains or losses belong to its investors) and its manager (which serves in an agency capacity). On this basis, we believe a different approach to regulated funds is warranted.

Second, the discussion in the preamble indicates that the Board is concerned about the prospect of a large covered company suffering a loss from its SPV investment because the provider of credit or liquidity support to the SPV fails or encounters material financial distress. The Board should not have the same concerns with regard to covered company investments in regulated funds. As noted above, a regulated fund manager serves in an agency capacity. It is not legally required to provide support to the regulated fund(s) it manages, nor do investors or the broader marketplace have any expectation of such support. Accordingly, it is not appropriate to consider potential distress of a fund manager on par with that of an institution providing credit or liquidity support to an SPV.

Third, any losses in the value of a large covered company's investment in a regulated fund are far more likely to be tied to exogenous factors (such as market conditions) rather than to any distress

[29] 81 Fed. Reg. at 14343.

experienced by the fund manager.[30] Indeed, regulated fund managers are unlikely to fail precisely because of the agency nature of the asset management business. In other words, the fund manager does not take on the risks inherent in the assets that it manages for regulated funds and other clients, or in other activities or strategies it may pursue on their behalf, such as securities lending.[31]

Fourth, the threshold articulated in the proposed rule text—"would cause a loss in the value of the investment"—makes little sense in the case of covered company investments in regulated funds. The threshold appears to be based on the notion that loss is something to be protected against. In fact, the potential for loss is inherent in any investment. The net asset value of a US equity mutual fund, for example, will fluctuate daily according to the market value of its underlying assets. Investors know this, and expect to enjoy the gains, or bear the losses, generated by the fund's portfolio. That is simply the nature of investing, and the Board's final rule should be crafted with that fact in mind.

Finally, we note that regulated funds have contractual and other business relationships with several key service providers beyond their managers (*e.g.*, custodian, principal underwriter). While the preamble seems to suggest that these relationships may not be the focus of the Board's concern, the broad wording of the proposed rule text potentially could capture them.

Most of these providers are highly regulated in their own right under securities or banking law. For regulated U.S. funds, these relationships are governed by the Investment Company Act and related rules, are subject to robust and ongoing oversight by the fund and its independent directors, and receive regular focus in SEC examinations.[32] Moreover, most of these key service providers are not entities that present risks of sudden failure. Any deterioration in the services they provide or other indications of financial distress are likely to be discernible through the regulated fund's monitoring and oversight programs, giving the fund the opportunity to replace the provider should that prove necessary. And in the case of the large banks that act as fund custodians, mitigating the risks of sudden failure is a constant point of focus for the banks and their regulators, including the Board.

---

[30] Concerns about the potential for "correlated distress" comes up in another part of the Proposal—the requirement to aggregate exposures to counterparties that are "economically interdependent." Economic interdependence would be deemed to exist where, if one of the counterparties were to experience financial problems, the other counterparty would be likely to experience financial problems as a result. Proposal § 252.76(a); 81 Fed. Reg. at 14332. In our view, this part of the Proposal is ill-defined, such that we have been unable to determine what implications (if any) it could have for regulated funds. We urge the Board not to adopt this requirement without first providing greater clarity as to how it would be applied, so as to preclude unintended consequences, inconsistent interpretations or overly burdensome compliance obligations.

[31] *See, e.g.*, Letter to the Financial Stability Oversight Council from Paul Schott Stevens, President & CEO, ICI, dated March 25, 2015 at 72-81 and Appendix B, available at https://www.ici.org/pdf/15_ici_fsoc_ltr.pdf.

[32] *Id.* at 58-72.

For all of these reasons, we recommend that the Board revise the Proposal to exclude large covered company investments in regulated funds from this provision.

* * * * *

Thank you for your consideration of these comments. If you have any questions or would like additional information, please feel free to contact me at (202) 326-5815 or david.blass@ici.org, Frances Stadler, Associate General Counsel and Corporate Secretary, at (202) 326-5822 or frances@ici.org, or Rachel Graham, Associate General Counsel, at (202) 326-5819 or rgraham@ici.org.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel

Attachment

cc: David W. Grim
Director, Division of Investment Management
Securities and Exchange Commission

ICI Global

110 Bishopsgate
19th Floor, Suites 19-06 and 19-07
London EC2N 4AY, UK
+44 (0) 207 961 0830
www.iciglobal.org

Suite 715–717, Level 7
Two Exchange Square
8 Connaught Place
Central, Hong Kong
+852 2168 0882

1401 H Street, NW
Suite 1200
Washington, DC 20005, USA
+001 202 326 5800
www.ici.org

March 17, 2016

Basel Committee on Banking Supervision
Bank for International Settlements
CH-4002 Basel
Switzerland

Re: Identification and measurement of step-in risk

Dear Sirs and Mesdames:

ICI Global[1] appreciates the opportunity to comment on the Basel Committee on Banking Supervision's (BCBS or Committee) preliminary consultation regarding the identification and measurement of step-in risk.[2] ICI Global members have a keen interest in a strong and resilient global financial system that operates on a foundation of sound regulation. We seek to engage actively with policymakers and to provide meaningful input on global financial regulatory policy initiatives, such as this one, that may have significant implications for regulated funds, their investors and the broader financial markets.

As explained in the executive summary, the consultation sets forth a "proposed conceptual framework [that] aims at identifying unconsolidated entities that could entail *significant* step-in risk for banks."[3] It describes step-in risk as "the risk that a bank may provide financial support to an entity beyond or in the absence of any contractual obligations, should the entity experience financial stress." The proposed framework also includes "potential approaches that could be used to reflect step-in risk in banks' prudential measures." Each of the approaches presented in the consultation would increase the bank's regulatory capital, even though the Committee professes that it "has yet to decide how the proposals will fall within the regulatory framework, including

---

[1] The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$18.4 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

[2] BCBS, *Consultative Document: Identification and measurement of step-in risk* (Dec. 2015) ("Consultative Document"), available at https://www.bis.org/bcbs/publ/d349.pdf.

[3] Consultative Document at 1 (emphasis added).

whether they fall within Pillar 1 [minimum capital requirements] and/or Pillar 2 [supervisory review process]."

