INVESTMENT COMPANY INSTITUTE®
ICI 1940 2015

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April 7, 2015

The Treasury Department
Attn: Qualified Financial Contracts Recordkeeping Comments
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Qualified Financial Contracts Recordkeeping Related to Orderly Liquidation Authority

Dear Sir or Madam:

The Investment Company Institute ("ICI")[1] appreciates the opportunity to comment on the proposal issued by the Secretary of the Treasury (the "Secretary"), as Chairperson of the Financial Stability Oversight Council ("FSOC"), to establish recordkeeping requirements (the "Proposed Rule") for qualified financial contracts ("QFCs").[2] The requirements are intended to assist the Federal Deposit Insurance Corporation ("FDIC") with exercising its rights and fulfilling its obligations under Title II of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act").[3]

As discussed below, ICI recommends that the Secretary revise the Proposed Rule in a number of respects. Specifically, ICI urges the Secretary to adopt a final rule that applies only to those entities likely to be resolved through the Dodd-Frank Act's Orderly Liquidation Authority ("OLA") and provide the agencies originally charged with adopting a joint rule an

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[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 $18.1 trillion and serve more than 90 million U.S. shareholders.

[2] Department of the Treasury, *Qualified Financial Contracts Recordkeeping Relating to Orderly Liquidation Authority*, 80 Fed. Reg. 966 (January 7, 2015) ("Notice").

[3] Title II establishes a mechanism for orderly resolution of a financial company whose failure and resolution under applicable federal or state law would have serious adverse effects on U.S. financial stability. Under Title II, the FDIC has receivership authority over financial companies in default or in danger of default for which a determination has been made by the Secretary to seek the FDIC's appointment as receiver.

appropriate role in administering requirements that apply to entities under their respective jurisdiction.

Specifically, ICI's comments address the following points:

- Registered investment companies ("regulated funds" or, where appropriate, "mutual funds") should be exempt from any final rule because regulated funds are extremely unlikely to be resolved through the OLA.

- The proposed $50 billion asset threshold is inconsistent with Section 210 of the Dodd-Frank Act, pursuant to which the Secretary is conducting this rulemaking.[4] Section 210 mandates that the implementing regulations must, as appropriate, differentiate among financial companies by taking into account specific factors including size, risk, complexity, leverage, frequency and dollar amount of QFCs, and interconnectedness to the financial system. Accordingly, any final rule should not use an asset threshold as the sole criterion for defining certain "records entities."

- The recordkeeping requirements of the Proposed Rule are overly burdensome, and recordkeeping requirements in any final rule should be no broader than similar requirements under FDIC rules applicable to banks in "troubled condition."[5]

- The Proposed Rule's application to affiliates of a "records entity" should be narrowed.

- Primary financial regulatory agencies or their representatives should have the authority to recommend exemptions to the Secretary (which the Secretary presumptively should grant), as each primary financial regulatory agency has the most complete understanding of entities under its jurisdiction.

Each of these points is addressed in detail below.

I. <u>Resolution of Regulated Funds under the OLA Is Extremely Unlikely and Regulated Funds Should Be Exempt from Any Final QFC Rule</u>

The Notice states that the definition of "records entity" is intended to capture "those financial companies with QFC positions for which the FDIC is most likely to be appointed as

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[4] 12 U.S.C. § 5390(c)(8)(H).

[5] 12 C.F.R. pt. 371.

receiver" under the OLA.[6] Appointment of the FDIC as receiver is likely to be a rare event. By statute, it requires, among other things, a determination by the Secretary that: (i) a financial company is in default or in danger of default; (ii) resolution under the Bankruptcy Code would have serious adverse effects on U.S. financial stability; and (iii) no viable private sector alternative is available to prevent the company's failure. In fact, the OLA concept as proposed by the Treasury Department was specially crafted with two situations in mind—the Lehman Brothers bankruptcy and the American International Group bailout.[7] The Regulatory Assessment provided in the Notice relies in part on the Lehman Brothers bankruptcy to justify the need for the Proposed Rule.[8]

