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Submitted by email to markt-consultation-shadow-banking@ec.europa.eu

European Commission
BERL 10/034
B-1049 Brussels

15 June 2012

RE: European Commission Green Paper on Shadow Banking

Dear Sir/Madam,

ICI Global appreciates the opportunity to comment on the European Commission's Green Paper on shadow banking ("the Green Paper").[1] ICI Global is a global fund trade organisation whose members are regulated non-US based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage over €750bn of assets.

The Green Paper raises a number of important issues for ICI Global members and their shareholders[2], both of whom have a strong interest in ensuring the creation of the stable and responsible financial markets the European Commission (the "Commission") is seeking through it shadow banking work. ICI Global, in conjunction with the Investment Company Institute (ICI)[3], has been deeply engaged in the work that has been undertaken by the Financial Stability Board (FSB) into shadow banking.

General remarks

We have set out in the following sections of this letter our more detailed response to each of the questions that have been posed in the Green Paper in the order presented. Below we set out a number of key remarks.

- We support the Commission's objective to create a more stable and responsible financial system and to limit the scope for regulatory arbitrage to prevent the creation and/or magnification of systemic risk;
- We are concerned that the use of the term "shadow banking" to describe the system of "market-based financing" discussed in the Green Paper continues to be merely an epithet, connoting that all activities so labelled lack both transparency and any regular or official status and casting a pejorative tone on the system of credit intermediation. We therefore urge the Commission to focus in its analysis on the differences between banking and capital market financing and regulation, with a view to ensuring that each is adequate to address the financial stability concerns that have been identified;

[1] Green Paper on Shadow Banking, European Commission, 19 March 2012 (available from http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf)

[2] References in this letter to "ICI Global Members" refer, as relevant, to fund management companies and regulated investment funds.

[3] The Investment Company Institute is the national association of US 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 $13.4 trillion and serve over 90 million shareholders.

- We do not concur that the broad range of investment funds and activities outlined in Section 3 of the Green Paper should be considered as possible shadow banking entities and activities and therefore subject to further analysis by the Commission. Far from residing in the shadows, these entities and activities are already subject to a comprehensive framework of national and pan-European regulation;
- We consider that the Commission should actively engage in the work that is being undertaken at international level in respect of market-based financing, including by IOSCO and the FSB, but it should not seek to press ahead with its own regulatory reforms for that system or define in a concrete manner the nature of the regulatory response that it intends to adopt until this international work has been completed;
- We consider that the Commission should actively contribute to ensuring the coordinated implementation of any global policy recommendations in the European Union, and to the extent appropriate and feasible, taking account of the broad suite of existing regulation governing the fund management sector.

Definition of shadow banking

The notion of a "shadow banking system" entered into policymaking and legislative parlance during the financial crisis including in the communiqué resulting from the London Summit of the G20 in 2009.[4] That communiqué set out the commendable objective that regulatory systems should be amended to ensure "*authorities are able to identify and take account of macro-prudential risks across the financial system ... to limit the build up of systemic risk*". Importantly, the communiqué made clear that the scope of additional regulation and oversight should be focused on "*systemically important financial institutions, markets and instruments*" and that the work of international bodies such as the IMF and FSB should be to "*prevent regulatory arbitrage*".

a) Do you agree with the proposed definition of shadow banking?

We consider that one of the key components of a regulatory system that is successful in preventing regulatory arbitrage is clarity and coherence in the scope of regulatory definitions and coordination in their application at a global level. Despite the widespread use of the term "shadow banking" over the last few years, as was noted by Commissioner Barnier at the recent shadow banking conference in Brussels, "an agreement on what this concept actually means" has not been reached.[5]

We think that the debate around what is or is not shadow banking is unhelpful. This is because it does not recognise that market-based financing is an alternative to and a competitor of bank-based financing. The underlying business models of institutions in these two systems are fundamentally different and as such the engagement proposition to the providers of capital to institutions in these two systems is entirely different. The attempt to view capital markets financing through the lens of banking regulation distorts its character and makes it more difficult for regulators and policymakers to assess the nature of the risks in this system and the potential threats to financial stability that the aggregate of the two systems could present.

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[4] Declaration on Strengthening the Financial System – London Summit, 2 April 2009 (available from http://www.g20.utoronto.ca/2009/2009ifi.pdf)
[5] Towards better regulation of the shadow banking system Conference on the shadow banking system, Speech by Michel Barnier (available from http://europa.eu/rapid/pressReleasesAction.do?reference=SPEECH/12/310&)

It also understates the importance of focusing on the engagement of banks in market-based financing systems – indeed it is the failure of banking regulation to comprehend and account for these activities in its regulation of banks that was a major source of risk precipitating the financial crisis, rather than any inherent characteristics of the capital markets systems themselves.

We would urge the Commission to take the bold step of recognising what all commentators have so far recognised: that the term 'shadow banking' is problematic. We need to move to a more rigorous and objective basis for analysis of the totality of the financial system. If the Commission feels that the public debate on this issue has progressed too far to abandon this unhelpful terminology, then we urge the Commission to tackle the detail of the analysis of the so-called shadow banking realm from the perspective of the market-based activity on their own terms, rather than from a starting position that seems to assume that these arrangements are inadequate and should be something they are not: i.e. banks and banking regulation.

Shadow banking entities and activities

In Section 3 of the Green Paper, the Commission has outlined those entities and activities on which it is focusing its analysis. As is discussed in our comments in this and subsequent sections of this letter, we strongly believe that many of these entities and activities should not be considered as shadow banks.

Some of the entities and activities in the Green Paper map to those identified by the FSB, for instance in respect of Money Market Funds (MMFs) and the activities of securitization and securities lending and repo. In other areas however, the list drawn up by the Commission appears to extend beyond the FSB's framework. The list includes, for instance, a reference to Exchange Traded Funds (ETFs) as a subset of investment funds, and a reference to the types of investment fund that should be considered to fall within those products with deposit-like characteristics which make them vulnerable to massive redemptions ("runs"). We consider that no type of investment fund has the characteristics of a "shadow bank" and as such the Commission should not consider investment funds further as part of its analysis.

b) Do you agree with the preliminary list of "shadow banking" entities and activities? Should more entities and/or activities be analysed? If so, which ones?

We do not concur that the broad range of investment funds and activities outlined in Section 3 of the Green Paper should be considered as possible "shadow banking" entities and activities. We have set out comments on several of the entities and activities included in the paper that are relevant to ICI Global Members.

Money Market Funds

Section 3 of the Green Paper includes a reference to "*Money Market Funds and other types of investment funds or products with deposit-like characteristics, which make them vulnerable to massive redemptions*". The FSB has requested that International Organization of Securities Commissions (IOSCO) undertake a review of the regulation of the role of MMFs in the non-bank financial intermediation system and potential regulatory reforms.

In order to develop policy recommendations by July 2012, IOSCO published a consultation on 27 April 2012 examining various policy options[6] ("IOSCO MMF Consultation"), to which ICI Global provided a response.[7]

As a preliminary matter, for the reasons outlined in the comment letter submitted jointly by the ICI, EFAMA and IMMFA to the chair of the IOSCO working group on MMFs, we do not concur with the assertion that MMFs are shadow banks.[8] The Green Paper asserts that there are four characteristics of bank-like credit intermediation outside of the banking sector that justify including this activity in a definition of shadow banking. These are: (i) accepting funding with deposit-like characteristics; (ii) performing maturing and/or liquidity transformation; (iii) undergoing credit risk transfer; and (iv) using direct or indirect financial leverage. We submit that MMFs, particularly those that are subject to tightened requirements post the financial crisis, do not meet these criteria.

Shares in MMFs are investments, they are not deposits. Depositors in banking institutions in most jurisdictions are provided a state or insurance backed guarantee of their deposits, subject to certain limits. There is no such deposit insurance guarantee scheme in place in respect of MMF investments, nor is there any evidence that investors in such funds consider that there is such a guarantee. Moreover, surveys of MMF investors demonstrate that they do not expect the sponsoring fund manager to back or guarantee the redemption at par of their MMF shares. Post-crisis, arrangements have been put in place to permit the controlled winding up of CNAV funds where there is a risk or likelihood of 'breaking the buck', acting as a constraint on the advantage of first-mover exit and thus of uncontrolled exit or 'runs' on such funds.

It is a fundamental characteristic of all investment funds, not just MMFs, that their shares are redeemable on demand. Indeed funds come and go in the investment market on a regular basis and this is not considered extraordinary nor is regulation focused on preventing the closure of funds in an orderly manner in the ordinary course of business. Fund investors know this and great pains are taken to disclose to fund investors, including MMF investors, the inherent risks of loss that investment funds can involve. On the contrary, closures of banks are not considered routine or desirable and are in fact subject to significant regulatory intervention to deal with the crystallization of the inherent maturity and liquidity mismatches that underlie the banking model. No depositor is expected to comprehend or assess the underlying risk of failure of a bank, and apart from being provided a limit on deposit insurance, they are relieved of any responsibility to make such an assessment.

