INVESTMENT COMPANY INSTITUTE®

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January 16, 2024

Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551
Attention: Ann E. Misback, Secretary

Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429
Attention: James P. Sheesley, Assistant Executive Secretary, Comments/Legal OES

Office of the Comptroller of the Currency
400 7th Street, SW, Suite 3E-218
Washington, D.C. 20219
Attention: Chief Counsel's Office, Comment Processing

Re: Regulatory Capital Rule: Large Banking Organizations and Banking Organizations with Significant Trading Activity (Federal Reserve Docket No. R-1813, RIN 7100-AG64; FDIC RIN 3064-AF29; Docket ID OCC-2023-0008)

Ladies and Gentlemen:

The Investment Company Institute[1] appreciates the opportunity to comment on the joint notice of proposed rulemaking issued by the Board of Governors of the Federal Reserve System (FRB), the Office of the Comptroller of the Currency (OCC), and the Federal Deposit Insurance Corporation (collectively, Agencies) to amend the capital requirements applicable to certain banking organizations (Proposal).[2] The Proposal would implement the final components of the

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[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. ICI's members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and UCITS and similar funds offered to investors in other jurisdictions. Its members manage $31.9 trillion invested in funds registered under the US Investment Company Act of 1940, serving more than 100 million investors. Members manage an additional $8.5 trillion in regulated fund assets managed outside the United States. ICI also represents its members in their capacity as investment advisers to certain collective investment trusts (CITs) and retail separately managed accounts (SMAs). ICI has offices in Washington DC, Brussels, and London and carries out its international work through ICI Global.

[2] *See* Regulatory Capital Rule: Large Banking Organizations and Banking Organizations With Significant Trading Activity, 88 Fed. Reg. 64,028 (Sept. 18, 2023).

Basel III framework and also apply a broader set of capital requirements to more banking organizations, in response to the March 2023 collapse of several regional banks.[3]

In its advocacy and educational efforts, ICI represents the interests of US registered investment companies (RICs), business development companies (BDCs) and similar funds organized outside the United States (which we refer to collectively as regulated funds). We also represent the interests of the investment advisers that manage regulated funds and other investment products intended for the benefit of individual investors including collective investment trusts that are offered in defined contribution plans (CITs). Accordingly, ICI typically does not weigh in on matters of banking regulation, particularly the setting of capital requirements. We do so only, as in this case, when we have significant concerns as to how a banking proposal may impact regulated funds, their advisers, and the millions of American households that invest in regulated funds and CITs to save for retirement and other important financial goals.

Regulated funds and CITs rely on a range of services provided by banking organizations. In fact, the Investment Company Act of 1940 (Investment Company Act) essentially directs that certain "mission critical" services—such as custody of RIC assets, and trusteeship of a unit investment trust—be provided by a bank. More broadly, banking organizations are integral participants in US and global financial markets, the proper functioning of which are vital to regulated funds, CITs, and the investors who use them to help provide for their families and their futures.

ICI members understand the importance of bank capital adequacy requirements and the role they play in promoting the safety and soundness of individual banking organizations and the banking system overall. Although we appreciate the Proposal's policy objectives, we have serious concerns about its sweeping nature and its potential impacts (both direct and indirect) for regulated funds and CITs and for the investors whom they serve. Troublingly, the vast majority of potential impacts we describe in this letter are not identified or discussed in the preamble to the Proposal. Nor does the preamble indicate that the Agencies have thoroughly analyzed how significant changes in the calculation and required levels of bank capital may affect: (i) the full range of activities engaged in, or services provided by, banking organizations, including liquidity provision; (ii) costs associated with such activities and services; and (iii) other financial market participants and the markets themselves. In other contexts, ICI has urged policymakers to conduct meaningful analysis of how complex rulemaking may be expected to affect financial markets, market participants, and investors, including the American families whose savings are invested in regulated funds and CITs.[4] We are concerned that, if the Agencies fail to do so here, unexpected changes and the introduction of new risks may result.

In a speech this past October, FRB Governor Michelle Bowman acknowledged recent banking failures and spoke about striking the right balance with respect to bank supervision and regulation. She noted:

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[3] *Agencies request comment on proposed rules to strengthen capital requirements for large banks* (press release dated July 27, 2023).

[4] *See, e.g.*, ICI Letter to SEC Chair Gensler (urging the agency to carefully analyze the implications of interrelated rule proposals on the functioning of the capital markets and potential impacts for investors and market participants) (Aug. 17, 2023).

> While some changes to the regulatory framework may be appropriate to promote financial stability, we should be careful to ensure that changes do not harm the long-term viability of banks, especially midsized and smaller banks. In my view, regulatory reform can pose significant financial stability risks, particularly if those changes to regulation fail to take sufficient account of the incentive effects and potential consequences. Regulatory actions also have the capacity to depress economic activity through the reduced availability of credit or by limiting the availability of financial products or services. These concerns are most acute when the reforms themselves may be inefficient or poorly targeted. For example, policymakers should carefully consider whether the contemplated significant increases in capital requirements in the United States relating to the finalization of Basel III capital standards meet this standard for being efficient and appropriately targeted.[5]

Our comments are intended to highlight areas of the Proposal that require further study and calibration, which may warrant a re-proposal by the Agencies. We begin with a summary of our comments on the proposal (Section 1). We provide information on regulated funds and CITs that provides necessary context for understanding ICI's perspective on the Proposal (Section 2). Next, we outline our concerns about potential impacts to financial markets (Section 3). Finally, we highlight several areas of particular concern for regulated funds, CITs, and their advisers. These include: the proposed public listing requirement for investment grade determinations; operational risk capital as applied to fee-based services for regulated funds; seed capital investments necessary to the launch of a new RIC or similar fund organized outside of the United States; preferred stock issuance by closed-end RICs; imposition of minimum haircut floors for non-centrally cleared securities financing transactions; and the impact of capital increases stemming from credit valuation adjustment risk (Section 4).

Section 1. Summary of Comments

Regulated funds and CITs play a major role in the US economy and financial markets. By law, they are required to operate under robust regulatory frameworks intended to protect investors. They are significant "buy side" participants in US and international financial markets and rely on efficient and resilient markets across all major financial asset classes. Banking organizations long have been key providers of liquidity across many markets, promoting the orderly functioning of the markets through the commitment of capital to facilitate market making.

It is essential for the Agencies to consider how the Proposal could be revised to achieve necessary policy objectives without creating unnecessary "friction" to market liquidity. It likewise is important for the Agencies to be cognizant of how the Proposal may intersect with other recently completed or pending rulemakings that may impact financial markets and liquidity provision, including the GSIB surcharge proposal.

ICI's letter also outlines specific concerns regarding several elements of the Proposal.