In this letter, we explain the many reasons why regulated funds[4] sponsored by banks or bank affiliates—both regulated money market funds and regulated stock and bond funds—are unlikely to present step-in risk and therefore should lie outside the scope of the Committee's effort to identify and measure sources of *significant* step-in risk for banks. We also discuss why a bank regulatory capital charge to address presumed step-in risk from a regulated fund would be inappropriate and conflict with US law.

Before turning to our substantive comments, we wish to express our agreement with the Committee's decision "to focus on the situations that give rise to step-in risk, rather than trying to provide a definition of a category of entities that should be considered."[5] Identifying the situations that may raise legitimate supervisory concerns is, in our view, a far more productive approach than simply taking broad aim at so-called "shadow banking entities."[6] This approach also should help the Committee to distinguish between bank relationships with unconsolidated entities that pose significant step-in risk and situations—such as with regulated funds—where step-in risk is remote and, therefore, does not warrant any additional capital requirements.

I. Summary of Comments

Regulated funds sponsored by banks or bank affiliates are unlikely to experience "weakness or failure" that would have any related negative impact on the bank and therefore should lie outside the scope of the Committee's proposed framework for identifying and measuring step-in risk. There are several reasons for this. First are the key regulatory and structural characteristics of regulated funds that bear directly on the nature of the relationship between a regulated fund and its bank-affiliated sponsor and that also mitigate the risk of material stress for the regulated fund. By way of illustration, these characteristics include:

- **Separation between a regulated fund and its bank-affiliated sponsor**, which sharply limits any incentive for the bank to absorb fund losses

---

[4] The term "regulated funds" includes "regulated US funds" (or "US mutual funds" where appropriate), which are comprehensively regulated under the Investment Company Act of 1940 ("Investment Company Act"), and "regulated non-US funds," which are organized or formed outside the US and substantively regulated to make them eligible for sale to retail investors (*e.g.*, funds domiciled in the European Union and qualified under the UCITS Directive ("UCITS")).

[5] Consultative Document at 10.

[6] *See* Financial Stability Board, *Transforming Shadow Banking Into Resilient Market-Based Finance: An Overview of Progress* (12 Nov. 2015) at 5, at http://www.fsb.org/wp-content/uploads/shadow_banking_overview_of_progress_2015.pdf (stating that the FSB "asked the BCBS to develop policy recommendations to ensure the spillover of risks from the shadow banking system to the banking system are prudentially mitigated.") ICI repeatedly has objected to the characterization of non-bank financial intermediaries as "shadow banks," a label that fails to distinguish among a range of intermediaries subject to varying degrees of regulation yet suggests that *all* are insufficiently regulated because they are not part of the banking system. *See, e.g.*, Letter to FSB from Paul Schott Stevens, President & CEO, ICI, dated June 3, 2011 (responding to a FSB background note entitled *Shadow Banking: Scoping the Issues*).

- **Provisions to mitigate conflicts of interest between a regulated fund and its bank-affiliated sponsor**, which in the US effectively prohibit or limit most forms of sponsor support
- **Regulated fund governance**, which includes strong independent oversight of regulated fund management and operations
- **Prospectus and other disclosure to investors**, which makes clear that regulated fund investors bear the risks of their investment
- **"Substitutability" of regulated funds and lack of "critical functions,"** which make it highly unlikely that a bank-affiliated sponsor would take measures to "safeguard" any one fund

Additionally, since the global financial crisis, the US Securities and Exchange Commission (SEC) has adopted two packages of significant reforms that sufficiently mitigate step-in risk associated with regulated US money market funds. Post-crisis measures also have made regulated European money market funds more resilient, and a pending legislative proposal would make further reforms, possibly including a prohibition on sponsor support.

Regulated stock and bond funds also are unlikely to present step-in risk. Fund investors understand that any gains or losses belong to them and accordingly have no expectation of sponsor support. These funds, moreover, do not experience "financial distress" of the sort that might occasion sponsor support. In the US, for example, ICI data show only modest redemptions by regulated stock and bond fund investors, even during periods of severe market stress.

To measure step-in risk, the Committee proposes approaches that would increase a bank's regulatory capital—a proposition that underscores why regulated funds should remain outside the proposed framework. Fund investors retain, and should expect to retain, all risks of their investment. Any suggestion to the contrary would introduce clear moral hazards, potentially making investors less careful in their choice of regulated funds and bank sponsors less disciplined in managing a fund's investments. And, as applied to regulated US funds, the Committee's proposed approaches conflict with the letter and spirit of a law that generally prohibits the US Federal Reserve Board from taking into account affiliated regulated fund activities when setting capital requirements for bank holding companies.

II. Regulated Funds are Unlikely to Present Step-in Risk

The Committee states that its focus in this consultation "is on the reputational risk that arises when a bank considers that the weakness or failure of an entity is likely to have a negative impact on the bank itself."[7] Relevant to this inquiry, therefore, are the nature of the entity itself, the likelihood that the entity will experience weakness or failure, and the impact that any such weakness or failure may have on the bank.

Under the proposed framework, banks and their supervisors would look at a bank's relationships with unconsolidated entities and apply certain "primary indicators" to identify those relationships that could entail significant step-in risk for the bank. The consultation states that

[7] Consultative Document at 9.

where a bank's relationship with an entity meets one of the primary indicators, the existence of significant step-in risk would be presumed.[8] The proposed framework sets forth a set of "secondary indicators" for use by supervisors in assessing the reasonableness of a bank's argument that a particular indicator of step-in risk has been mitigated.[9]

We begin by highlighting the regulatory and structural characteristics that sharply distinguish regulated funds—the most comprehensively regulated investment product in jurisdictions worldwide—from other types of unconsolidated entities with which the Committee may be concerned (*e.g.,* mortgage and finance companies, funding vehicles, and securitization vehicles).[10] These characteristics bear directly on the nature of the relationship between the regulated fund and its bank-affiliated sponsor. They also mitigate the risk of material stress for the regulated fund, whether from an adverse operational event, investment losses or market conditions. Next, we discuss the variety of reforms that regulators in the United States and other jurisdictions have proposed or adopted to strengthen the resiliency of regulated money market funds. These reforms sufficiently mitigate step-in risk for banks that sponsor such funds. Finally, we explain the additional reasons why other regulated funds (that is, regulated stock and bond funds) are unlikely to present step-in risk to their bank sponsors.

a. Distinguishing Characteristics of Regulated Funds

Regulated investment funds serve as the vehicle through which millions of people save and invest to meet their most important financial goals. The substantial advantages that these funds provide to investors—including professional money management, diversification, and reasonable cost—are consistent across international borders. They include the benefit of substantive government regulation and oversight, as befits an investment product eligible for sale to the retail public. All regulated funds typically are subject to substantive regulation in areas such as disclosure (*e.g.*, form, delivery and timing), form of organization, separate custody of fund assets, mark-to-market valuation, and investment restrictions (*e.g.*, leverage, types of investments or "eligible assets," concentration limits and/or diversification standards).[11]

Although the governing rules in different jurisdictions are not identical, they are very similar. Indeed, such rules reflect common principles developed by the International Organization of Securities Commissions (IOSCO)[12] for regulated funds (which IOSCO refers to as "collective

---

[8] Consultative Document at 16.

