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November 5, 2010

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

Re: Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (FSOC-2010-0001)

Ladies and Gentlemen:

Since the beginning of the legislative debate over the shape and scope of financial services regulatory reform, the Investment Company Institute¹ has been a strong proponent of improving the U.S. government's capability to monitor and mitigate risks across our nation's financial system, including by creating a new council of regulators to perform that function.² As both issuers of securities and large investors in U.S. and international financial markets, ICI's registered investment company members³ have an abiding interest in policies that promote a well-functioning financial system and ensure that system can withstand the periodic shocks that are an inevitable part of our complex, global market place.

In this advance notice of proposed rulemaking, the Financial Stability Oversight Council ("FSOC" or "Council") requests information to assist in its development of "the specific criteria and

¹ The Investment Company Institute is the national association of U.S. registered investment companies, including mutual funds, closed-end funds, exchange-traded funds ("ETFs"), and unit investment trusts ("UITs"). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$12.05 trillion and serve over 90 million shareholders.

² See, e.g., Investment Company Institute, *Financial Services Regulatory Reform: Discussion and Recommendations* (March 3, 2009) ("ICI White Paper"), available at http://www.ici.org/pdf/ppr_09_reg_reform.pdf; Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, on "Establishing a Framework for Systemic Risk Regulation" (July 23, 2009).

³ For ease of reference in this letter, we refer to all types of registered investment companies as "funds," unless the context otherwise requires.

analytical framework by which it will designate nonbank financial companies for enhanced supervision” pursuant to Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”).⁴ The FSOC’s ability to determine that an individual company poses potential risk to the entire U.S. financial system—and the regulatory oversight and heightened standards that would flow from that determination—is an extraordinarily potent legal authority powerful tool, and one that should be used with great care. ICI believes that the designation of individual companies for heightened supervision should be reserved for those circumstances, presumably quite limited, when the FSOC has determined that a specific company poses significant risks to the financial system that clearly cannot otherwise be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act, including the ability to impose new or heightened requirements on a “financial activity or practice” in accordance with Section 120 of that Act.

In this letter, we observe that regulators have available many new tools under the Dodd-Frank Act for addressing risks to the financial system, and explain why the FSOC should reserve the exercise of its authority under Section 113 for limited circumstances. We provide our views about how the FSOC should consider certain of the criteria set forth in Section 113 (including, among others, size, leverage, interconnectedness, and the degree to which a company is already regulated), both generally and by illustrating how these criteria would apply in the context of funds and their advisers. We also offer our perspective on how the FSOC should view a company’s participation in the government programs implemented during the recent financial crisis for purposes of Section 113.

Financial Regulators Have a Variety of New Tools at Their Disposal

All financial market activities involve some degree of risk. Indeed, the ability of market participants to spread, share, or take on risk through the financial markets is a prime characteristic of vibrant and innovative economies. Thus, the goal of systemic risk regulation, as a senior Treasury official recently acknowledged, should be to eliminate the abuses and excessive risk taking that can endanger the financial system, while at the same time encouraging acceptable levels of the risk taking that is necessary for innovation and economic growth.⁵

⁴ Financial Stability Oversight Council, *Advance Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 75 Fed. Reg. 61653 (Oct. 6, 2010).

⁵ See Deputy Treasury Secretary Neal S. Wolin, Remarks at McDonough School of Business, Georgetown University (Oct. 25, 2010) (“Wolin Speech”) (articulating the broad principles guiding the Administration’s implementation of the Dodd-Frank Act, including to “... protect the freedom for innovation that is absolutely necessary for growth. Our system allowed too much room for abuse and excessive risk. But as we put in place rules to correct for those mistakes, we have to achieve a careful balance and safeguard the freedom for competition and innovation that are essential for growth.”). Treasury Secretary and FSOC Chairman Timothy Geithner has expressed similar sentiments, stating that the FSOC wants “to preserve the right balance between the tough rules our system clearly requires, but we want rules that are still going to encourage innovation and competition.” See Ian Katz and Rebecca Christie, “Geithner’s Oversight Council Seeks to Identify Firms Posing Systemic Risk,” *Bloomberg* (Oct. 1, 2010).