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[5] FRB Governor Michelle W. Bowman, *Financial Stability in Uncertain Times*, Speech at The Reinventing Bretton Woods Committee and Policy Center for the New South Marrakech Economic Festival, Marrakech, Morocco (Oct. 11, 2023).

- Highly regulated entities, including RICs, foreign public funds, and BDCs, should be eligible for the lower 65% risk weight for investment-grade corporate exposures regardless of whether they have (or have a parent company that has) publicly traded securities outstanding.
- The Agencies should reconsider the significant over-calibration of the proposed operational risk capital requirement, particularly as it relates to fee-based business, potential implications for its impact on key services such as custody and lines of credit, and the competitive impact on bank-affiliated investment advisers.
- Banking organizations should be permitted to elect the use of banking book rules to measure their equity exposures to RICs and similar funds organized outside of the United States, provided they can demonstrate and document the lack of any trading intent.
- The Agencies should provide an explicit exclusion from the definition of "subordinated debt instrument" for closed-end RIC preferred stock. In the alternative, the definition of "subordinated debt instrument" should exclude any preferred stock that is not subordinated to any other material liabilities of the issuer. Additionally, the Agencies should assign preferred stock issued by closed-end RICs a lower risk weight than operating company preferred stock and the closed-end RIC's own common stock.
- We support the proposed exclusions from the minimum haircut floors for securities financing transactions (SFTs) with RICs and foreign public funds, and likewise urge the Agencies to exclude SFTs with CITs that hold ERISA plan assets and with BDCs.
- Given the robust regulatory protections to which RICs' use of derivatives are subject, ICI (1) urges the Agencies to allow for a more calibrated risk weight for RICs in the calculation of capital associated with credit valuation adjustment (CVA) risk; (2) that similar treatment be afforded for BDCs, whose use of derivatives likewise is subject to Investment Company Act Rule 18f-4; and (3) that the Agencies exempt the client-facing leg of a cleared derivative transactions from CVA capital requirements.

Section 2. Regulated Funds and CITs

Individual investors in the United States and abroad increasingly choose to place their investment dollars in regulated collective vehicles sponsored by investment advisers to build financial wealth. Collective vehicles offer several advantages over direct investing, including: full-time professional investment management; the opportunity to achieve a diversified investment portfolio; reasonable cost; and investment opportunities that individual investors would otherwise find difficult or impossible to access. These advantages are particularly important for so-called "Main Street" investors with modest amounts to invest.

Over the past three decades, there has been a landmark shift in the US private retirement system, away from defined benefit plans and toward defined contribution (DC) plans. Both RICs and CITs have assumed growing importance in DC plans, of which 401(k) plans are most common. At the end of 2022, for example, 62% of 401(k) plan assets—approximately $4.1 trillion—was invested in open-end RICs.[6] In large 401(k) plans, assets are increasingly held in CITs—up from 6% of plan assets in 2000 to 30% in 2021.[7]

As investors, RICs and CITs play a major role in the US economy and financial markets, and a growing role in global financial markets. At the end of 2022, RICs held 33% of US corporate equities outstanding, 23% of bonds issued by US corporations and foreign bonds held by US residents, and 12% of US Treasury and government agency securities outstanding. RICs also are important investors in the US municipal securities markets, holding 27% of securities outstanding at the end of 2022. Open-end RICs held 17% of the US commercial paper market at the end of 2022.[8]

In the subsections below, we briefly describe the operation and regulation of regulated funds and CITs. This information is intended to provide context for understanding ICI's perspective on the Proposal.

Section 2.1 Regulated Funds

In the United States, RICs operate under a comprehensive framework of regulation, including the Investment Company Act, the Investment Advisers Act of 1940, and other federal securities laws, serving both to protect investors and to mitigate risks to the financial system.

The Investment Company Act was developed in direct response to overreaching and self-dealing by RIC sponsors in the 1920s, which caused significant losses for investors. The Act seeks to minimize risk for RIC investors by, among other things, ensuring that the RIC and its investments are easily understood, portfolio assets will not be misappropriated, and the RIC's investment portfolio is managed for the benefit of its investors and not for the benefit of its investment adviser or other affiliates. Among the most significant of these protections are the following:

- *Custody of assets*: The Investment Company Act requires all RICs to maintain strict custody of RIC assets, separate from the assets of the adviser. Nearly all RICs use a bank custodian for domestic securities, and the custody agreement is typically far more elaborate than the arrangements used for other bank clients.

- *Transparency*: Under the Investment Company Act and regulations adopted by the Securities and Exchange Commission (SEC), RICs are subject to extensive disclosure requirements. RICs provide a vast array of information about their operations, financial conditions, contractual relationships with their advisers and other matters to the investing public, regulators, media, and third-party vendors such as Morningstar, and other interested parties—far more regular and periodic information than is available for other

[6] 2023 Investment Company Fact Book, Figure 8.8, page 103.

[7] *Id.* at Figure 3.12, page 49.

[8] *Id.* at Figure 2.4, page 21.

types of investment vehicles.

- *Oversight*: Actions taken on behalf of a RIC by its adviser and other service providers are subject to broad oversight by the RIC's board of directors (typically comprising at least a majority of independent members). RICs must have written compliance programs designed to prevent violations of the federal securities laws and overseen by a chief compliance officer, who can be removed only by the RIC's board (including a majority of the independent directors).

- *Transactions with affiliates*: The Investment Company Act contains a number of strong and detailed prohibitions on transactions between the RIC and RIC insiders or affiliated organizations, such as the corporate parent of the RIC's investment adviser.

- *Leverage*: The Investment Company Act and applicable SEC regulations constrain RICs' ability to borrow or issue any "senior security" that would take priority over the RIC's shares. The SEC adopted new Rule 18f-4 in 2021 to provide an updated and comprehensive approach to RICs' use of derivatives and certain other transactions.

- *Frequent market-based valuation of RIC assets*: Open-end RICs, which include mutual funds and exchange-traded funds (ETFs), value their portfolios each business day, from which they calculate the net asset values used to process daily purchases and redemptions by fund shareholders. Closed-end RICs must periodically value each of their portfolio holdings, with most closed-end RICs choosing to do so every business day. To determine fair value of applicable RIC assets in good faith, Rule 2a-5 under the Investment Company Act requires all RICs to assess and manage material valuation risk; establish and apply fair value methodologies, which must be consistent with US generally accepted accounting principles; test fair value methodologies; and evaluate any pricing services used.

- Because they must promptly meet investor redemptions under the Investment Company Act, open-end RICs are subject to a comprehensive liquidity risk management rule (Rule 22e-4 under the Investment Company Act) and a robust reporting and disclosure framework.[9] Among other things, this rule requires an open-end RIC to: adopt and implement a written liquidity risk management program, under which the fund must assess, manage, and periodically review its liquidity risk; classify each portfolio investment into one of four liquidity "buckets" at least monthly; determine and maintain a minimum amount of its portfolio in "highly liquid investments" (unless it qualifies for an exclusion); and limit illiquid investments to 15% of net assets.

