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May 29, 2015

Secretariat of the Financial Stability Board
c/o Bank of International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Consultation (2nd): Assessment of Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Sir or Madam:

The Capital Group Companies ("Capital Group") is one of the oldest asset managers in the United States. Through our investment management subsidiaries, we actively manage assets in various collective investment vehicles and institutional client separate accounts globally. The vast majority of these assets consist of the American Funds family of mutual funds, which are U.S. regulated investment companies distributed through financial intermediaries and held by individuals and institutions across different types of accounts. Capital Group does not take short positions, use substantial leverage or engage in securities lending. As a global asset manager, we have a significant interest in policies promoting a well-functioning financial system. We appreciate the opportunity to comment on the Consultative Document (2nd): Assessment of Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions ("2015 Consultation"), issued by the Financial Stability Board ("FSB") and the International Organizations of Securities Commissions ("IOSCO").

We offer below our views on a number of the more important aspects of the 2015 Consultation, many of which reflect the comments we submitted in response to the Consultative Document published last year ("2014 Consultation"). Most importantly, we believe that there is currently insufficient evidence to establish that the asset management industry creates systemic risk. We agree with the comments of Greg Medcraft, IOSCO Board Chair and Chairman of Australian Securities and Investments Commission, at a recent financial regulations conference:

> "There has been a lot of discussion about the systemic risk of fund managers. My personal view is that while fund management has grown significantly, I think the jury is still out in terms of whether it is a systemic risk or not. I think an area we've certainly got to work on is identifying where fund managers could cause systemic risk, but I don't think at this stage the case has been proven."[1]

In the absence of such evidence, we believe that activities-based regulation, rather than an entity-focused approach, is a more effective tool to address risks in the global financial system. We believe that the risks attributed to funds and the asset management industry, including those arising from leveraging, securities lending, investments in derivatives and counterparty and liquidity risk, are more appropriately regulated as activities. We further believe that individual investment funds or asset managers should not be singled out for a higher level of regulatory scrutiny merely because of their status or size. Activities-based regulation would address risks across industries or markets, regardless of the types of entities engaged in the risky activities.

However, before our discussion on the methodologies in the 2015 Consultation, we offer some brief observations regarding the comment process. Although the 2015 Consultation notes that certain changes from the 2014 Consultation are being proposed based on comments received (for example, the addition of asset managers within the scope of the methodologies), it generally fails to include any supporting explanations. Accordingly, it is unclear how previous comments, including our responses to the 2014 Consultation, were evaluated. We also note that the 2015 Consultation was published before the conclusion of the comment period for the Financial Stability Oversight Council's notice seeking public comment on asset management products and activities ("FSOC Release"). It is unfortunate that the 2015 Consultation was unable to benefit from the comments provided by members of the U.S. asset management industry in response to the FSOC Release, particularly since many topics are directly relevant to the questions raised in the 2015 Consultation. A copy of Capital Group's comment letter on the FSOC Release is attached as Exhibit A.

We encourage FSB and IOSCO to conduct a consultation based on more robust discussion and greater transparency. For example, the 2015 Consultation could have included a summary of the comments received in response to the 2014 Consultation, and in particular, the opinions of FSB and IOSCO regarding the various arguments. Such a summary might allow commenters to frame subsequent responses more clearly and improve discussions. We think that a more transparent rulemaking process could contribute to more thoughtful regulations specifically tailored to

[1] Michelle Price and Lisa Jucca, (2015). "Reuters Summit - Top securities regulator says no proof big funds pose systemic risks" [Online]. Available: http://www.reuters.com/article/2015/05/12/regulation-summit-funds-risks-idUSL3N0Y35IP20150512.

address proven risks in the global financial markets. We also encourage the FSB and IOSCO to take the time to fully evaluate comments without the pressure of arbitrary deadlines, particularly in light of the recent expansion of the 2015 Consultation to include asset managers.[2]

1. <u>There is insufficient evidence to prove that the asset management industry poses any significant threat to global financial stability. Before taking any global regulatory policy action, it is incumbent on FSB and IOSCO to clearly distinguish "systemic risk" from normal investment risk based on objective evidence.</u>

We believe that there is currently insufficient evidence to establish that the asset management industry creates global systemic risks. As FSOC acknowledged in the FSOC Release, "investment risk is inherent in capital markets, representing a normal part of market functioning."[3] Periodic shocks are an inevitable part of our complex, global market place. In remarks made earlier this year, Mark Flannery, the Chief Economist of the Securities and Exchange Commission ("SEC"), highlighted the impressive ability of the financial sector to absorb risks and cautioned against hypothetical concerns that, "…there could be big losses and look at all the horrible things that might happen under some unspecified circumstance…because it does a disservice to the notion that there are or there might be genuine systemic considerations."[4]

Given the important capital allocation role played by the asset management industry in the global economy and considering the significant potential consequences of systemic risk regulation, we believe the onus should be on FSB and IOSCO to clearly distinguish "systemic risk" from normal investment risk before implementing any global policy measures. We urge FSB and IOSCO to take into consideration economic consequences, historical precedents, contributing and exacerbating conditions, likelihood of reoccurrence, and any mitigating factors. Activities should not be labelled as systemically risky based on unsupported assertions and conjecture. To the extent FSB and IOSCO identify certain activities as posing a threat to global financial stability, then the risks of such activities should be demonstrable through objective evidence. Importantly, FSB and IOSCO should consider how risks might already be reduced or eliminated by existing or proposed regulations, the structure of a product, risk management practices, and investor behavior. At the conclusion of

[2] According to the 2015 Consultation, Phase 1 requires the FSB, in consultation with IOSCO, to revise the methodologies with the expectation that they be completed "by the end of 2015."
[3] Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001 (hereinafter "FSOC Release").
[4] "Asset Management, Financial Stability and Economic Growth", Remarks by SEC Chief Economist Mark Flannery at The Brookings Institution, Washington D.C. (January 9, 2015). Available: http://www.brookings.edu/~/media/events/2015/01/09-asset-management/20150109_asset_management_transcript.pdf

the process, any additional proposed measures to address activities that cause systemic risk should be tailored as narrowly as possible to minimize unintended negative consequences.

2. Without sufficient evidence that the asset management industry creates systemic risk, activities- based regulation is a more appropriate tool to address risks in the global financial system, rather than the selective designation of entities.

As discussed in our response to the 2014 Consultation, we believe that activities-based regulation is an appropriate tool to address any systemic risks that may exist.[5] An entity-focused approach may be appropriate for banks but would be inappropriate and counterproductive for the asset management industry. It is estimated that only 25% of global investable assets are managed by an asset manager and only 15% are in collective investment vehicles.[6] Accordingly, the entity-based approach of the 2015 Consultation would have limited impact in mitigating global systemic risk but could have severe negative consequences for the capital markets. As noted by U.S. Federal Reserve Board Governor Daniel Tarullo, "There is reasonable concern that designating a small number of nonbank-affiliated firms would increase moral hazard concern."[7] In addition, the application of costly policy measures to a small subset of market participants is likely to distort competition and could result in investors moving to competing products, which might be riskier.

Since the publication of the 2014 Consultation, regulatory authorities have made significant progress in mitigating risks in the financial markets. Banking agencies have implemented enhanced capital, leverage and liquidity standards. The SEC has adopted new rules for U.S. money market funds, which require prime money market funds sold to institutional investors to trade based on a floating net asset value and to restrict withdrawals through a system of gates and fees. Likewise, the European Union is in the process of finalizing its money market fund reforms. The Commodity Futures Trading Commission and the European Union have continued to expand their derivatives clearing mandates. International risk management standards have been strengthened for systemically important payment systems, central securities depositories, securities settlement systems, central clearing parties and trade repositories. Several efforts promoting data standardization and transparency are underway, including the global Legal Entity Identity initiative.

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[5] See Letter to Secretariat of the Financial Stability Board from James Rothenberg, Chairman of The Capital Group Companies, on the Consultative Document: Assessment of Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (April 7, 2014).
[6] BlackRock, "Fund Structures as Systemic Risk Mitigants," Viewpoint (September 2014), p. 3.
[7] "Regulating Systemic Risk", Remarks by U.S. Federal Reserve Board Governor Daniel K Tarullo at the 2011 Credit Markets Symposium (March 31, 2011). Available: (http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf).

Against this background of heightened regulatory scrutiny, the importance of focusing on activities has been acknowledged more widely. The FSOC Release considered the variety and complexity of asset management activities rather than focus on a few entities that conducted those activities. A recent International Monetary Fund report concluded that "…given that the [asset management] industry is diverse and that differences in investment focus seem to matter significantly for funds' contribution to systemic risk, a product- or activity-based emphasis seems to be important."[8] Most notably, FSB Chairman Mark Carney recently highlighted the importance of reviewing asset management activities:

> "…the FSB is prioritising work to understand and address vulnerabilities in capital market and asset management activities. This will comprise two linked projects. The first will examine the likely near-term risk channels and the options that currently exist for addressing these. The second will consider the longer-term development of these markets and whether additional policy tools should be applied to asset managers according to the activities they undertake with the aim of mitigating systemic risks."[9]

We welcome this more general FSB review of asset management activities and their risks and urge FSB to more fully shift its focus to these efforts rather than entity-based designation based on the proposed size filter. We believe that a comprehensive review of activities will be a more productive route to understanding and addressing any potential systemic risks arising from the asset management industry.

We continue to believe that the goal of systemic risk regulation should be to balance the need to eliminate abuses and excessive risk that can endanger the financial system, while at the same time, encouraging acceptable levels of risk taking that is necessary for innovation and economic growth. The global capital markets are extremely complex. Even the smallest regulatory change can lead to unintended consequences, which make them less efficient and negatively affect market participants. Consequently, extreme care should be taken by regulatory authorities to ensure that any analysis is based on actual data and any regulatory policy actions are carefully weighed against the potential for market disruption. We agree with statements made by U.S. Federal Reserve Board Governor Jerome Powell that:

> "…financial stability need not seek to eliminate all risks. We need to learn, but not overlearn, the lessons of the crisis. I

[8] International Monetary Fund, The Asset Management Industry and Financial Stability, Chapter 3 (April 2015), p. 118.

[9] See Letter to G20 Finance Ministers and Central Bank Governors from Mark Carney, Chairman of Financial Stability Board on Financial Reforms – Progress on the Work Plan for the Antalya Summit (April 9, 2015).

> believe there should be a high bar for "leaning against the credit cycle" in the absence of credible threats to the core or the reemergence of run-prone funding structures. In my view, the Fed and other prudential and market regulators should resist interfering with the role of markets in allocating capital to issuers and risk to investors unless the case for doing so is strong and the available tools can achieve the objective in a targeted manner and with a high degree of confidence."[10]

We also believe that regulation should apply to all entities engaged in an activity that has been identified to cause unacceptable risk. The money market fund reforms of the SEC provide an example of this approach. In 2008, the Reserve Primary Fund "broke the buck" when its net asset value fell to 97 cents per share as a result of the fund's exposure to Lehman Brothers commercial paper. This event resulted in substantial investor redemptions from the fund, giving rise to concerns around risks of potential runs on money market funds. To increase money market fund resilience to heavy redemptions in times of stress, the SEC engaged in rulemaking to modify the way money market funds operate, rather than identify individual money market funds for additional regulation.