The Proposed Rule would apply far more broadly, however, than is necessary to achieve its purpose. In particular, one prong of the proposed records entity definition would cover any financial company with $50 billion or greater in total assets that is predominantly engaged in financial activities. Consequently, the proposed definition would capture any regulated fund that has at least $50 billion in total assets. This is an inappropriate result given the many reasons why it is extremely unlikely that the FDIC ever would be appointed as receiver for a regulated fund, no matter what its size.[9]

No Disorderly Failure

On several previous occasions, ICI has explained, with supporting data and analysis, why regulated funds do not pose risks to financial stability.[10] Of particular relevance in this context is the fact that—in contrast to the large, complex, and highly leveraged financial institutions that experienced severe distress or failed during the global financial crisis, including

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[6] Notice at 972.

[7] *See, e.g.,* U.S. Department of the Treasury, *Treasury Proposes Legislation for Resolution Authority* (press release dated March 25, 2009), available at http://www.treasury.gov/press-center/press-releases/Pages/tg70.aspx.

[8] Notice at 990-91.

[9] The Notice makes clear that the Proposed Rule would apply to regulated funds. *See, e.g.,* Notice at 975 and n. 66 (clarifying that "[e]ach individual series of a registered investment company offering multiple series would be deemed to be a separate financial company for purposes of these rules").

[10] *See, e.g.,* Letter to Mr. Patrick Pinschmidt, Deputy Assistant Secretary for the FSOC, from Paul Schott Stevens, President & CEO, ICI, dated March 25, 2015, available at http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf. For further discussion, *see, e.g.,* Letter to Secretariat of the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated April 7, 2014, at Appendix F (discussing the historical experience of US stock and bond funds, including modest redemptions by mutual fund investors during periods of financial stress). The letter is available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf..

Lehman and AIG—regulated funds do not experience "distress" or "disorderly failure."[11] Regulated funds do not guarantee returns (or even a return of investors' principal) to investors, and investors know a fund's gains or losses belong to them alone. Unlike banks, mutual funds operate under strict regulatory restrictions on leverage and most use little to no leverage. Without leverage, it is virtually impossible for a fund to become insolvent—*i.e.,* for its liabilities to exceed its assets.

Even in times of severe market stress, regulated funds—particularly stock and bond funds—are generally able to satisfy investor redemptions without adverse impact on the fund's portfolio and the broader marketplace. Should a fund face an unexpected magnitude of redemption requests in a liquidity strained market, however, the Securities and Exchange Commission ("SEC") has the authority under Section 22(e) of the Investment Company Act to allow the fund to suspend redemptions for such period as the SEC determines necessary to protect the fund's shareholders.[12]

Several features of the structure and regulation of regulated funds, along with the dynamic and competitive nature of the fund business, facilitate "orderly resolution" and help explain why the need to resolve a regulated fund under the OLA is so unlikely to arise. These features include the independent legal character of a fund and Investment Company Act provisions concerning separate custody of fund assets, restrictions on affiliated transactions, and board oversight. The industry is very competitive, and regulated funds are highly substitutable. No single regulated fund is so important or central to the financial markets or the economy that the government would need to intervene or offer support to protect financial stability.

A regulated fund that does not attract or maintain sufficient assets typically will exit the business through a merger with another fund or liquidation. When a fund is liquidated, there is an established and orderly process by which the fund liquidates its assets, distributes the proceeds *pro rata* to investors and winds up its affairs, all without consequence to the financial system at large. This process adheres to requirements in the Investment Company Act and state or other relevant laws based on the domicile of the fund, including consideration and approval by the fund's board of directors.

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[11] *See, e.g.,* Investment Company Institute,*"Orderly Resolution" of Mutual Funds and Their Managers, available at* *http://www.ici.org/pdf/14_ici_orderly_resolution.pdf*.

[12] We note that the SEC has adopted rules allowing a money market fund to impose liquidity fees, suspend redemptions, and/or liquidate in times of severe market stress. *See* Rules 2a-7(c)(2) and 22e-3 under the Investment Company Act. The rules contain strict conditions designed to limit their use to certain circumstances and require a vote by the fund's board (including a majority of the independent directors) and prompt notice to the SEC and the public.

