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Via email to fsb@bis.org

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

Re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (3/2015)

Dear Members of the FSB and IOSCO:

We are writing on behalf of our client Federated Investors, Inc. and its subsidiaries ("Federated")[1] to comment on the Consultative Document (2nd) *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (NBNI G-SIFIs), published by the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO).[2] The Consultative Document ("Consultation") poses a number of questions regarding the assessment methodologies that should be used to identify NBNI G-SIFIs – those institutions whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity.

The Consultation requests comments on detailed NBNI financial sector-specific methodologies for finance companies, market intermediaries (broker-dealers), investment funds and asset managers. The investment funds sector is designed to cover authorised/registered

[1] Federated has sixty years of experience in the asset management business, including managing money market mutual funds (MMFs) and other investment funds and accounts. Federated submitted comments on 4 April 2014 on the FSB/IOSCO January 2014 consultation document (the "2014 Consultation" available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf) on this same topic.

[2] Consultative Document (2nd) *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* ("Consultation"), *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

open-end schemes that redeem their units or shares (whether on a continuous or periodic basis), as well as closed-end ones. The Consultation states that, by way of example, the methodology applicable to investment funds "would therefore cover disparate fund categories, from public mutual funds (including sub-categories thereof such as common mutual funds, money market funds (MMFs) and exchange-traded funds (ETFs) to private funds (including hedge funds, private equity funds and venture capital)."[3]

Our comments will address investment funds and to a lesser extent asset managers. In brief, Federated believes that:

- the main risk factors in funds and asset management involve the excessive use of leverage and derivatives and that counterparty risk is not present in unlevered and limited leverage funds that do not make significant speculative use[4] of derivatives;
- funds and asset management do not involve critical services/substitutability risks;
- funds should be evaluated individually, not as families;
- large size alone should not be a trigger or indicator of systemic risk in unlevered and limited leverage funds that do not make material use of derivatives;
- small size (both in absolute terms and relative to the size of the underlying portfolio asset classes) could appropriately serve as a safe harbor, below which a fund that does not make substantial use of leverage or significant, speculative use of derivatives should not ever be considered for G-SIFI status.
- if size is to be a consideration, either as a safe harbor from or a trigger of G-SIFI status review, gross asset size (rather than net) should be used;
- funds that do not make substantial use of leverage or significant, speculative use of derivatives should be considered at a higher gross asset value than levered funds, and size should be benchmarked to the underlying portfolio asset class (with "asset class" read broadly); and
- cross-border activities, use of open-end fund structures to invest in liquid assets, investment in a portfolio of debt securities, the nature of investor/clients, or the prudent use of repurchase agreements should not be viewed as factors weighing in favor of G-SIFI designation.

Federated believes that in light of the foregoing, as well as taking into consideration their simple structure and existing regulatory requirements, unlevered and limited leverage funds that do not make significant speculative use of derivatives, that use an external custodian, maintain investor transparency, use forward pricing and in the case of an open end fund structure hold

[3] Consultation at 31.

[4] Meaning use other than to hedge specific interest rate or currency risk or take modest directional portfolio positions consistent with the investment purposes of the fund.

marketable portfolio assets, should never be considered G-SIFIs. We note in this regard that many regulated investment funds (including in particular MMFs) do not use leverage or derivatives to any material degree, while others (such as some longer-term debt and equity mutual funds) may use leverage and derivatives only to a very limited degree and subject to strict regulatory limits.

Federated believes that NBNI asset managers are far too small in balance sheet size, too readily replaced by many competing asset managers, and as agents without custody or principal exposures to client/investors too little involved in counterparty risk to be G-SIFIs.

Federated believes that the Consultation overstates "fire sale" risks in the case of unlevered and limited-leverage funds, mislabels excessive leverage-related events and normal market functioning as "fire sales," and is generally too focused on remote and theoretical risks while ignoring the systemic risks posed by government and GSE activities. Moreover, the Consultation seems too ready to regulate funds and asset managers as an indirect means of regulating banks, rather than simply regulating banks' exposures to particular asset classes and funds.

Federated Agrees With Many Elements Discussed in Consultation

Federated agrees with much of what is stated in the Consultation regarding considerations in SIFI designation for NBNI funds and asset managers.

Central focus should be on leverage and derivatives

We agree with the Consultation's identification of excessive portfolio leverage and significant, speculative use of derivatives as *the* central elements of systemic risk for funds and asset managers.[5] Moreover, the two relevant pathways of transmission identified for asset management and funds activity (counterparty exposure and market impact/fire sales) when properly analyzed, are simply examples of how excessive leverage or use of derivatives can create, amplify and transmit systemic risk.[6]

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[5] Consultation at 32, 36, 40. Prudent use of derivatives by funds for risk-reducing hedging of identified portfolio interest rate and currency risks, or for taking modest directional portfolio positions, should not trigger heightened G-SIFI review.

[6] *See* Consultation at 32-34 (examples of asset liquidation/market channel involving rapid sales of portfolios upon loss of financing by levered funds). *Accord*, Federal Reserve Board Governor Stanley Fischer, *Nonbank Financial Intermediation, Financial Stability, and the Road Forward* (Mar. 30, 2015), avail. at http://www.federalreserve.gov/newsevents/speech/fischer20150330a.pdf.

The corollary is that an unlevered or limited leverage fund (particularly one with an outside custodian, simple, transparent structure, forward pricing, and portfolio liquidity consistent with redemption patterns) neither creates, amplifies, nor transmits systemic risk.

Critical function or services/substitutability channel not present in funds and asset managers

We agree with the conclusion of the Consultation, which repeats those of the January 2014 Consultative Document that "this [critical function or services/substitutability] channel was not considered significant for investment funds in light of the generally high level of substitutability" and that "the investment fund industry is highly competitive with numerous substitutes existing for most investment strategies."[7]

As stated in the 2014 Consultation:

> [F]unds close (and are launched) on a regular basis with negligible or no market impact.... [T]he investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable). A fund may close for a variety of reasons, for example not attracting sufficient investor interest or performing poorly over a given period, leading investors to gradually withdraw their money. As a result, a manager (or a fund's Board, depending on the jurisdiction) may choose among several options. For instance, it may choose to alter the underlying investment strategy, merge the fund's assets with those of another similarly managed fund, arrange (with investors' consent) for the assets to be managed by another manager on the basis of a new investment mandate, or orderly liquidate the assets and return investors' their monies."[8]

Unlevered and limited leverage funds can quickly shrink or grow to meet investor demands and market conditions. The hole left by the closing of one fund will be filled by the movement of shareholder investments to other funds, or to direct investment or other intermediaries. Substitution can occur in normal economic conditions or in a crisis, as demonstrated by the experience of the Putnam Prime Money Market Fund (Putnam Prime Fund) in September 2008. Just days after the Reserve Primary Fund suffered uncontrolled redemptions, the Putnam Prime Fund board acted to suspend redemptions and liquidate the fund, which provided sufficient time to effect a share exchange with Federated's Prime Obligations Fund, followed by an immediate liquidation of Putnam Prime Fund with redemptions of former Putnam Prime Fund shares at $1 per share. Shareholders received a quick resolution with

[7] Consultation at 35.