The Dodd-Frank Act provides regulators many new tools to address abuses and excessive risk taking by financial market participants. These include tools that will affect financial institutions generally (*e.g.*, comprehensive regulation of the OTC derivatives market, stress tests) and those targeted either to eliminate excessive risk taking in, or to improve regulatory oversight over, specific sectors (*e.g.*, regulation of private fund advisers, swaps push-out rule, Volcker Rule prohibitions on certain activities by banking entities). The Dodd-Frank Act also established the Office of Financial Research (“OFR”) “to address the critical need of regulators, policymakers, and industry for data that are better, more useful, and more reliable. The OFR’s capacity to organize and analyze data will also help the Council make more informed decisions about potential threats to the financial system.”⁶

Our financial system and its participants are nothing if not dynamic, however, and the rules set in place today, no matter how well crafted, will not necessarily prevent all of the unforeseen problems of tomorrow. The Dodd-Frank Act therefore gives the FSOC the authority to identify gaps in regulation and make recommendations to financial regulators, standard-setting bodies and Congress. Further, the critical monitoring function of the FSOC, with the help of the OFR, is intended to provide the capability to detect new buildups of risk in the financial system, allowing regulators to address changing circumstances early by enhancing existing, or adopting new, regulations. The FSOC is in a unique position to influence this process both informally, through its interactions with primary regulators, and in more a direct way, through use of its Section 120 authority.⁷

Despite these new and far-reaching powers, it is still possible that a single financial institution—by reason of its characteristics, activities, and degree of interconnection with other financial firms and the broader financial markets—could pose a risk to the U.S. financial system if it were to experience material financial distress. During a Congressional hearing in connection with the development of the Dodd-Frank Act, Federal Reserve Board Chairman Bernanke was asked expressly for his views on the number of firms that might be considered to be “systemically significant, too big to fail, too interconnected to fail.”⁸ Chairman Bernanke responded:

A very rough guess would be about 25. But I would like to point out that virtually all of those firms are organized as bank holding companies or financial holding companies, which means the Federal Reserve already has umbrella

⁶ See Wolin Speech, *supra* note 5.

⁷ Section 120 of the Dodd-Frank Act authorizes the Council to issue recommendations to one or more primary financial regulatory agencies to apply “new or heightened standards and safeguards” upon determining that the conduct of a financial activity or practice “could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies or the financial markets of the United States.” The primary regulator(s) must impose the recommended standards or similar standards acceptable to the Council, or explain in writing why the regulator has determined not to follow the Council’s recommendation.

⁸ See Regulatory Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals, Part II: Hearing before the House Committee on Financial Services (Serial No. 111-68), 111th Congress (2009), p. 47 (question by Rep. Campbell).

supervision. So, I would not envision the Fed's oversight extending to any significant number of additional firms.⁹

We agree with Chairman Bernanke's observation that Section 113 designations should be limited in number, for several reasons. First, aside from the country's largest commercial banks and bank holding companies—which are subject automatically to heightened prudential regulation and supervision under the Dodd-Frank Act—it will be very difficult for regulators to determine *in advance* which institutions are, or may prove to be, systemically significant.

Second, the designation has many implications for a nonbank financial company: the heightened requirements largely reflect banking regulation concepts. They include the mandatory and optional standards to be developed by the Federal Reserve Board under Section 165 of the Dodd-Frank Act, limitations on proprietary trading and sponsoring and/or investing in hedge funds and private equity funds under the Volcker Rule provisions in Section 619, capital requirements under the “Collins Amendment” set forth in Section 171, and consolidated supervision by the Federal Reserve Board. These “remedies” must be the right solution for the specific risk that the FSOC seeks to minimize. In other words, a company may present some of the characteristics of being systemically risky, but if the prudential standards to be applied are not tailored to the specific risks presented by that company, heightened supervision will have little actual value and may even be detrimental to the financial system and macroeconomy, as discussed below.

Third, from a systemic perspective, there is a high level of uncertainty as to how the markets and market participants would react to the designation of a company as systemically significant. Such a designation could signal that the government views the company as unsafe and a potential candidate for “orderly liquidation” under the process established in Title II of the Dodd-Frank Act. This could serve to increase the company's cost of financing if market participants become reluctant to transact with it. Alternatively, because the designation would require the company to operate under the watchful eye of the Federal Reserve Board, this heightened oversight could make the company appear to be a safer bet than its non-designated competitors. This could give the designated company a competitive advantage in terms of access to lower cost financing.¹⁰

Fourth, the designation could carry with it an expectation by market participants that the Federal Reserve Board and the FSOC will be able to mitigate any risks that a designated company may pose to the broader markets. Stated differently, designation may increase moral hazard, because market participants may be tempted to relax to their own due diligence with respect to a designated company based on the expectation that the government is monitoring and preventing risks.

⁹ *Id.*

¹⁰ See, e.g., ICI White Paper, *supra* note 2; Peter J. Wallison, *Regulation Without Reason: The Group of Thirty Report*, AEI Financial Services Outlook (Jan. 2009), available at http://www.aei.org/publications/pubID.29285/pub_detail.asp.

