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

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

Fidelity Management & Research Company ("Fidelity")[1] appreciates the opportunity to comment on the *Consultative Document (2nd): Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* ("Second Consultative Document"),[2] published by the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO"). We are disappointed, however, that the FSB[3] continues to pursue this regulatory approach, which is unjustified and would be ineffective. The asset management methodologies proposed in the Second Consultative Document are irredeemably flawed and should be abandoned in favor of a focus on products and activities in the asset management industry and capital markets more broadly.

Last year, the FSB recognized in its first proposal, *Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* ("First Consultative Document"),[4] that "another possible approach to assessing systemic risk in the asset management sector could be to consider possible financial stability risks that could arise out of certain asset management-related activities." In response to the First Consultative Document, the FSB and IOSCO received numerous comment letters (from Fidelity and many other experts and stakeholders) advising that the proposed methodology for designating large individual investment funds as Global Systemically Important Financial

[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.
[2] Fin. Stability Bd. & Int'l Org. of Sec. Comm'ns, *Consultative Document (2nd): Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (Mar. 4, 2015) (hereinafter, the "Second Consultative Document"), *available at* http://www.financialstabilityboard.org/2015/03/assessment-methodologies-for-identifying-non-bank-non-insurer-global-systemically-important-financial-institutions/.
[3] References to "FSB" refer to both the FSB and IOSCO as authors of the Second Consultative Document.
[4] Fin. Stability Bd. & Int'l Org. of Sec. Comm'ns, *Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, 32 (Jan. 8, 2014) (hereinafter, the "First Consultative Document"), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf.

Institutions ("G-SIFIs") should be abandoned. Commenters endorsed the product- and activity-focused approach as a constructive alternative to G-SIFI designation.[5]

Those comment letters presented substantial evidence showing that G-SIFI designation of an individual investment fund or asset manager[6] would be unwarranted and would not only fail to reduce risk, but would likely increase risk to the global financial system by, among other things, shifting assets out of regulated funds and reducing the appeal of funds in the very markets with which the FSB purports to be most concerned.[7] Investment funds and asset managers do not, and cannot, present the type and scale of risk required to justify a G-SIFI designation. And even if a single fund or manager were capable of presenting that kind of risk to the global financial system, designation would not effectively address the risk.

The Second Consultative Document ignores this evidence and instead *expands* the FSB's first G-SIFI designation proposal to include designation methodologies for both investment funds *and* asset managers. It also proposes a star-chamber designation process that would violate U.S. law in myriad ways notwithstanding the fact that it would apply almost exclusively to U.S. funds and managers.[8] The FSB does not offer any new arguments, much less any empirical evidence, to prove that an individual U.S. fund or manager could ever threaten global financial stability, or to justify the proposal to regulate them differently than their competitors through G-SIFI designation.

U.S. regulators cannot apply methodologies to U.S. entities that do not meet U.S. standards; and the asset management methodologies proposed in the Second Consultative Document do not meet these standards because they are based on mere speculation. Regulation must be based on facts and rigorous economic analysis. In this case, the facts and economic analysis strongly support the rejection of the proposed G-SIFI methodologies for investment

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[5] *See, e.g.*, Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to the Secretariat of the Fin. Stability Bd., 6 (Apr. 7, 2014) (hereinafter, "ICI-FSB Letter"), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140423af.pdf; Letter from Barbara Novick, Vice Chairman, BlackRock, Inc. to the Secretariat of the Fin. Stability Bd., 1 (Apr. 7, 2014) (hereinafter, "BlackRock-FSB Letter"), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140423h.pdf.

[6] We use the terms "investment fund" and "mutual fund" interchangeably to refer to SEC-registered traditional variable net asset value ("NAV") open-end mutual funds. We use the terms "asset manager" and "manager" to describe managers of mutual funds. Our comments in this letter are not intended to apply to stable NAV money market mutual funds, which differ from traditional mutual funds in a number of important respects.

[7] For the FSB's reference, we append Fidelity's comment letter on the First Consultative Document, as well as a pair of recent letters to the U.S. Financial Stability Oversight Council ("FSOC") addressing these and other related issues, as Appendix A (Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to Secretariat of the Fin. Stability Bd., 7 (Apr. 7, 2014) (hereinafter, "Fidelity-FSB Letter")), Appendix B (Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council (Mar. 25, 2015) (hereinafter, "Fidelity-FSOC Letter")), and Appendix C (Companion Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council (Mar. 25, 2015) (hereinafter, "Fidelity-FSOC Companion Letter")). We also refer you to the letter the ICI filed with the FSOC on March 25, 2015, *infra* note 104, and the other materials that ICI has published on this topic, which are available at http://www.ici.org/financial_stability.

[8] *See* Exhibits 1 and 2 (showing U.S. funds and managers identified by the proposed thresholds).

funds and asset managers in favor of a broad examination of investment funds, asset managers and the diverse capital markets in which they operate from a products and activities perspective.

Other regulatory groups have adopted this approach. Most notably, the FSOC shifted its focus away from examining individual funds or managers for potential designation as systemically important financial institutions ("SIFIs") almost one year ago.[9] The FSB should follow suit and abandon its proposed asset management methodologies.

With respect to U.S. funds, managers and markets, we respectfully request that U.S. members of the FSB and IOSCO reject these methodologies and support the process that the FSOC has begun, and which the Securities and Exchange Commission ("SEC") should lead going forward. We also request that they ensure that any future proposals by the FSB and IOSCO that they endorse meet U.S. standards and provide affected U.S. parties with the protections they enjoy under U.S. law.

In the rest of this letter, we show that:

I. The FSB is not required to develop a G-SIFI designation methodology for investment funds or asset managers, nor is it empowered to apply such a methodology to U.S. investment funds and asset managers.

II. The FSB's G-SIFI designation proposal is the product of a defective rulemaking process and proposes a defective process for applying the G-SIFI methodologies.

III. The FSB's proposals for G-SIFI designation of asset management entities are irredeemably flawed and should be abandoned.

IV. The proposed G-SIFI designation framework and methodologies for asset management entities do not apply to mutual funds or asset managers.

V. The FSB should abandon its designation methodologies for investment funds and asset managers and shift to a products and activities analysis of the asset management industry and capital markets.

VI. U.S. members of the FSB and IOSCO should reject the G-SIFI designation proposals.

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[9] Press Release, U.S. Treasury Dept. Office of Pub. Affairs, *Financial Stability Oversight Council Meeting July 31, 2014* (July 31, 2014), *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031%202014.pdf ("The Council directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."); *see also* Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488, 77,489 (Dec. 24, 2014) (hereinafter, the "FSOC Notice"), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-30255.pdf ("The Council is now seeking public comment in order to understand whether and how certain asset management products and activities could pose potential risks to U.S. financial stability.").

I. The FSB Is Not Required to Develop a G-SIFI Designation Methodology for Investment Funds or Asset Managers, nor Is It Empowered to Apply Such a Methodology to U.S. Investment Funds and Asset Managers.

The FSB's pursuit of G-SIFI methodologies for funds and managers is confounding. Not only is it contrary to experts' recommendations, sound economic and regulatory policy, and U.S. law, the G20 never directed the FSB to produce these methodologies. The Second Consultative Document states that "[a]t the Cannes Summit in November 2011, the G20 Leaders asked the [FSB], in consultation with [IOSCO], to prepare methodologies to identify systemically important non-bank non-insurer (NBNI) financial entities."[10] Nothing in that request requires the FSB to develop a G-SIFI designation methodology for either investment funds or asset managers. Further, the G20 did not instruct the FSB, and the FSB is not empowered, to apply such methodologies to U.S. funds or managers on which the proposed methodologies in the Second Consultative Document are clearly focused.

The relevant sentence in the G20's Cannes Summit Final Declaration—which comes without explanation or elaboration—merely states: "We also ask . . . the FSB in consultation with IOSCO to prepare methodologies to identify systemically important non-bank financial entities by end-2012."[11] There is no indication that the G20 believed that *any* asset management entities were among the "systemically important non-bank financial entities" for which the G20 wanted designation methodologies. The FSB is clearly not under any edict to develop a methodology for asset managers. Notably, the FSB did not propose such a methodology in the First Consultative Document, evidence that, at least at one point in time, the FSB similarly understood the modest scope of the G20 request.

As we explain in detail below, the "systemically important" label simply does not fit individual mutual funds or their managers. These entities lack any of the attributes that would make globally harmful failure possible, such as fixed obligations, material leverage, a critical function or service, or a shortage of substitutes.

It is well within the terms of the G20's request to conclude that individual funds and managers are not systemically important and therefore do not warrant G-SIFI designation methodologies. As we explain in Section V of this letter, we strongly encourage the FSB to so conclude and to abandon the proposed methodologies. The FSB can then focus its attention on analyzing whether capital markets activities, products and participants actually threaten, or enhance, global financial stability and economic growth and whether there is any need for

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[10] Second Consultative Document, *supra* note 2, at 1.

[11] CANNES SUMMIT FINAL DECLARATION, 6 (2011), *available at* https://g20.org/wp-content/uploads/2014/12/Declaration_eng_Cannes.pdf; *see also* G20 LEADERS' DECLARATION, 17 (2013), *available at* https://g20.org/wp-content/uploads/2014/12/Saint_Petersburg_Declaration_ENG_0.pdf ("We ask the FSB, in consultation with the International Organization of Securities Commissions (IOSCO) and other standard setting bodies, to develop for public consultation methodologies for identifying global systemically important non-bank non-insurance financial institutions by end-2013.").

additional regulation and coordination at a global level to reduce identified risks or enhance any benefits.

Such a shift in approach best implements the FSB's actual mandate to "assess vulnerabilities affecting the global financial system and identify and review on a timely and ongoing basis with a macroprudential perspective, the regulatory, supervisory and related actions needed to address them."[12] The FSB's current G-SIFI proposal violates that mandate by blindly pressing ahead with proposed methodologies for designating a few large funds and managers without any evidence that they present SIFI risk or could be regulated effectively through SIFI designation and in the face of substantial evidence to the contrary.[13] By continuing to pursue a designation approach the FSB is wasting scant regulatory resources that could be utilized to identify and address genuine systemic risks.[14]

The FSB's proposed thresholds for identifying funds and managers for scrutiny capture entities principally, if not exclusively, based in the United States. Excluding pension and sovereign wealth funds (as the FSB proposes), 13 investment funds have more than $100 billion in assets under management ("AUM") according to recent data.[15] All are domiciled in the United States. Likewise, after excluding managers affiliated with global systemically important banks ("G-SIBs") or global systemically important insurers ("G-SIIs") (as the FSB also proposes), all four of the asset managers with more than $1 trillion in AUM are domiciled in the United States.[16]

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[12] Fin. Stability Bd. Charter, Art. 2(1)(a).

[13] The FSB plans to rely heavily on "supervisory judgment" in an attempt to overcome the lack of data and analysis to support the development or application of the methodologies. *See, e.g.*, Second Consultative Document, *supra* note 2, at 1 (The proposed methodologies envision "a greater role for supervisory judgment in the assessment compared to the G-SIB and G-SII methodologies"). *Id.* at 10 ("[S]upervisory judgment could be used to add entities to the assessment pool even when they fall below the materiality threshold but are considered potentially globally systemic.").

[14] The concern about the diversion of regulatory attention and resources is a real one. There are risks to financial stability that can only be addressed on a global basis, by a consortium of regulators acting together. If the FSB does not address these global risks, it is not clear that anyone else is in a position to do so. Information security is one example. If a hacker sponsored or harbored by a hostile government were to submit false financial instructions or corrupt the databases of central counterparties or custodians in a major economy, such that individuals and entities could not prove what they own and what they owe, the likely impact on the global financial system would be significant. No one company or government can address risks of this nature, which have a "weakest link" character to them. Yet, instead of tackling such genuine global issues, the FSB continues to chase the chimera of asset management designation.

[15] *See* Exhibit 1 (Three of these funds are money market mutual funds.); *see also* Office of Fin. Research, *Asset Management and Financial Stability*, 5-6, Figures 2 & 3 (Sept. 2013), *available at* http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf.

[16] *See* Exhibit 2; *see also* Comm. on Capital Mkts. Regulation, *Nothing But the Facts: FSB-IOSCO Proposal for SIFI Designation* (Mar. 24, 2015), *available at* http://capmktsreg.org/app/uploads/2015/03/2015-03-24_Nothing_But_the_Facts_FSB_asset_managers.pdf. We note that the FSB's proposal would affect U.S. domiciled funds and managers presently; however, as initiatives such as the European Capital Markets Union project increase investment and market finance, assets under management for foreign domiciled funds and managers will increase. Over time, the FSB's proposal will cause similar problems for them and their national regulators and political leaders.

Although, on its face, the proposed G-SIFI designation process for investment funds and asset managers would apply globally, in practice it would result in only a U.S. regulator applying the FSB's international designation procedures and standards (under the FSB's direction) to U.S. funds and managers. U.S. funds and managers would be assessed if an "international oversight group" directs the "primary national authority" to do so or if they meet the FSB's materiality thresholds, "based on the applicable sector-specific methodologies" developed by the FSB.[17] For U.S. funds and managers, the "primary national authority" would be some unspecified U.S. regulator. To determine whether an entity should be designated as a G-SIFI, the FSB proposes that "the primary national authority" would assess the "global systemic importance" of funds and managers from that nation and report back to the "international oversight group" and the FSB for review and approval.[18]

The FSB has no authority to direct or oversee the actions of a U.S. regulator in this fashion. The Articles of Association establishing the FSB expressly provide that the "policy making and related activities" of the FSB, "including any decisions reached in their context, shall not be binding or give rise to any legal rights or obligations."[19] In addition, members of the FSB—which for the United States are the Treasury Department, the Federal Reserve Board and the SEC—"can recuse themselves at any time from these activities or decision-making where such activities or decision-making are not consistent with their legal or policy frameworks."[20] The Articles of Association specifically instruct that "[m]embers participate in the [FSB] in accordance with their respective legal and policy frameworks, which may not be modified or superseded by these Articles or any decision of the [FSB]."[21] The FSB's Charter likewise disavows any intention "to create any legal rights or obligations."[22]

U.S. regulators understand that FSB policies and decisions are not binding. Jacob Lew, Secretary of the Treasury, has affirmed that countries "retain their own national authority over their regulatory activities" no matter what the FSB proposes.[23] SEC Commissioner Daniel Gallagher has explained that "there is no basis in law for the assertion that decisions of the FSB are binding on U.S. regulators."[24] The FSOC has announced that "[d]ecisions reached in the FSB do not determine decisions made by the FSOC" and that "the FSOC is under no obligation to even consider a firm identified by the FSB for designation."[25]

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[17] Second Consultative Document, *supra* note 2, at 12-15, 59.
[18] *Id.* at 59.
[19] Fin. Stability Bd. Articles of Ass'n, Art. 10.
[20] *Id.*
[21] *Id.*, Art. 3(3).
[22] Fin. Stability Bd. Charter, Art. 23.
[23] Jacob Lew, Sec'y of the Treasury, Hearing Before the House Comm. on Fin. Servs.: *The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System* (Mar. 17, 2015).
[24] Daniel M. Gallagher, Comm'r, U.S. Sec. & Exch. Comm'n, Remarks at the 2015 Virginia Law and Business Review Symposium: *Bank Regulators at the Gates: The Misguided Quest for Prudential Regulation of Asset Managers* (Apr. 10, 2015), *available at* http://www.sec.gov/news/speech/041015-spch-cdmg.html.
[25] Fin. Stability Oversight Council, *Nonbank Designations – FAQs*, Q11 (last updated Feb. 4, 2015), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx.

U.S. regulators could not implement the FSB's G-SIFI designation proposals even if they wanted to, as U.S. regulators can operate only as permitted by U.S. law.[26] There is no U.S. law that would allow a U.S. regulator to apply international procedures or standards developed by the FSB to U.S. investment funds and asset managers to identify candidates for G-SIFI designation. To the contrary, the U.S. Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act")[27] establishes specific procedures and standards for designating U.S. entities as systemically important, which (as we explain in Section II.B. below) differ greatly from the procedures and standards proposed by the FSB.[28]

Any U.S. regulator that took on the G-SIFI designation role assigned to it by the FSB's proposal would be impermissibly circumventing the Dodd-Frank Act. Moreover, U.S. regulatory action based on procedures and standards developed by an international organization that have not been adopted by treaty, law or regulation in the United States would violate provisions of the U.S. Constitution regarding the exercise, separation and delegation of legislative, executive and judicial power. For example, the lack of U.S. executive, legislative or judicial control over the FSB's directives strikes at the heart of the U.S. constitutional "principles of political accountability,"[29] and thus would almost certainly violate the U.S. Constitution.[30]

II. The FSB's G-SIFI Designation Proposal Is the Product of a Defective Rulemaking Process and Proposes a Defective Process for Applying the G-SIFI Methodologies.

The FSB is following a thoroughly defective rulemaking process and has proposed an equally defective process for applying the proposed designation methodologies. Neither process would comply with U.S. law, which is a particularly troubling defect given that the FSB's G-SIFI designation proposals would apply principally, if not exclusively, to U.S. investment funds, asset managers and regulators. Such circumvention of U.S. law is impermissible.

A. Defective rulemaking process for designation methodologies

Regulatory rulemaking in the United States—which would include a government agency's adoption of SIFI designation procedures and standards—must comply with the Administrative Procedure Act.[31] As interpreted in U.S. courts, this statute requires that any rulemaking process exhibit key attributes of fair and reasoned decision-making. The FSB's

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[26] *See, e.g.*, *Citizens to Preserve Overton Park, Inc.* v. *Volpe*, 401 U.S. 402, 415 (1971).
[27] The Dodd-Frank Wall Street Reform and Consumer Protection Act ("The Dodd-Frank Act"), Pub. L. 111-203, 124 Stat. 1376 § 165 (2010).
[28] *See* 12 U.S.C. §§ 5323(a), (e) (2012) (U.S. SIFI designation procedures and standards); Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (2012) (same); Fin. Stability Oversight Council, *Supplemental Procedures Relating to Nonbank Financial Company Determinations* (Feb. 4, 2015) (hereinafter, "FSOC Supplemental Procedures"), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf (same).
[29] *Nat'l Ass'n of Regulatory Util. Comm'rs* v. *FCC*, 737 F.2d 1095, 1143 n.41 (D.C. Cir. 1984).
[30] *See, e.g.*, *Free Enter. Fund* v. *Pub. Co. Accounting Oversight Bd.*, 130 S. Ct. 3138, 3155 (2010) (requiring "a clear and effective chain of command" over all regulatory action).
[31] 5 U.S.C. §§ 551 et seq. (2012).

process for proposing G-SIFI designation methodologies for investment funds and asset managers exhibits too few of these attributes to satisfy this requirement. The FSB's "rulemaking" process would not survive scrutiny under U.S. law.

Failure to articulate satisfactory explanation. Under U.S. law, an agency must "articulate a satisfactory explanation for its action" that draws "a rational connection between the facts found and the choice made."[32] The FSB articulates no such "rational connection." The only supposed systemic risks for investment funds about which the FSB expresses any confidence at all are exposures to substantially leveraged funds and fire sales by funds operating in illiquid markets.[33] But their rationale for the proposed methodology is inapposite because the materiality thresholds would capture funds that exhibit neither risk.[34] The proposed $100 billion threshold for investment funds would principally capture unleveraged broad market index funds and money market funds.[35] And most of the proposed impact factors and indicators have nothing to do with either risk.[36]

Failure to answer objections. A U.S. agency must answer all reasonable objections to its proposed action.[37] Commenters submitted numerous compelling objections to the First Consultative Document's proposal for G-SIFI designation of asset management entities. Those objections remain unanswered. For example, many commentators explained how SIFI designation would be ineffective, if not counterproductive, in regulating any systemic risks in the asset management industry and recommended a shift to an industry- or market-wide analysis of products and activities.[38] The Second Consultative Document never explains how SIFI designation would regulate systemic risks effectively, let alone how it would do so better than a product- and activity-based approach. Indeed, the FSB twists the call for a shift to product and activity analysis into a supposed emphasis by commenters on "the relevance of a focus on activities of asset managers (or asset management activities)" that somehow justifies a

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[32] *Motor Vehicle Mfrs. Ass'n of U.S., Inc.* v. *State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983).

[33] Second Consultative Document, *supra* note 2, at 32-34. The only evidence of contagion cited refers to relatively short-term price dislocations that occurred in illiquid markets, particularly emerging market debt and equity. But mutual funds that specialize in emerging market investments (or high yield debt) are, by the nature of the products in which they invest and because they attract a relatively smaller portion of investable capital, simply too small to meet the proposed thresholds in the Second Consultative Document. The materiality threshold would have to be lowered to $15.1 billion in order to capture even the five largest emerging markets mutual funds – and doing so would require analysis of 219 funds, in total. Similarly, to capture at least the five largest high yield bond funds, the materiality threshold would have to be lowered to $10.4 billion – and doing so would require analysis of 341 funds, in total. *See* Exhibit 3.

[34] Second Consultative Document, *supra* note 2, at 35-36.

[35] *See* Exhibit 1. Of the 13 funds with more than $100 billion in AUM, six are index funds and three are money market funds.

[36] Second Consultative Document, *supra* note 2, at 37-46.

[37] *See Burlington Truck Lines, Inc.* v. *United States*, 371 U.S. 156, 168 (1962) (overturning adjudicatory order because agency was "unresponsive" to objections); *PPL Wallingford Energy LLC* v. *FERC*, 419 F.3d 1194, 1198 (D.C. Cir. 2005) ("[U]nless the [agency] answers objections that on their face seem legitimate, its decision can hardly be classified as reasoned." (internal quotation marks omitted)).

[38] *See, e.g.*, Fidelity-FSB Letter, *supra* note 7, at 3-4; ICI-FSB Letter, *supra* note 5, at 5-6; BlackRock-FSB Letter, *supra* note 5, at 15-16.

designation methodology for asset managers.[39] The call for a shift in focus by commenters was clearly offered as an *alternative* to designation, not a *basis* for it. Such a distortion and refusal to answer objections on their merits prevents stakeholders from participating meaningfully in the policy making process.