To speak therefore of 'runs' on MMFs or any other funds is to misapprehend the fundamental nature of such investment vehicles. Concerns among banking regulators about the over-reliance of banks on short-term funding vehicles such as MMFs are best addressed directly through regulation of banking activities rather than through attempts to re-engineer publicly traded funds to suit the underlying opacity and significant maturity and liquidity mismatches that lie at the core of the banking model.

[6] Money Market Fund Systemic Risk Analysis and Reform Options Consultation Report, IOSCO Technical Committee, 27 April 2012 (available from http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf)
[7] Letter from Karrie McMillan to the Mohamed Ben Salem, General Secretariat, IOSCO, dated 26 May 2012, regarding Public Comment on Money Market Fund Systemic Risk Analysis and Reform Options (available from http://www.ici.org/pdf/26205.pdf)
[8] Joint letter dated 16 February 2012 submitted by EFAMA, IMMFA and ICI to Patrice Bergé-Vincent regarding the IOSCO working group on money market funds (available from http://www.ici.org/pdf/25936.pdf)

MMF are by design and regulation highly liquid and as set out in the joint response that was submitted by the ICI, EFAMA and IMMFA to IOSCO's working group on MMF, the nature and extent of any liquidity transformation, is an order of magnitude less than performed by banks.[9]

In respect of credit risk transfer, MMFs are investment products. As such their prospectuses provide a clear description of the risks and rewards attributable to investors, and create no expectation of explicit or implicit underwriting of those risks by the fund manager.

Finally, in respect of leverage, whether direct or indirect, as heavily regulated vehicles available for general sale to the investing public, MMFs are strictly limited in the quantum of leverage that they can take on. The precise limitations vary across jurisdictions (*e.g.*, MMFs in the United States do not have any leverage), but in no case do they begin to approach the dramatic levels of leverage that obtain in banking structures or in some private investment fund structures. We consider that the controlled levels of leverage in regulated funds generally, including MMFs, should give confidence to regulators that potential financial stability concerns do not lurk in these types of funds.

We acknowledge however that IOSCO has proposed policy recommendations in its MMF Consultation examining whether MMFs must (i) be encouraged or required to implement a variable net asset value; (ii) be subject to capital and liquidity requirements if they seek to maintain a stable or constant net asset value; and/or (iii) be subject to other possible reforms. As such we have set out our comments on these proposals, referencing where appropriate the comment letter we have submitted to IOSCO.

The regulation of MMFs has been subject to considerable debate and subsequent reform in a number of jurisdictions around the world since the crisis. In Europe, despite already being subject to a strong regulatory framework including under the UCITS Directive, ESMA has revised the guidelines its predecessor organization CESR produced on European MMFs definitions on two separate occasions since their creation in 2010.[10] These changes are already being cited as contributing to improved market transparency and consistency.[11] In the US, the SEC completed extensive reforms to the regulation of MMFs in 2010 and continues to consider whether additional reforms are necessary.

The FSB explicitly requested that in developing a single set of policy options and recommendations, IOSCO review the different categories, characteristics and systemic risks posed by MMFs in various jurisdictions. The lack of a clear, global definition of a money market fund, however, is highly problematic when crafting a universal recommendation. As described in the IOSCO Report, there are tremendous differences globally among funds that would fall within the Report's general description of a money market fund. Without such a definition, the goal of global recommendations raises genuine and serious risks, both locally and globally. Rather than seeking global regulatory reforms, we recommend an exercise to identify features that have improved the operation of these types of funds. This work would be beneficial to markets and investors and would contribute to efforts to seek a common definition.

Indeed, the variety of differing circumstances for money market funds around the world must inform IOSCO's efforts to develop recommendations for money market funds on a global basis.

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[9] Joint letter from the European Fund and Asset Management Association (EFAMA), Institutional Money Market Funds Association (IMMFA) and the Investment Company Institute (ICI) to Patrice Bergé-Vincent regarding IOSCO working group on money market funds, 16 February 2012 (available from http://www.ici.org/pdf/25936.pdf)

[10] The most recent revision to "Questions and Answers – A common Definition of European Money Market Funds" was in February 2012 (available from http://www.esma.europa.eu/system/files/2012-113.pdf)

[11] Fitch Ratings, Sector Update, European Money market Funds, September 2011.

These circumstances include acknowledging (i) differences in regulation, markets and investors; and (ii) the true impact of the financial turmoil on MMFs that in many cases may not necessarily have been connected or transmitted to other markets. A global one-size-fits-all approach is neither advisable nor appropriate.

As the IOSCO MMF Consultation notes, and as is discussed in some detail in a report produced by the ICI[12], there are several different types of funds that co-exist within the European Union (EU). In the case of these MMFs, we consider that the work already undertaken by ESMA to enhance its guidelines has provided additional clarity as to the definition of a MMF. These stronger guidelines, coupled with the comprehensive framework already provided for by the UCITS Directive under which MMFs are regulated, address the concerns that have been expressed by regulators. We are therefore concerned by the inclusion of MMFs within the scope of the possible entities that are considered to be shadow banks by the Commission and furthermore the references in the Green Paper concerning the need to enhance prudential regulation to deal with shadow banking issues.

Money market funds are collective investment funds and therefore should not be subject to bank-like regulation. Instead, IOSCO and the FSB only should consider measures consistent with the structure of collective investment funds and tailored for local circumstances, *e.g.,* measures to strengthen fund liquidity, disclosure, portfolio composition. Further, given the role of the money markets for funds, investors, issuers and local economies, we recommend that IOSCO examine measures to strengthen the functioning of the money markets.

A focus on the use of amortized cost valuation by money market funds is not an effective or constructive response to addressing the risks identified by regulators. ICIG does not support a mandatory move to variable NAV or a prohibition on using amortized cost valuation.

We encourage IOSCO and the FSB to engage in further study of national initiatives and reforms of money market funds. There are significant benefits to be gained by analyzing the costs and benefits of existing money market fund regulation around the world. We urge policymakers to consider and assess the degree to which money markets have been strengthened by broader reforms impacting the strength and functioning of the global financial system, including (but not limited to) banking and mortgage lending reforms as well as initiatives related to asset back securities, derivatives and rating agencies.

We consider that it is inappropriate for the Commission to have reached any conclusions on the measures that should be taken in Europe in the absence of the completion of the work being undertaken by IOSCO. We also note that the Green Paper included alongside the reference to MMFs a reference to "*other types of investment fund or products with deposit-like characteristics, which make them vulnerable to massive redemptions*". As we have already set out, we do not consider MMFs or other investment funds to possess these characteristics.

[12] Investment Company Institute, *Report of the Money Market Working Group*, submitted to the Board of Governors of the Investment Company Institute, March 17, 2009, Appendix H, Survey of Select Offshore Jurisdictions' Regulation of Money Market Funds, available at http://www.ici.org/pdf/ppr_09_mmwg.pdf

Securities Lending and Repo

Section 3 of the Green Paper includes "securities lending and repo" within the list of possible shadow banking activities under consideration by the Commission. In this regard, as is also noted in the Green Paper, a workstream of the FSB has been established to develop policy recommendations, where necessary, by the end of 2012 to strengthen regulation of securities lending and repo. In order to inform the workstream's proposed policy recommendations an interim report providing a market overview and presenting financial stability issues of securities lending and repo has been published ("the FSB's securities lending and repo report")[13] to which ICI Global has responded.[14]

As a general remark, we consider that the securities lending and repo market provides significant utility to regulated investment funds.[15] As is outlined in the FSB's securities lending and repo report, there are a number of drivers for investment funds to participate in the securities lending and repo market. These include principally the ability for investment funds to earn incremental returns for their investors, the more efficient investment of collateral and, in the case of non-UCITS funds, the borrowing of securities including covering short positions.

As we noted in our response to the FSB, not all investment funds engage in transactions in the securities lending and repo transactions, in some cases because they may not have the necessary types of securities to repurchase, lend or post as collateral. In other cases investment funds do not participate because entering into securities lending and repo transactions may not be appropriate to the techniques or strategies through which the portfolio of the fund's assets is being managed.

In Europe all market participants engaging in securities lending and repo transactions on behalf of investment funds are regulated through either MiFID or the UCITS Directive (or from July 2013 the AIFM Directive) in addition to a number of national measures. As is set out in the FSB's securities lending and repo report, these transactions are already subject to a comprehensive framework of regulation governing many of the potential concerns that have been raised by the FSB.

The regulations governing investment funds in respect securities lending and repo transactions include the nature and value of collateral that is received, including a combination of qualitative and quantitative rules governing the haircuts and margins that are applied to collateral, the reuse and rehypothecation of collateral and the due diligence that must be undertaken on borrowers and counterparties. As noted in the response we submitted to the FSB's securities lending and repo report, these pan-European requirements governing securities lending and repo transactions include the role of depositaries under the AIFMD and the prior approval and disclosure of the reuse of collateral that is required under that Directive.

