



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 [www.ici.org](http://www.ici.org)

June 3, 2011

Via email ([fsb@bis.org](mailto:fsb@bis.org))  
Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002  
Basel, Switzerland

Re: Shadow Banking – Scoping the Issues

Dear Sir or Madam:

The Investment Company Institute (“ICI”) appreciates the opportunity to comment on the background note by the Financial Stability Board (“FSB”) entitled “Shadow Banking: Scoping the Issues” (“Note”).<sup>1</sup> ICI is the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. ICI encourages adherence to high ethical standards, promotes public understanding, and otherwise advances the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.41 trillion and serve over 90 million shareholders.

Since our inception in 1940, we have been active participants in the development of laws and regulations that have been instrumental in the growth of fund investing in the United States and worldwide. We have been deeply engaged in the development of laws and regulations responsive to the recent financial crisis, including mechanisms to counter systemic risk and to make money market funds<sup>2</sup> more resilient in the face of the most adverse market conditions, such as those caused by widespread bank failures in 2008.

---

<sup>1</sup> Financial Stability Board, *Shadow Banking: Scoping the Issues*, April 11, 2011, available at [http://www.financialstabilityboard.org/publications/r\\_110412a.pdf](http://www.financialstabilityboard.org/publications/r_110412a.pdf) (“Note”).

<sup>2</sup> We refer in this letter to “money market funds” as those U.S. funds registered under the Investment Company Act of 1940 (“Investment Company Act”) and subject to its requirements.

### The FSB's Note and Work

The FSB's directive from its member institutions is to "develop recommendations to strengthen the oversight and regulation of the 'shadow banking system' by mid-2011."<sup>3</sup> To that end, the FSB established a task force to consider the following: (1) a definition for "shadow banking"; (2) potential approaches to monitoring the "shadow banking" system; and (3) possible regulatory approaches to address systemic risk and regulatory arbitrage concerns posed by the "shadow banking" system. The Note describes the current thinking of the FSB's task force, particularly on the definition of the "shadow banking system."

The Note states that the financial crisis has shown that "the shadow banking system can also become a source of systemic risk, both directly and through its interconnectedness with the regular banking system."<sup>4</sup> The Note asserts that the shadow banking system can "create opportunities for arbitrage that might undermine stricter bank regulation and lead to a build-up of additional leverage and risks in the system."<sup>5</sup> The Note concludes that "[e]nhancing supervision and regulation of the shadow banking system in areas where systemic risk and regulatory arbitrage concerns are inadequately addressed is therefore important."<sup>6</sup>

Crucial to the FSB's project is a definition of the "shadow banking" system, which the Note very broadly identifies as "the system of credit intermediation that involves entities and activities outside the regular banking system."<sup>7</sup> Acknowledging that the definition is broad, the FSB limits the Note's view of "credit intermediation" to activities and entities involved either in extending credit (directly or as part of a chain) or in facilitating its intermediation. In further describing "credit intermediation," the Note observes that credit intermediation encompasses not only on-balance sheet transactions but also derivatives and other off-balance sheet transactions that would be part of the credit intermediation chain. The proposed definition would exclude "pure equity trading" and foreign currency transactions by entities outside of the banking system, unless such activities are part of the credit intermediation chain. The Note explicitly identifies the trading of credit-related financial

---

<sup>3</sup> Note at 1.

<sup>4</sup> *Id.*

<sup>5</sup> *Id.*

<sup>6</sup> *Id.*

<sup>7</sup> *Id.* at 2.

instruments, such as bonds and structured/hybrid financial products, as within the definition of credit intermediation.<sup>8</sup>

Although the Note begins broadly, it concedes that any focus should only be on non-bank credit intermediation where important risks are most likely to emerge. Consequently, the Note states that regulatory attention should focus on those “shadow banking” activities that give rise to either or both of the following:

- (1) Systemic risk: primarily arising from activities that generate maturity and/or liquidity transformation, that involve flawed credit risk transfer, and that create or facilitate leverage; and
- (2) Regulatory arbitrage: arising from activities that circumvent or undermine banking regulations.<sup>9</sup>

The Note defines “maturity transformation” as the activity of issuing short-term liabilities (such as deposits) and transforming them into medium–long term assets (such as loans). “Liquidity transformation” refers to the issuance of liquid liabilities to finance illiquid assets. For this purpose, the Note states that an asset is illiquid when it cannot be easily converted into cash without a loss in nominal value.<sup>10</sup> The Note does not include a definition of “flawed credit risk transfer”; there is only a general reference to flawed credit risk transfer through securitization.<sup>11</sup>

## Discussion

### A. Scope of Note

As a preliminary matter, ICI strongly objects to the use of the terms “shadow banks” and “shadow banking” because they are inherently inaccurate and misleading. These terms are merely epithets, connoting that all the activities so labeled lack both transparency and any regular or official status. Such is not the case. As a recent Staff Report of the Federal Reserve Bank of New York observes, “the label ‘shadow banking system’ . . . is an incorrect and perhaps pejorative name for such a large and important part of the financial system.”<sup>12</sup> We urge the FSB to use more precise and neutral

---

<sup>8</sup> *Id.* at 2-3. While “pure equity trading” is not defined, we assume it means purchasing stocks directly, rather than through any form of pooled investment vehicle.

<sup>9</sup> *Id.* at 3.

<sup>10</sup> *Id.* at footnote 5.

<sup>11</sup> *Id.* at 4.

<sup>12</sup> See “Shadow Banking,” Federal Reserve Bank of New York, Staff report no. 458 (July 2010).

terminology when discussing the various roles of non-bank financial intermediaries. As we discuss in Appendix A, those entities play a variety of important roles in the financial system. These roles may share some similarities with the role that banks play—but there are also critical differences and those differences should be respected.

We do agree that it is appropriate for the FSB to consider whether additional or different regulatory measures for non-bank financial intermediaries may be important to strengthening the global financial system. We also support the efforts of the FSB and the regulatory bodies it represents to study ways to monitor non-bank financial intermediaries, such as by improving and expanding data collection from these entities, as necessary, to help regulators identify and manage systemic risk.<sup>13</sup>

The proposed regulatory responses offered by the Note, however, are quite broad and amorphous. This result is not surprising, as the object of the Note's policy concern (the "shadow banking" system) is likewise ill-defined. The Note outlines possible policy responses, which unfortunately are subject to a wide range of interpretation. Depending on how these responses are interpreted, we would not necessarily take issue with many of them. Indeed, they could be viewed as aligned with regulatory responses implemented or under consideration in the United States. Other interpretations would be very problematic.

B. Discussion of Regulation of Non-Bank Financial Intermediaries

We have deep concerns with the tenor of much of the Note's lengthy discussion of the perceived deficiencies or laxity of regulation to which "shadow banks" are currently subject. In our judgment, simply characterizing what clearly are capital market activities as "shadow banking" is unhelpful in addressing the core issue—namely, how best to regulate non-bank financial intermediaries so that capital markets are robust and able to withstand shocks. Further, evaluating the regulation of these entities solely through a banking lens distorts and ignores the very substantive regulation and oversight to which these entities are subject through the securities laws.

First, the very term "shadow bank" implies that "credit intermediation that involves entities and activities outside the regular banking system" is inherently inappropriate and therefore best eliminated or subsumed within the banking system. The term also suggests that regulatory arbitrage occurs in these "shadow banks" because "prudential regulatory standards and supervisory oversight are either not applied or are applied to a materially lesser or different degree than is the case for regular

---

<sup>13</sup> In the United States, substantial progress has been made on that front, particularly with respect to proposing and adopting rules on legal entity identifiers, private funds, and money market funds. For example, since November 2010, the U.S. Securities and Exchange Commission has required money market funds to report, both to it and to the public, an exhaustive array of data.

banks.”<sup>14</sup> There is no room in this rubric for the notion that oversight of non-bank financial intermediaries via capital markets regulation provides a viable alternative to a banking regime.

Furthermore, the term naturally, but incorrectly, raises an implication that certain types of securities are equivalent to bank deposits. For example, the Note highlights money market fund shares, commercial paper, and short-term repurchase agreements as deposit-like instruments, even though these securities have key economic features that differentiate them from bank deposits and, at least in the United States, subject them to a detailed regime of securities regulation. In fact, so broad is the analysis suggested in the Note that it would seem in principle to encompass many other “short-term and highly liquid” securities such as Treasury bills, other sovereign debt, and shares of potentially any collective investment fund.

We submit it is imperative for the FSB to acknowledge and respect the differences that exist between banking and securities and their respective regulatory frameworks. In contrast to some other nations, banks and capital markets have existed alongside one another in the United States for centuries, with parallel bodies of regulation and oversight that have arisen to address specific financial and investor risks associated with each type of credit intermediation. The U.S. financial system and our economy at large have thrived on the benefits that banks and capital markets provide. Registered investment companies in the United States, for example, manage well over half of all mutual fund assets worldwide. We do not believe bank-like regulation is appropriate, necessary or workable for funds registered under the Investment Company Act of 1940 (“Investment Company Act”). Instead, the regulatory response “should be carefully balanced and targeted to the risks the system creates, taking into account the expected costs and benefits of potential policy interventions in a comprehensive way and using appropriate criteria on which to judge their efficacy,” as the Note elsewhere suggests.<sup>15</sup>

We therefore would urge the FSB to reevaluate the “universal bank” framework set forth in the Note, and carefully consider the long history, in the United States and elsewhere, of parallel systems for intermediation that capital markets and banks provide. Furthermore, it is critically important that the FSB identify those specific features and activities of capital markets that pose potential risks to the global financial system, why such risks arise, and how existing regulation does not address these risks. To assist the FSB in that endeavor, we have attached several appendices. We outline in Appendix A the history in the United States of the successful co-existence of the banking and securities industries, as well as the origins of the Investment Company Act, the provisions of which provide detailed and substantive regulation of mutual funds and other U.S. registered investment companies. We believe

---

<sup>14</sup> Note at 3.

