INVESTMENT COMPANY INSTITUTE

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October 22, 2012

Thomas J. Curry
Comptroller of the Currency
Office of the Comptroller of the Currency
250 E Street SW
Washington, D.C. 20219

Jennifer J. Johnson
Secretary of the Board
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, D.C. 20551

Robert E. Feldman
Executive Secretary
Federal Deposit Insurance Corporation
550 17th Street NW
Washington, D.C. 20429

Re: Basel III Capital Proposals

Dear Mr. Curry, Ms. Johnson, and Mr. Feldman:

The Investment Company Institute ("ICI")[1] appreciates the opportunity to comment to the Office of the Comptroller of the Currency, the Federal Reserve Board (the "Board") and the Federal Deposit Insurance Corporation (together, the "Agencies") on the three notices of proposed rulemaking

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[1] The Investment Company Institute is the national association of U.S. 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 $13.5 trillion and serve over 90 million shareholders.

("NPRs") to implement the Basel III capital accords in the United States.[2] ICI's comments focus on (i) the removal of the 7 percent risk-weighting option for equity exposures to money market funds under the Advanced Approaches NPR, (ii) the suggestion that this removal would subject money market fund exposures to a 20 percent risk-weight floor; (iii) the look-through approaches under the Standardized and Advanced Approach NPRs and, in particular, their application to investments in money market funds; and (iv) the proposed deduction for investments in unconsolidated financial institutions. Each of these issues is discussed below.

The 7 Percent Risk Weighting for Money Market Funds Should Be Retained

Section 54(e) of the Agencies' existing advanced approaches rules allows banking organizations to apply a 7 percent risk weight to equity exposures to money market funds that are subject to Rule 2a-7 under the Investment Company Act of 1940 and that have an external rating in the highest investment grade category. The Advanced Approaches NPR proposes to eliminate the 7 percent risk weighting, positing that money market funds demonstrated "at times, elevated credit risk" during the recent financial crisis.

ICI strongly disagrees with the Agencies' proposal to eliminate the 7 percent risk weighting option for money market fund exposures and questions the scant rationale provided by the Agencies for doing so. In 2007, the Agencies adopted the 7 percent risk weighting for money market funds in express recognition of the "low risk" posed by such funds, which the Agencies acknowledged are subject to Rule 2a-7's "portfolio maturity, quality, diversification and liquidity" requirements.[3] In ICI's view, this rationale continues to apply, and the Agencies have provided no data demonstrating to the contrary.

Rather, in the wake of the financial crisis, which affected not only money market funds but most other financial services industry participants, the Securities and Exchange Commission ("SEC") took steps to enhance significantly the stability and resiliency of money market funds. Specifically, in 2010, the SEC revised Rule 2a-7 to make money market funds more resilient by, among other things, imposing new credit quality, maturity, and liquidity standards, and increasing the transparency of these funds, as well as requiring the funds to conduct extensive stress tests. In the SEC's words, these changes

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[2] Regulatory Capital Rules: Regulatory Capital, Implementation of Basel III, Minimum Regulatory Capital Ratios, Capital Adequacy, Transition Provisions, and Prompt Corrective Action, 77 Fed. Reg. 52,792 (Aug. 30, 2012) ("Basel III NPR"); Regulatory Capital Rules: Standardized Approach for Risk-Weighted Assets; Market Discipline and Disclosure Requirements; 77 Fed. Reg. 52,888 (Aug. 30, 2012) ("Standardized Approach NPR"); Regulatory Capital Rules: Advanced Approaches Risk-Based Capital Rule; Market Risk Capital Rule; 77 Fed. Reg. 52,978 (Aug. 30, 2012) ("Advanced Approaches NPR").