Failure to explain changes in position. When a U.S. agency "changes its course" on a regulatory matter, it "must supply a reasoned analysis" for doing so.[40] The Second Consultative Document contains several dramatic changes of course, none of which are adequately explained. For example, the FSB inexplicably decided to add asset managers as potential G-SIFI designees after giving persuasive reasons for not including managers in the First Consultative Document[41] and receiving comments that nearly unanimously agreed with that position. The fact that the FSB may prefer a "more inclusive approach" is not sufficient justification for that change.[42]

Reliance on speculation and assumptions. In the United States, "speculation is an inadequate replacement for" an agency's "duty to undertake an examination of the relevant data and reasoned analysis."[43] The Second Consultative Document is filled with speculation unsupported by data or analysis. For example, the FSB asserts that "[i]n theory, several factors can contribute to or amplify forced asset sales" by an investment fund and then lists four possibilities.[44] But it cites no evidence that any of those possibilities have ever occurred, much less resulted in forced sales that threatened global financial stability. Nor does it cite any studies or independent analysis suggesting that those possibilities could realistically threaten global financial stability in the future.[45]

Failure to explain rejection of regulatory alternatives. In the United States, an agency must "cogently explain" why it did not pursue available alternatives to a proposed regulation.[46] Even though the FSB acknowledges 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," it offers no cogent explanation for why it disregards the many recommendations that it pursue alternatives to G-SIFI designation.[47] Instead, the FSB insists that its "focus is on

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[39] Second Consultative Document, *supra* note 2, at 30.
[40] *Motor Vehicle Mfrs.*, 463 U.S. at 56-56; *see also Ramaprakash* v. *FAA*, 346 F.3d 1121, 1124 (D.C. Cir. 2003) ("An agency's failure to come to grips with conflicting precedent constitutes 'an inexcusable departure from the essential requirement of reasoned decision making.'").
[41] First Consultative Document, *supra* note 4, at 30-31 ("The rationale for the proposed focus on funds.").
[42] Second Consultative Document, *supra* note 2, at 30.
[43] *Horsehead Res. Dev. Co., Inc.* v. *Browner*, 16 F.3d 1246, 1269 (D.C. Cir. 1994); *see also Indus. Union Dep't, AFL-CIO* v. *Am. Petrol. Inst.*, 448 U.S. 607, 634, 637 (1980) (agency cannot rely on unfounded assumptions).
[44] Second Consultative Document, *supra* note 2, at 33.
[45] The "contagion" studies that the FSB cites concern only funds operating in relatively illiquid markets (which would not be among the large funds captured by the proposed designation thresholds—as shown by Exhibit 1 (listing those funds)—address aggregate contributions of numerous funds to price movements (rather than impacts attributable to an individual fund)), and do not connect the supposed contagion effects to any actual harm to global financial stability. *See* Second Consultative Document, *supra* note 2, at 34.
[46] *Motor Vehicle Mfrs.*, 463 U.S. at 48; *see also Chamber of Commerce of U.S.* v. *SEC*, 412 F.3d 133, 144-45 (D.C. Cir. 2005).
[47] Second Consultative Document, *supra* note 2, at 31.

activities or risks that are best addressed through a designation-based approach."[48] But it never analyzes whether the activities and risks mentioned in the Second Consultative Document, many of which may be presented by entities other than funds and managers, actually are best identified or "best addressed through a designation-based approach" that focuses on funds and managers.

Failure to consider effects of regulation. U.S. law requires that an agency rigorously consider the likely consequences of a proposed regulation, including whether the regulation will have the desired effect.[49] The FSB does not begin to do this for its G-SIFI designation proposals regarding asset management entities. The FSB provides no analysis of the effects that G-SIFI designation would have on a fund, manager, investors and their discretion to invest, the asset management industry, financial markets, systemic risk, or global economic growth. The FSB does not even identify the "desired effects" of its actions, let alone explain how its actions would achieve those effects.

Failure to account for existing regulation. Before introducing a new regulation, U.S. agencies must analyze the existing regulatory regime and explain why the new regulation is needed,[50] and the FSOC is required by statute to consider existing regulations when evaluating non-banks for SIFI designation.[51] In passing, the Second Consultative Document acknowledges certain aspects of the extensive regulatory regime governing U.S. mutual funds and their managers, including strict leverage limits and fund-manager separation.[52] In fact, as the table attached as Exhibit 4 demonstrates, this comprehensive regulatory regime is meaningful and robust, including with respect to the products offered and services provided, highly effective and, when considered in the context of the asset management business, commensurate with the regulatory regime applied to G-SIBs with respect to their businesses.

The FSB provides no analysis to support its speculation that the protections afforded by existing fund and manager regulation might be insufficient to prevent the "destabilising impact" that the FSB says "could" arise despite that regulation.[53] Nor does the FSB even assert that G-SIFI designation would do anything to reduce the hypothetical possibility of a "destabilising impact."

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[48] *Id.*

[49] *Bus. Roundtable* v. *SEC*, 647 F.3d 1144, 1148 (D.C. Cir. 2011) (holding that, under the heightened standard of review, the agency must have "examine[d] the relevant data and articulate[d] a satisfactory explanation for its action including a rational connection between the facts found and the choices made" (quoting *Motor Vehicle Mfrs. Ass'n*, 463 U.S. at 43)); *Int'l Ladies' Garment Workers' Union* v. *Donovan*, 722 F.2d 795, 825, 826-27 (D.C. Cir. 1983) ("The Secretary's statements are unsupported by the record and, in effect, ask us to accept the Secretary's conclusory assurances. . . . [T]o cure the deficiencies in the Secretary's analysis we would be required to substitute our reasoning for the patently superficial explanation provided by the Secretary.").

[50] *Bus. Roundtable*, 647 F.3d at 1154-55 (Agency "failed to adequately address whether the regulatory requirements of [an existing law] reduce the need for, and hence the benefit to be had from, [new regulatory action]."); *Am. Equity Inv. Ins. Co.* v. *SEC*, 613 F.3d 166, 178-79 (D.C. Cir. 2010) (rejecting new regulation because agency "fail[ed] to determine whether on the existing regime sufficient protections existed").

[51] 12 U.S.C. § 5323(a)(2)(H) (2012) (One mandatory designation consideration is "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies.").

[52] Second Consultative Document, *supra* note 2, at 31, 32, 47.

[53] *Id.* at 31.

No opportunity for review. In the United States, parties aggrieved by agency action have a statutory right to judicial review of whether the agency engaged in reasoned decision-making and otherwise complied with applicable laws.[54] There is no similar opportunity for the targets of the FSB's G-SIFI methodologies to seek judicial or other review of the FSB's adoption or application of these methodologies. Without that opportunity, the FSB simply evades U.S. administrative law and any accountability to an affected fund or manager, their investors, U.S. authorities, the G20 or anyone else.

B. Defective process for applying the designation methodologies

The FSB's proposed process for designating investment funds and asset managers as G-SIFIs could not be adopted in the United States because it is completely inconsistent with U.S. law. It is contrary to the Dodd-Frank Act provisions and other U.S. laws and regulations that govern when and how a non-bank financial institution can be designated as a SIFI. The FSB's proposed process violates fundamental principles of due process and administrative procedure in the United States and no U.S. regulator could adopt the FSB's proposed process or use it to designate an entity as a SIFI. A U.S. regulator should not be able to import the same defective process (or its results) if it is adopted and applied abroad.

We, and many others, have long expressed serious concerns about the FSOC's U.S. SIFI designation process.[55] But as flawed as that process is, the FSB's proposed process is far worse. It does not afford potential G-SIFI designees any due process protection. Comparing the FSB's

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[54] 5 U.S.C. § 702 (2012) ("A person suffering legal wrong because of agency action, or adversely affected or aggrieved by agency action within the meaning of a relevant statute, is entitled to judicial review thereof.").

[55] *See, e.g.*, Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the U.S. Sec. & Exch. Comm'n (Nov. 1, 2013); Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council (Dec. 19, 2011); Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council (Nov. 5, 2010); Letter from Paul Schott Stevens, President & CEO, ICI to the Fin. Stability Oversight Council (Nov. 5, 2010); Letter from Paul Schott Stevens, President & CEO, ICI to the Fin. Stability Oversight Council (Feb. 25, 2011); Letter from Paul Schott Stevens, President & CEO, ICI to the Fin. Stability Oversight Council (Dec. 19, 2011); Letter from Thomas P. Vartanian, Dechert to the Fin. Stability Oversight Council (Feb. 24, 2011); Letter from Thomas P. Vartanian, Dechert, to the Fin. Stability Oversight Council (Dec. 19, 2011); Letter from Timothy S. Bishop, Mayer Brown LLP to the U.S. Sec. & Exch. Comm'n (Oct. 31, 2013); Letter from Paul Schott Stevens, President & CEO, ICI to the U.S. Sec. & Exch. Comm'n (Nov. 1, 2013); U.S. Gov't Accountability Office, *Financial Stability Oversight Council: Further Actions Could Improve the Nonbank Designation Process* (2014); U.S. Gov't Accountability Office, *Financial Stability Oversight Council: Status of Efforts to Improve Transparency, Accountability, and Collaboration* (2014); U.S. Gov't Accountability Office, *Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions* (2012); Am. Council of Life Ins. et al., *Petition for FSOC Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies* (Aug. 19, 2014); Letter from Jon Tester and Mike Johanns, U.S. Senate to Fin. Stability Oversight Council (Apr. 25, 2013); Letter from Dennis A. Ross et al., House of Representatives to Fin. Stability Oversight Council (Apr. 9, 2014); Letter from Mark Kirk et al., U.S. Senate to Fin. Stability Oversight Council (Jan. 23, 2014); Gallagher, *supra* note 24; Complaint, *MetLife, Inc.* v. *FSOC*, No. 15-cv-45 (D.D.C. Jan. 13, 2015), ECF No. 1; Michael S. Piwowar, Comm'r of the Sec. & Exch. Comm'n, Remarks before the Exchequer Club of Washington, D.C. (Mar. 20, 2015), *available at* http://www.sec.gov/news/speech/remarks-before-exchequer-club-washington-dc.html.

proposed NBNI G-SIFI process to the flawed FSOC non-bank SIFI process shows just how indefensible the FSB's proposal is.

Decision-making authorities unidentified and process undisclosed. For the U.S. SIFI process, the Dodd-Frank Act makes clear who participates in designation determinations (the 10 voting and five nonvoting members of the FSOC) and how those determinations are made (by a two-thirds majority of the voting members that must include the Secretary of the Treasury).[56] The Second Consultative Document, by contrast, describes the members of the International Oversight Group—which would select the Stage 0 list and oversee the designation process—in only the most general way.[57] It gives no indication of who the International Oversight Group members would actually be, how many there would be, how they would be selected, or whether their identities would be made public. The Second Consultative Document also never reveals the identity of the "primary national authority" for U.S. investment funds and asset managers that would develop the Stage 1 list of potential G-SIFIs; nor does it say anything about who from the "home jurisdiction" would select that national authority or to whom that national authority is accountable.[58] The public is left in the dark regarding how exactly the International Oversight Group and the primary national authority "together will determine the final list of G-SIFIs."[59] Would there be a vote? By whom? What level of agreement would be required? How would U.S. policy be determined and implemented? The Second Consultative Document is silent.[60]

No notice to targeted entities. Regulations provide that an entity under consideration in the U.S. SIFI designation process will receive notice within 30 days after the decision is made to commence active review in Stage 2 of the FSOC's three-stage designation process.[61] It will also receive notice if the FSOC moves it to Stage 3 and if the FSOC makes a preliminary designation decision.[62] The G-SIFI process proposed in the Second Consultative Document does not require notice at any stage: not when an entity is placed on a Stage 0 list, not when it is placed on a Stage 1 list, and not even when it is subject to a preliminary designation determination.[63] Even

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[56] 12 U.S.C. §§ 5321(b), 5323(a) (2012).
[57] Second Consultative Document, *supra* note 2, at 12-13.
[58] *Id.* at 13.
[59] *Id.* at 15.
[60] These issues and open questions have already manifested as problems with respect to insurance regulation in the United States that the FSOC voting member with insurance expertise has highlighted for Congress. Testimony of S. Roy Woodall, Jr., U.S. Senate Committee on Banking, Housing & Urban Affairs (Apr. 28, 2015). Mr. Woodall, who is the only voting member of the FSOC with insurance expertise, testified that international organizations like the FSB "may be attempting to exert what [he] consider[s] to be inappropriate influence on the development of U.S. regulatory policy." *Id.* at 3. He explained that the FSB has directed the International Association of Insurance Supervisors (IAIS) to develop international standards that the FSB intends to apply to insurers, including U.S. insurers, that it has designated G-SIIs and recommended caution regarding "on-going initiatives by international bodies that could be used to influence policy decisions that Congress has . . . expressly delegated" to others. *Id.* at 6. *See also* Gallagher, *supra* note 24.
[61] FSOC Supplemental Procedures, *supra* note 28, at 2. Notice is also a requirement of due process and the Administrative Procedure Act. *See Memphis Light, Gas & Water Div.* v. *Craft*, 436 U.S. 1, 13-16 (1978) (due process); *Indep. U. S. Tanker Owners Comm.* v. *Lewis*, 690 F.2d 908, 922-23 (D.C. Cir. 1982) (inferred APA requirement even in informal adjudications).
[62] FSOC Supplemental Procedures, *supra* note 28, at 2-3; 12 U.S.C. § 5323(e)(1) (2012).
[63] Second Consultative Document, *supra* note 2, at 12-15.

the proposed materiality thresholds would not tell an entity whether it is under consideration, because the FSB proposes unspecified buffers that could add entities and also apparently intends to exercise discretion to insert or exclude entities for other reasons.[64]

No opportunity to be heard. The U.S. SIFI process affords entities under consideration opportunities to be heard, submit evidence, meet with FSOC staff and decision makers, and respond to FSOC concerns.[65] The proposed G-SIFI process requires none of the FSB, the International Oversight Group or the primary national authority to provide a potential designee with any opportunity to be heard.[66] It merely permits national authorities, at their option, to consult with financial entities "through industry-wide consultations" or "directly."[67]

No explanation of designation decision. The Dodd-Frank Act, as well as due process and the APA, requires the FSOC to provide any non-bank financial institution designated as a SIFI with notice of the "final determination," "which shall contain a statement of the basis for the decision of the FSOC."[68] Under the FSB's proposed designation process, an entity being designated as a G-SIFI simply appears on an alphabetical list.[69] Neither the FSB nor anyone else is required to provide an explanation—written or otherwise—for why the entity merited designation and others did not. There is no indication that there would be any official statements accompanying the list to provide clarity. Nor is there any indication that a designated entity could get off the list or how an entity would go about doing this.

No opportunity for review. A non-bank financial institution designated as a SIFI under the Dodd-Frank Act has a right to challenge the FSOC's designation determination in court.[70] Under the FSB's proposed process, an NBNI designated as a G-SIFI has no opportunity to obtain review—in court or otherwise—of the designation decision.[71] As a result, there is no mechanism for correcting errors in the G-SIFI designation decision, due to, for example, failure to understand the true risk profile of a designated entity or simple, but significant, data mistakes.[72]

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[64] *See id.* at 13, 36 n.57.
[65] FSOC Supplemental Procedures, *supra* note 28, at 2-3; 12 U.S.C. § 5323(e)(2) (2012). An opportunity to be heard is also a requirement of due process and the Administrative Procedure Act. *See Memphis Light*, 436 U.S. at 16-19 (due process); *Indep. U. S. Tanker Owners*, 690 F.2d at 922-23 (inferred APA requirement even in informal adjudications).
[66] Second Consultative Document, *supra* note 2, at 12-15.
[67] *Id.* at 14.
[68] 12 U.S.C. § 5323(e)(3) (2012). An explanation of agency action is also a requirement of due process and the Administrative Procedure Act. *See Brock* v. *Roadway Exp., Inc.*, 481 U.S. 252, 264-65 (1987) (due process); *Indep. U. S. Tanker Owners*, 690 F.2d at 922-23 (inferred APA requirement even in informal adjudications).
[69] Second Consultative Document, *supra* note 2, at 15.
[70] 12 U.S.C. § 5323(h) (2012). Judicial review is also a requirement of due process and the Administrative Procedure Act. *See* 5 U.S.C. § 702 (2012); *Bartlett* v. *Bowen,* 816 F.2d 695, 699-700 (D.C. Cir. 1987).
[71] Second Consultative Document, *supra* note 2, at 15.
[72] The need for such error correction is evident in the 79-page complaint that MetLife has filed challenging the FSOC's SIFI designation. Complaint, *MetLife, Inc.* v. *FSOC*, No. 15-cv-45 (D.D.C. Jan. 13, 2015), ECF No. 1. That complaint is filled with compelling allegations of errors infecting the FSOC's designation determination, which followed on the heels of the FSB's unreviewable G-SIFI designation of MetLife.

Data errors are probable given the unavailability and inconsistency of data that the FSB laments throughout the Second Consultative Document.[73]

III. The FSB's Proposals for G-SIFI Designation of Asset Management Entities Are Irredeemably Flawed and Should Be Abandoned.

In addition to their procedural defects, the FSB's proposals for designating investment funds and asset managers as G-SIFIs are irredeemably flawed from a substantive perspective because they ignore the structure, economics and existing regulation of the asset management industry. There is no "right way" to designate a fund or manager as a G-SIFI and the FSB should accordingly abandon its designation methodologies for investment funds and asset managers. Based on the fundamental traits of mutual funds and their managers, SIFI designation would be unjustified and ineffective in reducing risk. In this section, we use mutual funds and their managers as examples to illustrate the fundamental conceptual flaws in the asset management proposals. In Section IV, we discuss some of the ways in which the proposed framework and methodologies do not apply to mutual funds and their managers specifically.

"SIFI risk" is the risk that a single company presents to the financial system when it is considered "too big to fail" ("TBTF").[74] The FSB recognizes that SIFI designation is a regulatory tool designed to reduce the probability of a company's *failure* and the potential for its failure to cause significant dislocation in the global financial system and adverse economic consequences across multiple countries.[75] SIFI designation serves no purpose unless (1) a company can fail and (2) its failure would disrupt global financial and economic activity so severely that policymakers and regulators are unwilling to allow it to fail through normal processes. This test does not vary by industry. A company is either TBTF, or it is not.

Neither mutual funds nor their managers meet the TBTF test. In general, mutual funds cannot "fail" like banks can because they have no material leverage or fixed obligations. Asset managers similarly are not at risk of sudden insolvency because they run a fee-for-service business that requires no leverage or principal risk-taking that could result in rapid financial

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[73] *See, e.g.*, Second Consultative Document, *supra* note 2, at 1 ("limitations in data availability"); *id.* at 4 ("limitations in obtaining appropriate data/information for assessing systemic risks of NBNI financial entities in a global context"); *id.* at 6 ("One of the key challenges in assessing the global systemic importance of NBNI financial entities is the difficulty in obtaining appropriate and consistent data/information."); *see also* Goebel (Nov. 1, 2013), *supra* note 55, at 19-20 (illustrating how the Office of Financial Research overstated Fidelity's AUM by approximately $200 billion).

[74] The stated objective of the FSB SIFI Framework is to "address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as TBTF," i.e., too big to fail. Fin. Stability Bd., *Progress and Next Steps Toward Ending "Too-Big-To-Fail" (TBTF): Report of the Financial Stability Board to the G-20*, 7 (Sept. 2, 2013) (hereinafter, "FSB TBTF Report"), *available at* https://www.financialstabilityboard.org/publications/r_130902.pdf.

[75] Fin. Stability Bd., *Reducing the Moral Hazard Posed by Systemically Important Financial Institutions*, 1 (2010) (hereinafter, "FSB SIFI Report"), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_101111a.pdf; FSB TBTF Report, *supra* note 74, at 2, 7-10.

distress.[76] A multitude of structural, economic and regulatory factors also make it impossible for the "failure" of any fund or manager to damage the global financial system or economy, including: the existence of many easy substitutes for any mutual fund or asset manager,[77] the ability of investors to manage their own assets,[78] the fact that each fund and each manager has its own distinct assets and liabilities,[79] and the requirement that mutual funds use independent custodians, which are heavily regulated. Asset management entities can always close or exit the business without presenting a threat to financial stability.[80] This is frequently not true for banks.

Despite these irrefutable facts, which comment letters submitted to the FSB, IOSCO and the FSOC have described in great detail,[81] the FSB resorts to unfounded assumptions and speculation to support its proposal. The FSB uses the words "may," "might," "could," "potential" and "potentially" an astounding 402 times in the Second Consultative Document, which is only 57 pages long. The FSB attempts to support its proposal by imagining a series of hypothetical circumstances in which an investment fund or asset manager could somehow create heavy losses for counterparties or experience disorderly asset liquidation.[82] The FSB provides no sound theoretical or factual basis to believe that there is any realistic possibility that those circumstances, which have never arisen for a mutual fund or its manager in the past, would ever occur in the future, let alone in a way that would actually threaten global financial stability. Nor

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[76] Andrew G. Haldane, Exec. Dir. of Fin. Stability, Bank of Eng., Speech: The Age of Asset Management?, 4, 9 (Apr. 4, 2014), *available at* http://www.bis.org/review/r140507d.pdf ("Asset managers are, to a large extent, insolvency-remote" and "asset managers are essentially unlevered.").

[77] Both the First Consultative Document and the Second Consultative Document acknowledge the easy substitution of funds and managers. First Consultative Document, *supra* note 4, at 30 ("[T]he investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable)."); Second Consultative Document, *supra* note 2, at 35, 49 (same for funds and managers).

[78] McKinsey & Company recently estimated that more than 75 percent of financial assets are either unmanaged or managed internally by asset owners. *See* McKinsey & Company, *Strong Performance but Health Still Fragile: Global Asset Management in 2013: Will the Goose Keep Laying Golden Eggs?*, 8, Exhibit 2 (July 2013), *available at* http://www.btinvest.com.sg/system/assets/17804/2013%20asset%20management%20brochure%20final.pdf (showing that the asset management industry managed a market share of 23.9 percent of total global financial assets in 2012).

[79] In the First Consultative Document, the FSB acknowledged that in most jurisdictions a fund is "a separate legal entity from its manager" and from other funds with separate and distinct assets. First Consultative Document, *supra* note 4, at 30. Accordingly, "[a]ny interconnectedness does not emanate from the manager's balance sheet." *Id.* at 30, n.36.

[80] Both the FSOC and the FSB have acknowledged that funds and managers close regularly with no systemic impact. *See, e.g.*, First Consultative Document, *supra* note 4, at 30 ("[F]unds close (and are launched) on a regular basis with negligible or no market impact."); *see also* FSOC Notice, 79 Fed. Reg. at 77494 ("The Council recognizes that asset management firms and investment vehicles have closed without presenting a threat to financial stability. The Council notes that an investment vehicle has a separate legal structure from the asset manager, any parent company, or any affiliated investment vehicles under the same manager. In addition, the assets of the investment vehicle are not legally available to the asset manager, its parent company, or affiliates for the purpose of satisfying their financial obligations or those of affiliated investment vehicles.").

[81] *See*, for example, the comment letters in response to the First Consultative Document available at http://www.financialstabilityboard.org/2014/04/r_140423/.

[82] Second Consultative Document, *supra* note 2, at 31-34, 48-49.

could it provide such support. All of the evidence shows that the risks imagined by the FSB are unrealistic.[83]

As leading academics have observed, to identify and regulate systemic risk, regulators must be able to define and measure it, not merely speculate about it.[84] For the FSB to have any confidence that it is pursuing a course of action that will reduce systemic risk without doing more harm than good, it must conduct robust empirical analysis to establish that a hypothetical threat is *plausible* and that proposed regulation would address the threat without excessive collateral damage. The FSB should not speculate, ignore contrary evidence, or demand that the industry prove that there is no conceivable circumstance in which an implausible hypothetical threat could ever arise. Such an approach cannot justify regulatory action. Federal Reserve Board Governor Jerome Powell recently described the prerequisites for regulatory intervention in capital markets and advocated restraint:

> [T]he 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.[85]

G-SIFI designation of mutual funds or managers cannot meet that standard. Designating a large fund or manager would not reduce any systemic risk but it is likely to distort the capital markets and harm the designated fund or manager and affected investors. Although the Second Consultative Document is silent about the regulation that would accompany G-SIFI designation, we know what SIFI designation means in the United States—bank-style prudential regulation that is incompatible with the asset management industry.[86]

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[83] Fidelity-FSB Letter, *supra* note 7, at 7-13; Fidelity-FSOC Letter, *supra* note 7, at 4-36. Matthew Richardson, Prof. of Applied Econ., NYU Stern Sch. Of Bus., *Asset Management and Systemic Risk: A Framework for Analysis*, 16-34 (Mar. 19, 2015) (on file with the Fin. Stability Oversight Council, Docket No. FSOC-2014-0001).

[84] *See, e.g.*, Lars Peter Hansen, *Challenges in Identifying and Measuring Systemic Risk*, 2 (Feb. 14, 2013), *available at* http://www.larspeterhansen.org/documents/FC_2012_Risk_BookSRMM_Challenges_in_Identifying.pdf; Richardson, *supra* note 83, at 5.

[85] Jerome H. Powell, Member, Bd. of Governors of the Fed. Res. Sys., Speech at the Stern School of Business, New York University (Feb. 18, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/powell20150218a.htm.