In contrast, the 2015 Consultation proposes to apply the methodologies to certain firms while excluding others, such as certain public financial institutions, sovereign wealth funds, and pension funds. We are not advocating that these entities should be regulated per se; however, we observe that the reasons for their exclusion do not seem consistent with the justifications for covering asset managers and funds.[11] For example, the 2015 Consultation proposes that sovereign funds be excluded because of government ownership and guarantees, even though this argument conflicts with one of the main goals of systemic regulation, which is to avoid the need for government intervention or taxpayer assistance in bailing out firms. Moreover, sovereign wealth funds pursue many of the same investment strategies and are engaged in similar activities as other investment funds. Given the size of assets they control, they are a significant participant in the global financial markets.[12] With respect to pension funds, the 2015 Consultation states that, "they pose low risk to global financial stability and the wider economy due to their long-term investment perspective." However, this same long-term investment focus is characteristic of the U.S. mutual fund industry. As of mid-2014, the overwhelming percentage of mutual

[10] "Financial Institutions, Financial Markets and Financial Stability", Remarks by U.S. Federal Reserve Board Governor Jerome H. Powell at the Stern School of Business, New York University, New York, New York (February 18, 2015). Available: http://www.federalreserve.gov/newsevents/speech/powell20150218a.htm

[11] 2015 Consultation at p. 5.

[12] As of 2014, sovereign wealth funds held $7.1 trillion in assets. Source: Investment Company Institute (data from Sovereign Wealth Fund Institute).

fund investors were individuals focused on retirement savings.[13] We urge FSB and IOSCO to apply any policy reasoning consistently across all market participants to protect fair and efficient global capital markets. An activities-based approach to risk regulation would address this concern.

3. Size should not be used as the primary indicator of systemic risk.

As noted above, we do not support an entity-based approach to systemic risk regulation for the asset management industry. Consequently, we are concerned that the materiality threshold in the 2015 Consultation continues to place an unwarranted emphasis on the size of a fund and asset manager in identifying candidates for potential designation. We appreciate that the stated goal of the threshold is merely to provide an initial filter to reduce the size of the assessment pool of firms to a manageable number.[14] However, we are concerned that the threshold might become the de facto test for designating a firm as being systemically important when, as noted in our comments to the 2014 Consultation, we do not believe that a focus on size will provide a reliable subset of entities engaged in activities that may arguably cause systemic risk. At most, size should be a secondary consideration only after it has been determined that the fund is engaged in other activities that lead to risk, such as excessive leverage. By way of example, a regulated mutual fund with more than $100 billion that invests with a long-only focus would have a lower risk profile than a $25 billion hedge fund with financial leverage of three times net asset value. Note that despite having greater risks, the latter example would not be captured by the size metric. Similarly, the materiality threshold would not have captured the Reserve Primary Fund, which peaked at around $65 billion in assets. Moreover, we believe that if a materiality threshold is to be employed, FSB and IOSCO should consult and coordinate with FSOC, which has recently undertaken an activities-based review of the U.S. asset management industry. We believe that successful regulation of global systemic risk requires consistency in the global and domestic approaches to regulating systemically important institutions, with as much deference as possible being granted to national regulators, as further discussed below.

4. Deference should be granted to national regulatory authorities to the greatest extent possible, which we believe is consistent with FSB and IOSCO mandates.

Although we do not think there should be a materiality threshold, we note that the threshold selected in the 2015 Consultation results in a focus on U.S. mutual funds and asset managers, which look to the SEC as their primary regulator.[15] As further

[13] ICI Research Perspective, Characteristics of Mutual Fund Investors, 2014, at 1, 2013 (Nov. 2014).
[14] 2015 Consultation at p. 10.
[15] U.S. mutual funds comprise a relatively small portion of the world's capital markets, which limits to some extent their ability to impact global financial markets. As of 2013, U.S. long-term mutual fund assets accounted for only 15.6% of global equity and bond markets. Source: Investment Company Institute (data from International Investment Funds Association and International Monetary Fund).

discussed in our attached responses to the FSOC Release, the U.S. asset management industry is already subject to a comprehensive regulatory framework. To the extent U.S. asset managers and mutual funds are to be subjected to additional regulation, we believe that the SEC is in the best position to consider and promulgate such regulations. The SEC has successfully supervised and regulated investment advisers and registered investment companies for 75 years. SEC Chair Mary Jo White recently stated that, "The U.S. Securities and Exchange Commission (SEC) has the tools it needs to address systemic risks to the extent they exist in the asset management industry."[16] She further explained that, "Risk regulation by the SEC is driven by its core mission of protecting investors, overseeing and protecting the capital markets."[17] We believe that the SEC, in effectively carrying out this mission over time, has taken actions that substantially reduce the ability of asset managers to cause systemic risk. The SEC has the necessary understanding of U.S. asset management products and services and a well-developed process for creating regulations tailored to the risk being targeted. This process includes appropriate data collection, a cost-benefit analysis and an open process with public notice and comment, all of which we encourage FSB and IOSCO to consider in their efforts. We do believe however that to the extent FSB identifies any systemic risks from its review of asset management activities, these can be addressed through the coordination and cooperation of FSB and SEC.

Since the publication of the 2014 Consultation, the SEC has already undertaken several initiatives designed to address systemic risk in U.S. financial markets. These include the efforts further discussed below to modernize and enhance data collection and reporting. The SEC is also working on stress testing requirements for financial companies, including asset managers and registered investment companies. In addition, the money market fund reforms adopted last year are still in the process of being fully implemented. FSB and IOSCO should allow sufficient time for the complete implementation of these initiatives to be able to consider their impact on reducing any risks to global financial stability before attempting to regulate U.S. asset managers and mutual funds.

We seek clarification on the scope and authority of the proposed International Oversight Group ("IOG"). In particular, we ask whether the IOG could supercede the judgment of a national regulator in making determinations relating to financial entities within its jurisdiction. We note that this may raise issues regarding the authority of FSB and IOSCO. We are concerned that the existence of IOG without a clearer understanding of its role may create uncertainty in the event of a disagreement with a national regulator. This could undermine the asset management industry's ability to look to its primary regulator. We seek confirmation that if national

[16] Rachel McTague, "SEC Chair White Affirms Agency Has Tools to Address Risks in Industry", (May 8, 2015). Available: http://www.ici.org/viewpoints/view_15_gmm_white.
[17] Ibid.

authorities reasonably believe that risks can be addressed through existing or proposed regulations, then the IOG should not be able to dictate otherwise. As an example, should national regulators deem it unnecessary to identify financial entities within their jurisdiction on a Stage 1 list, they should not then be required to assess the global systemic importance of any such firms because they appeared on IOG's Stage 0 list.

We believe the U.S. regulatory framework successfully mitigates risks in the financial markets and protects shareholders and clients through a system of compliance and disclosure requirements. The 2015 Consultation states that, "The FSB and IOSCO recognise that there are a variety of policy tools available for addressing potential financial stability risks that could arise out of asset management activities and products including changes to industry-wide regulation and designation."[18] We believe that designation should be reserved for circumstances in which other activity-based regulatory actions clearly would be insufficient to address or limit the perceived systemic risks.

5. <u>The regulation of systemic risk should be based on reliable data, the need for which cannot be replaced with supervisory oversight.</u>

The 2015 Consultation notes challenges in obtaining data and appears to replace the need for data with notions of "supervisory judgment" and "Narrative Assessments". We believe that the subjectivity inherent in these concepts cannot be used as the basis for regulation. We further believe that a significant amount of data is already available, although we acknowledge that reasonable efforts are required to enhance the usefulness of such data and collect additional information. Some of these efforts are already underway. Last year, the SEC implemented an initiative to expand existing data requirements. In connection with this initiative, the SEC recently proposed several rules to modernize and enhance the reporting and disclosure of information by mutual funds and investment advisers. The SEC proposal would require funds to report additional information in key areas, including use of derivatives, securities lending activities, liquidity, pricing of portfolio instruments and risk metrics. It would also require investment advisers to file new categories of information, particularly relating to separately managed accounts and the assets and derivatives held by such accounts. The proposal would also require enhanced and standardized disclosures in financial statements, and would permit mutual funds to provide shareholder reports by making them accessible on a website. In addition to SEC efforts within the U.S., there are ongoing global efforts in data standardization and transparency, including the Legal Entity Identity initiative. We believe that rather than relying on a subjective process, FSB and IOSCO should allow time for the various data collection efforts to yield results, which should then be taken into consideration in establishing policy measures.

[18] 2015 Consultation at p. 31.

6. Due to their structure and regulatory framework, U.S. mutual funds do not cause systemic risk.

We believe that the structure and regulatory framework of U.S. mutual funds make them highly unlikely to transmit risks to the broad financial system. Although we discuss these topics below and in our attached FSOC Release comment letter, we encourage FSB and IOSCO to review the Investment Company Institute's ("ICI") comment letter in response to the FSOC Release. The ICI letter describes the regulatory framework for U.S. mutual funds in much greater detail.[19]

The regulatory structure and operations of mutual funds are based on a fundamentally different principle than banks and other financial institutions, which operate through the use of leveraged capital. Mutual funds do not guarantee any type of return and a fund investor's claim is tied to the net asset value of the mutual fund. There is a daily mark to market valuation of all portfolio assets and if a security's market value is not readily available, a fund's board of directors must ensure that the fund has an effective fair valuation process. Detailed fund disclosure requirements make it clear that investors enjoy the gains and bear the risk of loss of their investments. Mutual funds must comply with strict disclosure requirements regarding their investment objectives, strategies and risks, including the risk that an investor can lose money investing in the fund. Mutual funds must also adhere to requirements relating to liquidity, leverage, capital structure, diversification, concentration of investments, daily fund valuation, custody of fund and client assets and affiliated entity transactions. They also have adequate tools to help meet their redemption obligations, are restricted from excessive exposures to leverage, have risk management practices to mitigate operational risks and are able to wind up affairs without government assistance. Mutual funds are closed or merged routinely, and are highly substitutable. Moreover, they are subject to a strict governance standard. Each fund's board of directors acts as a fiduciary in overseeing the mutual fund's operations and ensuring that the asset manager is properly executing the mutual fund's investment strategies in pursuit of the fund's investment objectives. Importantly, it is responsible for renewing the investment management agreement on an annual basis. For all of these reasons, we believe that mutual funds do not create systemic risk.

We urge FSB and IOSCO to consider that any proposed regulations for the asset management industry will have broad impact to investors. In the U.S., by year-end 2013, nearly 98 million investors owned mutual funds. If mutual funds are subjected to enhanced regulatory scrutiny, the attendant costs will likely be passed on to

[19] See Letter to Financial Stability Oversight Council from Paul Schott Stevens, President and CEO of Investment Company Institute on Notice Seeking Comment on Asset Management Products and Activities (FSOC-2014-0001) (March 25, 2015).

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investors in some form, potentially causing them to move to competing products, which might be riskier. As discussed in our attached comments to the FSOC Release, we believe that any proposal that could restrict investor choice to a more limited array of instruments or strategies could reduce the diversity of asset management products and investor behavior, thereby amplifying risks of "herding."

7. Asset managers do not pose significant systemic threat to the global economy and should not be within the scope of the methodologies.

