INVESTMENT COMPANY INSTITUTE

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February 25, 2011

Financial Stability Oversight Council
Attn: Lance Auer
1500 Pennsylvania Avenue, N.W.
Washington D.C. 20220

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (FSOC-2011-0001-0001)

Ladies and Gentlemen:

The Investment Company Institute[1] appreciates the opportunity to provide further comment as the Financial Stability Oversight Council ("FSOC" or "Council") seeks to develop the process by which it will designate certain nonbank financial companies for heightened supervision pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[2] As both issuers of securities and large investors in U.S. and international financial markets, ICI's registered investment company members are keenly interested in policies that promote a well-functioning financial system able to withstand the periodic shocks that are an inevitable part of our complex, global marketplace.

It is disappointing that the proposed rule does not specify how the FSOC intends to apply the criteria set forth in Section 113 when analyzing whether a particular company should be designated as a systemically important financial institution ("SIFI"). For example, while the Release outlines a proposed analytical framework for assessing the ten specific statutory criteria, the rule text contains no evidence of that framework. In addition, the Release gives little indication as to the Council's views on the specific criteria, and simply summarizes the views of commenters on its advance notice of proposed rulemaking ("ANPR"). We realize that the Council may wish to preserve sufficient flexibility to respond, as circumstances dictate, to new or emerging risks to the financial system. The need for

[1] The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of $12.31 trillion and serve over 90 million shareholders.

[2] Financial Stability Oversight Council, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 76 Fed. Reg. 4555 (Jan. 26, 2011) ("Release").

flexibility must be balanced, however, against the needs of financial market participants for clarity regarding the "rules of the road."[3]

As explained more fully below, we believe there are several ways in which the FSOC can—and should—provide useful guidance to financial market participants without unduly limiting its discretion. In particular, we recommend that the FSOC:

- formally adopt its proposed framework, either by incorporation into the text of the final rule or through an explicit discussion of the framework in the rule's adopting release;[4]

- to the greatest extent possible, disclose its own views on the Section 113 criteria; and

- provide some indication (for example, through a statement in the adopting release) that the Council intends to use its Section 113 authority advisedly—*i.e.,* in circumstances where other regulatory actions to address or limit perceived risks clearly would be inadequate.

The Dodd-Frank Act, by design, provides an array of new regulatory tools, in addition to the FSOC's SIFI designation authority. Moreover, it empowers the FSOC to influence oversight of risks to the financial system through its interactions with primary regulators. Ultimately this may prove to be one of the FSOC's most significant roles. In our view, the broad scope of these other authorities should allow the FSOC to reserve SIFI designation for those circumstances in which the risks to the financial system as a whole are both large and quite plain, and nothing less than designation will suffice to address them.

Finally, we turn to the suggestion by some commenters that certain (presumably larger) money market funds should be designated for heightened supervision pursuant to Section 113. We explain why such designation would *not* be an appropriate regulatory tool for further strengthening the resilience of money market funds to severe market distress.

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[3] A company that is deciding whether to restructure or enter a new line of business, for example, may need to consider whether its proposed move could have Section 113 implications. Likewise, ICI members and other institutional investors typically consider how a company is regulated as part of their investment analysis. Being able to surmise whether a particular nonbank financial company could become subject to prudential regulation and consolidated supervision by the Federal Reserve Board is relevant to the decision about whether and how to commit capital to that company.

[4] If the latter approach is followed, the rule text should contain a specific reference to the adopting release.

Formal Adoption of the Proposed Framework

Central to an inquiry under Section 113 are the various criteria that Congress directed the FSOC to consider. The text of the FSOC's proposed rule does little more than recite the statutory language in Section 113. The Release, however, proposes an analytical framework that provides some insight into the FSOC's interpretation of the Dodd-Frank Act criteria. The framework maps each of the specific criteria in Section 113 to one of six broad categories. As the Release indicates, the six categories identified by the FSOC—size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny—reflect different dimensions of a company's potential to pose risk to the financial system.[5]

ICI's letter responding to the ANPR discusses the Section 113 criteria in a way that largely tracks these six categories.[6] For convenience, we briefly summarize below our primary observations about the various categories, both in general terms and how they should apply specifically to registered investment companies ("funds") and their investment advisers.

