INVESTMENT COMPANY INSTITUTE

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

July 15, 2019

Ann E. Misback, Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, NW
Washington, DC 20551

Re: Control and Divestiture Proceedings (Federal Reserve Board Docket No. R-1662, RIN 7100-AF 49)

Dear Ms. Misback:

The Investment Company Institute[1] appreciates the opportunity to comment on the proposal (the "Proposal") issued by the Board of Governors of the Federal Reserve System (the "FRB") regarding the definition of control under the Bank Holding Company Act (the "BHC Act") and the Home Owners' Loan Act ("HOLA").[2]

The Proposal is of significant importance to ICI and its members. Many of the registered investment companies ("RICs") and other regulated funds[3] that ICI represents are sponsored and/or advised by banking organizations, and the Proposal would affect those funds' relationships with their advisers and other service providers as well as the investments the funds may make. The Proposal similarly may affect RICs and other regulated funds that are not affiliated with banking organizations but that make investments in banking organizations consistent with their investment strategies and objectives.

[1] The Investment Company Institute (the "ICI") is the leading association representing regulated funds globally, 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$22.4 trillion in the United States, serving more than 100 million US shareholders, and US$6.9 trillion in assets in other jurisdictions. ICI carries out its international work through ICI Global, with offices in London, Hong Kong, and Washington, DC.

[2] Control and Divestiture Proceedings, 84 Fed. Reg. 21634 (May 14, 2019).

[3] In this letter, we use the term "regulated funds" to refer to RICs, foreign equivalents of RICs, or RICs and their foreign equivalents collectively, depending on context.

Executive Summary

ICI appreciates the FRB's efforts to clarify and, in certain cases, liberalize its control framework. We respectfully request that the FRB modify aspects of the Proposal to ensure that the final rule does not unnecessarily impede routine and ordinary–course business relationships between regulated funds, their advisers and other affiliated entities; business relationships between regulated fund advisers and the funds' portfolio companies; or passive investments of regulated funds in banking organizations. In this letter, we describe how the Proposal can be adjusted to remain consistent with FRB precedent and the policy objectives reflected in the Proposal while addressing the specific concerns of ICI and its members.

As discussed in more detail below, ICI recommends the following changes to the Proposal:

Make targeted changes to the RIC exception.

- *The RIC exception should be revised to allow for a multiyear seeding period and greater post-seeding ownership threshold.* The RIC exception's ownership limits should be revised in two ways. First, the RIC exception should be revised to allow reasonable, multi-year seeding periods. The proposed one-year seeding period would discourage the sponsorship of new RICs by banking organizations as it does not accommodate prevailing industry practice and expectations with respect to launching new RICs. Second, the RIC exception should be revised to allow investment of up to 24.9% of any class of a RIC's voting securities after the seeding period expires. RICs are subject to comprehensive regulation, oversight by an independent board of directors, and strong conflict-of-interest protections, all of which meaningfully restrict the ability of an adviser to exercise undue influence over the management or policies of a RIC.

- *The RIC exception should reference the director independence requirements of the Investment Company Act of 1940 (the "1940 Act") and related rules.* The RIC exception should refer to the specific director independence standards to which RICs are already subject, rather than create overlapping director independence standards. Such an approach would achieve the FRB's regulatory purpose without imposing unnecessary compliance burdens on RICs and their advisers.

- *The RIC exception should accommodate ordinary-course business relationships between RICs and their advisers.* The RIC exception should not provide an exclusive and static list of permitted business relationships. It is important to the routine operation of RICs to obtain

services from their advisers and the advisers' affiliates, and the nature and scope of such services have evolved over time and likely will continue to do so. For these reasons, the list of permitted services should provide examples of the types of advisory, administrative and similar services that RICs may receive from their advisers and the advisers' affiliates without losing the ability to rely on the RIC exception.

- *The FRB should provide a parallel exception for funds that are foreign equivalents of RICs*. Regulated funds in non-U.S. jurisdictions are subject to extensive regulation, and the final rule should permit banking organizations to continue their traditional asset management business outside the United States and limit the extra-territorial impact of the BHC Act and HOLA by exempting foreign equivalents of RICs from the presumptions of control using requirements that are equivalent to those of the RIC exception. If the FRB does not provide a parallel exception, then it should at a minimum exclude these regulated funds from the investment fund presumption of control.

Exclude RICs and their foreign equivalents from the investment fund presumption of control.

- The investment fund presumption of control should be revised to strike a more appropriate balance between addressing control concerns and facilitating important and fundamental economic activities. Specifically, the presumption should be revised expressly to exclude regulated funds—both RICs and their foreign equivalents—from this presumption of control.

Confirm the FRB General Counsel letters related to control of banking organizations remain in effect.

- In a long line of letters to RIC complexes dating back more than 15 years, the FRB General Counsel has determined that RICs may collectively acquire up to 15% of the voting stock of a banking organization without the funds or their adviser being deemed to control the banking organization under the BHC Act, HOLA, or the Change in Bank Control Act (the "CIBC Act"). The FRB should clarify in any final rule that any investments made pursuant to those letters will continue to be treated as noncontrolling under the BHC Act, HOLA, and the CIBC Act and that any final rule adopted as a result of this Proposal does not affect those letters and the investments made in accordance with those letters.

