

January 14, 2013

Via email ([fsb@bis.org](mailto:fsb@bis.org))

Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002  
Basel, Switzerland

Re: Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Oversight and Regulation of Shadow Banking Entities

Dear Sir or Madam:

The Investment Company Institute (“ICI”) and ICI Global appreciate the opportunity to comment on the consultative document published by the Financial Stability Board (“FSB”) entitled “Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Oversight and Regulation of Shadow Banking Entities.”<sup>1</sup>

ICI is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (“ETFs”), and unit investment trusts (“UITs”) registered under the Investment Company Act of 1940 (“Investment Company Act”).<sup>2</sup> ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of U.S. registered funds, their shareholders, directors, and advisers. ICI Global is the global association of regulated funds publicly offered to investors in leading jurisdictions worldwide. ICI Global seeks to advance the common interests and promote public understanding of global investment funds, their managers, and investors. As of January 2013, members of ICI and ICI Global collectively manage total assets of over U.S. \$14.9 trillion.

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<sup>1</sup> Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: A Policy Framework for Oversight and Regulation of Shadow Banking Entities*, November 18, 2012, available at [http://www.financialstabilityboard.org/publications/r\\_121118a.pdf](http://www.financialstabilityboard.org/publications/r_121118a.pdf) (“Consultative Document”).

<sup>2</sup> The remainder of this letter uses the term “U.S. registered funds” to refer to all of such funds collectively, unless the context requires otherwise.

The Consultative Document is part of a broader FSB effort aimed at mitigating the potential systemic risks associated with “shadow banking.” It makes recommendations to assess and address risks posed by “other shadow banking entities,” *i.e.*, certain non-bank entities other than money market funds.

On behalf of our member funds, which are both issuers of securities and major investors in the financial markets around the world, ICI and ICI Global have actively engaged with policymakers on a broad range of legislative and regulatory issues and developments emanating from the global financial crisis. We have an interest in the matters discussed in the Consultative Document insofar as the recommendations it makes—in particular, those regarding entities described as “client cash pools”—implicate some of our member funds. As participants in the global financial markets, our members also have an interest in a strong and well-regulated global financial system.

Below we provide several general comments on the Consultative Document followed by more specific comments on the proposed recommendations.

### **General Comments**

The Consultative Document proposes a high-level policy framework that seeks to promote appropriate oversight and regulation of certain non-bank entities (other than money market funds) that engage in “credit intermediation.” As ICI stated in a comment letter on the FSB’s April 2011 background note, “Shadow Banking – Scoping the Issues,” we agree that it is appropriate for the FSB to consider whether additional or different regulatory measures for non-bank financial intermediaries may be important to strengthening the global financial system.<sup>3</sup> We are disappointed, however, that the Consultative Document fails to address significant concerns we raised in the June 2011 ICI Letter.

First and foremost, the Consultative Document continues to use the inherently inaccurate and misleading terms “shadow banks” and “shadow banking.” As we indicated previously, these terms are epithets that erroneously connote that all the activities so labeled lack both transparency and any regular or official status. We again urge the FSB to use more precise and neutral terminology when discussing the various roles of non-bank financial intermediaries.

We also are disappointed that the Consultative Document, like the April 2011 background note, continues to view the activities conducted by non-bank financial intermediaries and the regulation of these entities through a banking lens. Despite a brief mention that the credit intermediation activities these “shadow banks” conduct outside the “regular” banking system “often

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<sup>3</sup> See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Secretariat of the Financial Stability Board, dated June 3, 2011 (“June 2011 ICI Letter”), available at <http://www.ici.org/pdf/25258.pdf>.

generate benefits for the financial system and the real economy,” the overall implication is that such activities are inherently problematic and inappropriate.