<sup>15</sup> Note at 7.

this history is important to illustrate the complementary, yet separate, roles of banks and non-banks in the markets and credit intermediation. The history of mutual funds is also important as it helps explain the basis for the existing strong protections included in the Investment Company Act. While U.S. mutual funds are issuers, they also are investors, investing assets on behalf of more than 90 million shareholders.

In Appendix B, we detail further the basis for our deep concerns with the Note's description of shadow banking and credit intermediation. We discuss how capital markets and entities that operate in them provide credit intermediation in a manner that is quite different from banks. Our description of the Investment Company Act, in Appendix C, including the specific rules applicable to money market funds, is intended to explain how the existing regulatory structure addresses risks that otherwise could arise from mutual funds. The extensive regulatory framework applicable to mutual funds, although different from bank regulation, is stringent and robust. Mutual funds are fundamentally different from banks; they issue securities, and they are carefully limited by the Investment Company Act as to their ability to use leverage. Mutual funds are also highly transparent, are subject to strict limitations on transactions with affiliates, and have strong governance features, including oversight by independent directors.

### C. Conclusion

The FSB wields an unusually powerful tool, in its ability to forge global recommendations regarding those activities perceived to pose systemic risk and to require international attention. We urge the FSB to carefully weigh any proposals relating to non-bank financial intermediaries against its standard that "the regulatory response to shadow banking should be carefully balanced and targeted."<sup>16</sup> Such balance will only be achieved if the FSB's recommendations are closely informed by, and tailored to take account of, the unique features of existing regulatory regimes and the experiences of different financial markets.

\* \* \* \* \*

We appreciate the opportunity to provide comments on the Note. If you have any questions about our comments or would like additional information, please contact me at (202) 326-5901 or

---

<sup>16</sup> *Id.*

Secretariat of the Financial Stability Board

June 3, 2011

Page 7 of 7

[paul.stevens@ici.org](mailto:paul.stevens@ici.org), ICI General Counsel Karrie McMillan at (202) 326-5815 or [kmcmillan@ici.org](mailto:kmcmillan@ici.org),  
or ICI Chief Economist Brian Reid at (202) 326-5917 or [brian.reid@ici.org](mailto:brian.reid@ici.org).

Sincerely,

A handwritten signature in black ink that reads "Paul Schott Stevens". The signature is written in a cursive style with a large initial "P" and a long horizontal stroke at the end.

Paul Schott Stevens  
President & CEO  
Investment Company Institute

### **The Parallel Role of Banks and the Securities Industry in the U.S. Capital Markets**

The Note indicates that the FSB “formed a task force to develop initial recommendations for discussion that would. . . explore possible regulatory measures to address the systemic risk and regulatory arbitrage concerns posed by the shadow banking system.”<sup>1</sup> The Note’s focus on “credit intermediation. . . outside the regular banking system,”<sup>2</sup> suggests that the FSB believes that credit intermediation outside the banking system is relatively new and arises from regulatory arbitrage. This perspective seems to ignore centuries of credit intermediation by, and regulation of, the capital markets.

The banking system and the capital markets have historically followed two distinct organizational structures.<sup>3</sup> One structure is for banks to dominate the intermediation of credit with the capital markets only playing a modest role. The other structure, which has prevailed in the United States for nearly two centuries, is based upon a framework in which capital markets play a more substantial and at times equal role alongside banks in the credit intermediation process. While the Note seems to proffer the view that the bank-dominated model is superior, *i.e.*, poses less systemic risk because, in the FSB’s opinion, banks are more strictly regulated, the Note provides no substantiated basis for this view. We find this position particularly striking given the perennial banking crises that occur despite numerous global efforts to increase bank capital and reduce risk.<sup>4</sup> Further, the Note fails to provide an assessment of the costs and benefits of moving from the U.S.-styled bank/capital markets system to a bank-centered system. In our view, a system that concentrates intermediation in banks would not alleviate systemic risk and, in fact, could increase it by exacerbating the moral hazard problem associated with “too big to fail.”

#### *Historical Development of U.S. Capital Markets and Banking System*

Credit intermediation outside the banking system, and interconnectedness between the capital markets and the banking system, have a long and deep history in the United States. In fact, the banking and capital markets have coexisted and served critical roles in credit intermediation from the inception

---

<sup>1</sup> Financial Stability Board, *Shadow Banking: Scoping the Issues*, April 11, 2011, available at [http://www.financialstabilityboard.org/publications/r\\_110412a.pdf](http://www.financialstabilityboard.org/publications/r_110412a.pdf), at 1 (“Note”).

<sup>2</sup> *Id.*

<sup>3</sup> “U.S. Securities Markets and the Banking System, 1790-1840,” *Review*, Federal Reserve Bank of St. Louis, May/June 1998, at 83 (“Review”).

<sup>4</sup> Carmen M. Reinhart and Kenneth S. Rogoff, *This Time is Different: Eight Centuries of Financial Folly*, Princeton University Press, 2009.



*Appendix A*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

of the United States. The development of the capital markets in the United States was not prompted by regulatory arbitrage, but rather by the demand for funding from governments, businesses, and individuals that local banks with significant monopoly power did not have the capacity to provide or did so at rates above those in the open market.<sup>5</sup>

In the late eighteenth century, the foundation for a U.S. bond market was laid. Shortly after the various states adopted the U.S. Constitution and the federal government was formed, the U.S. Congress restructured outstanding debts issued by the United States during the Revolutionary War and its Confederation-era. It financed the restructuring with several new federal issues that were paid for through domestic excise taxes and tariffs. These new federal bonds also financed the federal government's assumption of certain state debts.<sup>6</sup>

These bonds were soon traded in New York, Philadelphia, and Boston, effectively creating a national market for the bonds and providing a means for investors to improve the liquidity of these securities. These markets were quite efficient, despite the lack of modern means of communication. Arbitrage occurred among various local markets, causing prices to converge and move together; this early national market for U.S. bonds created a high degree of efficiency in allocating capital across these various local markets.<sup>7</sup> Furthermore, foreign investors played an important role in the early bond markets, with more than half of the debt being held by English and Dutch investors, thereby evidencing early forms of global interconnectedness between financial markets and intermediaries.<sup>8</sup>

In the first decades of the nineteenth century, the U.S. capital markets continued to expand alongside a growing number of state-chartered banks because the demand for working capital outstripped banks' ability to provide sufficient funding for the rapidly expanding U.S. economy. In 1790, the United States had three state-chartered banks; by 1830, this number had expanded to nearly 400.<sup>9</sup> Over the next century, the number of banks continued to grow, reaching nearly 30,000 national, state, and private banks in 1920.<sup>10</sup> At the same time, the U.S. capital markets also grew and by the

---

<sup>5</sup> John A. James, *Money and Capital Markets in Postbellum America*, Princeton University Press, Princeton, New Jersey, 1978, at 175.

<sup>6</sup> *Review* at 86.

<sup>7</sup> *Id.* at 88.

<sup>8</sup> *Id.* at 88.

<sup>9</sup> *Id.* at 86.

<sup>10</sup> *Banking and Monetary Statistics 1914-1941*, Board of Governors of the Federal Reserve System, Washington DC, 1943, at 6 ("*Banking and Monetary Statistics 1914-1941*").

*Appendix A*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

1920s annual issuance of equity and debt securities outside the money markets totaled several billion dollars a year.<sup>11</sup> Although economic contraction during the 1930s slowed the issuance of securities, the capital markets remained an important source of financing for U.S. businesses during this period and have remained so for the past 80 years.

The money markets have also served as an important source of capital for nearly two centuries. Beginning in the early 1800s, firms began to issue open market paper, a precursor to commercial paper, giving rise to early forms of the U.S. money markets.<sup>12</sup> Initially, non-financial firms were the primary issuers of commercial paper. The size of the commercial paper market fluctuated during the post-bellum period in the United States, initially contracting after the Civil War and then expanding after the United States returned to the gold standard.<sup>13</sup> The market grew rapidly in the first two decades of the twentieth century, particularly after the creation of the Federal Reserve, which was allowed to rediscount commercial paper.<sup>14</sup> By 1920, between 4,000 and 5,000 corporations were issuing commercial paper, often through dealers, and more than 30 firms were actively involved as intermediaries in this market.<sup>15</sup> Issuers used the proceeds to finance imports and exports as well as receivables within the United States.<sup>16</sup> Although issuance of commercial paper slowed sharply in the 1920's, reaching its nadir in the early 1930s,<sup>17</sup> it began to grow after World War II, expanding 18-fold by 1959.<sup>18</sup> By the mid-1970s, the market had reached nearly \$50 billion, and was roughly equal to 10 percent of total loans outstanding at commercial banks and 33 percent of commercial and industrial loans.<sup>19</sup>

The growth of this market predated the creation of money market funds, reflecting not only a steady supply of commercial paper but also demand from investors that wanted short-dated, high

---

<sup>11</sup> *Id.* at 487.