Revise additional elements of the Proposal's control framework.

- *The Proposal's limits on business relationships are overly restrictive and should be revised to provide needed flexibility in the asset management context and to better align with FRB precedent.* The quantitative restrictions on business relationships should be revised so that such restrictions do not apply to arm's length, nonexclusive business relationships between the investee, on the one hand, and the adviser, its affiliates, and advised funds on the other. At a minimum, the quantitative thresholds for business relationships should be increased and should be based on measures that are generally available so that monitoring is less burdensome and does not necessitate increased involvement in the portfolio company.

- *The total equity calculation should be revised to eliminate the functionally equivalent test and look-through requirements and to recalibrate the recalculation requirement.* The "functionally equivalent to equity" test is unclear as to what interests would be treated as equity and how those interests would be valued. As a result, it may chill investment in debt securities and ordinary course commercial arrangements. The Proposal's look-through calculation requirement would be overly burdensome as it would require investors to understand whether the investee controls or is controlled by another company in which the investor also has an equity investment. The recalculation requirement also would be unnecessarily burdensome and should be recalibrated. A potential modification to address this issue would be to require calculation of total equity only when the investor acquires the investee's voting equity and after such acquisition would have 5% or more of a class of voting securities.

Clarify the exclusion for shares held without the sole discretionary authority to exercise voting rights.

- Consistent with the BHC Act, the limit on voting authority should only be applied to control of voting shares of a bank, and the final rule should confirm that sole discretionary authority to exercise voting rights does not include situations in which a regulated fund or other investment fund retains the right to revoke the authority to vote.

Apply the final rule's control framework for purposes of Regulations O and W.

- To avoid creating additional burden and divergences in outcome, the FRB should harmonize the Proposal with Regulations O and W by

replacing the presumptions of control in those regulations with the presumptions of control established in the final rule.

Discussion

I. Make Targeted Revisions to the RIC Exception.

The Proposal would presume that one company controls another under specified conditions. The Proposal includes a number of exceptions to the generally applicable presumptions. Among these is an exception for business relationships and investments by a "first company," such as an investment adviser, in a RIC (the "RIC exception").[4]

The Proposal asks whether it is necessary or appropriate to have such an exception to the control presumptions. ICI firmly believes that it is both. RICs are comprehensively regulated under the 1940 Act and other federal securities laws, and one of the primary purposes of this regulatory scheme is to protect the RIC and its investors from potential overreach by the adviser and its affiliates. Central to this scheme is robust, independent oversight by the RIC's board of directors: the board (and its members who are independent—that is, who are not "interested persons" of the adviser) is responsible for selecting and reviewing the major contractors to the fund, including the investment adviser, and for regularly reviewing and approving the adviser's contract, which must be terminable by the board on no more than 60 days' written notice. Indeed, a majority of the independent directors, voting separately, must approve the RIC's advisory contract and its renewal. Longstanding FRB precedent rightly has viewed a RIC as not being "controlled" by its adviser (provided the adviser does not hold a 25% or more equity interest in the RIC after the applicable seed period).

To qualify for the RIC exception as proposed, a number of requirements must be met. They relate to the adviser's level of ownership of the RIC, the adviser's business relationships with the RIC and the independence of the RIC's board. ICI does not object to conditioning the exception on requirements in these areas, but we believe that certain of the requirements should be revised to avoid impeding the sponsorship of new RICs to align better with FRB precedent and to account for the regulatory structure that already governs RICs. In particular, the final rule should: allow for a multiyear seeding period and a 24.9% voting equity threshold after such seeding period; align the director representation requirements with existing board-of-director independence requirements under the 1940 Act and related rules; and clarify the scope of permitted business relationships between RICs and their affiliated service providers.

---

[4] For purposes of the following discussion, we consider the "first company" to refer to the RIC's investment adviser ("adviser") and its affiliates.

A. The FRB Should Allow for a Multiyear Seeding Period and Higher Post-Seeding Ownership Threshold.

Under the Proposal, a RIC adviser would not be subject to various presumptions of control provided that, among other criteria, the adviser divests below 5% of each class of the RIC's voting securities and 25% of total equity of a RIC within one year.[5] The Proposal explains that the RIC exception is intended to be consistent with FRB precedent under the BHC Act and the Glass-Steagall Act.[6] We believe, however, that industry practice and FRB precedent do not align with the proposed approach.

To begin with, these elements of the exception would discourage the sponsorship of new RICs by banking organizations because they would not accommodate prevailing industry practice and expectations with respect to launching new RICs. One year generally is not enough time for a sponsor to seed a fund and divest to the applicable threshold of equity. Moreover, an ownership threshold of 5% or less of a RIC's voting securities after the seeding period is significantly less than banking organizations have been permitted to continue to hold relative to the FRB's precedents. As explained below, revising these two aspects of the proposed exception is necessary to make the exception workable and avoid impeding banking organizations' sponsorship of and provision of services to RICs.

First, the RIC exception should be revised to allow reasonable, multiyear seeding periods consistent with the FRB implementation of section 13 of the BHC Act (the "Volcker Rule").[7] Seeding is a common industry practice and the primary way for an investment adviser to launch a new RIC. At the outset, the adviser or an affiliate provides the initial "seed" capital in exchange for all or nearly all of the shares of the RIC. The adviser then attempts to establish the RIC, test its investment strategy and develop an investment track record that will attract third-party investors—with the objective of reducing the adviser's relative ownership of the RIC as investors buy RIC shares.