[86] Section 165 of the Dodd-Frank Act requires the Federal Reserve to apply "prudential standards" to non-bank SIFIs and large bank holding companies that are based on the Federal Reserve's bank holding company regulations and are "more stringent" than those that apply to smaller bank holding companies and non-banks. The Dodd-Frank Act, § 165. Piwowar, *supra* note 55 ("[B]anking regulators should not be permitted to expand their reach into capital markets, through 'prudential market regulation' or any other means. It is wholly inappropriate for them to impose their regulatory judgment in place of investment decisions made by informed investors, business decisions made by boards and officers, and regulatory policy decisions made by capital markets regulators. . . . Introducing 'prudential market regulation' also could force, for example, asset managers to face the impossible task of balancing their fiduciary duties to their clients and investors with regulatory obligations to do what is best for the financial system as a whole.").

Bank-style prudential regulation would subject a designated entity to added costs, operational restrictions, uncertainty and other regulatory burdens that most or all of its competitors would not face. The FSB recognizes that mutual funds and their managers face stiff competition for investors[87] and fund investors are highly sensitive to fees and performance.[88] As a result, SIFI designation is likely to prompt fund investors to move their assets out of a designated fund to avoid the disadvantages that would come with SIFI designation.[89] The easy substitutability of funds and asset managers would allow investors to move their assets quickly and easily. SIFI designation would cause assets to move to entities which are potentially less regulated and less transparent.[90]

Regulation can provide real benefits, but, if promulgated arbitrarily, it can fail to achieve its objectives and, if adopted without due regard to unintended consequences, it can do significant damage. Unlike the mistakes of private actors that are quickly corrected by market forces, poorly designed regulations are difficult to fix and much more likely to create systemic risk.[91]

A. Ignoring the risk of failure is a fundamental error that would result in evaluation of entities that could not present SIFI risk.

The FSB contends that its methodologies arose out of "its framework for reducing the systemic and moral hazard risks posed by SIFIs."[92] That framework is intended to address "[t]he 'too-big-to-fail' (TBTF) problem," which "arises when the ***threatened failure*** of a SIFI leaves public authorities with no option but to bail it out using public funds to avoid financial instability and economic damage."[93] The framework then proposes recommendations with a goal of *reducing the threat* of disorderly failure, such as adoption of effective resolution plans, increased loss absorption capacity to "increase the resilience of the institution as a going concern," and coordinated supervision "to reduce the probability" of their failure.[94] Failure and reducing the

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[87] First Consultative Document, *supra* note 4, at 30; Second Consultative Document, *supra* note 2, at 35, 49.
[88] *See* R. GLENN HUBBARD ET AL., THE MUTUAL FUND INDUSTRY: COMPETITION AND INVESTOR WELFARE (2010); George D. Cashman et al., *Investors Do Respond to Poor Mutual Fund Performance: Evidence from Inflows and Outflows*, 47 FIN. REV. 719 (2012).
[89] HUBBARD, *supra* note 88, at 41-43; Fidelity-FSB Letter, *supra* note 7, at 3-4; Richardson, *supra* note 83, at 41-43.
[90] Fidelity-FSB Letter, *supra* note 7, at 3-4; Richardson, *supra* note 83, at 41-42; *see also* Douglas Holtz-Eakin & Satya Thallam, *The Investor Cost of Designating Investment Funds as Systemically Important Financial Institutions*, AMERICAN ACTION FORUM (May 15, 2014), *available at* http://americanactionforum.org/uploads/files/research/The_Investor_Cost_of_Designating_Investment_Funds_as_Systemically_Important_Financial_Institutions.pdf (projecting that applying bank-style capital requirements to mutual funds could trim as much as 25% from a mutual-fund investor's returns over a lifetime of investing); Bill McNabb, CEO of Vanguard Group, *The Tax Threat to Your Mutual Fund*, WALL ST. J. (May 6, 2015), *available at* http://www.wsj.com/articles/the-tax-threat-to-your-mutual-fund-1430951829.
[91] *See, e.g.*, James Freeman, *Government Warns of Systemic Risks It Created*, WALL ST. J. (May 21, 2015) http://www.wsj.com/articles/government-warns-of-systemic-risks-it-created-1432214171.
[92] Second Consultative Document, *supra* note 2, at 1. We note that moral hazard risk in this context arises primarily if not exclusively from explicit or implicit government support. Banking firms receive such support. Mutual funds and their managers neither receive it nor need it.
[93] FSB TBTF Report, *supra* note 74, at 2.
[94] FSB SIFI Report, *supra* note 75, at 1-3.

risk of failure are at the very heart of the framework that motivated the proposed G-SIFI methodologies. Absent a realistic threat that an entity *could* fail—which threat could then be reduced through the framework tools—the framework itself is inapplicable.

The FSB expressly acknowledges the critical role that historical failures should play in the designation of entities as G-SIFIs. The Second Consultative Document emphasizes that the financial entity types included for consideration (including funds and their managers) were chosen in part due to "historical examples of financial distress or failures in these four sectors that had an impact (or potential impact) on the global financial system."[95] Yet the FSB has not and cannot identify any instance in which a traditional variable NAV mutual fund has ever suffered financial distress or failure having an impact on the global financial system. As explained in the comments to the First Consultative Document, there has never been an instance, during any time period including the recent financial crisis, in which one of the largest mutual funds—the funds that the FSB now proposes to consider designating—suffered a disruptive failure, much less one that affected the global financial system.[96]

In fact, both the FSB and the FSOC have acknowledged that the evidence shows that mutual funds and their managers regularly liquidate, merge or leave the business with no impact whatsoever on financial stability. In the First Consultative Document, the FSB recognized that "funds close (and are launched) on a regular basis with negligible or no market impact."[97] With respect to mutual funds in particular, the FSB went on to observe that according to relevant industry data for U.S. mutual funds, "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact" during the period from 2000 to 2012, which encompasses the bursting of the dot-com bubble and the 2008 financial crisis.[98] More recently, the FSOC recognized that "asset management firms and investment vehicles have closed without representing a threat to financial stability."[99]

Mutual funds cannot have a "disorderly failure" of the kind that the FSB framework is intended to prevent. Limits on leverage that mutual funds can employ effectively eliminate the possibility they will "fail" in any plausible scenario, let alone in a disorderly fashion that threatens global financial stability. History shows that they have not, even during the most

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[95] *Id.* at 8.
[96] *See* Fidelity-FSB Letter, *supra* note 7, at 7-10 (explaining that funds do not and have not failed); Letter from Avi Nachmany, Director of Research, Strategic Insight to the Fin. Stability Oversight Council, 3-4 (Mar. 23, 2015) (explaining that large stock and bond funds are more stable due to the heterogeneous nature of mutual fund investors: "[I]t is our view that large mutual funds and fund management companies . . . are actually more stable than are smaller investment pools with more concentrated investor bases, due to such large entities' diversified ownership by millions of individual investors and their wide and varied marketplace presence."); Richardson, *supra* note 83, at 32 ("There is nothing to suggest that large funds are more susceptible to redemption risk than smaller funds or more prone to run-like behavior on the part of investors. In fact, because we are comparing two groups of mutual funds with roughly the same total AUM, this result implies that fire sales are not any more of an issue for large funds than the rest of the mutual fund sector. Not only is there no indication of run-like behavior, but there is no evidence of any difference between large funds and the rest of the mutual fund sector with respect to flows.").
[97] First Consultative Document, *supra* note 4, at 30.
[98] *Id.* at 30, n.38.
[99] FSOC Notice, 79 Fed. Reg. at 77494.

severe financial crises. It is a pointless exercise to try to identify funds as G-SIFIs on the theory that they can fail, or under a construct that assumes they have already failed. Rather than try to counter this simple and critical fact, however, the Second Consultative Document simply ignores it.

The proposed methodologies expressly eschew consideration of "the *probability* that a failure could occur" at an entity being evaluated for G-SIFI designation.[100] This approach amounts to deciding to ignore the single most important factor that the framework is intended to address: the risk of failure.[101] If failure will not happen under any realistic scenario, then the hypothesized systemic impacts simply will never arise. A regulatory methodology that neglects to account for the probability of failure will doom regulators to evaluating, and potentially regulating, entities that could not present SIFI risk, while diverting attention and resources from more productive endeavors.

B. In a vain attempt to justify designation, the FSB simply assumes that a fund or manager has failed, and resorts to unsupported hypotheses about what might or could happen in that event.

Ignoring the probability that an entity could fail, the FSB claims that its designation methodologies provide "a comprehensive analysis of the *impact* of failure or distress that particular entities in the asset management industry could transmit to the global financial system."[102] In fact, the FSB identifies ***no*** data, study or analysis (much less a "comprehensive analysis") to support its assertion that the mythical "failure" of any large mutual fund or asset manager ever could impact the global financial system.

Given the central role that the FSB has assigned to assessing the impact of failure or distress, one might have expected the FSB to provide data or analysis to support its view that the "failure" of a single mutual fund or manager could impact the global financial system. The Second Consultative Document neither offers evidence to support the proposed methodologies nor contains a rebuttal of the substantial evidence published by academics, industry experts and others demonstrating the invalidity of the hypotheses the FSB and other regulators have offered recently in vain attempts to justify their interest in mutual funds and their managers.[103] Instead,

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[100] Second Consultative Document, *supra* note 2, at 10.

[101] Although it might be reasonable to ignore the probability of failure in the banking context because that risk is inherent in the banking business model, it is absurd to do so in the asset management context. Investment funds are financed primarily with equity, not debt like banks are. Their managers provide services for a fee; they are not in the business of taking principal risks with their balance sheets like banks are. These, and many other, fundamental differences among funds and managers on the one hand and other entities that the FSB has designated G-SIFIs, such as banks, on the other, render the FSB's construct of ignoring the probability of failure invalid.

[102] Second Consultative Document, *supra* note 2, at 8, 10 (emphasis added).

[103] For example, the FSB and others have speculated that investors could "run" on a long-term mutual fund and threaten financial stability; but this is a banking concept that is inapplicable to mutual funds and unsupported by any example. In producing their recent Blue Paper, Oliver Wyman and Morgan Stanley "analysed the periods of worst mutual fund redemptions in the last 35 years from market shocks" and reported that **"[c]ontrary to some perceptions, we cannot find an example of a run on a long-term mutual fund - as opposed to short-term money market funds."** Morgan Stanley & Oliver Wyman, *Wholesale & Investment Banking Outlook Liquidity*

the FSB merely offers unsupported conjecture about what "could," "might" or "may" happen, rather than defining and measuring systemic risk as one must do in order to regulate it:

- The FSB postulates that "[i]f an entity has to liquidate its assets quickly, this ***may*** impact asset prices."[104] But the FSB provides no examples of when this has ever happened to a variable NAV fund, it sets forth no quantity of assets the sales of which might trigger such price impact, it suggests no realistic circumstance in which a mutual fund might be forced to liquidate such a volume of assets, and it offers no basis for analyzing sales by mutual funds differently from sales by other owners of the same assets.

- The FSB concedes that public funds have regulatory limitations on their ability to use leverage, but then supposes that "it is still ***possible*** for an investment fund to become highly leveraged through derivatives that are not centrally cleared."[105] The FSB provides no example of any regulated investment fund that has ever used derivatives in this fashion, fails to analyze the effectiveness of regulations that constrain the use of such derivatives in the United States (the primary, and perhaps only, jurisdiction in which funds would be considered for designation), fails to define "highly leveraged" or what level of derivative use is expected to cause systemic impact, and fails to consider the collateral coverage being employed in those derivative transactions to manage those risks.

- The FSB recognizes that there is a generally high level of substitutability for investment funds, but then contends that "it is ***possible*** that a fund ***could*** attract significant investment and present features that are, in combination, fairly unique and ***may potentially*** have very few immediate substitutes." The FSB cannot

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Conundrum: Shifting Risks, What It Means (Mar. 19, 2015) (emphasis added), *available at* http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/2015_Wholesale_Investment_Banking_Outlook.pdf. Regarding the "herding" hypothesis, Strategic Insight reported that "the mutual fund industry has never experienced the harmonized and sizeable redemption behavior associated with the 'Herding' theory and its implied systemic risk" and provided data to support its conclusion. Nachmany, *supra* note 96, at 4. The FSB and IOSCO have previously suggested that mutual funds might be a part of a "shadow banking" system that could become a source of systemic risk. Professor Richardson notes, however, that variable NAV mutual funds cannot be considered part of the "shadow banking" system because they do not share the "rollover risk" and other risks typical of banks. *See* Richardson, *supra* note 83, at 34-38.

[104] Second Consultative Document, *supra* note 2, at 4 (emphasis added). The Second Consultative Document is riddled with instances in which the FSB repeats its imagined concern about market impacts caused by wholesale liquidations of funds. *See id.* at 31 ("forced liquidation of an investment fund . . . ***could*** have a destabilizing impact"); *id.* at 32 (exposure channel involved impact liquidation of an investment fund ***could*** have on other market participants); *id.* at 33 ("With respect to open-end funds, investors ***could*** have an incentive to redeem before other investors"); *id.* at 33 (large funds' abrupt sales ***could*** cause distortions); *id.* at 34 ("In sum, an individual investment fund ***could*** have the capacity under certain circumstances to exert downward pressure on the market prices of assets"). Despite the frequent recitation of what ***could*** or ***might*** happen, the FSB offers no data or analysis that supports its hypotheses or answers rebuttals of those hypotheses. *See, e.g.*, Fidelity-FSOC Letter, *supra* note 7, at 5-12; Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to the Fin. Stability Oversight Council, 10-49 (Mar. 25, 2015), *available at* http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf.

[105] Second Consultative Document, *supra* note 2, at 33.

> identify any such existing funds, nor can it explain how such a fund could be large enough to threaten global financial stability and merit designation but not attract imitators and competitors in the market.

The few studies that the FSB does reference are narrow in focus and weigh against the FSB's simplistic assumptions about investors, funds and managers and against an attempt to regulate them through SIFI designation. For example, the Gelos 2011 survey reviews literature on the "behavior of international mutual funds at the micro level" with a particular "focus on the empirical evidence for emerging markets."[106] International mutual funds are a small subset of the universe of mutual funds and emerging markets are a small subset of international capital markets and economies. Neither the literature that Gelos reviews nor the survey itself provides a basis for applying the limited findings to all funds or managers or for designating a large fund or manager a G-SIFI. In fact, Gelos finds that "a look from an aggregate perspective already reveals that any simplistic characterization of the behavior of [mutual] funds is likely to be misleading; while there is volatility both at the level of the flows in [and] out of these as well as in the funds' movements in and out of countries, emerging market funds do not move in tandem as a single herd."[107] Gelos also notes that "[u]nderstanding the behavior of international investors is key for informing" a consideration of the international financial architecture and that "[v]olatility of capital flows is to some extent driven by investors investing in emerging market funds rather than behavior at the level of the fund manager."[108] The Raddatz and Schmukler study similarly finds that flows in international equity and bond funds are driven by a combination of investor and manager behavior.

The FSB does not supplement the few studies that it cites with data or analysis of its own. In fact, the FSB repeatedly notes the "limitations in data availability," and "the difficulty in obtaining appropriate and consistent data/information."[109] The FSB acknowledges that in response to the First Consultative Document "many respondents asked for a more thorough analysis of the systemic risks associated with asset management entities."[110] Rather than initiate a process to collect appropriate and consistent data to enable a more thorough analysis of whether asset management entities pose systemic risk, the FSB simply presumes they do.[111] It

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[106] Gaston Gelos, *International Mutual Funds, Capital Flow Volatility, and Contagion—A Survey*, IMF WORKING PAPER (2011), *available at* http://www.imf.org/external/pubs/ft/wp/2011/wp1192.pdf.
[107] *Id.* at 9; *see also id.* at 8 ("Mutual funds themselves move actively in and out of countries during turbulent times, but there is substantial heterogeneity across funds, with large outflows coinciding with large inflows.").
[108] *Id.* at 18.
[109] *Id.* at 1, 6, 12.
[110] *Id.* at 1.
[111] We note that a significant amount of data is already reported to regulators. For example, U.S. investment funds and their managers report vast amounts of data to U.S. regulators. Fidelity and/or the funds it manages file information such as financial statements, comprehensive holdings (including derivatives exposure) and custody information with the SEC on forms such as 13D, 17h, ADV, NCSR, N-MFP, NQ, N-SAR and PF. One can get a sense of the scope and scale of the data already available by considering the amount of information reported on just one of these forms. In a 2013 report, SEC staff reported that over 2,300 advisers covering over 18,000 private funds had filed Form PF, pertaining to nearly $7.3 trillion in private fund assets. *See* U.S. Sec. & Exch. Comm'n, *Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports* (July 25, 2013), *available at* http://www.sec.gov/news/studies/2013/im-annualreport-072513.pdf.

then proposes a designation process that relies not on relevant and consistent data, but on whatever data is "currently available through existing regulatory reporting frameworks and public disclosure."[112] The proposal acknowledges that even with respect to the measures identified by the FSB, "there are limitations that may render some of the indicators unworkable," and thus invites regulators to apply a greater level of "supervisory judgment," including the use of "any other aspects that might seem relevant for the purpose of this methodology."[113] Without relevant data, the FSB methodology ultimately devolves to a "know-it-when-you-see-it" designation protocol, which is precisely what we warned against in our first comment letter.[114] We encourage you to consider our discussion—and that of recent Nobel laureate in economics, Lars Peter Hansen[115]—of why such an approach is so problematic.

C. Using the "transmission of risk" and "transmission channels" as a benchmark for regulatory concern in the context of asset management is not helpful and is likely to be misleading.

Funds are collective investment vehicles that provide professionally managed exposure to investment risk. Their purpose is to transmit specific investment risk to investors. Investors determine their desired exposures and levels of risk tolerance in selecting funds. Neither the manager nor the fund makes that choice for the ultimate owner of the asset—namely the investor.

Once the choice is made, asset managers provide a service to investors and play a valuable role in the capital markets. Asset managers manage funds so that they "transmit" the investment risk fund investors are seeking accurately and efficiently. Managers make tactical decisions to allocate capital to issuers and manage market risk.[116] Rather than asking whether funds or managers "transmit" risk, the real question should be whether the use of an asset manager or investment in a collective fund *creates or amplifies* risk with sufficient probability and magnitude that it would threaten the stability of the global financial system. Absent excessive leverage, there is no evidence that it does.

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[112] *Id.* at 37.
[113] *Id.* at 7, 37.
[114] Fidelity-FSB Letter, *supra* note 7, at 5-6.
[115] *See generally* Hansen, *supra* note 84.
[116] *See* Peter R. Fisher, Senior Lecturer & Senior Fellow, Center for Global Bus. & Gov't, Tuck Sch. Of Bus. at Dartmouth, Remarks at the Brookings Institution Asset Management, Financial Stability and Economic Growth Conference (Jan. 9, 2015), *available at* http://www.brookings.edu/events/2015/01/09-asset-management-financial-stability-economic-growth ("So I think the efficiency question for the economy is; do the assets end up in the hands of those who can take that slice of risk most efficiently? And the asset manager is the switching station in that. You have some clients who have very longer rated investment horizons, and others that have very short, and some that have very high volatility willing to take, and others very low, and you are trying to allocate among them.").

D. The FSB methodologies focus primarily on the size of funds and managers, despite evidence that size is not correlated to risk.

That the FSB's methodology is driven almost exclusively by size is reinforced repeatedly in the Second Consultative Document. The proposed "materiality" thresholds for investment funds are based on size (using a $100 billion net AUM or a $200 billion gross AUM), as are the thresholds for asset managers (considering balance sheet assets and total AUM—aggregating all funds and accounts).[117] The first systemic risk "indicator" also is the "size" of the entity.[118] The third indicator, substitutability, seeks to target "large funds that are considered dominant in particular asset classes or derivative products."[119] The fifth indicator, cross-jurisdictional activities, also implicitly targets larger funds and managers by simplistically counting the number of jurisdictions in which the fund or manager is present,[120] without considering the materiality of the activities of that fund or manager to a given jurisdiction, the materiality of its activities in that jurisdiction to the fund or manager, or the materiality of any of those metrics to the global financial system.[121] Although interconnectedness and complexity are also considered, the prime determinant of whether a fund or manager would be designated seems to be its size.

The FSB provides no evidence to support its faulty assumption that "the larger the size of the fund, the greater its potential impact on counterparties, markets and other market participants."[122] Had the FSB considered any data in devising its designation protocol, it would have recognized that for mutual funds and their managers, size is not indicative of systemic risk.[123] The largest funds did not create systemic risk or pose "too big to fail" concerns during the latest financial crisis. The largest funds and fund families did not fail during the 2008-2009 crisis, and did not have redemption levels that threatened the viability of the funds, let alone the stability of the financial system. All of the 20-largest variable NAV funds in 2004 were still in existence 10 years later without having received any government support or creating moral hazard risk like the largest banks did during the crisis.[124]

The International Monetary Fund ("IMF") did recently consider whether there is a correlation between fund size and systemic risk and reported that "the analysis shows that larger funds and funds managed by larger asset management companies do not necessarily contribute

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[117] Second Consultative Document, *supra* note 2, at 36, 50-51.
[118] *Id.* at 38, 52.
[119] *Id.* at 41, 53-54.
[120] *Id.* at 44-45, 55.
[121] The FSB's counting of jurisdictions ignores both the lack of correlation between the number of jurisdictions to which a fund is exposed and the probability or impact of its failure, as well as the benefits of such diversification. *See* Fidelity-FSB Letter, *supra* note 7, at 28.
[122] Second Consultative Document, *supra* note 2, at 38.
[123] Fidelity-FSB Letter, *supra* note 7, at 14-15; *see* Richardson, *supra* note 83, at 30-34. In fact, there is substantial evidence that the opposite is true, namely that large funds and managers present less risk. Richardson observes that "regulatory focus on size seems misplaced." Richardson, *supra* note 83, at 2; *see also* Nachmany, *supra* note 96, at 2 ("[L]arge mutual funds and fund management companies, through their extraordinary diversification of investors and marketplace presence, are actually more stable than are smaller investment pool[s] with more concentrated investor bases.").
[124] *See* Exhibit 5.

more to systemic risk."[125] The IMF also concluded that systemic risk "bears little relation to the size of a fund's asset management company."[126]

The deficiencies of a size-based threshold like $100 billion in AUM are further revealed when one considers that it would generate both false positives and false negatives. For example, this threshold would have missed the Reserve Primary Fund, which had only $62 billion in AUM when it "broke the buck." On the other hand, it would identify five large equity index funds with over $100 billion in AUM and little or no leverage. These index funds simply reflect the underlying market value of the stocks in which they are invested; because of their passive investment approach, their trades do not—and cannot—alter the information incorporated in market prices. As such, they do not warrant a detailed review—let alone designation—and yet the largest index funds would be identified by the proposed threshold.

There is no reason to believe that a fund with $100 billion in AUM would have more impact on markets or counterparties than would 10 funds each with $10 billion in AUM that follow the same strategy or own the same assets. The focus on size reflects the FSB's attempt to apply a G-SIFI approach that was designed for large banks. Clearly it does not fit mutual funds or their managers.

An activity- or product-based approach would. That is why we endorse such an approach. If the FSB demonstrates, for example, that the use of leverage or derivatives increases a fund's potential for creating systemic risk in ways that are not already regulated, then the FSB might work with national regulators to ensure that sound regulations are applied broadly in a coordinated manner to address the risk. Such an activities-based regulatory approach would cover both the fund with $100 billion in AUM and the 10 funds with $10 billion in AUM, and thus would be far more effective than designation.