<sup>12</sup> Marcia Stigum and Anthony Crescenzi, *Stigum's Money Market*, Fourth Edition, 2007, at 970.

<sup>13</sup> "The Rise and Fall of the Commercial Paper Market, 1900-1929," *Anglo-American Financial Systems*, New York University Salomon Center, 1955, at 221.

<sup>14</sup> *Id.* at 227.

<sup>15</sup> "The Commercial Paper Market," *Federal Reserve Bulletin*, June 1977, at 531 ("*Federal Reserve Bulletin*").

<sup>16</sup> *Banking and Monetary Statistics 1914-1941* at 465.

<sup>17</sup> *Id.* at 466.

<sup>18</sup> *Federal Reserve Bulletin* at 531.

<sup>19</sup> *Id.* at tables 1.23 and 1.33.

*Appendix A*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

quality investments that paid a market yield. Principal investors included bank trust departments that invested in paper on behalf of their clients, non-financial corporations, insurance companies, and state and local governments. Individual investors were not significant buyers in the early days of the commercial paper market; however, by the mid-1970s, some companies were offering 30-day paper with minimums of \$25,000.<sup>20</sup>

Asset managers introduced money market funds beginning in the early 1970s to provide individual investors access to the money markets. Initially, growth of money market funds spurred growth of the money markets; by the mid-1980s, money market funds' share of the commercial paper market had reached one-third, fluctuating between one-quarter and one-third of the overall money market until the late 1990s.<sup>21</sup> Other holders of commercial paper included insurance companies, pension funds, funding corporations, and businesses. Beginning in the mid-1990s, many corporate and other institutional investors relied increasingly on money market funds for their cash management. For decades, such investors had managed their cash internally, investing directly in commercial paper, repurchase agreements, and time deposits or through bank trust departments that managed the cash through collective trusts. As corporate cash management moved to money market funds, those funds' share of the commercial paper market edged up slightly, typically ranging from one-third to one-half of this market.<sup>22</sup>

*History of Mutual Funds and the Investment Company Act*

Although mutual funds and other investment companies have gained widespread popularity among small investors only over the past few decades, the investment company concept has existed since the late-18<sup>th</sup> century when a Dutch merchant and broker invited subscriptions from small investors to form a trust, the Eendragt Maakt Magt, to provide an opportunity for them to diversify.<sup>23</sup> In the 1800s, "investment pooling" emerged in England and brought the concept closer to U.S. shores.<sup>24</sup>

---

<sup>20</sup> *Federal Reserve Bulletin* at 529.

<sup>21</sup> *Flow of Funds Accounts of the United States*, Board of Governors of the Federal Reserve System, Washington DC 20551, at Table L. 208.

<sup>22</sup> *Id.* at Table L. 208.

<sup>23</sup> Rouwenhorst, *The Origins of Mutual Funds*, Yale ICF Working Paper No. 04-48, at 1 ("Rouwenhorst"). Based on its characteristics, Eendragt Maakt Magt would most likely be classified today as a closed-end fund.

<sup>24</sup> The enactment of two British laws, the Joint Stock Companies Acts of 1862 and 1867, permitted investors to share in the profits of an investment enterprise and limited an investor's liability to the amount of money invested. *See* Rouwenhorst at 1.

*Appendix A*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

In 1868, the Foreign and Colonial Government Trust was formed in London. This trust resembled the U.S. fund model in basic structure, providing “the investor of moderate means the same advantages as the large capitalists . . . by spreading the investment over a number of different stocks.”<sup>25</sup>

Perhaps more importantly for the U.S. fund industry, the British fund model established a direct link with the capital markets, helping finance the development of the post-Civil War U.S. economy. The Scottish American Investment Trust, formed in 1873, invested in the economic potential of the United States, chiefly through American railroad bonds. Many other trusts followed that not only targeted investment in the United States, but led to the introduction of the fund investing concept on U.S. shores in the late 1800s and early 1900s.<sup>26</sup>

The first true investment companies of any size in the United States were formed in the 1920s.<sup>27</sup> These funds were generally sponsored by, and affiliated with, investment or brokerage houses; indeed, investors expected and hoped that these funds would participate in the businesses of the financial firms with which they were affiliated.<sup>28</sup> The 1920s saw significant growth in the number and size of investment companies in the United States, particularly closed-end investment companies and, by 1929, they were being created at the rate of almost one a day.<sup>29</sup>

The first mutual, or “open-end,” fund was introduced in Boston in March of 1924. The Massachusetts Investors Trust, formed as a common law trust, introduced important innovations to the investment company concept by establishing a simplified capital structure, continuous offering of shares, the ability to redeem shares rather than hold them until dissolution of the fund, and a set of clear investment restrictions and policies.<sup>30</sup>

The 1929 stock market crash and the Great Depression that followed hampered the growth of pooled investments. Following the market crash, shares of closed-end investment companies that had sold at a premium almost uniformly sold at a discount, and the reputation of financial companies suffered as it was discovered that some management companies had engaged in fraud. Thereafter, the

---

<sup>25</sup> 2011 Investment Company Factbook, available at [http://www.ici.org/pdf/2011\\_factbook.pdf](http://www.ici.org/pdf/2011_factbook.pdf), at 190 (“ICI Factbook”).

<sup>26</sup> *Id.*

<sup>27</sup> Lemke, Regulation of Investment Companies, Section 2.02 (“Lemke”) and Jaretzki, *Investment Company Act of 1940*, 26 Wash. U. L.Q. 303, 306-307 (1941) (“Jaretzki”).

<sup>28</sup> Jaretzki at 306.

<sup>29</sup> S. Rep. No 1775, 76<sup>th</sup> Cong. 3d Sess. 3 (1940).

<sup>30</sup> ICI Factbook at 191.

*Appendix A*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

investment company industry floundered until a succession of landmark securities laws, beginning with the Securities Act of 1933, restored investor confidence.

Following the stock market crash, the U.S. Congress recognized that there were deficiencies, and potential for abuses, in investment companies, and directed the newly formed Securities and Exchange Commission (“SEC”) to study investment trusts and investment companies. The SEC’s exhaustive 1939 study concluded that, to an alarming extent, investment companies had been operated in the interest of managers and to the detriment of shareholders.<sup>31</sup>

Legislation to regulate the activities of investment companies was first introduced in the Senate in March 1940, and the Investment Company Act was finally approved by President Roosevelt in August of 1940.<sup>32</sup> The Act underwent significant amendments in 1970 and 1996 to enhance investor protections and address the needs of the growing industry. Appendix C details the key provisions of the Act, and how they both protect shareholders’ investments and lessen systemic risk.

---

<sup>31</sup> The main abuses described in the SEC’s study were those that “flow[ed] from the very nature of the assets of the investment companies,” and provided opportunity for persons to steal the assets of the fund or to use them in their own interests rather than in the best interests of the shareholders. The SEC’s study played a critical role in shaping the legislation that would govern the regulation of investment companies. Report of the Securities and Exchange Commission on Investment Trusts and Investment Companies (1939) at 1775.

<sup>32</sup> Lemke, Section 2.04.

**The Role of Banks and the Capital Markets in Credit Intermediation and**  
**Maturity/Liquidity Transformation Services**

Both banks and participants in the capital markets provide maturity and liquidity transformation services, and it is important for policy makers to identify, understand, and articulate how financial intermediaries provide these services when assessing the inherent risk of an activity. The Note, however, takes a bank-centric approach in discussing credit intermediation and maturity and liquidity transformation and fails to consider the benefits and efficiencies of how such services are provided in capital markets.

The Note begins with a very broad definition of the “shadow banking system,” defining it as “credit intermediation that involves entities and activities outside the banking system” and seems to suggest that credit intermediation is uniquely a bank function best provided by banks.<sup>1</sup> Although the Note states that it seeks to limit this definition to only “entities and activities involved in extending credit . . . or involved in facilitating its intermediation,” we believe that this framework continues to sweep in a broad swath of financial and securities markets, including most non-equity securities markets and financial intermediaries including mutual funds.<sup>2</sup> In fact, the only activities expressly excluded by the Note are pure equity and foreign exchange trading from credit intermediation.

For example, even under the Note’s “limited scope” definition, the U.S. Treasury market and other sovereign debt markets would likely be categorized as part of the shadow banking system. The Treasury market provides a means for individuals and institutions to extend credit “either directly or as part of a chain of credit intermediation” to the U.S. Treasury. On a regular basis, the U.S. Treasury issues its debt in auctions that permit investors, ranging from individuals to institutions, to place bids. Any investor whose bid is accepted receives electronic delivery of the security auctioned. Mutual funds, including money market funds, are also part of the chain of credit intermediation. For example, Treasury bond funds and Treasury money market funds purchase and hold U.S. Treasury securities and act as an intermediary between the Treasury and fund investors.