[9] *Id.* The consultation also suggests additional indicators specific to asset management. *Id.* at 26.

[10] Consultative Document at 10.

[11] For a more detailed overview of the comprehensive regulatory regime applicable to US mutual funds, *see* Letter to FSB from Paul Schott Stevens, President & CEO, ICI (April 7, 2014) ("April 2014 FSB Letter"), available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf, at Appendix C.

[12] The IOSCO Objectives and Principles of Securities Regulation set out 38 principles of securities regulation; these principles are based on the following three objectives of securities regulation: protecting investors; ensuring that markets are fair, efficient and transparent; and reducing systemic risk. *See* https://www.iosco.org/about/?subsection=display_committee&cmtid=19&subSection1=principles. IOSCO upgraded and strengthened these Principles in 2010. *See*

investment schemes" or "CIS") as well as IOSCO's more detailed work on core areas of CIS regulation.[13]

In the paragraphs that follow, we highlight the regulatory and structural characteristics of regulated funds that appear to be most pertinent to the Committee's concern about the possibility for "weakness or failure" that could be "likely to have a negative impact on the bank itself."[14]

- **Separation between the regulated fund and its bank-affiliated manager.**[15] The assets of a regulated fund are separate and distinct from, and not available to claims by creditors of, the fund manager. A regulated fund's economic exposures belong to it alone, and losses are not absorbed by the fund manager. Acting as agent, the fund manager provides investment management and other services to the fund in accordance with the fund's own investment objectives, strategies, and policies, for which the fund pays the manager an asset-based fee. For regulated US funds, the fund's board of directors (including a majority of its independent members) annually must review and approve the fund's contract with the manager, including the management fee to be paid by the fund. If the manager owns shares of the fund, it does so *pari passu* with other investors. In the situation where a manager owns a controlling interest in the fund (*e.g.*, the manager has provided seed capital to a new fund) or meets other criteria indicating a control relationship under accounting standards, the fund would be consolidated on the manager's balance sheet.[16]

---

https://www.iosco.org/library/pubdocs/pdf/IOSCOPD323.pdf.

[13] *See, e.g.*, Principles Regarding the Custody of Collective Investment Schemes' Assets (Oct. 2014), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD454.pdf; Principles for the Valuation of Collective Investment Schemes (May 2013), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD237.pdf; Examination of Governance for Collective Investment Schemes: Part I (June 2006), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD219.pdf, and Part II (Feb. 2007)("CIS Governance Part II"), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD237.pdf; Conflicts of Interest of CIS Operators (May 2000), available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD108.pdf.

[14] Consultative Document at 9.

[15] These characteristics are relevant to consideration of the proposed indicators relating to the extent of capital ties between the regulated fund and its manager, the decision making/management authority of the bank, the purpose and overall design of the fund, whether the bank has a relevant interest in the fund other than its management fee and whether the bank enjoys/assumes the majority of the risk and rewards. Consultative Document at 14-15, 17, 26.

[16] *See* FASB ASC 810, *Consolidation*, and IFRS 10, *Consolidated Financial Statements*. SEC-registered money market funds that comply with rule 2a-7 under the Investment Company Act and unregistered funds that operate in a similar manner are exempt from consolidation under US GAAP. A reporting entity (*e.g.*, a bank-affiliated fund sponsor) is required to disclose any financial support provided to such funds for the periods presented in the performance statement (FASB ASC 810-10-15-12).

- **Provisions to mitigate conflicts of interest.**[17] Although approaches differ across jurisdictions, there is an "overriding responsibility" on the part of a regulated fund manager to act in the best interest of the fund. As IOSCO has observed, this responsibility is often the premise for regulatory requirements that seek to avoid or mitigate conflicts of interest and to ensure fair treatment for investors.[18] In the US, for example, transactions between a regulated US fund and affiliated entities such as the fund manager, the corporate parent of the manager, or an entity under common control with the manager, are strictly proscribed. Only in limited circumstances—and only where there is a benefit to fund investors—will the SEC permit such transactions, subject to conditions including oversight by the fund's board and its independent members (as described in the "regulated fund governance" discussion below). In effect, the Investment Company Act prohibits or limits most forms of sponsor support.[19]

  In the EU, a regulated fund manager must establish, implement and maintain an effective conflicts of interests policy. That policy must be in writing and appropriate to the size and organization of the fund manager and the nature, scale and complexity of its business. Where a regulated fund manager is a member of a group, the policy must take into account any circumstances of which the manager is (or should be) aware that may give rise to a conflict of interest resulting from the structure and business activities of other members of the group. Member State regulators have published guidance on potential conflicts of interest, including the ones stemming from the relationship between the regulated fund and its manager.

- **Regulated fund governance.**[20] All regulated funds, notwithstanding differences in structure and organization across jurisdictions, have one or more mechanisms to provide for "adequate and objective oversight" of the activities of the regulated fund and its manager, in order to protect fund investors.[21] In the United States, regulated funds must have a board of directors that generally must have at least a majority of members who are independent of the fund's manager and certain related persons. In practice, independent directors make up three-quarters of most fund boards. Independent directors must select and nominate other

---

[17] These characteristics are relevant to consideration of the proposed indicator relating to whether the bank has a relevant interest in the fund other than its management fee (*e.g.*, loans to the fund) and whether the bank is able to exercise a "dominant" or "significant" influence over management. Consultative Document at 14-15, 26.

[18] *See* Conflicts of Interest of CIS Operators, *supra* note 13, at 11.