[8] 2014 Consultation at 30 (citations omitted).

minimal disruption. Investors were able to redeem at all times throughout, with no loss of liquidity, and without investment loss.[9]

The high substitutability of investment funds and asset managers is not simply an irrelevant factor. Instead, it affirmatively counsels against designation of investment funds and asset managers as SIFIs. The high substitutability of funds speaks also to the asset liquidation/market impact channel of transmission. When a fund or asset manager exits the market (or exits a market for underlying portfolio assets) it is replaced immediately as a competitor in the fund or service space and as an investor in the underlying asset market.

Funds should be viewed individually, not collectively as families

Federated agrees with the Consultation that funds should be viewed individually, not as part of "families" of funds.[10] Each fund has its own portfolio of investments and its own investors. Funds do not guarantee or pay the obligations of other funds. Asset managers (at least in the United States) are prohibited from guaranteeing the returns or asset values of funds they advise. The Consultation correctly concludes that each fund should be the unit of evaluation for G-SIFI status separate from any other funds.

Basic features of investment management establish lack of systemic risk in funds, managers

Federated agrees with the discussion in the Consultation regarding funds and asset managers being an agency activity with assets managed for the accounts of investor/clients (not a principal activity conducted by asset managers), typically characterized by custody of fund or advisory client assets in a regulated custodian bank or broker-dealer in a segregated account protected from the creditor claims of both the asset manager and the custodian, a simple structure, a high degree of transparency, and a high degree of substitutability.[11] Federated also agrees that public funds generally are required to be unlevered or use only limited leverage and are already highly regulated. Federated believes these basic characteristics of investment funds and asset managers all point to lack of systemic risk in unlevered funds and investment managers.

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[9] *See* Letter from Peter E. Madden to SEC (Feb. 13, 2013), https://www.sec.gov/comments/mms-response/mmsresponse-33.pdf.

[10] Consultation at 30.

[11] Consultation at 31-32, 47. *Accord*, SEC Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (Dec. 22, 2014), avail. at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

Federated is not alone in this view. The European Parliament's Committee on Economic and Monetary Affairs issued a report on systemic risk issues associated with non-bank financial firms, including asset management firms.[12] The Report called upon the European Commission to take into account whether the firms "trade on their own account and are subject to requirements regarding the segregation of the assets of their clients," noted that asset management firms' "client assets are segregated and held with custodians, and that therefore, the ability for these assets to be transferred to another asset manager is a substantial safeguard" and stated the committee's belief that "an effective securities law regime may mitigate many of the issues involved in the case of a large crossborder asset manager."[13] The European Parliament committee report further stated that "[t]he size and business model of the asset management sector does not typically present systemic risk."[14]

Similarly, the U.S. Congress heard testimony on the lack of systemic risk in funds:

> On economic grounds, there is no reason to believe that either specific mutual funds or mutual fund complexes should be designated as systemically important. The asset management industry plays a critical role in our economy by managing the funds of investors. The failure of a player in that industry in performing its role does not create a systemic risk. If one player runs in[to] trouble, another player can take its place. In general, difficulties with one player would not mean that the investors in the funds managed by that player would be at risk for regulated funds because the monies of the investors are segregated. Should a firm that manages mutual funds fail, the funds have boards that can replace the manager. There is no reason for that transition to be problematic.[15]

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[12] *Report on Recovery and Resolution Framework for Non-bank Institutions* (2013/2047(INI)) (Oct. 22, 2013).

[13] *Id.* at 10.

[14] *Id.* at 15.

[15] *Oversight of the Mutual Fund Industry: Ensuring Market Stability and Investor Confidence: Hearing Before the Subcomm. on Capital Markets and Government Sponsored Enterprises of the H. Comm. On Financial Services,* 111th Cong., at 3 (June 24, 2011) (statement of Rene M. Stultz, Everett D. Reese Chair of Banking and Monetary Economics, The Ohio State University), *available at* http://financialservices.house.gov/Calendar/EventSingle.aspx?EventID=247410.

Size criteria for fund designation should take into account size of underlying asset class, use of leverage; amount of AUM should not be a trigger

Federated agrees with the Consultation that the size criterion for evaluation of a fund for systemic risk should take into account the size of the fund relative to the underlying asset class as well as the use or absence of leverage in the fund.[16]

Excessive leverage itself is a risk factor, and its use may cause the gross asset value of a fund to be much larger than its net asset value (NAV). A highly levered fund at a given gross asset value poses a much greater risk than an unlevered or limited leverage fund of the same gross asset size, if other factors such as the asset class and other structural attributes are the same. A highly levered fund at a given NAV poses a *much* greater risk than an unlevered fund of the same NAV, all else being equal. The size criterion should *not* be set in such a way as to set a higher trigger for levered funds than for unlevered funds, which unfortunately is what the Consultation appears to be proposing.[17]

A fund with an asset size that is larger relative to the asset class has the potential for having more price impact in that asset class and in theory might face greater difficulty liquidating assets without a price impact. Accordingly, the Consultation's proposal to set a higher size criterion for a fund that invests in very large, deep and liquid assets is appropriate. For example, the money markets are very large. A recent European Central Bank report estimates the *turnover* in this market at €79 trillion.[18] The size of any one MMF relative to this market is very small. The aggregate AUM of the entire European MMF industry totals approximately €910 billion,[19] and the size of any one MMF is much smaller. The U.S. money market has well over $12 trillion in assets)[20] with many competing investors. U.S. MMFs hold approximately $2.6 trillion in assets.[21]

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[16] Consultation at 35-37.

[17] Consultation at 36 (proposing $400 billion back-stop size criterion for hedge funds and $100 billion for traditional public funds).

[18] ECB, Euro Money Market Study 2014 at 5, available at https://www.ecb.europa.eu/press/pr/date/2015/html/pr150430.en.html.

[19] EFAMA Press Release April 29, 2015, http://www.efama.org/Pages/Money-Market-Funds---Vote-in-Plenary.aspx.

[20] *Money Markets Today: Moving Past the Financial Crisis* at 2 (May 16, 2011), *available at* http://www.ici.org/pdf/mmsummit11_panel1.pdf.

[21] Investment Company Institute Money Market Fund Assets Release (April 30, 2015) available at http://www.ici.org/research/stats/mmf/mm_04_30_15.

The broader global market for very high quality "safe assets" across all maturities has been estimated at $74 trillion.[22] The broader market for "safe assets" is relevant because high credit quality borrowers may chose to issue medium and longer term debt instruments as an alternative to accessing credit in the short term money markets. To the extent that the method of transmission alleged to exist is the refunding risk of borrowers whose short-term debt is owned by a fund, the real market from the borrowers' perspective is much larger than $12 trillion money markets and any one fund makes up only a small fraction of the investment in this broader market for "safe assets" and thus is even less systemically important. Thus, in defining the asset market to use to set an amount to consider in the G-SIFI process for funds, a broad definition of that market is appropriate due to the ability of firms to substitute capital and financing sources.