Perhaps recognizing the vast reach of its definition, the Note then seeks to advise authorities to focus on activities that give rise to systemic risk such as those arising from the provision of maturity/liquidity transformation. Again, the Note seems to suggest that banks are uniquely or best suited to provide these functions. Indeed, the Note defines maturity and liquidity transformation in

---

<sup>1</sup> Financial Stability Board, *Shadow Banking: Scoping the Issues*, April 11, 2011, available [http://www.financialstabilityboard.org/publications/r\\_110412a.pdf](http://www.financialstabilityboard.org/publications/r_110412a.pdf), at footnote 2 (“Note”).

<sup>2</sup> *Id.*

the manner used by banks to provide these services. It defines “[m]aturity transformation [as] the activity of issuing short term liabilities (such as deposits) and transforming them into medium-long term assets (such as loans).”<sup>3</sup> It also describes “[l]iquidity transformation [to be] the issuing of liquid liabilities to finance illiquid assets,” and an asset as illiquid “when it cannot easily be converted into cash without a nominal loss.”<sup>4</sup>

Banks do engage in these activities, and are well-suited for intermediating opaque, illiquid, and nonmarketable debt instruments. For example, banks generally do not hold large amounts of marketable debt securities, but instead extend loans, often with maturities of 30 years or more, to large numbers of heterogeneous borrowers. Often there is little public information about the loans or the creditworthiness of the borrowers. Because each loan is unique, deep and liquid markets cannot form to allow for efficient trading of these debts. Banks finance most of these activities through deposits, which can be liquidated, often without penalty, for cash. Banks manage these maturity and liquidity transformation services through asset-liability management, lending and borrowing in the interbank market, and by having access to the discount window of the central bank and to deposit insurance.

Although the definition of non-bank credit intermediation in the Note attempts to narrow the focus, the Note fails to consider the benefits and efficiencies of having the capital markets also provide maturity and liquidity transformation services. Just as banks are well-suited for intermediating illiquid and opaque debt instruments, capital markets are far more efficient and better at intermediating liquid, marketable securities. Capital markets provide efficient systems of allocating capital not only because equity and debt issuers can be subdivided into individual securities that attract large numbers of investors, but also because they provide economic information and a means of managing risks.<sup>5</sup> Securities laws and regulations provide extensive rules for the issuance of such securities and the provision of public information about the issuers. These rules significantly reduce the informational asymmetries for those issuers that are able to tap these markets. The enhanced public information attracts large numbers of potential investors and significantly increases market efficiency and reduces the issuers’ cost of credit relative to bank loans.

---

<sup>3</sup> *Id.* at footnote 5.

<sup>4</sup> *Id.*

<sup>5</sup> *The Origins of Value: The Financial Innovations that Created Modern Capital Markets*, Edited by William N. Goetzmann and K. Geert Rouwenhorst, Oxford University Press, 2005, at 304.

Capital markets not only facilitate the issuance of securities but facilitate the trading of securities after they are issued. The negotiability of financial instruments is a key feature of modern capital markets, and the inherent maturity and liquidity transformation services of the markets increase investors' willingness to hold securities.<sup>6</sup> In a sense, one can think of maturity transformation arising from an investor being able to sell a security for cash before it matures, which effectively shortens the maturity of the security for the seller. The sale of the security may produce a gain or a loss to the investor, depending on fluctuations in interest rates or other market factors that arise between the time of the purchase and sale of the security.

The U.S. Treasury market again provides an example of how capital markets provide maturity and liquidity transformation services. Once an investor receives a Treasury security, the investor can sell it for cash prior to maturity. Brokers, banks, and other financial intermediaries act as market makers and facilitate the buying and selling of Treasury securities. The value of the security is equal to its current market value less any transaction costs associated with the sale. These costs depend on a variety of factors, including whether the instrument is newly issued or seasoned, the size of the order, and the depth of liquidity in the market for that security. Deep, transparent, and competitive capital markets help to reduce the transaction costs by narrowing bid-ask spreads or reducing brokerage commissions associated with the purchase and sale of the security, thereby enhancing the liquidity transformation of such securities.

Simply because mutual funds are part of the intermediation chain that relies on the maturity and liquidity transformation services of the capital markets, rather than those of banks, does not mean that they are a source of "regulatory arbitrage. . . used to circumvent and undermine banking regulations."<sup>7</sup> For example, U.S. bond or money market funds that invest in U.S. Treasury securities issue shares to investors and provide them with an undivided pro rata interest in the fund's portfolio. These shares are redeemable upon demand, although funds may hold delivery of cash to their shareholders for up to seven days. To meet any shareholder redemptions that exceed new-share sales, the fund sells securities in its portfolio. Similarly, the proceeds from the sale of shares that exceed shareholder redemptions are used to purchase additional securities. Just as capital markets provide maturity transformation and liquidity services to investors, funds also provide these services to their

---

<sup>6</sup> *Id.* at 7.

<sup>7</sup> Note at 3.



*Appendix B*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

investors through their transactions in the capital markets.<sup>8</sup> The shareholders in the funds, through their pro rata interest in the fund's portfolio, bear the risks of the portfolio.

Other capital markets provide investors with similar maturity and liquidity transformation services. These markets include those that trade corporate and municipal bonds, forward and futures contracts, equity, and money market instruments. Establishing a clear framework that differentiates between the intermediation activities of banks and capital markets is critical to pinpointing the key benefits and costs between bank and capital market credit intermediation and maturity and liquidity transformation. A well-defined framework is essential; otherwise, entities and activities are defined to be "bank-like" simply because they intermediate credit and transform maturity and liquidity. For example, the Note identifies "short-dated ABCP, short-term repos, and money market mutual funds" as being "bank-like" because they are "run-able" and "deposit-like." The Note, however, does not explain what particular features of these instruments make them "run-able" or "deposit-like." The Note indicates that bank deposits are short-term and highly liquid, but many capital and money market instruments have such features. This lack of clarity can lead policy makers to include activities as part of the "shadow banking system" when they are more accurately a part of a long-accepted and well-established capital markets model. This lack of justification for applying this framework to mutual funds generally, and money market funds specifically, is discussed in Appendix C.

---

<sup>8</sup> The regulatory framework applicable to mutual funds recognizes the liquidity transformation that occurs in a mutual fund as a result of being both an issuer and an investor in securities. Mutual funds are required to limit their acquisition of illiquid securities to ensure that all redemption requests will be satisfied within seven days. Specifically, the SEC has taken the position that mutual funds should not invest in illiquid securities if doing so would cause the fund to have less than 85 percent of its assets in liquid securities. A security is generally deemed to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the fund has valued it. Money market funds have more specific liquidity requirements under Rule 2a-7 under the Investment Company Act, *e.g.*, minimum holdings of "daily liquid assets" and "weekly liquid assets." *See* Appendix C.

### **The Investment Company Act Limits Systemic Risk and Regulatory Arbitrage**

As described in our letter, the Note advises authorities to concentrate on shadow banking activities that present systemic risk and/or regulatory arbitrage. For the reasons described below, even if the FSB determines that mutual funds, or certain types of mutual funds such as money market funds, engage in “shadow banking activities,” mutual funds do not give rise to the systemic risk and regulatory arbitrage described in the Note.<sup>1</sup> The Investment Company Act very much limits the systemic risk described in the Note, including through strict limits on leverage. Further, the detailed requirements of the Investment Company Act do not provide opportunities for regulatory arbitrage or serve to undermine banking regulation.

It is true that mutual funds and banks operate under different regulatory structures, but the businesses are fundamentally different and the approach to regulation, in each case, reflects their unique features. Bank regulation, among other things, reflects the availability of insurance and the high levels of capital that are necessary to protect that insurance pool; in contrast, mutual funds, including money market funds, are securities, and investors are informed through mandated disclosures of the risks they may incur. Further, laws governing mutual funds contain substantive provisions that not only protect shareholders, but also guard against systemic risks. The differences in these regulatory structures do not create arbitrage; rather, they are different ways to address very different products. Both structures are rigorous.

The Investment Company Act requires entities that meet the definition of “investment company” to register and to comply with the Act’s provisions (these entities are referred to as “registered investment companies”).<sup>2</sup> Unlike other federal securities laws, which are designed to protect

---

<sup>1</sup> Fund sponsors in the United States offer four types of registered investment companies: (1) open-end investment companies (commonly called “mutual funds”); (2) closed-end investment companies; (3) exchange-traded funds (ETFs); and (4) unit investment trusts (UITs). This Appendix focuses primarily on mutual funds, although many of the concepts are common to all types of registered investment companies. More detailed information regarding the other types of registered investment companies is available in the 2011 Investment Company Institute Factbook, available at [http://www.ici.org/pdf/2011\\_factbook.pdf](http://www.ici.org/pdf/2011_factbook.pdf). In addition, an extensive description regarding ETFs registered under the Investment Company Act is included in ICI’s comment letter on the Financial Stability Board’s April 2011 Note entitled “Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds,” available at <http://www.ici.org/pdf/25189.pdf>.

