

COMMENT LETTER

April 16, 2010

ICI Letter on Basel Committee's Proposed Standards Regarding a Global Framework for Banks' Liquidity Risk Management (pdf)

April 16, 2010 Secretariat of the Basel Committee on Banking Supervision Bank for International Settlements CH-4002 Basel, Switzerland Re: Basel Committee on Banking Supervision: Consultative Document— International Framework for Liquidity Risk Measurement, Standards and Monitoring Dear Members of the Basel Committee on Banking Supervision: The Investment Company Institute (“Institute”)¹ welcomes the opportunity to comment on the standards proposed by the Basel Committee on Banking Supervision (“Committee”) to establish a global framework to strengthen the supervision and monitoring of a bank’s liquidity risk management, including the control of liquidity risk exposures.² Central to its efforts, the Committee has proposed regulatory standards to achieve separate but complementary objectives: (1) a liquidity coverage ratio to promote short-term resiliency of the liquidity risk profile of banks; and (2) a net stable funding ratio to promote resiliency over a longer term with more stable sources of funding. These standards are intended to reinforce other efforts by the Committee and also respond to recommendations of the G20. Our comments are limited to the Committee’s recommendation concerning the net stable funding ratio and the treatment of “money market mutual funds.” The Institute and its members have been actively involved in recent issues related to US registered investment companies that are money market funds.³ 1 The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). 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 \$11.66 trillion and serve almost 90 million shareholders. 2 Basel Committee on Banking Supervision, Consultative Document, International Framework for Liquidity Risk Measurement, Standards and Monitoring, December, 2009 (“Document”), available at <http://www.bis.org/publ/bcbs165.pdf>. 3 See e.g., Report of the Money Market Working Group (“MMWG Report”), available on the Institute’s website at http://www.ici.org/pdf/ppr_09_mmwg.pdf; Letter from Karrie McMillan, General Counsel, Investment Company Members of the Basel Committee on Banking Supervision April 16, 2010 Page 2 of 6 As discussed more thoroughly below, we are particularly supportive of the Committee’s approach in the net stable funding ratio that would, under certain circumstances, give supervisors the flexibility to consider various liquidity risk factors

regarding “money market mutual funds” based on their national circumstances. We note that there is no global harmonized definition of a “money market fund” and the Committee has not defined the term “money market mutual funds” in its work. In fact, there are important and substantial differences among money market funds around the world.⁴ In addition, it is important to note that some of these funds, but not all, may be subject to specific national rules. Given the diversity in national approaches to money market funds, we therefore believe that flexibility is especially important because national supervisors will need the ability to consider the risk factors that should be appropriately applied to the money market funds in their jurisdiction. For example, in the United States, money market funds would typically refer to registered investment companies that seek to maintain a stable net asset value, typically at \$1.00 per share, and comply with a very strict, risk-limiting rule, as discussed below. Such funds are highly regulated and clearly defined under a specific regulatory framework of the Investment Company Act.⁵ Consequently, a US money market fund (defined below) should be evaluated and treated differently under this ratio than an unregulated or less regulated fund.

Liquidity Proposals The Committee’s liquidity proposals have three key elements: (i) a “liquidity coverage ratio” designed to ensure that a bank maintains an adequate level of unencumbered, high-quality assets that can be converted into cash to meet its liquidity needs for a 30-day time horizon under an acute liquidity stress scenario specified by supervisors; (ii) a “net stable funding ratio” designed to promote more medium and long-term funding of the assets and activities of banks over a one-year time horizon; and (iii) a set of common metrics—referred to as “monitoring tools”—that should be used by supervisors in their monitoring of liquidity risks at individual institutions.

Institute, to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission (“SEC”) (September 8, 2009) (commenting on the SEC’s proposed money market fund reforms). ⁴ See e.g., MMWG Report, *supra* note 3, at Appendix H (survey of select offshore jurisdictions’ regulation of money market funds); Committee of European Securities Regulators, Consultation Paper: A Common Definition of European Money Market Funds (CESR/09-850), October 20, 2009 (“CESR Paper”), available at http://www.cesr-eu.org/data/document/09_850.pdf; Letter from Susan M. Olson, Senior Counsel, International Affairs, Investment Company Institute, to Carlo Comporti, Secretary General, The Committee of European Securities Regulators (December 23, 2009) (commenting on CESR Paper). ⁵ As discussed in the MMWG Report, there are a range of alternative products and services in the United States that also offer a stable share price but that fall outside the careful regulatory framework in place for US money market funds. See MMWG Report, *supra* note 3, at Section 5.