To the extent that the FSB and its members have focused on the size of funds or managers in the hope of gaining more insight into or control over a substantial share of assets in the financial system, the designation-based approach would be ineffective. The approach is ineffective because even the largest mutual funds and their managers account for only a fraction of global financial assets. The FSB estimated the global financial system to account for $304.5 trillion of assets as of 2013.[127] The 13 funds that had more than $100 billion in AUM as of December 31, 2014 account for only $2.14 trillion in assets, or less than one percent of global

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[125] INT'L MONETARY FUND, GLOBAL FINANCIAL STABILITY REPORT, 93 (2015).
[126] *Id.* at 115.
[127] *See* Fin. Stability Bd., *Data Underlying the Exhibits in "Global Shadow Banking Monitoring Report 2014,"* 2, Exhibit 2-1 (Oct. 30, 2014) (hereinafter, "FSB Underlying Data"), *available at* http://www.financialstabilityboard.org/shadow_bkg_data/underlying_data_for_exhibits_pdf.pdf (estimating the total financial assets of financial intermediaries in 20 jurisdictions and the Euro Area in 2013 to be as follows (in trillions): banks – $139.2, insurance companies and pension funds – $54.8, public financial institutions – $12.4, monitoring universe of non-bank financial intermediation ("MUNFI") (based on other financial intermediaries ("OFIs") and including as a subsection 'other investment funds,' in particular fixed income funds, equity funds and other funds, as well as the other subcategories: money market funds, finance companies, structured finance vehicles, hedge funds, broker-dealers, and REITs (including REIT funds)) – $75.2 and central banks – $22.9 for a grand total of $304.5).

financial assets as of 2013.[128] Unlike the banks designated as G-SIBs, which account for over $45 trillion in assets (or 15 percent of global assets),[129] designation of the largest funds could not even marginally increase the insight into global assets that the FSB and its members have.[130] Furthermore, funds and their managers do not own or control the assets the way banks control their balance sheet assets. Investors have ultimate investment discretion over managed assets, so designation would not enable regulators to exert control over those assets by designating a fund or its manager.[131]

Further, the identities of the largest mutual funds and their managers change over time based on the investment decisions of individual fund investors and the prices of securities, which change daily. Flows are based on investor preferences at a given time and change in response to a variety of factors, sometimes rapidly as we have seen most recently in the case of PIMCO's Total Return Fund. As a result, funds that are above $100 billion today may be much smaller in the future, while funds that are smaller today could have more than $100 billion in less than a year. If this assessment were to take place annually, it would necessarily be lagging. For example, ICI reports that "of the largest 25 fund complexes in 2000, only 13 remained in this top group in 2013."[132] Similarly, 25 percent of the 20 largest mutual funds in 2004 are no longer among the 20 largest mutual funds 10 years later.[133] Different funds would consistently move above and below the proposed thresholds and indicators for G-SIFI designation as a result of normal market dynamics.

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[128] *See* Exhibit 1.
[129] *See* Exhibit 6.
[130] The FSB justifies inclusion of investment funds and asset managers in its designation approach based on its assessment that "(i) finance companies, (ii) market intermediaries (broker-dealers) and (iii) investment funds comprise 70-80% of the total financial assets of all NBNI financial entities (as proxied by Other Financial Intermediaries)." Second Consultative Document, *supra* note 2, at 8, n.13. But the FSB's analysis suffers from using both the wrong denominator and the wrong numerator. The denominator – Other Financial Intermediaries, defined in the FSB's Global Shadow Banking Monitoring Report 2014 as including "all non-bank financial intermediaries with the exception of insurance companies, pension funds and public financial institutions" – is wrong because it is not an appropriate measure of the financial system (whose stability is the focus of this exercise). *See* Fin. Stability Bd., *Global Shadow Banking Monitoring Report 2014*, 5-6 (Nov. 4, 2014) (hereinafter, "FSB Shadow Banking Report"), *available at* http://www.financialstabilityboard.org/2014/11/global-shadow-banking-monitoring-report-2014/. In fact, the FSB's own estimates suggest that Other Financial Intermediaries account for only 24.6 percent of the assets in the financial system. *See* FSB Underlying Data, *supra* note 127, at 3. Of that quarter of total financial assets, investment funds (including bond, equity and other funds) make up 38 percent, which means that they make up only 9.5 percent of the total global financial assets. *See* FSB Shadow Banking Report, *supra* note 130, at 14, Exhibit 4-1. Thus, at best, finance companies, market intermediaries and investment funds collectively account for only 25-30 percent of the financial system. The numerator is incorrect because the FSB methodology does not propose to regulate all of the entities within each category, but only the largest such entities, estimation of the assets held even by each category of entity is irrelevant because it does not reflect the assets that would actually be subject to regulation.
[131] *See* Barbara Novick et al., *Who Owns The Assets? A Closer Look at Bank Loans, High Yield Bonds and Emerging Markets Debt*, BLACKROCK VIEWPOINT (Sept. 2014), *available at* https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf.
[132] INVESTMENT COMPANY INSTITUTE, 2014 INVESTMENT COMPANY FACT BOOK, 27 (2014) (hereinafter, the "ICI FACTBOOK"), *available at* http://www.icifactbook.org/.
[133] *See* Exhibit 5.

E. The FSB methodologies would do more harm than good.

The FSB's proposed G-SIFI designation methodologies for funds and managers do not accomplish their most fundamental purpose: to identify entities that are TBTF and pose SIFI risk. By adopting the methodologies, the FSB threatens to impose additional costs on investors, distort market competition and reduce, rather than enhance, the liquidity and stability of the capital markets and economic growth.[134] Other recent efforts at financial market regulation that have been poorly conceived and based on bank-like prudential regulation demonstrate the ways in which the costs of the FSB's proposal could far outweigh any benefits.

The FSB has yet to identify "the systemic and moral hazard risks" that an individual mutual fund or manager could pose, or to propose the "incremental policy measures" it would apply through G-SIFI designation to address them.[135] The FSB has previously expressed an intent to require designated G-SIFIs to adopt "capital regimes" to increase their "loss absorption capacity," to "heighten[] supervisory expectations" and intensity, and to develop "more effective resolution mechanisms."[136] Leaving aside that such policy measures are unwarranted,[137] the imposition of such requirements would impose substantial costs on designated entities and investors who use mutual funds to save for retirement.[138] A 2014 study estimated the potential cost of a bank-style capital requirement to investors in the largest mutual funds. That study projected that if regulators imposed an eight percent capital requirement on the largest mutual funds, the resulting loss to investors who kept their assets invested in those funds over a 50-year period could be up to 25 percent of their total returns.[139]

Regulations can cause harm, and the recent history of international regulatory efforts does not bode well for investors in designated entities or the markets as a whole.[140] For example, regulators constructing Basel II set a zero risk-weighting for sovereign debt, which led banks to become over-exposed to such debt, and susceptible to a common shock when that debt proved more risky than expected.[141] Similarly, following the 2008 financial crisis, additional regulations

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[134] *See, e.g.*, Piwowar, *supra* note 55.
[135] Second Consultative Document, *supra* note 2, at 2.
[136] FSB TBTF Report, *supra* note 74, at 2.
[137] Because mutual funds consist primarily (at least 67 percent) or entirely of equity investments, and losses will be absorbed by fund investors, they already have capacity to absorb substantial losses, leading even the FSB to recognize their "shock absorber" role in the system. *See* First Consultative Document, *supra* note 4, at 29. The mutual funds that the methodology would evaluate are already subject to some of the most stringent regulation of any financial institution. Many mutual funds operate with no leverage. A fund with no leverage is financed with 100% equity capital. What would a "capital requirement" for such a fund look like? As recently discussed in detail in our comments to the FSOC, bank-style capital requirements, resolution plans and other "prudential" regulations simply make no sense with respect to mutual funds. *See* Fidelity-FSOC Letter, *supra* note 7, at 36.
[138] *See, e.g.*, McNabb, *supra* note 90; Stevens, *supra* note 104, at 6 (listing potential negative consequences of fund designation).
[139] *See* Holtz-Eakin, *supra* note 90.
[140] *See, e.g.*, Freeman, *supra* note 91.
[141] *See, e.g.*, Huw Jones, *Global Bank Watchdog to Review Rule on Zero-Risk Weighting for Sovereign Debt*, REUTERS (Jan. 23, 2015), *available at* http://www.reuters.com/article/2015/01/23/basel-sovereign-regulations-idUSL6N0V22ZO20150123; Josef Korte & Sascha Steffen, *A 'Sovereign Subsidy' – Zero Risk Weights and*

imposed on the European securitization market stifled the flow of credit to financial markets, a mistake that regulators are now trying to correct.[142]

The FSB's proposal to designate mutual funds and their managers as G-SIFIs would be added to this list. Reducing the attractiveness of mutual fund investments and restricting the ability of funds to invest in certain markets would increase systemic risk in the capital markets and inhibit economic growth. The FSB worries about the potential for large asset sales in "less-liquid asset classes."[143] Yet, mutual funds provide some retail investors the only meaningful route to access those assets, and thereby add liquidity to those markets. If designation or other regulation were to reduce the access or appeal of those mutual funds, the FSB would ironically raise the financing costs for issuers in those markets and reduce the liquidity of the very markets they are trying to protect. Designation would also be a destabilizing factor as a catalyst for asset sales as investors shift their assets to un-designated funds, or out of an asset class altogether. Mutual funds also provide the diversity of funding options that European regulators are actively trying to promote with their Capital Markets Union initiative.[144] The FSB's designation and regulation of entities that pose no systemic risk would *discourage* that capital markets funding just as other regulators and policymakers are trying to *encourage* it.[145]

Other experienced regulators have cautioned against such regulatory conduct, recognizing the risk of doing more harm than good. For example, Esther George, the President and CEO of the Federal Reserve Bank of Kansas City, has noted that the use of macroprudential policy as "the 'first line of defense' for maintaining financial stability . . . expects too much of tools for which our understanding is imperfect," and may "place a large burden on our regulatory

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Sovereign Risk Spillovers, VOX (Sept. 7, 2014), *available at* http://www.voxeu.org/article/sovereign-subsidy-zero-risk-weights-and-sovereign-risk-spillovers.

[142] *See, e.g.*, Mark Carney, Governor, Bank of Eng. & Chairman, Fin. Stability Bd., Remarks at the 29th Annual G30 International Banking Seminar: *Regulatory Work Underway and Lessons Learned* (Oct. 12, 2014), *available at* http://www.bis.org/review/r141015c.htm ("And we've learned about the unintended consequences of prudential capital and retention requirements on the securitisation market. Regulatory changes arguably treat asset-backed securities in ways that appear to be unduly conservative, particularly relative to other forms of long-term funding. Efforts to rebalance these incentives are now a priority.").

[143] *See* Second Consultative Document, *supra* note 2, at 33.

[144] Richardson, *supra* note 83, at 40-41; Fidelity-FSOC Companion Letter, *supra* note 7, at 6-7; Jonathan Hill, Member, European Comm'n, Speech at the Finance Watch Conference: *Finance at Your Service – Capital Markets Union as an Instrument of Sustainable Growth* (Feb. 4, 2015), *available at* http://europa.eu/rapid/press-release_SPEECH-15-4144_en.htm ("Well-functioning capital markets also help encourage greater diversity in funding, which reduces concentration of risk so they not only free up capital for growth but also support and strengthen financial stability."); Jon Cunliffe, Deputy Governor Fin. Stability, Bank of Eng., Speech at the City of London Corp. & Open Europe Conference in London: *Financial Stability, the Single Market and Capital Markets Union* (Jan. 20, 2015), *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech789.pdf.

[145] *See, e.g.*, Hill, *supra* note 144 ("We do not make the economy stronger by making our financial services weaker. We need to move from a position where the industry is seen as being part of the problem to one where it is seen as part of the solution." "[I]t's important to remember that 'capital markets' are not some abstract construct – they are someone's pension savings, someone's 'rainy day' money which is channelled to growth.").

infrastructure."[146] Mark Carney, Governor of the Bank of England, has also recognized that prudential capital and retention requirements can result in "unintended consequences" that negatively affect financial markets.[147] Ben Bernanke has emphasized that regulatory response should be cabined by the limited insight that regulators have in estimating market fundamentals.[148] Federal Reserve Governor Jerome Powell recently advocated restraint and questioned "whether supervisors will be able to correctly and in a timely manner identify 'dangerous' conditions in credit markets, without too many false positives and without unnecessarily limiting credit availability by interfering with market forces."[149] These experienced regulators recognize the harm that regulation can create for markets and the economy as a whole, and their warnings argue against adoption of ill-conceived regulation like a designation framework for mutual funds and their managers before identifying any risk that they pose to the financial system, or proving that designation would effectively address it.

IV. The Proposed G-SIFI Designation Framework and Methodologies for Asset Management Entities Do Not Apply to Mutual Funds or Asset Managers.

A. The proposed methodologies do not apply to mutual funds.

Mutual funds should be excluded from G-SIFI designation. We examine the many reasons why more fully in our comment letter to the First Consultative Document, and our responses to the FSOC Notice, which are attached to this letter as Appendices A, B and C. We discuss several illustrative examples below.

1. The FSB's transmission channels do not apply to mutual funds.

The three transmission channels for financial distress that the FSB identifies for investment funds demonstrate just how inapplicable the entire G-SIFI designation exercise is to mutual funds. The discussion of the "Exposures / Counterparty channel" all but concedes that mutual funds create no systemic risk by exposing other market participants to a fund's financial distress. The FSB describes only one source of such risk for investment funds: substantial leverage.[150] The FSB correctly recognizes, however, that mutual funds "currently have legal and regulatory limitations on their ability to use leverage (either balance-sheet leverage or synthetic

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[146] Esther L. George, President & CEO, Fed. Res. Bank of Kan. City, Speech at the Financial Stability Institute/Bank for International Settlements Asia Pacific High Level Meeting: *Monetary and Macroprudential Policy: Complements, Not Substitutes* (Feb. 10, 2015), *available at* http://www.kansascityfed.org/publicat/speeches/2015-George-Manila-BIS-02-10.pdf.

[147] *See, e.g.*, Mark Carney, *supra* note 142.

[148] Ben S. Bernanke, Member, Bd. of Governors of the Fed. Res. Sys., Remarks before the New York Chapter of the National Association for Business Economics: *Asset-Price "Bubbles" and Monetary Policy* (Oct. 15, 2002), *available at* http://www.federalreserve.gov/Boarddocs/Speeches/2002/20021015/default.htm ("[T]he Fed cannot reliably identify bubbles in asset prices. . . . [T]o declare that a bubble exists, the Fed must not only be able to accurately estimate the unobservable fundamentals underlying equity valuations, it must have confidence that it can do so better than the financial professionals whose collective information is reflected in asset-market prices. I do not think this expectation is realistic, even for the Federal Reserve.").

[149] *See* Powell, *supra* note 85.

[150] Second Consultative Document, *supra* note 2, at 32-33.

leverage)."[151] Indeed, U.S. mutual funds must have "asset coverage" that equals 300 percent of any borrowed money, which translates to a maximum asset-to-equity leverage ratio of 1.5-to-1.[152] Funds with synthetic leverage must fully cover their obligations under the products creating the leverage with liquid assets in a segregated account or through offsetting transactions.[153] Leverage at the 10 largest mutual funds comes in far below these limits, with an asset-to-equity ratio averaging just 1.04-to-1 (as of December 2013).[154]

The "Asset liquidation / Market channel" is no more applicable to mutual funds. The FSB speculates that mutual fund investors "could have an incentive to redeem before other investors," that such redemptions could force the fund to sell assets, and that those asset sales could adversely affect market liquidity and asset prices.[155] There is no basis for that speculation, and all of the evidence is to the contrary.

First, it is completely unrealistic to assume that mutual fund investors—who are predominantly individuals saving for retirement, education and other long-term goals[156]— would be able to predict accurately small changes in future NAVs due to concerns about redemptions by other investors, and be sufficiently motivated to trade based on that potential risk.[157] Historical evidence does not reveal that kind of behavior. On the contrary, the evidence shows that, even in times of extreme distress in the financial markets, investors in floating NAV mutual funds have redeemed at very modest rates, with average monthly outflows for all funds never exceeding four percent of assets and monthly outflows for individual funds overwhelmingly less than 10 percent.[158]

Second, mutual funds have and use a wide array of liquidity management tools to avoid "fire sales" of assets. Among other things, funds can use cash holdings, tap lines of credit, manage asset sales to minimize their impact, pay redemption requests in securities, or delay redemption payments for up to seven days.[159] These tools give mutual funds tremendous flexibility in responding to redemption requests.

Third, any asset sales by an individual mutual fund would be far too insignificant to affect asset liquidity or pricing across the global financial system. Total managed assets are less than a quarter of all financial assets.[160] Total mutual fund assets are less than a quarter of managed assets.[161] And the biggest actively managed mutual fund in the world, which was still the PIMCO Total Return Fund with $143.4 billion as of December 31, 2014, had only 1.2

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[151] *Id.* at 32, 33 n.46.
[152] 15 U.S.C. § 80a-18(f)(1) (2012); ICI-FSB Letter, *supra* note 5, at C2.
[153] *See* Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, 76 Fed. Reg. 55237, 55242-44 (2011).
[154] ICI-FSB Letter, *supra* note 5, at B2.
[155] Second Consultative Document, *supra* note 2, at 33-34.
[156] ICI FACTBOOK, *supra* note 132, at 103, 118; Fidelity-FSOC Letter, *supra* note 7, at 9.
[157] Richardson, *supra* note 83, at 18-21; Fidelity-FSOC Letter, *supra* note 7, at 8-12.
[158] ICI-FSB Letter, *supra* note 5, at F4-F13.
[159] Fidelity-FSOC Letter, *supra* note 7, at 6-7, 16, 18-21.
[160] Richardson, *supra* note 83, at 11.
[161] *Id.* at 12.

percent of all mutual fund assets and has demonstrated that substantial outflows, even during a period of reduced liquidity in fixed income markets, did not threaten the stability of those markets or the financial system.[162] The lack of impact is unsurprising when one considers that the entirety of that fund's portfolio assets at its peak of $293 billion in 2013[163] would represent less than 0.1 percent of the reported 2013 global financial asset figure of $304.5 trillion. Of course, given that the fund now has less than half that amount of assets and is still the largest actively managed mutual fund, it is even more apparent that any asset sales by an individual mutual fund would be far too insignificant to affect asset liquidity or pricing across the global financial system.

Nor is there any history of mutual fund "fire sales" causing global financial problems that SIFI designation is apt to solve. In the first instance, as noted above, this is because there is no evidence of an industry-wide tendency of mutual fund investors to abandon their long-term investment perspective, even in times of financial stress; hence, broadly speaking, "fire sales"—sudden, unexpected, extraordinary net redemptions in mutual funds requiring the rapid sale of assets and a precipitous decline in asset prices—have not occurred. And, moreover, to the extent that mutual fund investors at times adjust their portfolios, there is no meaningful economic difference between asset sales by mutual funds and sales of the same assets by other investors that would justify special regulation of mutual funds, let alone a few large ones.[164]

Mutual funds are just one vehicle through which investors may exercise their desire to trade risk for potential return. Should investors withdraw funds from, say, emerging markets equity in favor of U.S. government debt, the effect on market prices will be the same whether investors make those investments directly, or through pension funds, or through mutual funds. But investors may well prefer one vehicle over another if there are differences in how various vehicles are controlled and regulated: differences in cost or the ease with which orders can be executed could be of critical importance. Designating some vehicles as SIFIs, while leaving other economically identical vehicles undesignated, would be nonsensical.

Fourth, while the FSB suggests that its forced-sale hypothesis is "more relevant" for a dominant investor in a less liquid market, it offers no evidence that any mutual fund falls into that category.[165] At least 85 percent of each U.S. mutual fund's assets must be "liquid securities"

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[162] *See* Exhibit 1. In commenting on the First Consultative Document, the ICI observed that, of the eight equity mutual funds with assets over $100 billion, only one fund had total assets exceeding one percent of total U.S. or foreign market capitalization (at 1.19 percent of U.S. market capitalization). ICI-FSB Letter, *supra* note 5, at F24; *see also* Nachmany, *supra* note 96, at 15.

[163] Mary Childs, *Pimco Total Return Has Worst Ever Year of Redemptions*, BLOOMBERG BUSINESS (Jan. 2, 2015), *available at* http://www.bloomberg.com/news/articles/2015-01-02/pimco-total-return-has-worst-ever-year-of-redemptions.

[164] There is data showing, however, that mutual fund portfolio managers mitigate the impacts of shareholder redemptions because portfolio managers "act as a buffer – their purchasing patterns lag investor buying activity, and their redemptions also lag and mitigate short-term emotional redemptions by investors." Nachmany, *supra* note 96, at 3, 12; *see also* Stevens, *supra* note 104, at 34-36 (showing that mutual funds accommodate redemptions by varying both sales and purchases of portfolio securities).

[165] Second Consultative Document, *supra* note 2, at 33-34.

that can be sold within seven days at a price close to the fund's valuation of them.[166] But even if a large mutual fund were a dominant investor in a less liquid market, there is no evidence that the "less liquid market" would be relevant or able to threaten global financial stability. The entire market for "emerging market debt" that the FSB cites as an example of a "less liquid market" was recently sized at just over $10 trillion (just three percent of the $300 trillion financial system), of which *all* mutual funds *together* held only four percent.[167]

Surprisingly, the Second Consultative Document introduces the "Critical function or services / Substitutability channel" as a potential method by which investment funds could transmit financial distress[168] after the FSB correctly concluded that it was irrelevant to asset management in the First Consultative Document.[169] The FSB noted that "funds close (and are launched) on a regular basis with negligible or no market impact."[170] It also explained that "the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable)."[171] And the FSB acknowledges that the comments on the First Consultative Document agreed that "the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies."[172] The FSB apparently wants to reconsider the issue, even though it fails to cite any evidence calling its prior conclusion into question.

Nothing has changed. Mutual funds remain "highly substitutable." For any market segment popular enough to attract a material amount of investment, there will be dozens if not hundreds of investment fund choices. After all, there are over 16,000 registered investment companies, including almost 9,000 mutual funds, in the United States alone.[173] As a result, all of the biggest mutual funds have hundreds of direct competitors offering similar investment strategies[174] and, over time, the identities of the biggest funds change (five of 2004's top 20 largest funds did not make the list in 2014).[175] History confirms that when individual mutual funds perform poorly or fall out of favor with investors for other reasons, global financial stability is completely unaffected.[176] Between 2003 and 2013, over 6,000 mutual funds exited the business through liquidation or merger.[177] Those funds exited in an orderly manner without the need for special resolution planning and without having any effect on the broader financial

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[166] *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (1992).
[167] Chris Plantier, *Sizing Up Mutual Fund and ETF Investments in Emerging Markets*, ICI VIEWPOINT (Aug. 18, 2014), *available at* http://www.ici.org/viewpoints/view_14_sizing_funds_em.
[168] Second Consultative Document, *supra* note 2, at 34-35.
[169] First Consultative Document, *supra* note 4, at 29.
[170] *Id.* at 30.
[171] *Id.*
[172] Second Consultative Document, *supra* note 2, at 35.
[173] ICI FACTBOOK, *supra* note 132, at 20.
[174] ICI-FSB Letter, *supra* note 5, at F25.
[175] *See* Exhibit 5.
[176] Letter from Barbara Novick, Vice Chairman, BlackRock, Inc. to the U.S. Sec. & Exch. Comm'n, at F1-F3 (Nov. 1, 2013).
[177] ICI FACTBOOK, *supra* note 132, at 17.

system. Straightforward SEC regulations govern the ultimate resolution of a mutual fund through merger or liquidation.[178]

2. The FSB's materiality thresholds have no connection to systemic risk.

The proposed thresholds for subjecting "traditional investment funds" to G-SIFI designation scrutiny underscore the FSB's complete failure to link individual mutual funds to any threat to global financial stability.[179] The proposed threshold options that would rely on size alone make no sense for reasons we explain above.[180] Size of a U.S. mutual fund is not correlated with systemic risk.