- RIC financials are audited and subject to certification under the Sarbanes-Oxley Act.

[9] Money market funds are subject to different liquidity standards under Rule 2a-7 under the Investment Company Act.

BDCs likewise are subject to regulatory requirements in the areas outlined above, because they elect to be regulated by the SEC under many provisions of the Investment Company Act. A BDC is a specialized form of closed-end investment company created by Congress for the purpose of making capital more readily available to certain types of companies.[10] A BDC must invest at least 70 percent of its assets in companies that each qualify as an "eligible portfolio company," and certain other securities, and make available significant managerial assistance to those portfolio companies.

Investment advisers to RICs and BDCs must register with the SEC and are subject to SEC oversight and disclosure requirements. All investment advisers owe a fiduciary duty to each RIC and BDC they advise, meaning that they have a fundamental legal obligation to act in the best interests of the RIC or BDC pursuant to a duty of undivided loyalty and utmost good faith.

Outside of the United States, there is comparable regulation of funds that can be publicly offered to retail investors. In the Volcker Rule context, the Agencies determined that funds organized outside the United States that meet the contours of the definition for "foreign public fund" will be considered sufficiently similar to RICs.[11]

Section 2.2 CITs

CITs are structured to satisfy the exclusion from the definition of "investment company" under Section 3(c)(11) of the Investment Company Act.[12] To rely on Section 3(c)(11), CITs must limit their investors to tax qualified plans and eligible government retirement plans and be "maintained by a bank." To satisfy this requirement, the bank must exercise "substantial investment authority" over the CIT's investments.

CITs are subject to regulation, in the case of nationally chartered banks, pursuant to the OCC's Part 9 regulations (12 CFR 9.18) and, in the case of state-chartered banks, by the relevant state banking authority under applicable state banking law. OCC regulations require that a bank administering a CIT have exclusive management of the CIT, except to the extent such responsibilities are delegated to another party. The sponsoring bank that serves as CIT trustee often delegates investment management responsibilities to one or more subadvisors. These subadvisors, like the CIT trustee, are subject to the fiduciary requirements and prohibited transaction provisions of the Employee Retirement Income Security Act of 1974, as amended (ERISA).

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[10] Small Business Investment Incentive Act of 1980, PL No. 96-477 (Oct. 21, 1980).

[11] Prohibitions and Restrictions on Proprietary Trading and Certain Interests in, and Relationships With, Hedge Funds and Private Equity Funds, 85 Fed. Reg. 46422, 46431 (July 31, 2020) ("The agencies believe the revised requirements will make the foreign public fund exclusion more effective by expanding its availability, providing clarity, and simplifying compliance with its requirements, while continuing to ensure that the funds that qualify are sufficiently similar to U.S. registered investment companies.").

[12] In the absence of this exclusion, CITs would be deemed investment companies and subject to the requirements of the Investment Company Act because they are engaged in the business of investing, reinvesting or trading in securities.

Investment restrictions for CITs primarily stem from the trustee's status as an ERISA fiduciary and treatment of CIT assets as ERISA plan assets. Under ERISA, the trustee is subject to the exclusive benefit rule,[13] duties of prudence and loyalty, an obligation to diversify plan assets to minimize the risk of large losses, and a requirement to comply with plan documents (including the CIT's written plan) as well as the prohibited transaction provisions under ERISA.[14] ERISA does not limit CITs to specific investments or investment strategies, beyond the imposition of these general fiduciary duties. CITs may invest in equities, fixed income securities, mortgage instruments, real estate, alternative investments, and pooled investment vehicles such as RICs and private funds. CITs may use derivatives and engage in securities lending subject to the foregoing ERISA requirements and, in the case of CITs sponsored by national banks, the required risk evaluation such banks are required to perform, as described in the Handbook on Collective Investment Funds.[15]

The ability to purchase and sell interests in a CIT is governed primarily by the terms of the CIT's written plan. CITs are not required to offer daily liquidity to investors, although CITs designed for participant-directed DC plans almost always do. CITs sponsored by a national bank must describe in their written plans the basis and method that will be used to value fund assets, and generally value their assets at market value on an at least quarterly basis.[16] Admissions to, and withdrawals from, such a CIT must be processed as of a specified time on an established valuation date and must be based on the market value of the fund's assets as of that time.[17] While not subject to these OCC requirements, CITs sponsored by state-chartered banks typically operate in a similar fashion.

While not required, CITs typically value their interests and post valuations on their websites on a daily basis. The OCC Handbook states that national bank sponsors of CITs should ensure that the CIT has adequate liquidity to meet investor redemption requests, noting several factors to consider. The OCC Handbook states that such a CIT should be stress tested, looking for changes in fund flows and the availability of liquidity under various scenarios.[18]

The most common CIT today is one whose portfolio, valuation, and distribution are operated exactly like an open-end RIC. In many cases, the CIT will be a "clone" of a RIC managed by the

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[13] The exclusive benefit rule requires that an ERISA fiduciary act solely in the interest of plan participants and beneficiaries and for the exclusive purposes of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of administering the plan.

[14] CIT trustees are subject to ERISA's prohibited transaction provisions regarding party in interest transactions and fiduciary self-dealing, as well as conflict of interest transactions. *See* ERISA Sections 404 and 406.

[15] *See* Comptroller of the Currency, *Comptroller's Handbook: Collective Investment Funds*, Version 1.0 (May 2014) (OCC Handbook).

[16] *See* 12 C.F.R. §9.18(b)(4).

[17] *See* 12 C.F.R. §9.18(b)(5).

[18] OCC Handbook, *supra* note 15, at 7.

adviser or its affiliate. Both products will have similar portfolios and be managed by the same or overlapping investment personnel.

Section 3. Potential Impacts to Financial Markets

ICI members are significant "buy side" participants in US and international financial markets that transact on behalf of millions of investors across all major financial asset classes.[19] The availability of liquidity for each of these asset classes is a critical element of maintaining efficient and resilient markets, which regulated funds and CITs must have to provide investors with the benefits of investment diversification. Banking organizations long have been key providers of such liquidity across many markets, promoting the orderly functioning of the markets through the commitment of capital to facilitate market making. Important markets, such as those in fixed income securities, continue to operate in a dealer-to-client fashion, where regulated funds, CITs and other "buy side" participants rely on liquidity provision from banking organizations.

