



1401 H Street, NW, Washington, DC 20005-2148, USA
202-326-5800 www.ici.org

January 17, 2017

Federal Reserve Bank of Minneapolis
90 Hennepin Avenue
Minneapolis, MN 55401

Re: The Minneapolis Plan to End Too Big to Fail

Dear Sir or Madam:

The Investment Company Institute¹ appreciates the opportunity to comment on the proposal of the Federal Reserve Bank of Minneapolis (“Minneapolis Fed”) entitled “The Minneapolis Plan to End Too Big to Fail” (“Plan”). As both issuers of securities and large investors in financial markets around the globe, ICI members have an abiding interest in policies that promote a strong and resilient financial system. In the wake of the global financial crisis, ICI and its members actively have supported US and global efforts to address abuses and excessive risk taking and to bolster areas of insufficient regulation. We also regularly provide input on policy initiatives that could have significant implications for regulated funds, their investors, and the broader financial markets.

The Plan is not a formal regulatory proposal and, in any event, implementing changes of the nature and magnitude it contemplates would require the enactment of federal legislation (which, in our estimation, is highly unlikely at this time). Nevertheless, even if the Plan stands little chance of becoming law, we feel it is important to dispel mischaracterizations of or misunderstandings concerning regulated funds that could influence future policy initiatives.

¹ The Investment Company Institute (ICI) is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. ICI's members manage total assets of US\$18.4 trillion in the United States, serving more than 95 million US shareholders, and US\$1.6 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

In this letter, we focus on the Plan’s proposed tax on certain mutual funds and money market funds.² We explain why such a tax would be wholly inappropriate and would not advance the Plan’s policy goals.³

Background and Summary of Comments

Contending that existing law and regulation do not go far enough, the Plan proposes a new approach to minimize the risk of failure for very large banks and associated spillover effects to financial markets, the overall economy and American taxpayers. The Plan calls for high capital requirements—23.5% of risk-weighted assets—on the largest bank holding companies, those with assets of at least \$250 billion (“covered banks”). Such requirements, according to the Plan, would incentivize a covered bank to restructure to an extent that the US Treasury Secretary would certify that the covered bank is no longer systemically important. Covered banks not receiving such certification would be subject to a further “systemic risk charge,” designed to bring their total capital up to a maximum of 38% over time.

The Plan also seeks to “prevent future [too big to fail] problems in the shadow financial sector” on the assumption that higher capital requirements for covered banks will encourage the movement of “banking activity” to “less-regulated firms that are not subject to such stringent capital requirements.” It proposes to reduce the incentive for such movement, and to “equalize funding costs,” by applying a “leverage tax” to “shadow banks” with assets of at least \$50 billion.⁴ The Plan characterizes a widely diverse group of nonbank financial institutions—including mutual funds and money market funds—as lightly regulated or unregulated “shadow banks.”

We begin by explaining why mutual funds and money market funds do not present “too big to fail” concerns. These funds do not engage in “banking activity,” nor do they “fail” as banks do. Next, we briefly discuss why taxing the largest mutual funds and money market funds, as the Plan envisions, would not bring greater stability to the financial system. Instead, such a tax would only serve to harm American taxpayers who invest in regulated funds. For all of these reasons, any proposed “shadow bank” tax should not apply to regulated funds. In addition, we strongly recommend that the Minneapolis Fed make all comments on the Plan publicly available in their entirety.

² A money market fund is a type of mutual fund that adheres to strict risk-limiting conditions set forth in Rule 2a-7 under the Investment Company Act of 1940. In this letter, we use the term “mutual fund” to refer to those mutual funds investing primarily in stocks and bonds. We use the term “regulated funds” to refer collectively to money market funds and mutual funds.

³ Our letter does not offer an opinion on the merits of the Plan or its implications for banks or for nonbank financial institutions other than regulated funds.

⁴ All so-called shadow banks would pay a 2.2% tax on their borrowings, unless the Treasury Secretary certifies that a particular institution does not pose systemic risk (in which case the institution would pay a lower tax rate of 1.2%).