[3] 72 Fed. Reg. 69,288, 69,382 (2007).

have made money market funds even more "consistent with the objectives of preserving principal and maintaining liquidity."[4]

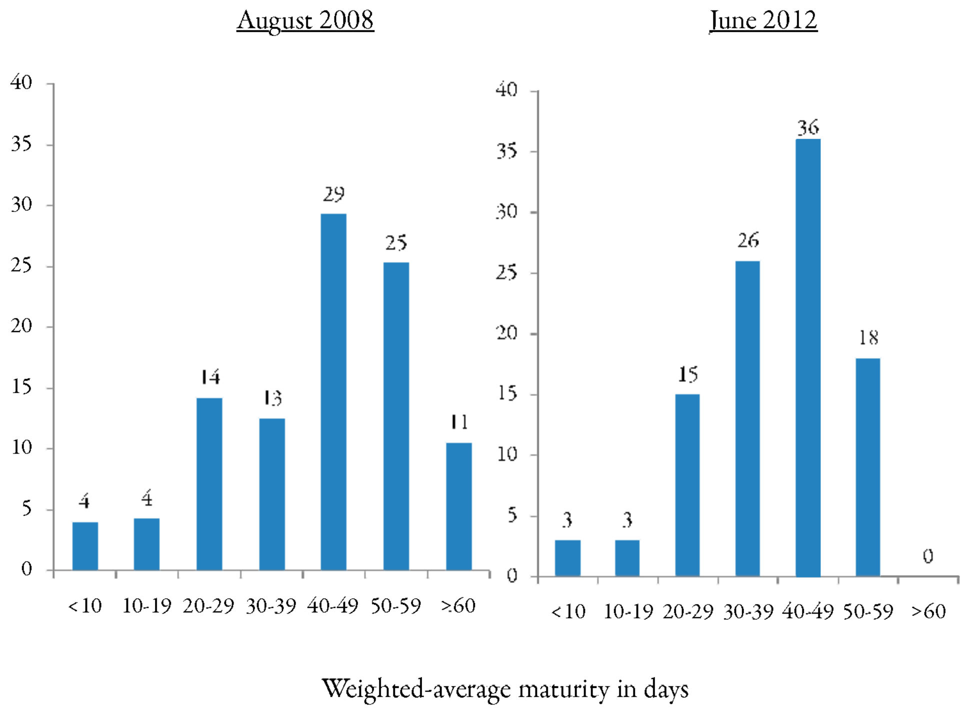
With respect to the objective of preserving principal, the SEC has raised credit standards and shortened the maturity of money market funds' portfolios—further reducing credit and interest rate risk. For example, the maximum dollar-weighted average maturity ("WAM") permitted by Rule 2a-7 was reduced from 90 days to 60 days, which has substantially lowered the average maturity of taxable money market funds (Figure 1). Preventing funds from holding a portfolio with a WAM in excess of 60 days also has reduced "tail risk"; this is seen in Figure 1 as a cutting off of the right-hand tail of the distribution of WAMs across taxable money market funds. This restriction has made money market funds more resilient to changes in interest rates that may accompany significant market shocks, and puts money market funds in a far better position to meet shareholder redemptions.

[4] 75 Fed. Reg. 10,060 (2010).