The Consultative Document also perpetuates the notion that most if not all of these “shadow banks” seek to engage in regulatory arbitrage. For example, it makes the sweeping generalization that “whereas banks are subject to a well-developed system of prudential regulation and other safeguards, the shadow banking system is typically subject to less stringent, or no, oversight arrangements.”<sup>4</sup> In so doing it dismisses the possibility that capital markets regulation can provide a viable alternative to a bank-oriented regulatory regime.

Further, the Consultative Document creates the false impression that the bank regulatory system has been an unmitigated success. Nowhere does the Consultative Document reference the proliferation of bank failures during and since the global financial crisis, nor does it acknowledge that banking regulation has flaws.<sup>5</sup> To be credible, the FSB must take care to present a realistic and more balanced view of the financial system and financial regulation.

### **Comments on Proposed Recommendations**

The Consultative Document indicates that the policy framework for “other shadow banking entities” consists of three elements: (1) the framework of five economic functions (or activities); (2) the framework of policy toolkits; and (3) information sharing among authorities. Our comments address certain aspects of the first two elements.<sup>6</sup>

#### Framework of Five Economic Functions

Under the proposed policy framework, regulatory authorities would categorize non-bank financial entities based on their economic function(s) rather than legal forms or names. This categorization is intended to help regulators determine which of the proposed policy toolkits (discussed below) would best address the risks posed by the credit intermediation activities in which a given non-bank entity engages. ICI and ICI Global recognize that there is logic to this approach but we caution

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<sup>4</sup> Consultative Document at ii.

<sup>5</sup> According to the Federal Deposit Insurance Corporation’s Failed Bank List (available at <http://www.fdic.gov/bank/individual/failed/banklist.html>), 456 banks have failed since September 2008. *See also* Testimony of Paul Schott Stevens, President and CEO, Investment Company Institute, Before the Committee on Banking, Housing and Urban Affairs, United States Senate, on “Perspectives on Money Market Mutual Fund Reforms” (June 21, 2012), available at [http://www.ici.org/pdf/12\\_senate\\_pss\\_mmf\\_written.pdf](http://www.ici.org/pdf/12_senate_pss_mmf_written.pdf), at 5-6 (discussing key market events leading up to and during September 2008, including “massive failures in the bank sector” after Lehman Brothers failed).

<sup>6</sup> ICI and ICI Global agree that the third element—information sharing among authorities—should serve to minimize regulatory gaps and regulatory arbitrage opportunities and is an appropriate component of this initiative.

that it may prove difficult to put into practice because the existing regulatory system in many jurisdictions is based on legal forms and involves multiple regulators with varying scopes of authority, responsibilities and missions.

The Consultative Document identifies five economic functions for this purpose. The first of these is Economic function 1: Management of client cash pools with features that make them susceptible to runs. The Consultative Document states that pooled investment vehicles can create “run” risk if they engage in maturity or liquidity transformation, and that the risk can be intensified if these vehicles are leveraged. It indicates that entities that are engaged in these activities include “credit investment funds (or mutual funds or trusts) that have a cash management or very low risk investment objective.” Following further discussion, it lists among possible examples “ultra short-term bond funds” and “short-duration exchange-traded funds (ETFs).” This category potentially would encompass some ICI and ICI Global member funds.

Many regulated funds, such as U.S. registered funds that are ultra short-term bond funds or short-duration ETFs, already are subject to strict regulatory requirements under the Investment Company Act of 1940 (“Investment Company Act”) and other U.S. federal securities laws that address the very concerns identified in the Consultative Document. While these types of funds are redeemable upon demand, their net asset value fluctuates and they are required to disclose clearly that they can lose value. They must comply with rules prohibiting the use of misleading fund names. Likewise, marketing or selling such funds in a manner that provides investors with an expectation that their investment will not lose value would violate rules governing advertising and/or sales practices. A self-regulatory organization oversees fund advertisements, reviewing them for compliance with applicable rules and providing comments.