Regulated funds and CITs are highly sensitive to adequate liquidity when making investment decisions and when trading the instruments in which they invest. An important investment criterion analyzed by portfolio managers is a security's liquidity, meaning whether a position can easily be acquired or sold in a timely and cost-efficient manner, *i.e.*, with minimal price impact. Valuation considerations also are key, for example, to calculate net asset values. If regulated funds and CITs cannot transact effectively in the financial markets due to a lack of liquidity, they may be reluctant to invest in certain instruments altogether.

Many variables affect capital markets activity and the liquidity in those markets. Clearly, however, friction created by regulatory requirements that are overbroad or insufficiently tailored to achieve the desired objective is one such variable that can and does influence the ways in which various entities—including banks and their affiliates—participate in the capital markets. In some critical markets—such as corporate bonds and US Treasuries—recent past economic and regulatory changes already have led banking organizations and other traditional liquidity providers to hold fewer types of assets in inventory and engage in the markets in an agency, rather than principal, capacity. This has presented regulated funds, CITs, and other market participants with growing challenges to obtaining adequate liquidity at times, and thus, the devotion of more resources and efforts than before to sourcing available liquidity and anticipating changes to liquidity conditions.

ICI believes it is essential for the Agencies to consider how the Proposal could be revised to achieve necessary policy objectives without creating unnecessary "friction" to market liquidity. We are deeply concerned that the Proposal would decrease existing liquidity, particularly in markets that continue to rely the most on banking entities to interact with bids and offers, including the fixed income and derivatives markets and the less liquid portions of the equities markets. A reduction of existing liquidity would have detrimental effects for regulated funds and CITs, leading to wider bid-ask spreads, less quoted depth, lower trading volumes, and greater

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[19] *See, e.g.*, 2023 Investment Company Fact Book, Figure 2.4, page 21.

price impact. All of this ultimately would contribute to higher costs for investors, including the everyday Americans using these investment vehicles to save.

We are not alone in calling for greater attention to how the capital surcharges envisioned by the Proposal may influence bank activity and, by extension, other market participants and market functioning.[20] Each of the FRB Governors who opposed the Proposal cited such concerns.[21] FRB Chair Powell and Vice Chair for Supervision Barr, each of whom voted in support of issuing the Proposal, highlighted the importance of evaluating its potential impacts on the resiliency and liquidity of financial markets.[22]

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[20] *See, e.g.*, Identifying an Optimal Level of Capital and Evaluating the Impact of Higher Bank Capital Requirements on US Capital Markets, Part III of SIFMA blog series on US capital requirements (May 15, 2023).

[21] Statement by FRB Governor Christopher J. Waller (July 27, 2023) ("I agree that a well-capitalized banking system is critical to the resilience of our financial system, but increases in capital requirements are not free. As such, we must ensure the resiliency benefits from increases in capital requirements outweigh the costs to bank customers and to the real economy. And we must recognize that, at some point, well-intended actions to improve financial resiliency can undermine the indispensable role banks play in providing financial intermediation. In my view, the Basel III proposal crosses that line. I am concerned that today's Basel III proposal will increase the cost of credit and impede market functioning without clear benefits to the resiliency of the financial system.").

Statement by FRB Governor Michelle W. Bowman (July 27, 2023) ("The proposed revisions would disproportionately affect capital markets activities, with significant consequences for customers and end-users. The estimated proportional increase in aggregate capital levels, which for some firms will exceed 20%, is dwarfed by the proportional increase in capital for trading activities. As noted in the proposal, the revisions to the market risk rule alone will increase risk-weighted assets from $430 billion to $760 billion for Category I and II firms, and from $130 billion to $220 billion for Category III and IV firms.[1] The magnitude of these increases is startling. We must consider whether this increase—combined with all of the capital and other prudential requirements that address the risks of these activities—is justified by the underlying risks of these activities.

The United States has deep debt and equity markets and supports businesses with a wide range of other products and services, including risk-management tools. These products and services are central for business financing and risk management and contribute to an efficient economy. Those who rely on these products and services will bear the cost of capital increases. For example, when a local government issues municipal bonds to finance local infrastructure, they may find that financing is more expensive, or in some cases unavailable. Manufacturers may find it harder to get loans to invest in equipment or facilities. Companies that operate on the international stage may find it more challenging to hedge their foreign exchange risks. Businesses may find it difficult to manage their interest rate risk exposures, or manage the risks of fluctuating commodity prices.

We should be cautious about the disruption that capital increases could cause and look critically at whether these increases are justified by risks. And we should ask whether there are more efficient alternatives—like improved supervision—that could address some of the same underlying concerns.").

[22] Statement by FRB Chair Jerome H. Powell (July 27, 2023) ("High levels of capital are essential to enable banks to continue to lend to households and businesses and conduct financial intermediation, even in times of severe stress. But raising capital requirements also increases the cost of, and reduces access to, credit. And the proposed very large increase in risk-weighted assets for market risk overall requires us to assess the risk that large U.S. banks could reduce their activities in this area, threatening a decline in liquidity in critical markets and a movement of some of these activities into the shadow banking sector.").

continued

It likewise is important for the Agencies to be cognizant of how the Proposal may intersect with other recently completed or pending rulemakings that may impact financial markets and liquidity provision. The most salient is the FRB's companion rulemaking to revise the calculation of the risk-based capital surcharge for the largest US global systemically important banking organizations (GSIBs).[23] In this regard, we note our members' concern that the GSIB surcharge proposal would expand the definition of "financial institution" (used for purposes of measuring a GSIB's interconnectedness) to include ETFs and, in so doing, discourage US GSIBs from interacting with ETFs.[24] Any pullback by the largest banking organizations from market-making related activity with respect to ETFs would have negative implications for liquidity and price discovery.[25] Other relevant rulemakings include several by the SEC that are likely to have wide-ranging implications for the functioning of the US securities markets, including the equity and fixed income markets, as well as the US Treasury markets.[26] As we have cautioned the SEC, an isolated and piecemeal approach to rulemaking risks unintentionally harming many aspects of

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Statement by FRB Vice Chair for Supervision Michael S. Barr (July 27, 2023) ("We have heard concerns that the proposal—when combined with our stress test requirements—might overestimate market and operational risk. We want to ensure that the rule is supportive of resilient and liquid financial markets. I look forward to comments on how specific activities may or may not be affected by the proposed changes.").

[23] Regulatory Capital Rule: Risk-Based Capital Surcharges for Global Systemically Important Bank Holding Companies; Systemic Risk Report (FR Y-15), 88 Fed. Reg. 60,385 (Sept. 1, 2023) (GSIB surcharge proposal).

[24] We note that defining "financial institution" to include ETFs would be inconsistent with the Basel Committee's approach for evaluating the systemic importance of banking organizations in the global context. *See* BCBS, Instructions for the end-2022 G-SIB assessment exercise (Jan. 2023). For that exercise, the Basel Committee specifically excluded bond ETFs from counting toward a banking organization's interconnectedness indicators. We urge the Agencies to consider the comments filed by the Financial Services Forum on the GSIB surcharge proposal, which recommend that the final rule not expand the definition of "financial institution" used in the interconnectedness indicators to include ETFs.