<sup>2</sup> Section 3(c) of the Investment Company Act exempts from the definition of investment company certain entities that otherwise would come within the definition and that, absent this provision, would be required to register under Section 8 of the Investment Company Act prior to offering or selling any securities. Such entities include: private investment companies; common trust funds; small loan companies; discounting companies; real estate companies; companies making

*Appendix C*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

investors primarily through disclosure, the Investment Company Act imposes substantive requirements on the operations of registered investment companies in addition to extensive disclosure requirements.

The vast majority of U.S. registered investment companies are mutual funds, both in terms of number of funds and assets under management. The different types of mutual funds include money market funds, bond funds, domestic equity funds, international equity funds, and hybrid funds. We focus on the additional detailed requirements uniquely applicable to money market funds in the section below entitled Money Market Funds Registered under the Investment Company Act—Additional Rules.

Individuals and institutions invest in a mutual fund by purchasing shares issued by the fund.<sup>3</sup> The Investment Company Act requires that mutual funds only issue voting securities. Mutual funds also issue “redeemable securities,” meaning the holder, upon its presentation to the mutual fund, is entitled to receive approximately his or her proportionate share of the mutual fund’s current net assets, or the cash equivalent thereof. Accordingly, each shareholder (unlike a bank depositor) owns a pro rata share of the fund’s investments and shares in the returns from the fund’s portfolio of stocks, bonds and other investments. A mutual fund shareholder therefore experiences many of the key features of directly investing in securities, *e.g.*, experiencing investment gains and losses, while benefiting from professional investment management, diversification, and liquidity at a relatively low cost.

Mutual funds are regulated under all four of the major U.S. securities laws: the Securities Act of 1933, which requires registration of the mutual fund’s shares and the delivery of a prospectus; the Securities Exchange Act of 1934, which regulates the trading, purchase and sale of fund shares and establishes antifraud standards governing such trading; the Investment Advisers Act of 1940, which regulates the conduct of fund investment advisers and requires advisers to mutual funds to register with the SEC; and, most importantly, the Investment Company Act, which requires all mutual funds to register with the SEC and to meet significant operating standards.<sup>4</sup>

---

loans relating to merchandise, services or insurance; religious or charitable organizations; and pension or profit-sharing plans.

<sup>3</sup> Each mutual fund is a separate legal entity, organized under state law either as a corporation or a business trust (sometimes called a “statutory trust”), with its own officers and board of directors or trustees. A mutual fund typically engages third parties or service providers to invest mutual fund assets and carry out other business activities.

<sup>4</sup> Mutual funds are also subject to oversight by state securities commissions and self-regulatory organizations, such as the Financial Industry Regulatory Association (“FINRA”). FINRA is a self-regulatory organization that oversees broker-dealers that distribute mutual fund shares and mutual fund advertising.

The core principles of the Investment Company Act originally were adopted to protect shareholders, but in fact contain strong systemic risk-limiting provisions. The key principles are described briefly below.

- (1) Limits on Leverage and Capital Structure: The Investment Company Act prohibits complex, unfair, or unsound capital structures. Contrary to the implications in the Note, mutual funds are subject to significant limitations on their ability to use leverage, one of the key factors identified by the FSB as indicating whether increased regulatory attention should be provided. Under the Investment Company Act, the maximum ratio of debt-to-assets allowed by law for a mutual fund is 1-to-3, which translates into a maximum allowable leverage ratio of total assets-to-equity of 1.5 to 1. Given the importance of leverage as a contributing factor to systemic risk, we describe in more detail below the Investment Company Act's leverage-limiting provisions.<sup>5</sup>
- (2) Disclosure and Transparency: The Investment Company Act ensures that the market and investors have access to extensive information about each mutual fund, including its strategy and investment risks as well as information on its current activities. In particular, mutual funds are subject to requirements that mandate disclosure of: (a) the types of securities in which they may invest and the related risks; (b) reports describing the results of operations and financial position; (c) quarterly portfolio holdings disclosure; (d) other detailed financial and operating disclosures; and (e) annual proxy voting disclosure. The marketplace simply does not have access to anything even approaching this degree of transparency about banks and their holdings. In fact, some believe that the opacity of banks' balance sheets contributed to the spread and severity of the recent financial crisis.<sup>6</sup>
- (3) Valuation and Liquidity: Registered investment companies offer shareholders liquidity and objective, market-based valuation of their investments. Mutual fund shares are redeemable on a daily basis at a price that reflects the current market value of the fund's portfolio securities.<sup>7</sup> The Investment Company Act includes detailed provisions for

---

<sup>5</sup> The Investment Company Act requires the issuance of voting securities and prohibits mutual funds from issuing debt or preferred stock. It also restricts the amount that funds may invest in securities issued by other investment companies, insurance companies, investment advisers, broker-dealers and underwriters (so-called anti-pyramiding provisions).

<sup>6</sup> *The Financial Crisis of 2008 in Fixed Income Markets*, Gerald P. Dwyer and Paula Tkac, Working Paper 2009-20, Federal Reserve Bank of Atlanta (August 2009).

<sup>7</sup> ETF and closed-end fund shares are traded intraday on stock exchanges at market-determined prices, providing shareholders with "real time" liquidity at market prices.

determining the value of each security in a mutual fund's portfolio. The SEC has taken the position that mutual funds should not invest in illiquid securities if doing so would cause the fund to have less than 85 percent of its assets in liquid securities.<sup>8</sup> These requirements are essential to promoting investor and market confidence. Further, these provisions are transparent to the marketplace and allow investors, counterparties, and others to understand easily the actual valuations of the funds' portfolios.

- (4) Oversight and Accountability: The Investment Company Act provides for a high degree of oversight and accountability. Internal oversight mechanisms include boards of directors or trustees, a super-majority of whom typically are independent directors or trustees. SEC rules require funds to have written compliance programs overseen by chief compliance officers, both at the mutual fund and adviser levels. External oversight is provided by the SEC, FINRA, and external service providers, such as certified public accounting firms. Here, too, the regulatory oversight of banks and mutual funds is different, but both are effective.
- (5) Transactions with Affiliates: The Investment Company Act contains detailed prohibitions on transactions between a mutual fund and mutual fund insiders or affiliated persons (such as the corporate parent of the mutual fund's adviser).<sup>9</sup> These prohibitions are intended to prevent over-reaching and self-dealing by mutual fund insiders, which serve to protect investors and promote investor confidence in mutual funds. The detailed and restrictive provisions of the Investment Company Act governing dealings with affiliates are no less stringent than those contained in Sections 23A and B of the Federal Reserve Act.
- (6) Diversification: Both U.S. tax laws and the Investment Company Act provide diversification standards for mutual funds.<sup>10</sup> This diversification feature is especially

---

<sup>8</sup> The SEC generally deems a security to be liquid if it can be sold or disposed of in the ordinary course of business within seven days at approximately the price at which the fund has valued it. *See* Registration Form Used by Open-End Management Investment Companies, SEC Release No. IC-23064 (March 13, 1998).

<sup>9</sup> In addition, a mutual fund's investment adviser has a fiduciary duty to put the fund's interest before those of the adviser and is subject to numerous restrictions on transactions that may pose conflicts of interest.

<sup>10</sup> Under the tax laws, all mutual funds, closed-end funds, and ETFs, as well as most UITs, qualify as "regulated investment companies" and, as such, must meet a tax diversification test every quarter. Although diversification is not mandatory under the Investment Company Act, that Act sets even higher standards for mutual funds that elect to be diversified. All mutual funds, closed-end funds, and ETFs must disclose whether they are diversified under the Investment Company Act's standards.

important for investors as a bank deposit (over any insured amounts) is subject to the single counterparty risk that the bank may fail.

- (7) Custody of Fund Assets: The Investment Company Act has specific custody rules requiring strict care of a mutual fund's assets.<sup>11</sup> These provisions protect investors from theft or misappropriation of their investments.
- (8) Regulatory Oversight: The Investment Company Act and companion Investment Advisers Act of 1940, and the rules adopted under these Acts, contain detailed rules for mutual funds and their management companies. To ensure compliance with these rules, the SEC carries out an inspection program in part based on risks that the funds could pose. The goals of the examinations conducted by SEC staff include detecting possible violations of laws, fostering strong compliance and risk management practices, monitoring risk, and providing the SEC and its policy divisions with information about the industry's compliance and the implementation of rules and laws. The SEC's staff focuses examination resources on those registrants and activities where staff believes that the investing public or market integrity is most at risk.<sup>12</sup> In contrast, banks in the United States follow a "prudential" model of regulation where the rules are less prescribed but the role of the regulator is more "hands-on". The regulatory oversight to which mutual funds and investment advisers are subject, although different from that of banks, is similarly robust.

*Leverage and the Investment Company Act*

We agree with the FSB's attention to leverage. Leverage can provide an important stimulus to financial systems. In times of strain, however, leverage also can act as a multiplier, turning small losses into large ones and creating risks for the system overall. For example, when a financial institution is highly leveraged (such as at 25-to-1), a five percent drop in asset values is more than enough to wipe out all of its equity. When one highly leveraged firm holds the debt of another highly leveraged firm, losses

---

<sup>11</sup> Although the Investment Company Act permits other arrangements subject to SEC rules, nearly all mutual funds use a bank custodian for domestic securities. The Investment Company Act contains six separate custody rules for the different types of permitted custody arrangements. UITs are subject to a separate rule that requires the use of a bank to maintain custody.

