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Via email to [markt-consultation-shadow-banking@ec.europa.eu](mailto:markt-consultation-shadow-banking@ec.europa.eu)

European Commission  
BERL 10/034  
B-1049 Brussels

RE: European Commission Green Paper on Shadow Banking

Dear Sir/Madam,

The Investment Company Institute (the “Institute”)<sup>1</sup> appreciates the opportunity to submit comments on the European Commission’s Green Paper on Shadow Banking (“Green Paper”).<sup>2</sup> We recognize the strong commitment of the European Union to advancing reforms in support of G20 commitments. We also are supportive of global efforts, including the efforts of national regulators and international regulatory organizations, to consider whether additional or different regulatory measures for non-bank financial intermediaries may be important to strengthening the global financial system.

In the Green Paper, the European Commission (“Commission”) states that its objective is to actively respond and further contribute to the global debate, continue to increase the resilience of the European Union’s financial system and ensure financial activities are contributing to economic growth. The purpose of the Green Paper is to take stock of current developments and to present on-going reflections on the topics to allow for a wide-ranging consultation.<sup>3</sup> As an active participant in discussions and consultations on these topics by international regulatory organizations and national authorities, we hope that the insights that we have previously offered to policymakers will assist the Commission as it seeks to examine these important issues in detail.

As a preliminary matter, we believe that the terms “shadow banks” and “shadow banking” are inherently inaccurate and misleading, connoting that activities so labeled lack both transparency and any regular or official status. Such is not the case. As a Staff Report of the Federal Reserve Bank of New

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds, and unit investment trusts. The Institute 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 the Institute manage total assets of \$13.4 trillion and serve over 90 million shareholders.

<sup>2</sup> European Commission, Green Paper Shadow Banking, COM(2012) 102 Final (March 19, 2102), available at [http://ec.europa.eu/internal\\_market/bank/docs/shadow/green-paper\\_en.pdf](http://ec.europa.eu/internal_market/bank/docs/shadow/green-paper_en.pdf).

<sup>3</sup> Green Paper at 2.

York observes, “the label ‘shadow banking system’ . . . is an incorrect and perhaps pejorative name for such a large and important part of the financial system.”<sup>4</sup> We urge policymakers to use more precise and neutral terminology when discussing the various roles of non-bank financial intermediaries. These entities play a variety of important roles in global and national financial systems. These roles may share some similarities with the role that banks play—but there are also critical differences and those differences should be respected.

#### Credit Intermediation Outside the Banking System (Questions in Sections 3-6)

With respect to your questions concerning a definition of non-bank credit intermediation, the risks and benefits as well as the challenges for authorities regarding oversight and regulatory approaches, we refer you to the comment letter that the Institute submitted to the Financial Stability Board (“FSB”)<sup>5</sup> on its background note, *Shadow Banking: Scoping the Issues*, published in April 2011 (“FSB Note”).<sup>6</sup> In that letter we outlined our concerns with the FSB’s definition, which definition the Commission has referenced in its Green Paper. In our letter to the FSB, we urged policymakers to acknowledge and respect the differences that exist between banking and securities and their respective regulatory frameworks.

For the United States, we noted that banks and the capital markets have existed alongside one another for centuries, with parallel bodies of regulation and oversight that have arisen to address specific financial and investor risks associated with each type of credit intermediation. We explained that bank-like regulation was not appropriate, necessary or workable for funds registered under the Investment Company Act of 1940 (“Investment Company Act”). Rather, we stated that, as the FSB Note suggests, a regulatory response “should be carefully balanced and targeted to the risks the system creates, taking into account the expected costs and benefits of potential policy interventions in a comprehensive way and using appropriate criteria on which to judge their efficacy.”<sup>7</sup>

We urged the FSB to reevaluate the “universal bank” framework, and carefully consider the long history of parallel systems for intermediation that capital markets and banks provide as well as the extensive regulatory framework applicable to funds registered under the Investment Company Act.<sup>8</sup> We

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<sup>4</sup> See “Shadow Banking,” Federal Reserve Bank of New York, Staff Report No. 458 (July 2010).

<sup>5</sup> Letter from Paul Schott Stevens, President and CEO of the Investment Company Institute to the Secretariat of the Financial Stability Board, June 3, 2011, available at <http://www.ici.org/pdf/25258.pdf>.