In addition to these and other disclosure and transparency requirements, these funds are subject to restrictions on leveraging, valuation and liquidity requirements, strong oversight and accountability mechanisms, prohibitions on transactions with affiliates, and diversification and custody requirements. As we indicated previously, these and other applicable requirements serve to limit systemic risk and do not provide opportunities for regulatory arbitrage.<sup>7</sup> Other jurisdictions around the world likewise regulate funds, including bond funds, in areas such as leverage, liquidity management, portfolio diversification, investments in derivatives, valuation and pricing, and through explicit or implicit limits on the types of securities the funds may hold.<sup>8</sup> As discussed below, regulators must take existing regulation into account when considering additional measures. This means, among other things, that the FSB’s policy framework needs to respect and accommodate other, equally important policy goals

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<sup>7</sup> The regulatory requirements that apply to U.S. registered funds are discussed in greater detail in Appendix C to the June 2011 ICI Letter, *supra* note 3.

<sup>8</sup> For example, regulatory limits on leverage and/or borrowing apply to UCITS in Europe and to funds in Canada, Chile, Korea, Japan, and Singapore, among other countries.

that underlie regulatory approaches and requirements for non-bank financial entities in different jurisdictions.<sup>9</sup>

### Framework of Policy Toolkits

The Consultative Document indicates that the second element of the policy framework is the framework of policy toolkits, consisting of “overarching principles that authorities should apply for all economic functions and a toolkit for each economic function to mitigate systemic risks associated with that function.”<sup>10</sup> It explains that the overarching principles are designed to ensure that non-bank financial entities that pose shadow banking risks are subject to oversight. To that end, it proposes the following four principles:

- Principle 1: Authorities should have the ability to define the regulatory perimeter.
- Principle 2: Authorities should collect information needed to assess the extent of risks posed by shadow banking.
- Principle 3: Authorities should enhance disclosure by shadow banking entities as necessary so as to help market participants understand the extent of shadow banking risks posed by such entities.
- Principle 4: Authorities should assess their non-bank financial entities based on the economic functions and take necessary actions drawing on tools from the policy toolkit.

ICI and ICI Global believe that the proposed overarching principles generally are reasonable,<sup>11</sup> but we suggest the following modifications. First, consistent with our previous comments, we recommend that the FSB modify the wording of the principles to eliminate references to “shadow banking.” For example, Principle 2 could be revised to read as follows: “Authorities should collect information needed to assess the risks to the financial system arising from credit intermediation activities conducted by non-bank financial entities.” Similarly, Principle 3 could be revised to state: “Authorities should enhance disclosure by non-bank financial entities as necessary to help market participants understand the risks posed by such entities.”

Eliminating the references to “shadow banking” from Principle 3 would have the added benefit of providing flexibility to regulators to determine the nature of risks that should be disclosed to market participants. ICI and ICI Global believe there are circumstances in which non-bank financial entities should report to regulators information relating to the extent of risks to the financial system, but it is

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<sup>9</sup> See 2011 ICI Letter, *supra* note 3, at 4-6 and Appendix A (discussing the parallel role of banks and the securities industry in the U.S. capital markets).

<sup>10</sup> Consultative Document at 3 (footnote omitted).

<sup>11</sup> We note that due to limits on the scope of regulators’ authority, Principle 1 likely will not be achievable in all cases.

not necessary or appropriate to require disclosure of that same information to market participants. In addition, for reasons discussed more fully below, we recommend adding the words “as appropriate” to the end of Principle 4.

Importantly, the Consultative Document states that the policy toolkit “presents a menu of *optional* policies from which authorities can draw upon as they think best fits the non-bank financial entities concerned, the structure of the markets in which they operate, and the degree of risks posed by such entities in their jurisdictions.”<sup>12</sup> It goes on to say that that the “policy tool(s) adopted should be proportionate to the degree of risks posed by the non-bank financial entities, and should take into account the adequacy of the existing regulatory framework as well as the relative costs and benefits of applying the tool.”<sup>13</sup>

These statements evidence the FSB’s intent to provide regulatory authorities with a substantial amount of discretion in whether or how they utilize the suggested policy tools to respond to perceived risks. ICI and ICI Global strongly support this approach. We agree that due to the significant variations in a number of areas both within and among different jurisdictions, regulators must have the ability to weigh all of the relevant considerations, including those identified in the Consultative Document, and determine what action is appropriate on that basis.