In the context of the Volcker Rule, the FRB and other agencies finalized a regulation that permitted a banking entity to hold 25% or more of the voting shares of a RIC during a one-year seeding period (with the potential for extension).[8] In a series of letters and other outreach, ICI and many other

---

5 84 Fed. Reg. at 21646 (to be codified at 12 CFR 225.32(j)(4)).

6 Id. at 21644.

7 12 CFR Part 248 (implemented pursuant to Section 619 of the Dodd-Frank Act, as codified in 12 U.S.C. § 1851).

8 The restrictions and limitations of the Volcker Rule apply to a "banking entity," the definition of which incorporates the principles of control under the BHC Act. See 12 CFR 248.2 (generally defining banking entity to include any "affiliate" and "subsidiary"

interested parties explained that multiyear seeding periods are quite common for (and necessary to) the successful launch of RICs and other regulated funds and that banking entities require certainty that they will be able to avail themselves of a sufficient seeding period with respect to these funds.[9] In response, staff of the FRB (and other agencies) acknowledged that a seeding period of multiple years is appropriate for RICs and consistent with the Volcker Rule ("FAQ 16").[10] FAQ 16 provided much-needed relief for regulated fund seeding. Nevertheless, the phrasing of the FAQ sparked some uncertainty because it could be read to suggest that, in the ordinary course, a three-year seeding period may be the maximum allowed.[11] The FRB, in its subsequent, jointly proposed rulemaking regarding the Volcker Rule, clarified that the three-year period was an example of a permissible seeding period and not the maximum permissible seeding period in all cases.[12]

During its seeding period and after, a RIC must be operated in accordance with the comprehensive regulatory regime administered by the Securities and Exchange Commission ("SEC") under the 1940 Act and other federal securities laws. FRB control precedent recognizes, and relies on, the controls placed on the

---

thereof, as such terms are defined under the BHC Act, which defines such terms by reference to control). The FRB indicated that its determination not to treat a RIC as a "banking entity" during the seeding period was consistent with FRB precedent regarding bank holding company control of and relationships with funds. See Volcker Rule Frequently Asked Question #14 ("FAQ 14") at n.24 and n.29, available at https://www.federalreserve.gov/supervisionreg/faq.htm#14.

9 See, e.g., ICI Letter to Chair Yellen dated June 1, 2015; ICI letter to the FRB and other agencies dated February 13, 2012. See also ICI letter to the Office of the Comptroller of the Currency ("OCC") dated September 21, 2017.

10 The staffs' position also encompassed certain regulated funds organized outside the United States, defined in the Volcker Rule implementing regulations as "foreign public funds" or "FPFs." See Volcker Rule Frequently Asked Question #16, *available at https://www.federalreserve.gov/supervisionreg/faq.htm#16* ("The staffs of the Agencies understand that the seeding period for an entity that is a RIC or FPF may take some time, for example, three years, the maximum period of time expressly permitted for seeding a covered fund under the implementing rules."). FAQ 16 was also issued in response to concerns that restricting bona fide investment management businesses in order to avoid treatment of funds as "banking entities" would put bank-affiliated investment advisers at a competitive disadvantage relative to nonbank-affiliated advisers engaged in the same activities without advancing the statutory purposes underlying the Volcker Rule. See generally 84 Fed. Reg. at 33443.

11 It states, in relevant part, that "the staffs of the Agencies understand that the seeding period for an entity that is a RIC or FPF may take some time, for example, three years, the maximum period expressly permitted for seeding a covered fund under the implementing rules."

12 84 Fed. Reg. at 33443 ("Recognizing that the length of a seeding period can vary, the staffs provided an example of three years, the maximum period of time expressly permitted for seeding a covered fund under the 2013 final rule, without setting any maximum prescribed period for a RIC or FPF seeding period.").

adviser under these laws.[13] Of particular significance in this context, RICs are subject to oversight by an independent board of directors and strong conflict of interest protections through prohibitions on affiliated transactions. In other words, these requirements meaningfully restrict the ability of an adviser to exercise undue influence over the management or policies of a RIC. FRB precedent further recognizes that the purpose of providing seed capital to a RIC is not to obtain control over the fund.[14] We note that this remains true regardless of the length of the seeding period.

Second, the RIC exception should be revised to allow investment of up to 24.9% of any class of a RIC's voting securities after the seeding period expires. Since at least 1999, the FRB has permitted a banking organization to retain up to 24.9% of the voting securities of a mutual fund after the end of the seeding period without finding that the banking organization controls the fund.[15] Similarly, the FRB permits a banking organization to control up to 24.9% of the voting shares of a RIC under the Volcker Rule.[16]

ICI respectfully submits that modifying the RIC exception to provide a more flexible, multiyear seeding period and 24.9% voting security ownership threshold would better reflect common industry practice and would continue to be consistent with a noncontrolling relationship between an adviser and its advised RIC. As the FRB previously has recognized, RIC advisers sponsor and invest in RICs as a means of ensuring they are well functioning, not to control the RIC or its underlying investments.