It is notable that a significant component of the FSB's securities lending and repo report, contains a description of the considerable variations between the secured finance markets in different jurisdictions, most notably between the US and Europe. As such ICI Global has strongly encouraged the FSB to consider carefully the fundamental regional and jurisdictions differences that exist across markets to inform the development of its policy recommendations.

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[13] Securities Lending and Repos: Market Overview and Financial Stability Issues, 27 April 2012 (available from http://www.financialstabilityboard.org/publications/r_120427.pdf)

[14] Letter from Dan Waters, Managing Director – ICI Global, to the Secretariat of the Financial Stability Board dated 25 May 2012, regarding FSB Interim Report on Securities Lending and Repos: Market Overview and Financial Stability Issues (available from http://www.iciglobal.org/pdf/26190.pdf)

[15] References to "regulated investment funds" in this letter refer to those funds that as a general matter are available for sale to the general public under an authorisation, licensing or other regulatory regime administered in their own domestic or regional jurisdiction. Funds domiciled in EU Member States will subject to authorisation under the UCITS Directive or national regime (and going forward the AIFM Directive).

Furthermore, we have considered that while there are some aspects of commonality between jurisdictions, we believe that it is neither practical nor desirable to adopt a one-size-fits-all approach across the board to the regulation of the global secured finance market. Nevertheless, we consider that the FSB should, as a matter of principle, seek to ensure to the greatest extent appropriate that regulatory frameworks are coordinated at international level.

The FSB's securities lending and repo report does not at this stage contain policy options or recommendations that we understand will be developed over the remaining course of 2012. As with the other aspects of shadow banking whereby policy recommendations are being developed by international bodies, we would strongly encourage the Commission to engage in this work to provide a European perspective but not to pre-judge the outcomes of these discussions in bringing forward its own policy recommendations.

The FSB has acknowledged that one of the drivers of the securities lending and repo market is the regulatory changes that are occurring in several jurisdictions in respect of the collateralisation and clearing of OTC derivatives. These changes include greater limitations in the collateral that must be posted to cover exposures arising from those transactions that are subject to mandatory cleaning – as is the case in the EU through the recent European Market Infrastructure Regulation (EMIR).

In most cases the use of OTC derivatives by ICI Global members is undertaken as part of a separate transaction from the securities lending and repo transactions. In many cases investment funds undertaking such transactions will be subject to the regulatory requirements emerging under the OTC derivative reforms and those emerging under the FSB's securities lending and repo work. As such it is important to ensure that policy recommendations are aligned to the greatest extent possible with the ongoing regulatory reforms and that any conflicts are satisfactorily resolved.

Exchange Traded Funds

The Green Paper includes ETFs within the scope of those investment funds on which the Commission is currently focusing its analysis. The FSB published a paper outlining its view on the financial stability risks arising from ETFs[16] in which it raised concerns about increased complexity and opacity in synthetic ETFs and the potential incentives for securities lending ("the FSB's ETF Report"). In its response to the FSB's ETF Report, the ICI supported recommendation that authorities and market participants should improve their understanding of the potential risks inherent in financial products, the ways financial innovations may interact with one another to amplify negative effects, and the ways in which such risks can be mitigated.[17]

Neither of the concerns expressed in the FSB's ETF Report in respect of increased complexity or opacity or the potential incentives for securities lending, appears to have been raised specifically from a shadow banking perspective, but instead from a financial stability perspective. In the case of the potential incentives for securities lending, as is acknowledged in Section 7.2 of the Green Paper, many of the points raised applied more generally to other types of open ended investment funds and as such are being addressed in a more horizontal manner rather than specifically in the context of ETFs.

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[16] Potential financial stability issues arising from recent trends in Exchange-Traded Funds (ETFs), Financial Stability Board, 12 April 2011 (available from http://www.financialstabilityboard.org/publications/r_110412b.pdf)

[17] Letter from Karrie McMillan, General Counsel – ICI, to the Secretariat of the Financial Stability Board, dated 16 May 2011, regarding Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds (available from http://www.ici.org/pdf/25189.pdf)

It is also notable that there does not appear to be any reference to ETFs in the FSB's shadow banking recommendations report, nor in the recent report on shadow banking produced for the G20 finance ministers and governors by the FSB ("the FSB Progress Report").[18]

Furthermore, the list of possible shadow banking entities and activities in Section 3 of the Green Paper refers to ETFs as a subset of those investment funds that "provide credit or are leveraged". As investment funds regulated under the UCITS framework, we agree that ETFs may in some cases incur low levels of leverage consistent with the limits imposed by UCITS. Such funds are not however able to provide "credit" in the form of loans or financing in the same way as a banking entity.

As such, it remains unclear why ETFs are explicitly noted by the Commission in the list of possible shadow banking entities or activities as a subset of investment funds. Our view is that for the same reasons outlined above in respect of other investment funds, these should not be considered by the Commission to be shadow banks. We believe the strong framework under which ETFs are regulated coupled with the work being undertaken by ESMA to develop guidelines for ETF and other UCITS that reflect the commonality of their features is beneficial[19] and address many of the concerns raised in the Green Paper.

Risks and benefits of market based financing

As was discussed extensively at the Commission's recent shadow banking conference, and in the various papers produced by the FSB and by IOSCO and the Commission on shadow banking topics, we consider it of utmost importance that the entities and activities discussed in this Green Paper are considered from the perspective of the risks and benefit they provide.

c) Do you agree that shadow banking can contribute positively to the financial system? Are there other beneficial aspects from these activities that should be retained and promoted in the future?

We reiterate here our fundamental concern that the Commission recognise in its analysis the core role played by market-based financing in the success and sustainability of global, national and regional markets. Indeed recent initiatives by the Commission demonstrate its belief in the importance of this aspect of the financial system, for example in its efforts to develop socially responsible investing funds.

We consider that market-based financing can contribute positively to the financial system and the real economy. Paul Schott Stevens, President and CEO of the ICI, outlined in a speech earlier this year the role investment funds, particularly MMFs, play in financing the US economy.[20] This role played by funds, and the benefits this brings to market participants, are equally true in Europe where MMFs also represent a critical component of the market through which financial intermediaries and institutions manage their cash. In particular, MMFs facilitate the steady, efficient flow of liquid resources from investors to issuers and back again and providing the only way for many investors to achieve a current money market yield and the safety of a diversified, professionally managed portfolio.

[18] Strengthening the Oversight and Regulation of Shadow Banking: Progress Report to G20 Ministers and Governors, 16 April 2012 (available from http://www.financialstabilityboard.org/publications/r_120420c.pdf)
[19] Consultation Paper on ESMA's guidelines on ETFs and other UCITS issues, 30 January 2012, (available from http://www.esma.europa.eu/system/files//2012-44_0.pdf)
[20] Preserving the Value of Money Market Funds for Investors and the Economy, Speech by Paul Scott Stevens, President and CEO ICI, 12 March 2012 (available from http://www.ici.org/pressroom/speeches/12_pss_mmx)

In the US, MMFs were the first component of the financial system to see comprehensive reform after the crisis. The reforms completed by the SEC in 2010 have been tested and shown to have strengthened MMFs and the market within which the funds operate. Despite this, further reforms are being considered by the SEC fuelled by a number of myths and misstatements over the role such funds played in the crisis and their characteristics and features. The speech given by Paul Stevens comments in detail on the role of MMFs during the crisis and their characteristics and features (see Annex for full text).

As noted in our previous comments, we do not concur that the broad range of investment funds included in Section 3 of the Green Paper as possible "shadow banking" entities and activities should be those on which the Commission is focusing its analysis. We consider however that the entities and activities outlined in this section of the Green Paper do however provide a number of benefits as set out below:

- As acknowledged in IOSCO's MMF Consultation, MMFs provide an efficient way in which retail and institutional investors can achieve diversified cash management and are an important source of financing in Europe for governments, businesses and financial institutions. IOSCO also goes on to acknowledge that the "*health of MMFs is important not only to their investors, but also to a large number of businesses and national and local governments that finance current operations through the issuance of short-term debt.*"
- As acknowledged in the FSB's securities lending and repo report, the securities lending and repo market provides a number of investment and financing benefits to a range of investors, including pension funds, insurance companies and investment funds for whom it can provide additional returns to support the delivery of investment objectives such as retirement saving. The FSB report underscores the importance of securities lending and repo markets by noting that "*liquid securities financing markets are … critical to the functioning of underlying cash, bond, securitisation and derivatives markets*".
- As is also acknowledged in an FSB's ETF report published last year, ETFs provide investors with many benefits including the ability to diversify their portfolio at low-cost, and "*can also offer an additional source of liquidity for the underlying markets in which they trade*".

d) Do you agree with the description of channels through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

We disagree with the premise that "shadow banking activities" can create new risks or transfer these to other parts of the financial system through the channels identified in the Green Paper.