Finally, there are other potential costs and unintended consequences associated with applying Section 113 in too broad a fashion. Financial companies might be more likely to exit certain businesses, or reduce their participation in those businesses, in order to avoid designation by the FSOC. This, in turn, could reduce competition and consumer choice. It is also possible that financial companies might be tempted to shift to less regulated jurisdictions and products.

Given these challenges and possible negative consequences, ICI believes that the FSOC should reserve this authority for those circumstances, presumably quite limited, when it has determined that a specific company clearly poses significant risks to the financial system that cannot otherwise be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act.

Observations about the Designation Criteria

The Dodd-Frank Act requires the FSOC to consider a list of specific factors in determining whether a particular nonbank financial company should be designated as systemically significant, and also gives the FSOC the discretion to consider any other risk-related factor that it deems appropriate. We agree with this flexible approach because the potential for systemic risk arises from the interplay of many different factors.

No single factor in isolation—such as how “big” a firm is—is sufficient.¹¹ Instead, it is the weight of various factors in combination with one another that indicates the potential to pose systemic risk. At the same time, the list of factors in the Dodd-Frank Act should not be used as a checklist: the factors are meant to inform the FSOC’s deliberation and help regulators follow a reasoned process in identifying those specific firms for which designation is clearly the appropriate course.

Size of the Company

Among the criteria that Section 113 directs the FSOC to consider in determining whether to designate a nonbank financial company for supervision by the Federal Reserve Board of Governors is the company’s size. A company’s size alone, however, reveals very little about its potential to pose risk to the financial system: for example, two large companies can have extremely different risk profiles. As a result, this criterion could be highly misleading if considered in isolation.

The very structure of Section 113 reflects Congress’ recognition that size alone should not be a determining factor in designating a nonbank financial company for heightened supervision and prudential regulation. It mentions size merely as one of seven elements listed together within one of the ten subparagraphs of Section 113(a)(2) enumerating the criteria the FSOC must consider. In fact, the

¹¹ We strongly urge the FSOC to resist the counsel of those who would urge the designation of nonbank financial companies as systemically risky on the basis of their size alone. Special pleading of this kind reflects principally a desire to game the system for competitive purposes, and by no means accords with the more complex, searching and objective analysis that the Dodd-Frank Act charges the FSOC to conduct.

Senate Banking Committee concluded that it would be inappropriate for the FSOC to designate a company solely on the basis of its size. The Committee's report on S. 3217, the Restoring American Financial Stability Act (a precursor to the Dodd-Frank Act), states: "Size alone should not be dispositive in the FSOC's determination; in its consideration of the enumerated factors, the FSOC should also take into account other indicia of the overall risk posed to U.S. financial stability, including the extent of the nonbank financial company's interconnections with other significant financial companies and the complexity of the nonbank financial company."¹² We agree.

In assessing a company's size for purposes of Section 113, the FSOC should focus on the size of the company's potential on- and off-balance sheet risks, and the impact on the U.S. financial system of potential losses. As discussed further below, many characteristics of funds—including their simple capital structure, limited use of leverage, and comprehensive regulatory scheme—put funds at the "less risky" end of the spectrum when considering the potential for systemic risk created by nonbank financial companies.

Managed Assets

Section 113(a)(2)(F) instructs the FSOC to consider "the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse." In measuring the size of a company—such as a fund's investment adviser—that manages assets owned by others (*e.g.*, fund shareholders), the managed assets should not be attributed to the manager/adviser. While an investment adviser may sponsor numerous, and perhaps even hundreds, of funds within a single fund "complex," there are clear reasons why the assets held in these funds should not be attributed to the investment adviser. For example:

- Each fund is a separate legal entity.
 - The shareholders or creditors of one fund have no recourse against the shareholders or creditors of any other fund.
 - Each shareholder in a fund is a pro rata owner of the underlying fund assets through their ownership of fund shares. The fund's assets are recorded on the fund's balance sheet, not the balance sheet of the fund's adviser.¹³
- Shareholder recourse for losses is solely with respect to the fund, and not its adviser (absent wrongdoing on the part of the adviser). Thus, even if a fund were to lose all of

¹² S. Rep. No. 111-176, at 48-49 (2010) ("Senate Report").