<sup>12</sup> Certain deficiencies or violations may be referred to the SEC's Division of Enforcement, which investigates possible violations of securities laws, recommends Commission action when appropriate, either in a federal court or before an administrative law judge, and negotiates settlements.

*Appendix C*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

can mount exponentially and spread quickly. As a result, we agree that companies that are highly leveraged pose greater potential risk to the financial system.<sup>13</sup>

Recent history confirms this. Well before it failed, Bear Stearns was leveraged at 31-to-1—each dollar of capital was supporting \$31 in assets. Similarly, in August 2007, twelve full months before it failed, Lehman Brothers was leveraged at 30-to-1.<sup>14</sup> And, at the end of 1997, roughly ten months before it failed, Long-Term Capital Management (not a registered investment company) had a leverage ratio of 25-to-1.<sup>15</sup>

Historically, large banks and broker-dealers have tended to have leverage ratios of assets-to-equity in the range of 10-to-1 to 30-to-1. Certain kinds of private funds, which in the United States are often referred to as hedge funds and are not subject to the Investment Company Act, sometimes have comparable leverage ratios. For mutual funds, by contrast, the maximum ratio of debt-to-assets allowed by law is 1-to-3,<sup>16</sup> which translates into a maximum allowable leverage ratio of total assets-to-equity of 1.5-to-1. As a result, most mutual funds operate with little if any leverage. This important distinction between mutual funds and many banks has been recently recognized by the U.S. Congress in the Senate Banking Committee report on S. 3217, which states: “a typical mutual fund could be an example of a non-bank financial company with a low degree of leverage.”<sup>17</sup>

The Investment Company Act and related guidance from the SEC and its staff also strictly limit the extent to which mutual funds can enter into types of transactions that have a leverage component, such as selling securities short, purchasing securities on margin, or investing in certain

---

<sup>13</sup> For example, suppose that a financial institution initially has assets of \$100 million and capital of \$4 million, implying a leverage ratio of assets-to-equity of 25-to-1. This also implies that the firm has debt of \$96 million. If the value of the firm’s assets drop by \$4 million (a 4 percent decline), the firm now has assets of \$96 million, debt of \$96 million, and equity capital of zero. If the value of the firm’s assets drops further, the firm no longer has any capital to buffer losses. In that case, even if the firm were able to sell off all of its assets at current market values (*e.g.*, \$95 million), the firm would be unable to fully repay its debts of \$96 million. If this firm’s creditors are also highly leveraged, the firm’s losses and inability to fully repay its obligations could result in cascading losses among creditor firms, as the creditor firms in turn suffer losses on their assets.

<sup>14</sup> Source: Bloomberg.

<sup>15</sup> See *Hedge Funds, Leverage, and Lessons of Long-Term Capital Management*, Report of the President’s Working Group on Financial Markets (April 1999).

<sup>16</sup> See Section 18(f) of the Investment Company Act, which prohibits any registered open-end investment company (mutual fund) from issuing any class of senior security or selling any senior security of which it is the issuer, but permits borrowing from a bank, provided that there is asset coverage of at least 300 percent for all such borrowings.

<sup>17</sup> See S. Rep. No. 111-176, at 48 (2010).

*Appendix C*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

derivatives. As a result, mutual funds may not engage in these types of transactions unless they “cover” their exposure. Funds typically comply by segregating liquid assets on their books or by maintaining offsetting positions.<sup>18</sup> The existing rules and related guidance generally limit mutual funds’ use of transactions involving leverage and help provide assurance that a mutual fund will be able to meet its obligations.<sup>19</sup> As such, they tightly constrain the risks a fund might pose to the financial markets broadly.

*Money Market Funds Registered under the Investment Company Act—Additional Rules*

The Note describes “money market mutual funds” as part of the “shadow banking system.” We strongly disagree, for the reasons discussed below.

While there is no single, global definition of a “money market fund,”<sup>20</sup> U.S. money market funds, like all U.S. mutual funds, are subject to the comprehensive requirements of the Investment Company Act, as described above. Indeed, money market funds share key features with other mutual funds. They issue shares that are redeemable upon demand, invest in marketable securities, and, with one exception discussed below, adhere to the same rules and regulations that apply to all mutual funds.

The same key features that distinguish a bond fund investing in U.S. Treasuries from a bank, likewise differentiate money market funds from banks. First, money market funds do not make loans or use other forms of debt financing, but instead invest in marketable securities. These securities include very short-dated U.S. Treasury and agency securities, commercial paper, time deposits, repurchase securities, and bank and corporate notes. Second, money market funds meet shareholder

---

<sup>18</sup> See, e.g., Merrill Lynch Asset Management, L.P., SEC No-Action Letter, July 2, 1996 (funds may segregate cash or liquid securities); “Dear Chief Financial Officer” Letter from Lawrence A. Friend, Chief Accountant, Division of Investment Management (pub. avail. Nov. 7, 1997) (funds may designate segregated assets on their own books, and not on the fund custodian’s records); Dreyfus Strategic Investing & Dreyfus Strategic Income, SEC No-Action Letter, June 22, 1987 (a fund may cover certain positions by entering into offsetting transactions in lieu of segregating assets).

<sup>19</sup> In 2010, the SEC announced that the staff is reviewing funds’ use of derivatives. See *SEC Staff Evaluating the Use of Derivatives by Funds*, SEC Press Release 2010-45 (March 25, 2010). The review will consider a number of aspects of derivatives use, including how funds treat derivatives for purposes of the leverage, concentration, and diversification provisions of the Investment Company Act, risk management, valuation, board oversight, and disclosure, and will seek to determine what, if any, changes in SEC rules or guidance may be warranted.

<sup>20</sup> Although many jurisdictions identify a class of funds as “money market funds,” the market circumstances, the regulatory structure and the operation of such funds vary significantly from one jurisdiction to another. See *Report of the Money Market Working Group*, Investment Company Institute (March 17, 2009) (“MMWG Report”) Appendix H, available at [http://www.ici.org/pdf/ppr\\_09\\_mmwg.pdf](http://www.ici.org/pdf/ppr_09_mmwg.pdf).



redemptions that are in excess of new sales by selling securities or not reinvesting proceeds from maturing assets, providing funds with a high degree of flexibility in meeting shareholder redemptions. Third, unlike bank deposits, which are bank liabilities and create leverage on the balance sheet, money market fund shares provide investors with an undivided pro rata interest in the underlying securities of the fund's portfolio, thereby mimicking the investment features of direct money market investments.

One defining feature of money market funds is that, in contrast to other mutual funds, they seek to maintain a stable net asset value or share price, typically \$1.00 per share. As a result, money market funds must comply with an additional set of regulatory requirements in Rule 2a-7 under the Investment Company Act. Rule 2a-7 exempts money market funds from the valuation provisions generally applicable to all mutual funds and permits them to determine their net asset value using the amortized cost method of valuation, which facilitates money market funds' ability to maintain a stable net asset value. Under the amortized cost method, portfolio securities generally are valued at cost plus any amortization of premium or accumulation of discount.<sup>21</sup> The basic premises underlying money market funds' use of the amortized cost method of valuation are these: (1) high-quality, short-term debt securities held until maturity will return to their amortized cost value, regardless of any temporary disparity between the amortized cost value and market value; and (2) while held by a money market fund, the market value of such securities ordinarily will not deviate significantly from their amortized cost value.<sup>22</sup> Thus, Rule 2a-7 permits money market funds to value portfolio securities at their amortized cost so long as the deviation between the amortized cost and current market value remains minimal and results in the computation of a share price that represents fairly the current net asset value per share of the fund. In practice these risk limiting conditions generally keep deviations between money market funds' per share market value and amortized costs small. Data from a sample of taxable money market funds covering one-quarter of U.S. taxable money market fund assets show that the average per-share market values varied between \$1.002 and \$0.998 during the decade from 2000 to 2010.<sup>23</sup>

To reduce the likelihood of a material deviation occurring between the amortized cost value of a portfolio and its market-based value, Rule 2a-7 contains a number of conditions designed to limit the

---

<sup>21</sup> Rule 2a-7 also permits money market funds to use the penny rounding method of pricing. Under this method, share price is determined by valuing securities either at market value, fair value, or amortized cost, and rounding the per share net asset value to the nearest cent on a share price of \$1.00.

<sup>22</sup> See *Pricing of U.S. Money Market Funds*, Investment Company Institute (January 2011), available at [http://www.ici.org/pdf/ppr\\_11\\_mmf\\_pricing.pdf](http://www.ici.org/pdf/ppr_11_mmf_pricing.pdf) ("*Pricing of U.S. Money Market Funds*").