Considering the 13 funds that would surpass the proposed $100 billion AUM materiality threshold[181] confirms that the size thresholds are unsound and the FSB's rationale for its proposed methodology is incoherent because none of these funds raise the systemic risks about which the FSB purports to be concerned. Six are index funds, and all invest in very broad U.S. and global markets. None of the funds have material leverage, and none dominate less liquid markets let alone the broad markets in which they principally invest. Finally, none offer unique strategies, functions or services.

The FSB's additional threshold metrics are equally baseless. The FSB suggests that a mutual fund might qualify for G-SIFI designation scrutiny if it has $30 billion in NAV and balance sheet financial leverage of 3 times NAV.[182] No justification is provided for those arbitrary numbers, which the FSB selected without showing an empirical connection to any signal of systemic risk.[183] The leverage threshold in particular is bewildering. It is one-fifth of the 15-to-1 assets-to-equity ratio that the FSOC uses to screen non-bank SIFI candidates at the U.S. domestic level.[184] It is one-eleventh of the 33-to-1 Basel III total leverage ratio for banks.[185] How could one possibly think that a $90 billion investment fund with $30 billion in equity and 3-to-1 leverage warrants the same G-SIFI designation as a $1 trillion bank with as little as $30 billion in equity and 33-to-1 leverage? SIFI risk is the same risk to the same global financial system regardless of industry. The standards should be the same in an objective methodology.

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[178] 17 C.F.R. § 270.8f-1 (liquidation); 17 CFR § 270.17a-8 (merger); *see also* ICI-FSB Letter, *supra* note 5, at E1-E2 (describing liquidation process); Fidelity-FSOC Letter, *supra* note 7, at 56 (same).
[179] Second Consultative Document, *supra* note 2, at 35-37.
[180] *See supra* notes 117-133 and accompanying text.
[181] *See* Exhibit 1; *see also* ICI-FSB Letter, *supra* note 5, at Appendix F.
[182] ICI-FSB Letter, *supra* note 5, at 36.
[183] Nor does the threshold seem likely to capture many funds. Virtually all "traditional investment funds" with more than $30 billion are U.S. registered funds that are subject to SEC leverage restrictions that should prevent them from having 3-to-1 or greater leverage.
[184] Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637, 21661 (2012).
[185] *See* Basel Comm. on Banking Supervision, *Basel III Leverage Ratio Framework and Disclosure Requirements* (Jan. 2014), *available at* http://www.bis.org/publ/bcbs270.htm.

The FSB also suggests that a mutual fund with $200 billion in gross AUM might avoid G-SIFI designation scrutiny if it can be shown that it "is not a dominant player in its markets."[186] The FSB offers two potential measures of such dominance: a "substitutability ratio below 0.5%" and a "fire sale ratio below 5.0%."[187] The basis for these metrics is completely unexplained.

The Second Consultative Document, perhaps predictably at this point, does not specify how the ratios are intended to be calculated. It suggests that the "substitutability ratio" is a fund's "trading volume" as a percentage of "the daily trading volume of the underlying asset class."[188] It indicates that the "fire sale ratio" is a fund's "total net AUM" as a percentage of "the daily trading volume of the underlying asset class."[189] These "suggestions" raise many more questions than they answer. Why does a fund with a more active trading strategy represent greater systemic risk? Is a fund's *daily* trading volume the numerator for the "substitutability ratio"? Over what period are daily trading volumes measured? What does "underlying asset class" mean? What happens if a fund holds more than one "underlying asset class" (e.g., cash, Treasuries, ETF shares, derivatives and individual securities)? And how will the daily trading volume of the "underlying asset class" be measured?

The bigger problem, however, is that the FSB's proposed ratios are useless. The FSB's "substitutability ratio" implicitly and incorrectly presumes that the only substitution possible is between a mutual fund and the individual stocks of its underlying portfolio; this is rarely true, but is most obviously false in the case of index funds. For an investor, the best substitute for one S&P 500 index fund is almost invariably not the direct purchase of all 500 stocks in the S&P index individually, but rather investing in a different index fund, an exchange traded fund, an active fund benchmarked against the S&P 500, or even a derivative tied to the index.

At most, the FSB's "substitutability ratio" captures some sense of the degree to which a particular investment fund contributes to the average liquidity in the market for the stocks it holds in its portfolios. In and of itself, that is not helpful for distinguishing whether a particular portfolio poses systemic risk. If, for example, a fund were to maintain large holdings of an illiquid asset – but not trade in that asset – it would have a low ratio, according to the FSB; still, under stressed conditions, those large holdings (because they were not normally traded) could create considerable pricing pressure if they were released to the market.[190] Similarly, the FSB's "fire sale ratio" presumes that the only cash-raising strategy for a mutual fund manager is selling stock into the daily trading volume under stressed conditions, and it wrongly imagines a hypothetical in which the entire AUM of the fund needs to be sold immediately, and the assets are withdrawn from the market entirely. This hypothetical is so far from any known reality that it does not need to be seriously entertained. Not only does it ignore the ability of most mutual funds to satisfy redemptions through an in-kind transfer of securities, but it also ignores the likelihood that, after redeeming, investors will buy the same securities directly or invest in a

[186] Second Consultative Document, *supra* note 2, at 36.
[187] *Id.*
[188] *Id.* at 36 n.55.
[189] *Id.* at 36 n.56.
[190] Of course, there is nothing unique in this fact set about mutual funds. This could be true of any investor.

different fund. Of course, the scenario the FSB fears has never occurred. Regulators in other industries do not base regulation on such extreme and unrealistic assumptions. For example, under the Basel III Liquidity Coverage Ratio ("LCR"), certain large banks are required to hold sufficient stock of high quality liquid assets (i.e., cash or Treasuries) to cover the anticipated net cash flows during a 30-day liquidity stress scenario,[191] not daily.

3. The FSB's systemic importance indicators are flawed.

We commented on many of the proposed indicators for assessing the systemic importance of investment funds in response to the First Consultative Document. Our critiques remain valid and unanswered. We encourage you to consider them.[192]

4. The FSB fails to account for the investor profile of mutual funds.

In response to the FSB's question (Q2-3) in the Second Consultative Document whether other entities "should be excluded from the definition of NBNI financial entities so that NBNI G-SIFI methodologies would not apply,"[193] we note that the very reason that the FSB is considering the exclusion of pension funds[194] leads inexorably to the exclusion of registered mutual funds. That is, pension funds and mutual fund investors share a "long-term investment perspective" which renders both sets of funds a "low risk to global financial stability."[195]

We agree that the investment horizon and goals of fund investors are important to assessing the risks, if any, that a fund poses to the financial system. Not only do long-term investors tend not to redeem their mutual fund shares in times of market downturns, many

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[191] *See* Basel Comm. on Banking Supervision, *Basel III: The Liquidity Coverage Ratio and Liquidity Risk Monitoring Tools* (Jan. 2013), *available at* http://www.bis.org/publ/bcbs238.pdf ("The [Basel Committee] has developed the LCR to promote the short-term resilience of the liquidity risk profile of banks by ensuring that they have sufficient [high quality liquid assets] to survive a significant stress scenario lasting 30 calendar days."). On September 3, 2014, the Federal Reserve, OCC and FDIC approved a final rule implementing the Basel III LCR for certain large domestic bank holding companies, savings and loan holding companies and depository institutions in the United States. Although the final rule implementing the Basel III LCR in the United States is, in some respects, more restrictive than international standards, it still uses a 30-day stress scenario. *See* Liquidity Coverage Ratio: Liquidity Risk Measurement Standards, 79 Fed. Reg. 61440 (Oct. 10, 2014), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-10-10/pdf/2014-22520.pdf.

[192] Fidelity-FSB Letter, *supra* note 7, at 26-29. (For example, the FSB's simple counting metrics (such as the number of jurisdictions in which a fund is invested or offered) completely miss the point that diversification among investors and investments is a powerful method of reducing risk. Most of the indicators suffer from similar defects: they are ill-defined; no historical evidence or scholarly research links them to systemic risk; or they actually signal reduced risk.)

[193] Second Consultative Document, *supra* note 2, at 5.

[194] Notwithstanding the fact that many private and public pension plans are significantly undercapitalized, the FSB proposes to exclude them from consideration by the proposed methodologies. *See* Alicia H. Munnell, Jean-Pierre Aubry & Mark Cafarelli, *The Funding of State and Local Pensions: 2013-2017*, CENTER FOR RETIREMENT RESEARCH AT BOSTON UNIVERSITY (June 2014) (stating that a mere 6% of state and local public pensions are estimated to be fully funded; on average, state and local pensions are 72% funded); *see also* Brendan McFarland, *Corporate Pension Funding Declined in 2014, Largely Reversing 2013 Gains*, TOWERS WATSON (Jan. 16, 2015) (estimating that Fortune 1000 pensions ended 2014 only 80% funded, in aggregate).

[195] Second Consultative Document, *supra* note 2, at 5.

investors invest during a downturn (either because of automated purchase plans or programmatic rebalancing), which provides a buffer against large market movements. Mutual fund investors are overwhelmingly long-term investors. Investors in non-money market mutual funds are almost exclusively individuals, almost all of whom (92 percent) are investing for retirement.[196] Indeed, over half of the household assets invested in mutual funds are invested through retirement accounts, such as IRAs and 401(k)s.[197] Given that mutual funds are predominantly used for retirement and other long-term goals, the FSB's rationale for excluding pension funds from G-SIFI designation—that their long-term investment perspective poses low risk to global financial stability—applies equally to mutual funds.

Even during the 2008 market downturn, mutual funds traded far less than their proportionate holdings of shares,[198] meaning that heavy sales of securities during that period were driven by investors other than mutual fund investors. As Brian Reid, Chief Economist for the ICI has commented about mutual funds, "the reason that you tend to have a great deal of stability is that . . . these retail investors are long term investors . . . so as a result, that money is staying there."[199] The FSB correctly cited the long-term investment horizon of investors as one reason that no mutual fund liquidations had a systemic market impact from 2000 to 2012.[200]

The exclusion of pension funds but not mutual funds and the rationale for excluding sovereign wealth funds based on assumed guarantees from governments further illustrate the incoherence of the FSB's proposed methodologies. One objective of the FSB's SIFI framework is to combat the moral hazard that comes with taxpayer support. Both pension funds and sovereign wealth funds present this precise moral hazard: taxpayers are exposed to unfunded pension liabilities, and government issuers have defaulted on their debt, threatened to default on their debt or restructured their debt in order to avoid default with regularity in recent times.[201] In a recent working paper, Ricardo Correa, Chief of the International Stability Section of the U.S. Federal Reserve, and a co-author explore the fragility created by the interconnectedness between

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[196] ICI FACTBOOK, *supra* note 132, at 103, 118.
[197] *Id.* at 147.
[198] ICI-FSB Letter, *supra* note 5, at F6-F7.
[199] Brian Reid, Chief Economist, Investment Company Institute, Presentation at the Brookings Institution Asset Management, Financial Stability and Economic Growth Conference (Jan. 9, 2015), *available at* http://www.brookings.edu/events/2015/01/09-asset-management-financial-stability-economic-growth.
[200] First Consultative Document, *supra* note 4, at 30, n.38 ("[E]ven when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the observation period. Part of the explanation may be that many U.S. investors hold mutual fund shares for retirement purposes. As such, these investors' investment horizon could be long-term, whereby they would prefer to remain invested rather than cash-out during a market downturn.").
[201] Argentina has defaulted, and flirted with default, numerous times since 2000. For a list of the largest defaults since 2000, *see* Daniel Huang, *Don't Cry for Them: The World's Biggest Sovereign Defaults Since 2000*, WALL ST. J. (July 2, 2015), *available at* http://blogs.wsj.com/moneybeat/2014/07/02/dont-cry-for-them-the-worlds-biggest-sovereign-defaults-since-2000/. Even now, the IMF is developing contingency plans for providing continuing support in the aftermath of the 2012 Greek default. Gabriele Steinhauser, *IMF Works With Greece's Neighbors to Contain Default Risks*, WALL ST. J. (May 10, 2015), *available at* http://www.wsj.com/articles/imf-works-with-bank-regulators-on-contingency-plans-for-greek-default-1431295441. These instances of sovereign default are not new or rare: sovereign default has a long history, often associated with banking crises, as documented by Carmen M. Reinhart & Kenneth S. Rogoff, *From Financial Crash to Debt Crisis*, 101 AM. ECON. REV. 1676 (2011).

sovereign debt and the global banking sector. These authors conclude that "[t]he close relationship between sovereigns and banks increases the fragility of the system, as it amplifies shocks that either one of these sectors may suffer independently. As a result, broad domestic economic conditions may suffer and spillovers may affect other countries."[202] The FSB's decision to focus its energies on a methodology that does not and cannot reduce systemic risk, while purposefully ignoring such undeniable contributors to systemic risk as sovereign financial exposures, virtually ensures that the FSB cannot meet this critical objective.

B. Asset managers do not pose systemic risk, and designating one a G-SIFI would be counterproductive and destructive.

The First Consultative Document correctly excluded asset managers from consideration for G-SIFI designation. The Second Consultative Document inexplicably reverses course. The FSB offers no sound reasons to include them and fails to explain why the FSB's original rationale for excluding them is no longer valid. All the FSB offers is baseless speculation that managers could hypothetically threaten global financial stability. The FSB's speculation is unpersuasive and unable to rebut the compelling rationale for excluding them.

1. No reason to reverse course

In the First Consultative Document, the FSB provided several well-founded reasons for not considering managers for G-SIFI designation. It explained that "[t]he 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."[203] That separation of manager and fund is crucial, the FSB observed, because it is the fund's "portfolio of assets that creates the respective exposures to the financial system."[204] The FSB's original decision to exclude asset managers from G-SIFI designation was correct. Individual asset managers do not pose systemic risk. Asset managers are not susceptible to sudden disruptive "failure" and, even if they were, their failure could not cause or amplify disruption to the global financial system.

Commenters on the First Consultative Document agreed that asset managers are not an appropriate focus of regulation.[205] In fact, there was widespread agreement with the FSB's proposal to exclude asset managers from potential SIFI designation. The FSB acknowledges this consensus, but facilely asserts that, "in the context of assessing risks arising from asset management entities and their possible global impact on the market, the responses also emphasised the relevance of a focus on activities of asset managers."[206] This characterization

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[202] Ricardo Correa & Horacio Sapriza, *Sovereign Debt Crises*, BD. OF GOV. OF THE FED. RES. SYS., INT'L FIN. DISCUSSION PAPERS, 18 (May 2014).
[203] First Consultative Document, *supra* note 4, at 30.
[204] *Id.* at 30.
[205] *See, e.g.*, Letter from Jiří Król, Deputy CEO, Alt. Investment Mgmt. Ass'n to the Secretariat of the Fin. Stability Bd., 17-18 (Apr. 7, 2014) ("[W]e agree with the FSB and IOSCO that . . . asset managers, either on a stand-alone basis or with their funds collectively, are not the correct focus for monitoring systemic risk because asset managers: . . . do not act as lender or counterparties; have limited interconnections; may be substituted with relative ease.").
[206] *See* Second Consultative Document, *supra* note 2, at 30.

distorts commenters' main point: that the FSB should focus on activities as an *alternative* to SIFI designation, not as a *basis* for designation of funds and managers. The FSB itself has acknowledged that focusing on "asset management-related *activities*" is not the same as focusing on asset managers themselves.[207] Indeed, it is the opposite: a focus on an activity addresses that activity across the industry, whether it is practiced in a large, medium or small firm. Designation, by contrast, addresses that activity only when it is practiced in a large firm, and ignores the same activity in thousands of other firms.

Mutual fund advisers are no more vulnerable to failure than any other firm in the business of providing services, and less vulnerable than many. Their income comes from a steady stream of fees paid by the funds they manage. Most of their expenses (such as employee compensation and marketing) can easily be reduced if fee income falls. Their business model is not reliant on debt. And they are not on the hook for investment losses experienced by the funds they manage.[208]

"Failure" of an asset manager would leave the global financial system unaffected. Because asset managers "are only agents for the mutual funds and, thus, are not exposed to the credit, market, and liquidity risks of the funds, an asset manager's balance sheet is not directly 'interconnected' with a mutual fund's assets."[209] Asset managers are easily and regularly substituted without incident, even in times of distress.[210] The failure of a manager does "not generate systemic risk the same way a failure of a large, complex bank or insurance company or its subsidiaries might produce such risks."[211]

The FSB appears fundamentally to misunderstand the nature of asset management. For example, it suggests that there are times when "an asset manager guarantees the performance of investment funds that it manages."[212] This is simply not true.

2. Focus on asset manager activities

The FSB says that any assessment of "the systemic importance of an asset manager" must be based on the manager's "management *activity*" and "*other activities*."[213] The Second Consultative Document focuses on *activities* in which asset managers might engage.[214] These

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[207] *See* First Consultative Document, *supra*, note 4, at 32 (emphasis added).
[208] *Id.* at 29 (Asset managers serve as agents passing on "both upside rewards and downside risks from movements in the value of the underlying assets" to their customers.).
[209] Richardson, *supra* note 83, at 3.
[210] *See infra* note 214.
[211] Richardson, *supra* note 83, at 3.
[212] Second Consultative Document, *supra* note 2, at 53.
[213] *Id.* at 47 (emphasis added).
[214] *See id.* ("The *FSB and IOSCO are interested in exploring the types of other activities and the extent to which various other activities may be relied upon by investors, financial institutions and corporations, and which are difficult to readily substitute.*" (emphasis added)); *id.* ("When assessing how the impact of the failure or distress of a fund's asset manager may be transmitted to other financial entities and markets or designing a detailed methodology (or indicators) for assessing the systemic importance of an asset manager, it is important to consider the variety of

include "securities lending agent services (including provision of indemnification to securities lenders), provision of risk management platforms or pricing services to clients, and consulting/advisory services that rely on the asset managers' breadth of asset expertise."[215] If those activities are the FSB's concern, then why is G-SIFI designation the proper regulatory approach? Those activities are not restricted to a few large asset managers or even to asset managers at all. Why not directly target the activities that supposedly create systemic risk and whatever types of entities might conduct them with an activity-based approach? The Second Consultative Document's entirely size-based materiality thresholds for G-SIFI designation have nothing whatsoever to do with whether a particular manager engages in any supposedly risky activities.

3. Materiality thresholds

The FSB's proposed size-alone thresholds ($1 trillion in AUM or $100 billion in balance sheet assets) for asset managers are completely arbitrary and make no sense for the same reasons that size-alone thresholds make no sense for investment funds. First, size is not indicative of systemic risk in asset management. To the contrary, larger asset managers tend to be more resilient.[216] Second, the threshold figures chosen are unsupported by any showing that they reflect or even relate to some tipping point between managers that present systemic risk and those that do not.

The $1 trillion AUM threshold is particularly baffling. A manager's total AUM are not consolidated on the manager's single balance sheet, like assets held by a banking firm's subsidiaries are, nor are they consolidated in a single managed fund or account. In fact, large managers typically manage accounts and funds that number in the hundreds or thousands.[217] Each of them is legally and economically separated from the others and from the manager and owned by different investors.

The FSB acknowledges that "AUM may not always be the most effective threshold measure"—"given the agency model of asset managers"—but it hypothesizes that larger managers may be subject to "reputational risks" that would make AUM a valid risk metric.[218] No evidence supports this hypothesis. Managers that have experienced even grievous reputational injuries have never threatened global financial stability. There are numerous examples. Reputational risk is no more probable, and its impact no more severe, at a larger manager. Reputational risk is not systemic; it is idiosyncratic. SIFI designation also does nothing to reduce its probability or impact, which is evident when considering the multitude of incidents that have tarnished the reputations of the G-SIBs in recent years.

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business models of asset managers, not only their core investment funds' management activity (e.g. managing assets as an agent) but also *their other activities* that are set out above." (emphasis added)).

[215] *Id.* (emphasis added).

[216] *See* Exhibit 7; Nachmany, *supra* note 96, at 2.

[217] For example, Fidelity's registered investment advisers currently manage over 500 different funds.

[218] Second Consultative Document, *supra* note 2, at 51-52.

The alternative threshold of $100 billion in balance sheet assets also does not withstand scrutiny. The FSB asserts, without support, that because managers "are known to maintain low balance sheet assets," a "manager with a large balance sheet could indicate the existence of potentially significant non-asset management activities."[219] This concern exposes the absurdity of both *size*-based regulation of asset managers and of asset management designation generally. If the FSB is concerned about "non-asset management *activities*," why would it look for those activities only in asset managers? And why look for them only in large firms? The attempt to justify designation of large asset managers by relying on non-asset management activities highlights the arbitrary and capricious nature of this entire project.

4. Transmission channels

The FSB's description of potential risk transmission channels confirms that asset managers are not suited for G-SIFI designation. That description rests entirely on unfounded speculation. The only thing that the discussion of asset manager transmission channels actually establishes is that the FSB's true concern is activities, not managers, and that the activities of supposed concern are not unique or limited to large asset managers or to asset managers at all.[220]

With respect to the "Exposures / Counterparty channel," the FSB argues that "[t]o the extent an asset manager acts not only as an agent, but also as a counterparty, then the failure or distress of the asset manager could also be transmitted to other market participants."[221] As an example, the FSB mentions an asset manager investing its "equity as seed money in new funds."[222] But seeding such *new* funds, by definition, involves *small* amounts of money relative to the market as a whole. Such small amounts of money can have no *systemic* impact on the global financial system, and there are no historical instances of such impact. Further, U.S. law *requires* every newly registered investment company to have at least $100,000 of seed capital before distributing its shares to the public.[223]

In discussing the "Asset liquidation / Market channel," the FSB expresses unfounded concern that asset managers face special reputational- and operations-based risks. For example, it asks whether "the departure of key individuals, or operational problems" might lead to "substantial redemptions . . . in a way that could adversely affect the global financial system."[224] But the available data on this point demonstrates that mutual funds can weather *substantial* redemptions—attributable to the departure of key personnel or any other reason—without

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[219] *Id.* at 50.
[220] *Id.* at 48 (describing various activities).
[221] *Id.*
[222] *Id.*
[223] Investment Company Act of 1940, 15 U.S.C. § 80a-14(a) (2012). Section 14(a) has been interpreted to mean that a new investment company cannot make a public offering of its securities until the company has a net worth of $100,000, and that such amount cannot be loaned or redeemed as a temporary accommodation by those persons who make the investment, nor can there be any intention, when the investment is made, to redeem or dispose of such investment. *See, e.g.*, Automation Shares, Inc., 37 S.E.C. 771 (1957); Champion Fund, Inc. (pub. avail. Mar. 9, 1972 and June 26, 1972).
[224] Second Consultative Document, *supra* note 2, at 49.

systemic market effects. For example, after the departure of a key employee, PIMCO's Total Return Fund—which had over $200 billion in AUM—experienced net redemptions of 11 percent of its assets in September of 2014, 14 percent of its assets in October, and five percent and 12 percent of its assets in the next two months, respectively.[225] Despite these extraordinary redemptions representing over one-third of the Fund's assets, there was no price dislocation for the fund or for the bond market or the financial system as a whole.[226]

As for the "Critical function or services / Substitutability channel," the FSB sees potential systemic risk in "delays or other obstacles in transferring contracts to another asset manager" in the event of stress or a default.[227] Such concerns are easily dispelled by abundant available evidence. The competition that has led to the large volume and variety of funds has also led to the development of robust systems and processes to make transfers easy and reliable for investors. Substitutability requires both options for substituting and ease of transfer. The asset management industry offers market participants both. For example, in each of 2013 and 2014, our defined contribution business had over 7,000 instances in which a plan sponsor moved assets out of one fund or share class and into another. These transitions involved over 87,000 funds and share classes and almost $109 billion in assets in 2013 and over 108,000 funds and share classes and over $148 billion in assets in 2014.[228] These figures do not capture plan participants' decisions to re-allocate or re-balance their individual 401(k) accounts or industry-wide activity. Those transfers can be made simply and quickly, in all market conditions, via a website or over the phone.