[19] The detailed and restrictive provisions of the Investment Company Act governing dealings with affiliates are no less stringent than those contained in Sections 23A and B of the US Federal Reserve Act. *See also infra* note 51 (mentioning post-crisis reforms affecting transactions between US insured banks and their affiliates).

[20] These characteristics are relevant to consideration of the proposed indicators relating to whether the bank is able to appoint or remove the majority of members of the governing body or otherwise exercise a "dominant" or "significant" influence over management. Consultative Document at 14-15.

[21] *See* CIS Governance Part II, *supra* note 13, at 4-5.

independent directors. Fund directors are subject to duties of care and loyalty and have a legal duty to serve as "watchdogs" for the interests of fund investors. In broad terms, the fund board oversees the management, operations and investment performance of the fund. Directors have significant and specific legal responsibilities, including to approve the contract with the fund's manager and oversee the manager's provision of services under that contract, and to oversee potential conflicts of interest as well as the fund's compliance program. Although rarely exercised, a fund board has the authority to terminate the manager's contract and engage a new manager for the fund. It is worth noting that, under longstanding precedent, the US Federal Reserve Board views regulated US funds as being under the control of their independent boards of directors (and not affiliates of a banking organization) for purposes of banking law (except in cases where the bank sponsor owns a controlling equity investment in the fund).[22]

Regulated non-US funds typically employ different mechanisms for independent oversight. UCITS, for example, must appoint a depositary—an entity regulated and supervised by Member State regulators under the UCITS Directive requirements—that is independent of the fund and fund manager.[23] The depositary must be a national central bank, a credit institution, or other entity that is authorized to provide depositary services; it is subject to prudential regulation and to capital adequacy requirements under the Capital Requirements Directive (CRD IV). The depositary acts "both as a supervisor (the "legal conscience") of [the] UCITS fund . . . and as a custodian over the fund assets."[24] Its responsibilities include safeguarding fund assets, monitoring the fund's cash flows and performing certain oversight functions as described in the "robust risk and compliance framework" discussion below. In carrying out its responsibilities, the depositary "shall act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS."[25]

- **Robust risk and compliance framework.**[26] Regulated US funds must adopt and implement a formal compliance program, including written policies and procedures reasonably designed to prevent violation of US federal securities laws. These policies and

---

[22] *See, e.g.*, Commerzbank AG, 83 Fed. Res. Bull. 679 (1997).

[23] On 18 December 2015, the European Commission published proposed level 2 measures for Directive 2014/91/EC (amending Directive 2009/65/EC) with additional specifications regarding the obligations of depositaries. The proposed Delegated Regulation is available at http://ec.europa.eu/transparency/regdoc/rep/3/2015/EN/3-2015-9160-EN-F1-1.PDF. The level 2 measures further ensure the independence between the depositary and the UCITS/the UCITS manager and other third-parties in the UCITS value chain.

[24] *See* Press Release, European Commission, UCITS—Improved Requirements for Depositaries and Fund Managers—Frequently Asked Questions (3 July 2012), available at http://europa.eu/rapid/press-release_MEMO-12-515_en.htm.

[25] Directive 2014/91/EU (amending Directive 2009/65/EC), Article 25, available at http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:02009L0065-20140917&from=EN.

[26] In broad terms, these characteristics are relevant to the likelihood of weakness or failure of the regulated fund.

procedures must provide for the oversight of compliance by the fund's key service providers. A fund also must designate a chief compliance officer responsible for administering the fund's compliance policies and procedures. The CCO must report in writing at least annually to the fund's board on the operation of the fund's (and its service providers') policies and procedures and each material compliance matter that occurred since the date of the last report. Building on the existing, robust compliance structure, the SEC has proposed new requirements designed to enhance controls on risks related to portfolio composition—specifically, liquidity risk and derivatives-related risks.[27]

Regulated non-US funds adhere to comparable requirements relating to compliance and risk management. UCITS, for example, must have a documented risk management policy covering, among other things, how the UCITS will manage liquidity to meet redemptions. The compliance function for a UCITS must be functionally independent from portfolio management. Additionally, the UCITS depositary—an independent entity—is charged with overseeing the fund manager's compliance with applicable law and fund policies. The depositary's oversight functions include, for example: (1) ensuring that fund shares are issued and redeemed, and the fund's net asset value (NAV) is calculated, in accordance with fund rules and applicable law; and (2) supervising fund management to ensure that it follows regulations and rules and, in particular, the fund's investment policies and restrictions. The depositary must report instances of non-compliance with investment restrictions to the Member State regulator.

- **Prospectus and related disclosure to investors.**[28] A regulated fund's prospectus provides extensive information to current and prospective investors and the markets about the fund and its operations, including investment objectives, investment strategies, fees and expenses, and investment performance. Of particular relevance to this consultation are required prospectus disclosures concerning the risks of investing in the fund. Additionally, in the US, regulated fund advertisements must adhere to strict guidelines as to presentation of performance information and provide required disclaimers cautioning investors that past performance should not be taken as indicative of future performance. In Europe, beyond the required prospectus, UCITS also must prepare a document containing "key investor information" (the "KIID"). The KIID must describe the risk/reward profile of the fund and provide "appropriate guidance and warnings in relation to the risks associated with

---

[27] *See* SEC, *Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release,* Release No. 33-9922 (Sept. 22, 2015) ("SEC Liquidity Management Proposal"), available at http://www.sec.gov/rules/proposed/2015/33-9922.pdf; SEC, *Use of Derivatives by Registered Investment Companies and Business Development Companies,* Release No. IC-31933 (Dec. 11, 2015) ("SEC Derivatives Proposal"), available at http://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

[28] These characteristics are relevant to consideration of the proposed indicators relating to investor expectations, including with respect to the likelihood of support from the bank, whether the bank has provided investors with guarantees on the performance of the fund or its assets, and whether the bank has provided investors with an explicit commitment to meet any shortfall in returns. Consultative Document at 18, 26.

investment" in the UCITS (*e.g.*, disclaimers cautioning investors that past performance is not indicative of future performance).

- **Information to regulators.**[29] Regulated funds provide extensive information to their primary regulators on a regular basis. This includes copies of the fund's prospectus and any amendments thereto, as well as annual reports (containing audited financial information) and semi-annual reports that funds also provide to their investors. Regulated US funds must file a complete list of their portfolio holdings with the SEC following their first and third quarters. Under a pending SEC proposal, such funds would report more extensive information about their portfolio holdings and would report on a more frequent (monthly) basis. The proposal also would require enhanced, standardized disclosures about derivatives in fund financial statements.[30] Similarly, certain specified statistical information regarding a UCITS must be submitted to the home Member State regulator of a UCITS, *i.e.*, the regulator in the fund's domicile. Primary regulators also can request regulated fund information in connection with their supervisory responsibilities.