Fund liquidations are relatively straightforward because mutual funds have simple capital structures. A fund contracts with a limited number of service providers and it pays these service providers through routine asset-based or annual service fees that are accrued in advance on the fund's books.[13] The Investment Company Act strictly regulates and limits the ability of a fund to borrow or lend money or other assets, and (as noted above) to engage in transactions involving leverage. Accordingly, a primary focus of the liquidation process is the conversion of the fund's portfolio investments to cash or cash equivalents. How long this process takes will depend upon such factors as portfolio liquidity,[14] the degree of ease in converting portfolio securities to cash or cash equivalents and the fund's investment strategy and objectives. Typically, the process will take place over a time period that the fund's investment adviser and board of directors—consistent with their fiduciary obligations to the fund—deem appropriate. If a particular situation demands an expedited timetable, the investment adviser and fund board have the ability to act swiftly. Nothing would require, however, an immediate sell-off of a fund's entire portfolio or the distribution of liquidation proceeds to investors within seven days. All of this demonstrates that in the case of regulated funds, there is a "viable private sector alternative" for their "orderly liquidation."

For the foregoing reasons, it is nearly inconceivable that a regulated fund would be resolved under the OLA. The definition of records entity therefore should be revised to exempt regulated funds.[15]

Regulated Funds Are Not "Large Corporate Groups"

The Notice explains that the Proposed Rule would *only* apply to "large corporate groups" in which at least one member of the corporate family fits within the records entity criteria; it further states that this treatment of large corporate groups is necessary because

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[13] In addition to the investment adviser, these typically include the custodian, administrator, auditor, transfer agent and distributor.

[14] At least 85 percent of a mutual fund's portfolio must be invested in "liquid securities"—namely, assets that can be "sold or disposed of in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the instrument on its books." *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612, 57 Fed. Reg. 9828 (March 20, 1992)("SEC Liquidity Guidelines Release"); and SEC Division of Investment Management, IM Guidance Update No. 2014-1 at 6 (January 2014), available at www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf (explaining that the 1992 Guidelines are Commission guidance and remain in effect).

[15] It is ICI's strongly held view that regulated funds do not pose risks to U.S. financial stability and that a determination under Title I of the Dodd-Frank Act that a regulated fund could pose a threat to U.S. financial stability would be wholly inappropriate. Nevertheless, we would not object if the final rule were to apply the QFC recordkeeping requirements to any regulated fund that was so designated.

"affiliated companies" that are part of a large corporate group could play an important role in determining the risks that are present and information about affiliates may help the FDIC in its role as receiver.[16] Curiously, the Paperwork Reduction Act section of the Notice lists the types of "large corporate groups" likely to meet the proposed definition of a "records entity" and the list includes regulated funds. Referring to an individual regulated fund—the entity potentially captured by the rules—as a "large corporate group" is inaccurate and suggests a fundamental misunderstanding of such funds. Likewise, regulated funds that have a common investment adviser, that share other common service providers or that have a common board of directors should not be viewed as being part of a "corporate group" that the FDIC will need to resolve.

First, each regulated fund is a distinct legal entity, separate from its investment adviser and any other fund or advisory client. The fund itself, not the manager, is the principal/party to any transactions in the fund's portfolio (including, *e.g.*, derivatives or other financial contracts). And a regulated fund is not consolidated on the balance sheet of any other regulated fund that shares the same investment adviser or their common investment adviser.

Second, the Investment Company Act contains a number of strong and detailed prohibitions on transactions between a regulated fund and affiliated organizations such as the fund's investment adviser, a corporate parent of the fund's adviser, or an entity under common control with the adviser.[17] These Investment Company Act provisions prohibit or strictly limit financial interconnections both between a fund adviser and the funds it manages, and among funds managed by the same adviser.