[25] During March 2020, for example, ETFs acted as a price discovery tool for investors, particularly in the fixed-income market, where market participants faced challenges in finding liquidity and establishing pricing for individual bonds. *See generally* ICI, *Experiences of US Exchange-Traded Funds During the COVID-19 Crisis*, Report of the COVID-19 Market Impact Working Group (Oct. 2020).

[26] For example, the SEC's March 2023 amendments to accelerate the standard settlement cycle from T+2 to T+1 by late May 2024 will significantly impact the equity, corporate bond, and municipal bond markets, among others. The SEC has also issued a series of rule proposals that, if adopted, would render fundamental changes to US equity market structure. *See, e.g.*, Regulation NMS: Minimum Pricing Increments, Access Fees, and Transparency of Better Priced Orders, 87 Fed. Reg. 80,266 (Dec. 29, 2022); Order Competition Rule, 88 Fed. Reg. 128 (Jan. 3, 2023); and Regulation Best Execution, File No. S7-32-22, 88 Fed. Reg. 5440 (Jan. 27, 2023). We further note that the SEC has pursued additional initiatives to reform the US Treasury markets, which include a recently adopted central clearing mandate for US Treasury securities transactions and proposals that would broaden the regulatory definitions of "dealer" and "exchange" to apply to certain US Treasury market participants. *See* Further Definition of "As a Part of a Regular Business" in the Definition of Dealer and Government Securities Dealer, File No. S7-12-22, 87 Fed. Reg. 23,054 (Apr. 18, 2022); Amendments Regarding the Definition of "Exchange" and Alternative Trading Systems That Trade U.S. Treasury and Agency Securities, National Market System Stocks, and Other Securities, File No. S7-02-22, 87 Fed. Reg. 15,496 (Mar. 18, 2022).

our capital markets, to the detriment of ICI members and long-term investors, including retirement savers.[27]

We recognize that it is challenging for the Agencies to evaluate the possible negative impacts of the Proposal for the markets and ultimately the economy, but the importance of doing so cannot be overstated. We are reminded of past experience with implementation of Section 619 of the Dodd Frank Act, commonly known as the Volcker Rule. When the Volcker Rule was first proposed, ICI and others raised serious concerns about the ability of banks to play their historic role as market makers buying and selling securities, noting that Congress specifically designated certain activities such as market making-related activity as outside the scope of the Volcker Rule. Excessive limitations on banks' ability to engage in these activities raised the specter of wider bid-ask spreads, higher transaction costs, and diminished returns, with implications for the broader economy, job creation and investments in US businesses.[28] With robust engagement with the public and industry, the Agencies (together with capital markets regulators) worked hard to mitigate those concerns and better effectuate Congress' intent. We believe the learning of that time could help the Agencies consider more targeted changes to this Proposal while still meeting their policy objectives.

Section 4. Areas of Particular Concern for Regulated Funds, CITs, and Their Advisers

Beyond the broader, overarching points noted above, ICI has specific concerns regarding several elements of the Proposal. We explain those specific points in the following subsections.

Section 4.1 Proposed Listing Requirement for Investment Grade Determinations

Under the Proposal, in order to qualify for a 65% risk weight for investment grade corporate exposures (rather than a more onerous 100% risk weight), the exposure must be both (1) a company that is investment grade, and (2) a company that has, or is controlled by a parent that has, publicly traded securities outstanding. This second requirement would limit availability of the lower risk weight to companies that satisfy the listing standards of a securities exchange, making it more difficult for many regulated entities to obtain both credit (*e.g.*, lines of credit) and non-credit related financial products (*e.g.*, derivatives for hedging and SFTs, due to the implied increase in counterparty credit risk when facing these entities).

This public listing requirement is neither necessary nor appropriate for highly regulated entities such as RICs in light of the Agencies' stated objectives of improving consistency, transparency and market discipline in credit underwriting. The comprehensive regulatory regime applicable to all RICs include requirements applicable to portfolio management, pricing and valuation, capital structure, and governance; limitations on the use of leverage; prohibitions and limitations on conflicts of interest; audited financial statements; and robust disclosure and regulatory reporting. RIC adherence to these requirements results in levels of public transparency and market

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[27] *See supra* note 4.

[28] *See e.g.,* ICI Comment Letter on Prohibitions and Restrictions on Proprietary Trading and Certain Interests In, and Relationships With, Hedge Funds and Private Equity Funds (Feb. 12, 2012).

discipline that are at least as rigorous, if not more so, than those compelled by exchange listing standards.

Moreover, application of the public listing requirement to RICs would lead to highly incongruous results that do not reflect creditworthiness. First, despite being subject to substantially similar regulatory requirements, different types of RICs would be treated differently under the Proposal. Nearly 3,000 ETFs, whose shares are publicly listed, would qualify for the 65% risk weight, while over 8,000 mutual funds, whose shares are not publicly listed, would be risk-weighted at 100%.[29] These disparities become even more pronounced when one considers that all mutual funds and nearly all ETFs are structured under the Investment Company Act as open-end funds.[30] Second, closed-end funds, a form of RIC that is intended for less liquid investments, may choose whether or not to list their shares. Roughly two-thirds of closed-end funds list their shares and the remaining third do not. Closed-end funds are subject to substantially the same comprehensive regulation under the federal securities laws, yet the Proposal would assign different risk weights based simply on whether the shares are listed or unlisted.

ICI believes that the public listing requirement is similarly inapt for foreign public funds, some which list their shares and some which do not. Foreign public funds are subject to the same sort of comprehensive regulation as RICs, including with respect to portfolio management, valuation of assets, and disclosure. Distinguishing among foreign public funds based on their listing status is therefore unnecessary in evaluating whether the fund should qualify for the lower risk weight.

Finally, we note that both the EU and UK propose continuing to permit internal models for credit risk, subject to a standardized output floor, which typically results in effective risk weights significantly lower than 65%. For unrated corporate entities, including for purposes of the output floor, neither the EU nor the UK has proposed a public listing requirement.[31] Adopting a public listing requirement would perpetuate significant divergences in overall capital requirements between US and European banking organizations.

Based on the foregoing, we suggest that the Agencies remove the public listing requirement for certain highly regulated entities, such as RICs and foreign public funds, or drop the requirement altogether. We further recommend that the Agencies afford similar treatment to BDCs.

Section 4.2 Operational Risk Capital as Applied to Fee-based Services for Regulated Funds

The Proposal sets out a standardized approach for calculating a banking organization's operational risk capital. Under the standardized approach, operational risk capital would be a

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[29] ICI data (as of August 2023).