Figure 1

WAMs for Taxable Money Market Funds

Percentage of funds



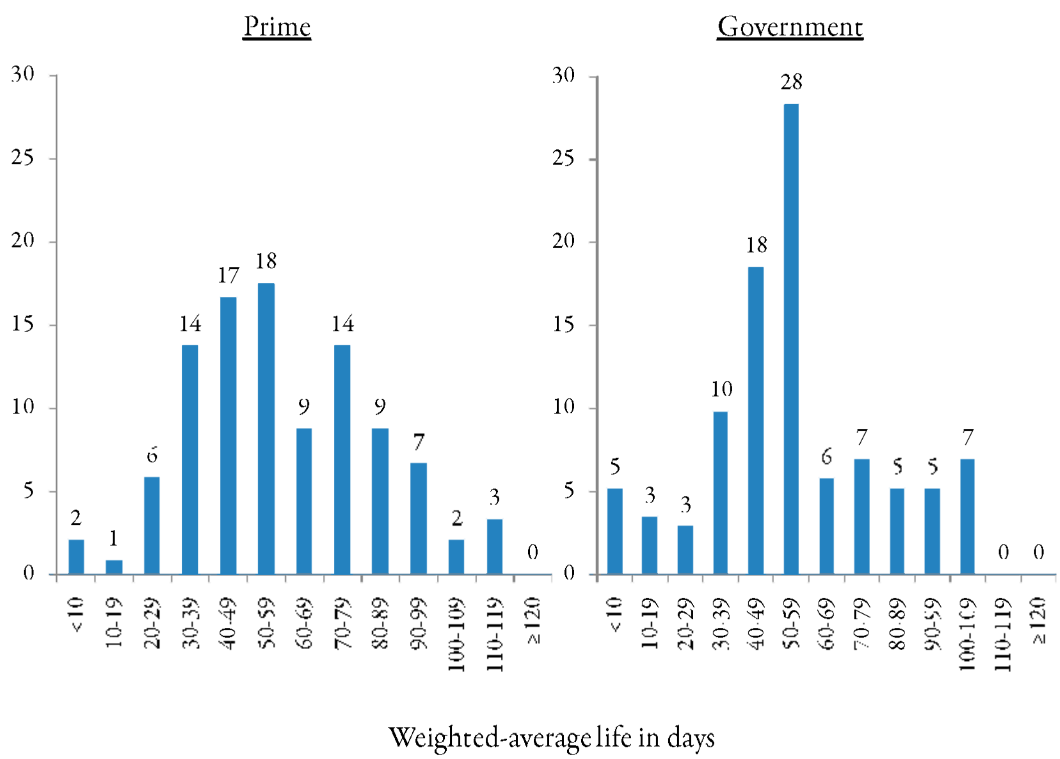
Source: Investment Company Institute tabulation of SEC Form N-MFP data

The introduction of a limit on money market funds' weighted average life ("WAL") also has strengthened the ability of money market funds to withstand shocks and meet redemption pressures. Unlike a fund's WAM calculation, the WAL of a portfolio is measured without reference to interest rate reset dates. The WAL limitation—currently a maximum of 120 days—thus restricts the extent to which a money market fund can invest in longer term adjustable-rate securities that may expose a fund to spread risk. Although data on WALs before November 2010 are not publicly available, publicly available data since then suggest that the new WAL requirement likely has bolstered the resilience of funds. Figure 2 depicts the distribution of WALs for taxable money market funds as of June 2012. Most funds are well below the 120-day maximum, with the great majority having WALs in the range of 30 to 90 days. Only a very small proportion of funds have WALs in excess of 100 days.