We are very concerned about the addition of asset managers to the scope of the 2015 Consultation, contrary to the 2014 Consultation's original determination not to include asset managers and despite support for this position from commenters. Indeed, we find it particularly confusing given that the 2014 Consultation noted numerous mitigating characteristics of advisers that would suggest they were not appropriate for inclusion within the scope of systemic regulation:

> "In many jurisdictions, other considerations further distinguish the risk profile of a fund from that of a fund manager. For the purposes of this consultation, the methodology is designed to focus on the fund level for the following reasons outlined below:
>
> Economic exposures are created at the fund level as they emanate from the underlying asset portfolio held by the fund. It is therefore the portfolio of assets that creates the respective exposures to the financial system.
>
> A fund is typically organised as a corporation or business trust under national law, and, as such, is a separate legal entity from its manager.
>
> The assets of a fund are separated and distinct from those of the asset manager and as a result, the assets of a fund are not available to claims by general creditors of the asset manager. There are also practical reasons for focusing on funds. Certain data (such as data collected through the SEC/CFTC Form PF/PQF in the US and the Alternative Investment Fund Managers Directive (AIFMD) transparency reporting requirements in the EU) is or will be available to supervisors in a per entity format."[20]

In addition, fund managers act as agents for the funds and serve in a fiduciary capacity. Subject to a written contract, they manage each portfolio in accordance with the fund's investment objectives and policies, as disclosed in the fund's

[20] Consultative Document: Assessment of Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, (January 8, 2014) p. 30.

prospectus. Competition to manage assets is intense and asset managers are highly substitutable.

As discussed in our comments to the FSOC Release (see attached), asset managers play a critical role in deploying capital through the markets and offering investors a diverse range of investment vehicles and services that allow them to benefit from economies of scale and the asset manager's professional services. They are also important to the price discovery process that is the foundation of our financial markets. Active managers are particularly important in this regard since they invest based on their own due diligence and investment strategies. This means that in times of asset price declines, at least some asset managers are continuing to engage in opportunistic buying of securities at distressed pricing, acting as an important source of liquidity. We urge FSB and IOSCO to consider how any proposed regulation of asset managers might deprive investors of investment choice and channel them into a more limited array of strategies or instruments. This would not only likely to cause distortions in capital allocation, but may in fact increase risks as greater pools of money are concentrated in fewer types of assets and markets.

8. <u>The methodologies should expressly include processes for a provisionally designated firm to engage with regulators, submit additional information and appeal its status. We also urge FSB and IOSCO to consider a process by which a firm could avoid designation by de-risking its business.</u>

It remains unclear in what form enhanced regulation would take place if a fund or asset manager is designated a global systemically important financial institution. Given the potential gravity of the consequences, we are concerned that the 2015 Consultation does not include explicit processes for provisionally designated firms to engage with regulators or submit additional information. We also believe that there should be a process for a firm to appeal its designation. We urge FSB and IOSCO to adopt such processes and consider a more collaborative and transparent rulemaking process to avoid issues of due process. We also urge FSB and IOSCO to consider including an "off-ramp" process by which a firm can avoid designation by altering its business structure or practices to eliminate identified risks. We believe this could be an effective way to reduce systemic risk while allowing firms some flexibility to take action to change the course of designation.

9. <u>Conclusion</u>

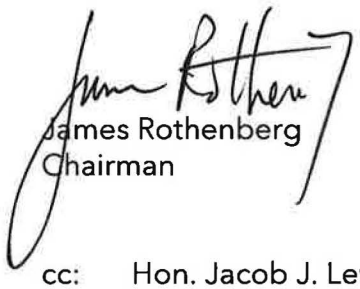
As appropriately observed by IOSCO Board Chair Greg Medcraft, the case for asset managers being systemically important has yet to be proven. Without sufficient evidence to establish that the asset management industry poses significant threat to global financial markets, we believe that identified risks should be addressed through activities-based regulation rather than the selective designation of individual entities due to their status or size. We applaud FSB efforts to evaluate the risks of activities

within the asset management industry and urge the FSB to further focus on these efforts.

We do not believe that the asset management industry creates systemic risks. Any potential threats to the global economy are mitigated by the agency nature of the relationship between asset managers and the funds and accounts they advise. We also believe that the regulatory framework governing asset managers and mutual funds already adequately mitigates any systemic risks. This regulatory regime has evolved over the years to respond to changes in the markets and their risks, and it is further adaptable to address new issues as they may arise. We encourage FSB and IOSCO, in consultation with national regulators, to carefully evaluate existing empirical data (and collect additional data if needed) to identify activities that may pose systemic risks. We also urge FSB and IOSCO to consider the significant progress that national regulators have made in already reducing or eliminating global risks through recent rulemaking and various initiatives.

We truly appreciate the opportunity to comment on the 2015 Consultation. If you have any questions regarding our comments, please feel free to contact Maria Manotok at (213) 615 0200.

Sincerely,



James Rothenberg
Chairman

cc: Hon. Jacob J. Lew, Secretary, U.S. Department of Treasury
Hon. Mary Jo White, Chair, U.S. Securities and Exchange Commission
Hon. Timothy G. Massad, Chairman, U.S. Commodities and Futures Trading Commission
Hon. Janet L. Yellen, Chairman, Board of Governors of the Federal Reserve

EXHIBIT A

The Capital Group Companies, Inc.
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Los Angeles, California 90071-1406

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March 25, 2015

Mr. Patrick Pinschmidt
Deputy Assistant Secretary
Financial Stability Oversight Council
1500 Pennsylvania Avenue. NW
Washington, DC 20220

Re: Docket Number FSOC-2014-0001

Dear Mr. Pinschmidt:

The Capital Group Companies is one of the oldest asset managers in the nation. We, through our investment advisory subsidiaries, actively manage assets in various collective investment vehicles and separate accounts. The vast majority of these assets consist of the American Funds family of mutual funds, which are distributed through financial intermediaries and held by individuals and institutions across different types of accounts. We support efforts of the Financial Stability Oversight Council ("Council") to undertake a detailed analysis of asset management products and activities to understand their potential for causing systemic risk. The capital markets are extremely complex. Even the smallest regulatory change can inadvertently make them less efficient and negatively affect market participants. Consequently, we believe that extreme care should be taken by the Council to ensure that its analysis is based on objective facts and any regulatory policy actions it considers are carefully weighed against the potential to disrupt markets.

We appreciate the opportunity to respond to the Council's release seeking public comment on whether risks associated with liquidity and redemptions, leverage, operational risk and resolution in the asset management industry could affect U.S. financial stability (the "Release"). However, before addressing specific topics raised in the Release, we offer below some general comments regarding potential systemic risk regulation, which we strongly urge the Council to consider. Additionally, as we believe that the Securities and Exchange Commission ("SEC") has already acted to address risks raised by the Release with respect to money market funds through the amendments to Rule 2a-7 last year, we do not address money market funds in this letter. If the Council has remaining concerns regarding money market funds, we encourage the Council to address those specifically rather than through any proposed action that could affect mutual funds or asset managers more broadly.

1. General Comments

a. Asset managers play an important role in the capital markets and with investors. Any proposed regulation directed at the asset management industry should be implemented in a fair, tailored and certain manner to protect capital market efficiency and avoid unnecessary costs for investors.

As previously stated in our letter to the SEC in response to the September 2013 report by the Office of Financial Research, *Asset Management and Financial Stability* ("OFR Report"), we strongly believe that the goal of systemic risk regulation should be to balance the need to eliminate abuses and excessive risk that can endanger the financial system, while at the same time, encouraging acceptable levels of risk taking that is necessary for innovation and economic growth.[1] This is consistent with SEC Chair Mary Jo White's recent statement that:

> "[The SEC's] objective, however, is not to eliminate all risk. Far from it, investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors. Just as our regulatory program evolves, so too must our understanding of the balance that program strikes between reducing undue risks and preserving the principle of "reward for risk" that is at the center of our capital markets."[2]

Asset managers offer a diverse range of investment vehicles and services that allow investors to effectively participate in the market, benefitting from economies of scale and the asset manager's professional services. Asset managers, which employ a wide variety of investment strategies, play a critical role in deploying capital through the markets, which has been instrumental in creating and sustaining our vibrant and innovative economy. Any proposed regulation that might deprive investors of investment choice by channeling them into a more limited array of strategies or instruments is not only likely to cause distortions in capital allocation, but may in fact increase risks as greater pools of money are concentrated in fewer types of assets and markets.

Asset managers also play a critical role in the price discovery process that is the foundation of our financial markets. Active managers are particularly important in this regard since they invest based on their own due diligence and investment strategies. This means that in times of asset price declines, at least some asset managers are continuing to engage in opportunistic buying of securities at distressed pricing, counterbalancing the impact of any forced sales and technical trading, and acting as an important source of liquidity. This theory is supported by research from Strategic Insight, which demonstrated that even during times of market stress, when mutual fund

[1] See Letter to United States Securities and Exchange Commission from James Rothenberg, Chairman of The Capital Group Companies, on the Office of Financial Research – Report on Asset Management and Financial Stability (November 1, 2013).

[2] Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Speech by SEC Chair Mary Jo White at The New York Times Dealbook Opportunities for Tomorrow Conference, New York, NY (Dec. 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VIoGhTHF884.

investor redemptions were particularly high, fund portfolio managers had positive net purchases, providing liquidity to the markets and counteracting downward price movements.[3]

It is important to note that any proposed regulations for the asset management industry will potentially have broad impact. For example, by year-end 2013, nearly 98 million U.S. investors owned mutual funds.[4] If mutual funds are subjected to enhanced regulatory scrutiny, the attendant costs will likely be passed on to investors in some form. The designation of mutual funds as "systemic" and the application of costly policy measures could result in investors moving to competing products, which might be riskier. Finally, any proposal that could restrict investor choice to a more limited array of instruments or strategies could reduce the diversity of asset management products and investor behavior, thereby amplifying risks of "herding." Consequently, we believe the Council should focus on activities that have demonstrated to unacceptably increase systemic risk and not on particular types of investment vehicles or their managers.

If after careful analysis and deliberation, systemic risks are identified in the asset management industry, we strongly urge the Council to perform a detailed and thorough cost-benefit analysis of all regulatory alternatives. The process should involve not only close coordination with the SEC, but communication, discussion and debate with industry members and trade organizations, as well as the general public. Any proposed regulatory action should be designed to address any identified risk in a narrowly tailored fashion that avoids unnecessary impacts to capital market efficiency and investor costs.

b. Due to their structure and regulatory framework, mutual funds do not cause systemic risk.

The U.S. mutual fund industry serves the diverse needs of a wide range of individual and institutional investors across various distribution channels. Mutual funds provide investors with a cost-effective way to access capital markets and diversify their investments, while benefitting from professional management services and economies of scale. They have a heterogeneous investor base, with differing risk profiles, investment goals and investment styles. This helps mitigate any "herding" behavior. Many mutual fund investors have a long-term investment horizon. As of mid-2014, the overwhelming percentage of mutual fund investors were individuals focused on retirement savings.[5] This helps to mitigate any excessive redemption activity. The use of financial advisers can also assist in minimizing short-term emotional redemptions by investors.

We believe that mutual funds are constructed in a way that naturally reduces their ability to transmit risks to the broad financial system. Their regulatory structure and operations are based on a fundamentally different principle than banks and other financial institutions, which operate through the use of leveraged capital. Bank depositors are guaranteed their money in full upon

[3] Strategic Insight, A Perspective on Mutual Fund Redemption Activity and Systemic Risk, November 1, 2013 (hereinafter "Strategic Insight Report").
[4] Investment Company Institute. 2014 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company (hereinafter "ICI Fact Book").
[5] ICI Research Perspective, Characteristics of Mutual Fund Investors, 2014, at 1, 2013 (Nov. 2014).

demand and rely on the bank's capital cushion for payment of their claim. In contrast, mutual funds do not guarantee any type of return and a fund investor's claim is tied to the net asset value of the mutual fund. There is a daily mark to market valuation of all portfolio assets and if a security's market value is not readily available, a fund's board of directors must ensure that the fund has an effective fair valuation process. In order to help investors understand that they enjoy the gains and bear the risk of loss of their investments, the SEC has focused its regulations on mutual fund transparency and detailed disclosure requirements. Most prominently, mutual funds are required to register under the Investment Company Act of 1940 (the "1940 Act") and comply with strict disclosure requirements regarding their investment objectives, strategies and risks, including the risk that an investor can lose money investing in the fund.