We make two further observations that suggest size should be a "safe harbor" from designation rather than a criterion for designation. First, if the asset class is small, troubles in the asset class as a whole may not be able to transmit a systemic impact on the financial system. It is hard to imagine that a fund below a certain size that does not make excessive use of leverage, even with a dominant position in a very small market, could have a global systemic impact. Impact in that market, yes (and thus a good reason for local market regulation), but troubles in that market would not be significant enough to impact the global financial system. Second, in view of the high degree of substitutability of funds, the size benchmark for funds that invest in very large and deep public market segments with many investors should be very large.

The Consultation proposes two alternative size triggers in evaluating public (generally unlevered) funds for G-SIFI designation:

(i) Option 1: USD 30 billion in net asset value (NAV) and balance sheet financial leverage of 3 times NAV, with a size-only backstop of USD 100 billion net assets under management (AUM).

(ii) Option 2: USD 200 billion in gross AUM (GAUM) unless it can be demonstrated that the investment fund is not a dominant player in its markets (e.g. substitutability ratio below 0.5% or fire sale ratio below 5%).[23]

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[22] SEC Division of Economic and Risk Analysis, *Demand and Supply of Safe Assets in the Economy* (Mar. 17, 2014), *available at* http://www.sec.gov/comments/s7-03-13/s70313-324.pdf (citing International Monetary Fund, *Global Financial Stability Report: The Quest for Lasting Stability* at 88 (April 2012)).

[23] Consultation at 11.

The footnotes define "substitutability ratio" as "the funds' trading volume in relation to the daily trading volume of the underlying asset class (i.e. whether it is easily replaceable)" and "fire sale ratio" as "the extent to which the total net AUM of the fund could be easily absorbed, in a stressed market scenario, by the daily trading volume of the underlying asset class."[24]

In other words, the Consultation suggests a fund should be reviewed as a potential G-SIFI if it is larger than the aggregate size trigger ($100 billion AUM or $200 billion gross AUM) unless its portfolio assets represent less than 5% of the underlying asset class *and* less than 0.5% of the daily trading volume in that asset class. Unless the asset classes used to measure these ratios are very broadly defined, such as "all equities traded anywhere in the world," " all debt traded anywhere in the world" and "all money market assets outstanding," the ratios are far too low and would generate far too many false positives to be an appropriate check on the presumptive $100 billion or $200 billion trigger. In addition, we note that unlevered funds and limited leverage funds as a practical matter are not called upon to sell all of their assets in a single day.

We respectfully suggest that either the asset classes be very broadly defined, or the triggering asset numbers and ratios be raised to far larger percentages, to make this a meaningful and useful measure for evaluating global systemic importance of a fund. Moreover, these numbers should be used as "safe harbors" from designation for those funds that fall below the cut-off, rather than as automatic triggers that puts a fund above the asset size on the path to review and designation as a G-SIFI.

Balance sheets and external exposures of nonbank asset managers generally are far too small to present systemic risks, but AUM is not an appropriate criterion for designation of asset managers

Federated agrees with the statements in the Consultation that the balance sheet and external counterparty exposures of most NBNI asset managers are far too small to pose systemic risks.[25] In light of the fact that investment management is an agency activity, client and fund assets generally are held in segregated custody accounts at third-party regulated custodians, and the high degree of substitutability and administrative ease and speed with which the asset manager to separate client accounts and fund accounts can be replaced by one or more competing firms without the clients transferring custody, selling the account assets or exiting the asset class, the use of asset manager AUM is not a relevant criterion for assessing the systemic risk of an asset managers. If a manager fails, it does not sell those assets or even transfer their

[24] Id. at fn. 19, 20.

[25] Consultation at 50.

custody location. One or more other asset management firms step in to manage the accounts. The only real issue is temporary client inconvenience while other competing firms transition administration of its funds and client accounts.

Points in FSB 2014 Consultation bear repeating

The 2014 Consultation made some additional points relevant to the absence of systemic risk in funds that bear repeating. The 2014 Consultation document noted that funds are unlike banks both because investors (unlike bank depositors) knowingly undertake risk of investment loss and because funds are financed primarily by shareholder equity which absorbs portfolio losses and prevents transmission of those losses to counterparties. The 2014 Consultation document noted that:

> Unlike banks, for instance, where capital is set aside to protect depositors and other creditors against the risk of losses, investment management is characterized by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund's invested portfolio. As such and at least in theory, fund investors decide, based on full disclosure, to take on investment risks.
> In addition, from a purely systemic perspective, funds contain a specific "shock absorber" feature that differentiates them from banks. In particular, fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system. As explained above, fund investors bear both upside rewards and downside risks from movements in the value of the underlying assets. Bank depositors, on the other hand, are not in the same position and generally neither benefit from a bank's profits (that goes to bank shareholders) nor do they bear the primary risk of a bank default.[26]

Asset managers and funds are not banks and are not "shadow banks." Unlevered funds and limited leverage funds do not create, amplify or transmit systemic risks in the ways that large banks do.

The 2014 Consultation also described why funds should be evaluated individually and not as part of groups of "families" of funds or as part of the asset manager, in assessing systemic risk. According to the 2014 Consultation "[e]conomic 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."[27]

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[26] 2014 FSB Consultation document at 29-30.

[27] 2014 FSB Consultation document at 30.

Some points of ambiguity in FSB Report need clarification

Although we agree with much of what is contained in the Consultation, there are a few points that would benefit from clarification, which we briefly list below.

Prohibition on asset manager ex ante guarantees

The Consultation suggests that asset managers may guarantee client or fund assets, and thus the counterparty exposure of asset managers to funds and clients should be evaluated.[28] Contrary to the suggestion of the Consultation, asset managers (at least U.S. registered investment advisers and banks) generally are not permitted to guarantee the values or returns of their client accounts or advised funds.[29] Indeed, funds are required to clearly disclose to investors the lack of a guarantee and their risk of loss on an investment in a fund or other securities.[30] Regulatory surveys demonstrate that retail investors have long understood they as investors bear the risk of loss on fund investments.[31] The Consultation's discussion of manager exposures from guarantees of accounts and funds is inapposite, at least in countries that prohibit the practice. It may, however, be appropriate to consider guarantees by managers in those countries that permit them to make *ex ante* guarantees to clients.

Size criterion for unlevered funds should be much larger than for levered funds

The Consultation proposed a lower asset size threshold to trigger G-SIFI review of generally unlevered and limited leverage public funds ($100 billion) than it proposes for hedge funds which are more likely to be more highly levered ($400 billion). In view of the overriding significance of leverage to systemic risk and the extensive regulatory framework governing public funds, this is at best backward from what should be the respective review triggers for levered and unlevered funds. The size criterion for review of funds that do not make substantial use of leverage or derivatives should be significantly higher than the threshold set for funds that do make substantial use of either leverage or derivatives.