- **Ability of regulated fund investors to exit their investment.**[31] US mutual funds offer their investors the ability to redeem shares on a daily basis. Many regulated non-US funds similarly offer shares that can be redeemed on a daily basis. This is a defining feature of these funds, and it is one around which many of the regulatory requirements and operational practices for these funds are built. Of particular importance are mark-to-market valuation of portfolio assets and maintaining much of the portfolio in liquid investments. Regulated fund managers have a range of tools that can be employed, both to support redemptions and to protect the interests of those investors remaining in the fund. In the case of US mutual funds, ICI data show that these funds have a strong record of managing investor redemptions, even during periods of market stress.[32]

  There have been similar findings in other jurisdictions. For example, the Bank of Canada recently issued a report on the Canadian financial system that included an assessment of potential vulnerabilities in Canadian open-end mutual funds and found that these funds

---

[29] These characteristics are relevant to the likelihood of weakness or failure of the regulated fund. The obligation to report regularly to securities regulators (who have enforcement authority) incentivizes compliance with applicable legal and regulatory requirements.

[30] *See* SEC Derivatives Proposal, *supra* note 27.

[31] These characteristics are relevant to consideration of the proposed indicator relating to the ability of investors to dispose freely of their financial instruments. Consultative Document at 18. For more detailed discussion of how regulated funds manage their liquidity needs and the tools used to support redemptions, *see, e.g.*, Letter to FSB from Paul Schott Stevens, President & CEO, ICI (May 29, 2015) ("May 2015 FSB Letter"), available at https://www.ici.org/pdf/15_ici_fsb_comment.pdf, at 26-30; Letter to Brent J. Fields, Secretary, SEC from David W. Blass, General Counsel, ICI (Jan. 13, 2016), available at https://www.ici.org/pdf/16_ici_sec_lrm_rule_comment.pdf.

[32] *See, e.g.*, April 2014 FSB Letter, *supra* note 11, at Appendix F.

"appear to be managing . . . liquidity risks effectively."[33] Similarly, the Bank of England's Financial Policy Committee (FPC) commissioned a survey analyzing the risks associated with "open-end funds offering short-notice redemption" in the context of "potentially more fragile market liquidity." The FPC reported that the survey results suggest that "funds operating under UCITS ensure that remaining investors are not disadvantaged when redemptions occur. This reduces incentives for investors to redeem if they suspect others will do the same. These funds also operate with minimal amounts of borrowing."[34]

- **Additional protections against idiosyncratic risks.**[35] Regulated US funds are required to maintain fidelity bond coverage as specified by regulation and subject to annual approval by the fund's board of directors. Such bonds typically afford coverage against dishonest or fraudulent acts or theft by various persons associated with fund activities, including fund officers and employees. In the case of UCITS, the depositary is liable to the UCITS and its investors for any loss of assets entrusted to the depositary for custody. The depositary also is liable for other losses that result from its negligent or intentional failure to fulfill its obligations under the UCITS Directive.[36] This risk of liability is covered by capital requirements as stringent as CRD IV, to which the depositary is subject.

  Regulated US funds also typically procure liability insurance coverage for themselves and their directors and officers to cover judgments, settlements and legal defense costs incurred in certain investor lawsuits or other third-party claims relating to fund activities. US managers of regulated funds (alone or together with one or more affiliated companies providing services to the regulated funds) similarly often purchase such coverage for themselves. Regulated non-US funds and their managers likewise may and do procure this kind of liability insurance coverage.

- **Substitutability and absence of "critical functions"**[37] Regulated funds are highly substitutable and do not provide critical functions to sponsors or third parties; therefore, it

---

[33] *See* Bank of Canada, Financial System Review (June 2015), available at http://www.bankofcanada.ca/wp-content/uploads/2015/06/fsr-june2015.pdf, at 46-54. With regard to fixed income funds, the report attributed this finding to various factors including: (1) funds hold sufficient cash to meet large redemptions; and (2) funds have a stable investor base—as demonstrated by the fact that Canadian fixed income flows have been stable during past periods of stress. *Id.* at 50.

[34] *See* Bank of England, News Release - Financial Policy Committee statement from its policy meeting (23 Sept. 2015), available at http://www.bankofengland.co.uk/publications/Pages/news/2015/022.aspx.

[35] These characteristics are relevant to consideration of the proposed indicator relating to the existence of "major economic dependence of the entity on the bank." Consultative Document at 17.

[36] As noted above, a depositary is subject to prudential supervision and capital adequacy requirements.

[37] These characteristics are relevant to consideration of the proposed indicator relating to whether the fund would be "safeguarded for its continuity of critical functions in accordance with the bank's recovery and/or resolution plans." Consultative Document at 19. For more detail, *see* May 2015 FSB Letter, *supra* note 31, at 30-32 and additional ICI sources cited therein.

is highly unlikely that a regulated fund manager would take measures to "safeguard" any one fund. As the Financial Stability Board has recognized, "the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable)."[38] Investors have considerable choice and flexibility to move their assets from one regulated fund to another. Not surprisingly, regulated fund managers routinely close or reorganize regulated funds for a variety of reasons, including the inability to attract or maintain sufficient assets, departures of key portfolio managers, or poor investment performance.[39] When a US mutual fund liquidates, there is an established process by which the fund liquidates its assets, distributes the proceeds *pro rata* to investors and winds up its affairs. This process adheres to requirements in the Investment Company Act and other applicable laws based on the fund's domicile. The fund manager and fund directors oversee this process and determine how quickly it takes place, in accordance with their fiduciary obligations to the fund. UCITS similarly have orderly liquidation procedures as described in their fund rules and the laws of the UCITS home Member State. Liquidations are subject to the fiduciary responsibilities of the UCITS' management company and/or directors, requiring the liquidation to be conducted in an orderly manner and in the best interests of investors.