---

[13] See, e.g., Letter to H. Rodgin Cohen, Esq., dated June 24, 1999 ("First Union Letter"); Mellon Bank Corp., 79 Fed. Res. Bull. 626 (1993).

[14] See, e.g., First Union Letter. See also 79 Fed. Reg. 5536 at 5676-5677. See also ICI Letter to the OCC, dated September 21, 2017.

[15] See, e.g., First Union Letter (finding that the banking organization would not "control the mutual funds that it supervises for purposes of the Glass-Steagall Act and that the proposal would not be inconsistent with the BHC Act"). Although the proposal cites the First Union Letter in support of the proposed presumption of control for service as an investment adviser to an investment fund in which it controls 5% or more of the fund's voting securities after the end of the seeding period (84 Fed. Reg. at 21644 n.45), the First Union Letter was also cited recently to support a threshold of 24.9% of voting securities for purposes of determining whether a fund is controlled and therefore a "banking entity" subject to the Volcker Rule and for purposes of determining the scope of subsidiaries that are subject to restrictions on qualified financial contracts ("QFCs"). See 79 Fed. Reg. at 5676 at n.1736 and n.1739; 82 Fed. Reg. 42882 at 42893 at n.91 (Sept. 12, 2017) (citing First Union Letter and 12 CFR 225.86(b)(3)).

[16] See 12 CFR 248.12(b).

B. The RIC Exception Should Reference the Director Independence Requirements of the 1940 Act and Related Rules.

Under the Proposal, the RIC exception is not available if director representatives of the RIC adviser occupy more than 25% of the RIC's board of directors.[17] The proposed definition of "director representative" would include any individual that (1) the adviser nominated or proposed to serve; (2) is a current employee, director or agent of the adviser; (3) served as an employee, director or agent for the adviser during the preceding two years; or (4) is a member of the immediate family of any employee, director or agent of the adviser. This definition is not specific to the RIC exception but is used more broadly throughout the Proposal in provisions that refer generally to a "first company" and its relationship to a "second company."

ICI believes strongly that the RIC exception should not incorporate this independence requirement but instead should refer to the director independence standards to which RICs are already subject under the federal securities law. Although the 1940 Act board independence standards differ in some respects from the Proposal, they are specifically designed "to supply an independent check on management" in the RIC context.[18] Such an approach would achieve the FRB's regulatory purpose without imposing unnecessary compliance burdens on RICs and their advisers.

Like the proposed limit on "director representatives," the 1940 Act and related rules already limit the proportion of "interested persons" (*i.e.*, not independent) serving on a RIC's board of directors. The 1940 Act generally requires at least 40% of the board members to be independent, and SEC rules under that Act effectively require that a majority of the board be independent.[19] In practice, most RIC boards are more independent than the law requires—according to a recent industry survey by ICI and the Independent Directors Council, 87 percent of RIC boards are composed of at least 75% independent directors.[20]

---

[17] 84 Fed. Reg. at 21646 (to be codified at 12 CFR 225.32(j)(3)).

[18] See Burks v. Lasker, 441 U.S. 471, 484 (1979), citing S. Rep. No. 91-184 (1969), at p. 32: ("Without question, '[t]he function of these provisions with respect to unaffiliated directors [was] to supply an independent check on management and to provide a means for the representation of shareholder interests in investment company affairs.'").

[19] See 15 U.S.C. § 80a-10; Role of Independent Directors of Investment Companies, 66 Fed. Reg. 3734 (Jan. 16, 2001) (amending 10 rules under the Investment Company Act that most RICs rely on to operate so that each such rule requires, among other things, that (i) independent directors constitute a majority of the RIC's board of directors, and (ii) independent directors select and nominate other independent directors).

[20] See Independent Directors Council, *Fundamentals for Newer Directors*, Fund Directors/Trustees, Director Independence, available at http://fundamentals.idc.org/fund/fund_director.

The 1940 Act, like the proposed definition of "director representative," would not consider an employee or director of the adviser, or certain family members of such persons, to be independent. The 1940 Act also generally precludes an independent director from having, or from having had at any time during the previous two years, a material business relationship with the fund's adviser, principal underwriter (distributor) or affiliates.[21] In addition, an independent director for a RIC cannot own stock of the adviser or certain related entities, such as parent companies or subsidiaries.

In purpose and effect, therefore, the 1940 Act, SEC rules under that Act and accepted industry practice already ensure that a RIC board of directors is not unduly influenced by individuals who may be closely aligned with the adviser.

If the FRB chooses not to defer to the 1940 Act and SEC rules under that Act in this respect, ICI recommends that the RIC exception, at a minimum, incorporate a slightly revised definition of "director representative." As noted above, the Proposal defines director representative to include any individual who was nominated or proposed to serve as director by a RIC adviser.[22] This requirement would not account for the fact that a RIC adviser usually is responsible for selecting the initial members of the RIC's board including by recruiting unaffiliated individuals to serve as independent directors. This involvement by the adviser does not undermine the FRB's regulatory objective, however, because the board selected by the adviser must satisfy the standards for independence set forth in the 1940 Act and SEC rules under that Act.[23] Accordingly, the FRB should clarify that any RIC board member who meets those standards for independence is not considered a "director representative" of the adviser solely because the adviser "nominated or proposed" the individual to serve.