¹³ At various times the Financial Accounting Standards Board has considered whether an investment adviser should consolidate funds advised for financial reporting purposes. *See, e.g.*, FASB ASU No. 2010-10, Amendments for Certain Investment Funds (February 2010). Even if accounting standards are modified at some future time to require such consolidation, we believe, for the reasons described herein, that assets held in the funds should not be attributed to the investment adviser for purposes of an analysis under Section 113.

its assets, the fund's investment adviser would suffer a reduction in its reputation and ongoing profit, but the adviser would not be financially responsible for such losses nor be required to take any direct charge against its capital.

- The investment adviser cannot pledge a fund's assets to advance its own interests: fund assets must be held in custody by an independent third party. Thus, in the highly unlikely event that a fund's investment adviser were to go bankrupt, the fund's assets would be transferred to another investment adviser, subject to fund board approval, through a procedure that is governed by the Investment Company Act of 1940 ("Investment Company Act") and is outside the adviser's bankruptcy proceeding. This entire process essentially would be seamless for fund shareholders.
- The adviser does not take on leverage to manage a fund's portfolio—any leverage is taken on by the fund itself and in accord with strict limitations under the Investment Company Act and related SEC guidance, as discussed later in this letter.
- The adviser must manage the fund's assets as a fiduciary and in accord with the fund's own investment objectives and restrictions. The adviser thus cannot use the fund's assets for its own purposes.¹⁴

Leverage / Indebtedness

As the Dodd-Frank Act seems to acknowledge, systemic risk arises from a whole range of factors, none of which in isolation is a sufficient indicator of the likelihood that a bank or nonbank financial company will pose system-wide risk. Nevertheless, historically, virtually all systemic crises have arisen when a financial institution (or group of financial institutions) has taken on excessive leverage or debt-like exposure (such as through credit default swaps). Leverage provides the grease that makes modern financial systems an efficient engine for economic growth. But in times of strain, leverage also can act as a multiplier, turning small losses into large ones, and creating risks that can shake 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 can mount exponentially and spread quickly. As a result, companies that are highly leveraged pose greater potential risk to the financial system.¹⁵

¹⁴ While the case for excluding assets managed on behalf of others is especially strong in the fund context, the same concepts also apply with respect to other types of managed assets, such as separately managed accounts and collective investment trusts.

¹⁵ 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 (\$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.

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-1.¹⁶ And, at the end of 1997, roughly ten months before it failed, Long-Term Capital Management (“LTCM”) had a leverage ratio of 25-to-1.¹⁷

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 hedge funds also sometimes have comparable leverage ratios. For mutual funds, by contrast, the maximum ratio of debt-to-assets allowed by law is 1-to-3,¹⁸ 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. Recognizing this, the Senate Banking Committee report on S. 3217 states: “a typical mutual fund could be an example of a nonbank financial company with a low degree of leverage.”¹⁹

The Investment Company Act and related guidance from the SEC and its staff also strictly limit the extent to which 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 derivatives. As a result, 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.²⁰ The existing rules and related guidance generally limit funds’ use of transactions involving leverage and help provide assurance that a fund will be able to meet its obligations.²¹ As such, they tightly constrain the risks a fund might pose to the financial markets broadly.

¹⁶ Source: Bloomberg.

¹⁷ See *Hedge Funds, Leverage, and Lessons of Long-Term Capital Management*, Report of the President’s Working Group on Financial Markets (April 1999) (“LTCM Report”).

¹⁸ 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.

¹⁹ See Senate Report, *supra* note 14, at 48.

²⁰ 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).

²¹ Earlier this year, 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 (Mar. 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.

Interconnectedness

Interconnectedness is a term that is being used with increasing frequency, but with little precision. The Dodd-Frank Act leaves the term undefined. Virtually all firms are “interconnected” to some degree. A large automobile manufacturing firm, for example, can have many suppliers and its rapid collapse could lead to the failure of some of its suppliers and creditors, thus creating a ripple effect in the economy. Likewise, financial firms serve as intermediaries and commingle resources of many creditors and investors to extend credit and invest in securities.

One working definition of interconnectedness has been offered by Federal Reserve Chairman Ben Bernanke:

Our financial system is extremely complex and interconnected, and Bear Stearns participated extensively in a range of critical markets. The sudden failure of Bear Stearns likely would have led to a chaotic unwinding of positions in those markets and could have severely shaken confidence. *The company's failure could also have cast doubt on the financial positions of some of Bear Stearns' thousands of counterparties* and perhaps of companies with similar businesses.²²

On this understanding of “interconnectedness,” the key issue is not so much whether a financial firm is highly “connected” to other market participants, but whether failure of a financial firm could force a disorderly unwinding of the firm’s on- and off-balance sheet positions and spark a cascade of failures among the firm’s counterparties that then spread to the counterparties of those firms.