(i) Deposit-like funding structures may lead to "runs"

We consider the Commission to have made an incorrect and unjustified generalisation to assert that all "*shadow baking activities are exposed to similar financial risks as banks*" and then seeking to draw comparison between the constraints on such activities imposed by banking regulation and supervision.

We note the example cited by the Commission in seeking to draw comparators between banking and shadow banking activities, that "*certain shadow banking activities are financed by short-term funding, which is prone to sudden and massive withdrawal of funds by clients*". We fundamentally disagree with the comparator that is being drawn.

Instead, we consider that any financial risks that may arise from such activities to be a function of a number of different factors including (i) the nature and characteristics of the financing of such activities; (ii) the contractual nature of the terms of such financing; (iii) the rights of depositors, creditors and shareholders; and (iv) the regulatory framework under which funds operate.

We would outline a number of key points:

(i) Units or shares in investment funds are investments, they are not deposits.
(ii) Depositors in banking institutions in most jurisdictions are provided a state or insurance backed guarantee of their deposits, subject to certain limits. There is no such deposit insurance guarantee scheme in place in respect of investment funds, nor is there any evidence that investors in such funds consider that there is such a guarantee.
(iii) It is a fundamental characteristic of all investment funds, not just MMFs, that their shares are redeemable on demand. Indeed funds come and go in the investment market on a regular basis and this is not considered extraordinary nor is regulation focused on preventing the closure of funds in an orderly manner in the ordinary course of business.
(iv) To speak therefore of 'runs' on MMFs or any other funds is to misapprehend the fundamental nature of such investment vehicles. Concerns among banking regulators about the over-reliance of banks on short-term funding vehicles such as MMFs are best addressed directly through regulation of banking activities rather than through attempts to re-engineer publicly traded funds to suit the underlying opacity and significant maturity and liquidity mismatches that lie at the core of the banking model.

We have set out below a comparison of the characteristics of banks compared to regulated investment funds and furthermore a comparison of the rights of depositors and creditors in a bank compared to fund investors.

Characteristics of Banks vs. Regulated Investment Funds

Banks	Regulated Investment Funds
"Debt Financed" including through non-transferable/marketable privately funded securities and deposits	**"Equity Financed"** through transferable/marketable publicly available units and shares
Contractually *fixed* financing based on interest rate differential for assets and liabilities as a pre-requisite for business model	**Variable, market dependent return** based on investment selection not contractually fixed obligations
Funding – constant need to roll over/re-finance assets even in "steady state" (i.e. no increase in assets or liabilities)	**Investment** – cash received from investors only invested to take advantage of investment opportunities not contractual obligation
Market dependent financing – rate and term of funding dependent on market factors	**Independent financing** – investor subscription based on opportunity cost not solely market factors
Inherent liquidity mismatch – business models require shorter term liabilities and longer term assets	**Active liquidity management** – redemption terms and liquidity management tools are used to align the liquidity of the fund portfolio to investors

Rights of Depositors/Creditors vs. Fund Investors

Bank Depositors/Creditors	Regulated Fund Investors
Deposit claims and securities representing contractual debt claims on a bank.	**Equity subscriptions** representing a pro-rata interest in the fund.
Contractual and/or governmental guarantee through contract law and/or depositor protection scheme.	**No contractual or governmental** implied or explicit guarantee – investors bear gains and loss.
Contractual rate of return at lower funding rate than asset return to generate interest margin.	**Market return** – return generated from investment of equity subscriptions.
Deposit/funding return subject to "intermediation" by bank based on profitable asset/trading book revenue.	**Direct pass through of return** – valuation of fund shares/units reflects current market value (less fund fees and expenses).
Insolvency subordination based on relative position in creditor hierarchy and domestic insolvency regulation/law.	**Pro-rata distribution of assets** to investors as equity holders in the event of liquidation.

(ii) Build-up of high, hidden leverage

We agree with the Commission that the "build-up of high, hidden leverage" is one of the groups within which the risks of "shadow banking" can be categorized. However the use of leverage by regulated, publicly available investment funds operating in Europe is subject to a tight framework of regulation. The two principal legislative instruments of relevance for investment funds are the UCITS and AIFM Directives. We would draw out a couple of particular aspects of this regulatory framework that are relevant:

- The UCITS Directive mandates strict limits on the use of derivatives to create embedded leverage[21] and the use of borrowing to create financial leverage[22], both of which must be disclosed on a periodic basis to investors.[23]
- The AIFM Directive on the other hand requires a maximum limit for leverage to be set, which is deemed to be reasonable by the relevant supervisory authorities, and subject to a comprehensive framework of disclosure to investors and reporting to regulatory authorities. Additional requirements are mandated in respect of those funds employing leverage on a substantial basis.

The combination of these measures means that regulated investment funds can't build up high levels of leverage that are hidden from supervisory and regulatory authorities.

[21] Article 51(3) of Directive 2009/65/EC requires that "a UCITS shall ensure that its global exposure relating to derivative instruments does not exceed the total net asset value of its portfolio" (available from http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2009:302:0032:0096:EN:PDF)
[22] Article 83(2) of Directive 2009/65/EC provides derogation for a UCITS to borrow subject to this being on a temporary basis and not exceeding 10% of the value/assets of the fund.
[23] Article 69(3) of Directive 2009/65/EC requires that the annual report for a UCITS includes a balance sheet/statement of assets and liabilities and the commitments arising from financial derivative instruments (Article 51 and Schedule B of Annex I)

(iii) Circumvention of rules and regulatory arbitrage

Care is needed in the concept of regulatory arbitrage. This concept implies a course of action chosen by a market participant to avoid or evade regulatory requirements which would otherwise be imposed upon its activities. This does not describe the relationship between banking finance and capital market financing. As outlined above, the banking and investment fund business models and the investor propositions they embody are entirely different and need to be analysed on their own terms.

Regulatory arbitrage probably does describe, however, the activities of some banks in the run-up to the crisis to escape banking regulatory capital and other requirements through the use of off-balance sheet structures. Again, these are problems related to the regulation of banks and their use of market-based financing arrangements. Requirements in respect of such activity should be directed to banks. Regulatory arbitrage may also describe actions that might be taken in future by banks to evade new and more demanding requirements upon them post-crisis: again the remedy for this it seems to us is more comprehensive regulation of banks and their activities, given the underlying vulnerabilities of their business model and the risks to depositors and the system more generally if they are permitted to evade banking regulatory requirements. We note that this is one of the main workstreams in train at the FSB and we fully support a rigorous approach in this regard, particularly given the demonstrated failure of many banks to manage adequately the risks in their engagement with market-based financing vehicles in the run up to the financial crisis.

As is outlined in our responses to a number of questions, we consider that investment funds operating in Europe are subject to a comprehensive framework of regulation that does not give rise to the circumvention of rules or regulatory arbitrage. The AIFM and UCITS Directives both contain a comprehensive framework for cross-border cooperation between Member State supervisory authorities and as is the case in the AIFMD an appropriately robust regime for third country investment funds and their managers operating in the EU.

(iv) Disorderly failures affecting the banking system

The Commission's expressed concern that some activities are often closely linked to the regular banking system and failure in this system could lead to contagion and spill-over effects through credit or market channels.

As we have outlined in other comments, the regulatory regimes under which regulated investment funds operate in Europe limit to a considerable extent the nature and scale of financing from banks and other counterparties. The use of this financing is not unique to investment funds and indeed is even used by individuals to obtain loans and mortgages. As such we consider that risks arising from such activities that give rise to regulatory concerns should be dealt with through the direct management of credit risk and counterparty risk by lenders, rather than through measures targeted at the users of finance that will not be comprehensive or consistently applied.

Concerns have been raised by banking regulators about the over-reliance on banks to short-term funding vehicles and hence the concern that such vehicles, such as MMFs, might become unavailable as a source of such funding, through 'runs' on their assets by investors. It seems to us that the question of the extent of the reliance on short-term funding of banks is one for banking regulators to resolve. It does not seem sensible, however, that the resolution of that question should be to attempt to re-engineer MMFs to be a reliable and essentially risk-free source of funding for banks in any and all market circumstances no matter how extreme.

Such an approach, as analysis in the US has made abundantly clear, would be to remove these funds entirely from the market, as the business proposition for both fixed providers and investors would be unattractive. Rather, banking regulators should look to direct regulation of the liquidity and maturity profiles of banks to ensure that such over-reliance is not permitted.

The regime under which regulated investment funds operate in Europe also imposes restrictions on the concentrations of the exposures of funds to the same asset or type of asset. This does not mitigate the risk that a number of different investment funds with concentrated positions seek to liquidate their holdings in unison. However, such an issue concerns the nature of the capital markets in which funds and other financial institutions participate rather than an activity that could be considered to represent shadow banking or indeed unique to the fund management sector.

e) Should other channels be considered through which shadow banking activities are creating new risks or transferring them to other parts of the financial system?