The ability of mutual funds to create systemic risk is substantially mitigated by their regulatory framework. Mutual funds must adhere to requirements relating to liquidity, leverage, capital structure, diversification, concentration of investments, daily fund valuation, custody of fund and client assets and affiliated entity transactions. Among other things, the 1940 Act and related rules: (a) require a fund to maintain a portfolio consisting of at least 85% liquid assets, (b) prohibit the issuance of senior securities by open-end funds, (c) require a fund to maintain 300% asset coverage for temporary borrowings from a bank, (d) require a fund to segregate, earmark or holding offsetting assets equal to 100% of any obligation to a counterparty created through the use of derivatives or other instruments, (e) limit a fund's exposure to its counterparties through collateral control requirements and the use of qualified custodians which must segregate fund assets from other assets held at the bank, (f) limit a fund's investment concentration in a single industry to 25% (unless otherwise disclosed in the fund's prospectus) of the fund's holdings, and (g) limit a fund's investment in any one financial firm to 5%. Mutual funds are also subject to special tax rules in subchapter M of the Internal Revenue Code. In order to qualify as a regulated investment company under subchapter M, mutual funds must comply with certain diversification rules. Taken together, the diversification and concentration limits of the 1940 Act and Internal Revenue Code restrict exposure of a mutual fund to any particular issuer or industry, thereby reducing and broadening the impact of any concentrated market shock.

Mutual fund asset managers act as agents for the funds and serve in a fiduciary capacity. Subject to a written contract, they manage each portfolio in accordance with the fund's investment objectives and policies, as disclosed in the fund's prospectus. Mutual funds and their asset managers are separate legal entities, with separate balance sheets. A fund manager's creditors have no recourse against the mutual fund and vice versa. Similarly, losses or liabilities incurred by one fund are not the responsibility of any other funds, even if overseen by the same manager.

Mutual funds are also subject to a strict governance standard. As a matter of practice, mutual fund boards generally operate with a majority of independent directors. According to research by the Independent Directors Council, nearly two-thirds of fund complexes have Independent Board Chairs.[6] The board of directors acts as a fiduciary in overseeing the mutual fund's operations and ensuring that the asset manager is properly executing the mutual fund's investment strategies in pursuit of the fund's investment objectives. Importantly, it is responsible for renewing the investment management agreement on an annual basis.

[6] Investment Company Institute website, at http://www.ici.org/pubs/faqs/ci.faq_fund_gov_idc.idc.

As further discussed below, mutual funds have adequate tools to help meet their redemption obligations, are restricted from excessive exposures to leverage, have risk management practices to mitigate operational risks and are able to wind up affairs without government assistance. For all of these reasons, we believe that mutual funds do not create systemic risk.

c. The concept of "systemic risk" needs to be precisely defined and distinguishable from normal investment risk before it can serve as the basis for regulation.

As the Council has acknowledged in its Release, "investment risk is inherent in capital markets, representing a normal part of market functioning."[7] The reality is that not all investment risks are rewarded. Capital markets are characterized by significant volatility (see Exhibit A). We are concerned that parts of the Release could be read to imply that significant price declines in and of themselves constitute systemic risk, even though they are a natural part of normal market functioning. If the goal is to evaluate the potential of asset management products and activities to cause systemic risk, then a clear definition of "systemic risk" is an essential prerequisite to the analysis. We believe it is incumbent on the Council to establish this definition. It should be clearly distinguishable from normal investment risk and take into consideration economic consequences, historical precedents, contributing and exacerbating conditions, likelihood of reoccurrence, and any mitigating factors. As applied to asset management products and activities, the Council should also consider how risks might already be reduced or eliminated by existing (or proposed) regulations, the structure of a product, risk management practices, and investor behavior. Importantly, the Council should consult with the SEC and engage in continuous and open discussion with industry members, trade organizations and the public to determine if any identified risks have real systemic significance. For instance, we believe that the various comments made by SEC officials and industry members at the Council's conference on asset management last year were helpful in distinguishing asset managers from banks and other financial service companies and focusing the regulatory discussion on asset management activities that might involve risk rather than applying policy measures to a few individual asset managers.

d. The SEC, as the primary regulator of asset managers, is in the best position to regulate risks relating to the asset management industry.

The Council has acknowledged that "…there are meaningful differences within the asset management industry, with diverse investment strategies, corporate structures, regulatory regimes, and customers." We believe that any analysis of the asset management industry must be based on a comprehensive understanding of the products and services and a detailed analysis of all relevant data. As the primary regulator for asset managers, we believe the SEC is in the best position for considering and promulgating any regulations affecting the asset management industry.

[7] Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001, available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf (hereinafter "Release").

The SEC has successfully supervised and regulated investment advisers and investment companies for 75 years, since the passage of the Investment Advisers Act of 1940 (the "Advisers Act") and Investment Company Act in 1940 (the "1940 Act"). Its mission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. We believe that the SEC, in effectively carrying out this mission over time, has taken actions that substantially reduce the ability of asset managers to cause systemic risk. Over the years, the SEC has recalibrated its regulatory program to adapt to evolving market conditions and new financial instruments. For example, in 2003, the SEC required advisers and funds to implement written compliance programs and appoint chief compliance officers to address abusive "market timing" practices. These requirements have since helped asset managers more broadly mitigate various operational risks. Notably, the SEC has a well-developed process for creating regulations tailored to the risk being targeted, which includes a cost-benefit analysis and an open process with public notice and comment, which we urge the Council to follow.

Importantly, the SEC has already undertaken several initiatives that are designed to address many of the risks described in the Release. These include efforts to modernize and enhance data collection and reporting, particularly relating to fund investments in derivatives, the liquidity and valuation of fund holdings, securities lending practices and separately managed accounts. The SEC is also reviewing client asset transition plans and fund-level controls to address portfolio composition risks, including those relating to liquidity levels and derivatives. Finally, the SEC's staff is currently working on stress testing requirements for financial companies, including asset managers and registered investment companies, as required by the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act"). We believe that the Council should consider the impact of these SEC initiatives on reducing any risks to U.S. financial stability before attempting to further regulate the asset management industry.

e. <u>U. S. members of the Financial Stability Board ("FSB") and International Organization of Securities Commission ("IOSCO") should urge FSB/IOSCO to focus on asset management products and activities, rather than size, when assessing systemic risk.</u>

We note that on March 4, 2015, FSB/IOSCO published their second consultation on a methodology to assess mutual funds and asset managers for possible designation as global systemically important financial institutions ("Consultation"). Since this was three weeks before the comment deadline for the Release, FSB/IOSCO were unable to consider and benefit from comments on the asset management industry, which could have been informative in drafting the Consultation. While we believe the Council's efforts are rightfully focused on understanding whether asset management products and activities can even cause systemic risk, the Consultation appears to remain improperly focused on size and sets a materiality threshold that targets U.S. mutual funds and asset managers. We are particularly concerned with this inconsistency in approaches in light of the shared membership between the Council and FSB.

We further note that, "[t]he FSB's decisions are not legally binding on its members – instead the organisation operates by moral suasion and peer pressure, in order to set internationally agreed

policies and minimum standards that its members commit to implementing at national level."[8] Consequently, we urge U.S. members of FSB/IOSCO to persuade these organizations to adopt the same approach as FSOC, which considers the variety and complexity of asset management activities rather than focusing on a few of the entities that conduct those activities. As noted by U.S. Federal Reserve Board Governor Daniel Tarullo, "There is reasonable concern that designating a small number of nonbank-affiliated firms would increase moral hazard concern."[9]

2. Liquidity and redemptions

The Release asks whether investors in pooled investment vehicles that offer near-term access to redemptions could face increased redemption incentives, especially during periods of financial market stress. In particular, the Release expresses concern that because the costs associated with redemptions are shared and, as a result, partially borne by remaining investors, investors could have an incentive to redeem before others in the fund to avoid sharing redemption costs, the so-called "first mover advantage". The Release asks whether this incentive is magnified for vehicles invested in less liquid securities, where portfolio managers might be pressured into either selling assets at a discount to meet redemptions or selling the more-liquid portfolio assets, thereby minimizing price impact but concentrating liquidity risk on investors remaining in the fund. Finally, the Release requests information regarding risk management practices employed by asset managers in managing liquidity risks. We respond to these questions below. We do not comment on the questions in the Release relating to securities lending as our organization does not engage in this activity.

The vast majority of assets managed by our organization are in the American Funds, which are distributed through financial intermediaries. We believe that investors in our mutual funds, advised by their financial advisers, are better able to understand the implications of short-term market disruptions for their long-term investment horizons. Consistent with the broader mutual fund industry, our investor base is extremely diverse, with investors having different risk profiles, investment goals and investment styles. Similar to the industry, where approximately 93% of households own mutual fund assets in retirements plans, individual retirement accounts and other tax-deferred accounts, many of our investors hold retirement accounts and have long-term investment horizons.[10] American Funds investors represent millions of individual decision-makers and this diversity reduces the risk of investors redeeming in any significantly concerted manner (i.e., "herding behavior"). Our redemption rates have consistently been lower than the industry redemption rates. For example, for calendar year 2014, the redemption rate for our complex was 13.4%, as compared to the industry redemption rate of 27%.[11]

We do not believe that liquidity and redemption practices of mutual funds or their managers pose risk to the U.S. financial system. Mutual funds are able to absorb fund investor redemptions in a

[8] Financial Stability Board website, at http://www.financialstabilityboard.org/about/#framework.
[9] Regulating Systemic Risk – Remarks by U.S. Federal Reserve Board Governor Daniel K Tarullo at the 2011 Credit Markets Symposium, March 31, 2011, p. 7 (http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf).
[10] See ICI Fact Book at page 107.
[11] Investment Company Institute data, obtained through Simfund.

way that tends to moderate rather than transmit or amplify market shocks. Unlike in the bank context, "a run on a fund" is unlikely since fund investors understand that they are not guaranteed their money back and that they assume the market risks of their investments. Furthermore, fund assets are financed completely with investor capital and redemptions are met from the assets of the fund itself. According to Strategic Insight, "Looking back at 50 years of mutual fund history, Strategic Insight has concluded that capital preservation driven withdrawals were always short lived, non-recurring and limited in magnitude. During times of lengthy financial uncertainty, investors reduce (not increase) the turnover of their financial assets; thus redemption activity tends to decline during a bear market, with the exception of brief and modest spikes during sharp down-market days or weeks."[12] Evidence suggests that even in times of financial crisis, mutual fund investor redemptions are relatively limited in magnitude. Strategic Insight research on stock funds demonstrates that for the month of October 2008, fund investors net redeemed (i.e., net of cash inflows) under 2% of aggregate stock fund assets. In the same month, portfolio managers net redeemed only 0.4% of stock fund assets, demonstrating that heightened redemptions had limited impact on portfolio manager activity.[13]

We also do not believe that the mutualization of fund trading costs creates any first mover advantage. In our view, trading costs, which can be measured in terms of commissions and market impact, are unlikely to affect the decision of a long-term investor to redeem. The mutual fund pricing mechanism was designed to effect transactions for long-term investors and is not vulnerable to pricing arbitrage. This is particularly true because mutual fund transactions are based on forward pricing and investors do not know the fund's NAV at the time of the redemption request. Investors also do not know what portfolio securities will be sold to raise cash and what impact this might have on the NAV of the fund. In addition, because mutual fund advisers are required to "fair value" their portfolio securities, the fund's adviser may write down the value of fund assets to reflect market forces. Taken together, portfolio diversification, forward pricing, NAV pricing that reflects current market prices, as well as the potential and uncertain application of the "fair value" mechanism, mitigate the potential for any first mover advantage.

