



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

November 5, 2010

Financial Stability Oversight Council  
c/o United States Department of the Treasury  
Office of Domestic Finance  
1500 Pennsylvania Avenue, N.W.  
Washington, D.C. 20220

*Re: Public Input for the Study Regarding the Implementation of the Prohibitions on Proprietary Trading and Certain Relationships with Hedge Funds and Private Equity Funds (FSOC-2010-0002)*

Ladies and Gentlemen:

The Investment Company Institute<sup>1</sup> is writing to provide comments on the Financial Stability Oversight Council's ("FSOC") request for information on the "Volcker Rule" contained in Section 619 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act").<sup>2</sup> Section 619 requires that FSOC conduct a study of the Volcker Rule, which study must be considered by the relevant regulatory agencies in implementing the Rule's provisions.

Our comments focus on the impact on registered investment companies ("funds") of the Volcker Rule's prohibition on proprietary trading. In particular, we recommend that the FSOC study make clear that the exceptions to the proprietary trading prohibition permit covered entities under the Rule to continue to provide execution services and liquidity to funds when trading. In addition, our letter highlights potential unintended consequences for funds and their advisers under the Rule and asks that FSOC's recommendations for Volcker Rule implementation advise the relevant regulatory agencies to avoid these outcomes.

---

<sup>1</sup> The Investment Company Institute is the national association of U.S. registered 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 \$12.05 trillion and serve over 90 million shareholders.

<sup>2</sup> Docket No. FSOC-2010-0002 (October 1, 2010), 75 FR 61758 (October 6, 2010).

## Impact of Volcker Rule on Trading by Funds

The Volcker Rule, among other things, prohibits “banking entities” from engaging in “proprietary trading.” The Rule, however, recognizes the need to permit certain types of proprietary trading and provides exceptions for a number of “permitted activities.” Question 2 of the request for information asks about the key factors and considerations that should be evaluated when making recommendations on implementing the proprietary trading provisions of the Volcker Rule. Question 4 asks about the factors and considerations that should inform decisions on the definitions of some of the key terms used in the Rule, including the definitions of “proprietary trading,” and several permitted activities such as a transaction “in connection with .... market making related activities” and “the purchase, sale, acquisition, disposition of securities or other instruments ‘on behalf of customers.’”

The Institute believes that Congress intended to preserve the ability for banking entities to engage in traditional trading activities to serve the needs of customers, such as funds.<sup>3</sup> Banking entities provide crucial execution services and liquidity to the securities market, which activities should be permitted either as market making-related activities or as activities “on behalf of customers.”

Most significant to funds, banking entities provide liquidity and capital commitment in support of the securities market, including the trading activities of funds, in a variety of asset classes and under a number of different circumstances. When acting as a market maker in active, liquid markets, banking entities may execute transactions rapidly at or near publicly displayed quotes. When acting as a market maker for less liquid securities or for large positions, banking entities will sometimes have to hold positions for weeks or even months before finding an outlet for the position.

The Volcker Rule, by framing the permitted activity as “market making-related,” rather than just “market making,” recognizes the wide range of market making-related services provided by banking entities. In the colloquy between Senator Bayh (D-IN) and Chairman Dodd (D-CT), Chairman Dodd affirmed Senator Bayh’s clarification that the market making-related permitted activity “would allow banks to maintain an appropriate dealer inventory and residual risk positions, which are essential parts of the market making function. Without that flexibility, market makers would not be able to provide liquidity to markets.”<sup>4</sup>

Banking entities also provide valuable services on behalf of funds as block positioners, providing liquidity and minimizing market disruption. When acting as a block positioner, a banking entity will take on a large position from a customer and may need to hold the position for some time to avoid selling the block at a large loss or causing severe movements in the price of the stock. Block positioning

---

<sup>3</sup> See, e.g., Letter from Sens. Merkley (D-OR), Levin (D-MI), *et al* to Members of the Financial Stability Oversight Council, dated October 28, 2010 (“[t]he extent of permitted activities ... should be strictly and clearly delineated to ensure that high-risk proprietary trading stops, while economically beneficial and risk reducing activities continue.”)

<sup>4</sup> 156 CONG. REC. S5902 (daily ed. July 15, 2010) (statement of Sen. Bayh).

is important to a fund that wants to buy or sell a large amount of stock quickly but that could be disadvantaged by placing the large order into the market all at once. The large order may negatively impact the price of the stock and could allow for the leakage of information about the fund's position in the security. Block trading can eliminate these concerns by facilitating the execution of the large order through the banking entity.