Mutual Funds and Money Market Funds Do Not Present “Too Big To Fail” Concerns

As a threshold matter, ICI repeatedly has objected to banking regulators’ sweeping mischaracterizations of nonbank financial activity as less visible and less regulated simply because it is not subject to banking regulation.⁵ With regard to regulated funds, these mischaracterizations are particularly egregious. These funds are highly transparent and are the most comprehensively regulated investment product offered in the United States. The regulatory scheme to which they adhere—most notably, the Investment Company Act of 1940 and the rules that implement it—protects the interests of fund investors but also mitigates risk to the broader financial system.⁶ And money market funds must meet strict requirements in addition to those that apply to all regulated funds—requirements that the SEC expanded in recent years through two packages of significant money market fund reforms, one in 2010 and the second in 2014.⁷

Underpinned by this strong regulatory foundation, regulated funds are structured and operate quite differently from banks. They do not engage in “banking activity.” And for this and other reasons, they do not “fail” like banks do. We elaborate on these points below.

Regulated Funds Do Not Engage in “Banking Activity”

Quite simply, it is incorrect to view regulated funds as (less regulated) substitutes for banks. Chief among these reasons are that, in contrast with banks:

- Regulated funds operate for a singular purpose—to invest pooled investor dollars to meet a specified investment objective

⁵ See, e.g., Letter to the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated June 3, 2011 (responding to an FSB background note entitled *Shadow Banking: Scoping the Issues*); Statement of Paul Schott Stevens, President & CEO, ICI, before the Committee on Financial Services, US House of Representatives, Subcommittee on Monetary Policy and Trade, on the Financial Stability Board’s Implications for US Growth and Competitiveness (September 27, 2016), available at https://www.ici.org/pdf/16_house_fsc_fsb.pdf, at 4-5.

⁶ See, e.g., Letter to the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated April 7, 2014 (“2014 ICI NBNI G-SIFI Comment Letter”), at Appendix C. This letter, available at https://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf, responded to a 2014 FSB consultation on *Assessment Methodologies for Identifying Non-Bank, Non-Insurer Global Systemically Important Financial Institutions* (“2014 FSB NBNI G-SIFI Consultation”), available at http://www.fsb.org/wp-content/uploads/r_140108.pdf. The SEC recently adopted new requirements to enhance mutual funds’ liquidity risk management. See *infra* note 20.

⁷ See US Securities and Exchange Commission, *Money Market Fund Reform*, Rel. No. IC-29132 (February 23, 2010), available at <https://www.sec.gov/rules/final/2010/ic-29132.pdf>; US Securities and Exchange Commission, *Money Market Fund Reform; Amendments to Form PF*, Rel. No. IC-31166 (July 23, 2014), available at <https://www.sec.gov/rules/final/2014/33-9616.pdf> (collectively, “SEC Money Market Fund Reforms”). A chart summarizing money market fund requirements is available at https://www.ici.org/mmf/latest/16_mmf_reg_summ.

- Investors buy shares of regulated funds; each share represents an investor's part ownership in the fund and the income it generates⁸
- Regulated funds "fund" their asset purchases almost entirely with paid-in capital (equity)⁹ from investors, which means that investors bear any gains or losses
- Regulated funds adhere to limitations on leverage
- Regulated funds invest largely in liquid, tradeable securities¹⁰
- Regulated funds revalue all their assets daily to reflect current market value¹¹
- Regulated funds sell and redeem their shares at prices based on net asset value
- Regulated funds do not engage in credit or risk transformation, because losses are borne by investors
- Regulated funds provide comprehensive, detailed, and recurring disclosure to investors, including to underscore that gains or losses belong to investors on a *pro rata* basis¹²

The Plan derives its list of "shadow banks" from work conducted by the Financial Stability Board ("FSB"). Over the past few years, the FSB has engaged in a lengthy review of the asset management sector—first, in attempting to develop methodologies to identify nonbank, non-insurer

⁸ See US Securities and Exchange Commission, *Mutual Funds and ETFs, A Guide for Investors*, available at <https://investor.gov/system/files/publications/documents/english/mutual-funds.pdf>, at 4.

⁹ In contrast, banks are financed primarily with debt. The term "debt" is well understood to connote "an obligation to repay a specified amount." See Stephen A. Ross and Randolph W. Westerfield, *Corporate Finance*, Times Mirror/Mosby College Publishing, 1988, at 830-831. Debt financing occurs when "a firm [*e.g.*, a bank] raises money for [working capital](#) or [capital expenditures](#) by selling bonds, bills or notes." See "What is Debt Financing," *Investopedia*, at <http://www.investopedia.com/terms/d/debtfinancing.asp>. Regulated funds do not use debt financing—in particular, they issue *equity* interests which involve no obligation to repay a "specified amount" (shares are redeemed at the next-computed net asset value). This includes shares of money market funds. See *infra* note 11.