<sup>23</sup> See *Pricing of U.S. Money Market Funds* at 26.

fund's exposure to certain risks by governing the credit quality, liquidity, maturity, and diversification of a money market fund's investments.<sup>24</sup> These risk-limiting conditions include requirements that money market funds:

- only invest in high-quality securities that mature in 13 months or less (with exceptions for certain types of securities including variable and floating rate securities that have an interest rate reset of no more than 397 days or a demand feature), which a fund's board of directors (or its delegate) determines present minimal credit risks, and a requirement that at least 97 percent of a fund's assets be invested in securities held in government obligations or other securities that either received the highest short-term rating or are of comparable quality;
- maintain a sufficient degree of portfolio liquidity necessary to meet reasonably foreseeable redemption requests, including a requirement that all taxable funds maintain at least 10 percent of assets in cash, Treasury securities, or securities that convert into cash within one day ("daily liquid assets"), and that all funds maintain at least 30 percent of assets in cash, Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week ("weekly liquid assets");
- maintain a weighted average portfolio maturity that reduces both interest rate and credit spread risk; and
- maintain a diversified portfolio designed to limit a fund's exposure to the credit risk of any single issuer.

In addition, Rule 2a-7 includes certain procedural requirements overseen by the money market fund's board of directors. One of the most important is the requirement that the fund periodically compare the amortized cost net asset value of the fund's portfolio with the mark-to-market net asset value of the portfolio.<sup>25</sup> If there is a difference of more than ½ of 1 percent (or \$0.005 per share), the

---

<sup>24</sup> Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule's risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7.

<sup>25</sup> Indeed, as a result of Rule 2a-7's risk-limiting conditions, money market funds' underlying per-share market price deviates by only a few basis points from \$1.00 in all but the most extreme market conditions. For example, the SEC's decision to reduce the maximum allowable weighted average maturity of money market funds' portfolios significantly reduces volatility in per-share market prices arising from changes in interest rates. See *Pricing of U.S. Money Market Funds*.

*Appendix C*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

fund's board of directors must consider promptly what action, if any, should be taken, including whether the fund should discontinue the use of the amortized cost method of valuation and re-price the securities of the fund below (or above) \$1.00 per share, an event colloquially known as "breaking the dollar." Regardless of the extent of the deviation, Rule 2a-7 also imposes on the board of a money market fund a duty to take appropriate action whenever the board believes the extent of any deviation may result in material dilution or other unfair results to investors or current shareholders. Moreover, all funds must dispose of a defaulted or distressed security (*e.g.*, one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund.

Money market funds also must prominently disclose on the first page of their prospectus that "an investment in the [f]und is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. Although the [f]und seeks to preserve the value of your investment at \$1.00 per share, it is possible to lose money by investing in the [f]und."<sup>26</sup>

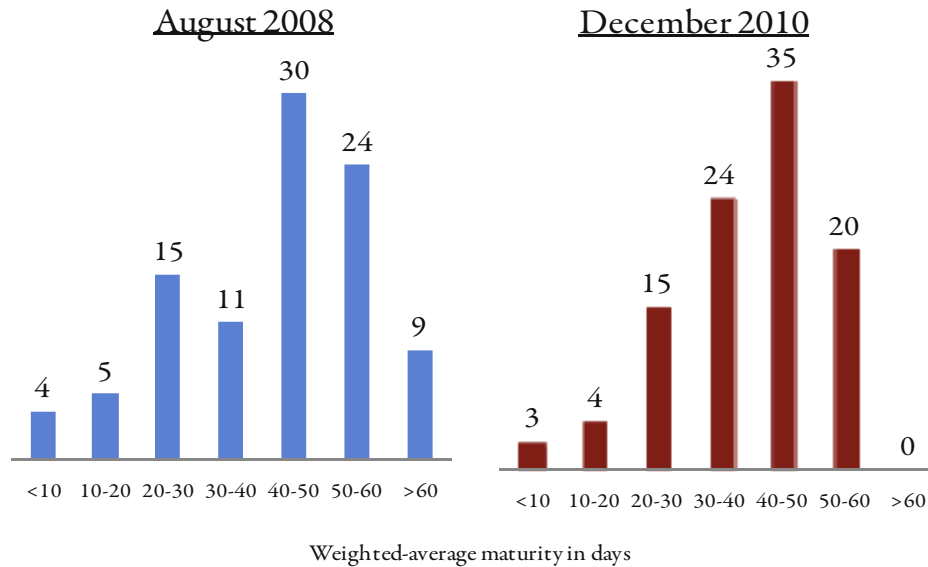
Building upon the lessons of the financial crisis, the SEC's 2010 rule amendments raised credit standards and shortened the maturity of money market funds' portfolios—further reducing credit and interest rate risk.<sup>27</sup> For example, the reduction in funds' weighted average maturity ("WAM") from 90 days to 60 days lowered the average maturity of taxable money market funds (Figure 1). It also reduced "tail risk" by preventing funds from holding a portfolio with a WAM in excess of 60 days; this is seen in Figure 1 as a "lopping off" of the right-hand tail of the distribution of WAMs across taxable money market funds. Reducing money market funds' WAM so that a higher percentage of their assets mature sooner than before the onset of the financial crisis, makes them more resilient to changes in interest rates that may be accompanied by other market shocks, and puts money market funds in a better position to meet shareholder redemptions.

---

<sup>26</sup> In light of money market funds' experience during the financial crisis, the MMWG Report recommended that money market funds evaluate whether their disclosures, including advertising and marketing materials, and in particular their risk disclosures, fully capture the risks that money market funds may present and, if appropriate, revise their disclosures. *See* MMWG Report at 91-92.

<sup>27</sup> *See Money Market Fund Reform*, SEC Release No. IC-29132 (February 23, 2010), available on the SEC's website at <http://sec.gov/rules/final/2010/ic-29132.pdf>. A chart comparing money market fund regulations before and after the recent amendments is available on ICI's website at [http://www.ici.org/policy/regulation/products/money\\_market/11\\_mmf\\_reg\\_summ](http://www.ici.org/policy/regulation/products/money_market/11_mmf_reg_summ).

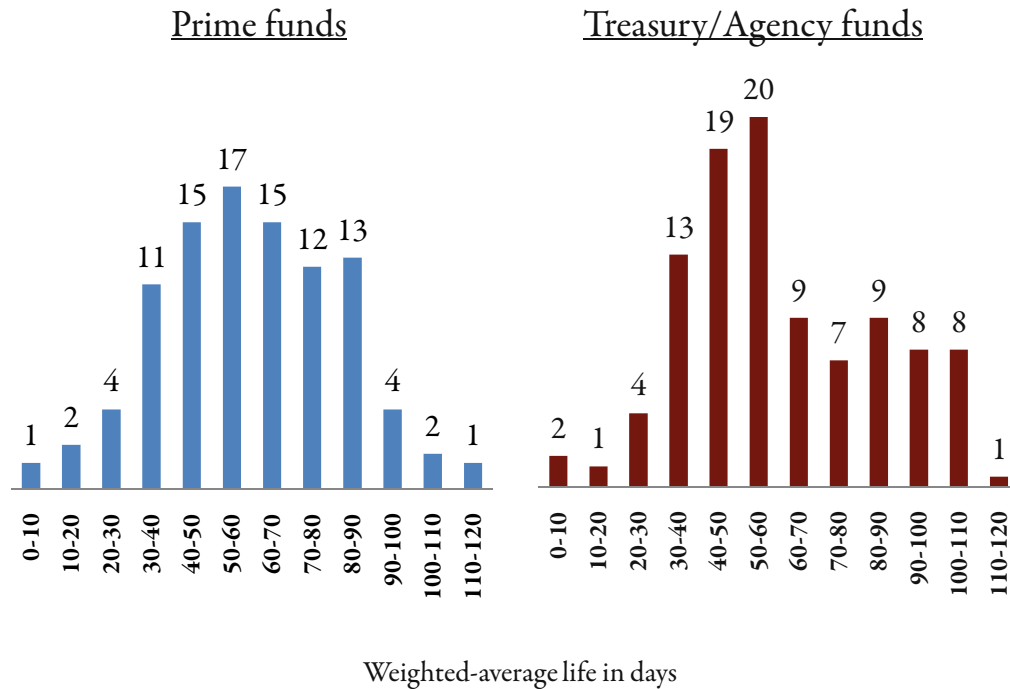
**Figure 1: WAMs for Taxable Money Market Funds**  
 Percent of funds



Source: Investment Company Institute

The introduction of a limit on money market funds’ weighted average life (“WAL”) also has strengthened the ability of money market funds to meet redemption pressures. Unlike a fund’s WAM calculation, the WAL of a portfolio is measured without reference to interest rate reset dates. The WAL limitation thus restricts the extent to which a money market fund can invest in longer term adjustable-rate securities that may expose a fund to spread risk. Although publicly available data on WALs do not exist before November 2010, the available data since then suggest that the new WAL requirement likely has bolstered funds’ ability to sustain market shock. Figure 2 depicts the distribution of WALs for taxable money market funds as of December 2010. According to Figure 2, a very small proportion of funds have WALs in excess of 100 days. Indeed, the great majority of funds have WALs ranging from 30 to 90 days, in part reflecting the fact that money market securities (including Treasury and agency securities) are issued with maturities in essentially the same range.

**Figure 2: WALs for Taxable Money Market Funds**  
 Percent of funds, December 2010



Note: Excludes money market funds that invest primarily in other money market funds (e.g., master/feeder structure).