Third, even if regulated funds share a common board, which often is the case, the boards of directors are elected by shareholders, not by the fund's sponsor or investment adviser; thus, one regulated fund does not have the power to elect the directors or trustees of another regulated fund. Lastly, under the Investment Company Act, the assets of a regulated fund must be kept separate from the assets of its manager, using an eligible custodian (typically a U.S. bank

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[16] Notice at 970, 994. Under the Proposal Rule, an affiliate is defined as "any entity that controls, is controlled by, or is under common control with a financial company or counterparty." In turn, an entity is deemed to control another entity if the first entity (1) has the power to vote 25% or more of any class of voting securities of the other entity, (2) controls the election of a majority of the directors or trustees of a the other entity, or (3) consolidates the other entity for financial or regulatory reporting purposes.

[17] Among other things, Section 17 of the Investment Company Act prohibits transactions between a regulated fund and an affiliate acting for its own account, such as the buying or selling of securities (other than those issued by the fund) or other property, or the lending of money or property. It also prohibits joint transactions involving a fund and an affiliate. In some cases, transactions involving an affiliate are permitted in accordance with SEC rules and exemptive orders, which impose conditions designed to protect investors and require the fund's board of directors, including the independent directors, to adopt and review procedures designed to ensure compliance with those conditions.

for domestic assets), which further underscores the separateness of each individual regulated fund. In sum, the liquidation of one regulated fund in a complex likely has no implications for other funds in the same complex and certainly has no implications for U.S. financial stability.

II. The Proposed $50 Billion Asset Threshold Is Inconsistent with Congressional Intent

Under the Proposed Rule, the term "records entity" includes any financial company that is predominantly engaged in financial activities, has total assets equal to or greater than $50 billion and is a party to an open QFC or guarantees, supports or is linked to an open QFC.[18] This approach of capturing all financial companies with at least $50 billion in total assets in the definition of records entity is inconsistent with the Dodd-Frank Act's framework for the QFC recordkeeping requirement.

In particular, Section 210 of that Act requires that in determining the financial companies to which the recordkeeping requirements will extend, the rule writing agency "shall, as appropriate, differentiate among financial companies by taking into consideration their size, risk, complexity, leverage, frequency and dollar amount of qualified financial contracts, interconnectedness to the financial system, and any other factors deemed appropriate."[19] This language is unequivocal in indicating that size alone should *not* be used to determine whether a financial company is subject to QFC recordkeeping requirements; rather, it seems clear that the requirements should apply to complex, highly leveraged and interconnected financial companies—not merely financial companies that cross a certain asset threshold.[20]

The Notice indicates that, for this prong of the "records entity" definition, size intentionally was used as the exclusive proxy for the more rigorous and refined analysis called for by the Dodd-Frank Act. The Notice suggests that the $50 billion asset threshold "is a useful means for identifying entities that are of a sufficient size that they could be considered for orderly liquidation under Title II" and "sufficient to differentiate" financial companies that might be subject to the OLA. It further states that a $50 billion threshold is already used as an "initial evaluation tool for determining whether a nonbank financial company could pose a threat to the financial stability of the United States" under Title I of the Dodd-Frank Act.

ICI believes this rationale for the $50 billion asset threshold falls far short of the Dodd-Frank Act's requirements. As previously explained, a regulated fund—regardless of its size—is

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[18] Notice at 997 (to be codified at 31 C.F.R. § 148.2).

[19] 12 U.S.C. § 5390(c)(8)(H)(iv).

[20] The other prongs of the "records entity" definition focus on nonbank financial companies and financial market utilities that FSOC has designated as systemically important.

highly unlikely ever to be resolved under the OLA. Nor has the Secretary explained why a regulated fund's size (or, for that matter, the mere size of any financial company) qualifies it as a financial company for which the FDIC is "most likely to be appointed as receiver." Indeed, in the case of nonbank financial companies, Section 113 of the Dodd-Frank Act and the FSOC's own related interpretive guidance make it quite clear that a company's size alone is *not* a sufficient indicator of the company's potential to pose risks to financial stability (*e.g.,* as a result of the company's "material financial distress"). Section 113 enumerates ten factors that the FSOC, at a minimum, must consider when it evaluates a nonbank financial company for potential designation; size (*i.e.,* the "amount and nature" of the company's financial assets) is just one of these factors.[21] The FSOC guidance outlines an analytical framework under which nonbank financial companies will be subject to further review if they have at least $50 billion in total consolidated assets *and* meet at least one of five other uniform quantitative thresholds.[22]