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[28] Consultation at 48-49.

[29] *See* SEC Staff Letter to Robert Reinhart (Sep. 21, 1971); Contingent Advisory Compensation Arrangements, SEC Rel. IA-721 (May 16, 1980); 12 U.S.C. §§ 371c, 1851(f).

[30] *See, e.g.*, SEC, Instructions to Form N-1A; Interagency Statement on Retail Sales of Non-Deposit Investment Products (Feb. 1994); 12 U.S.C. §§ 1851(d)(G)(v), (viii), (f).

[31] *Mutual Fund Shareholders: Characteristics, Investor Knowledge and Sources of Information*, report on 1996 Joint OCC/SEC Survey of mutual fund investors (concluding that "Most mutual fund purchasers know that it is possible to lose money in stock, bond, and money market mutual funds...."), avail. online at http://www.occ.gov/publications/publications-by-type/occ-working-papers/1999-1993/wp97-13.pdf.

Cross-border activities should not be a factor in SIFI designation

The Consultation states early on that cross-border activities will not be considered as a separate size criterion in G-SIFI designations.[32] In the body of the document, however, the existence of cross-border activities is repeatedly mentioned as a factor to be considered.[33] If a fund invests across borders, its asset size relative to the markets of each country is smaller (and more broadly diversified) than would be the case if its portfolio investments and investors were all concentrated in one country. Moreover, cross-border fund and asset manager investments and activities are important to the operation of efficient markets and global capital flows. If cross-border activities are used as a criteria for G-SIFI status consideration, an incentive is created for firms *not* to engage in cross-border operations and investments. Several decades of work by IOSCO and its member organizations (and trade negotiators) to open up global markets could be undermined by use of cross-border activities as a factor in G-SIFI designation. Federated respectfully suggests that conduct of cross-border activities not be considered as a criterion or factor in evaluating or designating a fund or asset manager as a G-SIFI.

Focus on real risks, not imaginary horribles

The Consultation states that "the NBNI G-SIFI assessment methodologies aim to measure the impact that an NBNI financial entity's failure can have on the global financial system and wider economy, rather than the *probability* that a failure could occur."[34] Federated respectfully suggests that the criteria take into account a realistic assessment of both the impact and the probability of occurrence. Our concern is that theoretical effects that may never have been documented to occur, the real impacts unknown, and whose probabilities of occurrence are at best remote and potentially non-existent, will play a factor in designating funds and asset managers, displacing realistic assessments of actual risks.

When theoretical and improbable events can form the basis for G-SIFI designation, the "grab bag" of ill-defined systemic risks of which Professor Hansen has warned is opened up for regulatory abuse.[35] Goal-oriented designations for purposes ranging from protectionism to turf-expansion to a chauvinistic need to impose one's own regulatory and industry structures on those of other countries and regulators are much easier to achieve if they can be based on a parade of imaginary horribles rather than on real and present risks.

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[32] Consultation at 11-12.

[33] Consultation at 44-45.

[34] Consultation at 10.

[35] Lars Peter Hansen, *Challenges in Identifying and Measuring Systemic Risk* at 1 (Feb. 11, 2013), *available at* http://www.nber.org/chapters/c12507.pdf.

The financial system is subject to the known risk of shocks emanating from outside the financial sphere and beyond the control of financial regulators. These can be both far more damaging to the financial system and far more likely to occur than many of the remote and theoretical risks that have been used to justify systemic risk actions, such as the risk of a never-before-seen policyholder "run" on an insurance company,[36] or the possibility of an as-yet undocumented and unmeasured "incremental incentive" to redeem MMF shares based on the use of a VNAV rather than a CNAV pricing mechanism.[37] Compare these to the probability and impact on the global financial system of, for example, an open war in the Middle East or Eastern Europe, a repeat of the Carrington event, the use of electromagnetic pulse weapons or a concerted sovereign cyber-attack on financial centers, a global pandemic, a sudden economic slow-down in China, *de facto* political dissolution of the United Kingdom, the European Union or the United States, or sudden upward or downward movements in the price or supply of oil.

And those are known risks. The Black Swans -- unknown unknowns -- are out there as well. An analysis of risks to the financial system that is so inward-focused that it elevates any real or imagined threat from within the industry no matter how small or unproven is blind to the very large and very real threats to the financial system originating outside the financial sector.

Moreover, a regulatory strategy of forcing asset managers and funds into a G-SIFI regulatory framework designed by bank regulators in the image of banks will inevitably result in further concentration of financial assets in the largest government-insured global banks and GSEs and hobbling competition from a market-based model. If all entities are structured the same they share the same weaknesses. This will make the financial system more fragile and susceptible to systemic shocks from wherever they may come, rather than less so.[38]

G-SIFI designation is not binding on FSB member countries

It is easy to forget in this era of global citizenry that the world has no central government. The FSB has no actual legal authority binding on any country. FSB designation of a bank,

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[36] http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf

[37] SEC, *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 47736, 47775 (Aug. 14, 2014).

[38] For an example of regulation intended to reduce systemic risk instead increasing systemic risk, see P. Glasserman, C. Moallemi and K. Yuan, *Hidden Illiquidity With Multiple Central Counterparties*, OFR Working Paper 15-07 (May 7, 2015) http://financialresearch.gov/working-papers/files/OFRwp-2015-07_Hidden-Illiquidity-with-Multiple-Central-Counterparties.pdf; A. Capponi, W.A. Cheng, S. Rajan, *Systemic Risk: The Dynamics Under Central Clearing*, OFR Working Paper 15-08 (May 7, 2015), http://financialresearch.gov/working-papers/files/OFRwp-2015-08_Systemic-Risk-The-Dynamics-under-Central-Clearing.pdf.

insurance company or NBNI firm as a G-SIFI is a suggestion to FSB's members. Each member government must develop and implement a process for designation through its own legal framework and consultation process. Each nation must engage in a full process under its own laws, subject to its own requirements and judicial, legislative or administrative reviews before it can (or should) designate a firm as a SIFI.[39]

Nor should nations be expected to reach the same conclusions as the FSB on SIFI status. Each nation must apply its own processes to a designation. The risk of going along with a regulatory overreach by the FSB is a local backlash against central dictates. The risk of a member regulator using the FSB G-SIFI process to end-run its home country legal processes is an undermining of the rule of law. Either weakens the ability to achieve prudent and achievable goals in enhancing the stability of the global economic system.