ICI Global Members have a strong interest in a stable financial system. We consider that the programme of regulatory reform in train across many parts of the financial sector, including many of the measures that are already being taken in respect of shadow banking activities, should be allowed to see their course.

Challenges for the supervision and regulation of shadow banking

The Green Paper sets out a number of the legitimate challenges faced by supervisory and regulatory authorities in meeting the G20 commitment to ensure the "appropriate degree of regulation and oversight" is applied to those shadow banks that are systemically important. As the Green Paper also notes, in the immediate term co-operation between supervisory authorities should be strengthened and in the medium to longer-term there are challenges for these authorities in building up expertise in shadow banking.

f) Do you agree with the need for stricter monitoring and regulation of shadow banking entities and activities?

We do not consider that market-based financing is inherently risky or in need of additional supervision. To the extent risks identified haven't been addressed, we believe that regulatory authorities should have the ability to monitor and as necessary regulate shadow banking entities and activities.

g) Do you agree with the suggestions regarding identification and monitoring of the relevant entities and their activities? Do you think that the EU needs permanent processes for the collection and exchange of information on identification and supervisory practices between all EU supervisors, the Commission, the ECB and other central banks?

Section 5 of the Green Paper briefly outlines the main regulatory and supervisory authorities at a pan-European level, noting the need for them to continue to build up expertise on shadow banking and fill the current data gaps that exist in respect of the interconnectedness between banks and non-bank financial institutions on a global basis.

The Green Paper does not explicitly mention investment funds in this context but it is important to acknowledge that investment funds which are operating in the EU are already subject to comprehensive reporting obligations. Funds domiciled in Eurozone countries are, for instance, subject to a comprehensive reporting framework to the ECB on a quarterly and monthly basis.[24] Alternative investment funds (AIF), including those domiciled in third countries but managed and/or marketed with the EU, will be subject to a comprehensive framework from July next year under the AIFM Directive.[25]

We consider that investment funds are already subject to a comprehensive framework of reporting under the existing regulatory framework in the EU. The key matter which remains to be resolved is the framework for the co-operation and sharing of this information to ensure that the relevant regulatory and supervisory authorities are able to able to view the data that is reported to them from a sufficiently "macro" prospective.

We note for instance that all the main EU Directives that relate to investment funds contain explicit provisions requiring supervisory co-operation and the exchange of information between authorities[26], including in the case of the AIFM Directive with authorities in third countries[27]. Despite the explicit framework for co-operation and information exchange that is mandated in legislation, the way in which information is reported and shared between authorities often results in the duplication of reporting requirements by financial institutions to multiple authorities.

A prime example of the duplication of reporting is contained within the AIFM Directive. Under this Directive a third country Alternative Investment Fund Manager (AIFM) marketing a third country AIF to investors in several EU Member States will be required report data separately to each of the supervisory authorities in the Member States where marketing is taking place. In many cases the AIFM may also be subject to reporting requirements in its third country jurisdiction (e.g. to the SEC in the case of a US AIFM) and may have to adopt different formats for the reporting of such data to satisfy each of the Member State authorities. The stated purpose of reporting requirements under the AIFM Directive was to provide pan-European authorities such as ESMA and the ESRB with a macro prospective on the activities of AIFMs in the financial markets with the objective of identifying systemic risk. The framework that has resulted however appears duplicative and unnecessarily complex. While we support the need for regulators to have access to information to complement fully the macro-perspective, we urge that a cost-effective and non-duplicative regime be put in place

h) Do you agree with the general principles for the supervision of shadow banking set out above?

The second set of challenges set out in Section 5 of the Green Paper concern how supervisory authorities should determine their approach to supervising market-based financing entities. As previously stated, we do not agree that the broad range of investment funds outlined in Section 3 of the Green Paper constitute shadow banking entities. As significant participants in the financial markets and counterparties for many transactions with other financial institutions, including banks, ICI Global members have a strong interest in the supervisory framework for banking and market-based financing entities and activities.

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[24] Regulation (EC) No 958/2007 of the European Central Bank concerning statistics on the assets and liabilities of investment funds (available from http://www.ecb.int/ecb/legal/pdf/l_21120070811en00080029.pdf)
[25] Article 3 and Article 24 of Directive 2011/61/EU on Alternative Investment Fund Managers (available from http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF)
[26] Article 50, 53 and 54 and of Directive 2011/61/EU on Alternative Investment Fund Managers.
[27] Article 52 of Directive 2011/61/EU on Alternative Investment Fund Managers.

The Commission has set out its view that the supervision of shadow banking entities should firstly "*be performed at the appropriate level, i.e. national and/or European*" and secondly should "*be proportionate*". These two elements are already enshrined in the core principles of subsidiary and proportionality on which the treaties governing the operation of the EU, and indeed the Commission, are based.[28] As such these are not new concepts. Nevertheless, we would restate that in considering future regulatory measures for this system, the principles of subsidiarity and proportionality dictate that the Commission should be mindful of ensuring that it takes an appropriately targeted and focused approach.

Such an approach should recognise the differences in the nature of activities and the systemic risks activities pose and particularly in the context of ensuring the principle of proportionality is respected, as clearly mandated by the FSB, the Commission must fully assess the degree of financial importance of an entity or activity.[29]

The third and fourth elements of the Commission's proposed approach concern ensuring that measures take "*account (of) supervisory capacity and expertise"* and the need for measures to be integrated with "*the macro-prudential framework*". In this regard, we note that the Commission considers most national authorities to have the relevant expertise to identify and monitor market-based financing activities but that many of the pan-European authorities need to further build their expertise.

We are not in a position to comment on the extent to which further expertise needs to be built by pan-European authorities, but in principle we support such efforts in particular to ensure a clear understanding of the nature of activities including their position in so called "chains" of credit intermediation. Such an understanding is imperative from the perspective of understanding the macro-prudential implications of such chains and the interconnectedness, if any, of the shadow banking system. Perhaps more importantly however such an understanding enables regulators to identify the correct balance between the direct and indirect regulation of such activities.

i) Do you agree with the general principles for regulatory responses set out above?

The third set of challenges for the supervision and regulation of market-based financing outlined in Section 5 of the Green Paper refer to possible extension of "*the scope and nature of prudential regulation*", citing the regulatory measures proposed by the FSB in its shadow banking recommendations report[30]. We note that in no case in its report does the FSB specify that regulatory measures to address shadow banking issues should be focused only on those regulatory responses that are prudential in nature. Consistent with the current framework of regulation, we consider that such measures are only appropriate to banks including those entities comprising part of the banking system that are performing shadow banking activities.

As previously stated, we do not agree that the broad range of investment funds outlined in Green Paper constitute shadow banking entities. In the event that the Commission considers the extension of the scope and nature of regulation to investment funds then only measures consistent with the structure of collective investment funds should be taken. As is outlined in the response we have provided to the consultation issued by IOSCO on Money Market Fund Systemic Risk Analysis and Reform Options, such measures should be appropriately tailored to the European market.

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[28] The principles of "subsidiarity" and "proportionality" were most recently amended by Lisbon Treaty comprising Article 5 of the consolidated Treaty (available from http://register.consilium.europa.eu/pdf/en/08/st06/st06655.en08.pdf)

[29] The FSB has stated an assessment of the "degree of financial importance" of an entity or activity is a core principle of countries and jurisdictions in respect of global adherence to regulatory and supervisory standards on international cooperation and information exchange (available from http://www.financialstabilityboard.org/publications/r_111102.pdf)

[30] Section 3 "Proposed regulatory measures to address concerns related to the shadow banking system", Shadow Banking: Strengthening Oversight and Regulation; Recommendations of the Financial Stability Board.

In all cases, we consider that the approach proposed by the Commission that such measures should be "*targeted, proportionate, forward-looking, adaptable, effective and subject to assessment and review*" is entirely correct. We entirely agree that a one-size-fits-all approach is unlikely to be effective in most cases and as such it is important that while a degree of consistency and a strong degree of coordination is maintained, authorities should be able to adopt a specific kind of approach to different entities and activities.

We would however underscore the importance of ensuring clarity from the outset as to the purpose of any regulatory measures, including particularly an assessment of possible or realised unintended consequences from such measures and the appropriateness in the balance between direct and indirect measures to avoid regulatory under-lap or over-lap.

j) What measures could be envisaged to ensure international consistency in the treatment of "shadow banking" and avoid global regulatory arbitrage?

We consider it to be of utmost importance that any measures adopted by the Commission in respect of "shadow banking" entities or activities, are entirely consistent with the recommendations of international standard setting and regulatory bodies, particularly the FSB and IOSCO. Such consistency is particularly important in determining the scope of the system and in establishing key definitions relating to entities and activities. In achieving this consistency the Commission also should ensure a high degree of cooperation with other regulators in cases where the implementation of regulatory measures, whilst remaining consistent global recommendations, reflects the significant differences in the nature of regional and national markets and regulatory frameworks.