¹⁰ As discussed further below, the Securities and Exchange Commission ("SEC") recently has enhanced liquidity requirements for portfolio investments of both mutual funds and money market funds. See *infra* note 20 and accompanying text.

¹¹ Money market funds meeting the definition of "retail" money market fund or "government" money market fund are permitted to price and transact in their shares at a stable net asset value, using amortized cost and/or penny-rounding valuation methods, but only so long as the deviation from current market value remains minimal and the fund's board believes the share price represents fairly the market-based net asset value per share of the fund.

¹² For example, money market funds that seek to maintain a stable \$1.00 per share net asset value must include the following statement in advertisements and in the summary section of the statutory prospectus: "You could lose money by investing in the Fund. Although the Fund seeks to preserve the value of your investment at \$1.00 per share, it cannot guarantee it will do so. . . . An investment in the Fund is not insured or guaranteed by the Federal Deposit Insurance Corporation or any other government agency. The Fund's sponsor has no legal obligation to provide financial support to the Fund, and you should not expect that the sponsor will provide financial support to the Fund at any time." See SEC Rule 482(b)(4)(ii) under the Securities Act of 1933 (advertising disclosure requirement); Investment Company Act Form N-1A, Item 4(b)(1)(ii)(B) (prospectus disclosure requirement).

globally systemic important financial institutions (so-called NBNI G-SIFIs) and most recently, in proposing policy recommendations responding to perceived “structural vulnerabilities” in asset management activities. In the course of this work, the FSB has acknowledged distinctions between banks and investment funds, many of which parallel the features of regulated funds noted above. For example:

- “Unlike banks, for instance, where capital is set aside to protect depositors and other creditors against the risk of losses, investment management is characterized by the fact that investors are knowingly exposed to the potential gains and losses of a fund’s invested portfolio.”¹³
- Investment funds “contain a specific ‘shock absorber’ feature that differentiates them from banks. In particular, fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system.”¹⁴
- Investment funds other than hedge funds adhere to “strict leverage limitations imposed by existing regulations.”¹⁵
- “[T]here is little historical evidence of systemic risks arising from investment funds.”¹⁶
- “Asset managers and their funds pose very different structural issues from banks and insurance companies . . . [t]his different structure of the asset management sector offers some important stabilizing features to the global financial system.”¹⁷

We find it noteworthy that the Plan contains a specific exclusion for insurance companies, on the basis that “insurance firms do not engage in the maturity transformation or reliance on short-term funding that typically generates systemic risk” and hence “the business model of insurance firms does not justify them paying the shadow bank tax.” For the reasons noted at the outset of this subsection, the same is true of regulated funds.

More broadly, we believe that the Plan’s “one size fits all” approach to nonbank financial institutions is fundamentally misguided. The Minneapolis Fed, in our view, would be well advised to revisit the observations by Roger Ferguson, former Vice Chairman of the Board of Governors of the

¹³ 2014 NBNI G-SIFI Consultation, *supra* note 6, at 29.

¹⁴ *Id.*

¹⁵ *Id.* at n.43.

¹⁶ FSB, *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (12 January 2017), available at <http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf> at 9.

¹⁷ *Id.* at 8-9.

Federal Reserve System, in his keynote address at the September 2016 TBTF Symposium. Mr. Ferguson rightly advised that “[t]he primary policy goal” is a resilient financial system able to withstand stress. Such resilience, he cautioned, should be achieved through a “nuanced approach that recognizes the differences in various institutions,” noting that “an approach that treats all firms in a monolithic fashion could end up making the system less stable.”¹⁸

Regulated Funds Do Not “Fail”

In sharp contrast to the hundreds of banks that failed during the global financial crisis, regulated funds do not “fail.” Regulated funds do not guarantee returns (or even a return of investors’ principal) to investors, and investors know a fund’s gains or losses belong to them alone. Regulated funds generally are able to satisfy investor redemptions without adverse impact on the fund’s portfolio or other market participants, even during times of significant market stress. And in the unlikely event that a regulated fund experiences higher than expected redemptions, existing regulatory tools and market dynamics can ensure an “orderly resolution” for the troubled fund. We briefly explain these points in the paragraphs that follow.