Members of the Basel Committee on Banking Supervision April 16, 2010 Page 3 of 6 The Document states that compliance with the liquidity proposals would be mandatory for all “internationally active banks,” but that the ratios and monitoring tools may be used for other banks as well. In particular, the Document states that certain of the ratios’ parameters will need to be set by national supervisors to take into account jurisdiction-specific conditions. For example, according to the Committee, the net stable funding ratio, which is intended to promote longer-term structural funding of banks’ balance sheets, off-balance sheet exposures, and capital markets activities, requires a minimum amount of funding that is expected to be stable over a one year time horizon based on liquidity risk factors assigned to assets and off-balance sheet liquidity exposures. Under this ratio, the amount of stable funding required by supervisors is measured using supervisory assumptions on the broad characteristics of the liquidity risk profiles of an institution’s assets, off-balance sheet exposures, and other selected activities. In particular, with respect to certain off-balance sheet exposures (that is, items requiring funding), including stable value “money market mutual funds,” national supervisors have the flexibility to specify the liquidity risk factors, if any, that reflect the amount of the particular item that supervisors believe should be supported with stable

funding. We believe this flexibility is particularly appropriate because within the global money market there is currently no harmonized definition of a money market fund and, in fact, there are significant differences in national approaches to money market funds.

Regulation of US Money Market Funds In the United States, a money market fund is a type of mutual fund that has as its objective the generation of income and preservation of capital and liquidity through investments in short-term high quality securities. These funds also typically seek to maintain \$1.00 net asset value per share. Money market funds, like all US mutual funds, are subject to a comprehensive regulatory scheme under the US federal securities laws that has worked extremely well for 70 years. Their operations are subject to all four of the major US federal securities laws administered by the SEC, including the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Advisers Act of 1940, and, most importantly, the Investment Company Act of 1940 (“Investment Company Act”).⁶ We refer to these very specific money market funds as “US money market funds.” The Investment Company Act goes far beyond the disclosure and anti-fraud requirements that are characteristic of the other US federal securities laws and imposes substantive requirements and prohibitions on the structure and day-to-day operations of mutual funds. Among the core objectives of the Investment Company Act are to: (1) provide for a high degree of oversight and accountability; (2) ensure that investors receive sufficient information about the fund, including its fees and expenses, and that the information is accurate and not misleading; (3) protect the physical integrity of the fund’s assets by having explicit rules concerning the custody of portfolio securities; (4) prohibit or restrict affiliated transactions and other forms of self-dealing; (5) prohibit unfair and unsound capital

⁶ Mutual funds also are subject to most of the requirements that apply to US corporate issuers under the Sarbanes-Oxley Act of 2002. Members of the Basel Committee on Banking Supervision April 16, 2010 Page 4 of 6 structures (by, for example, placing constraints on the use of leverage); and (6) ensure the fairness of transactions in fund shares.⁷ In addition to the substantive requirements of the Investment Company Act, US money market funds are subject to the strict requirements of Rule 2a-7 under the Investment Company Act, which was recently amended to strengthen an already resilient product through explicit liquidity standards, stress testing, “know your customer” procedures, shorter portfolio maturities, improved credit quality, and more disclosure.⁸ Rule 2a-7 includes several risk-limiting conditions intended to help a fund stabilize its share price at \$1.00. These conditions limit risk in a US money market fund’s portfolio by governing the credit quality, liquidity, maturity, and diversification of a US money market fund’s investments.⁹ Among these risk-limiting conditions, requirements include that US money market funds:

- only invest in high quality securities that mature in 13 months or less, which a fund’s board of directors (or its delegate) determines present minimal credit risks, and a requirement that at least 97 percent of a fund’s assets be invested in securities held in US government obligations or other securities that either received the highest short-term rating or are of comparable quality;
- maintain a sufficient degree of portfolio liquidity necessary to meet reasonably foreseeable redemption requests, including a requirement that all taxable funds maintain at least 10 percent of assets in cash, US Treasury securities, or securities that convert into cash within one day, and that all funds maintain at least 30 percent of assets in cash, US Treasury securities, certain other government securities with remaining maturities of 60 days or less, or securities that convert into cash within one week;
- maintain a weighted average portfolio maturity that reduces both interest rate and credit spread risk;

and

⁷ Each of these core objectives is discussed in detail in Section 4 of the MMWG Report, *supra* note 3.

⁸ See Money Market Fund Reform, SEC Release No. IC-29132 (February 23, 2010) (“Release”), 75 FR 10060 (March 4, 2010). Although the amendments to Rule 2a-7 are effective May 5, 2010, funds have until May 28, 2010 (and in some cases, June 30) to comply with the changes relating to quality, maturity,

diversification, liquidity, and stress testing. 9Any fund registered under the Investment Company Act that holds itself out as a money market fund, even if it does not rely on the exemptions provided by Rule 2a-7 to maintain a stable share price, also must comply with the rule's risk-limiting conditions. The SEC adopted this approach to address the concern that investors would be misled if an investment company that holds itself out as a money market fund engages in investment strategies not consistent with the risk-limiting conditions of Rule 2a-7. Members of the Basel Committee on Banking Supervision April 16, 2010 Page 5 of 6 • maintain a diversified portfolio designed to limit a fund's exposure to the credit risk of any single issuer. US money market funds that use the amortized cost method of valuation¹⁰ also must periodically "shadow price" or mark their portfolios to market to ensure that the actual value of the fund does not deviate from \$1.00 per share by more than one-half of 1 percent. Moreover, all funds must dispose of a defaulted or distressed security (e.g., one that no longer presents minimal credit risks) "as soon as practicable," unless the fund's board of directors specifically finds that disposal would not be in the best interests of the fund. The comprehensive protections of the Investment Company Act, combined with the exacting standards of Rule 2a-7, have contributed to the strength of US money market funds. Since the SEC adopted Rule 2a-7 in 1983, money market fund assets have grown from \$180 billion to \$2.9 trillion as of April 2010. Today, retail and institutional investors alike rely on them as a low-cost, efficient cash management tool that provides a high degree of liquidity, stability in principal value, and a market-based yield. As noted above, US money market funds are a key component of the money market,¹¹ relied upon by individuals and institutions alike. The resilience of US money market funds is in no small measure attributable to the comprehensive protections of the Investment Company Act, and, in particular, Rule 2a-7. Given the lack of a uniform global definition of a money market fund, we support the Committee's approach that would, under certain circumstances, give supervisors the flexibility to consider various liquidity risk factors regarding "money market mutual funds" based on their national circumstances. Indeed, we believe such flexibility is particularly important for local supervisors as they consider the risk factors and appropriate treatment of US money market funds. * * * * 10 To maintain a stable price per share, US money market funds use the amortized cost method of valuation and/or the penny-rounding method of pricing. Under the amortized cost method of valuation, US money market funds value their portfolio securities by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. Under the penny rounding method of pricing, share price is determined by valuing securities either at market value, fair value, or amortized cost, and rounding the per share net asset value to the nearest cent on a share price of \$1.00. 11 In the United States, the market for debt securities with a maturity of one year or less is generally referred to as the "money market." Securities that have final maturities of more than one year but whose yields are reset weekly, monthly, or quarterly also are generally considered part of the money market. Members of the Basel Committee on Banking Supervision April 16, 2010 Page 6 of 6 We would welcome the opportunity to speak with you in more detail about our comments. If we can provide any more information, please feel free to contact me directly at solson@ici.org or 1 202- 326-5813 or Jane Heinrichs, Senior Associate Counsel, at jheinrichs@ici.org or 1 202-371-5410. Sincerely, /s/ Susan M. Olson Susan M. Olson Senior Counsel, International Affairs