[30] By rule and exemptive order, the SEC customizes the applicable regulatory requirements to permit intraday trading in ETF shares.

[31] Bank of England, CP16/22 – Implementation of the Basel 3.1 standards ("CP 16/22"), ¶ 1.5 n. 3 (Nov. 30, 2022); Proposal for amending Regulation (EU) No 575/2013 as regards requirements for credit risk, credit valuation adjustment risk, operational risk, market risk and the output floor, COM/2021/664 ¶ 465 (Oct. 27, 2021).

function of a banking organization's business indicator component and its internal loss multiplier. Unlike other aspects of the Proposal targeted to the risks of specific products and services, the operational risk capital requirements apply on a firm-wide basis, thereby impacting the cost and availability of all financial products and services. Moreover, the proposed standardized methodology does not distinguish by risk among the many types of fee-related activities in which the banking organization may engage. Rather, it bluntly treats all fee-related activities similarly. ICI and its members are concerned about what this aspect of the Proposal might mean for services provided by banking organizations to regulated funds and their advisers.

Regulated funds rely on banking organizations for many important services. Some of those services, such as custody, are "mission critical" and are performed almost exclusively by banks. Under the Investment Company Act, for example, RICs must maintain strict custody of their assets, separate from the assets of the adviser. For custody of US-issued securities, nearly all RICs satisfy this requirement by using a bank custodian.[32] A RIC's custody agreement with a bank is typically far more elaborate than the arrangements used for other bank clients. The custodian's services generally include safekeeping and accounting for the RIC's assets, settling securities transactions, receiving dividends and interest, providing foreign exchange services, paying fund expenses, reporting failed trades, reporting cash transactions, monitoring corporate actions at portfolio companies, and monitoring corporate actions at portfolio companies and any securities loaned by the RIC.

Most RICs also transact with banks to obtain lines of credit.[33] Although open-end RICs typically manage their liquidity needs primarily through portfolio management (*i.e.*, fund flows and determining the types and amounts of portfolio investments to buy, hold, and sell), lines of credit are a useful supplemental tool for RICs to have in place even if they do not frequently use them,[34] providing RICs with a cost-effective and efficient source of short-term liquidity.[35] In some circumstances, for example, temporarily drawing on a line of credit may be preferable to selling portfolio investments.

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[32] The Investment Company Act contains six separate custody rules for the possible types of custody arrangements for mutual funds, closed-end funds, and ETFs. UITs are subject to a separate rule that requires the use of a bank to maintain custody. *See* Section 17(f) of the Investment Company Act and SEC Rules 17f-1 through 17f-7. In addition, Section 17(f)(5) requires that if a bank serves as a RIC's custodian, the fund's cash assets also must be maintained with its bank custodian.

[33] These arrangements between banks and RICs have different contractual attributes (*e.g.*, size of the line, whether the line is committed or uncommitted, and whether the line is dedicated to a single fund or shared among several funds within a complex).

[34] Recent regulatory filings suggest that only about 16 percent of open-end RICs having one or more lines of credit used them during the reporting period. Based on an ICI analysis of funds' recent Form N-CEN filings with the SEC, 5,961 open-end funds with $21.8 trillion in combined assets (which represented 66% of total open-end fund assets as of October 2023) each had at least one line of credit. During the period analyzed, 1,153 of those funds with approximately $1.36 trillion in combined assets (which represented 6% of total open-end fund assets as of October 2023) used at least one line of credit.

[35] *See* Rule 22e-4(b)(1)(i)(C) under the Investment Company Act (listing, as a liquidity risk factor for funds' consideration, "[h]oldings of cash and cash equivalents, as well as borrowing arrangements and other funding sources").

If the Agencies adopt the Proposal without change, we expect the cost of custody and related services to increase for regulated funds. These cost increases would be passed on to investors as a fund expense. To illustrate: currently, blended custody and accounting fees for RICs can vary widely from 0.2 basis points to 3 basis points, depending on the size and complexity of the RIC(s) covered by the custody arrangement. If we assume a custody fee of 1 basis point and assume a 10-20% increase[36] in this fee, based on $31.1 trillion in RIC assets as of September 30, 2023, this would result in a year-over-year increase of $310 million - $620 million paid by RICs and, by extension, their investors. This would be the case even though the Agencies have not identified any increase in riskiness of custody-related activities that would warrant requiring banking organizations to hold more capital against these activities.

We likewise would expect the costs associated with lines of credit to increase. Any regulation that arbitrarily reduces the availability of these lines to RICs or increases their costs (or both) due to an over-calibration of operational risk capital requirements would unnecessarily harm RICs and their investors. Again, the Agencies have not identified any increase in riskiness in these lines of credit to warrant such consequences for RICs and their investors.

We likewise urge the Agencies to address the Proposal's effect on bank-affiliated investment advisers. For those organizations, the capital impact is compounded due to the need to absorb in full the standardized operational risk capital charge. Unlike in the case of net interest income, banking organizations are not permitted to net fee-related expenses against fee-related income when calculating their operational risk capital, nor is there a cap that limits the weighting of fee-related income as a whole. Bank-affiliated investment advisers are an important part of the competitive landscape of the asset management industry serving the needs of millions of investors. The Proposal competitively disadvantages bank-affiliated investment advisers, including their services and investment product offerings, harming their competitive position and their clients and customers.

The Basel Committee has recognized that the proposed standardized approach overcapitalizes banks with high levels of fee-related income.[37] While the Basel Committee has not taken action to address the problem, we urge the Agencies to carefully look at this issue and consider particular regulatory and market circumstances in the United States to more precisely inform and calibrate risk assessments or profiles of fee-related activities. This would include considering the degree to which US banking organizations are providing services to regulated funds and CITs. RICs and CITs, for example, are significant investment options in DC plans and individual retirement accounts, which together totaled $21.3 trillion at year-end 2022.[38] That fact alone should compel the Agencies to consider how to more carefully meet their policy goals while

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[36] *See* Statement by FRB Governor Michelle W. Bowman, *supra* note 21 ("The estimated proportional increase in aggregate capital levels, which for some firms will exceed 20%, is dwarfed by the proportional increase in capital for trading activities.").

[37] The first Basel consultative document specifically acknowledged that the proposed operational risk framework "does not lend itself to accurate application in the case of banks engaged predominantly in fee-based activities." BCBS, Consultative Document: Operational risk – Revisions to the simpler approaches ¶ 46, at 16 (2014).

[38] ICI, The US Retirement Market, Third Quarter 2023 (Dec. 2023) at Table 1.

mitigating the risk of adverse and unnecessary impacts to the retirement savings of millions of Americans.