Interconnectedness poses the greatest risk when it is coupled with leverage. A nonbank financial firm that has a large number of creditors that are themselves leveraged poses the greatest risk. In such a case, the failure of the nonbank financial firm could potentially lead to failure among its creditors, which in turn could have implications for still more firms. By contrast, in the event of the failure of a firm whose creditors are not highly leveraged, those creditors would take a charge against their own capital, but these events would be unlikely to spark further failures among other “interconnected” firms.

Individual funds “interact” with large numbers of shareholders and are counterparties to large numbers of financial transactions. But these interconnections pose very modest risks because funds have little or no leverage. Each investor in a fund is an undivided pro rata owner of all the underlying fund assets through their ownership of fund shares, and each investor shares proportionately in all the gains and losses of the fund. Shareholders never can lose more than the balance of their account, and thus do not face unexpected capital calls.

²² Testimony of Ben S. Bernanke, Chairman, Federal Reserve Board, Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, on “Developments in the Financial Markets” (April 3, 2008) (emphasis added), available at <http://www.federalreserve.gov/newsevents/testimony/bernanke20080403a.htm>.

Moreover, between 2007 and 2009, fully 1,000 funds liquidated, and such events did not occasion disorder in the broad financial markets.²³ The Investment Company Act sets out the process by which a fund files an application with the SEC stating that it has distributed substantially all of its assets to shareholders, and is winding up its affairs.²⁴ Investors receive their pro rata share of the fund's current net asset value. Thus, the concerns that arise from an undisciplined dissolution process, and the effect on counterparties and other market participants that such dissolution may have, largely do not exist for funds.²⁵

Provision of Credit

The Dodd-Frank Act also directs the FSOC to consider the importance of a company as a source of credit for households, businesses, and state and local governments. The notice asks what measures might be used to assess a nonbank financial firm's importance under this factor.

As a starting point, a company is more likely to pose systemic risk if it is a single or primary source of credit for households, businesses, or state and local governments, and if no other financial intermediaries can step in as an alternative source of credit. Although the collapse of a creditor *per se* creates no risk for existing borrowers, it can disrupt the future credit creation process. Put another way, if other market participants cannot step in and provide new flows of credit, the resulting pressures on liquidity could cause economic activity to slow, perhaps significantly. For example, the rapid decline in financial stability of Fannie Mae or Freddie Mac had the potential to pose a serious threat to the ability of home buyers to finance their purchases. Private market participants simply could not have stepped in to replace Fannie and Freddie as alternate sources of financing.

When assessing the significance of credit provision to the economy, it is crucial to go a step further and consider whether that credit is being funded through debt or equity. When a company provides credit with equity rather than debt, there is considerably less risk to the financial system. This is because, in the event of a negative economic shock, such a company could lose all of its assets and capital without creating a domino effect among other firms. In contrast, a company that relies heavily on borrowing to finance its credit operations (or, in other words, provides credit with debt) would negatively impact its own creditors if it were to default on its debt. Again, the experience of Fannie Mae and Freddie Mac is instructive. Both of these entities relied very heavily on borrowing to finance their operations, although their assets had been viewed as presenting nearly the same level of credit risk as U.S. Treasury securities. Defaults on their debt would have had a negative impact on their creditors globally, which is why the U.S. government opted to place the entities in conservatorship in September 2008.

²³ 2010 Investment Company Fact Book at Figure 1.9, available at www.icifactbook.org.

²⁴ See Rule 8f-1(b) under the Investment Company Act.

²⁵ In light of the truly exceptional experience of the Reserve Primary Fund in late 2008, the SEC has authorized fund boards to suspend redemptions and thereby help assure an orderly liquidation of a money market fund if it is unable to maintain its stable NAV per share.

As purchasers of both debt and equity instruments, funds are significant providers of credit to state and local governments and U.S. financial and operating companies, as well as to the U.S. Treasury, Fannie Mae and Freddie Mac.²⁶ Importantly, however, no one fund is a primary or sole source of credit to any of these markets. Furthermore, the vast majority of this credit is funded by paid-in capital (equity) from fund shareholders.

In seeking to mitigate potential systemic risk, whether by designating an individual nonbank financial company for heightened supervision or through use of other regulatory tools provided by the Dodd-Frank Act, regulators must be very careful not to discourage, even inadvertently, any financial firm or group of firms from undertaking their normal investment or credit review process. A credit provider *must* be allowed to decline to roll over loans or other commitments should it determine that a particular borrower is no longer a suitable credit risk. Although such a pullback of credit might add to the pressure on a distressed financial company, and even perhaps contribute to its ultimate failure, this is an essential feature of the credit process (and, in the case of fund advisers, it is a fundamental incident of their fiduciary duty to shareholders). Put simply, the market must allow creditors to discipline borrowers if capital markets are to function efficiently.