The many factors highlighted above should allay the Committee's concern about the possibility for "weakness or failure" in the structure and operation of regulated funds that could be "likely to have a negative impact on the bank itself."

b. Post-Financial Crisis Reforms Sufficiently Mitigate Step-In Risk Associated with Regulated Money Market Funds

The consultation points to the experience of some money market funds during the global financial crisis as a "prominent example" of banks giving credit or liquidity support, beyond a contractual obligation to do so, to entities "not included within the scope of regulatory consolidation." The Committee acknowledges that "[t]he impact of step-in risk has been tackled by various authorities following the financial crisis." With respect to money market funds, the consultation points to reforms that the US SEC adopted for regulated US money market funds in 2014. Later on, however, the consultation fails to mention these reforms when listing examples of potential "collective rebuttals" to the presumption of step-in risk.[40]

---

[38] FSB, Consultative Document, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (8 January 2014), available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf, at 30.

[39] Liquidations and mergers are commonplace. *See, e.g.*, ICI, *"Orderly Resolution" of Mutual Funds and Their Managers* (July 2014), available at http://www.ici.org/pdf/14_ici_orderly_resolution.pdf.

[40] The consultation introduces the concept of "collective rebuttals," describing these as rebuttals that would apply "on a jurisdictional basis, if the supervisor is satisfied that step-in risks are mitigated by existing public policy that is enforceable by law." Consultative Document at 24. The Committee envisions collective rebuttals to include areas in which "there is existing law (or regulation) that prohibits a significant portion of banks or other market participants from providing non-contractual support to off-balance-sheet entities." *Id.*

We believe that the Committee is viewing the experience of money market funds through too narrow a lens. In this section, we explain that the SEC has adopted *two* packages of significant reforms applicable to regulated US money market funds, the first in 2010 and the second in 2014. The totality of these reforms is sufficient to support a "collective rebuttal" that would exclude regulated US money market funds from the proposed step-in framework.[41] We also highlight the post-crisis measures that have made regulated European money market funds more resilient, as well as the pending legislative proposal in Europe for further reforms.

Post-crisis reforms in the US. Regulated US money market funds adhere to regulatory requirements in addition to those described in the previous section that are applicable to all regulated funds. Even before the financial crisis, these additional requirements included credit quality, maturity and diversification standards designed to limit a money market fund's exposure to credit risk, interest rate risk, liquidity risk, and the risk that certain investors may act precipitously to seek large redemptions.

Starting from this regulatory foundation, the SEC adopted the 2010 and 2014 reforms to make regulated US money market funds "more resilient . . . while preserving, to the extent possible, the benefits of money market funds."[42] Among other things, the reforms:

- Raise credit standards and shorten the maturity of money market funds' portfolios, further reducing credit and interest rate risk.

- Impose explicit daily and weekly liquidity requirements—responding directly to the fact that, during the financial crisis, some funds had to liquidate assets quickly to meet unusually high redemption requests.

- Require funds to adopt "know your investor" procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly.

- Impose stress testing requirements—first adopted with the 2010 reforms, and further enhanced by the 2014 reforms.

- Strengthen applicable requirements concerning portfolio diversification, including those related to affiliated issuers and demand features/guarantees attributable to a single institution.

---

[41] As a general matter, the Committee's concept of "collective rebuttal" is too narrow in that it encompasses only those areas where step-in risks are mitigated by "existing public policy that is enforceable by law." The Committee should be willing to exclude from this framework any entity not presenting significant step-in risk, even if no specific law expressly prohibits a bank or bank affiliate from providing financial support.

[42] SEC, *Money Market Fund Reform; Amendments to Form PF*, Rel. No. IC-31166 (July 23, 2014) ("SEC 2014 MMF Adopting Release"), available at http://www.sec.gov/rules/final/2014/33-9616.pdf, at 16.

- Enhance the transparency of regulated US money market funds to investors and regulators by requiring: (1) daily website disclosures regarding liquidity levels, net inflows and outflows, and mark-to-market prices; (2) more robust periodic disclosures; and (3) enhanced reporting to the SEC.

- Require institutional prime money market funds (including institutional municipal money market funds) to offer their shares at a "floating" NAV—a reform that the SEC expects will "dis-incentivize" redemption activity "that can result from investors attempting to exploit the possibility of redeeming shares at a stable share price even if the portfolio has suffered a loss."[43] In declining to require a floating NAV for all regulated money market funds, the SEC recognized the differences among types of regulated money market funds and their investors, and tailored this particular reform to those funds shown to be more susceptible to heavy redemptions during times of market stress.[44]

- Provide the boards of all regulated US money market funds with "new tools to stem heavy redemptions."[45] In particular, fund boards have discretion to impose a liquidity fee or gate if a fund's weekly liquid assets fall below the required regulatory threshold. In addition, all non-government money market funds (including floating NAV money market funds and retail money market funds) must impose a liquidity fee if the fund's weekly liquid assets fall below a designated threshold, unless the fund's board determines that imposing such a fee is not in the best interests of the fund.[46] The SEC 2014 MMF Adopting Release explains that fees and gates are intended to enhance money market funds' ability to manage and mitigate potential contagion from high levels of redemptions and make redeeming investors pay their share of the costs of the liquidity that they receive. The SEC acknowledges that fees and gates rarely will be imposed during normal market conditions.[47]

- Authorize the board of a regulated US money market fund to suspend redemptions and proceed to an orderly liquidation of the fund in extreme circumstances (*i.e.*, severe market stress coupled with heavy redemption pressures). In the view of the SEC, this powerful tool

---

[43] *Id.* at 141.

[44] *See, e.g.*, *id.* at 140-42.

[45] *Id.* at 1.

[46] The consultation erroneously suggests this tool is available only to institutional prime and institutional municipal money market funds. As stated above, it is required for all non-government money market funds. In addition, government money market funds (which are required to invest 99.5 percent of their assets in cash, government securities and repurchase agreements fully collateralized by government securities) may opt to impose a liquidity fee.