Section 4.3 Seed Capital Investments

The Proposal would require banking organizations to apply the revised market risk framework (rather than a banking book "look-through" approach) to measure their equity exposure to an investment fund for which a banking organization has sufficient information regarding the fund's underlying holdings, including seed capital investments in RICs and foreign public funds. We understand this would be a significant departure from current rules, which generally consider exposures to be held in the banking book. ICI and its members therefore are deeply concerned about how this proposed change may impact the ability of US bank-affiliated investment managers to develop and launch new RICs and foreign public funds.

Seeding is a common industry practice and the primary way for an investment adviser to launch a new RIC. At the outset, the adviser provides the initial "seed" capital in exchange for all or nearly all of the shares of the RIC. The adviser then attempts to establish the RIC, test its investment strategy, and develop an investment track record that will attract investors—with the objective of reducing the adviser's relative ownership of the RIC as investors buy RIC shares. Multi-year seeding periods are common for (and necessary to) the successful launch of RICs, largely because investors expect a demonstrated track record before investing in a new fund. Most RICs need to establish at least a three-year track record before analysts such as Morningstar will cover them, or consultants to institutional investors and pension plans will recommend them. Importantly, banking organizations *do not* hold seed investments for the purpose of short-term resale or with the intent of benefiting from actual or expected short-term price movements, or to lock in arbitrage profits.

During its seeding period, a RIC must be operated in accordance with the comprehensive regulatory regime administered by the SEC under the Investment Company Act and other federal securities laws. The RIC's adviser must manage the RIC's portfolio in accordance with stated investment objectives, and the actions of the adviser are subject to oversight by an independent board of directors. It bears emphasizing that the adviser is acting in a fiduciary capacity with respect to any trading on behalf of the RIC.

As the Agencies are aware from their work on the Volcker Rule, similar dynamics are at play with respect to a US bank-affiliated adviser's development and launch of foreign public funds.

The Proposal does not address seed capital investments in RICs or foreign public funds or explain the Agencies' rationale for the proposed change to the calculation methodology for the equity exposure of banking organizations to these highly regulated funds. Nor does the Proposal consider the implications of the expected capital increase on the ability of US bank-affiliated investment managers to compete with both US asset managers not affiliated with a bank and asset managers affiliated with non-US banks, whose seeding activity with respect to RICs and foreign public funds would not be subject to the type of capital surcharge envisioned by the Proposal. At the very least, bank-affiliated manages would need an extended time frame to establish a compliance program in order to measure fund exposures under trading book rules.

Other trade associations have recommended that banking organizations be permitted to elect the use of banking book rules to measure their equity exposures to investment funds, provided they can demonstrate and document the lack of any trading intent. ICI urges the Agencies to consider this alternative with respect to equity exposures to RICs and foreign public funds.

Section 4.4 Preferred Stock Issuance by Closed-End RICs

The Proposal's treatment of subordinated debt instruments could lead to anomalous results for preferred stock issued by closed-end RICs. Under the Proposal, banking organizations may classify such preferred stock as a "subordinated debt instrument," defined as "a debt security that is a corporate exposure . . . similar instrument, or other debt instrument as determined by the [Agency], that is subordinated by its terms . . . to any creditor of the obligor, or preferred stock that is not an equity exposure."[39] Subordinated debt instruments would receive a 150 percent risk weight, resulting in preferred stock of closed-end RICs receiving the same treatment as operating company preferred stock and worse treatment than the closed-end RIC's own common stock. As explained in detail below, these results would be inappropriate.

Closed-end RICs issue preferred stock, often rated investment grade, to raise additional capital for investment subject to the strict confines of the Investment Company Act.[40] The Investment Company Act only permits a closed-end RIC to issue one class of preferred stock and one class of debt.[41] In addition, the Investment Company Act requires that a closed-end RIC have 200 percent asset coverage before issuing any preferred stock and before declaring any dividends.[42] This means that for each $1.00 of preferred stock issued, the RIC must have $2.00 of assets at issue and each dividend declaration date. Further, preferred stockholders have the right, as a class, to elect at least two directors at all times and to elect a majority of directors if dividends on their stock are unpaid for two full years, continuing to be so represented until all dividends in arrears are paid or otherwise provided for.[43] Together, these provisions work to ensure that a closed-end RIC has sufficient assets to pay off its obligations and to protect its preferred stockholders.[44]

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[39] *See* proposed definition in § __.101.

[40] Closed-end RICs that invest primarily in municipal securities issue the majority of closed-end RIC preferred stock, as they can pass through "exempt-interest dividends" under Internal Revenue Code Section 852(b)(5) that reflect the tax-exempt nature of the municipal securities and are not taxable to the preferred stock investors. Preferred stock investors, such as banking organizations, are willing to accept lower payments on the preferred stock because they may receive favorable tax treatment on the dividends. Accordingly, municipal closed-end RICs that issue closed-end RIC preferred stock may significantly limit the costs of obtaining additional capital compared to other types of borrowings (*e.g.*, debt issuances).

[41] Section 18(c) of the Investment Company Act.

[42] Section 18(a)(2)(A) and (B) of the Investment Company Act.

[43] Section 18(a)(2)(C) of the Investment Company Act.

[44] The terms of closed-end RIC preferred stock issuances often include more stringent constraints than those required under the Investment Company Act. For example, many types of closed-end RIC preferred stock include covenants with stricter

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Under the Proposal, operating company preferred stock would be given the same risk weighting as closed-end RIC preferred stock. Operating companies can issue multiple classes of preferred stock that could be subordinate to multiple layers of senior securities and other preferred stock. In addition, operating companies are not subject to asset coverage requirements or to other aspects of the comprehensive regulatory framework to which closed-end RICs adhere. The lack of these protections greatly increases the risk of default and non-payment to the holders of operating company preferred stock.

Similarly, the Proposal would favor a closed-end RIC's common stock over its preferred stock. Currently, and under the Proposal, common stock of a closed-end RIC generally would be treated as "equity exposures," which are permitted to be "looked through" to the underlying investments of the RIC. This "look through" treatment often results in risk weightings that are significantly lower than the proposed 150 percent risk weighting for subordinated debt, despite the preferred stock's preference over the common stock with respect to dividends and liquidation.

The application of a 150 percent risk weighting to closed-end RIC preferred stock also would severely and detrimentally impact financial markets. With a 150 percent risk weighting, the market for bank-held, closed-end preferred stock may become unviable. This would force closed-end RICs to look for alternative sources of capital, resulting in significant refinancing risk to the sector. Additionally, there would be a significant increase in the costs of capital for closed-end RIC common shareholders, who are predominantly retail investors.[45]

To avoid these inequitable and impactful results, the Agencies should provide an explicit exclusion from the definition of "subordinated debt instrument" for closed-end RIC preferred stock. In the alternative, the definition of "subordinated debt instrument" should exclude any preferred stock that is not subordinated to any other material liabilities of the issuer. We also urge the Agencies to modify the Proposal to assign preferred stock issued by closed-end RICs a lower risk weight than operating company preferred stock, to reflect their relative differences in credit risk. Finally, we recommend that the Agencies provide better treatment for a closed-end RIC's preferred stock than its common stock, based on the priority given to preferred stock with respect to dividends and liquidation preference.