In response to Council concerns around the impact of heavy redemptions on vehicles invested in less liquid securities, we remind the Council that as discussed above, mutual funds are heavily regulated. In addition to legal requirements that limit mutual fund exposure to illiquid securities, mutual funds are subject to diversification rules and must segregate existing liquid assets to cover potential forward commitments in order to limit portfolio leverage. Collectively, these requirements require liquidity and limit leverage in a manner that is far more conservative than for banks and insurance companies.

Asset managers have several tools at their disposal to assist during times of heavy redemptions. Portfolio managers regularly monitor securities ownership and fund liquidity levels, taking into consideration redemption levels, as well as interest rate and credit spread shocks. They often employ prudent cash management and liquidity programs to use existing cash and liquid security holdings of the fund, as well as cash inflows (e.g., new purchases, dividends and interest income),

[12] See Strategic Insight Report at page 3.
[13] See Strategic Insight Report at page 5.

to meet redemptions. The use of cash to meet redemptions both protects investors remaining in the funds and softens the impact of redemptions on the broader market. Liquidity buffers also often allow funds to supply liquidity to the markets even during times of market stress. In addition, mutual funds can extend the time in which they pay redemption proceeds. Today, mutual funds typically pay redemption proceeds within one to two days. However, by law, they can take up to seven days. They can also establish purchase blocking policies to make it clear to investors that funds are not designed to serve as vehicles for frequent trading. Funds could also obtain lines of credit or establish interfund lending facilities, although we do not believe these are used to any substantial degree. As an extreme measure, a mutual fund could also pay redemptions in kind. Finally, in an emergency situation, under Section 22(e) of the 1940 Act, a fund could seek SEC relief to temporarily suspend redemptions or postpone the payment of redemptions beyond seven days. The SEC has used this authority in the past in response to trading disruptions in certain markets, including outside of the U.S.

Since mutual funds have varying investment objectives and strategies, we believe that liquidity management needs to be a dynamic process. SEC efforts to update liquidity standards are the appropriate starting point for any discussion related to the liquidity or redemption features of mutual funds. We encourage the Council to coordinate with the SEC on these efforts.

3. Leverage

The Release requests information on ways in which the use of leverage could have implications to U.S. financial stability by increasing the potential for forced asset sales or exposing counterparties to losses or unexpected market risks during times of financial market stress. The Release asks how investment vehicles use leverage and what risk management practices are used by asset managers to monitor and manage leverage risks. We do not comment on questions in the Release relating to securities lending as our organization does not engage in this activity. Since the vast majority of our assets under management are in mutual funds, we focus our responses on the use of leverage in mutual funds (although we note that use of leverage in our separately managed accounts is not materially different.)

For the American Funds, the use of leverage is limited both in scope and quantity. Although as a whole, our organization does not engage in a significant amount of derivative transactions, use of derivatives represents the primary means by which the American Funds are exposed to leverage. The use of derivatives in an American Fund is generally discussed internally and with the fund board of directors, and is subject to committee approval.

Leverage is defined in the Release as being created when an investor enters a transaction, resulting in investment exposure exceeding the equity capital used to initiate the transaction. We agree that systemic risk can be created by institutions that have significant leverage and which are interconnected with other highly leveraged institutions and/or institutions that have a significant mismatch between the maturities of their assets and liabilities. For a highly leveraged financial company, a relatively small decline in asset values could cause the firm's debt to exceed its assets and if that debt is held by another highly leveraged firm, losses could spread quickly.

However, as the Release notes, the use of leverage can vary significantly across investment vehicles and in particular, the use of leverage in mutual funds is limited and subject to 1940 Act provisions governing diversification, concentration, investing in certain types of securities-related issuers, valuation, accounting, financial reporting and disclosures. For example, a fund is required to segregate, earmark or hold offsetting liquid assets to meet future obligations to a counterparty created through the use of derivatives or other instruments. Use of this process can effectively manage the amount of indebtedness or leverage a fund can assume. Fund board oversight and disclosure requirements also ensure that the derivatives are employed in a manner consistent with the fund's investment objectives, policies, and restrictions, its risk profile, and relevant regulatory requirements, including those under federal securities laws.

Mutual funds may use derivatives to enhance returns or hedge current portfolio exposures, which may cause them to take on leverage. Compared to investing directly in the securities markets, derivatives offer greater liquidity, lower round-trip transaction costs, lower taxes, and reduced disruption to the portfolio's longer-term positioning. Although the use of derivatives can entail both counterparty risks and risks relating to the reference asset on which the derivative is based, existing regulations and portfolio management practices help to mitigate these risks. Portfolio managers and others, such as risk and quantitative teams, use reports to review the impact of derivatives on their portfolios. Fund managers also maintain internal oversight committees that review processes, internal limits and operational risks associated with certain instruments.

Additionally, under the Dodd-Frank Act, several measures were enacted to address counterparty risk, as well as to require recordkeeping and reporting on the use of certain derivative instruments to allow regulators like the SEC and the U.S. Commodity Futures Trading Commission to monitor their usage, including concentrations and trends that may indicate potential areas of risk. While clearing has been a well-known means of reducing counterparty risk since the early 1900s, the Dodd-Frank Act requires that many interest rate and credit default swaps be subject to mandatory clearing, which requires trades to be "given up" to central clearinghouses with strict protocols in place meant to protect against investor losses. It is important to note that many of these clearinghouses have been designated as systemically important financial institutions and that there are ongoing discussions regarding enhanced risk management standards for these firms. Further, exchange-traded and centrally cleared derivatives are subject to specific margin rules and clearinghouse protocols to protect against potential losses in the event of counterparty failure. These initiatives are designed to mitigate counterparty and contagion risk should one market participant fail.

We believe that it is too early to judge the effectiveness of some of the more recent changes to the regulatory framework for derivatives trading. We support SEC efforts to enhance mutual funds' disclosure regarding the use of derivatives to investors, improve data collection from mutual funds regarding their derivatives usage and evaluate funds' use of leveraged investment exposures and the obligations that such instruments can create. We believe that these efforts should be afforded an opportunity to be fully implemented, after which an analysis can be performed on their effectiveness. To the extent the Council, in consultation with the SEC, subsequently deems it necessary to impose additional requirements on fund use of leverage, we

strongly urge as discussed above, that such changes be subject to a detailed cost-benefit analysis and public comment period.

4. Operational risk

The Release defines "operational risk" as "…the risk arising from inadequate or failed processes or systems, human errors or misconduct, or adverse external events." The Release asks whether any operational risks to asset managers could have broader implications for U.S. financial stability. In particular, the Release expresses interest in risks relating to the substantial reliance placed by asset managers on both affiliated and unaffiliated providers of technology, data, and other operational services for important components of their business. The Release also asks for information regarding operational interconnections and practices employed by asset managers to manage operational risks. We respond to these questions below. However, since the vast majority of our assets under management are in mutual funds, we do not comment on questions in the Release regarding the operational risks of transferring client assets in separately managed accounts.

Although we agree that operational risks may disrupt asset management activities, we are unaware of any such risks that could result in systemic risk, even in times of market distress. The asset management industry is highly competitive and reputational risk is of the utmost importance. Regulatory compliance and operational risk management are well-developed areas within this industry and central to an organization's long term business prospects. Consequently, asset managers invest significant resources and employ various tools to avoid operational issues that could adversely affect their clients or the assets they manage. For example, within our organization, in managing operational risks, the various business areas are supported by associates in the areas of Compliance and Operational Risk, Data Security, Information Technology, Business Continuity, Legal and Compliance and Strategic Sourcing and Procurement. We use different systems and applications for compliance purposes, maintain business continuity/disaster recovery plans and engage in regular contingency planning. Service providers for critical services are subject to a detailed vendor risk assessment process, and where appropriate, onsite due diligence visits.

The regulatory framework for asset managers and mutual funds mitigates operational risks. Asset managers and mutual funds are required to have Chief Compliance Officers and many organizations have entire departments dedicated to operational risk management. The risk to client assets is mitigated by the fact that as previously mentioned, assets are not usually held by the manager but rather by a third party custodian, typically a bank subject to prudential regulations. Moreover, Rule 206(4)-7 of the Advisers Act requires each asset manager to adopt and implement written policies and procedures reasonably designed to prevent it from violating the Advisers Act. As part of an asset manager's compliance program, they must establish a reasonable process for responding to emergencies, contingencies and disasters, appropriately scaled to the asset manager's business operations and client commitments. Many asset managers have built-in redundancies for their critical systems, as well as back-up sites. In addition, many firms employ an enterprise risk management practices, based on widely accepted frameworks, including those published by the Committee of Sponsoring Organizations (COSO). Firms also

use cybersecurity risk management standards, such as those published by the National Institute of Standards and Technology (NIST), the International Organization for Standardization (ISO) and the Federal Financial Institutions Examination Council (FFIEC). Often, internal controls and procedures are subject to both internal and independent third party review and evaluation.

Another area that asset managers focus on is the variety of third party providers they rely on for services such as custody, pricing or other functions. Since asset managers cannot outsource their regulatory compliance obligations, they are incentivized to take particular care in the selection and monitoring of service providers for essential services to make sure they are delivering services properly. Asset managers use a combination of various processes in monitoring service providers, including: (a) a comprehensive vendor risk assessment process, (b) contractual obligations, including data security requirements and service level agreements, with key performance indicators against which quality of service can be measured, (c) requiring the vendor to regularly provide a SSAE 16 report (formerly a SAS 70 Report) or similar document evidencing the review and assessment of the service provider's procedures by a third party auditor, (d) where appropriate, periodic onsite visits at vendor's centers of operation, (e) regular meetings and internal review of service providers, and (f) assignment of dedicated personnel responsible for the overall relationship with the service provider. The use of affiliates can limit operational risk since an asset manager could have more transparency into operations and greater control over the services, as compared to the use of an unaffiliated third party; however, asset managers must evaluate the performance of affiliated service providers to the same standard as any third party provider.

It is important to note that there are some areas in which asset managers are forced to rely on a limited pool of service providers for critical services. For example, asset managers only have a few custodians from which to select, but these are subject to prudential regulation, which helps to mitigate risks. Importantly, for equity securities and bonds, assets held by a custodian bank are subject to certain protections under applicable banking law that segregate such assets from risks relating to the bank's balance sheet. For other areas of limited competition, such as pricing vendors or central counterparties, we believe that higher standards of resilience and redundancy testing, substitutability, and transition and resolution planning would be reasonable.