Both mutual funds and money market funds offer their investors the ability to redeem shares on a daily basis. This is a defining feature of these funds, and it is one around which many of their regulatory requirements and operational practices are built.¹⁹ Of particular note, these requirements and practices include daily mark-to-market valuation of fund portfolio investments and managing liquidity to support redemptions. And, in recent years, the SEC has enhanced liquidity and other requirements both for money market funds and for mutual funds.²⁰ In this regard, government securities or repurchase agreements backed by government securities accounted for 87 percent of taxable money market fund assets as of November 2016, shortly after the final compliance date for the latest round of money market fund reforms.²¹

¹⁸ See Plan at 47. Along these same lines, in a recent speech ICI President & CEO Paul Schott Stevens explained why—rather than seeking to achieve financial “stability” through a rigid, bank-centered system and the avoidance of risk—a far better goal for policymakers would be a “robust” financial system that offers and promotes diversity, encourages innovation and experimentation, and is adaptable. See *Enough Already: Is Post-Crisis Financial Reform Going Too Far?*, Luncheon Keynote Speech by Paul Schott Stevens, President & CEO, ICI, at the American Chamber of Commerce in Japan (October 19, 2016), available at https://www.ici.org/pressroom/speeches/16_pss_japan_finreg.

¹⁹ See, e.g., Letter to Mr. Patrick Pinschmidt, Deputy Assistant Secretary for the Financial Stability Oversight Council (“FSOC”), from Paul Schott Stevens, President & CEO, ICI, dated March 25, 2015 (“2015 ICI FSOC Comment Letter”), available at http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf, at 15-18.

²⁰ See SEC Money Market Fund Reforms, *supra* note 7; US Securities and Exchange Commission, *Investment Company Liquidity Risk Management Programs*, Rel. Nos. 33-10233; IC-32315 (October 13, 2016), available at <https://www.sec.gov/rules/final/2016/33-10233.pdf>.

²¹ The underlying data are available at https://www.ici.org/info/mmf_summary_161130.xls

Even in times of severe market stress, regulated funds generally are able to satisfy investor redemptions while still maintaining the overall integrity of the fund's portfolio.²² Should a fund face an unexpected magnitude of redemption requests in a liquidity strained market, however, the SEC has the authority under Section 22(e) of the Investment Company Act to allow the fund to suspend redemptions for such period as the SEC determines is necessary to protect the fund's shareholders.²³

This authority is very rarely needed. Moreover, various features of the structure and regulation of funds, along with the dynamic and competitive nature of the fund industry, facilitate "orderly resolution" of regulated funds.²⁴ These features include the independent legal character of a fund and Investment Company Act provisions concerning separate custody of fund assets, restrictions on affiliated transactions, and board oversight. As the FSB has observed, the industry is very competitive, and regulated funds are highly substitutable.²⁵

Indeed, hundreds of mutual funds routinely exit the business each year.²⁶ But even when these exits occur during, or are precipitated by, a period of severe market stress, they do not occasion disorder broadly affecting the investing public, market participants or financial markets. The FSB itself has recognized that mutual funds regularly exit the market with no systemic impact, finding that "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the [2000-2012] observation period."²⁷

Taxing the Largest Regulated Funds Would Not Make the Financial System "More Stable"—But It Would Harm Fund Investors

As noted above, the Plan envisions a tax on all "shadow banks" with at least \$50 billion in assets. If the Treasury Secretary certifies that a particular nonbank institution "does not pose systemic risk," the institution will pay a lower tax rate.²⁸ Looked at another way, the Plan presumes that all nonbank

²² See, e.g., 2015 ICI FSOC Comment Letter, *supra* note 19.

²³ We note that the SEC has adopted rules allowing a money market fund to impose liquidity fees, suspend redemptions, and/or liquidate in times of severe market stress. See Rules 2a-7(c)(2) and 22e-3 under the Investment Company Act. The rules contain strict conditions designed to limit their use to certain circumstances and require a vote by the fund's board (including a majority of the independent directors) and prompt notice to the SEC and the public.

²⁴ This process is described in detail in ICI, "Orderly Resolution" of Mutual Funds and Their Managers (July 15, 2014), available at http://www.ici.org/pdf/14_ici_orderly_resolution.pdf

²⁵ See 2014 FSB NBNI G-SIFI Consultation, *supra* note 6, at 30.

²⁶ See, e.g., 2015 ICI FSOC Comment Letter, *supra* note 19, at 75.

²⁷ 2014 FSB NBNI G-SIFI Consultation, *supra* note 6, at 30, n. 38.

²⁸ See *supra* note 4. The Plan does not outline a proposed certification process, nor can we envision a process that would be workable in practice. Moreover, there would appear to be little, if any, incentive for the Treasury Secretary to make such a certification. For these reasons, it seems likely that all large "shadow banks" would end up being taxed at the higher rate.

financial institutions are systemically risky based *solely* on their size.²⁹ And, even those institutions certified as *not* posing systemic risk would pay a tax based solely on the fact of meeting the \$50 billion asset threshold.