Any individual investor searching for a particular strategy or risk profile for its investments could find it offered by multiple managers and the process of switching is easy. Given the high substitutability of managers and funds, most, if not all, investors will take their assets elsewhere via redemptions or termination of a distressed manager long before the manager is actually resolved. At the point of resolution, the manager is systemically irrelevant because it will manage few assets, if any.

There is no evidence of the (unspecified) obstacles that the FSB imagines impeding asset transfers or threatening the global financial system. Even during the height of the 2008 financial crisis, managers were able to promptly transfer contracts to other managers without any market disruption.[229] Some managers even specialize in taking over mutual funds, and are willing, ready and able to pick up funds from a distressed manager.[230] At the same time, the fund board

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[225] *See* Nachmany, *supra* note 96, at 14-15.
[226] *Id.* at 15.
[227] *Id.*
[228] Fidelity Investments internal data. These transitions involve both Fidelity and non-Fidelity funds.
[229] Alan Greene of State Street—a "custodian" firm that handles the mechanics of such transfers—explained that during the financial crisis in 2008, "[the firm] transferred portfolios from managers that wanted to move entire funds from their complex to another complex," doing one transfer in just "six days." Alan Greene, Exec. Vice President, U.S. Investor Services, State Street Corp., Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C., 210 (May 19, 2014).
[230] *See History of Franklin Resources, Inc.*, FRANKLIN TEMPLETON INVESTMENTS (last visited May 23, 2015), *available at* http://www.franklinresources.com/corp/pages/generic_content/about_us/history.jsf (describing history

can fire the manager and hire a new one for the same fund or fund investors can easily and quickly "fire" a distressed manager by redeeming their fund shares and moving their money to a fund managed by a different manager. This process is common, happening "thousands of times a day."[231] As the FSB itself recognizes, asset managers are "generally substitutable" and "there is considerable competition in the marketplace."[232]

V. The FSB Should Abandon Its Designation Methodologies for Investment Funds and Asset Managers and Shift to a Products and Activities Analysis of the Asset Management Industry and Capital Markets.

The FSOC has shown that seeking to designate individual investment funds and asset managers is not the only way or the best way to assess or regulate the asset management industry and its roles in capital markets. Heeding the suggestions of industry participants, finance scholars and others in comment letters, meetings and at a May 2014 conference,[233] the FSOC directed its efforts away from SIFI designation and asked its staff to "undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."[234]

A products and activities approach is a more effective way to analyze and address the benefits and risks of the asset management industry and capital markets. The industry's primary regulator, the SEC, has regulated funds and managers effectively from this perspective for the last 75 years.[235] The SEC's targeted industry-wide approach to regulating all aspects of mutual fund operations and management, including custody, leverage, liquidity, pricing and transparency, has been successful in allowing mutual funds to become the preferred investment

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of acquisitions by one adviser); *A Brief Overview of Investco Ltd.'s History*, INVESCO (last visited May 23, 2015), *available at* http://www.invesco.com/portal/site/global/History/ (same).

[231] John Gidman, Chief Info. Officer, Loomis, Sayles & Co., Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C., 235 (May 19, 2014).

[232] Second Consultative Document, *supra* note 2, at 49. Contrary to the FSB's speculation, there is no exception for (unnamed) "specific activities, for which [a manager] has developed a specific skill." *See id.* Any skill important enough to have *systemic* impact will not be unique or confined to one manager.

[233] *See, e.g.*, Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the U.S. Sec. & Exch. Comm'n (Nov. 1, 2013); Letter from Paul Schott Stevens, President & CEO, Investment Company Institute to the U.S. Sec. & Exch. Comm'n (Nov. 1, 2013); Letter from Barbara Novick, Vice Chairman, BlackRock, Inc. to the U.S. Sec. & Exch. Comm'n (Nov. 1, 2013); Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C. (May 19, 2014); Letter from Timothy W. Cameron, Head & Managing Director, SIFMA Asset Management Group, and John Gidman, President, Ass'n of Institutional Investors to U.S. Dep't of Treasury (Sept. 23, 2014), *available at* http://www.sifma.org/issues/item.aspx?id=8589951018.

[234] *Minutes of the Financial Stability Oversight Council*, 3 (July 31, 2014), *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031,%202014.pdf.

[235] *See, e.g.*, The Investment Company Act of 1040, 15 U.S.C. §§ 80a-1 et seq. (2012); The Investment Advisers Act of 1040, 15 U.S.C. §§ 80b-1 et seq. (2012); *see also* Piwowar, *supra* note 55 ("Make no mistake — it is the Commission, not the banking regulators, that has the *statutory authority and responsibility* for regulating the capital markets. It is the Commission, not the banking regulators, that has the requisite *expertise and experience* with capital markets. It is the Commission, not the banking regulators, that should be regulating the capital markets. Period.").

vehicle for millions of investors, and a diverse source of capital markets funding,[236] while preventing traditional variable NAV mutual funds from ever becoming a source or amplifier of systemic risk.[237, 238] As the SEC considers whether and how to enhance risk monitoring and regulatory safeguards in the U.S. asset management industry, it is following the same approach that has proven to be so successful historically[239] and serves as a model for other jurisdictions that want to replicate the economic and financial stability benefits that U.S. capital markets provide.[240] Vítor Constâncio, Vice President of the European Central Bank, endorsed this approach in a recent speech describing the attributes of an ideal Capital Markets Union. These attributes include a "level-playing field" framework where all market participants: "(i) face a single set of rules when they decide to deal with financial instruments and/or services; (ii) have equal access to a set of financial instruments and/or services; and (iii) are equally treated when they are active in the market."[241] In describing this ideal market, Constâncio illustrates why singling out a large fund or manager for SIFI designation and different regulation than its

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[236] *See, e.g.*, ICI FACTBOOK, *supra* note 132, at 7-14. Similar regulatory regimes have produced good results in other jurisdictions. As one U.K. official recently observed, the European Union's UCITS model "has enabled the growth of EU investment funds" that have raised "nearly €8 trillion of assets." Cunliffe, *supra* note 144.

[237] *See* ICI-FSB Letter, *supra* note 5, at Appendix F; Nellie Liang, Dir., Program Direction Sec. of the Off. of Fin. Stability Pol'y & Res., Bd. Of Governors of the Fed. Res. Sys., Remarks at the Brookings Institution Asset Management, Financial Stability and Economic Growth Conference (Jan. 9, 2015), *available at* http://www.brookings.edu/events/2015/01/09-asset-management-financial-stability-economic-growth ("Mutual funds in their current form have been around for a long time . . . without noticeably contributing to systemic risk.").

[238] Questions about stable NAV money market mutual funds that arose after the Reserve Primary Fund broke the buck in 2008 have inspired much of the broader regulatory interest in the asset management industry. The concerns regarding money market mutual funds ultimately resulted in two rounds of SEC regulatory reforms, the second of which appropriately focused on funds that experienced stress during the crisis. In light of those reforms, we believe that U.S. money market mutual funds do not merit further attention as part of this consultation, but the SEC's money market mutual fund regulatory process is illustrative of the sort of focused, deliberate and public process we believe should govern any consideration of additional regulation of the asset management industry. The SEC articulated its concerns clearly, explored the differences among funds empirically and analyzed their implications for the SEC's concerns and potential responses. The reforms that the SEC adopted also illustrate the proper structure of asset management and capital markets regulation. Namely, funds are regulated at the product level and subject to the same regulation across the industry. The SEC did not single out a few of the largest money market mutual funds for different regulation, as SIFI designation would, because the identified risk was not confined to those entities and regulating them differently than their competitors would not have reduced it. Nor did the SEC regulate all money market mutual funds as if they present the same risk because the data showed that different products had different risk profiles.

[239] Mary Jo White, Chair, Sec. & Exch. Comm'n, Speech at the New York Times DealBook Opportunities for Tomorrow Conference: *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry* (Dec. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

[240] *See, e.g.*, Cunliffe, *supra* note 144, at 6-7 ("[M]arket as opposed to bank-based financing is still very undeveloped in the EU compared to the US;" "the relative size of market-based financing in the US compared to the EU illustrates graphically the scope in the EU to go much further;" and "It is very probable that one of the reasons the US has recovered faster from its financial crisis than Europe is that in the US banks do not dominate the provision of finance to anything like the same degree as in the EU. When the banking system was damaged in the US, a well-developed alternative existed to help meet the financing needs of the real economy.").

[241] Vítor Constâncio, Vice-President of the European Central Bank, Speech at the Joint Conference on European Financial Integration and Stability: *Financial Integration and Macro-Prudential Policy* (Apr. 27, 2015), *available at* https://www.ecb.europa.eu/press/key/date/2015/html/sp150427.en.html.

competitors and other market participants would distort markets and should be avoided. A products and activities approach creates a level playing field and is clearly superior.

Such a shift in focus would be consistent with the systemic risk concerns expressed in the Second Consultative Document, such as fund pricing, investments in less liquid assets and securities lending[242]—activities that funds, managers and others engage in to varying degrees across the industry and capital markets, regardless of their sizes.[243] Shifting this workstream to product and activity analysis also is consistent with the FSB's recently announced plan to "evaluate the role that existing or additional activity-based policy measures could play in mitigating potential risks."[244] The FSB concedes that academic research on issues such as "capital markets contagion" "does not generally focus on *individual* investment funds, but rather the investment funds' *aggregate* contribution to market movements."[245] The FSB identifies no academic research that supports an approach of managing systemic risk by singling out an individual fund or manager for different regulation than its competitors. The very limited academic research that does exist points to risks associated with "funds' aggregate contribution to market movements,"[246] which is consistent with a focus on specific products and activities of funds, not on large funds or managers.

The FSB should abandon its methodologies for SIFI designation of investment funds and asset managers. The FSB is out of step with other regulators and with basic economics on the proper approach to analyzing and regulating the asset management industry and capital markets. Regulators, industry participants[247] and leading academics[248] all endorse a products and activities approach over SIFI designation for investment funds and asset managers because it avoids the problems of unequal treatment and risk shifting that would come with SIFI designation in the highly competitive asset management industry. The FSB should heed the guidance from experts, which it specifically requested in the First Consultative Document,[249] and its own recognition of

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[242] Second Consultative Document, *supra* note 2, at 33, 48.
[243] *See, e.g.*, Bob Grohowski & Sean Collins, *Securities Lending by Mutual Funds, ETFs, and Closed-End Funds: The Market*, ICI VIEWPOINTS (Sept. 16, 2014), http://www.ici.org/viewpoints/view_14_sec_lending_02; Richardson, *supra* note 83, at 30-34.
[244] Press Release, Fin. Stability Bd., *Meeting of the Financial Stability Board in Frankfurt on 26 March* (Mar. 26. 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/Press-Release-FSB-Plenary-Frankfurt-final-26Mar15.pdf.
[245] Second Consultative Document, *supra* note 2, at 34 (emphasis added).
[246] *Id*.
[247] Twenty-one separate comment letters on the First Consultative Document—from those who best know the industry—all recommended that the FSB focus on activity and product analysis instead of G-SIFI designation for individual funds and managers. *See, e.g.*, Fidelity-FSB Letter, *supra* note 7; ICI-FSB Letter, *supra* note 5; BlackRock-FSB Letter, *supra* note 5; Letter from Hal Scott et al., Director of the Comm. on Capital Mkts. Regulation to the Secretariat of the Fin. Stability Bd. (Apr. 7, 2014); Letter from Timothy W. Cameron & Matthew J. Nevins, Managing Directors of the Sec. Indus. & Fin. Mkts. Ass'n (SIFMA) (Apr. 4, 2014).
[248] *See, e.g.*, Richardson, *supra* note 83, at 41-43; Scott, *supra* note 247, at 3 ("Systemic risk in capital markets is not confined to or concentrated in a few discrete entities. Rather, it shifts with capital flows, which themselves are driven by investor preferences and other market dynamics. Regulating the systemic risk posed by capital markets requires . . . a focus on market infrastructure and on systemically risky activities and products.").
[249] *See* First Consultative Document, *supra* note 4, at 32 – Q.6-4.

the economic and financial stability benefits of asset management and market finance,[250] and adopt a regulatory approach that protects and enhances those benefits rather than the G-SIFI approach that does not do so and would not reduce systemic risk.

VI. U.S. Members of the FSB and IOSCO Should Reject the G-SIFI Designation Proposals.

If the FSB does not abandon its proposed methodologies for G-SIFI designation of investment funds and asset managers, the U.S. members of the FSB should affirmatively reject them. In practice, the proposals would apply primarily if not exclusively to U.S. funds and managers[251] and would interfere with the ongoing efforts of U.S. regulators to evaluate the existing risk monitoring and regulation of the U.S. asset management industry and capital markets.[252] The problems with this type of international interference have been widely recognized by FSOC members and others.[253]

These proposals also could never survive scrutiny under U.S. law. No U.S. law authorizes any U.S. regulator to perform the tasks that would be assigned to it by the FSB under these proposals. As we explain above, expressly non-binding policy documents issued by international organizations provide no basis for circumventing U.S. law on the very same subject. Nor are they a valid basis for circumventing or overriding the decision of the FSOC to focus its analysis of asset management on "industry-wide products and activities."[254]

The FSB's process for adopting its G-SIFI designation proposal also lacks the basic attributes of reasoned decision-making required by U.S. law, and the substance of the proposed G-SIFI designation process would also violate U.S. law.

U.S. regulators should *not* participate in the FSB's defective extraterritorial G-SIFI designation process, which would be illegal in the United States, or attempt to import that process or its results into the United States. The problems with this approach may not be fully apparent at the proposal stage, but if U.S. regulators ever attempted to implement the methodologies in the United States, they would be unable to ignore the methodology's flaws or defend those flaws against challenges in front of U.S. political or judicial authorities.

We also request that U.S. regulators ensure that any future proposals by the FSB and IOSCO that they endorse meet U.S. standards and provide affected U.S. parties with the protections they enjoy under U.S. law.

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[250] Press Release, *supra* note 244 ("[T]he trend towards greater market-based intermediation through asset management entities is welcome and should contribute to the overall resilience of the financial system by providing alternative sources of funding").
[251] *See* Exhibits 1 and 2; *Nothing but the Facts*, *supra* note 16.
[252] White, *supra* note 239.
[253] *See supra* note 60.
[254] *See* FSOC Notice, 79 Fed. Reg. at 77488.

Fidelity would be pleased to provide any further information or respond to any questions that the FSB or IOSCO may have.

Sincerely,

cc: Jacob J. Lew, Secretary of the Treasury and Chairman of the Financial Stability Oversight Council
Thomas J. Curry, Comptroller of the Currency
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
Timothy G. Massad, Chairman of the Commodity Futures Trading Commission
Debbie Matz, Chairman of the National Credit Union Administration
Melvin L. Watt, Director of the Federal Housing Finance Agency
Mary Jo White, Chair of the U.S. Securities and Exchange Commission
S. Roy Woodall, Jr., Independent Insurance Expert
Janet L. Yellen, Chair of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Richard Berner, Director of the Office of Financial Research
Michael T. McRaith, Director, Federal Insurance Office, Department of the Treasury
Adam Hamm, Insurance Commissioner, North Dakota Insurance Department
John P. Ducrest, Commissioner of the Louisiana Office of Financial Institutions and Chairman of the Conference of State Bank Supervisors
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division

Mark Carney, Chair, Financial Stability Board
Greg Medcraft, Chairman, International Organization of Securities Commissions
David Wright, Secretary General, International Organization of Securities Commissions
Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union, European Commission

Luis Aguilar, Commissioner, U.S. Securities and Exchange Commission
Daniel Gallagher, Commissioner, U.S. Securities and Exchange Commission
Kara Stein, Commissioner, U.S. Securities and Exchange Commission
Michael Piwowar, Commissioner, U.S. Securities and Exchange Commission

Exhibit 1
Investment Funds Greater Than or Equal to $30 BN in AUM

Rank	Fund Company	Fund Name	AUM as of December 31, 2014 (USD Millions)	Investment Type
1	Vanguard	Vanguard Total Stock Market Index Fund [2, 3]	$ 383,003	Open-End Fund
2	State Street	SPDR® S&P 500 ETF [3]	$ 215,908	Exchange-Traded Fund
3	Vanguard	Vanguard Five Hundred Index Fund [2, 3]	$ 198,712	Open-End Fund
4	Vanguard	Vanguard Institutional Index Fund	$ 187,725	Open-End Fund
5	PIMCO	PIMCO Total Return Fund	$ 143,358	Open-End Fund
6	American Funds	American Funds Growth Fund of Amer	$ 142,631	Open-End Fund
7	Vanguard	Vanguard Total Bond Market Index Fund [2, 3]	$ 136,673	Open-End Fund
8	Vanguard	Vanguard Total Intl Stock Idx Fund [2, 3]	$ 134,442	Open-End Fund
9	Vanguard	Vanguard Prime Money Market Fund	$ 132,692	Money Market Fund
10	American Funds	American Funds Europacific Growth Fd	$ 120,868	Open-End Fund
11	JPMorgan	JPMorgan Prime Money Mkt Fund	$ 118,520	Money Market Fund
12	Fidelity	Fidelity® Cash Reserves	$ 113,946	Money Market Fund
13	Fidelity	Fidelity® Contrafund® Fund	$ 109,845	Open-End Fund
14	American Funds	American Funds Income Fund of Amer	$ 96,829	Open-End Fund
15	American Funds	American Funds Capital Income Bldr	$ 96,656	Open-End Fund
16	Tianhong Asset Management	TianHong Income Box Money Market Fund [4, 5]	$ 93,308	Money Market Fund
17	Franklin Templeton	Franklin Income Fund	$ 92,535	Open-End Fund
18	Vanguard	Vanguard Total Bond Market II Index Fund	$ 90,753	Open-End Fund
19	Vanguard	Vanguard Wellington™	$ 88,753	Open-End Fund
20	American Funds	American Funds Capital World Gr&Inc Fd	$ 86,333	Open-End Fund
21	Fidelity	Fidelity Spartan® 500 Index Fd	$ 85,079	Open-End Fund
22	American Funds	American Funds American Balanced Fund	$ 79,664	Open-End Fund
23	American Funds	American Funds Washington Mutual Fund	$ 77,000	Open-End Fund
24	American Funds	American Funds Invmt Co of Amer	$ 75,474	Open-End Fund
25	American Funds	American Funds Fundamental Invs	$ 71,684	Open-End Fund
26	iShares	iShares Core S&P 500 [3]	$ 69,686	Exchange-Traded Fund
27	Franklin Templeton	Templeton Global Bond Fund	$ 69,138	Open-End Fund
28	Fidelity	Fidelity® Instl MM Fds Money Market Port	$ 65,850	Money Market Fund
29	Dodge & Cox	Dodge & Cox International Stock Fund	$ 64,040	Open-End Fund
30	BlackRock	BlackRock Liquidity Funds TempFund	$ 63,701	Money Market Fund
31	JPMorgan	JPM US Dollar Liquidity [5]	$ 63,272	Money Market Fund
32	Vanguard	Vanguard Emerging Markets Stock Idx Fund [2, 3]	$ 62,465	Exchange-Traded Fund
33	Dodge & Cox	Dodge & Cox Stock Fund	$ 60,260	Open-End Fund
34	Vanguard	Vanguard Mid-Cap Index Fund [2, 3]	$ 58,928	Open-End Fund
35	JPMorgan	JPMorgan US Government Money Market	$ 58,500	Money Market Fund
36	American Funds	American Funds New Perspective Fund	$ 56,600	Open-End Fund
37	BlackRock	BlackRock Global Allocation Fund	$ 55,078	Open-End Fund
38	iShares	iShares MSCI EAFE [3]	$ 53,221	Exchange-Traded Fund
39	Vanguard	Vanguard Short-Term Investment-Grade	$ 53,073	Open-End Fund
40	BlackRock	BlackRock ICS Sterling Liq [4, 5]	$ 52,862	Money Market Fund
41	Metropolitan West	Metropolitan West Total Return Bond Fund	$ 51,171	Open-End Fund
42	Vanguard	Vanguard REIT Index Fund [2, 3]	$ 50,658	Exchange-Traded Fund
43	Vanguard	Vanguard Windsor™ II Fund	$ 50,557	Open-End Fund
44	Vanguard	Vanguard Small Cap Index Fund [2, 3]	$ 50,473	Open-End Fund
45	First Eagle	First Eagle Global Fund	$ 49,952	Open-End Fund
46	Harbor	Harbor International Fund	$ 46,972	Open-End Fund
47	Vanguard	Vanguard PrimeCap Fund	$ 46,310	Open-End Fund
48	Fidelity	Fidelity® Low-Priced Stock Fund	$ 46,293	Open-End Fund
49	Wells Fargo	Wells Fargo Advantage Heritage Money Mkt	$ 46,220	Money Market Fund
50	Vanguard	Vanguard Developed Markets Index Fund [2, 3]	$ 45,215	Exchange-Traded Fund

Continued on next page.