As discussed, we do not believe that any operational risks can result in systemic risk. As a consequence of regulatory imperatives and competitive incentives, asset managers have always focused on business continuity planning, disaster recovery, data protection and other cybersecurity issues. This has allowed the asset management industry to withstand various operational disruptions, including those related to extreme weather conditions (Hurricane Sandy), acts of terrorism (9/11) and technical issues in the market (May 2010 Flash Crash). However, we recognize that any prior success in this regard cannot be taken for granted and that we need to continue to improve processes to keep up with evolving risks. For example, we agree that cybersecurity risks require an ongoing allocation of resources to identify new threats, vulnerabilities and potential business impact. To the extent the Council, in consultation with the SEC, deems it necessary to take additional regulatory action, we again strongly urge that it be based on a detailed cost-benefit analysis and only come after careful debate and discussion with industry members, trade organizations and the general public.

5. Resolution

The Release includes several questions focused on whether the failure or closure of an asset manager or an investment vehicle it manages could have an adverse impact on U.S. financial stability. We do not believe that the resolution of either an asset manager or a mutual fund gives rise to any systemic risk. The mutual fund industry is very competitive, funds are highly substitutable and the asset management business is easily transferable because of the agency nature of the business. Mutual funds do not "fail" in the same way as banks and insurance companies. We believe that most of the questions in the Release regarding resolution risks have been explored in great detail by the Investment Company Institute in their study, *"Orderly Resolution" of Mutual Funds and Their Managers*, which we have attached as Exhibit B (the "Orderly Resolution Study").

As discussed in the Orderly Resolution Study, mutual funds are closed or reorganized each year without government intervention or taxpayer assistance, including during times of market stress. Based on Investment Company Institute data, in 2014 alone, 362 mutual funds were merged or liquidated while 25 fund sponsors exited the business, all without disrupting U.S. financial stability. History has shown that even during times of market stress, there are many firms willing and able to take on additional fund assets under management. The Investment Company Institute references a study by Grail Partners LLC, showing that in 2008, the global merger and acquisition activity in the asset management industry totaled $2 trillion, which increased to $4 trillion in 2009. Fund mergers and acquisitions occur on a routine basis, without undue disruption to the fund and its investors. For example, in the case of a sale of the advisory business, where the investment advisory agreement is transferred to a new manager, the underlying portfolio assets remain with the existing custodian selected by the fund or client and the custodian simply receives instructions from the board on the identity of the new manager and those authorized to transact on behalf of the fund. A similar process would apply in the unlikely event of a fund manager filing for bankruptcy. The fund board could simply terminate the fund's contract. The fund manager and its creditors would have no claim on the fund's assets.

The terms of any merger of a manager resulting in a change of control are subject to the review and approval of the fund boards, acting in their fiduciary capacity. Mergers involving affiliated funds are conducted in accordance with Rule 17a-8 of the 1940 Act, which seeks to ensure that the transaction is in the best interests of the investors of each fund. With respect to fund liquidations, the Orderly Resolution Study describes the established and orderly process by which the fund liquidates its assets, distributes the proceeds prorate to investors and winds up its affairs, all without impacting the broader financial institution. This process needs to meet the requirements of the 1940 Act, as well as any state or other laws based on the domicile of the fund. Similar to fund mergers, all actions taken by the fund manager and the fund board of directors in the context of a fund liquidation must be consistent with their fiduciary obligations. To the extent an expedited timetable is required due to extreme market conditions or other extraordinary circumstances arise, the SEC has authority under Section 22(e) of the 1940 Act to allow a fund to suspend redemptions as necessary to protect fund investors.

For the reasons noted above, we do not believe that the resolution of asset managers and mutual funds pose a threat to U.S. financial stability. However, we support the efforts of the SEC to address transition planning for circumstance where an adviser is no longer able to serve its client, including the ongoing servicing of client needs while assets are being transferred from one asset manager to another.

6. Conclusion

We support efforts of the Council to better understand whether asset management products and activities can cause systemic risk. In our view, these products and activities, particularly mutual funds, do not pose a threat to U.S. financial stability. As discussed, the nature and regulatory framework of mutual funds reduce their ability to transmit risks to the broader financial system. They have adequate tools to help meet redemptions, are restricted from excessive exposures to leverage, have risk management practices that address operational risks and are able to resolve their affairs without government assistance. We urge the Council to coordinate its efforts with the SEC and to the extent additional regulatory action is deemed necessary, such action should be designed to address any identified risk in a narrowly tailored manner that avoids unnecessary impacts to capital market efficiency and investor costs.

We truly appreciate the opportunity to comment on the Release and hope that the Council's efforts in this area result in enhanced awareness of the risks relating to asset management products and activities. If you have any questions regarding our comments, please feel free to contact Maria Manotok at (213) 615 0200.

Sincerely,

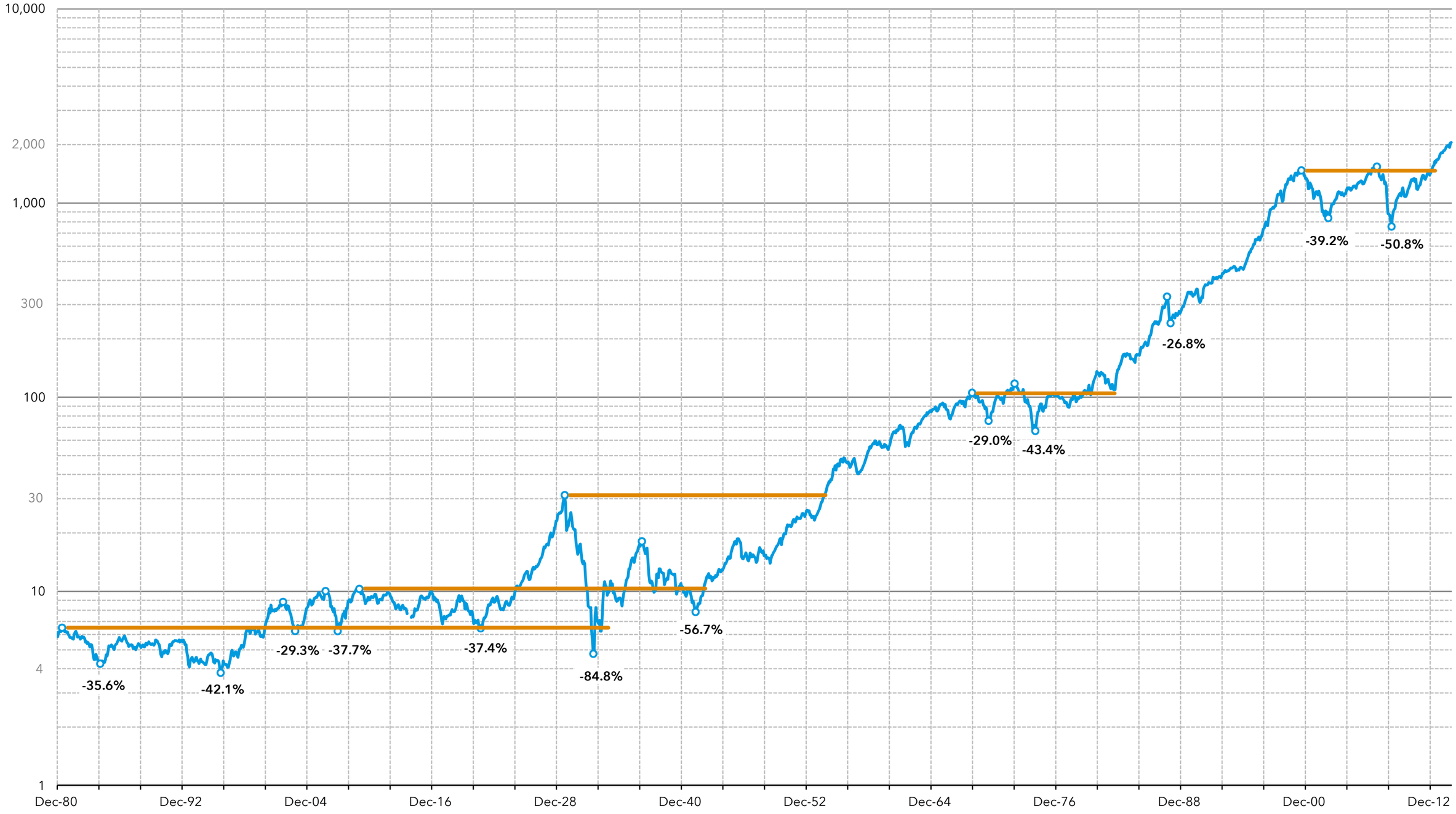
James Rothenberg
Chairman

cc: Hon. Jacob J. Lew, Secretary, U.S. Department of Treasury
Hon. Mary Jo White, Chair, U.S. Securities and Exchange Commission
Hon. Timothy G. Massad, Chairman, U.S. Commodities and Futures Trading Commission
Hon. Janet L. Yellen, Chairman, Board of Governors of the Federal Reserve
Hon. Thomas J. Curry, Comptroller, Office of the Comptroller of the Currency
Hon. Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
Hon. Luis B. Aguilar, Commissioner, U.S. Securities and Exchange Commission
Hon. Daniel M.. Gallagher, Commissioner, U.S. Securities and Exchange Commission
Hon. Kara M. Stein, Commissioner, U.S. Securities and Exchange Commission
Hon. Michael S. Piwowar, Commissioner, U.S. Securities and Exchange Commission
Lona Nallengara, Chief of Staff, U.S. Securities and Exchange Commission
David Grim, Acting Director, Division of Investment Management, U.S. Securities and Exchange Commission

EXHIBIT A

1881 - 2014

Standard and Poor's Composite Index: monthly averages



Sources: Cowles Commission Report, 1938; Standard and Poor's

EXHIBIT B

"Orderly Resolution" of Mutual Funds and Their Managers
July 15, 2014

During the global financial crisis, the distress or disorderly failure of certain large, complex and highly leveraged financial institutions—banks, insurance companies and investment banks—required direct intervention by governments, including a number of bailouts, to stem the damage and prevent it from spreading. One focus of post-crisis reform efforts has been to ensure regulators are better equipped to "resolve" a failing institution in a way that minimizes risk to the broader financial system and costs to taxpayers. The new tools provided under the Dodd-Frank Act include requirements for the largest bank holding companies and nonbank SIFIs to engage in comprehensive resolution planning in advance, and a new "orderly resolution" mechanism for financial institutions whose default could threaten financial stability.

These requirements are unnecessary for mutual funds and firms that sponsor or manage them.[1] As a threshold matter, funds do not "fail." Investors are not promised gains on their investment, or even a return of the principal amount they invested. All investment results—gains and losses, no matter how big or small—belong to the fund's investors on a *pro rata* basis. If a fund doubles in value, it is the investors who reap this reward. And if the fund plunges in value, it is the investors who absorb the impact of those losses. This is the expectation shared by all investors in mutual funds and by the broader marketplace.

Moreover, funds and fund managers routinely exit the asset management business. 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. This paper provides a summary overview of the reasons why.

We begin by providing data to illustrate that fund and manager exits from the mutual fund business are routine. Next, we explain how fund structure and regulation, as well as competitive dynamics, help to facilitate these regular comings and goings in the fund industry. Finally, we describe the various exit strategies available to funds and managers, all of which can be accomplished within the existing regulatory framework.

[1] Typically, the firm that sponsors a fund also serves as its manager.