In recent testimony before the Senate Banking Committee, Federal Reserve Board ("FRB") Governor Daniel Tarullo explained that bank holding companies with $50 billion or more in assets are not—merely by being large entities—subject to the same regulatory requirements as the largest and most complex banking organizations. Governor Tarullo testified that, in imposing Dodd-Frank mandated standards on bank holding companies, the FRB has focused not just on asset size but also on the *risks* posed by banking firms.[23]

In sum, ICI believes that the proposed $50 billion asset threshold is inconsistent with Congressional intent and would cause the QFC rule to apply far more broadly than just to

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[21] We note that the FSOC has not designated any nonbank financial company with less than $500 billion in total consolidated assets as a systemically important financial institution under Title I of the Dodd-Frank Act. *See* FINANCIAL STABILITY OVERSIGHT COUNCIL, DESIGNATIONS (Feb. 4, 2015), http://www.treasury.gov/initiatives/fsoc/designations/pages/default.aspx (including links explaining the FSOC's rationale for designating each of MetLife, Inc., American International Group, Inc., General Electric Capital Corporation, Inc., and Prudential Financial, Inc. as systemically important and disclosing the total consolidated assets of the entities (other than American International Group, Inc.), as follows: MetLife, Inc. with $909 billion, General Electric Capital Corporation with $539 billion, and Prudential Financial, Inc. with $709 billion); *see also* American International Group, Inc. 2013 Form 10-K Filing with the Securities and Exchange Commission, available at http://www.aig.com/Annual-Reports-and-Proxy-Statements_3171_438018.html (disclosing American International Group Inc.'s total consolidated assets of $541 billion).

[22] FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637 (April 11, 2012).

[23] *Application of Enhanced Prudential Standard to Bank Holding Companies Before the S. Comm. on Banking, Housing and Urban Affairs,* 114th Cong. 1 (2015) (statement of Daniel K. Tarullo). Governor Tarullo also indicated that the Dodd-Frank Act's use of the $50 billion threshold for application of certain enhanced prudential standards to bank holding companies is inappropriately low and ought to be revised.

those financial companies for which the FDIC is most likely to be appointed as receiver. We accordingly recommend revising the definition of "records entity" to take into consideration, in addition to size, a financial company's "risk, complexity, leverage, frequency and dollar amount of qualified financial contracts, interconnectedness to the financial system, and any other factors deemed appropriate."

III. <u>The Proposed Rule's Requirements Are Too Broad</u>

There are other ways in which the scope of the Proposed Rule is overly broad, as discussed below.

The Scope Should Be Consistent with FDIC Requirements for "Troubled" Banks

The Notice acknowledges that the Proposed Rule looked to the FDIC's recordkeeping requirements for banks "in a troubled condition"[24] as a starting point, but, as proposed, the requirements are "more extensive" than the FDIC's rules.[25] In addition, the Proposed Rule applies to all records entities, irrespective of whether the financial company is in "troubled condition" (and presumably more likely to face resolution under the OLA).

Thus, the Proposed Rule both has "more extensive" data requirements than the FDIC's rule and also applies to a broader range of financial companies. For example, the Proposed Rule would require records entities to keep certain position-level data and counterparty-level data that are not required by the FDIC's rule, and would require a standardized format that is not required by the FDIC's rule. The Notice provides no policy justification for this approach. ICI recommends revising the Proposed Rule either to apply its requirements only to financial companies in "troubled" condition (this approach also would be consistent with the Dodd-Frank Act's mandate that the rule take into account a financial company's risk) or to narrow the scope of the data requirements.