Amount and Nature of the Company's Assets and Liabilities

Section 113 directs the Council to consider both the amount and nature of the financial assets of the company and the amount and types of the liabilities of the company. As stated above, we believe that no one factor or group of factors should be considered in isolation as indicative of the systemic risk that a nonbank financial firm may pose. Still, we wish to highlight two aspects in this area that are worthy of special consideration by the FSOC: the liquidity of a financial firm's assets and the transparency of its balance sheet.

Liquidity of Assets. Generally speaking, financial institutions holding assets that can be sold quickly at a price approximating fundamental value are more resilient to economic shocks because such assets give financial institutions the flexibility to respond quickly to the kinds of rapidly changing economic circumstances that are common during financial crises. By contrast, institutions holding assets that do not trade in deep secondary markets may tend to pose more of a systemic concern. For example, banks use deposits (liabilities) to fund commercial, personal, and real estate loans (assets). While such loans often are neither callable nor readily tradable, deposits, for the most part, may be withdrawn upon demand. Mutual funds have analogous obligations, in that a mutual fund's shareholders have the right under almost any circumstances to redeem shares daily. Importantly, however, the regulation of mutual funds controls the potential risks of redemption very differently than banks do the potential risks of withdrawals.

²⁶ At the end of 2009, funds held 28 percent of the outstanding U.S. corporate equity, 11 percent of U.S. and foreign corporate bonds, 12 percent of Treasury and government agency securities, 35 percent of municipal securities, and 51 percent of commercial paper.

Unlike banks, mutual funds must maintain liquidity for ordinary redemptions. At least 85 percent of a mutual fund's portfolio must be held in "liquid securities," which are defined as any assets that can be disposed of within 7 days at a price approximating market value.²⁷ As a result, mutual funds typically invest the vast majority of their assets in marketable securities. They can—and do—routinely handle large flows (purchases, exchanges, and redemptions) without perceptible consequences to the broader financial system. In a typical year, between 40 percent and 60 percent of long-term mutual funds are in net outflow. Indeed, gross redemptions from all stock funds totaled 28 percent of fund assets in 2009, and bond fund redemptions totaled one-third of their assets.

Transparency of Balance Sheet. For a number of reasons, a financial firm is more likely to pose a threat to the overall economy when its assets and liabilities are difficult for market participants to evaluate. For example, balance sheet opacity played an important role in the growth and subsequent collapse of LTCM.²⁸ Among other things, balance sheet opacity makes it difficult for creditors or other stakeholders to monitor a financial institution's health and exert discipline well in advance of a crisis. It can also make it difficult for counterparties to assess their positions in a financial institution relative to those of all other counterparties, and thus to understand the risks they are taking.

Mutual funds have an inherently simple and transparent capital structure. When investors buy shares in a fund, they know they are getting an undivided pro-rata interest in the fund's net assets: each mutual fund shareholder has the same rights as every other shareholder. Mutual funds may not issue preferred shares or senior securities that would preempt the claims of shareholders on a mutual fund's assets. Also, mutual funds are limited to buying and selling securities that fit the funds' names, investment objectives, and other prospectus disclosures.

Mutual funds provide or make easily available to their shareholders—and to the investing public, regulators, media, and other interested parties—far more information than is available for other types of investments. Required fund disclosure documents include fund prospectuses, statements of additional information, and semi-annual shareholder reports. Moreover, Morningstar and numerous other private-sector vendors are in the business of compiling all public disclosures by funds in ways designed to closely inform investors and the market.

Mutual funds also are required to disclose (in greater depth and specificity than other financial institutions) details of their portfolio holdings. For example, they must provide a graphical

²⁷ Pursuant to Rule 2a-7 under the Investment Company Act, money market funds are subject to more stringent liquidity requirements.

²⁸ As the President's Working Group on Financial Markets noted, "Assessed against the trading practices of hedge funds and other trading institutions . . . the LTCM Fund stood out with respect to its opaqueness and low degree of external monitoring, and its high degree of leverage. Although its mark-to-market valuations called LTCM's managers' attention to the Fund's problems well before the Fund's net worth was exhausted, individual counterparties—partly because there were so many—were not necessarily aware of the depth of LTCM's liquidity problems. Neither were the balance sheet and income statements that LTCM provided to its counterparties very informative about the Fund's risk profile and concentration of exposures in certain markets. This opaqueness of LTCM's risk profile is an important part of the LTCM story . . ." See LTCM Report, *supra* note 20.

presentation of portfolio holdings in semi-annual shareholder reports. SEC Regulation S-X requires funds to disclose their entire portfolio of investments four times per year. The disclosure generally identifies *each* security held by the fund at the report date, and will name: the issuer/issue, shares/principal amount, and fair value at the report date. Where a fund holds a derivative contract, the disclosure identifies: reference asset/index, notional value, fair value, number of contracts, counterparty, and expiration.