Section 4.5 Minimum Haircut Floors on Non-Centrally Cleared Securities Financing Transactions

The Proposal would impose new minimum haircut floors that apply (absent a qualifying exemption) to non-centrally cleared SFTs, including repurchase and reverse repurchase transactions and securities lending transactions, with an unregulated financial institution. Under the Proposal, if the level of collateral posted in an SFT fails to meet the haircut floors, there

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asset coverage requirements, mandatory deleveraging if asset coverage restrictions are not met, and/or prompt cures of any other breaches.

[45] This is especially true for municipal closed-end RICs that rely heavily on preferred stock, instead of debt, for attaining additional capital. *See supra* note 40.

would be no recognition of the credit risk mitigation provided by the collateral and the transaction would be treated as fully uncollateralized.

The stated purpose of these floors is to "limit the build-up of excessive leverage outside of the banking system and reduce the cyclicality of such leverage, thereby limiting risk to the lending banking organization and the banking system."[46] As proposed, excluded from the framework would be SFTs with (1) a RIC and "foreign equivalent thereof" and (2) an employee benefit plan defined by reference to ERISA, a "government plan" as defined in 29 U.S.C. § 1002(32) that complies with the tax deferral qualification requirements provided in the Internal Revenue Code and any similar employee benefit plan established under the laws of a foreign jurisdiction. The proposed exclusions for SFTs with RICs and foreign public funds are appropriate given their highly regulated nature, including with respect to their restricted use of leverage. For similar reasons, we likewise urge the Agencies to exclude SFTs with CITs that hold ERISA plan assets and with BDCs.

ICI also believes that the Agencies should examine the potential broad market impacts of this new approach. While we understand and support the policy goal underlying this requirement as proposed, it is important that the Agencies tailor the framework to avoid unnecessary detrimental effects. These markets are of critical importance to RICs, who typically participate as lenders seeking to manage their cash and/or to utilize their assets to generate additional income and enhance returns for the direct benefit of fund investors. Securities lending, in particular, helps to promote liquidity and efficiency in the capital markets through lower bid-ask spreads, thus resulting in lower trading costs. To the extent that minimum floors cause these markets to be less efficient or diminish their role in facilitating liquidity and price discovery, it may affect the ability or willingness of banking organizations to participate in these markets moving forward, which would ultimately harm RICs and their investors, as well as other market participants.

We further note that policymakers in the UK and EU have opted not to propose minimum haircut floors as they continue to deliberate their impact on markets and fundamental utility. The United Kingdom's Prudential Regulatory Authority, for example, has stated that it "will consider whether implementation in the capital framework is appropriate in due course, taking into account data available under SFT reporting,"[47] while European regulatory bodies prepare "to report . . . on the appropriateness of implementing in the [European] Union the minimum haircut floors framework applicable to SFTs."[48]

Section 4.6 Credit Valuation Adjustment Risk

RICs and BDCs use derivatives, including OTC and cleared derivatives contracts, to manage their portfolios in accordance with the investment objectives and strategies set forth in their respective prospectuses. For example, RICs may use derivatives to hedge different types of

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[46] Proposal at 64064.

[47] CP16/22, *supra* note 31, at ¶ 1.5 n. 3.

[48] EU Proposal, *supra* note 31, at 27.

portfolio risk, including interest rate risk and duration, as well as to manage cash positions generally. Derivatives also may help to enhance liquidity for RICs by allowing them to equitize cash that cannot be immediately invested in direct equity holdings or otherwise gain or reduce exposure when access to other instruments is otherwise difficult, costly, or practically impossible. Thus, derivatives help to enhance RICs' ability to manage portfolios efficiently and reduce costs for the benefit of RIC investors.

The Proposal contemplates new and increased bank capital requirements for credit valuation adjustment (CVA) risk, which measures the market value of counterparty credit risk. We are concerned that increased capital requirements for CVA risk will be passed on to RICs and, by extension, to RIC investors. We note that RICs already face higher costs and limited liquidity in certain types of transactions, because applicable regulation prohibits banking organizations (as well as affiliated dealer counterparties or clearing members) from rehypothecating or reusing the collateral pledged by RICs.[49] We likewise are concerned that this proposed requirement could have the unintended effect of reducing competition in the market for derivatives, particularly from banking organizations that are not currently subject to capital requirements relating to CVA risk.

Regulation of RICs' use of derivatives under Investment Company Act Rule 18f-4 minimizes the risk of RIC default. The rule is intended to ensure that RICs do not engage in undue speculation and can pay off their obligations, consistent with statutory requirements. A RIC investing in more than a de minimis level of derivatives must comply with value-at-risk leverage limits, adopt a derivatives risk management program, and adhere to certain reporting requirements. The RIC's board of directors is responsible for overseeing the RIC's compliance with Rule 18f-4 and the RIC's derivatives risk management function. The SEC envisions that the RIC board will have active and regular engagement with the derivatives risk manager (when applicable) as part of its oversight role. The board also must receive reports on derivatives risk management activities and issues. Given the robust regulatory protections to which RICs' use of derivatives are subject, ICI urges the Agencies to allow for a more calibrated risk weight for RICs in the calculation of capital associated with CVA risk. We further recommend that similar treatment be afforded for BDCs, whose use of derivatives likewise is subject to Investment Company Act Rule 18f-4.

The proposed overstatement of CVA risk for derivatives is particularly concerning for cleared swaps. Following the Dodd-Frank Act, many swaps are subject to a mandatory clearing requirement. To the extent that a RIC or BDC enters into a cleared derivative via a banking organization futures commission merchant, the banking organization has exposure to the RIC or BDC (due to the guarantee that it provides to the central counterparty of the RIC's of BDC's performance) but cannot suffer CVA losses with respect to that exposure. Thus, not only would the Proposal's CVA framework overstate CVA risk for such transactions with RICs and BDCs, but also would be inconsistent with Congress and the Agencies' objective of promoting central

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[49] *See generally* Section 17 of the Investment Company Act and the regulations thereunder.

clearing. We urge the Agencies to exempt the client-facing leg of a cleared derivative transactions from CVA capital requirements.

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ICI appreciates the opportunity to comment on this significant proposal. If you have any questions, please contact us by email (eric.pan@ici.org, solson@ici.org or rgraham@ici.org) or by phone at 202-326-5800.

Regards,

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