The Proposed Rule's Application to Affiliates of a "Records Entity" Should Be Narrowed

The proposed definition of "records entity" includes in paragraph 1(D) a financial company that is a member of a corporate group (i) in which at least one financial company meets the criteria specified in paragraphs 1(iii)(A), (B) or (C) of the "records entity" definition and (ii) that *is a party to an open QFC* or that guarantees, supports or is linked to an open QFC of an affiliate that is part of the corporate group. Based on the broad definition of "control" in

[24] 12 C.F.R. 371.1.

[25] Notice at 970.

the Proposed Rule, a regulated fund might for purposes of the Proposed Rule be deemed to be an affiliate of its sponsor or investment adviser during the period in which the sponsor or investment adviser holds a level of seed money investment equal to 25 percent or more of the fund.

For the reasons discussed above, we submit that regulated funds should in any event be exempt from the final rule. We further submit that there is no policy or legal basis for applying the recordkeeping requirements to an affiliate unless the affiliate guarantees, supports or is linked to an open QFC of another affiliate. This is because Section 210(c)(16) of the Dodd-Frank Act grants authority to the FDIC as receiver only with respect to the enforcement of contracts of affiliates of a "covered financial company" (*i.e.*, the company being resolved) that are "guaranteed or otherwise supported by or linked to" such covered financial company. Given that the FDIC's authority as receiver would not extend to the enforcement of contracts of a subsidiary or affiliate that are simply "open," such contracts should not be encompassed by the record keeping requirements. Thus, we urge that the language in paragraph (D)(1) of the definition of records entity relating to being a party to an open QFC be deleted.

IV. The Primary Financial Regulatory Agencies Should Determine Exemption Eligibility for Entities under Their Jurisdiction

The Proposed Rule would allow the Secretary to issue specific exemptions for individual records entities and general exemptions for types of entities, after receipt of a written recommendation to the Secretary from the FDIC.[26] The FDIC would have to consult with the primary financial regulatory agency of the records entity or entities subject to the exemption.[27]

ICI supports the use of an exemption process, but we recommend revising the Proposed Rule to permit the primary financial regulatory agencies (or representatives from such agencies) to make recommendations for exemptions directly to the Secretary. In addition, the Secretary presumptively should grant any recommended exemptions.

As revised, the exemption framework would be consistent with the mandate set forth in Section 210 of the Dodd-Frank Act. In particular, Section 210 directed the primary financial regulatory agencies jointly to "prescribe" QFC recordkeeping rules. These rules would have been adopted by each primary financial regulatory agency, applicable to the entities under each agency's respective jurisdiction and separately administered by each agency. Thus, even though Section 210 calls on the Secretary to prescribe the QFC recordkeeping rules in the absence of

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[26] Notice at 998 (to be codified at 31 C.F.R. 148.3(c)).

[27] *Id.*

joint agency action, it does not mandate joint administration of the rule (or administration by the Treasury or the FDIC).

ICI accordingly recommends that any final QFC rule provide that the Secretary presumptively will grant exemptions for entities under an agency's jurisdiction, upon a recommendation by that agency or its representatives. This approach would leverage the experience of the primary financial regulatory agencies. In particular, each agency is most familiar with the business, operations and risks of entities under its jurisdiction—as well as the recordkeeping requirements that already apply to those entities—and therefore is well positioned to understand whether and how QFC recordkeeping requirements are appropriate for such entities.[28]

We note, however, that even a well-crafted exemption mechanism cannot substitute for an appropriately tailored rule, as called for by Section 210.

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ICI appreciates the opportunity to comment on the Proposed Rule. If you have any questions regarding our comments or would like additional information, please feel free to contact me at 202/326-5815, Frances M. Stadler at 202/326-5822, or Rachel H. Graham at 202/326-5819.

Sincerely,

/s/ David W. Blass

David W. Blass
General Counsel

[28] According to the Notice, "the exemption provisions set forth in the Proposed Rules are designed to enable the rules to work in conjunction with the CFTC's, SEC's and other regulatory recordkeeping requirements, as they would provide the ability for the Secretary to be flexible in taking such requirements into account." Notice at 986.