[47] SEC 2014 MMF Adopting Release, *supra* note 42, at 46, 71.

will help to assure equitable treatment for all investors in the fund.[48]

- Require public disclosure of any sponsor support to a regulated US money market fund for a period of 10 years—a measure viewed by the regulated fund industry as a strong deterrent to providing such support.[49]

We believe the above discussion should dispel the Committee's mistaken impression that "for retail money market funds, the potential for a sponsor to step in remains as it was pre-financial crisis."[50] To the contrary, we strongly believe that the regulatory requirements applicable to regulated US money market funds, as enhanced through two significant rounds of post-financial crisis reform, sufficiently mitigate step-in risk associated with these funds.[51]

Post-crisis measures in Europe, and pending reform proposal. In Europe, post-crisis money market fund guidelines developed by the Committee of European Securities Regulators (CESR) came into effect in 2011.[52] CESR's successor, the European Securities and Markets Authority (ESMA), has endorsed the guidelines (now commonly referred to as the "ESMA guidelines"). The ESMA guidelines establish robust standards, including with regard to valuation, eligible assets, maximum residual maturity of portfolio instruments, currency exposure, risk management, and "proactive" stress testing.[53] In addition to these risk-limiting elements, of particular note in the context of this consultation is the requirement to provide specific disclosure "to draw attention to the difference between the money market fund and investment in a bank deposit."[54] The guidelines state that "[i]t should be clear, for example, that an objective to preserve capital is not a capital guarantee."[55]

---

[48] *See* SEC, *Money Market Fund Reform*, Rel. No. IC-29132 (Feb. 23, 2010), available at http://www.sec.gov/rules/final/2010/ic-29132.pdf, at 97-101.

[49] SEC regulations allow an affiliate of a regulated US money market fund to purchase securities from the fund's portfolio, subject to specific conditions. Other forms of sponsor support, such as a loan from an affiliate to the fund, are prohibited without prior approval from the SEC.

[50] Consultative Document at 5.

[51] In addition, the US Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") revised pre-existing restrictions on transactions between US insured banks and their affiliates to make it more difficult for US banks to obtain regulatory approval to lend to and offer other types of support to affiliated funds and other affiliates. Dodd-Frank Act § 608.

[52] CESR, CESR's Guidelines on a common definition of European money market funds, CESR/10-049 (19 May 2010), available at https://www.esma.europa.eu/sites/default/files/library/2015/11/10-049_cesr_guidelines_mmfs_with_disclaimer.pdf.

[53] The guidelines establish a two-tiered approach that distinguishes between "short-term money market funds," which have a very short weighted average maturity (WAM) and weighted average life (WAL), and "money market funds," which operate with a longer WAM and WAL.

[54] CESR (ESMA) Guidelines at 3.

[55] *Id.*

In practice, many regulated European money market funds adhere to stricter standards than those set forth in the ESMA guidelines. For example, it is customary for funds that maintain a constant NAV (CNAV) to obtain ratings; to do so, such funds must operate in accordance with standards at least equivalent to those described above for regulated US money market funds. In addition, CNAV funds typically are members of the Institutional Money Market Funds Association (IMMFA) and comply with the IMMFA Code of Practice, which establishes standards intended to be "significantly tighter" than the ESMA guidelines.[56] Finally, as the consultation acknowledges, a European Commission proposed regulation to enhance the resiliency of regulated money market funds remains under discussion; it is possible that the final regulation will prohibit sponsor support.[57]

c. Regulated Stock and Bond Funds are Unlikely to Present Step-In Risk

The consultation asserts that "the types of entities that banks have a relationship with that may lead them to provide financial support when that entity is in financial stress are likely to include" not only money market funds but also "other investment funds."[58] There is no further indication as to what the Committee intends for that category to encompass. In this section, we explain why regulated stock and bond funds should lie outside the scope of the proposed framework.

First, as discussed above, regulated stock and bond funds have numerous regulatory and structural features that both distinguish these funds from the other types of unconsolidated entities and serve to mitigate the risk that a regulated stock or bond fund would experience material stress.

Second, regulated stock and bond funds operate with a floating NAV. The consultation states that a fund with a floating NAV "attracts less step-in risk" than a stable NAV fund.[59] Fund investors understand that their principal is not guaranteed: the value of their investment will fluctuate and any gains or losses belong to them. There is no basis for investors to have an expectation of sponsor support. The Bank of Canada recently concurred, finding that "although many Canadian fund management firms are affiliated with a major bank, these banks are unlikely to suffer losses from stress in any of the management firm's funds, since funds and their management firms are separate legal entities and there is no implicit expectation that a long-term mutual fund's price would be supported to maintain a certain value."[60]

Third, as is the case with regulated money market funds, regulated stock and bond funds must adhere to certain risk-limiting requirements that have the effect of constraining the permissible investments for these funds. For example, in the case of US mutual funds, at least 85%

---

[56] *See* http://www.immfa.org/about-immfa/immfa-code.html.

[57] *See* http://ec.europa.eu/finance/investment/money-market-funds/index_en.htm.

[58] Consultative Document at 10. Similarly, in discussing asset management, the consultation points to experience with money market funds in the financial crisis as an example of sponsor support but makes additional reference to "funds" that do not seem to be limited to money market funds. *See id.* at 26-27.

[59] *Id.* at 5.

[60] Bank of Canada report, *supra* note 33, at 54.

of the fund's portfolio must be invested in liquid securities, and some funds voluntarily adopt more restrictive policies regarding investment in illiquid securities. US mutual funds also must comply with limits on leverage, with attendant effects on a fund's use of certain derivatives. Likewise, UCITS must invest at least 90% of their assets in transferable securities and other liquid assets. These assets may include derivatives, subject to requirements related to counterparties, underlying instruments, liquidity, exposure limits and risk monitoring. Exposure is generally limited to the total net value of a fund's assets.

Fourth, US and global regulators are currently examining regulated funds' liquidity management and use of leverage, among other activities, and considering further measures to bolster existing rules. The consultation takes specific note of the SEC's proposal on liquidity risk management.[61] It also recognizes that other ongoing work could be relevant.[62] We agree. For example, the SEC has issued a proposal that seeks to impose specific limits on a regulated US fund's use of derivatives and financial commitment transactions.[63] In addition, the US Financial Stability Oversight Council (FSOC), IOSCO, and the FSB are considering issues related to asset management and financial stability (*e.g.,* liquidity management, leverage, operational risk) that may have implications for this consultation.[64]

Finally, historical data demonstrate that regulated US stock and bond funds do not experience "financial distress" of the sort that might occasion sponsor support. Specifically, redemptions from such funds are modest even in times of severe market stress.[65] The reasons for this include not only various regulatory and structural features discussed earlier but also the nature of the regulated fund investor population, which in the US largely consists of retail investors. In fact, tens of millions of retail investors hold more than 95 percent of regulated US stock and bond fund shares and, for many of them, saving for retirement is their primary investment goal. In addition, nearly 80 percent of those who invest in mutual funds outside of employer-based

---

[61] Consultative Document at 5. The consultation indicates that the SEC proposal is one of several initiatives in which authorities are tackling the impact of step-in risk. This is a mischaracterization of the motivation for the SEC's proposal. In addition, it incorrectly implies that regulated US stock and bond funds pose step-in risk to a degree that warrants a regulatory response. As we state above, regulated stock and bond funds are unlikely to present step-in risk. While a sensible liquidity risk management rule could make it even more unlikely for such risk to materialize, this is not the SEC's focus.