C. The RIC Exception Should Accommodate Ordinary-Course Business Relationships between RICs and Their Advisers.

The Proposal's RIC exception would permit RICs to have certain relationships with their advisers and the adviser's affiliates without triggering a presumption of control. Those permitted business relationships are "limited to investment

---

21 15 U.S.C. § 80a-2(a)(19)(A)(vii).

22 84 Fed. Reg. at 21663 (to be codified at 12 CFR 225.31(e)(2)(i)(A)).

23 On a going forward basis, SEC rules effectively require that new independent directors be nominated and approved by the RIC board's existing independent members. See Role of Independent Directors of Investment Companies, supra note 19, at 3737 (further noting that "[c]ontrol of the selection and nomination process at all times should rest with a [RIC's] independent directors," although the adviser "may suggest independent director candidates if the independent directors invite such suggestions").

advisory, custodian, transfer agent, registrar, administrative, distributor and securities brokerage services."[24]

We appreciate and support the FRB's recognition that a RIC may require certain services from the adviser and its affiliates. We are concerned, however, with the way the Proposal circumscribes permitted business relationships, as it is common for RICs to obtain a wide range of services from the adviser and other parties affiliated with the adviser. For example, RIC advisers and their affiliates may provide securities lending and clearing services to their advised funds, act as proxy voting or proxy administration agent for their advised funds and provide index provider services for self-indexed funds. It is not clear that each of these services is included within the list set forth by the FRB, but we know of no reason why they should not be.

As the foregoing discussion suggests, not only is it important to the routine operation of RICs to obtain services from their advisers and the advisers' affiliates, but also the nature and scope of such services have evolved over time and likely will continue to do so. For these reasons, we urge the FRB to revise the language in the Proposal. Instead of providing an exclusive and static list, the list in the Proposal should provide examples of the types of services that RICs may receive from their advisers and the advisers' affiliates without losing the ability to rely on the RIC exception. We suggest revising the proposed wording to specify that business relationships with the adviser and its affiliates are "limited to advisory services, administrative services and similar services, such as investment advisory, custodian, transfer agent, registrar, administrative, distributor, index provider, proxy voting agent, lending and clearing services, and securities brokerage services…."

D. The FRB Should Provide a Parallel Exception for Funds that are Foreign Equivalents of RICs.

Although the governing rules for RIC may vary from regulated funds in other jurisdictions, these rules reflect common principles developed by the International Organization of Securities Commissions ("IOSCO") for regulated funds (which IOSCO refers to as "collective investment schemes," or "CIS") as well as IOSCO's more detailed work on core areas of CIS regulation. All regulated funds, notwithstanding differences in structure and organization across jurisdictions, have one or more mechanisms to provide for "adequate and objective oversight" of the activities of the regulated fund and its manager, in order to protect fund investors.[25] Foreign equivalents of RICs typically employ their own mechanisms for independent oversight. Undertakings for collective

---

[24] 84 Fed. Reg. at 21646 (to be codified at 12 CFR 225.32(j)(2)).

[25] See IOSCO, Examination of Governance for Collective Investment Schemes: Part II (Feb. 2007) at 4-5, available at http://www.iosco.org/library/pubdocs/pdf/IOSCOPD237.pdf

investment in transferable securities ("UCITS"), for example, must appoint a depositary—an entity regulated and supervised by Member State regulators under the UCITS Directive requirements—that is independent of the fund and fund manager. The depositary must be a national central bank, a credit institution, or other entity that is authorized to provide depositary services; it is subject to prudential regulation and to capital adequacy requirements under the Capital Requirements Directive ("CRD IV"). The depositary acts "both as a supervisor (the 'legal conscience') of [the] UCITS fund . . . and as a custodian over the fund assets."[26] Its responsibilities include safeguarding fund assets, monitoring the fund's cash flows and performing certain oversight functions as described in the "robust risk and compliance framework" discussion below. In carrying out its responsibilities, the depositary "shall act honestly, fairly, professionally, independently and solely in the interest of the UCITS and the investors of the UCITS."[27]

Thus, these funds, like RICs, are subject to extensive regulation and generally have similar investment strategies. Moreover, the policy concerns regarding the application of the BHC Act to foreign equivalents of RICs are at least very similar to those of section 13 of the BHC Act[28]; in all cases, ICI respectfully submits that the FRB should take care to limit the extraterritorial impact of the BHC Act and HOLA (without explicit statutory language to the contrary)[29] and to allow U.S. banking organizations and their foreign affiliates to carry on traditional asset management businesses outside of the United States.[30] Accordingly, the final rule should treat RICs and their foreign equivalents the same. Specifically, the final rule should include an exemption for foreign equivalents of RICs that satisfy the other requirements of the proposed RIC exception, to account for the differences

---

26 See Press Release, European Commission, UCITS—Improved Requirements for Depositaries and Fund Managers—Frequently Asked Questions (3 July 2012), available at http://europa.eu/rapid/press-release_MEMO-12-515_en.htm.

27 Directive 2014/91/EU (amending Directive 2009/65/EC), Article 25, available at http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:02009L0065-20140917&from=EN.