Transparency of mutual funds' portfolios is further evinced in the process of pricing the securities they hold. Funds must determine their net asset value each day using market prices or, in the case of any assets for which a market price is not readily available, fair market value as determined under the funds' board-approved pricing policies. Like other issuers whose financial statements are required to comply with Generally Accepted Accounting Principles (GAAP), funds must provide in a tabular format financial statement note disclosure showing where assets/liabilities valued at fair value fall within the "fair value hierarchy."²⁹ This disclosure enables a reader to see what portion of assets/liabilities is within each of three fair value levels, and thereby helps illuminate companies' relative degrees of liquidity and valuation risk. Assets or liabilities classified as "Level 1" are valued based upon quoted prices (unadjusted) in active markets for identical assets or liabilities that the reporting entity has the ability to access at the measurement date. Assets or liabilities classified as "Level 2" are valued based upon inputs other than quoted prices included within Level 1 that are observable³⁰ for the asset or liability, either directly or indirectly. Assets or liabilities classified as "Level 3" are valued based upon unobservable inputs³¹ for the asset or liability. As a result of the regulatory requirements relating to liquidity and valuation of fund shares, funds are primarily invested in Level 1/Level 2 assets.

²⁹ Financial Accounting Standards Board, Accounting Standards Codification Topic 820-10-50-2.

³⁰ Observable inputs are inputs that reflect the assumptions market participants would use in pricing the asset or liability developed based on market data obtained from sources independent of the reporting entity.

³¹ Unobservable inputs are inputs that reflect the reporting entity's own assumptions about the assumptions market participants would use in pricing the asset or liability developed based on the best information available in the circumstances.

Degree of Existing Regulation

Section 113 directs the FSOC to consider “the degree to which the company is already regulated by [one] or more primary financial regulatory agencies.” This direction to the FSOC is consistent with an important theme that runs throughout the Dodd-Frank Act: that of filling “gaps” in the regulatory framework by extending federal regulatory oversight to certain types of market participants. Among the gaps addressed by the Act are the registration and regulation of advisers to privately offered funds, increased regulation of entities with a significant level of involvement in the derivatives markets (so-called “major swap participants”), and oversight of mortgage and other lenders by the new Consumer Financial Protection Bureau.

For purposes of a Section 113 designation, requiring the FSOC to look to the degree of existing regulation imposed on a financial company is simply common sense. Each financial company that already is highly regulated—regardless of type of company—is more likely to have robust internal controls and compliance procedures. Moreover, the financial regulatory agency with primary oversight for that company is the “subject matter expert” regarding the applicable regulatory scheme, and will be knowledgeable about the industry of which the company is a part, industry best practices, areas of regulatory concern and the markets in which the company operates. These circumstances may militate against the need for imposing additional regulation by the Federal Reserve Board, as is required for any company designated by the FSOC under Section 113.

In evaluating a company in accordance with Section 113, we encourage the FSOC to look not just at the degree to which the company is already regulated, but in particular at the degree to which the applicable regulatory requirements serve to limit or control risk. As a general matter, financial companies that are required to adhere to risk-limiting requirements should be less likely to pose a risk to the U.S. financial system, which is precisely what a Section 113 designation is meant to address.

For the benefit of those many members of the FSOC whose regulatory responsibilities are unrelated to funds, ICI will make a future submission detailing the comprehensive regulatory regime to which funds are subject under the Investment Company Act and other federal securities laws. Suffice it to say here that these laws encompass not only disclosure and anti-fraud requirements but also substantive requirements and prohibitions on funds’ structures and day-to-day operations. Fund investment advisers likewise must register with the SEC and are subject to SEC oversight and disclosure requirements.³² All advisers owe a fiduciary duty to each fund or client they advise, meaning that they have a fundamental legal obligation to act in the best interests of the fund/client pursuant to a duty of undivided loyalty and utmost good faith. Actions taken on behalf of a fund by its adviser and other service providers are subject to broad oversight by the fund’s board of directors (typically comprised of at least a majority of independent members) and the fund’s chief compliance officer. Funds must have

³² Some investment advisers also may be subject to other SEC requirements in their capacity as corporate registrants, or to regulatory schemes administered by other financial regulators. The safeguards provided by these additional requirements should be considered.

written compliance programs designed to prevent violations of the federal securities laws. Fund directors, as well as fund and adviser officers and employees, are subject to codes of ethics.