Exhibit 1
Investment Funds Greater Than or Equal to $30 BN in AUM

Rank	Fund Company	Fund Name	AUM as of December 31, 2014 (USD Millions)	Investment Type
51	Vanguard	Vanguard Growth Index Fund [2, 3]	$ 45,062	Open-End Fund
52	Vanguard	Vanguard Health Care Fund	$ 44,627	Open-End Fund
53	American Funds	American Funds AMCAP Fund	$ 44,265	Open-End Fund
54	T. Rowe Price	T. Rowe Price Growth Stock Fund	$ 42,993	Open-End Fund
55	Fidelity	Fidelity® Growth Company Fund	$ 42,269	Open-End Fund
56	Vanguard	Vanguard Instl Total Stock Market Index	$ 41,493	Open-End Fund
57	Federated	Federated Prime Obligations Fund	$ 41,426	Money Market Fund
58	Vanguard	Vanguard Extended Market Index Fund [2, 3]	$ 41,052	Open-End Fund
59	Fidelity	Fidelity® Instl MM Fds Prm MMkt Port	$ 41,043	Money Market Fund
60	Vanguard	Vanguard Intermediate-Term Tax-Exempt	$ 40,811	Open-End Fund
61	PowerShares	PowerShares QQQ [3]	$ 40,449	Exchange-Traded Fund
62	Vanguard	Vanguard Wellesley® Income Fund	$ 40,375	Open-End Fund
63	DoubleLine	DoubleLine Total Return Bond Fund	$ 40,202	Open-End Fund
64	PIMCO	PIMCO Income Fund	$ 40,091	Open-End Fund
65	BlackRock	BlackRock Cash Funds Institutional Fund	$ 40,008	Money Market Fund
66	Schwab	Schwab Cash Reserves™	$ 39,324	Money Market Fund
67	Dodge & Cox	Dodge & Cox Income Fund	$ 39,128	Open-End Fund
68	Prudential	Prudential Core Taxable MMkt	$ 39,113	Money Market Fund
69	Oppenheimer	Oppenheimer Developing Markets Fund	$ 39,070	Open-End Fund
70	State Street	State Street Instl Liquid Reserves Fund	$ 38,658	Money Market Fund
71	Vanguard	Vanguard Short-Term Bond Index Fund [2, 3]	$ 38,555	Open-End Fund
72	M&G	M&G Optimal Income Fund [3]	$ 38,155	Open-End Fund
73	Goldman Sachs	Goldman Sachs Fincl Sqr Trs Instr	$ 37,695	Money Market Fund
74	Dreyfus	Dreyfus Treasury Prime Cash Management I	$ 37,413	Money Market Fund
75	Franklin Templeton	Templeton Global Bond Fund [3]	$ 37,226	Open-End Fund
76	Goldman Sachs	Goldman Sachs FS Government Fund	$ 36,983	Money Market Fund
77	Lord Abbett	Lord Abbett Short Duration Income Fund	$ 36,777	Open-End Fund
78	Vanguard	Vanguard Value Index Fund [2, 3]	$ 36,431	Open-End Fund
79	Standard Life	SLI Global Abs Ret Strat [4]	$ 36,125	Open-End Fund
80	American Funds	American Funds American Mutual Fund	$ 35,893	Open-End Fund
81	MFS	MFS® Value Fund	$ 35,247	Open-End Fund
82	Goldman Sachs	Goldman Sachs FS Money Market Fund	$ 34,510	Money Market Fund
83	Franklin Templeton	Templeton Global Total Return[3]	$ 34,426	Open-End Fund
84	Morgan Stanley	Morgan Stanley Inst Liquidity Gov PORT	$ 34,370	Money Market Fund
85	Vanguard	Vanguard Target Retirement 2025 Fund	$ 32,318	Open-End Fund
86	Federated	Federated Government Obligs Fund	$ 32,192	Money Market Fund
87	iShares	iShares MSCI Emerging Markets [3]	$ 32,188	Exchange-Traded Fund
88	PIMCO	PIMCO All Asset Fund	$ 31,322	Open-End Fund
89	Vanguard	Vanguard Total International Bd Idx Fund [2, 3]	$ 30,553	Open-End Fund
90	iShares	iShares Russell 2000[3]	$ 30,289	Exchange-Traded Fund
91	T. Rowe Price	T. Rowe Price Equity Income Fund	$ 30,001	Open-End Fund

Notes:

[1] Dataset includes all managed investments from Morningstar, with the following restrictions:

[a] Fund base currency is one of the following: US Dollar (USD), Australian Dollar (AUD), Brazilian Real (BRL), British Pound Sterling (GBP), Canadian Dollar (CAD), Chinese Yuan Renminbi (CNY), Euro (EUR), Hong Kong Dollar (HKD), Japanese Yen (JPY), Mexican Peso (MXN), Russian Ruble (RUB), or Swiss Franc (CHF).

[b] Variable annuity and variable life share classes of the funds, and funds only available in 529 plans are excluded.

[2] The fourteen Vanguard funds indicated with a "[2]" had both open-end and ETF share classes. The "Investment Type" for these funds is the share class with the largest total AUM.

[3] Funds indicated with a "[3]" had share classes with multiple base currencies including US Dollar. US Dollar AUM are reported in the table.

[4] Funds indicated with a "[4]" had all their share classes in a single foreign base currency: TianHong Income Box Money Market Fund in CNY, BlackRock ICS Sterling Liq in GBP, and SLI Global Abs Ret Strat in GBP. Exchange rates as of December 31, 2014 from the St. Louis Fed FRED database are used to convert these currencies to US Dollars.

[5] Funds indicated with a "5" are identified with a category of “Money Market” in Morningstar although their “Investment Type” is “Open-End”.

Sources:

[1] Morningstar Direct.

[2] St. Louis Fed FRED Database.

Exhibit 2

Nothing But the Facts: FSB-IOSCO Proposal for SIFI Designation

The Financial Stability Board ("**FSB**") is an international group of regulators from the G-20 nations that monitors and makes recommendations to the G-20 about the global financial system. The U.S. has three representatives on the FSB: the Chair of the Securities and Exchange Commission, the Undersecretary for International Affairs from the Department of the Treasury, and a Governor of the Federal Reserve System. The FSB recently issued a proposal with the International Organization of Securities Commissions ("**IOSCO**") that would implement a framework for designating certain non-bank non-insurers as global systemically important financial institutions ("**G-SIFIs**").[1]

This Nothing But the Facts statement by the Committee on Capital Markets Regulation focuses on the framework as it applies to asset managers. As proposed, the FSB-IOSCO materiality threshold for designation as a SIFI would be $1 trillion in assets under management ("**AUM**").[2] Based on the most recent publicly available data, there are 15 asset managers that meet this threshold. There are another 5 asset managers with over $800 billion in total AUM that could potentially be subject to designation if their AUM were to sufficiently increase.

However, the FSB proposal exempts asset managers that are affiliated with a bank or insurer that has either been designated as a global systemically important bank ("**G-SIB**") or a global systemically important insurer ("**G-SII**"), as these asset managers are already subject to a G-SIB or G-SII framework on a consolidated basis.[3]

We find that each of the 6 foreign-based managers with AUM over $1 trillion are affiliated with a G-SIB or G-SII and are therefore exempt from the proposal. However, there are 7 U.S. asset managers with assets over $800 billion that are *not* affiliated with a G-SIB or G-SII (highlighted in the below chart). The result is that G-SIFI designations for asset managers would only apply to U.S. institutions, raising the question as to whether this should be a matter for only U.S. regulators rather than for the FSB.

The Financial Stability Oversight Council has indicated that, instead of designating individual asset managers as systemically important, they may adopt a products and activities-based approach to identify and address risks related to the asset management industry as a whole. However, the FSB has exempted sovereign wealth funds and pension funds from their proposal;[4] this raises the question of whether exempting these investors is inconsistent with U.S. regulatory efforts to address the risks posed by products and services that might be used by these investors.

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[1] FSB-IOSCO Consultative Document (2nd) *Assessment Methodologies for Non-Bank Non-Insure Global Systemically Important Financial Institutions*, 4 March 2015.
[2] FSB-IOSCO Consultation at 51.
[3] FSB-IOSCO Consultation at 10.
[4] FSB-IOSCO Consultation at 5.

Rank	Manager	Nationality	Assets ($ millions)
1	**BlackRock**	**US**	**$4,651,895**
2	**Vanguard Group**	**US**	**$3,000,000**
3	State Street Global	US	$2,448,000
4	**Fidelity Investments**	**US**	**$1,980,000**
5	Allianz Global Investors	Germany	$1,952,462
6	J.P. Morgan Chase	US	$1,744,000
7	BNP Paribas	France	$1,717,000
8	Bank of New York Mellon	US	$1,710,000
9	AXA Group	France	$1,383,780
10	**Capital Group**	**US**	**$1,366,084**
11	Deutsche Bank	Germany	$1,260,000
12	Goldman Sachs Group	US	$1,180,000
13	Prudential Financial	US	$1,180,000
14	Amundi	France	$1,100,000
15	UBS	Switzerland	$1,032,000
16	HSBC Holdings	UK	$954,000
17	**Northern Trust Asset Management**	**US**	**$934,000**
18	**Wellington Management**	**US**	**$892,000**
19	Natixis Global Asset Management	France	$890,000
20	**Franklin Templeton**	**US**	**$880,100**

* * *

Founded in 2006, the Committee on Capital Markets Regulation is dedicated to enhancing the competitiveness of U.S. capital markets and ensuring the stability of the U.S. financial system. Our membership includes thirty-seven leaders drawn from the finance, investment, business, law, accounting, and academic communities. The Committee is chaired jointly by R. Glenn Hubbard (Dean, Columbia Business School) and John L. Thornton (Chairman, The Brookings Institution) and directed by Hal S. Scott (Nomura Professor and Director of the Program on International Financial Systems, Harvard Law School). The Committee is an independent and nonpartisan 501(c)(3) research organization, financed by contributions from individuals, foundations, and corporations.

Exhibit 3
Count of Funds Above Selected AUM Thresholds

AUM Rank	Fund Name	AUM as of 12/31/2014 (USD millions)	Number of Funds above the AUM
Emerging Market Funds			
3	American Funds New World Fund	$ 23,045	102
5	DFA Emerging Markets Core Equity Fund	$ 15,122	164
10	Virtus Emerging Markets Opportunities Fd	$ 8,558	339
High Yield Bond Funds			
3	BlackRock High Yield Bond Portfolio	$ 14,837	169
5	Fidelity® Capital and Income Fund	$ 10,388	264
10	Lord Abbett Bond Debenture Fund	$ 9,085	317

Notes:

[1] Funds listed above are the 3rd, 5th, and 10th largest funds as of December 31, 2014 in their respective categories.

[2] Dataset includes all managed investments from Morningstar, with the following restrictions:

[a] Fund domicile is the United States and base currency is US Dollars (includes funds of foreign asset managers that are registered with the US SEC).

[b] Investment Type is listed as open-end, closed-end or exchange-traded fund. Funds of funds and index funds within these types are included.

[c] Money market funds, variable annuity and variable life share classes of the funds, and funds only available in 529 plans are excluded.

[3] Number of Funds above the AUM column indicates the count of all funds, regardless of Morningstar category, that are larger than or equal to the threshold fund in size.

Source:

Morningstar.

EXHIBIT 4

Existing Regulation of U.S. Mutual Funds

Leverage / Asset Coverage Ratio	• Mutual funds have a 300% asset coverage ratio (1.5-to-1 maximum asset-to-equity leverage ratio).[1] • Unlike banks, which are not required to address leverage on an entity-by-entity basis, each mutual fund managed by a common manager is separately required to abide by this asset coverage ratio.
Liquidity	• Mutual fund portfolios must be composed of at least 85% liquid securities.[2] This represents 20x the highest average monthly net outflows at times of market stress.[3] • Mutual funds' assets are typically highly liquid, marked-to-market daily and have detailed public disclosure. • Unlike banks that promise to repay the full amount of each customer's deposits on hand, mutual funds promise to redeem only the current value of a shareholder's investment in the fund, based on the fund's NAV.[4]
Valuation	• Mutual fund investors are able to redeem their shares daily, based on the current market value of the fund's portfolio securities. Daily pricing, using well regulated pricing mechanics, assures investors that they will receive an accurate NAV for their shares. • SEC rules require that all shareholder transactions be processed at the NAV next determined after a purchase or redemption order is received, typically at the end of that business day (*i.e.*, at 4 pm when the NYSE closes for the day).[5] • The valuation of fund assets and pricing of fund shares are monitored and evaluated regularly, including oversight by the mutual fund boards and their independent trustees, and are subject to inspection and examination by the SEC as well.

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1 15 U.S.C. § 80a-18(f)(1). In addition, the SEC also limits the degree to which funds can employ synthetic forms of leverage through, for example, derivatives transactions. *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. IC-10666, 44 Fed. Reg. 25,128 (Apr. 27, 1979). Funds with synthetic leverage must fully cover their obligations under the products creating the leverage with liquid assets in a segregated account or through offsetting transactions. *See* Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, 76 Fed. Reg. 55237, 55242-44 (2011).

2 Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (1992).

3 4/7/14 ICI-FSB Ltr. at F4-F13.

4 Additionally, mutual funds can delay payment of proceeds for up to seven days if making immediate payment would adversely affect the fund. Investment Company Act § 22(e), 15 U.S.C. § 80a-22(e).

5 *See* 17 C.F.R. § 270.22c-1.

Transparency / Disclosure	• The cornerstone of the disclosure regime for mutual funds is the prospectus. In it, a mutual fund must disclose its investment objectives, strategies, risks, fees and policies (including as to borrowing and concentration).[6] • A mutual fund must also disclose all of its holdings on a quarterly basis,[7] and calculate the fair value of all of its assets on a daily basis.[8] • Open-end mutual funds issue only equity and are prohibited from issuing senior securities, except for in the case of borrowings from banks which are subject to strict conditions.[9]
Prohibition on Transactions with Affiliates	• Mutual funds are subject to strict rules against self-dealing. For example, they are prohibited from engaging in certain transactions involving their "affiliated persons."[10] • "Affiliated persons" include any person owning 5% or more of the mutual fund's voting securities, any person in which the mutual fund owns 5% or more of the voting securities, and any person directly or indirectly controlling, controlled by or under common control with the mutual fund.[11] • Federal Reserve member banks are similarly restricted from entering certain covered transactions with "affiliates."[12] In the banking context, however, "affiliates" are defined using a 25% ownership threshold, rather than a 5% threshold.[13]
Custody	• Unlike a bank, mutual funds' assets generally must be held in custody by a U.S. bank, foreign sub-custodian or securities depository.[14] This prevents an investment adviser or affiliate from seizing, abusing or commingling fund assets.
Examination Regime	• In addition to periodic examinations[15] of individual companies, the SEC initiates robust examinations of products and services when it discovers potential issues.[16]

6 15 U.S.C. § 80a-8(b)(1)-(3); SEC Form N-1A, Items 2, 4, 9, 16.
7 17 C.F.R. §§ 270.30b1-1, 270.30b1-5.
8 17 C.F.R. § 270.22c-1.
9 *See* 15 U.S.C. § 80a-18(f)-(g).
10 15 U.S.C. § 80a-17(a).
11 15 U.S.C. § 80a-2(a)(3).
12 12 U.S.C. § 371c(a)(1).
13 12 U.S.C. § 371c(b)(1)(A) and (b)(3)(A)(i).
14 Investment Company Act § 17(f), 15 U.S.C. § 80a-17(f).
15 For an overview of the regular examination process, see Securities & Exchange Comm'n, *Examinations by the Securities and Exchange Commission's Office of Compliance Inspections and Examinations*, 15-30 (Feb. 2012), *available at* https://www.sec.gov/about/offices/ocie/ocieoverview.pdf.
16 For example, there has been substantial enforcement activity and reforms by the SEC regarding mutual fund pricing practices and disclosures in the last decade. *See e.g.*, Sec. & Exch. Comm'n, Final Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22,300 (Apr. 23, 2004); Sec. & Exch. Comm'n, Final Rule: Disclosure of Breakpoint Discounts by Mutual Funds; 69 Fed. Reg. 33,262 (June 14, 2004); *see also* Press Release, Sec. & Exch. Comm'n, *Putnam Agrees to Pay $55 Million to Resolve SEC Enforcement Action Related to Market Timing by Portfolio Managers* (Apr. 8, 2004); Press Release, Sec. & Exch. Comm'n, *Prudential to Pay $600 Million in Global Settlement of Fraud Charges in Connection With Deceptive Market Timing of Mutual Funds* (Aug. 28, 2006).

Exhibit 5
Change in Asset Share Rankings of the Largest Mutual Funds in 2004
2004 Compared to 2009 and 2014

	2004			2009			2014		
Fund Name	**AUM (USD Millions)**	**Asset Share**	**Rank**	**AUM (USD Millions)**	**Asset Share**	**Rank**	**AUM (USD Millions)**	**Asset Share**	**Rank**
Vanguard Five Hundred Index Fund[5]	$ 106,579	1.9%	1	$ 93,283	1.3%	5	$ 198,712	1.6%	2
American Funds Growth Fund of Amer	$ 95,266	1.7%	2	$ 156,151	2.2%	2	$ 142,631	1.1%	5
PIMCO Total Return Fund	$ 78,773	1.4%	3	$ 201,742	2.8%	1	$ 143,358	1.1%	4
American Funds Washington Mutual Fund	$ 75,870	1.4%	4	$ 50,214	0.7%	14	$ 77,000	0.6%	18
American Funds Invmt Co of Amer	$ 75,867	1.4%	5	$ 61,581	0.9%	12	$ 75,474	0.6%	19
Fidelity® Magellan® Fund	$ 63,296	1.1%	6	$ 24,830	0.3%	38	$ 16,582	0.1%	118
Vanguard Total Stock Market Index Fund[5]	$ 57,014	1.0%	7	$ 115,256	1.6%	3	$ 383,003	3.0%	1
American Funds Income Fund of Amer	$ 53,576	1.0%	8	$ 65,027	0.9%	9	$ 96,829	0.8%	10
American Funds Europacific Growth Fd	$ 51,644	0.9%	9	$ 100,052	1.4%	4	$ 120,868	1.0%	8
Vanguard Institutional Index Fund	$ 48,483	0.9%	10	$ 69,168	1.0%	8	$ 187,725	1.5%	3
American Funds American Balanced Fund	$ 44,974	0.8%	11	$ 47,875	0.7%	15	$ 79,664	0.6%	17
Fidelity® Contrafund® Fund	$ 44,484	0.8%	12	$ 63,892	0.9%	10	$ 109,845	0.9%	9
Dodge & Cox Stock Fund	$ 43,266	0.8%	13	$ 39,986	0.6%	19	$ 60,260	0.5%	24
American Funds Capital Income Bldr	$ 41,889	0.7%	14	$ 79,510	1.1%	7	$ 96,656	0.8%	11
American Funds New Perspective Fund	$ 39,767	0.7%	15	$ 43,727	0.6%	18	$ 56,600	0.4%	26
Fidelity® Low-Priced Stock Fund	$ 35,976	0.6%	16	$ 27,689	0.4%	31	$ 46,293	0.4%	36
Vanguard Windsor™ II Fund	$ 34,570	0.6%	17	$ 34,895	0.5%	25	$ 50,557	0.4%	31
Vanguard Wellington™	$ 33,930	0.6%	18	$ 47,742	0.7%	16	$ 88,753	0.7%	14
American Funds Capital World Gr&Inc Fd	$ 33,223	0.6%	19	$ 81,954	1.1%	6	$ 86,333	0.7%	15
Fidelity® Growth & Income Portfolio	$ 32,106	0.6%	20	$ 6,501	0.1%	182	$ 7,679	0.1%	292

Notes:

[1] AUM data are as of December 31st of the year indicated.

[2] Dataset comprises the open-end mutual funds in the Morningstar database, with the following restrictions:

[a] Fund domicile is the United States and base currency is US Dollars (includes funds of foreign asset managers that are registered with the US SEC).

[b] Funds of funds, variable annuity and variable life share classes of the funds, and funds only available in 529 plans are excluded.

[3] Asset share is calculated as the fund's assets under management as a percentage of the total assets under management in the dataset in the given year.

[4] The fund assignments are based on current available data. Therefore, the figures above include the effects of mergers.

[5] Vanguard Five Hundred Index Fund and Vanguard Total Stock Market Index Fund have an ETF share class along with their open-end share classes.

Source:

Morningstar Direct.

Exhibit 6
G-SIB Size Estimates as of December 31, 2014

Global Systemically Important Banks	AUM Comparable (USD Millions)
HSBC	$ 3,253,453
JP Morgan Chase	$ 3,743,466
Barclays	$ 2,354,280
BNP Paribas	$ 2,726,056
Citigroup	$ 2,766,227
Deutsche Bank	$ 1,977,158
Bank of America	$ 2,810,246
Credit Suisse	$ 1,320,604
Goldman Sachs	$ 1,484,013
Mitsubishi UFJ FG[3a]	$ 3,420,792
Morgan Stanley	$ 1,281,235
Royal Bank of Scotland	$ 1,711,516
Agricultural Bank of China	-
Bank of China	-
Bank of New York Mellon	$ 418,632
BBVA	$ 875,104
Groupe BPCE	$ 1,617,420
Group Crédit Agricole	$ 2,085,010
Industrial and Commercial Bank of China Limited	-
ING Bank	$ 1,408,379
Mizuho FG	-
Nordea	$ 792,029
Santander[3b]	$ 1,900,272
Société Générale	$ 1,705,271
Standard Chartered[3b]	$ 805,067
State Street	$ 292,212
Sumitomo Mitsui FG	-
UBS	$ 982,850
Unicredit Group	$ 1,251,753
Wells Fargo	$ 2,191,752
Total AUM Comparable of G-SIBs	**$ 45,174,793**

Notes:

[1] The AUM comparable for Global Systemically Important Banks is the size indicator defined by the Basel Committee on Banking Supervision: "Total exposures as defined for use in the Basel III leverage ratio". See Source [1].

[2] For US Banks, total exposure data are from Banking Organization Systemic Risk Reports, FR Y-15. For Non-US banks, total exposure data are from Global Systemically Risky Financial Institution Quantitative Indicator Data disclosures. Exchange rates as listed in St. Louis Fed's FRED database are used to convert values listed in local currency to US Dollars.

[a] Data were not found for Agricultural Bank of China, Bank of China, Industrial and Commercial Bank of China Limited, Mizuho FG, and Sumitomo Mitsui FG.

[3] AUM Comparable data are as of December 31, 2014, except for the following companies:

[a] Mitsubishi UFJ FG data are from March 31, 2014.

[b] Santander and Standard Chartered data are from December 31, 2013.

Sources:

[1] Basel Committee on Banking Supervision. "Global Systemically Important Banks: updated assessment methodology and the higher loss absorbency requirement". July 3, 2013. <http://www.bis.org/publ/bcbs255.pdf>

[2] Banking Organization Systemic Risk Reports, FR Y-15.

[3] Company Global Systemically Risky Financial Institution Quantitative Indicator Data disclosures.

[4] St. Louis Fed FRED Database.

Exhibit 7

Survival Rate of U.S. Mutual Fund Asset Managers
2004-2014

Asset Manager Size Decile in 2004	Percentage of Decile that Survived to 2014	Percentage of Decile that Did Not Survive to 2014	Percentage of Surviving Asset Managers in 2014 Size Deciles (Largest) 10	9	8	7	6	5	4	3	2	(Smallest) 1
(Largest)												
10	98.3%	1.7%	83.1%	15.3%	1.7%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%	0.0%
9	91.5%	8.5%	18.5%	50.0%	20.4%	7.4%	0.0%	3.7%	0.0%	0.0%	0.0%	0.0%
8	83.3%	16.7%	4.0%	14.0%	36.0%	26.0%	10.0%	8.0%	0.0%	2.0%	0.0%	0.0%
7	71.2%	28.8%	0.0%	23.8%	4.8%	33.3%	19.0%	11.9%	7.1%	0.0%	0.0%	0.0%
6	61.7%	38.3%	0.0%	5.4%	16.2%	24.3%	24.3%	10.8%	13.5%	5.4%	0.0%	0.0%
5	61.0%	39.0%	0.0%	2.8%	2.8%	11.1%	19.4%	19.4%	30.6%	13.9%	0.0%	0.0%
4	45.0%	55.0%	0.0%	0.0%	3.7%	3.7%	7.4%	14.8%	33.3%	18.5%	14.8%	3.7%
3	52.5%	47.5%	0.0%	3.2%	0.0%	0.0%	6.5%	12.9%	16.1%	32.3%	22.6%	6.5%
2	36.7%	63.3%	0.0%	0.0%	4.5%	0.0%	0.0%	0.0%	31.8%	18.2%	9.1%	36.4%
1	40.7%	59.3%	0.0%	0.0%	0.0%	12.5%	8.3%	0.0%	20.8%	12.5%	29.2%	16.7%
(Smallest)												
Average	64.2%	35.8%										

Notes:

[1] Asset Manager Size Deciles are created by grouping asset managers by total AUM. Decile 10 is the largest, representing the largest 10% of asset managers. Decile 9 is the second largest, representing the 10^{th} to 20^{th} percentile of asset managers by AUM. Decile 8 is the third largest, representing the 20^{th} to 30^{th} percentile of asset managers by AUM. Ranking goes on proportionately; hence the smallest decile, Decile 1, represents the 90^{th} to 100^{th} percentile of asset managers by AUM, which is equivalent to the smallest 10%.

[2] Data are from Lipper, as of December 31st of the year indicated. The dataset:

[a] Includes mutual funds domiciled in the United States with base currency as US Dollars.

[b] Excludes closed-end funds, funds of funds, hub and spoke funds, money market funds, funds with variable annuities, and funds only available in 529 plans.

[3] Deciles for 2014 are 2004 size buckets adjusted for the market using the S&P 500 Index.