Furthermore, to prevent regulatory arbitrage the Commission, Council of Ministers and the European Parliament as co-legislators should be particularly mindful of adopting measures that are protectionist in nature, create barriers to entry or are contain unachievable or unrealistic measures applicable to jurisdictions outside the EU. Instead, the Commission should seek to engage in discussions at an international level and to adopt measures that are in line with globally agreed standards, in all cases seeking to avoid instances of regulatory under-lap or over-lap.

<u>Existing shadow banking regulation</u>

k) What are your views on the current measures already taken at the EU level to deal with shadow banking issues?

Section 6 of the Green Paper outlines the indirect and direct regulation of some shadow banking activities and the possible enlargement in the scope of current prudential regulation to cover some of these activities. We note the references in the Green Paper to the regime to which regulated investment funds and their managers operating in Europe are subject including the UCITS and AIFM Directives, the review of MiFID, the work being undertaken by ESMA on MMFs and ETFs, and the regulation of credit rating agencies. We consider this to represent a comprehensive regulatory framework that addresses the regulatory concerns outlined in the Green Paper.

Other "Shadow Banking"

l) Do you agree with the analysis of the issues currently covered by the five key areas where the Commission is further investigating options?

In our prior comments in response to question b), we have set out our views on the specific entities and activities within the scope of the Commission's current analysis. Below we provide a number of general comments as to the framework for analysis that should be adopted by the Commission in defining the scope of the shadow banking system

As is noted in the Green Paper, the FSB is undertaking additional work to examine the regulation of shadow banking entities (other than MMFs) with a view to developing policy recommendations by September this year. We understand that the Commission has been engaged with the work described in the FSB's recent progress report to G20 ministers and governors[31] to categorise a wide range of non-bank financial institutions (known as "Other Financial Intermediaries" or OFIs) through a data collection exercise with the objective of developing a "short-list" of entities on which to focus.

We support the Commission's engagement in the FSB's work to ensure that it is in a position to provide a European perspective, but furthermore to ensure it is in a position to precisely implement the spirit and letter of any recommendations that emerge to contribute to consistency in the international implementation of such measures. In this regard, ICI Global considers that while the Commission should engage in the work being undertaken by the FSB it should wait until this work is completed before determining precisely the scope of the shadow banking system as it applies in the European Union.

We are therefore concerned that in Section 5 of the Green Paper the Commission has sought to describe the final step in the process being undertaken by the FSB as involving the development of "additional prudential measures" for shadow banking entities. We have not been able to identify in any of the recent publications from the FSB, including the FSB Progress Report to the G20, any concrete proposal or recommendation that prudential measures should be applied. Instead, the FSB has been at pains to state that a range of policy recommendations could be developed. Furthermore the FSB notes in its Progress Report that it did not even expect to complete its prioritisation process for the development of policy recommendations until April/May. As such we are strongly of the belief that the Commission should allow the work being undertaken by the FSB to be completed before seeking to define the types of measures that may need to be taken in the context of the European Financial System.

m) Are there additional issues that should be covered? If so, which ones?

We have not identified any additional issues that should be covered.

n) What modifications to the current EU regulatory framework, if any, would be necessary properly to address the risks and issues outlined above?

As discussed in our other responses, investment funds and their fund managers operating in the EU are already subject to a comprehensive framework of regulation and subject to appropriate oversight

[31] Strengthening the Oversight and Regulation of Shadow Banking: Progress Report to G20 Ministers and Governors, 16 April 2012 (available from http://www.financialstabilityboard.org/publications/r_120420c.pdf)

by national Member State supervisors in conjunction now with the European Securities and Markets Authority.

We are concerned about the final step that has been identified by the Commission in Section 7.5 of the Green Paper to place additional prudential measures on shadow banking entities for which a gap in existing regulatory regimes has been identified. We consider that such measures may be appropriate for certain entities performing bank-like activities. We do not consider that investment funds or their managers constitute shadow banking entities. In the event that the Commission identifies such funds or their managers as constituting part of the shadow banking system, we would not consider it appropriate to assume that prudential regulatory measures are the more appropriate response.

Instead we would consider that regulatory tools that have been successfully deployed by capital markets and securities supervisors are examined as mitigants of the issues that give rise to regulatory concerns. In its response to the FSB's scoping the issues report, the ICI outlined how the regulatory tools deployed by capital markets and securities supervisors have been used successfully alongside banking regulation in the US since the beginning of the last century.[32] We consider that the Commission should undertake such an exercise in respect of Europe.

In the case of investment funds, all of those permitted for sale to retail investors will be subject to authorisation either on a domestic basis or in the case of cross-border funds under the UCITS Directive. Even in the case of those non-UCITS investment funds reserved for professional investors, either the fund itself and/or the fund manager will be subject to either domestic regulation or as is more likely to be the case some form of pan-European regulation under either MIFID (or from July next year the AIFM Directive) if they are operating in the EU. As such we believe that for investment funds, in most if not all cases Member State supervisors will already have the necessary powers to collect data on activities that give rise to regulatory concern.

o) What other measures, such as increased monitoring or non-binding measures should be considered?

As outlined previously, we do not consider that other measures, binding or otherwise, until the important work being undertaken by the FSB and other international standard setting bodies has been concluded.

We appreciate the opportunity to provide comments on the Commission's Green Paper. If you have any questions about our comments or would like additional information please contact me (dan.waters@ici.org or +44 203 009 3101) or Giles Swan, Director of Global Funds Policy (giles.swan@ici.org or +44 203 009 3103).

Sincerely,

/s/

Dan Waters
Managing Director

[32] Appendix A, Letter from Paul Scott Stevens, President and CEO, to Secretariat of the FSB dated 3 June 2011 regarding Shadow Banking – Scoping the Issues (available from http://www.ici.org/pdf/25258.pdf)

Annex – Preserving the Value of Money Market Funds for Investors and the Economy, Speech by Paul Scott Stevens (President and CEO of ICI), 12 March 2012

Good morning. Thank you, Brian [Kalish, co-chair of conference], for that introduction and your warm words. I'd also like to thank iMoneyNet for giving me the honor of delivering the keynote to your conference today.

The Money Market Expo is in its 14th year, and has grown tremendously in that time. It serves a wide range of participants in the money market—treasurers, cash managers, issuers of money market securities, and, of course, money market funds.

You all are here because you recognize the vital role that the money market plays in fuelling the American economy. Last month, I appeared on a panel with the treasurer of FMC Corporation, who described the delicate balance of investing and borrowing to meet FMC's daily cash needs as managing "the lifeblood of our company."

Whether you represent a company or a city government, a university or an insurance company, a pension plan or a brokerage, you know how vital the role of cash management is in your operations. Cash is truly the lifeblood of our economy—and the money market is the circulatory system. Indeed, America's economy today quickly would cease to function without a steady, efficient flow of liquid resources from investors to issuers and back again.

Money market funds are a crucial component of this market. Cash managers who need to balance daily income and outflow tell us that money market funds offer greater flexibility, diversification, and liquidity than either bank products or direct investments in money market instruments.

For 56 million individual investors, money market funds offer the *only* way to achieve a current money market yield and the safety of a diversified, professionally managed portfolio. Since 1990, retail investors have earned $242 billion more in returns from money market funds than they would have earned in competing bank products.

And the $2.7 trillion entrusted to money market funds is put to valuable uses throughout the economy—financing commercial paper, short-term municipal debt, asset-backed commercial paper, bank CDs, Treasury bills. In short, money market funds help keep the lifeblood of the economy flowing.

The question we face today is: Do we preserve the vital role that money market funds play? Will money market funds continue to serve investors and the economy?

As you all know, the Securities and Exchange Commission [SEC] has signalled its plans to unveil soon a set of structural changes to money market funds. These proposed changes may take one of two courses.

In the first option, money market funds will lose their stable $1.00 per-share value and will be forced to "float."

In the second, they will be subject to a complicated regime of capital buffers and redemption restrictions.

In either case, investors tell us that regulators will have crippled the very features that make money market funds so valuable to users as cash management tools.

The result is predictable—investors will reduce their use of money market funds, or abandon them altogether. And when that happens, the flow of finance through the money markets, that lifeblood for the economy, will be disrupted, creating a market with higher costs and *more* systemic risk—at great cost to investors and the economy.

Scores of organizations—representing corporate treasurers, finance officials from state and local governments, nonprofits, financial advisers, and individual investors—have written to the SEC warning of the consequences of misguided changes for their finances and for the economy. Many of you here may have weighed in—and if you haven't, I hope you will.

In the fund industry, we have spent countless hours in recent years trying to help regulators find ways to make money market funds more resilient in the face of adverse markets.