- **Size**[7]—A company's size alone reveals very little about its potential to pose risk to the financial system and, consequently, could be highly misleading if considered in isolation. In assessing a company's size as part of its overall analysis, the FSOC should focus on the size of the company's potential on- and off-balance sheet risks, and the impact on the U.S. financial system of potential losses. In the case of a company that manages assets owned by others, there are several clear reasons why the managed assets should not be attributed to the company. With regard to a fund's investment adviser, these reasons include: (1) the fund is a separate legal entity; (2) shareholder recourse for losses is solely with respect to the fund, absent wrongdoing on the part of the adviser; (3) the adviser cannot pledge the fund's assets to advance its own interests; (4) the adviser does not take on leverage to manage the fund's portfolio; and (5) the adviser must manage the fund's assets as a fiduciary and in accord with the fund's own investment objectives and restrictions.

- **Lack of Substitutes**[8]—Captured within this category is a company's importance as a source of credit (*e.g.*, for households, businesses, and state and local governments). A company is more likely to pose systemic risk if it is a single or primary source of credit for such purposes and no

[5] Under the proposed framework, the six categories are further divided into two groups: (1) those that seek to assess the potential for spillovers from the firm's distress to the broader financial system or real economy (size, lack of substitutes, and interconnectedness); and (2) those that seek to assess how vulnerable a company is to financial distress (leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny).

[6] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010 ("ICI's ANPR Response"), available at http://www.ici.org/pdf/24696.pdf.

[7] *See* ICI's ANPR Response at 5-7.

[8] *See id.* at 10-11.

other financial intermediaries can step in as alternate sources of financing. A crucial additional consideration is whether the credit is funded through debt or equity, with the latter posing considerably less risk to the financial system. While funds are significant providers of credit—to state and local governments, U.S. financial and operating companies, the U.S. Treasury, Fannie Mae and Freddie Mac—no one fund is a primary or sole source of credit to any of these markets and the vast majority of this credit is funded by paid-in capital (equity) from fund shareholders.

- **Interconnectedness**[9]—The key issue appears to be whether a financial firm's failure could force a disorderly unwinding of the firm's on- and off-balance sheet positions and spark a cascade of failures among the firm's counterparties that then spread to the counterparties of those firms.[10] Interconnectedness poses the greatest risk when it is coupled with leverage, either of the firm itself or its counterparties. Funds' interactions with shareholders and participation as counterparties in financial transactions pose very modest risks because funds have little or no leverage.

- **Leverage**[11]—As history amply demonstrates, companies that are highly leveraged pose greater potential risk to the financial system. For example, when one highly leveraged firm holds the debt of another highly leveraged firm, losses can mount exponentially and spread quickly. As required by law, most mutual funds operate with little if any leverage and segregate liquid assets (or maintain offsetting positions) in order to meet their obligations in leverage transactions. This has the effect of tightly constraining the risks a fund might pose to the financial markets.

- **Liquidity Risk and Maturity Mismatch**[12]—Generally speaking, financial institutions holding assets that can be sold quickly at a price approximating fundamental value are more resilient to economic shocks. Such assets give those institutions the flexibility to respond quickly to the kinds of rapidly changing economic circumstances that are common during financial crises. By contrast, institutions holding assets that do not trade in deep secondary markets may tend to pose more of a systemic concern. In order to maintain liquidity for ordinary redemptions, mutual funds must hold at least 85 percent of their portfolios in "liquid securities," which are defined as any assets that can be disposed of within seven days at a price approximating market

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[9] *See id.* at 9-10.

[10] As discussed in ICI's ANPR Response at pages 12-13, another important consideration is balance sheet transparency. For a number of reasons, a financial firm is more likely to pose a threat to the overall economy when its assets and liabilities are difficult for market participants to evaluate. For example, balance sheet opacity makes it difficult for creditors or other stakeholders to monitor a financial firm's health and exert discipline well in advance of a crisis.

[11] *See id.* at 7-8.

[12] *See id.* at 11-12.

value.[13] As a result, mutual funds can—and do—routinely handle large flows (purchases, exchanges, and redemptions) without perceptible consequences to the broader financial system.

- **Existing Regulatory Scrutiny**[14]—A financial company that already is highly regulated is more likely to have robust internal controls and compliance procedures. Moreover, its primary regulator is the "subject matter expert" regarding the applicable regulatory scheme, and will be knowledgeable about the industry of which the company is a part, industry best practices, areas of regulatory concern, and the markets in which the company operates. These circumstances may militate against the need for imposing additional regulation by the Federal Reserve Board, as is required for any company designated by the FSOC under Section 113. Further, the FSOC should look specifically at the degree to which the regulatory requirements already applicable to that company serve to limit or control risk. As a general matter, a financial company that must adhere to risk-limiting requirements is less likely to warrant a SIFI designation. Funds are subject to a comprehensive regulatory regime under the Investment Company Act of 1940, the most significant protections of which relate to leverage, custody of assets, transparency, mark-to-market valuation of fund assets, and transactions with affiliates. Fund investment advisers also are highly regulated.