Fund and Manager Exits are Routine, Even in Times of Severe Market Stress

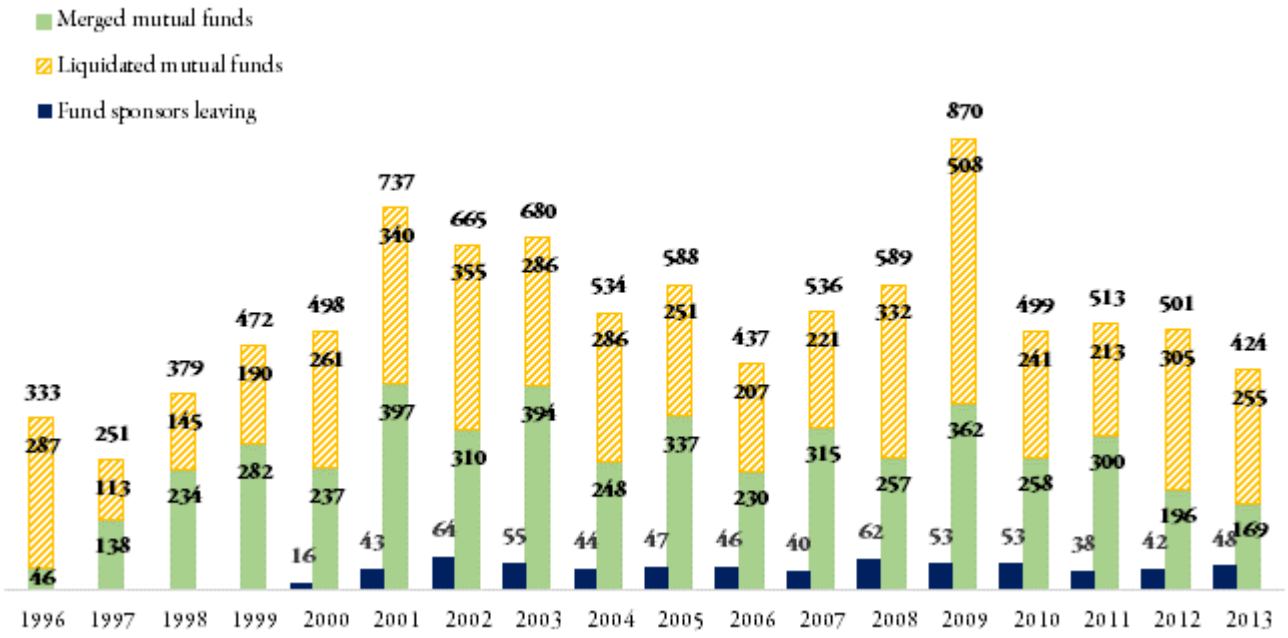
Mutual fund mergers and liquidations occur routinely for a variety of reasons. One common reason for liquidating a fund or merging it with another is the inability of the fund to attract or maintain sufficient assets. Frequently, a fund is launched by a fund manager seeking to offer a new or improved investment strategy, or following the hiring of new portfolio management personnel with expertise in a particular strategy. But if the fund fails to attract sufficient assets over time, and does not attain certain economies of scale, the fund will not ultimately be viable from a business perspective. Furthermore, if the fund does not acquire sufficient assets over time, its expenses will be spread over a smaller asset base, leading to higher expenses for fund shareholders and impairing the fund's ability to compete with similar funds. In such a scenario, the fund manager may and often does recommend liquidation or merger of the fund to the fund's board of directors.

A fund may fail to attract or maintain sufficient assets for a variety of reasons. Poor investment performance—whether or not due to market conditions—is likely the most common reason. Other factors can include difficulties in marketing the fund or gaining access to certain distribution platforms, an inability to distinguish the fund from its competitors, or the departure of key portfolio management personnel.

Likewise, fund managers also exit the business on a routine basis. This may occur where the fund manager itself has failed to attract or maintain sufficient assets under management, or could happen in the event of the bankruptcy of the manager's parent company. It could also occur due to a reputational problem impacting the ability of the manager to retain fund shareholders and other clients, or the retirement or death of the firm's founder.

The figure below shows the number of US mutual funds that have been merged or liquidated in each year since 1996, as well as the number of mutual fund sponsors exiting the business in each year since 2000. The numbers are significant. In 2013 alone, for example, 424 mutual funds were merged or liquidated, and 48 mutual fund sponsors left the business. Outside of press coverage by the media specific to the US fund industry, these 2013 events passed with little notice and certainly did not create distress in the financial markets.

US Mutual Funds and Mutual Fund Sponsors Routinely Exit the US Mutual Fund Market*



Note: Data for number of mutual funds that are merged or liquidated include US mutual funds that are funds-of-funds and those that are not. Excludes ETFs and closed-end funds. Number of fund sponsors leaving is unavailable before 2000.
Source: Investment Company Institute

Fund Structural and Regulatory Features and Industry Competitive Dynamics Facilitate Exits

Several features of the structure and regulation of mutual funds, along with the dynamic and competitive nature of the fund management business, are instrumental in facilitating the "orderly resolution" of funds and their managers.

The most relevant aspects of fund structure and regulation include the following.

Fund structure. Each mutual fund is a separate legal entity, distinct from its manager and from other funds in the same fund complex. A fund typically has no employees of its own; fund operations are carried out by service providers, including the fund manager (also called the "investment adviser").

Separate custody of fund assets. The Investment Company Act of 1940 requires mutual funds to maintain strict custody of fund assets, separate from the assets of the fund manager, using an eligible custodian. Nearly all mutual funds use a US bank custodian.

Role of the fund manager. Acting as an agent, the fund manager manages the fund's portfolio under a written contract with the fund and in accord with the fund's investment objectives and policies as described in the fund's prospectus. The fund manager does not take on the risks inherent in the securities or other assets it manages for a fund; those risks are borne by the fund and its shareholders. Shareholder recourse for losses is limited to the fund and does not extend to the fund's manager (absent breach of a contractual standard of care). The manager does not own fund assets and may not use those assets to benefit itself or any other fund or client. Likewise, creditors of the manager have no claim on fund assets.

Role of the fund board of directors. Mutual funds are required by statute to have a board of directors (or trustees). The board generally must have a proportion of members who are independent of the fund manager, and in practice most fund boards have 75% or more independent members.[2] Fund directors are subject to fiduciary duties of care and loyalty under state law, and the independent directors serve as "watchdogs" for the interests of fund shareholders. In broad terms, the fund board oversees the fund's management, operations, and investment performance. Specific responsibilities include annual review and approval (including by a majority of the independent directors) of the fund's investment advisory contract and overseeing the fund manager's provision of services under that contract.

Fund industry competitive and marketplace dynamics play an important role.

Competition in the mutual fund industry. The mutual fund business is very dynamic. There were more than 800 sponsors of mutual funds in the United States in 2013. Long-run competitive dynamics have prevented any single firm or group of firms from dominating the market. For example, of the largest 25 fund complexes in 2000, only 13 remained in this top group in 2013.

A prominent measure of market concentration is the Herfindahl-Hirschman Index, which weighs both the number and relative size of firms in an industry. Index numbers below 1,000 indicate that an industry is unconcentrated. The U.S. mutual fund industry had a Herfindahl-Hirschman Index number of 481 as of December 2013. This lack of concentration in the industry also demonstrates that fund managers are highly "substitutable" and that there would be no need for government intervention to support the activities or survival of any particular manager.

Individual funds likewise are highly substitutable. Appendix A shows that there are typically well over 100 different mutual funds within each investment category—and, in many cases, several

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[2] As of year-end 2012, independent directors made up three-quarters of boards in 85 percent of fund complexes. *See* Independent Directors Council/Investment Company Institute, *Overview of Fund Governance Practices, 1994–2012*, available at http://www.idc.org/pdf/pub_13_fund_governance.pdf.

hundred funds—available to investors in the market. Fund sponsors generally offer funds in many different categories. Investors can and do move their investments easily from one fund to another without causing market disruption.

An active and robust M&A market. The high degree of competition in the fund industry also suggests that there are many potential bidders for a fund management business should it be put up for sale. Historical experience has borne this out, even during times of severe market stress.[3] Similarly, there is no shortage of firms willing and able to take on additional fund assets under management, for example through fund mergers.

Fund managers have a very strong incentive to acquire assets under management and thereby diversify their offerings to achieve greater economies of scale. Although a fund manager's assets under management can grow organically, acquiring more assets under management through the acquisition of another manager's business is a well-known strategy in the industry. While the manager does not own the assets of its funds and other clients, its contracts to manage those funds and the accounts of other clients are considered to be valuable "assets" of the manager. In any situation in which a fund manager decided or was forced to leave the business, other fund managers (or other financial institutions seeking to enter the fund management business) could be expected to be bidders for that business.[4]

"Orderly Resolutions" of Funds and Managers – The Exit Strategies

Fund Mergers and Liquidations

In the vast majority of cases, a fund merger or liquidation is not compelled by unusual circumstances, so the process can unfold over a time period that the fund manager and fund board deem appropriate. As a result of its oversight functions, a fund board generally will be attuned to any difficulties with the fund, such as lagging performance, failure to attract assets or investor outflows. Tax-free fund mergers or the sale of an advisory business (discussed below) may be preferred options, because they do not involve potential adverse tax consequences (*i.e.*, recognition of capital gains) for shareholders.

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[3] To provide some context, in 2008, the global merger and acquisition activity in the asset management industry totaled $2 trillion. In 2009, the level of such activity reached $4.0 trillion, with nine deals in excess of $100 billion. Source: Grail Partners LLC, Current and Future State of the Asset Management Industry and Implications on Fund Manager Merger and Acquisition Transactions (June 2014).

[4] In 2004, for example, Wells Fargo announced that it was acquiring the mutual fund business of Strong Capital Management. *See* Wells Fargo press release at https://www.wellsfargo.com/press/strong05262004?year=2004. The deal was prompted by an SEC enforcement action (settled just six days prior to the deal announcement) that, among other things, barred Strong's founder from the industry. *See Strong Capital Management and Founder Richard Strong Agree to Pay $140 Million to Settle Fraud Charges Concerning Undisclosed Mutual Fund Trading* (May 20, 2004), available at http://www.sec.gov/news/press/2004-69.htm.

In the face of extreme market conditions or other extraordinary circumstances, these transactions may need to occur on a more expedited basis. The Securities and Exchange Commission also has sufficient authority to provide regulatory relief if necessary to protect the interests of fund shareholders.

Fund mergers. Funds are merged into other funds on a routine basis. A merger could be recommended when a fund fails to attract or maintain sufficient assets, and there is another fund advised by the manager with similar investment objectives and strategies. A merger involving affiliated funds would be conducted in accordance with Rule 17a-8 under the Investment Company Act, which seeks to ensure that the transaction is in the best interests of the shareholders of each fund. Fund mergers are also common following the merger of two fund managers who have similar or overlapping lineups of fund offerings. In this instance, the newly combined manager will frequently rationalize its investment product offerings by merging similar funds.[5] Fund boards play a critical role in evaluating and approving the terms of any merger, consistent with their fiduciary obligations.[6]

Fund liquidation. When a mutual fund does need to liquidate, there is an established and orderly process by which the fund liquidates its assets, distributes the proceeds *pro rata* to investors and winds up its affairs, all without consequence to the financial system at large. This process, which is explained in detail in Appendix B, adheres to requirements in the Investment Company Act and state or other relevant laws based on the domicile of the fund, including consideration and approval by the mutual fund's board of directors. Furthermore, as with fund mergers, all actions by the fund manager and the fund board are undertaken in accordance with their fiduciary obligations to the fund. As the SEC has observed, "liquidations will proceed differently depending on a fund's particular circumstances, and we believe that fund management, under the supervision of the board, is best able to devise and execute a plan of liquidation that is in the best interests of fund shareholders."[7]

Fund liquidations are relatively straightforward because mutual funds have simple capital structures. A fund contracts with a limited number of service providers (in addition to the fund manager, these typically include the custodian, administrator, auditors, transfer agent and distributor) and it pays these service providers through routine asset-based or annual service fees that are accrued in advance on the fund's books. The Investment Company Act strictly regulates and limits the ability of a

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[5] As part of the Wells Fargo acquisition of the Strong funds, as described in footnote 4 above, several Strong funds were merged into similar funds already offered by Wells Fargo, while the remaining Strong funds continued to be offered under a new management contract with Wells Fargo. *See Company News; Wells Fargo Will Merge Some Strong Capital Funds*, New York Times (Sept. 16, 2004), available at http://query.nytimes.com/gst/fullpage.html?res=9F0CE6DA1F30F935A2575AC0A9629C8B63.