We are confident we achieved that goal in 2010. With the fund industry's strong support, the SEC adopted rule amendments that raised the credit quality, shortened the maturity, enhanced the transparency, and increased the liquidity of money market fund portfolios.

These reforms were tested in the troubled markets of the last year—and they passed with flying colors. Thanks to the 2010 amendments, money market funds are stronger today—and today's money market fund is a very different product from its 2008 predecessor.

Money market funds in fact were the first component of the financial system to see comprehensive reform after the crisis. The SEC strengthened money market funds *six months* before the Dodd-Frank Act was passed—and, at the current rate, years before Dodd-Frank's rules will go into effect.

And these reforms were the first to be tested, and the first to succeed. By any measure, this is a great achievement.

The SEC should be proud that it achieved so much, so quickly, to strengthen money market funds—without undermining their core principles or their role for investors and the economy.

US financial regulators should take credit for this success. Few do.

Instead, SEC Chairman Mary Schapiro pre-judged the force of the 2010 amendments. Even before voting on them, she declared that regulators wanted a "Round II" of "structural changes" to money market funds.

Two years later, as we see the SEC's trial balloons, we're discovering that "structural change" means proposals that will undermine the core features of money market funds and their value to investors and the economy.

The fact that the power of the 2010 reforms is not acknowledged—that's disappointing.

Even more troubling are the arguments that critics use to justify changes that clearly will undermine the value of money market funds to investors and the economy. The debate around money market funds is riddled with myths and misstatements.

There are at least three big myths at the heart of the case for "reforming" money market funds.

First, there's the myth of 2008—the notion that money market funds somehow caused or accelerated the financial crisis. That's a false narrative, and it's the source of a great deal of mischief.

The myth of 2008 feeds another misconception—the myth that money market funds are "susceptible to runs" and likely to trigger systemic risk.

And in the hands of some commentators, these first two myths fuel a third. That's the notion that banks offer the superior model for all financial activities and that capital market institutions like money market funds are really "shadow banks." This myth leads to proposals to impose bank-style regulation on money market funds.

Take these three myths together, and we end up where we are today—rushing headlong into unnecessary, flawed, and harmful regulatory changes.

I'd like to take some time today to set the record straight. It won't be easy, because these myths are deeply embedded. But I'll try.

Before I tackle the myths, let's start with a fact that *all* policymakers should acknowledge at the outset—the proven success of the 2010 amendments.

The SEC's amendments redefined what it means to be a money market fund—and the new model for these funds is far stronger and more resilient.

Remember what these amendments did:

- They shortened the maximum weighted average maturity of money market funds from 90 days to 60 days.
- They instituted more frequent portfolio disclosures by funds, including monthly reports of portfolio holdings and mark-to-market values.
- They raised the credit quality of the securities money market funds were allowed to hold.
- For the first time, the rule amendments set explicit standards for the liquid assets funds must hold—backing up those minimums with know-your-investor requirements and portfolio stress-testing to ensure that liquid assets are sufficient to meet expected redemption demands.
- *And* the rule amendments gave fund boards the power to assure a fair and orderly liquidation of a money market fund, should that be necessary.

As Fidelity Investments pointed out in a recent analysis, the industry's required weekly liquidity, at almost $800 billion, is more than five times the industry's peak borrowing from the facility created by the Fed to support commercial paper during the crisis. And the industry's *actual* weekly liquidity at the end of January was 40 percent above the requirements.

As it happened, we didn't have to wait long to put these reforms to the test. Last summer, financial markets were rattled by three significant events:

- The eurozone struggled to get ahead of the growing possibility of a Greek sovereign debt default.
- The US Congress waited until the eleventh hour to increase the US debt ceiling.

- And then, shortly afterward, Standard & Poor's downgraded the rating of US government long-term debt.

At ICI, we monitored these challenges closely. And we fielded constant questions, fueled in no small part by statements from Federal Reserve officials, about whether these events would put money market funds at risk.

Well, what happened?

Money market funds did indeed see large redemptions. From early June to early August, investors withdrew 10 percent of their assets from prime money market funds—$172 billion in all. In fact, during the debt-limit showdown at the end of July, even government funds were affected. Together, prime and government funds saw an outflow of $114 billion in just four trading days.

One recent academic paper called the outflow from prime funds a "silent run."

Now *there's* an oxymoron—like a "routine emergency." You have to wonder: If a "run" is so silent that no one can tell it happened—if it has no spillover effects on the broader markets—why does it matter?

In fact, while the eurozone and US debt crises certainly took their toll on equity and fixed income markets, the withdrawal from money market funds had *no* discernable effects *at all*—either on the funds or on the markets. Consider this: from April through December, prime money market funds kept their daily liquidity at more than twice the required level, and weekly liquidity stayed one-third to one-half *higher* than the standard.

Did the redemption pressure put any funds at risk of breaking the dollar?

We've examined the portfolio data that all money market funds now are required to file with the SEC for public release. Among the prime funds with the greatest exposure to European financial institutions, the average mark-to-market price of their portfolio fell by nine-tenths of a basis point.

Let me see…on a $1.00 fund share, that's a dollar sign followed by 0-point-0-0-0-0-9.

Right. Nine one-thousandths of a penny.

Put it another way—that change wouldn't move the value of a share priced at $1.00, and it wouldn't move the value of a $10 share. It would move the value of a share priced at $100—by one cent. We can't call that breaking the buck—so I guess we'd have to call it "breaking the Benjamin."

So—have the 2010 amendments been tested? Yes.

Have they made money market funds more resilient in the face of crisis? Yes.

Have they made investors more secure, at a reasonable price? Yes.

Are the new rules a success? Most emphatically—yes.

Indeed, I would go further. I would argue that the 2010 amendments are the latest chapter in one of the great success stories of modern financial regulation. Throughout the history of money market funds, the SEC has carefully crafted rules that balance these funds' competing objectives of convenience, liquidity, and yield. Under this regulatory regime, money market funds have flourished and innovated—to the great benefit of investors and the economy.

Yet regulators are not content. Despite the proven success of the 2010 reforms, SEC Chairman Mary Schapiro insists that the financial system is "living on borrowed time" because money market funds have "structural risks."

How do the SEC and other regulators justify such statements?

This is where the first of the three myths come in—the false narrative of 2008 that holds money market funds responsible for accelerating the financial crisis.

Let's all go back, in our minds, to Sunday, September 14, 2008. Yes—I know it's painful. But it will be instructive.

The worst financial crisis since the Great Depression was raging. In the prior 12 months, at least 13 major US or European financial institutions had declared bankruptcy, been taken over, or received significant government or private help to survive—names like Citigroup, Northern Rock, and, of course, Bear Stearns. That count includes Fannie Mae and Freddie Mac, which were placed into government conservatorship on September 7. I'm sure you can all recall those anxious Monday mornings when we woke up and turned on the television to find out whether the latest candidate for failure had indeed been rescued.

On Sunday, September 14, the government abruptly broke that pattern and refused to rescue Lehman Brothers. And on September 16, the Reserve Primary Fund, which had invested in Lehman Brothers' paper, failed to maintain its $1.00 per-share value. It broke the dollar.

What happened next? According to Chairman Schapiro: "when the Reserve Primary Fund broke the buck…it set off a run so serious that the federal government was forced to step in and guarantee the multi-trillion dollar industry."

That's the conventional wisdom. But let's think about that narrative.

It's true that prime money market funds were hit by a strong wave of redemptions—about $300 billion in the week that Lehman failed. And these flows were destabilizing. The government's responses, designed to restore confidence and inject liquidity into the money market, were justified.

But it's also true that for every dollar that left prime funds, 63 cents flowed *into* Treasury and government funds. In fact, when you look at all taxable funds—combining prime, Treasury, and government—total assets were down by only 4 percent during the week of September 15.

Investors did not abandon *money market funds*. Instead, an equally plausible explanation for these flows is that investors were reacting to their concerns about the financial health of US banks, the US government's unpredictable response to financial institutions' collapse, and concerns about whether prime funds could continue to sell assets into the frozen commercial paper market.

As you might predict, under those conditions, investors sought the refuge of US Treasury securities. And they chose money market funds as their vehicle.

The events of 2008 are used to justify the notion that money market funds are fragile teacups, likely to shatter at the slightest touch of trouble. You all know that they're not—but you can't tell that from the media commentary around this issue.

In fact, it took a tremendous financial shock to cause one prime fund to break, and others to suffer heavy outflows.

Consider again the environment of September 2008.

Federal authorities had just upended investor expectations of how they would handle failing banks. They then reversed themselves again with the extraordinary $85 billion rescue of AIG.

In the turmoil, *banks* were refusing to lend to *each other*, even overnight. Corporate treasurers were desperate to get their cash to safety—even if that meant getting out of the commercial paper market.

I submit to you—in that environment, outflows from prime money market funds were inevitable.

Critics like to talk about the "contagion" unleashed by Reserve's failure.