The FSOC's proposed analytical framework provides for a more focused inquiry than would result if the FSOC simply ticked through each of the criteria listed in the Dodd-Frank Act. It also provides companies and markets with a somewhat better understanding of how the FSOC intends to approach its analysis. We urge that this framework be reflected in the rule text (either explicitly or by specific reference in the rule to a discussion of the framework in the adopting release).[15]

FSOC's Views on Specific Criteria

As the FSOC is no doubt aware, there is considerable uncertainty and concern among financial market participants about how the Council will apply the Section 113 criteria in making its determinations. In ICI's view, this rulemaking provides the Council with the opportunity to make known some of its policy judgments about the various criteria, without unduly constraining its flexibility.

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[13] Pursuant to Rule 2a-7 under the Investment Company Act of 1940, money market funds are subject to more stringent liquidity requirements. Specifically, money market funds must hold at least 95 percent of their portfolios in liquid securities and adhere to explicit daily and weekly liquidity requirements in order to meet reasonably foreseeable redemption requests.

[14] *See* ICI's ANPR Response at 14-16.

[15] We are encouraged by language in the Release suggesting that the FSOC may contemplate formally adopting the proposed analytical framework in the final rule. *See* Release at 4560 (stating that "[i]f adopted in a final rule, this framework would be used by the Council in meeting its statutory obligations of assessing the threat a nonbank financial company may pose to the financial stability of the United States, taking into consideration the factors set forth in the [Dodd-Frank Act]").

We believe a logical place to start would be with some of the issues on which the ANPR solicited comments. The first half of the Release summarizes comments the FSOC received and, in particular, highlights areas of agreement among most commenters (*e.g.*, that size alone does not fully reflect a firm's ability to pose systemic risk). Unfortunately, the Release offers little indication of the FSOC's own views, including with regard to these areas of general consensus. There is, however, one notable exception. In the ANPR, the Council requested comment on whether it should consider a financial company's receipt of government assistance as a criterion in its analysis under Section 113. The Release helpfully indicates that receipt of such assistance will not be a separate criterion "as that assistance should be viewed in light of the facts and circumstances under which it was provided." [16]

More statements of this kind by the FSOC would provide useful information to market participants without tying the Council's hands. Such statements also would establish some guideposts for the FSOC with respect to SIFI designations, which may help assure that the FSOC fulfills its statutory responsibilities in a principled and consistent manner. We accordingly urge that the adopting release discuss, to the greatest extent possible, the Council's views on the Section 113 criteria, particularly in regard to the areas of general consensus as noted above.

FSOC's Use of its Section 113 Authority

As noted in ICI's ANPR Response, Section 113 provides the Council with an extraordinarily potent legal authority. In that letter, we explained the reasons for our belief that the Council should use this authority with care, and reserve its application for those circumstances when the FSOC has determined that a specific company poses significant risks to the financial system that cannot otherwise be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act. Several other commenters expressed similar views.[17]

ICI believes one important reason for restraint with respect to SIFI designations is that it should help ensure that the FSOC and other financial regulators use the "right tool for the job." In the context of designations under Section 113, we think this means, among other things, that the FSOC should have a reasonable expectation that the "remedies" that would flow from SIFI designation are necessary and will be effective to address the specific risk(s) that the FSOC seeks to minimize.[18] This is

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[16] *Id.* at 4561.

[17] *See, e.g.,* ANPR comment letters from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co. (Nov. 5, 2010); Kenneth E. Bentsen, Jr., Executive Vice President, Public Policy and Advocacy, Securities Industry and Financial Markets Ass'n (Nov. 5, 2010); David T. Hirschmann, President and Chief Executive Officer, Center for Capital Markets Competitiveness, U.S. Chamber of Commerce (Nov. 5, 2010).

[18] These remedies include imposition of enhanced supervision and prudential standards by the Federal Reserve Board, application of minimum leverage capital requirements and minimum risk-based capital requirements, and prohibitions on proprietary trading and on sponsoring or investing in hedge funds or private equity funds.