Areas of Disagreement with Consultation Report

"Fire sale" label misapplied

The "fire sale" concept is poorly defined and loosely used in the Consultation. In some cases it is inappropriately used to reference rational decisions by investors to sell an asset rather than used to note an involuntary sale at a disrupted price. Fire sales are badly overstated as a driver of systemic risk in investment funds and asset management businesses where funds and managed accounts are a substitute for direct investment in underlying asset class, forward pricing is used, portfolios are diversified, and the investment strategies do not involve material leverage.

The Consultation lists three "transmission channels" for evaluating systemic risk: (i) exposures/counterparty; (ii) asset liquidation/market; and (iii) critical function or service/substitutability.[40] The Consultation all but concedes that for unlevered funds that do not make significant use of derivatives are not able to transmit systemic risk to the financial system through transmission channels (i) and (iii). Instead, the Consultation focuses on the asset liquidation/market channel as relevant for an evaluation of systemic risks of funds and asset managers. In theorizing upon the ability of a fund or asset manager to transmit systemic risk to the financial system, the Consultation relies predominantly upon an undefined "fire sale" effect.

The Consultation theorizes that funds are potentially destabilizing to the financial system because people might sell securities, or a lender might foreclose and sell collateral, or an investor

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[39] SEC Commissioner Daniel M. *Gallagher, Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers: Remarks at the 2015 Virginia Law and Business Review Symposium* (April 10, 2015), avail. at http://www.sec.gov/news/speech/041015-spch-cdmg.html.

[40] Consultation at 4, 32-35.

might redeem shares of a fund causing it to sell portfolio securities, each causing the market price of the securities to decline.

The Consultation raises the spectre of a fund dumping assets at any price, triggering a downward spiral in overall prices.[41] Others have cited the risk of heavy redemption requests on an open-end fund in a stressed market as a way in which funds and asset managers could pose "systemic risk."[42] The normal financial context in which the downward spiral phenomenon is cited involves margin calls and sales of collateral by creditors and counterparties, who are seeking to recover a portion of a bad or defaulted credit by selling a collateral security quickly.[43] Unlevered funds do not borrow and do not have significant creditors that have a need or an incentive to foreclose on collateral and sell it at any cost. Limited leverage funds and those that use derivatives only to a modest degree as part of a diversified liquid portfolio do not create large counterparty risk exposures or significant risks of forced sales of large portfolio positions that could have a market or systemic impact. Funds have shareholders. Shareholders are equity owners of the fund and experience any portfolio losses; a risk they knowingly undertake when they invest in the fund. The risk of a bank run is different from redemptions from a mutual fund. A bank is legally obligated to pay demand deposits on demand. If a bank fails to do so, it defaults. When the depositors of a bank rush to withdraw funds from the bank, the bank is under the stress of the demands of numerous creditors and the default risk is concentrated in the bank.

In contrast, investments in funds are the investor's equity, not the fund manager's liability. When investors in a fund make redemption requests, they cannot put the fund manager in default. Fund shares generally are issued and sold under a "forward pricing" convention.[44] An investor placing a purchase or redemption order does not get the share price from the previous market close, nor a share price based on portfolio values as of the time that the order was placed. Instead, the shareholder gets the share price determined later in the day *after* the

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[41] Consultation at 33; 2014 Consultation at 3, 29.

[42] FSOC, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77488, 77489-91 (Dec. 24, 2014; Office of Financial Research, *Asset Management and Financial Stability* at 12-16 (Sept. 2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

[43] *Id.* at 17, 22. Redemptions from mutual funds have a weak effect on market prices on the underlying markets in which they invest, in part because they do not have a sufficient share of those markets, and are not strong enough to sustain a market decline. Eli M. Remolona, Paul Kleiman, and Debbie Gruenstein, *Market Returns and Mutual Fund Flows*, Federal Reserve Bank of New York Economic Policy Review (July 1997) at 33, 36, 45 (1997), http://www.newyorkfed.org/research/epr/97v03n2/9707remo.pdf. The effect tends to be greater in smaller and less liquid markets. The effect in the underlying markets of any such decline is temporary and reverses after a period of time. Amil Dasgupta, Andrea Prat, & Michela Verardo. *Institutional Trade Persistence and Long-Term Equity Returns*, 66 Journal of Finance 635 (2011).

[44] 17 C.F.R. §§ 275.2a-4, 275.22c-1.

order is placed and frequently after the manager has placed orders to sell underlying portfolio securities to address net daily redemptions. The price impact of selling pressure on the individual securities in a mutual fund's portfolio is factored into the redemption price that the investor receives. The forward pricing convention does a good job of addressing any first mover advantage related to pricing that is caused by the open-end fund structure.

Funds are an efficient method for investors to invest at lower transactions costs and with greater diversification. If investors invest in directly in markets, the same impact on underlying securities market, their investment decisions will still drive market prices and liquidity, which go up and down based on buyer and seller interest.

The term "fire sale" is undefined in the Consultation document, although the term "fire sale ratio" is defined as the ratio of the value of a funds' portfolio assets to the daily trading volume in the markets for the underlying assets, suggesting it may mean sale of all of a fund's portfolio assets into the market in one day. The examples provided for fire sales relate to sudden, involuntary sales into a price-disrupted market by a levered fund, such as foreclosure on collateral or a margin call. The term fire sale is used as a label for a phenomenon that is unmeasured and whose frequency, size, severity and impact are all unknowns. Sales of assets into a relatively liquid market by a seller who is not forced by circumstances to do so at any price is not a fire sale even if prices decline. Sales that temporarily depress prices, and purchases that increase them, are parts of the basic supply and demand mechanism by which a market establishes prices.

When unleveraged equity investors sell stocks they own or redeem equity mutual funds to move to government securities it is not a fire sale, it is a choice. Prohibiting investors from selling their holdings (or prohibiting their asset managers from doing so on their behalf) is not preventing a fire sale; it is an effort to prop up prices in order to deceive the markets about what a market-clearing price in the asset is under current conditions.

Limiting the leverage employed in a portfolio is important. But this is done by regulating lenders and the terms on which they lend. This is why we have margin rules. Similarly, forced sales needed to raise cash have been addressed by fund managers and national securities regulators by limits on redemption (closed end funds, private funds and insurance company separate accounts) and by maintaining portfolio liquidity and diversity (open-end funds). They are further addressed for individually-managed client accounts through asset allocation and suitability decisions designed to match client portfolios with the client's need for liquidity. Asset managers have been dealing with these issues for generations. This is not a "systemic risk" issue, but a fiduciary and investor protection issue.

Excessive Leverage the real culprit in "fire sale" examples

Many of the examples of "fires sales" provided in the Consultation and elsewhere are simply illustrations of the risk of excessive leverage. When lots of assets are purchased with debt and pledged to the creditors with authority to sell the asset at any price to repay the debt, problems can ensue. This is true whether the asset is single family housing or marketable securities. The problem is excessive leverage, not home ownership or securities investing. The solution to the problem is in regulating credit, not regulating ownership or investing. Once the substitutability of funds is conceded (which the Consultation does) and excessive use of leverage as a key systemic risk driver is acknowledged (which it is) it is hard to continue with the fire sale theory for unlevered and limited leverage funds.