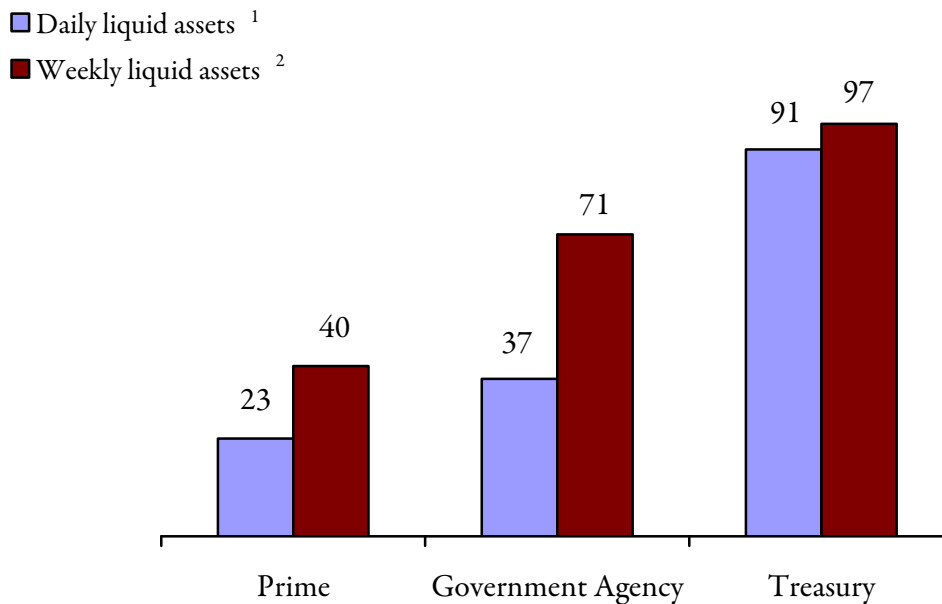
Source: Investment Company Institute tabulation of Form N-MFP data collected from SEC website

In addition, the 2010 amendments directly addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements. The amendments further require funds to have “know your investor” procedures to help them anticipate the potential for heavy redemptions and adjust their liquidity accordingly. As Figure 3 shows, as of December 2010, funds’ assets exceeded the minimum daily and weekly liquidity requirements by a fair margin; 23 percent of the assets of taxable money market funds were in daily liquid assets and 40 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated \$1.4 trillion in highly liquid assets, which includes \$660 billion held by prime money market funds.<sup>28</sup> In comparison, during the business week of

<sup>28</sup> Prime money market funds are funds that may invest in high-quality, short-term money market instruments including Treasury and government obligations, certificates of deposit, repurchase agreements, commercial paper, and other money market securities.

Monday, September 15 to Friday, September 19, 2008 (the week Lehman Brothers failed), prime money market funds experienced estimated outflows of \$370 billion.

**Figure 3: Liquid Assets for Taxable Money Market Funds**  
 Percent of total assets, December 2010



<sup>1</sup>Daily liquid assets include securities with a remaining maturity of one business day, Treasury securities of any maturity, and securities with a demand feature that is exercisable within one business day. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for daily liquid assets.

<sup>2</sup>Weekly liquid assets include securities with a remaining maturity of five business days, Treasury securities of any maturity, government agency securities with a remaining maturity of 60 days or less (regardless of whether those securities were initially issued at a discount), and securities with a demand feature that is exercisable within five business days. Securities with a demand feature are excluded if it could not be determined when the demand feature is exercisable and the security does not meet any of the other criteria for weekly liquid assets.

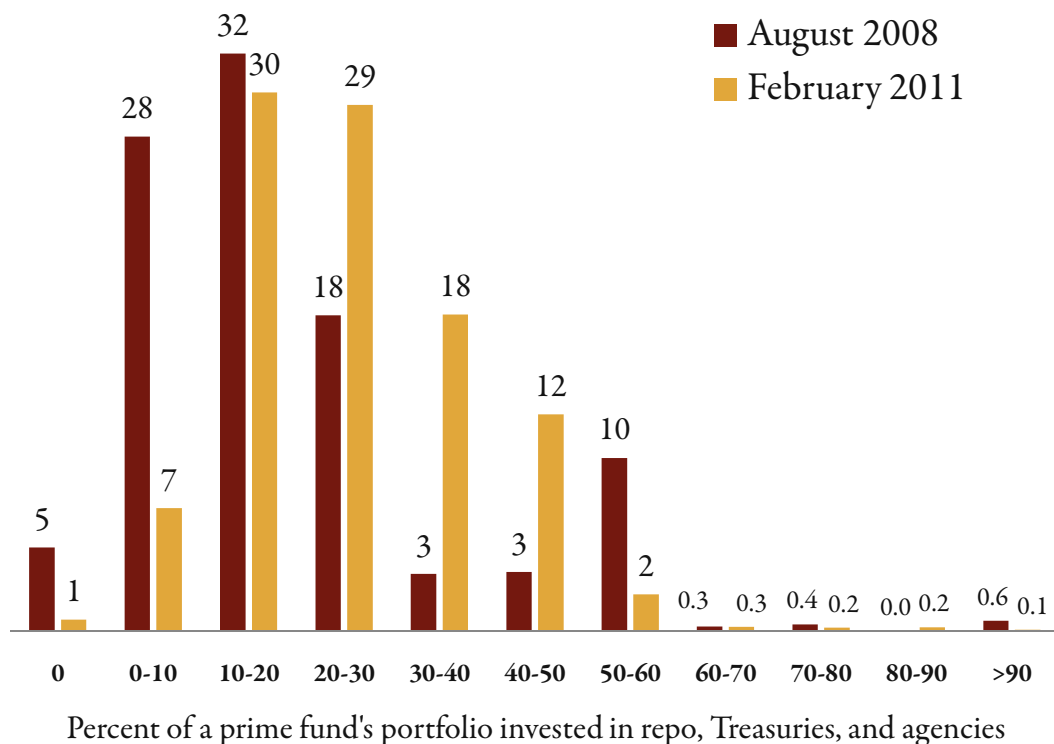
Source: Investment Company Institute tabulation of Form N-MFP data collected from SEC website, and Bloomberg

Prime money market funds appear, in part, to be meeting the minimum liquidity requirements by altering their portfolio holdings toward repurchase agreements and Treasury and agency securities. Figure 4 compares the concentration of prime money market funds' holdings of these securities in August 2008 to February 2011. From August 2008 to February 2011, the distribution shifts right, indicating that more prime money market fund assets are now in repurchase agreements and Treasury

and agency securities. Indeed, money market funds often use one or seven day repurchase agreements to maintain liquidity to meet redemptions. Under Rule 2a-7 (as amended in 2010), Treasury securities automatically satisfy the daily liquidity requirement, while certain agency securities automatically satisfy the weekly liquidity requirement.

**Figure 4: Concentration of Prime Money Market Funds Assets by Holdings of Repo, Treasury, and Agency Securities**

Percent of prime funds assets



Source: Investment Company Institute

The rule changes also require more frequent disclosure of money market funds' holdings, so both regulators and investors will better understand funds' portfolios. In addition, the SEC took an important step to help bolster money market funds' resilience to severe market stress and redemption pressures. The SEC gave money market fund boards of directors, upon a determination of the board, including a majority of members who are independent of fund management, the ability to suspend redemptions if a fund has broken or is about to "break the dollar"—a powerful tool to assure equitable

*Appendix C*  
*Letter from Investment Company Institute to*  
*Secretariat of the Financial Stability Board*  
*June 3, 2011*

treatment for all of the fund's shareholders, stem any flight from the fund, and ensure an orderly liquidation of a troubled fund. Indeed, this capability, which is available only if the board has determined to liquidate the fund, protects shareholders under extreme circumstances by ensuring that the actions of investors who exit a money market fund first do not harm those remaining behind.

Finally, U.S. regulators are actively evaluating other proposals to make money market funds less susceptible to market stresses. Specifically, last October, the President's Working Group on Financial Markets ("PWG") issued a report ("PWG Report") discussing several options for further reform of money market funds and recommending that the Financial Stability Oversight Commission ("FSOC") examine those options.<sup>29</sup> These options range from measures that could be implemented by the SEC under current statutory authorities to broader changes that would require new legislation, coordination by multiple government agencies, and the creation of new private entities. More recently, the SEC hosted a roundtable on money market funds and systemic risk that consisted of SEC officials, representatives of the FSOC, and participants from academia, the business community, the fund industry, and state and local governments.

Indeed, the active oversight of money market funds by regulators clearly demonstrates that they are not vehicles of the sort without regulatory attention, as discussed by the FSB. To the extent additional measures are necessary to further strengthen these valuable investment products, regulators are already actively engaged in the debate.

---

<sup>29</sup> The PWG Report is available on the Treasury Department's website at <http://www.treasury.gov/press-center/press-releases/Documents/10.21%20PWG%20Report%20Final.pdf>. The PWG directed the SEC to solicit comments on the Report to assist the FSOC in its examination of the reform options, *see* SEC Release No. IC-29497 (Nov. 3, 2010), available at <http://www.sec.gov/rules/other/2010/ic-29497.pdf>. In response to this request, ICI, along with more than 90 other commenters, provided its views on the reform options outlined in the PWG Report. *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (Jan. 10, 2011), available on ICI's website at [http://www.ici.org/pdf/11\\_sec\\_pwg\\_com.pdf](http://www.ici.org/pdf/11_sec_pwg_com.pdf).