Capital requirements, for example, are a tool of proven value in banking and broker-dealer regulation. But they do not make sense in all contexts. Requiring an asset manager that sponsors pooled investment vehicles operated basically as pass-through particularly important because, in practice, designation decisions—once made—will have significant consequences that are unlikely to be reversed.

Judicious use of the FSOC's Section 113 designation authority also is consistent with legislative intent, as described by former Senate Banking Committee Chairman Christopher S. Dodd. In a Senate colloquy, Chairman Dodd stated: "The Banking Committee intends that only a limited number of high-risk, nonbank financial companies would join large bank holding companies in being regulated and supervised by the Federal Reserve."[19] Federal Reserve Board Chairman Ben Bernanke likewise has expressed his view that Section 113 designations should be limited in number.[20]

As noted above, the text of the proposed rule largely incorporates, and is limited to, the FSOC's statutory mandate under Section 113. The Release does not indicate how the FSOC intends to use this potent legal authority. Without further elucidation, this rulemaking is likely to perpetuate the uncertainty among companies and the markets about what to expect with respect to such designations. We therefore urge the FSOC to state in the adopting release that it intends to use its Section 113 designation authority in an appropriately restrained fashion. Doing so would be helpful to financial market participants, yet still preserve the FSOC's ability to use this authority when necessary to prevent or mitigate a threat to U.S. financial stability posed by a single financial company.

SIFI Designation Not Appropriate for Money Market Funds

Some commenters have suggested that the FSOC should use its authority under Section 113 to designate certain (presumably larger) money market funds for enhanced supervision and regulation by the Federal Reserve Board.[21] We strongly disagree, for the reasons discussed below.

Risk-Limiting Characteristics of Money Market Funds

Analysis of the application of the Section 113 criteria using the six broad categories proposed by the FSOC (size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny) to money market funds would be similar to the analysis for mutual funds generally, as discussed in ICI's ANPR Response and above. In fact, money market funds must

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entities (such as mutual funds) to hold capital could imply a form of financial backstop against customers' market losses that would be fundamentally inconsistent with the nature of the fund. The risks of investing in the securities of such a fund are properly borne by fund investors, as disclosed in funds' prospectuses and advertising materials.

[19] 156 Cong. Rec. S5903 (daily ed. July 15, 2010).

[20] *See* Regulatory Perspectives on the Obama Administration's Financial Regulatory Reform Proposals, Part II: Hearing before the House Committee on Financial Services (Serial No. 111-68), 111th Cong. (2009), p. 47 (response by FRB Chairman Bernanke to question by Rep. Campbell).

[21] *See* ANPR comment letters from Christopher Cole, Senior Vice President and Senior Regulatory Counsel, Independent Community Bankers of America (Nov. 5, 2010) and Richard L. Trumka, President, American Federation of Labor and Congress of Industrial Organizations (Nov. 4, 2010).

comply with an additional set of regulatory requirements beyond the comprehensive requirements of the Investment Company Act to which all registered investment companies are subject. These legal requirements include stringent credit quality, liquidity, maturity, and diversification standards. The basic objective of money market fund regulation is to limit a fund's exposure to credit risk, interest rate risk, liquidity risk, and the risk that certain shareholders may act precipitously to seek large redemptions.

Building upon the lessons of the financial crisis, the Securities and Exchange Commission ("SEC") in early 2010 put in place significant enhancements to these requirements that were designed to better enable money market funds to withstand certain short-term market risks.[22] The SEC's amendments raised credit standards and shortened the maturity of money market funds' portfolios—further reducing credit and interest rate risk. The rule changes also require more frequent disclosure of money market funds' holdings and mark-to-market prices, so both regulators and investors will better understand funds' portfolios. In the recent financial crisis, some money market funds had to liquidate assets quickly to meet unusually high redemption requests. The SEC's amendments directly addressed this liquidity challenge by imposing for the first time explicit daily and weekly liquidity requirements. The amendments further require funds to have "know your investor" procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly.

In addition, the SEC took an important step to help bolster money market funds' resilience to severe market stress and redemption pressures. The SEC gave money market fund boards of directors, the majority of whose members are independent of fund management, the ability to suspend redemptions if a fund has broken or is about to break the dollar—a powerful tool to assure equitable treatment for all of the fund's shareholders, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund. This capability, which is available only if the board has determined to liquidate the fund, protects shareholders under extreme circumstances by ensuring that the actions of investors who exit a money market fund first do not harm those remaining behind.