The policy tools proposed for “management of client cash pools with features that make them susceptible to runs” help illustrate why it is crucial to give regulators ample leeway. Some of the proposed regulatory policies might make sense as new protective measures for certain types of pools in some jurisdictions. In other cases, those same regulatory policies may already be in place, may not be permissible under local law, or may not be necessary or appropriate in light of other applicable restrictions or for other reasons.

For example, we understand that in Japan, tax law specifies that regulated ultra short-term bond funds must adhere to restrictions on the maturity of their portfolio assets. In the United States, portfolio asset maturity restrictions do not directly apply to registered funds other than money market funds; however, the “fund name” rule requires that a fund that includes “ultra short bond fund” or similar terms in its name would have to invest at least 80 percent of the value of its assets in a manner consistent with that name.<sup>14</sup> Moreover, as discussed earlier in this letter, the current regulatory scheme addresses the risks posed by registered funds (including ultra short-term bond funds) in a multitude of other ways. Limits on leverage, for example, constrain the risks a U.S. registered fund might pose to the financial markets broadly. Such limits are appropriately included on the list of policy tools for regulators to consider.

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<sup>12</sup> Consultative Document at 4 (emphasis added).

<sup>13</sup> *Id.*

<sup>14</sup> See Rule 35d-1 under the Investment Company Act.

Another important factor that regulators need to be able to take into account is the extent to which a proposed policy tool would be permitted by law in a given jurisdiction. For example, the proposed tools for managing redemption pressures in stressed market conditions include suspension of redemptions. In the United States, regulated funds that issue redeemable securities are only permitted to suspend redemptions in extremely limited circumstances.<sup>15</sup> Although the Consultative Document describes suspension of redemptions as an “exceptional measure,” it ignores the fact that such action may be prohibited by applicable law. In fact, IOSCO has developed principles on suspensions of redemptions in collective investment schemes,<sup>16</sup> which specifically recognize that suspension of redemptions may be justified only if permitted by law.<sup>17</sup> Any final version of the FSB’s proposed recommendations should make specific reference to the need for regulators to consider whether a given policy tool would be consistent with law in their jurisdiction.

In conclusion, ICI and ICI Global strongly urge that any final FSB recommendations reflect clearly the FSB’s intent to provide flexibility to regulatory authorities to utilize the proposed policy tools as they deem appropriate in their particular circumstances.<sup>18</sup>

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<sup>15</sup> See Section 22(e) of the Investment Company Act; see also Letter from Susan M. Olson, Senior Counsel – International Affairs, Investment Company Institute, to Mr. Mohamed Ben-Salem, International Organization of Securities Commissions (“IOSCO”), dated May 27, 2011 (commenting on IOSCO’s consultation report, *Principles on Suspensions of Redemptions in Collective Investment Schemes*), available at <http://www.ici.org/pdf/25243.pdf>.

<sup>16</sup> IOSCO, *Principles on Suspensions of Redemptions in Collective Investment Schemes*, Final Report, Technical Committee of the International Organization of Securities Commissions (January 2012), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD367.pdf>.

<sup>17</sup> *Id.* at 11 (Principle 4).

<sup>18</sup> Our proposed change to Principle 4, noted on p. 5 above, would help accomplish this goal.

Secretariat of the Financial Stability Board

January 14, 2013

Page 8

We thank you for this opportunity to share our views. If we or our members can be of further assistance as you consider this important matter, please do not hesitate to contact the undersigned.

Sincerely,

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