Investment in debt securities is not a systemic risk factor

The Consultation suggests that a fund whose portfolio consists of debt instruments may create or amplify systemic risk by choosing not to continue to invest in debt instruments, thus forcing issues to find some other source of funding.[45] This analysis contains two main flaws.

First, funds invest in marketable securities where there are many participants in the market. Issuers in public markets are large companies and governments with access to many institutional investors and lenders and other forms of credit such as bank loans and longer-term notes and bonds. No one fund is a sole source of liquidity, and none is the point of access by the issuer to the market. If a fund chooses not to reinvest in new paper of an issuer upon maturity of the old, there are many other buyers in the market equally well positioned as purchasers. This is in sharp contrast to bank financing, where the bank is simultaneously the source of the funding, the holder of information about the risk and financing needs of the borrower and the relationship gatekeeper between the borrower and the source of funding. [46] If the bank suddenly withdraws funding, the borrower often has nowhere else to turn to replace that funding source.

Second, the risk of transmission through loss of funding to financial firms is essentially a problem of regulating the capitalization, liquidity and balance sheets of the borrower financial institutions. Overreliance by banks on short term debt is most directly addressed by regulating

[45] Consultation at 4.

[46] Ben S. Bernanke, *Non-monetary Effects of the Financial Crisis in the Propagation of the Great Depression*, 73 AM. ECON. REVIEW 257, 263-266 (1983); Douglas W. Diamond & Philip H. Dybvig, *Bank Runs, Deposit Insurance and Liquidity*, 91 J. OF POLITICAL ECON. 401 (1983).

banks' liquidity, as is now required by Basle III. [47] Regulating investment funds as an indirect means of limiting bank overuse of short term debt is inappropriate.

Prudent use of repo is not a systemic risk factor

As a subset of the above discussion, the Consultation suggests that funds' use of repurchase agreements ("repo") is a source of systemic risk.[48] Repo is simply a form of secured lending. The bulk of funds' use of repo is as a portfolio investment (rather than as a source of financing) and the main assets used are government securities. When done prudently, it is a low-risk and highly efficient form of short term investing and borrowing between counterparties.

Nature of investors in funds is not a systemic risk factor

The Consultation suggests that the presence of institutional investors as fund shareholders is an indication of systemic risk.[49] The Consultation states that institutional investors are quick to move money out of investments -- either because they are quick moving, savvy investors or because they stupidly follow the herd -- while retail investors tend to be slow to react. The Consultation's view is a gross oversimplification. If a fund manager to an open-end fund knows its client/investors, and the investor/clients have a clear understanding of the portfolio assets of the fund, it is able to address redemption issues by holding sufficient portfolio liquidity and having appropriate redemption gates and deferral mechanisms. Funds generally are required to use forward pricing based upon the value of the portfolio computed after the redemption order is processed, and institutions are no more able to exist a fund ahead of a price decline than if they were direct investors in the underlying portfolio assets.

Funds, investment managers and client/investors ultimately are motivated by wanting the best return relative to the risks involved. Funds and their investment managers are simply reacting to the needs of their investor/clients from whom they serve as agents and fiduciaries. In times of trouble, there is inevitably a movement to safer asset classes to avoid general market downturns. In times when the economy is booming, there is a movement to riskier, longer term and less liquid investments to seek higher returns. This is not systemic risk. It is rational economic behavior and an important part of the way by which markets function.

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[47] See Federal Reserve Chair J. Yellen, *Finance and Society Conference* remarks (May 6, 2015) available at http://www.federalreserve.gov/newsevents/speech/yellen20150506a.htm.

[48] Consultation at 39.

[49] Proposed Indicator 2-7.

To the extent that the concern is risk of loss on equity investments in funds by institutions as shareholders, this is already addressed by restrictions on permitted investments of banks and other financial institutions, as well as capital and liquidity rules that apply steep haircuts on risky and less liquid assets.

Redeemable shares are not a risk factor in unlevered or limited leverage forward-priced fund

The Consultation suggests that the issuance of redeemable shares by open-end funds is a risk factor.[50] The examples provided, however, all relate in one way or other either to use of borrowed funds or securities and other forms of leverage (as discussed above, the real risk factor) at the fund or its asset manager, or to large redemptions from open-end funds that invest in illiquid securities in small markets. The Consultation also posits that investors may have an incentive to redeem ahead of other investors to avoid price declines caused by their redemptions, but fails to recognize the predominate use of forward pricing for purchases and redemptions of open-end funds and assumes the investor's redemptions will be sufficiently large that, when channeled through same-day portfolio sales by a diversified fund will drive down prices not just of individual securities but of the entire asset class. How these academic musings would project systemic risk at a typical open-end fund that invests in a broad and deep asset market, uses forward pricing, is transparent and simple in structure, and does not make substantial or excessive use of leverage or derivatives, is hard to fathom. And even for the hypothetical examples provided involving small markets,[51] it should be kept in mind that the question is global systemic risk, not the potential for local price impacts on certain small markets.

As discussed above, decisions by investors to sell securities or redeem fund shares are part of normal market functioning. A market price impact is not a systemic risk, but simply part of the mechanism by which markets arrive at a market-clearing price for securities.

Amounts due to fund by financial firms is not a risk factor

The Consultation in Indicator 2-6 treats "Intra-financial system liabilities to G-SIFIs" as a systemic risk indicator. The Consultation would measure this "as the total net current credit exposure of G-SIFIs to the investment fund" in order to "capture an investment fund's interconnectedness with G-SIFIs" noting that "[t]he larger the exposure to the distressed fund by counterparties, especially by G-SIFIs, the greater the potential impact of its liquidation to transmit systemic risk the financial system." To the extent this is intended to mean money owed by a fund through its borrowings or derivatives positions to G-SIFIs, Federated views this indicator as an

[50] Consultation at 33-34.

[51] Consultation at 34.

appropriate elaboration upon the basic premise that risk comes primarily from use of leverage and derivatives.

If, however, the indicator is intended to measure also the amounts of money owed by G-SIFIs and other financial firms to a fund, Federated does not believe this is an appropriate risk indicator. Funds that invest in debt instruments are an efficient means of management of fixed income portfolios. The underlying issuers into the markets have access to many sources of funding (equity, long-term, medium-term and short-term debt) as well as bank financing. The winding up of a fund will not cut off that access in any meaningful way.

The investor/clients are in charge of ultimate decisions

Investment management is an agency activity. The investor/clients are the principals and make the ultimate decisions on asset allocation. Investment managers are advisers, not owners of the investments. Most securities investors are sophisticated and have a say in how their money is invested, how it is allocated among asset classes and what investment funds are used as investment vehicles. Those that are not personally sophisticated and involved in this process typically are represented by professionals who are, such as trustees, manager-of-manager style advisers, and other professionals or family members.