[62] The consultation states that "there are other reform initiatives currently underway [in addition to those it specifically mentions] . . . which alone or combined may limit or prohibit the extent of banks' exposure to step-in risk. Consultative Document at 7. It also recognizes that "the asset management industry has been and continues to be subject to an evolving regulatory environment." *Id.* at 26.

[63] *See* SEC Derivatives Proposal, *supra* note 27.

[64] *See, e.g.,* Minutes of the FSOC (Jan. 28, 2016), available at https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/January%2028,%202016-Meeting%20Minutes.pdf (discussing the status of the staff's review of asset management products and activities); Letter from Mark Carney, Chairman, FSB to G20 Finance Ministers and Central Bank Governors (Feb. 22, 2016), available at http://www.fsb.org/wp-content/uploads/FSB-Chair-letter-to-G20-Ministers-and-Governors-February-2016.pdf (discussing the status of the FSB's work to evaluate potential risks to financial stability in asset management and anticipated next steps).

[65] *See supra* note 32.

retirement accounts rely on the advice of a financial professional.[66] This combination of retirement saving and the use of financial professionals leads investors to pursue savings and investment strategies with a focus on their long-term goals.

III. A Capital Charge Against Presumed Step-in Risk from a Regulated Fund Would be Inappropriate and Would Conflict With US Law

The Committee's proposed approach for addressing step-in risk—*i.e.*, possibly by assigning new regulatory capital charges to bank sponsors of regulated funds—gives rise to additional reasons why regulated funds should remain outside the scope of the framework. First, banks that sponsor regulated funds are acting as agents for their funds. Fund investors retain, and should expect to retain, all investment risks. Disclosure to investors of that fact, and of the nature of these risks, should be clear and unambiguous. Regulatory policy should seek to frame and confirm these expectations.

Second, regulators should guard against taking actions that, by their nature, create perceptions or raise expectations that the bank is prepared to absorb any part of that risk. A capital charge intended to address this contingency would introduce clear moral hazards. The prospect of any form of bank backstop may make investors less careful in their choice of regulated funds and potentially could make bank sponsors less disciplined in managing a fund's investments.

The Committee's proposed approach to step-in risk, moreover, could have very troubling consequences. The consultation outlines three categories of methodologies for measuring step-in risk: full consolidation of an entity on the bank's balance sheet; partial consolidation (where two or more banks share the step-in risk); and "conversion."[67] It suggests that a "conversion" approach to assets under management (AUM) might be an appropriate way to measure step-in risk in the case of an investment fund—for example, attribution of 1 percent of a fund's AUM to the bank.[68] But even a 1 percent attribution could result in a vast expansion of a bank's capital requirements, which would be far out of proportion to any potential risk, given all of the mitigating factors discussed above. Any potential instance of sponsor support in this context is likely to be highly idiosyncratic, making an across-the-board capital charge far too blunt of a tool. The practical effect would be to deter banks—unjustifiably, in our view—from sponsoring regulated funds.

Precisely for the purpose of avoiding this result, federal law in the United States *prohibits* the Federal Reserve Board from taking into account affiliated regulated fund activities when setting

---

[66] ICI, 2015 Investment Company Fact Book, available at https://www.ici.org/pdf/2015_factbook.pdf, at 122.

[67] "Conversion" would involve attribution of a percentage of an unconsolidated entity's assets to the bank for regulatory capital purposes by applying a risk-adjusted "conversion" factor. Consultative Document at 20-21.

[68] *Id.* at 26.

capital requirements for bank holding companies, subject to limited exceptions.[69] The legislative history of this provision reflects congressional recognition that regulated US funds have their own appropriately tailored regulatory framework. For example, the Report from the US House of Representatives Committee on Banking and Financial Services stated that "[i]nvestment companies are regulated entities that must meet diversification, liquidity and other requirements specifically suited to their role as investment vehicles."[70] In light of the existing regulatory framework, the Committee noted that "it was important to ensure that the [US Federal Reserve] Board not indirectly regulate these entities through the imposition of capital requirements at the holding company level, except in the very limited circumstances noted above."[71] These statements suggest an intent to create a regulatory structure that would prevent the Federal Reserve Board from using capital requirements in a way that would restrict bank holding company offerings of regulated funds. The approaches the consultation suggests—at least as applied to regulated US funds—appear to conflict with the letter and spirit of this law.

* * * * *

We appreciate the opportunity to comment on this consultation. If you have any questions regarding our comments or would like additional information, please contact me at (011) 44-203-009-3101 or dan.waters@iciglobal.org; Susan Olson, Chief Counsel, ICI Global, at (202) 326-5813 or susan.olson@iciglobal.org; Frances Stadler, Associate General Counsel, ICI, at (202) 326-5822 or frances@ici.org; or Rachel Graham, Associate General Counsel, ICI, at (202) 326-5819 or rgraham@ici.org.

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director
ICI Global

---

[69] Enacted in 1999 as part of the Gramm-Leach-Bliley Act, the relevant provision states: "In developing, establishing, or assessing bank holding company capital or capital adequacy rules, guidelines, standards, or requirements for purposes of this paragraph, the [Federal Reserve] Board *may not take into account* the activities, operations, or investments of an affiliated investment company registered under the Investment Company Act of 1940 unless the investment company is— (i) a bank holding company; or (ii) controlled by a bank holding company by reason of ownership by the bank holding company (including through all of its affiliates) of 25 percent or more of the shares of the investment company, and the shares owned by the bank holding company have a market value equal to more than $1,000,000." 12 U.S.C. § 1844(c)(3)(C) (emphasis added).

[70] H.R. Rep. No. 106-74, pt. 1, at 130 (1999).

[71] *Id.*