Figure 2

WALs for Taxable Money Market Funds

Percentage of funds, June 2012



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

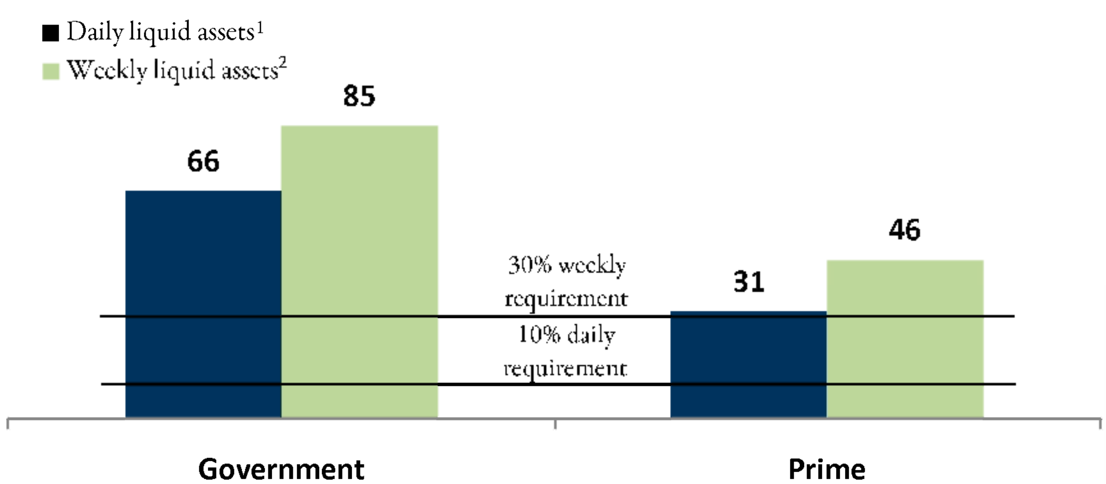
With respect to maintaining liquidity, the 2010 amendments directly and meaningfully addressed the liquidity challenge faced by many money market funds during the financial crisis by imposing for the first time explicit daily and weekly liquidity requirements. Under the new requirements, money market funds must maintain a sufficient degree of portfolio liquidity to meet reasonably foreseeable redemption requests. In addition, at a minimum, all taxable money market funds must maintain at least 10 percent of assets in daily liquid assets, and all money market funds must maintain at least 30 percent of assets in weekly liquid assets. The daily and weekly minimum liquidity requirements are measured at purchase. Thus, if a money market fund's holdings of daily liquid assets or weekly liquid assets fall below 10 percent or 30 percent of total assets, respectively, due to shareholder redemptions or redemptions in combination with changes in the value of portfolio securities, that will not violate these minimum requirements. Rather, Rule 2a-7 forbids the fund from acquiring anything other than a daily liquid asset or weekly liquid asset if, immediately after the acquisition, the fund would have invested less than 10 percent or 30 percent (as applicable) of total assets in daily liquid assets or weekly liquid assets. The purchase by the fund of assets other than daily liquid assets or weekly liquid assets would trigger a violation.

Indeed, the new minimum liquidity requirements have had a transformative effect on money market funds. As Figure 3 shows, as of June 2012, funds exceeded the minimum daily and weekly liquidity requirements by a considerable margin. For example, 31 percent of the assets of prime money market funds were in daily liquid assets and 46 percent of their assets were in weekly liquid assets. In dollar terms, taxable money market funds now hold an estimated $1.38 trillion in daily or weekly liquid assets, which includes an estimated $629 billion held by prime money market funds. In comparison, during the business week September 15, 2008 to September 19, 2008 (the week Lehman Brothers failed), prime money market funds experienced estimated outflows of $310 billion. Accordingly, in June 2012, prime money market funds held daily and weekly liquid assets equal to more than twice the level of outflows they experienced during the worst week in money market fund history.

Figure 3

Liquid Assets for Taxable Money Market Funds

Percentage of total assets, June 2012



[1]Daily liquid assets include securities with a remaining maturity of one business day, and Treasury securities with a remaining maturity of 397 days or less.

[2]Weekly liquid assets include securities with a remaining maturity of five business days or less, and Treasury securities with a remaining maturity of 397 days or less.

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

The amendments also require funds, as part of their overall liquidity management responsibilities, to have "know your investor" procedures to help fund advisers anticipate the potential for heavy redemptions and adjust their funds' liquidity accordingly and to have procedures for periodic stress testing of their funds' ability to maintain a stable net asset value. The stress tests, results of which must be reported to the funds' board of directors, quantify the changes in interest rates, spreads, credit ratings, and redemptions that could cause a money market fund no longer to maintain a stable share price. The stress tests improve the directors' ability to oversee and manage the risks taken by their funds.

The 2010 amendments also increased the transparency of money market funds by requiring them to provide updated portfolio information on their websites within 5 business days from month end. In addition, each month funds must file with the SEC new Form N-MFP, which contains detailed information (including mark-to-market prices) about the fund and its portfolio. The information provided in Form N-MFP becomes publicly available 60 days after the end of the month covered by the report.

Finally, the SEC adopted new Rule 22e-3, which allows the board of directors of a liquidating fund to suspend redemptions. This rule will help assure a fair and orderly resolution of any fund that can no longer maintain a stable net asset value. Shareholders in a liquidating fund will receive pro rata distributions of cash as rapidly as the portfolio can be liquidated. Even in adverse market conditions, this should not be an extended period, given the limitations on a fund's WAM and WAL and the required levels of daily and weekly liquid assets.