ICI previously has explained why, in the case of regulated funds, size alone is not a reliable indicator of risk—to say nothing of systemic risk.³⁰ Further, we and other commenters have provided empirical data and analysis on the reasons (including those discussed earlier in this letter) why even the largest regulated funds do not pose risks to the financial system at large.³¹ Accordingly, we fail to see how imposing a “shadow bank” tax on large regulated funds would advance the Plan’s intended goal of “a future where the financial system is much more stable and financial firms are not TBTF.”³²

Moreover, imposing a “shadow bank” tax on the largest regulated funds would directly harm the millions of people who invest in these funds to save for retirement and meet other important financial goals. This is because the tax automatically would pass through as a fund expense, reducing investor returns.³³ And a tax on regulated funds would disadvantage fund investors relative to investors holding stocks or bonds directly. By penalizing investors for holding a pooled product, the tax would have a disproportionate impact on investors of more modest means, including those who own regulated funds in their retirement accounts. Ironically, these fund investors are part of the US taxpayer population whose interests the Plan seeks to protect.

²⁹ By proposing to use a nonbank financial institution’s size alone as a proxy for systemic risk, the Plan diverges from the approach taken in Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (which establishes certain criteria the FSOC must consider before designating a nonbank financial institution as systemically important) and in the FSB’s proposed NBNI G-SIFI assessment methodologies (including the proposed methodology for identifying global systemically important investment funds). Each of these would require examining a range of factors to determine whether a nonbank financial institution poses potential risks to US/global financial stability.

³⁰ See, e.g., 2014 ICI NBNI G-SIFI Comment Letter, *supra* note 6, at 11-13 and Appendix F. Although we believe that any threshold based solely on size is inherently flawed, we are compelled to note the enormous disparity between the proposed asset threshold for application of enhanced capital requirements to covered banks (\$250 billion) and the proposed threshold for application of a “shadow bank” tax to nonbank financial institutions (\$50 billion).

³¹ See, e.g., 2014 ICI NBNI G-SIFI Comment Letter, *supra* note 6; Letter to Mr. Jonah Crane, Deputy Assistant Secretary for the FSOC, from Paul Schott Stevens, President & CEO, ICI, dated July 18, 2016 (“2016 ICI FSOC Letter”) (responding to FSOC’s April 2016 *Update on Review of Asset Management Products and Activities*), available at https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf. Appendix B to the 2016 ICI FSOC Letter provides an analysis of the high-yield bond market and high-yield bond funds from November 2015 to December 2016, a period of significant stress in the high-yield bond market. Examining actual investor behavior, the analysis shows that, contrary to the hypotheses some regulators and academics have advanced, investors redeemed only modestly during that period.

³² Plan at 35.

³³ The Plan indicates that one possible alternative approach to the “shadow bank” tax would be to impose capital requirements on “shadow banks” at the same levels as proposed for banks. Plan at 29. We note that if the “shadow bank” tax were to be replaced with a capital requirement, similar harm to fund investors would result. See, e.g., 2014 ICI NBNI G-SIFI Comment Letter, *supra* note 6, at 29-32.

For all of these reasons, any proposed “shadow bank” tax should not apply to regulated funds.

Comments on the Plan Must Be Made Public

Included at the end of the Plan is a detailed appendix touting the “open and accessible” process by which the Minneapolis Fed has pursued its Ending TBTF initiative to date. The appendix states that “[t]he dual goal of this transparent approach is to explore and analyze substantive solutions through the gathering of economists, policymakers and other issue-area experts in a series of policy symposiums, while also educating the public about TBTF issues through open public forums.”

Curiously, the Plan states that specific comments on the Plan will not be made public and that the Minneapolis Fed instead will publish an aggregated summary. While bank regulators are well known for preferring to conduct their work in the shadows, as it were, we believe this proposed approach is altogether inconsistent with the stated goals of this initiative and with the development of sound public policy. The comments should be publicly available in their entirety, and the record permitted to speak for itself.

Thank you for the opportunity to submit these views. If you have any questions regarding our comments or would like additional information, please feel free to contact me at (202) 326-5901 or paul.stevens@ici.org, Brian Reid, ICI Chief Economist, at (202) 326-5917 or reid@ici.org, or Frances Stadler, Associate General Counsel and Corporate Secretary, at (202) 326-5822 or frances@ici.org.

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President & CEO
Investment Company Institute