Industry-Wide Solutions

To the extent there is a desire to bolster yet further the resilience of money market funds to severe market stress, designating each of the 652 money market funds or even each of the 277 prime money market funds[23] offered in the U.S. market as a SIFI and subjecting each to ongoing prudential

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[22] *See Money Market Fund Reform*, SEC Release No. IC-29132 (Feb. 23, 2010), 75 FR 10060 (Mar. 4, 2010), available on the SEC's website at http://sec.gov/rules/final/2010/ic-29132.pdf. A chart comparing money market fund regulations before and after the recent amendments is available on ICI's website at http://www.ici.org/policy/regulation/products/money_market/11_mmf_reg_summ.

[23] Prime money market funds are funds that may invest in high-quality, short-term money market instruments including Treasury and government obligations, certificates of deposit, repurchase agreements, commercial paper, and other money market securities. Based on our study of money market funds and the industry's experience in 2007 to 2009, we strongly believe that any further reforms should be limited to prime money market funds as an industry, as their role in the broader

supervision by the Federal Reserve Board is not the way to accomplish this.[24] Nor does it make sense to pick and choose among money market funds or complexes for this purpose, or to designate a fund adviser solely on the basis of its money market fund activities.[25] Rather, a process to assist the FSOC in determining the appropriate course of action is already well underway. And that process, quite appropriately, is focused on industry-wide solutions.

More specifically, last October, the President's Working Group on Financial Markets ("PWG") issued a report ("PWG Report") discussing several options for further reform of money market funds and recommending that the FSOC examine those options.[26] These options range from measures that could be implemented by the SEC under current statutory authorities to broader changes that would require new legislation, coordination by multiple government agencies, and the creation of new private entities. Nowhere in its detailed and thoughtful analysis of money market funds, however, does the PWG even suggest that the FSOC consider taking a fund-by-fund, complex-by-complex, or adviser-by-adviser approach under Section 113. To the extent the FSOC has any remaining concerns with respect to money market funds, we urge it to evaluate money market funds under this separate path as outlined in the PWG Report.

In our comment letter on the PWG Report, we explained that after examining the reform options outlined in the PWG Report, we believe that creating a private emergency facility to serve as a back-up source of liquidity for all prime money market funds in the event of unusual market stress is the best way to strengthen money market funds and mitigate any remaining risks these funds pose to

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money market can directly affect the commercial paper market. In contrast, government and Treasury funds do not pose the same concerns and, in fact, saw substantial inflows following the collapse of Lehman Brothers.

[24] Not only is this impractical, but as with other mutual funds, the remedies associated with such a designation (*e.g.*, prudential standards under Section 165 of the Dodd-Frank Act) are either unnecessary or inappropriate for money market funds. Several of the prudential standards to be applied if a money market fund were designated are largely addressed in the current money market fund regulatory regime (such as limits on leverage, mandatory liquidity buffers, or enhanced disclosure). Other concepts, such as risk-based capital standards, reflect banking regulation concepts that would not work for money market funds and could potentially increase systemic risks, moral hazard, or impose undue burdens on the funds' continued ability to provide a high quality product to investors and the U.S. economy.

[25] While an investment adviser may sponsor numerous money market funds within a single fund complex, each fund is a separate legal entity that is not legally dependent on its adviser for financial support. Rather, the adviser must manage each fund's assets as a fiduciary on behalf of the fund and its shareholders, in accordance with the detailed requirements of Rule 2a-7 and the fund's own investment objectives and restrictions.

[26] The PWG Report is available on the Treasury Department's website at http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf. The PWG directed the SEC to solicit comments on the Report to assist the FSOC in its examination of the reform options, *see* SEC Release No. IC-29497 (Nov. 3, 2010), available at http://www.sec.gov/rules/other/2010/ic-29497.pdf. In response to this request, ICI, along with more than 50 other commenters, provided its views on the reform options outlined in the PWG Report. *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Jan. 10, 2011) ("ICI Comment Letter"), available on ICI's website at http://www.ici.org/pdf/11_sec_pwg_com.pdf.

the U.S. financial system with the least negative consequences.[27] We would welcome any further opportunities to discuss this proposal with the FSOC.

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If you have any questions regarding our comments or would like additional information, please feel free to contact me (202/326-5901), ICI General Counsel Karrie McMillan (202/326-5815), or ICI Chief Economist Brian Reid (202/326-5917). Thank you for your consideration of these comments.

Sincerely,

/s/

Paul Schott Stevens
President & CEO
Investment Company Institute

[27] For a detailed description of ICI's model for an emergency liquidity facility for prime money market funds, *see* ICI Comment Letter at 23-31.