All of the foregoing requirements are already in effect, and the cumulative effect of these reforms has been to improve meaningfully the safety and liquidity of money market funds, making money market funds even more appropriate for investment by banks.

Notwithstanding these significant and important regulatory changes to money market funds, the Agencies do not acknowledge the changes or explain why the SEC's enhanced regulatory framework for money market funds is insufficient to address any concerns that the Agencies may have. In the absence of any such explanation, ICI believes that the Agencies' elimination of the 7 percent risk weighting for money market fund exposures is arbitrary, capricious, and unduly severe.

A 20 Percent Floor for Money Market Funds is Unnecessary and Arbitrary

The Advanced Approaches NPR states that, "[a]s a result of the proposed changes," the risk weight for equity exposures to money market funds would be "subject to a 20 percent floor."[5] The

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[5] 77 Fed. Reg. at 52,989.

Advanced Approaches NPR does not provide any explanation for why a 20 percent floor would apply. Moreover, the text of Proposed Rule Section 154 (in the Advanced Approaches NPR) does not include a 20 percent floor for money market fund exposures.

The reference in the Advanced Approaches NPR to a 20 percent floor applying to money market funds thus is confusing and merits clarification. As the Agencies well know, the current advanced approaches do not provide for a 20 percent floor for money market fund exposures, and the proposed elimination of the 7 percent risk weight for money market funds would not, by itself, result in the application of a 20 percent floor. We suspect, therefore, that the reference to a 20 percent floor was a drafting error, and we request that the Agencies clarify this point.

If that is not the case however, ICI respectfully submits that it is inappropriate to adopt a 20 percent floor exclusively for money market funds—and not for other fund vehicles. No rationale for doing so is offered and, respectfully, none is available. Indeed, it seems illogical to subject money market funds, which are extensively regulated, to a 20 percent risk-weighting floor but to allow other less regulated pooled investment vehicles (including other funds that invest in highly liquid assets but are not subject to Rule 2a-7) to receive a potentially more favorable risk weighting under one of the look-through approaches proposed by the Agencies.

A 20 percent floor for money market funds also could impose a capital "penalty" when the money market fund's underlying exposures would be risk-weighted at less than 20 percent if held directly by a banking organization. For example, bank investments in a money market fund that invests entirely in U.S. Treasuries would be subject to a 20 percent floor, but, in contrast, the bank could hold these Treasury securities directly and avoid any capital charge because the risk weight for Treasury securities is zero. Moreover, this disparate treatment would apply even if the bank held long-term Treasury securities, which are subject to greater interest rate risk than money market funds.[6] This result is unnecessary and makes no sense.

[6] Treasury-only money market funds, like all money market funds, must hold a weighted average portfolio maturity of 60 days or less, which limits interest rate risk.

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The proposed treatment of money market funds may reflect a concern that redemptions by other shareholders could impair the liquidity of shares held by banks. This concern fails to take into account, however, Rule 2a-7's new requirement that money market funds maintain sufficient liquidity to meet anticipated redemptions, including minimum daily and weekly liquid assets comprising nearly a third of the portfolio.

For all of these reasons, we recommend that the Agencies clarify that the risk weight for equity exposures to money market funds will not be subject to a 20 percent floor.

The Look-Through Approaches Are Useful but Must Be Made Workable for Money Market Fund and Other Investment Fund Exposures

Under both the Standardized and Advanced Approaches NPRs, equity exposures to investment funds would be risk-weighted according to the Full, Simple Modified, or Alternative Modified Look-Through Approaches (collectively, the "Look-Through Approaches"). These approaches essentially allow banking organizations to calculate risk weightings based on the underlying assets of, or permissible investments of, the investment funds in which the banking organizations invest.