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

- Leverage: As discussed above, the Act constrains funds' ability to borrow or issue any "senior security" that would take priority over the fund's shares.
- Custody of assets: The Act requires all funds to maintain strict custody of fund assets, separate from the assets of the adviser. Nearly all funds 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 Act and applicable SEC regulations, funds are subject to extensive disclosure requirements. Funds 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 vendors such as Morningstar, and other interested parties with far more information on funds than is available for other types of investments.
- Mark-to-market valuation of fund assets: All mutual funds provide market-based valuations of their shares at least daily. The valuation process results in a net asset value for the fund, which is the price used for all transactions in mutual fund shares.
- Transactions with affiliates: The Act contains a number of strong and detailed prohibitions on transactions between the fund and fund insiders or affiliated organizations, such as the corporate parent of the fund's investment adviser.

Money market funds have all the protections of the Investment Company Act, and are subject to additional regulation pursuant to Rule 2a-7 under that Act. This rule permits money market funds to value their securities at amortized cost, in order to maintain a stabilized value, usually \$1.00 per share. In addition to the important protections described above, money market funds also must comply with stringent maturity, credit quality, and diversification standards (collectively, "risk-limiting provisions") designed to minimize the deviation between a money market fund's stabilized net asset value and its mark-to-market per-share value. The basic objective of money market fund regulation is to limit a fund's exposure to credit, interest rate, liquidity, and other risks. Money market funds may only invest in high-quality securities, which the fund's board of directors (or its delegate) determines

present minimal credit risks. In addition, money market funds may invest only in U.S. dollar-denominated instruments and thus do not have currency exchange rate risk.³³

Participation in Government Programs

In its notice, the FSOC observes that “[d]uring the financial crisis, the U.S. Government instituted a variety of programs that served to strengthen the resiliency of the financial system. Nonbank financial companies participated in several of these programs.” The FSOC requests comment on how it should consider “the Government’s extension of financial assistance to nonbank financial companies” in the context of its determinations under Section 113.

During the fall of 2008 and in 2009, the federal government provided direct assistance to certain financial and nonfinancial firms and created numerous programs that assisted broad groups of companies and industries. These efforts succeeded in pulling the U.S. and global financial system back from the brink of collapse, not by addressing the root causes of the financial crisis, but by containing its damage and restoring stability to the markets. Collectively, these programs were unprecedented in their nature and scope. They succeeded in restoring confidence in the financial system, saving hundreds of financial and nonfinancial firms from collapse.

Since the end of the financial crisis, both Congress and the financial regulators have been focused on addressing the weaknesses of the financial system and the regulatory structure that led to the crisis. Given the regulatory changes underway to improve the overall resiliency of the financial system, and the emergency nature of the programs implemented during the crisis, we believe that a financial company’s participation in one or more of these programs, in and of itself, normally should be accorded little weight in evaluating the risks that the company could pose to the stability of the financial system going forward. At the same time, it may be reasonable for the FSOC to consider whether a firm that received an individual bail-out from the government should be reviewed under the Section 113 criteria.

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³³ Money market funds have been subject to heightened regulatory attention following the market crisis. In January 2010, the SEC issued comprehensive rules designed to strengthen these funds by, among other things, adding strong liquidity buffers, improving credit quality, shortening the average maturity limits of the funds’ portfolios, mandating periodic stress tests, and increasing the information reported to fund shareholders and the SEC. The President’s Working Group on Financial Markets recently issued a report on Money Market Fund Reform Options (“PWG Report”), requesting that the FSOC consider the options discussed in the Report. We agree that the FSOC should examine possible structural reforms to the way money market funds operate, as outlined in the PWG Report. To assist the FSOC in its analysis, the SEC, as the regulator of money market funds, was tasked with soliciting public comments. ICI’s comment letter to the SEC will include a detailed discussion of money market funds and the options outlined in the PWG Report.

Financial Stability Oversight Council

November 5, 2010

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Thank you for the opportunity to submit these views in advance of any formal rule proposal. If you have any questions regarding our comments or would like additional information, please feel free to contact me at (202) 326-5901 or paul.stevens@ici.org, Karrie McMillan, ICI General Counsel, at (202) 326-5815 or kmcmillan@ici.org, or Brian Reid, ICI Chief Economist, at (202) 326-5917 or reid@ici.org.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President & CEO
Investment Company Institute