That control is exercised by investor/clients when a decision is made on an allocation strategy, the selection or approval of funds and asset managers to manage assets, and in periodic (often annual) reviews and approvals by the investor/client of those decisions.

Yet the Consultation fails to recognize investor/clients as having thoughts, viewpoints, investment objectives at risk tolerances, and ultimate control over how and where their accounts are invested. It fails to ascribe "agency" to investor/client or recognize them as thinking, independent actors. Investment managers refine these client goals and implement them, and in so doing improve the efficiency of the markets. But the ultimate drivers of overall market prices are the decisions of the investor/clients.

The Consultation attributes to funds and managers the collective systemic impact of investor/clients, and tacitly assumes that by imposing more regulation on funds and manages the impact of the decisions of millions of investor/clients can be muted or channeled. Although it may feel therapeutic, yelling at the waves will not hold back the tide.

Small asset classes do not present systemic risks

We agree that a fund has more potential to have a price impact on an asset class if its portfolio and trading activity represents a larger part of the market for that asset class, than if it represents a smaller share. But not all asset classes are large enough or sufficiently connected to

the financial system to give rise to in global systemic risk. Some are simply too small or disconnected to present global systemic risk, even if a fund owns a dominant part of it. There should be a minimum size cut off, beneath which an unlevered or limited leverage fund will not be considered for G-SIFI status regardless of its share of portfolio market.

Stated another way, for unlevered and limited leverage funds, size should be a safe harbor from G-SIFI designation, not a trigger for review. Below a certain absolute size, an unlevered or limited leverage fund should never be considered for G-SIFI designation, regardless of what percent of the underlying asset class it represents.

Systemic risk pathways through banks readily-- and best -- addressed by bank regulation

Pruned to its base, the Consultation seems to be measuring the ways by which a fund or manager could cause one or more large banks to fail. In the case of an unlevered or limited leverage fund, it is hard to see how that could occur absent imprudent investment and balance sheet management by the bank. That risk is more directly addressed by regulating banks and credit than by regulating funds and their managers. Systemic risk transmission pathways regarding bank exposures should be addressed by regulating banks and credit, not by regulating investment managers or funds.

Governments and GSEs create, amplify and transmit systemic risk

The Consultation starts with an assumption that government-sponsored enterprises (GSEs) and governments do not present systemic risk.[52] This assumption is counterfactual and a dangerous assumption if the goal is to reduce systemic risk. Governments themselves as issuers of securities are subject to downgrade and default. Sometimes the issue in the sovereign debt is financial, in other cases it is a political impasse, and in some situations, it is both. Due to a combination of political considerations (and a lack of political will) and the harsh economic impact of recognizing and addressing problems in government finance, all too often the situation is simply ignored, downplayed and rolled along until it becomes a financial crisis. The favored status given to government securities as an investment for banks has resulted in banks loading their balance sheets with the assets often without regard to the risk of the government that is the issuer or guarantor. The endless rounds of restructurings to avoid default often are used to mask the true risk on bank balance sheets of their government exposures.

These manifested in the Summer of 2011 with the European debt crisis, followed immediately by the U.S. budget impasse that gave rise to fears of default by the U.S. Treasury on its debt securities. Although the Consultation styles these as funds causing the market instability

[52] Consultation at 11.

in the government markets, the reality is concerns over potential government defaults and their ripple effects through banks as investors are what caused the crisis. In the 2011 European debt crisis, U.S. regulators pressured U.S. MMFs not to renew funding to European banks (evidencing another form of sovereign risk-- market risks exacerbated by imprudent regulatory actions).[53] GSEs can also pose risks, as shown by the events of 2008 and the many prior failures of the U.S. Farm Credit System.

A second, more subtle problem with giving government entities and sovereign wealth funds a "pass" from systemic risk analysis is that it would further distort markets and expand rather than contract systemic risk. Financial intermediation forced out of markets, asset managers and funds (and other traditional financial intermediaries) by the costs and burdens of increased SIFI regulation will move somewhere. If governments and their controlled entities are exempted from close scrutiny and risk controls, a large chunk of these assets may be re-routed through GSEs, sovereign funds and other governmental entities to arbitrage their lack of coherent regulation. Politicians have strong incentives to ignore systemic risks for short term economic gains in order to appease their voter base. By squeezing one section of the balloon, we send the air to a weaker section. Ultimately it will burst.

Politics, protectionism, turf expansion and pretext designations

G-SIFI designation should be solely used as a means to reduce systemic risk posed by that entity to the global financial system. Designation of an entity and the crafting of tests and

[53] U.S. regulators began making public statements questioning MMF investments in European banks in May 2011. At an SEC roundtable discussion on MMFs, then-Commodity Futures Trading Commission Chairman Gary Gensler stated, "The [MMF] industry does support U.S. commercial paper, but the majority of the money, I think this was correct, is funding European and Asian banks' dollar deposits. . . . Be a heck of a perverse outcome if our taxpayers have to stand behind European and Asian financial institutions through the transmission of U.S. money market funds . . . ." Roundtable on Money Market Funds and Systemic Risk (May 10, 2011), *available at* https://www.sec.gov/spotlight/mmf-risk/mmf-risk-transcript-051011.htm. Within weeks, Federal Reserve officials were making public statements warning of the risks to MMFs of holding the short-term debt of European banks. Eric Rosengren, President, Federal Reserve Bank of Boston, Defining Financial Stability, and Some Policy Implications of Applying the Definition (June 3, 2011), *available at* http://www.bostonfed.org/news/speeches/rosengren/2011/060311/index.htm. Press coverage warning of potential risks to European banks, from a Greek default or otherwise, appeared shortly thereafter. *See, e.g.*, Graham Bowley, *Worries Grow About Breadth of Debt Crisis*, N.Y. TIMES, June 16, 2011 ("The worry is that the worst case, a Greek debt default, would lead to damaging losses for European banks and spur a global panic, replaying the events of September 2008."); Mary Pilon, *Investors New Worry: Is There Greek Debt in My Money Fund?*, WALL ST. J., June 28, 2011 ("Last week, lawmakers and regulators registered concerns about money-market funds' exposure to the European debt crisis. About half of the assets in the 10 largest U.S. prime money-market funds are invested in European bank debt, according to a report from Fitch Ratings."); Graham Bowley, *The Ripples of a Debt Crisis*, N.Y. TIMES, June 29, 2011. Given the intense scrutiny of this issue by U.S. regulators, MMFs were left with little choice but to divest from European banks' short term paper.

criteria for designation should not be used to "send a message" or as a pretext for some other objective. For example, criteria carefully tailored to reach only U.S. asset management firms and funds, limit competition with and avoid more direct regulation of banks as government-favored class of institutions, expand jurisdiction of certain national regulators, impose one country's favored fund structure globally, impose protectionist approaches, or impose normative judgments, would be entirely inappropriate.