28 See 12 CFR 248.10(c)(1); Volcker Rule FAQ #14 available at https://www.federalreserve.gov/supervisionreg/faq.htm#14.

29 "It is a longstanding principle of American law 'that legislation of Congress, unless a contrary intent appears, is meant to apply only within the territorial jurisdiction of the United States.'" EEOC v. Arabian American Oil Co., 499 U.S. 244, 248 (1991) (quoting Foley Bros, Inc. v. Filardo, 336 U.S. 281, 285 (1949)).

30 See 79 Fed. Reg. at 5678.

in structures.[31] At a minimum, the final rule should exclude foreign equivalents of RICs from the investment fund presumption of control, as discussed below.

II. Exclude RICs and Their Foreign Equivalents from the Investment Fund Presumption of Control.

Outside of the RIC exception, the Proposal would presume that an investment adviser controls its advised investment fund if the adviser controls 5% or more of the voting securities or 25% or more of the total equity of the fund after a one-year seeding period.[32] The Proposal explains that "investment adviser" would be defined broadly to include any person registered as an investment adviser under the Investment Advisers Act of 1940, any person registered as a commodity trading advisor under the Commodity Exchange Act and foreign equivalents of any such adviser.[33] "Investment fund" would include a wide range of investment vehicles, including RICs, companies that are exempt from registration under the 1940 Act, and foreign equivalents of either RICs or exempt companies. Other investment entities, such as commodity funds and real estate investment trusts, generally also would be included as investment funds.[34]

This presumption of control should be revised to strike a more appropriate balance between addressing control concerns and facilitating important and fundamental economic activities. Importantly, it should be revised to expressly exclude regulated funds—both RICs and their foreign equivalents.

The preamble to the Proposal suggests that the FRB already contemplates that no RIC should be automatically presumed to be controlled by its adviser, even if it cannot qualify for the RIC exception. The preamble states:

> A first company that does not satisfy the criteria in the registered investment company exception would not necessarily be presumed to control the second company [the RIC]. Instead, the first company may or may not be presumed to control the second company depending on the applicability of the other proposed presumptions of control.[35]

---

[31] Of course, the director independence standard for foreign equivalents should be that of the relevant jurisdiction for the regulated fund.

[32] 84 Fed. Reg. at 21644 (to be codified at 12 CFR 225.32(h)).

[33] Id.

[34] Id.

[35] 84 Fed. Reg. at 21646. The Proposal would create an automatic presumption of control of RICs if the RIC exception were not met due to the proposed seeding period or ownership requirements. For example, if a RIC could not meet the RIC exception because the adviser owned 6% of the RIC's voting shares after the applicable seeding

To effectuate this intent, however, the FRB should incorporate an express exclusion for RICs from the investment fund presumption of control. Further, for the reasons described in section I.D. of this letter, the investment fund presumption of control should expressly exclude foreign equivalents of RICs.

III. Confirm that FRB General Counsel Letters Related to Control of Banking Organizations Remain in Effect.

In a long line of letters to RIC complexes dating back more than 15 years, the FRB General Counsel has determined that RICs (and other vehicles and accounts sponsored and/or managed by the same or affiliated advisers) may collectively acquire up to 15% of the voting stock of a banking organization without the funds or their adviser being deemed to control the banking organization under the BHC Act, HOLA or the CIBC Act.[36]

As explained below, the FRB should clarify in any final rule that any investments made pursuant to those letters will continue to be treated as noncontrolling under the BHC Act, HOLA and the CIBC Act and that any final rule adopted as a result of this Proposal does not affect those letters and the investments made in accordance with those letters. In addition, the FRB should confirm that the final rule does not affect the ability of the FRB General Counsel to continue to provide such letters or the General Counsel's willingness to grant similar letters to other RIC complexes that present similar factual circumstances as those complexes that have received letters already.

The FRB General Counsel letters are predicated on the unique circumstances presented by RIC complexes including affiliated service providers and other investment funds. In particular, the letters rely on the fact that RIC complexes do not present the same control risks as investors in banking organizations do generally.[37] The letters thus recognize that the general restrictions on investments in banking organizations are not appropriate for RIC complexes. For this reason, the letters do not impose all of the same limits on RIC complexes that the FRB has traditionally required of other investors. For example, the letters do not limit business relationships between investee banking entities and investor RICs and their affiliated service providers. To our view, these differences highlight an

---

period, then the presumption of control over the fund would automatically apply. We do not believe that this was the intent of the Proposal based on the Proposal's discussion quoted above, and we believe that such results are arbitrary and punitive.

[36] See, e.g., Letter to Satish Kini dated April 11, 2013.

[37] The letters explain that the investments in banking organizations are not proprietary investments of the adviser but are rather made on behalf of the beneficial owners of the funds or other customer accounts, and the investments of the funds are made for investment purposes with the expectation of resale and not to exercise a controlling influence over the management or policies of banking organizations. See, e.g., id.

important aspect of the controlling influence analysis—that the analysis should consider all the relevant facts and circumstances and may find that control is not present based on different balances of control indicia. In other words, this analysis, although different than what is presented in the Proposal, should continue to be appropriate notwithstanding any final rule.