Clarity as to the scope of permitted activities is desirable, given their importance to funds and similarly situated users of these services. These activities may be particularly important when implementing more difficult or complex investment strategies that involve illiquid securities, time sensitive large trades or the immediate need for creditworthy counterparties. We believe that it is important to provide guidance to make clear that the definitions of, for example, "market making-related activities" and "on behalf of a customer" include the activities banking entities may conduct when providing execution and trading services to funds. The Institute therefore recommends that the FSOC study clarify that these types of services and activities are covered under the permitted activities exception and recommend that its interpretations be respected in final rulemaking by the appropriate regulators.

We recognize the importance of satisfying the goals of the Volcker Rule and the concerns that have been expressed about conflicts of interest that may exist in connection with proprietary trading. We do not believe, however, that construing the permitted activities exception in the manner discussed above would impede achieving the Rule's goals or pose risks to banking entities that the Rule was designed to address. The Volcker Rule is clearly focused on limiting banking entities from taking positions for the purpose of selling and to profit from short term price movements. In contrast, block positioning for customers is generally undertaken at the request of, and to accommodate, customers that need to liquidate a position quickly. Reducing the ability of banking entities to take on their customers' positions will simply disadvantage these customers, without addressing the core concerns of the Volcker Rule.

### **Potential Unintended Consequences for Funds and Their Advisers**

As discussed above, the Volcker Rule prohibits a "banking entity" from engaging in "proprietary trading." Below we describe several potential unintended consequences for funds and their advisers, and ask that FSOC's recommendations for Volcker Rule implementation advise the relevant regulatory agencies to avoid these outcomes.

#### Mutual Fund Seed Capital

We ask FSOC to recommend that investment adviser investments of seed capital to launch new mutual funds (or other registered investment companies) should not be considered "proprietary trading" for purposes of the Volcker Rule. Typically, the adviser provides the necessary seed capital and, in exchange, receives shares of the fund, usually for a temporary period until the fund receives sufficient

additional investments from public shareholders. This standard commercial practice is explicitly contemplated by Section 14 of the Investment Company Act of 1940, the statute that regulates the activities of registered investment companies. An adviser's provision of seed capital to a mutual fund or other registered investment company does not pose the conflicts of interest that the Volcker Rule seeks to prohibit, and we do not believe that the Congressional drafters of the Rule intended to capture this practice under the definition of "proprietary trading." Nevertheless, if regulators were to adopt a literal reading of the definition as part of the implementing regulations, it could have this unintended consequence for any investment adviser that is a "banking entity."<sup>5</sup> Therefore, to avoid any possible confusion, FSOC should recommend that this practice not be considered "proprietary trading" under the Volcker Rule.

#### Scope of "Banking Entities"

The Federal Reserve Board has long viewed mutual funds and other registered investment companies as being controlled by their independent boards of directors and not by their advisers or the other entities that provide the funds with administrative, brokerage, and other services.<sup>6</sup> FSOC should recommend to the regulatory agencies that they affirm this long-held interpretation of the Bank Holding Company Act and expressly confirm that funds are not brought within the scope of the term "banking entities" or otherwise subjected to the Volcker Rule by virtue of their relationship to banking entities. Subjecting funds to the Volcker Rule merely because they are sponsored or advised by, or receive other services from, banking entities clearly was outside the intent of Congress and would serve no purpose other than to limit investment options for retail investors.

#### Banking Entity Investments in Money Market Funds

Finally, we request that FSOC recommend that investments by a banking entity in shares of money market funds should not be considered "proprietary trading" for purposes of the Volcker Rule. Banking entities may purchase and sell shares of money market funds as principal for their trading accounts for cash management purposes. As a technical matter, this activity could fall within the broad definition of "proprietary trading." These transactions do not raise the conflict of interest or other concerns that the Volcker Rule aims to address, however, because they are not conducted to generate trading profits or losses and do not involve undue risk. Money market funds seek to maintain a stable net asset value, typically \$1.00 per share. They are strictly regulated by the SEC under the Investment Company Act, including the recently tightened requirements of Rule 2a-7 under that Act. Rule 2a-7 limits money market fund portfolio investments to short-term, high quality investments with a weighted average maturity of no more than 60 days and imposes diversification and liquidity requirements. ICI does not believe that Congress intended for a banking entity's investments in money

---

<sup>5</sup> The definition of "trading account" may reduce, but does not necessarily eliminate, the possibility of such a reading.

<sup>6</sup> See, e.g., Bankers Trust New York Corp., 83 Federal Reserve Bulletin 126 (1998).

Financial Stability Oversight Council

November 5, 2010

Page 5 of 5

market funds to be considered “proprietary trading.” Nevertheless, given the potential breadth of that term, we believe that clarification on this point is warranted.

\* \* \* \* \*

If you have any questions on our comment letter, please feel free to contact me directly at (202) 326-5815 or Ari Burstein at (202) 371-5408.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan  
General Counsel  
Investment Company Institute