Need to consider systemic risk created by inappropriate SIFI designations

The Consultation fails to consider adverse systemic impact of designating funds and managers and ignores indirect systemic consequences of designating asset managers and funds as G-SIFIs. Federated believes that the direct and indirect consequences on the financial system of imposing G-SIFI regulation upon a fund should be analyzed. To the extent that such a designation results in imposition of bank-like capital and regulatory requirements on funds, such designation would increase, rather than decrease, systemic risk by making funds less useful to investors, resulting in a shift of investor assets into either "too big to fail" G-SIFI banks or into direct investment into securities or into other less regulated and less transparent fund and investment structures.[54] Designation of funds and asset managers could increase, rather than decrease, systemic risk.

Conclusion

Federated agrees with much of what is contained in the Consultation as regards funds and asset managers. In particular, this includes the use of concrete and specific criteria in the NBNI G-SIFI review and designation process, the focus of the analysis on leverage and use of derivatives in portfolios, the Consultation's recognition of the high substitutability of funds and asset managers, the focus on individual funds rather than fund families, the recognition that investment management is an agency activity with very limited counterparty exposures, and the scaling of size considerations to the size of the portfolio asset class. Subject to the points of clarification and suggested changes outlined above, we believe that the application of these criteria should generally result in the exclusion from G-SIFI status of funds and NBNI asset managers that do not make significant use of leverage or derivatives in their investment portfolios.

[54] Such a result would also undermine European efforts to increase market-based financing and reduce the dominance of a handful of large banks in intermediating capital flows in Europe. *See generally,* European Commission, *Capital Markets Union, http://ec.europa.eu/finance/capital-markets-union/index_en.htm.*

We appreciate the opportunity to provide our comments in response to the Consultation.

Respectfully submitted,

David. F. Freeman, Jr.

Appendix-- Responses to selected questions

Investment Funds Questions:

Q6-1. Please explain any potential systemic risks associated with the financial distress or disorderly liquidation of an investment fund at the global level that are, in your view, not appropriately captured in the above description of each risk transmission channel? Are there elements that have not been adequately captured? Please explain for each of the relevant channels separately.

Federated believes the Consultation has overstated the systemic risks associated with unlevered funds by conflating the risks of distressed sales by creditors involving leveraged positions and use of derivatives with normal rational decision-making by investors to sell securities and redeem shares in response to their decisions to exit an investment or asset class.

Q6-2. For the asset liquidation/market channel, to what extent is the potential for risk transmission heightened with respect to an individual fund that is a dominant player (e.g. its asset holdings or trading activities are significant relative to the market segment) in less liquid markets?

The potential for market price movements in an asset class based upon sales of fund portfolio assets is larger if the fund has a dominant position in the asset class. A large market position may indicate a small asset class that, taken in the aggregate, is not systemically important.

Q6-3. Under what conditions might the asset liquidation/market channel apply to an individual fund in ways that are distinct from industry-wide behaviours in contributing to broader market contagion?

Excessive use of leverage and/or derivatives by an individual fund coupled with the ability of counterparties and creditors to sell collateral to recoup their exposures without consideration of the loss to the fund's investors from sales into an illiquid and price-displaced market is the main factor to consider. Absence of portfolio transparency to investors, failure of the fund to use forward pricing, an external custodian and to match the liquidity of the portfolio to redemption features in an open-end fund are also factors that are relevant to consider.

Q6-4. Is the proposed threshold defined for private funds appropriately calibrated? If not, please explain the possible alternative level (e.g. USD 200 billion of GNE) that could be adopted with clear rationale for adoption and quantitative data to back-up such proposed level?

The size criteria should be safe harbors from review, rather than triggers of review. For large asset classes, particularly for unlevered and limited leverage funds that do not make significant use of derivatives, the proposed size criteria are too small.

Q6-5. In your view, which option for the proposed threshold applied to traditional investment funds is the most appropriate initial filter to capture the relevant funds for detailed assessment and why? Also, are they appropriately calibrated? Please provide evidence (data or studies) to support your argument. If you prefer Option 2, please provide a practical definition of a dominant market player that can be applied in a consistent manner.

The size criteria should be safe harbors from review, rather than triggers of review. For large asset classes, particularly for unlevered funds that do not make significant use of derivatives other than prudently for risk reducing portfolio interest rate or currency hedging purposes or taking modest directional portfolio positions, the proposed size criteria are too small. Gross assets, rather than net assets, should be the appropriate size measure.

Q6-6. In addition to the two options for traditional investment funds, the FSB and IOSCO also considered a simplified version of Option 2 using GAUM (e.g. USD 200 billion) with no dominant player filters. Please provide your views if any on this as a potential threshold with the rationale (especially compared to the proposed two options above).

See response to Q6-5.

Q6-7. Please explain any proposed revised indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning.

See discussion at pages 6-9, 11, 15-20 of our comment letter.

<u>Asset Managers Questions</u>:

Q7-3. For the exposure/counterparty channel, to what extent does the assessment adequately describe the types of risks posed by asset managers' activities, such as securities lending, distinct from individual funds? Are there other activities that warrant further assessment?

Federated believes the Consultation has overstated the systemic risks associated with asset managers by failing to take sufficient account of their status as agents for investor/clients that are independent actors, and by failing to take account of the fact that NBNI asset managers generally are small in balance sheet assets and are not counterparties or guarantors to any significant degree. See discussion at pages 9-11, 20 of attached comment letter.

Q7-4. For the asset liquidation/market channel, to what extent and under what circumstances might reputational or operational risks of the asset manager impact the entity's individual funds, contributing to high redemptions? How might it impact the transfer of SMAs?

Federated believes this effect is overstated in the Consultation. Asset managers generally do not have custody of funds or client assets. Other functions, including asset pricing and portfolio execution, as well as many other administrative functions are commonly performed by other firms. Asset managers (at least in the United States) are prohibited from guaranteeing the investment returns of client accounts or funds. A client or fund board can readily transfer management of the account or fund to a new manager without changing custodians or selling any assets.

Federated believes the Consultation has overstated the systemic risks associated with asset managers by conflating the risks of distressed sales by creditors involving excessively leveraged positions and speculative use of derivatives with normal rational decision-making by investors to sell securities and redeem shares in response to their decisions to exit an investment or asset class. See discussion at pages 4-5, 9-11 and14-17 of attached comment letter.

Q7-8. Please explain any proposed indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning. What alternative indicators should be added and why would they be more appropriate?

For NBNI asset managers with an external custodian, that do not issue ex ante guarantees of client returns, and do not make excessive use of portfolio leverage or speculative use of derivatives, AUM is not an appropriate measure. See discussion at pages 5-6, 9- 11, 14-17 and 20 of attached comment letter.

Q7-9. What are the practical difficulties (e.g. data availability, comparability) if any with collecting data related to these indicators? Please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

Q7-10. Which of the proposed indicators set out above, in your view, should be prioritised in assessing the systemic importance of an asset manager?

Excessive portfolio leverage and significant, speculative use of derivatives.