IV. Revise Additional Elements of the Proposal's Control Framework.

The revisions discussed in sections I through III of this letter should allow the final rule to avoid unduly restricting the formation of RICs and other regulated funds as well as the day-to-day operations of the funds, their advisers, and the advisers' affiliates. In other words, these revisions are necessary to ensure that the Proposal's generally applicable presumptions of control do not significantly restrict the operations and investments of RICs and other regulated funds or the ordinary-course business activities of their advisers.[38] The FRB should also revise the generally applicable presumptions of control as discussed below to mitigate the negative effects the presumptions would have on regulated funds that may not fall within an exclusion discussed above.

A. The Proposal's Limits on Business Relationships Are Overly Restrictive and Should Be Revised to Provide Needed Flexibility in the Asset Management Context and Better Align with FRB Precedent.

The Proposal's presumptions of control as they relate to certain business relationships are overly restrictive. In some cases, certain of these presumptions should be eliminated or relaxed to provide needed flexibility in the asset management context and to better align with FRB precedent. The types of business relationships that arise in the asset management context are critical to supporting fund formation and the ongoing, day-to-day operations of funds. At the same time, these business relationships do not allow an investment adviser to otherwise exert a controlling influence over an investee company.

The Proposal includes certain quantitative and qualitative limits that could apply to business relationships between investment advisers and companies in which the advisers invest. For instance, the business relationships between a "first company" (such as an adviser or its affiliate) and an investee company, for an adviser that controls between 5% and 10% of the investee company's voting stock, would trigger a presumption of control if such relationships generate in the aggregate 10% or more of the total annual revenues or expenses of either company.[39] As the adviser's voting stake in the investee company increases, the business relationship threshold (as measured by revenues and expenses generated

---

[38] See 84 Fed. Reg. at 21658-59 (to be codified at 12 CFR 225.32(c), (d), (e) and (f)).

[39] Id. at 21641 (to be codified at 12 CFR 225.32(d)(4)).

by the business relationships) decreases. In addition, the Proposal presumes that, if an investor controls 10% or more of a investee's voting securities and has business relationships with the investee that "are not on market terms," then the investor controls the investee.[40]

These presumptions of control should be revised to account more appropriately for the types of services that investment advisers and their affiliates commonly provide in the asset management context. As discussed above, investment advisers and their affiliates commonly provide arm's length services (*e.g.*, retirement or employee-benefit plan services) to banking organizations; banking organizations also provide services (*e.g.*, custody, brokerage, securities lending, fund accounting) to RICs and other clients of an investment adviser. The FRB has previously recognized that arm's length business relationships do not raise the same control concerns as other types of relationships.[41] These types of relationships, moreover, are wholly unrelated to passive investments in equity that are made on an agency basis for RIC investors and other clients and do not pose an opportunity to control the management or policies of a banking organization in which a RIC or other asset management vehicle is invested. Moreover, monitoring these limits, including the "market terms" element, imposes burdens that are not commensurate with any policy benefit (because even the mere possibility of control is not present) and impedes the provision of asset management services to investors and passive investments in banking organizations.

Therefore, we recommend revising the quantitative restrictions on business relationships so that such restrictions do not apply to arm's-length, nonexclusive business relationships between the investee, on the one hand, and the adviser, its affiliates, and advised funds on the other. At a minimum, the quantitative thresholds for business relationships should be increased and should be based on measures that are generally available, such as the assets of the banking organization, so that monitoring is less burdensome and does not necessitate increased involvement in the portfolio company.

---

40 Id. (to be codified at 12 CFR 225.32(e)(3)(i)). The Proposal does not define market terms, and the ICI presumes that the Proposal does not intend to narrow current, reasonable industry understandings of the term. For example, differences in terms (e.g., discounts) based on the scale of business relationships alone may still be considered market terms.

41 See, e.g., FRB, Policy statement on equity investments in banks and bank holding companies at 13 (Sept. 22, 2008), http://www.federalreserve.gov/newsevents/press/bcreg/bcre g%2020080922b1.pdf (indicating that business relationships, "even when accompanied by a material investment," are less likely to raise control concerns if they are "on market terms, nonexclusive, and terminable without penalty by the banking organization.")

B. The Total Equity Calculation Should Be Revised to Eliminate the Functionally Equivalent Test and Look-Through Requirements and to Recalibrate the Recalculation Requirement.

The Proposal's method of calculating total equity should be revised. First, the "functionally equivalent to equity" test should be eliminated. Second, the recalculation requirement should be revised to require recalculation only from acquisitions above a certain threshold. Third, the Proposal's look-through calculation requirement, which relates to an investor's interest in the parent of a investee company, should be eliminated.

Under the Proposal, an investor would be presumed to control a banking organization if the investor owns: (i) one-third or more of the total equity of the banking organization, regardless of whether the investor owns any voting equity or otherwise has the ability to influence the management or policies of the banking organization; or (ii) more than 25% of the total equity of the banking organization and more than 15% of any class of voting securities of the banking organization.[42] The Proposal prescribes a method for calculating total equity, which could include debt and other interests that are "functionally equivalent to equity," and requires that total equity be recalculated each time the investor acquires control over, or ceases to control, equity instruments of the banking organization.[43] The Proposal also requires a look-through calculation of total equity to reflect a parent company's interest in a investee (as described below).[44]

First, the "functionally equivalent to equity" test is unclear and unnecessary. Many ICI members provide investment options and solutions for clients across asset classes, including fixed income as well as equity. Application of the test to ICI members may increase burden and chill investment in debt securities and ordinary course commercial arrangements because it is unclear under the qualitative test what interest would be treated as equity and how those interests would be valued. RICs would need to engage in a facts-and-circumstances analysis to determine whether investments by the RIC in debt instruments meet this test. To address this issue, the functionally equivalent to equity test could be eliminated entirely or only include bright-line tests for the instruments that are clearly equity.