In fact, Reserve only failed in the *middle* of a raging epidemic.

Nonetheless, the false narrative of 2008 fuels the second myth of this debate—the idea that money market funds are "susceptible to runs."

I'll quote Chairman Schapiro again. She says: "Funds remain vulnerable to the reality that a single money market fund breaking of the buck could trigger a broad and destabilizing run."

I wanted to be on solid footing here, so I took out my dictionary. It says that the word "vulnerable" means…"susceptible."

So I looked up "susceptible." That means "easily influenced…likely to be affected."

That certainly doesn't describe money market funds. They are *not* "easily" broken. Nor are they "likely to be affected" in a significant way outside of extreme market conditions.

We all know that, in the first 25 years after Rule 2a-7 was adopted, exactly one money market fund broke the dollar, in 1994.

This is a sophisticated audience, but I doubt that 10 people in this room could name that fund. Do I have any takers?

It was the Community Bankers US Government Money Market Fund. The reason it's not famous is because it broke the dollar and *did not* trigger a broad and destabilizing run. In fact, money market fund assets *grew* the month after Community Bankers broke the dollar.

The contrast between September 1994 and September 2008 is the fact that, in 1994, the *banking system* was not mired in crisis. There was no reason for investors in other funds to lose confidence in the assets their funds were holding. And so there were no aftershocks.

When Reserve Primary failed in 2008, there were aftershocks—caused, as I said, primarily by the financial crisis in which Reserve's failure was but one more of a seemingly endless series of events. And, as I noted, investors didn't lose confidence in the money market fund structure.

So I would submit to you that money market funds have *never* been "susceptible to runs."

What's more important for today's debate is whether destabilizing runs are likely in the future.

I am even more confident in saying that today's money market funds are *not* likely to trigger events that place the financial system in jeopardy.

In a free market, we can never stop investors from moving away from risks. In fact, blocking those movements would be dangerous and destructive. Mechanisms that try to blunt the natural reaction to risk, like deposit insurance, create moral hazard.

But we can *reduce* risks…we can *remove incentives* for investors to move rapidly…and we can *limit the impact* of the movements that do occur.

In fact, that's exactly what the SEC's 2010 money market fund reforms *have* achieved.

The reforms reduce the risks that money market fund investors face, by raising credit standards and shortening maturities. We've seen those changes in action. As I noted earlier, you have to go to the fifth decimal place to find any impact on portfolio values from last summer's trio of crises.

The reforms remove incentives that might encourage investors to move rapidly out of money market funds. Monthly disclosure gives investors information they need to judge the strength of a funds' portfolio. Required liquidity strengthens funds' ability to meet redemption demands. Today's prime funds could meet a $300 billion outflow in one week—and have $138 billion in liquid assets left over.

Finally, and perhaps most importantly, the 2010 reforms sharply reduce the spillover impact of money market fund redemptions on the broader markets.

When investors pulled out of prime funds in 2008, the economic harm came not from shrinking the funds, but from the funds' need to sell assets into declining markets when liquidity was scarce or nonexistent. The only place liquidity could be found was in the Treasury, government, and repurchase agreement markets.

Today's money market funds are different from 2008's. Today's funds carry substantial liquidity buffers. Those buffers are composed of cash, government securities, and repurchase agreements, mostly collateralized by Treasury and agency securities.

What does that mean? In essence, almost 30 percent of any prime fund today is a *government* fund, holding assets that *any* government fund could own.

So what would happen today if investors pulled 20 percent of their assets out of prime funds? The funds would not be forced to dump commercial paper or bank CDs into a declining market, taking losses and squeezing the economy's cash flow.

Instead, they could simply unwind their repos and liquidate their Treasuries and agencies. The most likely buyers would be government funds that are gaining assets from investors' move away from risk.

This is a remarkable change, and even more evidence of the value of the 2010 reforms.

Unfortunately, the power of this one important development has gone largely unrecognized.

By now, I think I've demonstrated that the drive for further regulatory changes is fueled primarily by two myths—the myth of 2008 and the myth of susceptibility to runs. But there's a third myth that motivates many of the critics of money market funds—including some of the most influential regulators.

That is the banking myth— the notion that banks offer the superior model for all financial activities and that money market funds are really "shadow banks."

This one has deep roots—long before money market funds.

In 1790, under the newly enacted Constitution, the federal government took two important steps: it assumed the debts of the states, creating the US bond market, and it formed the First Bank of the United States.

Since then, capital markets and banking have existed side-by-side in this country. That has created healthy competition and innovation for both savers and users of capital—and it's an important reason why America's financial system is so dynamic and efficient.

Skip forward a couple of centuries to the modern era and the growth of the money market since the 1970s—a development that has changed the picture for banking regulators.

When a corporation sells its commercial paper to investors via a money market fund, the Federal Reserve's control over the US financial system shrinks. Little wonder that the Fed opposed the creation of money market funds, or that central bankers around the world are spreading the idea that money market funds are "shadow banks" that need to be brought into the light of their control.

Paul Volcker, who has a 40-year record of fighting money market funds, has charged that they represent "regulatory arbitrage."

And Federal Reserve Chairman Ben Bernanke earlier this month suggested that the financial system could do just as well without money market funds. While he allowed that these funds are "a useful source of short-term money," the chairman went on to tell the Senate Banking Committee: "You know, Europe doesn't have any, and they have a financial system."

Well—Europe does have money market funds, with $1.5 trillion in assets. That's real money.

And here in the United States, money market funds aren't just "useful"—they're essential. Any vehicle that funds more than one-third of the commercial paper market and more than one-half of short-term municipal debt should not—*cannot*—be viewed as an afterthought.

Finally, I hope you all know that money market funds are not banks, and that they don't need bank-style regulation.

Banks are highly leveraged: 80 to 90 percent of the liability side of their balance sheets is deposits, CDs, long-term bonds, and other borrowings. They invest these borrowed funds in mortgages and other long-term loans, for households, small businesses, and other borrowers who lack access to public credit markets.

The maturities of bank loans can range from overnight to 30 years. These loans are usually highly illiquid, because they can't be called or sold quickly. Frequently, a bank's assets are concentrated in a particular region or industry. And most bank assets are opaque, because many bank borrowers have unique characteristics that make their credit quality hard to assess. Indeed, a banker's skill at separating good borrowers from bad is the bank's first line of defense.

But even with the most skilled bankers, this model of long-term, illiquid, concentrated, and opaque portfolios is *inherently* risky.

So banks are surrounded by a superstructure of regulation, capital requirements, and deposit insurance—a system that ultimately transfers that risk to the public. Despite these safeguards, 450 banks have failed since 2000, according to the Federal Deposit Insurance Corporation.

That's the banking model, and it serves many useful social purposes. But it's not the model of money market funds.

By contrast, money market funds' use of leverage is tightly limited—and these funds typically make very limited use of borrowed funds. Indeed, the liability side of a money market fund's balance sheet is essentially 100 percent capital. Money market fund shareholders are equity investors—with all of the risks of ownership, fully disclosed.

On the asset side, money market funds are required by Rule 2a-7 to invest only in short-term securities, with a maximum maturity of 13 months and a weighted average maturity of 60 days or less.

These securities must pose minimal credit risk and must meet strict standards for diversification. Fund investors know where their money is going, because funds disclose all of their holdings every month.

And since the 2010 amendments, money market funds are required to hold specified levels of liquid assets to meet redemption needs.

In short, banks are designed to make risky loans, and a variety of protections are built up around that structure. Money market funds, by contrast, are designed from the start to limit risks.

Would bankers exchange their lending system for the highly restricted portfolios of money market funds? I doubt it.

But by the same token, why should money market funds accept the regulatory burdens placed on banks—regulations designed for an entirely different system? The answer is clear: they shouldn't.

Now, I've given you a lot to think about. I have to tell you, as the fund industry's representatives in Washington, my ICI colleagues and I have been at the forefront of the debates over these issues for years now.

It's frustrating that the public dialogue is so riddled with myths and misconceptions.

It's disappointing that the success of the 2010 amendments is ignored in the pursuit of changes that will compromise core features of money market funds, their utility to investors, and ultimately their role in the economy.

It seems clear that we are now approaching a critical juncture in this debate.

We will muster all of our resources, in legal and economic analysis, in operational expertise and communications, to alert investors, issuers, businesses, state and local governments, and political leaders to the implications of any proposed structural changes.

Why?

Because this is a matter that is bigger than the fund industry alone.

Earlier I mentioned that scores of organizations representing investors and issuers have already spoken out against ideas like the floating NAV [net asset value]. If you want to add your voice, we've distributed a distinctive orange-and-blue flyer that lays out our mission: "Keep Money Market Funds Working for Investors, for America." Or you can find us on the Internet at www.PreserveMoneyMarketFunds.org.

Please add your voice to the chorus, and keep money market funds working for us all.

Thank you. I'll be happy to take your questions.