ICI supports the use of the Look-Through Approaches but urges the Agencies to ensure that banking organizations are able to utilize fully the Full Look-Through Approach. In particular, because the Full Look-Through Approach appears to require that a banking organization have extensive information about a fund's underlying investments on a "real-time" basis, any constraint on a banking organization's ability to access such information may prevent it from using this approach and may result in a less favorable capital calculation. This may be a practical issue for banking organization investments in money market funds. As noted above, money market funds publicly disclose certain portfolio holdings information on their websites within 5 business days from month end, and more detailed information (including mark-to market prices) through Form N-MFP 60 days after month end.

To address this timing issue, a banking organization should be permitted to apply the Full Look-Through Approach to its money market fund investments in reliance on such funds' most recent public disclosures. Given the limitations of Rule 2a-7, the risk profile of money market funds will not change materially over any 35 day (or even a 60-day) period. Accordingly, banking organizations' use of public money market fund disclosures to conduct Full Look-Through analyses should not raise supervisory or safety and soundness concerns.

The Proposed Deduction for Investments in Unconsolidated Financial Institutions is Too Broad

The Basel III NPR would require banking organizations to deduct from capital investments in unconsolidated financial institutions. As originally contemplated by the Basel Committee, the deduction was intended to limit double counting of capital among banking organizations, and to account for the potential systemic risks arising out of interconnectedness between financial institutions. But the Agencies' proposed definition of "financial institution" is so broad that it would inappropriately sweep in many non-bank companies and activities that do not present such risks.

To avoid this result, the Agencies should narrow the proposed definition of "financial institution." At a minimum, the Agencies should clarify that neither registered investment companies ("registered funds"), nor investment advisers to registered funds, are captured. The Agencies have presented no data—and we are aware of none—indicating that banking organization investments in registered funds (or their investment advisers) pose any interconnectedness risks or threat to financial stability. Registered funds and their investment advisers are subject to extensive regulatory requirements that not only protect all fund investors, including banking organization investors, but also limit potential risks to the financial system.[7] In addition, the NPRs' increased risk-weights for equity exposures, including exposures from banking organization investments in registered funds, make a separate capital deduction unnecessary. For example, under the Look-Through Approaches, a banking organization's investment in a registered fund that holds publicly traded equities would be assigned a 300 percent risk-weight, a 200 percent increase from the current rules. In sum, ICI does not believe it is appropriate or necessary to apply the proposed deduction to banking organization investments in registered funds or their investment advisers.

ICI therefore recommends that the Agencies exclude both registered funds and their investment advisers from the definition of "financial institution" for purposes of the proposed deduction for unconsolidated investments. To address the status of registered funds' investment advisers, the Agencies should clarify that the phrase "investment or financial advisory activities"—which is used to describe asset management activities that would *not* bring a company within the definition of "financial institution"[8]—includes any financial and investment advisory activities

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[7] *See, e.g.,* Letters from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council (Nov. 5, 2010 and Feb. 25, 2011), available at http://www.ici.org/pdf/24696.pdf and http://www.ici.org/pdf/24994.pdf, respectively.

[8] The proposed definition of "financial institution" includes any company that is predominantly engaged in "asset management activities (not including investment or financial advisory activities)."

permissible for a bank holding company under Regulation Y, including advising registered funds.[9] Interpreting the phrase in this manner not only will eliminate ambiguity, but also will ensure that banking organization investments in investment advisers to registered funds—which investments have not been shown to pose any interconnectedness risks—are not inappropriately required to be deducted from capital.

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We thank the Agencies for considering our comments. If you have any questions regarding this letter, please feel free to contact me directly at (202) 326-5815 or Jane Heinrichs, Senior Associate Counsel, at (202) 371-5410.

Sincerely,

/s/ Karrie McMillan

Karrie McMillan
General Counsel

[9] *See* 12 C.F.R. 225.28(b)(6) (financial and investment advisory activities permissible for bank holding companies); *id.* 225.28(b)(6)(i) (permitting bank holding companies and their affiliates to serve as investment advisers to registered funds).