Second, the Proposal's look-through calculation requirement would be overly burdensome and should be eliminated. Under the Proposal, equity investments in a parent company of a investee (*i.e.*, a company that controlled the investee under the BHC Act or HOLA) would be added (in proportion to the parent company's

---

[42] 84 Fed. Reg. at 21658-59 (to be codified at 12 CFR 225.32(c), (f)).

[43] Id. at 21660 (to be codified at 12 CFR 225.34).

[44] Id.

equity ownership of the investee) to the investor's equity investment in the investee.[45] This aggregation should be eliminated because it would require investors to understand whether the investee controls or is controlled by another company in which the investor also has an equity investment. Passive investors, such as institutional investors that can report their ownership on the SEC's Schedule 13G, generally will not have the information necessary to make this calculation. As the FRB has acknowledged in other contexts,[46] imposing BHC Act control analysis requirements outside the context of banking organizations is unduly burdensome.

Third, the recalculation requirement would be unnecessarily burdensome and should be recalibrated. The requirement could, for example, cause investors to be presumed to control based on the actions of the bank organization (for example, if the investor sold part of its voting equity in a banking organization after the banking organization suffered a substantial loss to retained earnings). A potential modification to address this issue would be to require calculation of total equity only when the investor acquires the investee's equity and after such acquisition would have 5% or more of a class of voting securities.[47]

V. Clarify the Exclusion for Shares Held without the Sole Discretionary Authority to Exercise Voting Rights.

The Proposal's presumptions of control do not apply to the extent that shares are held in a fiduciary capacity, as long as the fiduciary lacks sole discretionary authority to exercise the voting rights associated with the shares.[48] The Proposal would exclude from fiduciary treatment shares held with the sole discretionary authority to exercise voting rights.

The BHC Act and HOLA have specialized rules that apply when one party may have investment or voting discretion over the shares of a company. Consistent with the BHC Act, the limit on voting authority should only be applied to control of voting shares of a bank.[49] In addition, the final rule should confirm that an

---

[45] Id.

[46] 82 Fed. Reg. 42882, 42896 (Sept. 12, 2017) (explaining that the FRB's final rule regarding restrictions on qualified financial contracts ("QFC") was changed from the proposal to address comments that many QFC counterparties to global systemically important banks are not familiar with BHC Act control).

[47] The addition of a voting equity requirement to the proposed presumption of control based solely on total equity would make the presumption consistent with the BHC Act. Specifically, section 2(a)(3) requires that any company that controls less than 5% of another company be presumed to not control the second company. 12 U.S.C. § 1841(a)(3).

[48] 84 Fed. Reg. at 21647 (to be codified at 12 CFR 225.32(k)).

[49] See, e.g., 12 U.S.C. § 1841(a)(5)(A); 12 CFR 225.12(a).

adviser lacks sole discretionary authority to exercise voting rights in situations in which a regulated fund retains the right to revoke the adviser's voting authority.

VI. Apply the Final Rule's Control Framework for Purposes of Regulations O and W.

The Proposal would only apply to the definition of control under the BHC Act and HOLA. ICI members that are affiliated with banking organizations and those that are not must analyze control under these frameworks as well as those established by Sections 22(g), 22(h), 23A and 23B of the Federal Reserve Act. Accordingly, divergences among the definitions create additional burden (by triggering multiple control analyses) and divergences in outcome. Although there are minor differences in statutory language of Section 23A,[50] the relevant provisions of the Federal Reserve Act are in large part worded the same and may be interpreted the same. Moreover, there appears to be no compelling policy reason to interpret the control concepts differently for these sections of the Federal Reserve Act, and the FRB has not provided a rationale for maintaining three different definitions of control (including the related concepts of affiliate and related interest) for four regulations promulgated solely by the FRB (i.e., Regulations O, W, Y and LL). Accordingly, the FRB should harmonize the Proposal with these regulations by replacing the presumptions of control in Regulations O and W with the presumptions of control established in the final rule.

* * * * *

We appreciate this opportunity to share our views regarding the Proposal. We have focused in this letter on issues that are of the greatest concern to our membership and on which we have significant expertise, and we think it is important for the FRB to address these issues in any revisions to the Proposal.

If you have any questions regarding our comments or would like additional information, please contact me at (202) 326-5813 or solson@ici.org; Rachel H. Graham, Associate General Counsel, at (202) 326-5819 or rgraham@ici.org; or

[50] See, e.g., 12 U.S.C. § 371c(b)(1)(D) (defining affiliate to include an "investment fund with respect to which a member bank or affiliate thereof is an investment adviser").

Frances M. Stadler, Associate General Counsel and Corporate Secretary, at (202) 326-5822 or frances@ici.org.

Sincerely,

/s/ Susan M. Olson

Susan M. Olson
General Counsel