[6] *See generally Board Consideration of Fund Mergers*, Independent Directors Council Task Force Report, June 2006, available at http://www.idc.org/pdf/ppr_idc_fund_mergers.pdf.

[7] *See* Money Market Fund Reform, 75 Fed. Reg. 10060, 10089 (Mar. 4, 2010).

fund to borrow or lend money or other assets, and to engage in transactions involving leverage. Accordingly, a primary focus of the liquidation process is the conversion of the fund's portfolio investments to cash or cash equivalents. As noted in Appendix B, how long this process takes will depend upon such factors as portfolio liquidity, the degree of ease in converting portfolio securities to cash or cash equivalents and the fund's investment strategy and objectives.

Extraordinary circumstances. If a particular situation demands an expedited timetable, the fund manager and fund board have the ability to act swiftly. An example from the height of the 2008 financial crisis is instructive. On September 18, 2008, Putnam Investments announced the closing of the Putnam Prime Money Market Fund and the distribution to investors of the fund's assets. The fund had no exposure to Lehman Brothers or other troubled issuers, but had experienced significant redemption pressures from its concentrated institutional investor base. The fund manager and the fund's board of directors determined to close the fund rather than sell portfolio securities into a liquidity constrained market; this action allowed the fund to treat all of its investors fairly. Just six days later, on September 24, the fund merged with Federated Prime Obligations Fund at $1.00 per share and investors did not lose any principal.[8] The transaction required no government intervention.

Even in times of severe market stress, funds—particularly stock and bond funds—are generally able to satisfy investor redemptions without adverse impact on the fund's portfolio and the broader marketplace.[9] Should a fund face a "perfect storm" of unusually heavy redemption pressures and difficult market conditions, however, the SEC has the authority under Section 22(e) of the Investment Company Act to allow a fund to suspend redemptions for such period as the SEC determines necessary to protect the fund's shareholders. The need for such relief is rare. We are aware, however, that during the height of the financial crisis, the SEC invoked this authority to facilitate the orderly liquidation of several money market funds and a short-term bond fund, all of which were managed by Reserve Management Company, Inc. The funds' boards of directors requested the relief "to ensure that each of the funds' shareholders will be treated appropriately in view of the otherwise detrimental effect on each fund of the recent unprecedented illiquidity of the markets and extraordinary levels of redemptions that the funds have experienced." The SEC concluded that the circumstances "require immediate

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[8] *See* "Putnam Fund Shifts Investors to Federated," *New York Times* (September 24, 2008) (citing *Bloomberg News*), available at http://www.nytimes.com/2008/09/25/business/25fund.html.

[9] The reasons for this are outside the scope of this paper. For further discussion, *see, e.g.,* Letter to Secretariat of the Financial Stability Board from Paul Schott Stevens, President & CEO, ICI, dated April 7, 2014 at Appendix F (discussing the historical experience of US stock and bond funds, including modest redemptions by mutual fund investors during periods of financial stress). The letter is available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

action to protect the funds' security holders" and issued an order allowing each fund to suspend redemptions until it had liquidated.[10]

The SEC is expected to finalize additional reforms designed to enhance further the resiliency of money market funds in the face of difficult market conditions. Recent press reports indicate that the reforms, among other things, will authorize money market funds to suspend redemptions in times of severe market stress.[11]

Sale or Merger of Advisory Businesses

Because of the dynamic nature of the fund industry, as described above, a likely exit strategy for a fund manager would be to find a buyer for its business. A fund board must carefully consider the terms of any proposed transaction. In addition, Section 15(f) of the Investment Company Act addresses circumstances under which a fund manager may receive compensation or other benefits in connection with the sale of its business, consistent with its fiduciary obligations to fund shareholders. Pursuant to Section 15(f), the fund board must maintain a high degree of independence from both the original manager and the acquiring manager for a three-year period, and there can be no "unfair burden" (*e.g.*, fee hikes) on the fund as a result of the transaction for at least two years.

Sale or merger of a fund business may happen for a variety of "routine" business reasons. Such a transaction also may be prompted by financial difficulty of the fund manager, or if there were a problem with an entity affiliated with the fund manager (e.g., the bankruptcy of the manager's parent company), there would likely be a sale or spin-off of the advisory business.

Fund custody arrangements facilitate the movement of an advisory contract to another manager. Because a fund's custody arrangements are governed by a separate contract between the fund and the custodian, there would be no immediate need to alter the fund's custody arrangements. In general, the custodian would simply need instructions from the board on the identity of persons at the new adviser who are authorized to transact on behalf of the fund.

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[10] *See* Reserve Municipal Money-Market Trust *et al.*, SEC Rel. No. IC-28466, File No. 812-13585 (Oct. 24, 2008). We note that the SEC has since adopted a rule allowing a money market fund to suspend redemptions to allow for the orderly liquidation of fund assets, if the fund board (as well as a majority of the independent directors) has determined that the extent of deviation between the fund's amortized cost price per share and its current net asset value per share may result in material dilution or other unfair results to investors or existing shareholders. The rule contains strict conditions designed to limit its use to "extraordinary circumstances," including a vote of the fund's board (including a majority of the independent directors) irrevocably to liquidate the fund and prior notice to the SEC. Rule 22e-3 under the Investment Company Act.

[11] *See, e.g.,* Andrew Ackerman, *SEC to Vote on Money-Fund Reforms July 23*, Wall Street Journal MoneyBeat (July 14, 2014), available at http://blogs.wsj.com/moneybeat/2014/07/11/sec-to-vote-on-money-fund-reforms-july-23/.

Transfer of Fund Management Contract to a New Manager

As noted earlier in the paper, the fund manager serves as manager to the fund pursuant to a contract that must be approved annually by the fund board, including a majority of the independent directors. Typically, any issues relating to the manager's provision of services to the fund are discussed and resolved as a part of the board's regular oversight function and/or as part of the contract renewal process. The fund board has the authority under the Investment Company Act to terminate a fund's contract with its manager and engage a new manager for the fund. If necessary, this can be done quickly on an interim basis, subject to later shareholder approval.[12]

This process can occur without undue disruption to the fund and its shareholders. For example, as is the case with the sale of an advisory business, there would be no immediate need to alter the fund's custody arrangements. The custodian would simply need instructions from the board on the identity of persons at the new manager who are authorized to transact on behalf of the fund. It also bears re-emphasizing that the manager and its creditors would have no claim on the fund's assets.

Resolution of the Fund Manager

We are unaware of any notable fund manager in its own right filing for bankruptcy protection. In the unlikely event of a solvency problem with a fund manager, the fund board could exercise its authority to terminate the fund's contract with the manager, as discussed above.

The resolution of a fund manager would be a very straightforward process. The manager's own assets would typically be limited to, for example, real estate, and telecommunication, computer and office equipment, and possibly some proprietary equity investments in the funds it (previously) managed, that would rank *pari passu* with investments held by other shareholders. Liabilities would typically be limited to, for example, leases and contracts for services used in the asset management business (e.g., investment research, pricing vendors, legal, and accounting) and routine liabilities tied to personnel.

It is worth noting that two of the nonbank financial companies that have been designated as "systemically important" under Title I of the Dodd-Frank Act have asset management subsidiaries that are considered to be "material entities" that must be included in their resolution plans.[13] The plans for

[12] Rule 15a-4 under the Investment Company Act.

[13] Section 165(d)(1) of the Dodd-Frank Wall Street Reform and Consumer Protection Act; *Resolution Plans Required*, 76 Fed. Reg. 67323 (Nov. 1, 2011) (implementing rules).

both companies contemplate a Chapter 11 bankruptcy proceeding for their asset management subsidiaries. Moreover, one of those plans specifically contemplates the sale of certain businesses from its asset management holding company as part of the Chapter 11 proceeding.[14]

[14] *See* Prudential Financial Inc., 2014 Resolution Plan, Public Section (June 30, 2014), available at http://www.federalreserve.gov/bankinforeg/resolution-plans/prudential-fin-1g-20140701.pdf; American International group, Inc., Resolution Plan, Section I: Public Section (July 1, 2014), available at http://www.federalreserve.gov/bankinforeg/resolution-plans/aig-1g-20140701.pdf.

Appendix A

Number of Mutual Funds by Investment Category, July 14, 2014

Mutual Fund Category	Number of Mutual Funds
Equity Funds	
Multi Cap Growth	172
Large Cap Growth	306
Mid Cap Growth	185
Small Cap Growth	209
Multi Cap Value	255
Large Cap Value	351
Mid Cap Value	199
Small Cap Value	236
Multi Cap Blend	272
Large Cap Blend	454
Mid Cap Blend	141
Small Cap Blend	204
Sector	372
Emerging Market	320
Global	493
International	587
Regional	76
Bond Funds	
High Yield ex. Floating Rate	197
High Yield - Floating Rate	50
Government	149
Mortgage Backed	74
Investment Grade	587
Multi-Sector	142
Global/International	225
Emerging Market	108
State Specific Municipal	336
National Municipal	239
Mixed-Asset Funds	
Hybrid (Balanced, Flexible, Income-Mixed)	569
Alternative Strategies	504

Source: Investment Company Institute

Appendix B

Process for Liquidating and Dissolving a Mutual Fund[*]

1. Consideration of whether to liquidate the fund, by fund manager and fund board
2. Determine whether approval by fund investors is needed, based upon state law and the fund's charter documents
3. Prepare a plan of liquidation and dissolution
4. Fund board to consider and approve the plan of liquidation and dissolution
    a. Fund directors to consider the details of the proposed plan and the rationale for liquidating the fund
        i. Is liquidation and dissolution in the best interests of the fund?
        ii. Are there other viable options?
    b. Directors will make a determination based on their duties to the fund
5. Announce the plan of liquidation and related details
    a. Date on which fund will be closed to new investors
    b. Date on which liquidation proceeds will be paid to investors ("Closing Date")
        i. The Closing Date will depend upon factors such as portfolio liquidity, the degree of ease in converting portfolio securities to cash or cash equivalents, recommendations of the fund's portfolio manager, and the fund's investment strategy and objectives
    c. Description of how purchases, redemptions and exchanges will be conducted during the period prior to the Closing Date
6. Fund to begin the liquidation process
    a. Set aside reserves for liquidation-related expenses (typically limited)
    b. Pay any debts or other obligations (often limited to previously accrued fees to service providers)
    c. Begin to convert portfolio securities to cash or cash equivalents
7. Pay liquidation proceeds to investors on the Closing Date
8. File last financial reports with the SEC
9. File an application with the SEC for deregistration of the fund (on Form N-8F)
10. File with the state to dissolve the fund (typically a perfunctory filing)

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[*] For further detail, *see* Jack Murphy, Julien Bourgeois and Lisa Price, *How a Fund Dies*, Review of Securities & Commodities Regulation, Vol. 43 No. 21 (Dec. 1, 2010).