<sup>6</sup> Financial Stability Board, *Shadow Banking: Scoping the Issues*, April 11, 2011, available at [http://www.financialstabilityboard.org/publications/r\\_110412a.pdf](http://www.financialstabilityboard.org/publications/r_110412a.pdf).

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

<sup>8</sup> The letter includes an appendix describing the history in the United States of the successful co-existence of the banking and securities industries, as well as the origins of the Investment Company Act, the provisions of which provide detailed and substantive regulation of mutual funds and other U.S. registered investment companies. In

similarly urge the Commission to proceed cautiously and ensure that any responses be carefully balanced and targeted, taking account of the unique features of existing regulatory frameworks that govern capital markets activities, including for investment funds, fund managers and securities markets.

#### Outstanding Issues – Asset Management Regulation (Questions in Section 7.2)

The Green Paper states that the Commission is looking at both exchange traded funds (“ETFs”) and money market funds in its examination of non-bank financial intermediation. The Commission’s work is informed by how the FSB has framed issues regarding ETFs and money market funds. The Green Paper also acknowledges the current work of the European Securities and Markets Authority (“ESMA”) on ETFs and the UCITS framework. New guidelines related to money market funds also were recently introduced in Europe.

With respect to modifications to the existing European framework for ETFs and money market funds, we urge the Commission to spend time evaluating reforms that have already been implemented or may soon be implemented. It is vital that policymakers consider both the costs and the benefits of reforms. Such work is essential to the consideration of any new measures.

#### ETFs

On ETFs, the Green Paper refers to the FSB’s identification of issues as well as topics in the current regulatory debate related to liquidity, conflicts, swap transactions and securities lending. We refer the Commission to three recent letters that the Institute submitted to the FSB and ESMA regarding ETFs.

In response to the FSB’s April 2011 note on ETFs, *Potential Financial Stability Issues Arising from Recent Trends in Exchange-Traded Funds*, the Institute submitted a comment letter. In the letter, we addressed the issues raised by the FSB and described the U.S. laws applicable to ETFs as investment companies registered under the Investment Company Act (“U.S. ETFs”), including requirements

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another appendix we describe our deep concerns with the description of “shadow banking” and credit intermediation, describing how capital markets and entities that operate in them provide credit intermediation in a manner that is quite different from banks. Lastly, we include an appendix describing the Investment Company Act, including the specific rules applicable to money market funds. This appendix is intended to explain how the existing regulatory structure addresses risks that otherwise could arise from mutual funds. The extensive regulatory framework applicable to mutual funds, although different from bank regulation, is stringent and robust. Mutual funds are fundamentally different from banks; they issue securities, and they are carefully limited by the Investment Company Act as to their ability to use leverage. Mutual funds are also highly transparent, are subject to strict limitations on transactions with affiliates, and have strong governance features, including oversight by independent directors.

regarding conflicts, liquidity and securities lending.<sup>9</sup> We described robust regulatory requirements applicable to U.S. ETFs that mitigated concerns raised by the FSB.

The Institute also submitted comment letters to ESMA in response to ESMA's two recent consultations related to UCITS ETFs in July 2011 and January 2012.<sup>10</sup> We support policymaker efforts to improve the understanding of the potential risks inherent in financial products and support ESMA's goals to improve secondary market investors' understanding of their status and rights with respect to purchasing and selling shares of UCITS ETFs, as well as efforts to seek ways to strengthen the ability of such investors to sell their shares. We do not support proposals to allow secondary market investors to redeem their UCITS ETF shares at any time during a day. We do not understand how an ETF could operate from a management or operational perspective if it provided investors with the ability to buy and sell shares intra-day on the market, as well as the ability to redeem single shares at the end of each business day directly from the ETF.

### Money Market Funds

The Green Paper generally states that the main concerns identified by the FSB for money market funds relate to risks of runs due to credit and liquidity risks as well as valuation. In April, the Technical Committee of International Organization of Securities Commissions ("IOSCO") issued a consultation report, *Money Market Fund Systemic Risk Analysis and Reform Options* ("IOSCO MMF Report").<sup>11</sup> The Institute submitted a comment letter on the IOSCO MMF Report ("MMF Letter").<sup>12</sup> Our MMF Letter addresses the issues raised in the Green Paper and by the FSB.

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<sup>9</sup> Letter from Karrie McMillan, General Counsel of the Investment Company Institute to the Secretariat of the FSB, May 16, 2011, available at <http://www.ici.org/pdf/25189.pdf>.

<sup>10</sup> See Letter from Karrie McMillan, General Counsel, to Steven Maijoor, Chair, ESMA, September 30, 2011, available at <http://www.ici.org/pdf/25540.pdf> (supporting certain disclosure proposals for UCITS ETFs and raising questions regarding possible changes to the redemption policies of UCITS ETFs) and Letter from Karrie McMillan, General Counsel, to Steven Maijoor, Chair, ESMA, March 30, 2012, available at <http://www.ici.org/pdf/26012.pdf> (expressing strong concerns regarding proposed guidelines related to either (i) a requirement for a fund or its management company to ensure investors can sell their shares whenever the market is open by requiring the fund or its management company to ensure market makers continue to transact, take action to replace market makers if they fail to do so or make arrangements so shares can be sold back to the fund or the management company; or (ii) require UCITS ETFs to accept redemptions directly from secondary market investors at any time).

<sup>11</sup> *Money Market Fund Systemic Risk Analysis and Reform Options*, CR07/12, Technical Committee of IOSCO (April 27, 2012), available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD379.pdf>.

<sup>12</sup> Letter from Karrie McMillan, General Counsel, to Mr. Mohamed Ben Salem, General Secretariat, IOSCO, May 25, 2012, available at [http://www.ici.org/pdf/12\\_iosco\\_mmf\\_com\\_ltr.pdf](http://www.ici.org/pdf/12_iosco_mmf_com_ltr.pdf).

Based on our experience in the United States, we disagree with policymakers' suggestion that the financial crisis of 2007-2008 highlighted that U.S. money market funds<sup>13</sup> are particularly "susceptible" to runs. The highly unusual events during the 2007-2008 time period, compared to the only other time a U.S. money market fund failed to return a full \$1.00 per share (or "broke a dollar"), illustrate the importance of context. How investors react in the very rare event that a money market fund is unable to return a full \$1.00 per share depends, in our judgment, entirely on the events that precede and surround that occurrence. Section I of our MMF Letter further describes our views. The IOSCO MMF Report itself also describes how financial turmoil in 2007 and 2008 impacted money market funds differently in different countries.<sup>14</sup>

As importantly, Section II describes how amendments in 2010 to the rules applicable to U.S. money market funds have made these U.S. funds even more liquid, transparent and stable than ever before. Europe, too, has enacted new rules relating to money market funds. We urge the Commission (and IOSCO and the FSB) to avoid falling into the trap of looking at these funds and possible reforms as though it were still 2008, and instead to recognize that in the United States and Europe, money market funds themselves, and the global financial markets, are meaningfully different today.<sup>15</sup>

With regard to the use of amortized cost valuation, we address in Section III.A. of our MMF Letter the reform proposal that would eliminate the ability of money market funds to use amortized cost in an effort to force them to let their shares prices fluctuate or "float." Specifically, we challenge the argument that requiring money market funds to float their NAV, will reduce the tendency of money market funds to experience large redemptions during periods of extreme financial stress. To this end,

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<sup>13</sup> We refer to "U.S. money market funds" as those money market funds that are registered under the Investment Company Act and adhere to the requirements of Rule 2a-7 under the Investment Company Act.

<sup>14</sup> See also Letter from Dan Waters, Managing Director, ICI Global, to Mr. Mohamed Ben Salem, General Secretariat, IOSCO, May 26, 2012, available at <http://www.ici.org/pdf/26205.pdf> (referencing how the IOSCO MMF Report also described different impacts globally to money market funds from financial turmoil in 2007-2009).

<sup>15</sup> Since the onset of the global financial crisis, the G20 has established core elements of a new global financial regulatory framework that are intended to make the financial system more resilient and better able to serve the needs of the global economy. Through the efforts of the FSB, the national authorities and international bodies have further advanced this financial reform program. These include reforms designed to, among other things, improve the soundness of the banking system, address the risks posed by systemically important financial institutions, strengthen the regulation and oversight of non-bank financial intermediation, improve the over-the-counter and commodity derivatives markets, develop "macroprudential" frameworks and tools to identify and monitor systemic risk, strengthen and converge global accounting standards, strengthen adherence to international financial standards, and reduce reliance on credit rating agency ratings. See generally Report of the FSB to G20 Leaders, *Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability* (November 4, 2011), available at [http://www.financialstabilityboard.org/publications/r\\_111104.pdf](http://www.financialstabilityboard.org/publications/r_111104.pdf)

we describe evidence from the United States for products with floating NAVs that suggests regulators' assumption is incorrect. We also describe the following three characteristics of U.S. money market funds that contribute to the stability of their share price: (i) daily declaration of dividends; (ii) very short duration portfolios with minimal credit risk; and (iii) amortized cost with penny rounding. We note that requiring U.S. money market funds to use mark-to-market pricing in lieu of amortized cost pricing would not, under normal circumstances, cause the shares of such funds to float and therefore would not be ultimately helpful in desensitizing investors to daily fluctuations as a way to reduce their tendency to redeem during periods of financial stress. Amortized cost valuation was not a cause of heavy redemptions in money markets funds and its elimination would not have prevented the impacts on money market funds on either side of the Atlantic that occurred during the financial turmoil in 2007 and 2008.

#### Outstanding Issues – Securities Lending and Repurchase Agreements (Questions in Section 7.3)

The Green Paper states that securities lending and repurchase agreements can be used to increase leverage and are a source of funds for some non-bank financial intermediaries. The Commission and the FSB are examining current practices, identifying regulatory gaps and considering inconsistencies among jurisdictions.<sup>16</sup> Issues of interest include collateral management, reinvestment, re-use, transparency and market infrastructure. The Institute recently submitted a comment letter on the **interim report by the FSB's Workstream on Securities Lending and Repos ("SL Report")**.<sup>17</sup> We recommend that the Commission continue to study and consider these issues along with other regulators and policymakers. Work with market participants is essential to ensure unintended consequences are avoided.

As described in our letter on the SL Report, securities lending and repo financing in the United States are subject to a number of regulatory requirements designed to protect investors. We believe that many of these requirements also serve to allay financial stability concerns highlighted in the SL Report. In our letter, we describe the activities of U.S. registered investment companies lending securities and U.S. money market funds participating in repo financing. We also discuss some of the financial stability concerns raised in the SL Report as well as in the Green Paper, including issues related to transparency, collateralization (including valuation of collateral), indemnification, and procyclicality.

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<sup>16</sup> In addition, the U.S. Securities and Exchange Commission ("SEC") also is examining these topics. Section 984 of the Dodd-Frank Wall Street Reform and Consumer Protection Act requires the SEC to adopt rules designed to increase the transparency of information available to brokers, dealers, and investors with respect to securities lending. The SEC has not yet issued a rule proposal.

<sup>17</sup> Letter from Robert C. Grohowski, Senior Counsel, to the Secretariat of the FSB, May 25, 2012, available at <http://www.ici.org/pdf/26196.pdf>.

On repos, we describe recent work in the United States related to tri-party repos, including a white paper on tri-party repo by the Federal Reserve Bank of New York that provides a comprehensive description of the U.S. repo market.<sup>18</sup> We also describe additional work by a special Task Force on Tri-Party Repo Infrastructure (the “Task Force”), which was formed in September 2009 under the auspices of the Payments Risk Committee, a private sector body sponsored by the Federal Reserve Bank of New York. In February, the Task Force concluded its work, highlighting a number of areas in which significant progress was made to meaningfully reduce both the potential for systemic risk and the magnitude of the risk associated with the U.S. tri-party repo infrastructure.<sup>19</sup>

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We appreciate your consideration of our comments on the issues raised in the Green Paper. If you have any questions or need additional information, please contact me at + 1-202-326-5815, or Susan Olson, Senior Counsel – International Affairs (+1-202 326 5813).

Sincerely,

/s/ Karrie McMillan

Karrie McMillan  
General Counsel

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<sup>18</sup> *Tri-Party Repo Infrastructure Reform*, A White Paper Prepared by the Federal Reserve Bank of New York, May 17, 2010, available at [http://www.newyorkfed.org/banking/nyfrb\\_triparty\\_whitepaper.pdf](http://www.newyorkfed.org/banking/nyfrb_triparty_whitepaper.pdf).

<sup>19</sup> Task Force on Tri-Party Repo Infrastructure, Payments Risk Committee, Final Report (February 15, 2012), available at [http://www.newyorkfed.org/tripartyrepo/pdf/report\\_120215.pdf](http://www.newyorkfed.org/tripartyrepo/pdf/report_120215.pdf).