Source:

Lipper for Investment Management.

APPENDIX A

April 7, 2014 Letter from Scott C. Goebel, Senior Vice President & General Counsel, Fidelity Management & Research Company to the Financial Stability Board

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April 7, 2014

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

Submitted via e-mail to: fsb@bis.org

Re: Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Fidelity Management & Research Company[1] ("Fidelity") appreciates the opportunity to comment on the Consultative Document "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (the "Proposal"), published by the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO") on January 8, 2014.[2]

We applaud the FSB and IOSCO for recognizing many of the key attributes of investment funds and their managers. They correctly observe that the risk profile of an investment fund is distinct from that of its manager and from other funds because assets belong to the fund, not the manager.[3] They also recognize that investors own those assets and easily move them from one fund to another.[4] These and other attributes make funds and their managers fundamentally different from other entities that the FSB has designated "SIFIs," such as banks.[5]

Perhaps most importantly, in contrast to banks, investment funds are not financed primarily with debt. Most funds employ little or no leverage and are essentially 100% equity capital. Such funds cannot become insolvent and thereby disrupt the financial system by transmitting losses to their creditors. Instead, unlike banks, the substantial equity capital absorbs any declines in the value of the fund's portfolio of assets.[6]

Regulators are extremely unlikely to find an investment fund that meets the criteria necessary to be a SIFI. Further, even if a fund could present that kind of risk to the global financial system, designating that fund would not effectively mitigate that risk. Therefore, we applaud the FSB and IOSCO for asking whether a focus on activities may be superior to entity-by-entity SIFI designation. While this would be a fundamental change from the approach for assessing risk in banks and insurers, we believe the

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[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.
[2] FSB and IOSCO, "Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies," Jan. 8, 2014 [hereinafter *Proposal*].
[3] *Id.* at 30 (explaining that "other considerations further distinguish the risk profile of a fund from that of a fund manager").
[4] *Id.*
[5] *See*, *e.g.*, *id.* at 3, 29.
[6] *Id.* at 29.

substantial differences between those businesses and asset management require a different approach. We urge the FSB and IOSCO to refocus their efforts on identifying activities that could create systemic risk and publish a new methodology for comment.

If, however, they proceed with the methodology as currently envisioned, we urge them to consider that:

- The SIFI assessment process must be designed to identify only those entities (i) that can fail and (ii) whose failure would disrupt the global financial system.
- Funds without leverage or significant fixed obligations cannot fail.
- If the FSB and IOSCO are determined to produce a factor-based framework, the framework should be designed to account for the following:
    - Analysis of investment funds is more appropriate than focusing on asset managers or groups of entities, such as funds and their managers or families of funds;
    - The $100 billion threshold for size is arbitrary and will produce both false positives and false negatives;
    - Size alone is not indicative of potential systemic risk;
    - Leverage should be a materiality threshold and separate impact factor rather than merely an indicator of interconnectedness; and
    - Existing regulatory scrutiny should be considered expressly within the framework.
- Designation of a small subset of investment funds will be ineffective in mitigating any systemic risk, given the high level of substitutability and competition in the industry.
- Focus should shift from individual entities to activities conducted by funds and other market participants; and any identified risks should be addressed by targeted regulations that apply broadly to anyone engaged in a given activity.

Fidelity continues to believe that investment funds and their managers do not present the types and the scale of risk that SIFI designation was intended to address. We further believe that the proposed methodology to identify investment funds as potential non-bank non-insurance ("NBNI") SIFIs is flawed and should be abandoned in favor of an approach focused on activities rather than entities. In Part One of this letter, we provide a narrative discussion of our positions. In Part Two, we respond directly to selected questions in the Proposal.

Part One

Before answering selected questions individually, we provide supporting detail on the points outlined above.

Funds do not present the necessary indicators of systemic importance

The FSB defines a "SIFI" as an individual company that has a certain combination of characteristics, such as size, market importance (measured by substitutability), and interconnectedness, such that its failure would disrupt the global financial system and adversely impact the global economy.[7] For purposes of the SIFI designation analysis and this letter, 'failure' equals financial losses that lead (or could lead) to insolvency. A company is insolvent when its liabilities exceed its assets or it is unable to meet its obligations when due. Policy measures endorsed by the FSB and the G-20 leaders, such as the "FSB SIFI Framework"[8] that underlies all SIFI assessment methodologies, are based upon this concept of failure. The stated objective of the FSB SIFI Framework is to "address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as TBTF," i.e., too big to fail.[9]

Thus, in order for a company to be a SIFI, two conditions must be present: (i) it must be able to fail *and* (ii) its failure must significantly disrupt the global financial system and global economic activity. (Henceforth, the phrase "Systemically Important" means that both conditions are present.)

The Proposal accurately describes many of the key functions and attributes of investment funds and their managers, but it fails to acknowledge that most funds have little or no leverage. Without excessive leverage or fixed obligations that represent a substantial portion of its assets (as in the case of a pension fund, for example), an investment fund simply cannot fail and thus cannot be a SIFI. Unleveraged funds are 100% equity capital, which means that the capital absorbs any declines in the value of the fund's portfolio of assets.

Even if a particular fund could fail, such fund would be unlikely to disrupt the global financial system. As the Proposal recognizes, investment funds are highly substitutable and, thus, if a fund were to fail, it would not disrupt financial markets by depriving clients of essential or irreplaceable services. In fact, the Proposal recognizes that funds open and close regularly with "negligible or no market impact."[10] Further, in the absence of excessive leverage, one fund's distress will have minimal impact on others in the financial system. The largest individual investment funds use little or no leverage and are too small to be relevant to the global financial system. In fact, they are a small fraction of the size of G-SIFI banks ("G-SIBs"). At year-end 2013, the largest U.S. mutual fund had $307 billion in assets and the tenth largest had $114 billion.[11] By comparison, as of September 30, 2013, the largest G-SIB had $3.1 *trillion* and the tenth largest had almost $2.3 *trillion*.[12]

SIFI designation would be ineffective

Even if a fund were to pose a risk to the global financial system, SIFI designation would not be an effective regulatory response. Although the Proposal does not specify the regulations that would apply if a fund were designated, by its nature SIFI designation would result in different treatment of individual investment funds. It would subject those designated funds to added costs, restrictions, uncertainty and

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[7] *Id.* at 2
[8] FSB, "Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines," Oct. 20, 2010, *available at* http://www.financialstabilityboard.org/publications/r_101111a.pdf.
[9] FSB, "Progress and Next Steps Toward Ending 'Too-Big-To-Fail': Report of the Financial Stability Board to the G-20," Sept. 2, 2013, at 7, *available at* https://www.financialstabilityboard.org/publications/r_130902.pdf (discussing the objectives of the FSB SIFI Framework).
[10] *Proposal*, *supra* note 2, at 30.
[11] Strategic Insight Simfund/MF Desktop.
[12] Maria Tor and Saad Sarfraz, "Largest 100 Banks in the World," SNL (Dec. 23, 2013), http://www.snl.com/InteractiveX/article.aspx?cdid=A-26316576-11566&TabStates=0.

other regulatory burdens that most or all of their competitors would not face, which in turn would lead capital to shift away from the designated funds to less regulated entities.

Fund investors are highly sensitive to fees and performance. If a fund were designated a SIFI, its ability to pursue its investment strategy effectively and at competitive fee levels would be diminished. As a result, investors in a designated fund could (and likely would) simply move their assets to another undesignated fund employing a similar management strategy without the uncertainty and costs of designation, thereby shifting elsewhere the risks that led to the initial designation decision.

An annual process to evaluate and designate individual investment funds will inevitably put regulators in a position of chasing, and failing to catch, individuals and assets as they move among funds and markets. Not only would this process fail to achieve its desired objectives, designation would likely be destructive and distort markets.

Focus on market activities, not entities

The proposed methodology would analyze a few large funds to determine whether they are Systemically Important. This analysis would present an incomplete picture of the industry, and would likely fail to identify any systemic risk in asset management and the capital markets. For example, it would not identify any risk that may be created by, and shift among, a large number of smaller funds and other market participants.

We believe, therefore, that analysis and regulation focused on activities will be the only effective means for the FSB and IOSCO to identify and mitigate any systemic risk associated with asset management. Such an approach has been employed to mitigate other market risk issues. In the derivatives markets, for example, regulators did not simply apply restrictions to a few large market participants; rather, they imposed broadly applicable structural reforms, such as central clearing and minimum margin requirements, on all participants trading derivatives.[13]

Targeting regulations to identified risks arising from activities on an industry- or market-wide basis has been used effectively by regulators for many years. For example, this structure is used in the U.S. to regulate mutual funds, their managers and other investment vehicles.[14] Similar structures are in place in other jurisdictions, such as the regulations governing Canadian mutual funds and UCITS in the European Union.[15] Although we continue to believe that investment funds and their managers do not threaten global financial stability, if the FSB and IOSCO or any of their members believe there are risks

[13] *See generally* Wall Street Transparency and Accountability Act of 2010, Pub. Law 111-203, 124 Stat. 1376, 1641-1802; Regulation 648/2012, of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories, 2012 O.J. (L201) (commonly referred to as the European Markets Infrastructure Regulation or "EMIR").
[14] *See generally* Investment Company Act of 1940, 15 U.S.C §§ 80a-1-80a-64; Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1-80b-21.
[15] In Canada, mutual funds are subject to securities laws of the various provinces, as well as to national rules. *See*, National Instrument 81-102. In the European Union, several directives and regulations apply to UCITS. *See, e.g.*, Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), 2009 O.J. (L302), 32; Directive 2009/111/EC of the European parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards Banks Affiliated to Central Institutions, Certain Own Funds Items, large Exposures, Supervisory Arrangements, and Crisis Management, 2009 O.J. (L302), 97; and Regulation No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, 2009 O.J. (L302), 1.

that must be addressed, any further steps should be carefully considered and applied broadly through the robust regulatory regimes already in place.

Objective, Rigorous, Consistent and Transparent

Regardless of whether the FSB and IOSCO refocus their efforts on activities or decide to proceed with an entity-specific methodology, we request that they revise the methodology to reflect standards that are objective, rigorous, consistent and transparent, and publish those revisions for additional consultation.

1. Regulatory discretion

The current Proposal relies too heavily on regulatory discretion and provides too little information about the designation criteria. As a result, in its current form, the methodology will not deliver one of the fundamental benefits that it should: the reduction of risk in the market without SIFI designation.

Sufficient clarity regarding how regulators will determine whether an investment fund is a SIFI and the consequences of that designation would allow investors and asset managers to evaluate the costs and benefits of engaging in higher-risk activities. A clear, transparent methodology would serve as a deterrent and prompt many to reduce their risk profiles, thereby reducing risk in the system more effectively than individual SIFI designations could.

The Proposal, however, provides too little information to market participants and to regulators. Rather than providing objective criteria supported by rigorous economic analysis and models, the FSB and IOSCO seem to endorse a 'know it when you see it' approach that invites "a substantial amount of regulatory discretion" and "can also lead to bad government policy."[16] As the Nobel laureate Lars Peter Hansen observes, the discipline that comes from rigorous models and methods is critical both to advance the general understanding of these issues and because it could produce useful measurements of systemic risk to help counter the "temptation [of regulators] to respond to political pressures," which will be difficult to resist without rigorous support.[17] The absence of rigorous models and analysis supporting the Proposal raises serious concerns for the SIFI designation process and future international financial regulation.

In point of fact, the methodology for investment funds appears to be based only on an unsupported $100 billion materiality threshold and regulatory discretion. The Proposal contains no economic models, meaningful numerical metrics or supporting data. The absence of data is striking because much is available to the FSB, IOSCO and their members individually, and the Proposal emphasizes both its importance and the difficulty of attempting to conduct any analysis without it.[18]

We request, therefore, that the FSB and IOSCO analyze available data as they revise their methodology. If key data are unavailable, the appropriate conclusion is that regulators need to collect additional data in order to proceed, not that this unavailability somehow justifies proceeding based solely on regulatory discretion as the Proposal suggests.[19] We also request that the FSB and IOSCO publish and

[16] Lars Peter Hansen, "Challenges in Identifying and Measuring Systemic Risk," (Feb. 11, 2013), at 2, *available at* http://www.nber.org/chapters/c12507.pdf.
[17] *Id*.
[18] *See, e.g.*, *Proposal*, *supra* note 2, at 5-6.
[19] *Id*. at 6.

request comment on a revised methodology that includes, among other things, numerical metrics for impact factors, along with empirical analysis showing that they are indicative of systemic risk.

2. Additional information needed

We do not believe that the FSB and IOSCO have described with sufficient precision the system they hope to protect, the potential harm they seek to prevent, or their methods of measuring either. Thus, Fidelity requests that the FSB and IOSCO define and publish for comment key concepts, provide data and models to support the definitions, and describe their methods for measurement. For example, the Proposal does not define 'significant disruption', 'global financial system' or 'economic activity.' Clear definitions of these concepts are required in order for this methodology to be objective, rigorous, consistent and transparent.

3. Consequences

The Proposal also contains no discussion of the consequences of NBNI SIFI designation. In order for the models and explanations requested above to be effective, they must account for the consequences of designation. We are quite concerned that the unintended consequences of designation could significantly harm individual companies, their customers, financial markets and the global economy. Shareholders have invested $13 trillion in over 8,000 mutual funds in the U.S. alone.[20] These funds provide a means for over 90 million individuals to save for long-term goals such as buying a home, paying for college and funding retirement. In doing so, they provide long-term financing to businesses and governments and help drive economic growth. The stakes are too high to proceed without the necessary data, analysis and transparency. Consequently, we believe that the FSB and IOSCO must:

- Create and publish for comment a more objective, consistent, rigorous and transparent methodology;
- Explain how and why any designation would effectively reduce systemic risk;
- Carefully and transparently consider other regulatory options that may be lower risk, more effective, and more efficient before making a designation; and
- Rigorously examine the actual impacts of any designation.

Part Two

Q6-2 - Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

We support much of the discussion in Section 6.2 of the Proposal. The discussion is incomplete, however, because it does not acknowledge that many funds simply cannot fail. In order for an entity to be Systemically Important, two conditions must be present: (i) it must be able to fail and (ii) its failure must significantly disrupt the global financial system and global economic activity. As we explain below, investment funds can only meet the first condition if they employ excessive leverage or have fixed

[20] *See* Investment Company Institute, "2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry" (2013), at 2, 18, *available at* http://www.ici.org/pdf/2013_factbook.pdf.

obligations that represent a substantial percentage of their assets. Most funds have neither. Further, several characteristics make it unlikely that a fund could meet the second condition, even if it met the first. As a result, many individual funds should not even be considered for SIFI designation as they are highly unlikely to create the type or scale of global systemic risk that this framework is intended to identify and address.

An Entity that Cannot Fail Cannot Be a SIFI

In order to be Systemically Important an entity must be able to fail. The ability to fail can be assumed in the G-SIFI assessment methodology designed for banks because banks do fail, and frequently.[21] All banks use leverage, as the business model of the entire industry is based on doing so. The susceptibility of banks to failure is inherent in the model because the liabilities of a bank with a leveraged balance sheet could easily exceed its assets and loss absorbing capital. The probability a particular bank will fail and the impact of that failure are functions of the degree of leverage it employs, among other factors.

Without excessive leverage or substantial fixed obligations, a fund cannot fail.[22] Most investment funds employ little or no leverage and a fund without leverage is 100% equity capital. This is a critical difference between investment funds and banks.

The G-SIFI frameworks, which are designed to address the potential impact of an entity's failure, are simply inapplicable to entities that cannot fail. Unfortunately, the FSB and IOSCO have endorsed an approach that ignores the probability of a company's failure and instead focuses solely on the impact of its failure.[23] That is controversial even for non-bank entities that can fail but rarely do, such as insurance companies. It is nonsensical for an investment fund with 100% equity capital that *cannot* fail.[24]

The Proposal also seems to equate runs in investment funds with bank runs and failures. The hypothesis appears to be that the problems of an individual asset manager or fund could prompt investors to behave in a way that disrupts the global financial system. Not only is this logically unsound, but the Proposal presents no data or verifiable economic models to support the claim.

The Proposal misperceives and overstates the risk of runs on funds. A run is primarily a banking concept that does not describe redemptions from funds. A bank's portfolio contains a high percentage of illiquid, hard-to-value assets, such as mortgages and commercial loans. A run on a bank occurs when

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[21] Between January 2008 and December 2012, 465 banking organizations in the United States failed. *See* Federal Deposit Insurance Corporation, "Failed Bank List," *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.

[22] As acknowledged in the Proposal, investment funds generally may decline in value through market losses and redemptions and may ultimately liquidate, but those liquidations "represent an ordinary phenomenon" and historically have not created a "systemic market impact." *See Proposal*, *supra* note 2, at 31 n.39, 30 n.38. Investment funds do not "fail" in the same way banks and bank holding companies do unless they employ considerable amounts of leverage. Certain stable NAV money market funds may face liquidity pressure but, like other investment funds, they do not become insolvent. Other collective vehicles, such as pension funds do have fixed obligations. If their assets are insufficient to meet those obligations, they can be said to have "failed," but their liabilities are not redeemable on demand.

[23] *See*, *e.g.*, *id.* at 2 n.7 ("The methodologies' emphasis is on identifying indicators that point to systemic impact on failure, rather than an institution's likelihood of failure").

[24] A quick aside about the consequences of designation clearly demonstrate the wrong-headedness of assuming that a fund composed of 100% equity can fail. Two of the primary consequences of SIFI designation are "higher loss absorbency capacity" (i.e., more capital) and resolution planning, both of which are intended to "reduce the probability and impact of their failure." A fund that is already 100% capital cannot add more capital, nor does it need additional resolution planning. *See* FSB, *supra* note 8.

depositors (or other short-term creditors) fear that the bank will be unable to pay them what they are owed. Driven by that fear and a low tolerance for losses, they demand repayment from the bank in sufficient numbers that the bank becomes illiquid and, ultimately insolvent.[25] Thus, the necessary ingredients for a run are: (i) substantial redeemable debt or fixed obligations, (ii) low tolerance for loss among creditors or holders of those fixed obligations, (iii) the potential inability to pay that debt or meet those obligations, and (iv) the absence of an effective mechanism to mitigate that risk.

U.S. mutual funds, on the other hand, lack the necessary ingredients for a run. These funds typically have little or no debt and are subject to strict limits on their ability to employ leverage. These limits, such as the 300% asset coverage requirement in the Investment Company Act of 1940,[26] are much tighter than the leverage limits that apply to banks, including the designated G-SIBs.[27] As a result, even though the value of a mutual fund's assets may decline, it is highly unlikely that the value of a fund's equity will be wiped out either by its creditors or market losses.

We agree with the statement in the Proposal that, "from a purely systemic perspective, funds contain a specific 'shock absorber' feature that differentiates them from banks," which mitigates any potential "contagion effects in the broader financial system" by distributing any losses broadly to investors.[28] We manage our customers' money in an attempt to maximize the returns on their investments within the bounds of the relevant investment mandate but, as we discuss in more detail in our response to Q6-4, the risk of loss is prominently disclosed and is accepted by investors. Investors may lose money, but a loss creates no solvency risk for a fund without debt or substantial fixed obligations.[29]

Mutual funds also allow daily redemptions and, in support of that ability, are required to maintain at least 85% of their portfolios in liquid assets.[30] Funds also have a variety of liquidity management tools available to manage redemptions, as the Proposal acknowledges.[31] Further, most have variable share prices and mark the values of their underlying assets to market daily, such that redeeming investors receive the current market value of their investments.[32]

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[25] Those consequences help explain the FSB SIFI Framework and the creation of the federal safety net for banks in the U.S., including deposit insurance and Federal Reserve liquidity support.

[26] 15 U.S.C. § 80a-18(f)(1).

[27] *See* Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirements," Jan. 2014, *available a*t http://www.bis.org/publ/bcbs270.htm. This framework stipulates that banking organizations must maintain a minimum 3% leverage ratio, calculated by dividing an organization's Tier 1 Capital, as defined by the Basel III capital framework, *see* Basel Committee on Banking Supervision, "Basel III: A Global Framework for More Resilient Banks and Banking Systems," Dec. 2010, *available at* http://www.bis.org/publ/bcbs189.pdf, by all of the organization's on-balance sheet assets and certain off-balance sheet exposures. *See also Regulatory Capital Rules*, 78 Fed. Reg. 51101 (Aug. 20, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-08-20/pdf/2013-20143.pdf.

[28] *Proposal*, *supra* note 2, at 29.

[29] *See* note 22 above for a discussion of stable NAV money market funds.

[30] *See Revisions of Guidelines to Form N-1A*, Investment Company Act Release No. 18612, 57 Fed. Reg. 9828 (Mar. 12, 1992). Although the SEC has rescinded the Guidelines to Form N-1A, *see Registration Form used by Open-End Management Investment Companies*, Investment Company Act Release No. 23064, 63 Fed. Reg. 13916 (Mar. 13, 1998), the position taken in the Guidelines relating to liquidity continues to represent the staff's position. *See, e.g.*, "Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management," *available at* http://www.sec.gov/divisions/investment/icvaluation.htm. The SEC subjects money market funds to further liquidity restrictions, requiring them to hold at least 95% of their portfolio in liquid securities and comply with additional daily and weekly liquidity requirements in order to meet reasonably foreseeable redemption requests. *See* 17 C.F.R. § 270.2A-7(c)(5).

[31] *See Proposal*, *supra* note 2, at 30.

[32] In the case of certain U.S. money market funds, which some believe are more susceptible to runs than other funds, the SEC is considering proposals that would make money market funds more similar to other registered funds.

Our experiences with investor redemptions across a variety of funds and asset classes, during a variety of market conditions, show that mutual funds can handle heavy redemptions. Redemptions are part of the normal business cycle and cannot properly be called "runs." That is not to say that high redemptions in the face of falling asset prices cannot be painful for investors (and investment managers).[33] No matter the volume, however, redemptions do not result in failure in the absence of leverage or substantial fixed obligations and data do not support that they pose risks to the financial system.

Impact of Failure

Designation is intended to mitigate the damage that a single entity's failure could have on the financial system.[34] In the G-SIFI context, the FSB assesses the impact of an entity's failure from a combination of factors, including size, complexity, interconnectedness and substitutability.[35] FSB policy measures are focused on reducing both the probability and impact of an entity's failure so that the government is less likely to be put in a position where it feels obligated to bail the entity out.[36] The FSB has posited that the likelihood of a bail out could encourage an entity to take excessive risks.

Investment funds do not present the systemic or moral hazard risks that the FSB measures are intended to address. Section 6.2 of the Proposal correctly recognizes some, but not all, of the characteristics of investment funds and their managers that are "important aspects worth considering" because they reduce or prevent any "global systemic impact" if a fund were to fail.[37] These characteristics include, among others: (i) a 'shock absorber' feature (in that losses are distributed broadly to equity investors who accept the risk of loss rather than concentrated in creditors or counterparties with less tolerance for loss) and an absence of government support that differentiate funds from banks, (ii) a high degree of substitutability; (iii) high mobility of investment fund assets, (iv) effective liquidity management tools, and (v) legal, regulatory and economic separations among funds and managers that insulate each from the other.[38] We discuss a number of these factors in greater detail above and in our responses to Q6-3 and Q6-4.

Although redemptions may ultimately lead a fund to close, we agree with the Proposal that such closures reflect investor preferences, are part of the normal business cycle, and have no systemic market impact. For example, Fidelity is currently in the process of liquidating a fund whose assets peaked in 2007. The fund, which was held by more than 30,000 retail and institutional accounts, has since suffered net outflows of more than 50%. We are liquidating the fund because we believe it offers limited growth potential given its history and ready substitutes. Shareholders will be able to exchange their shares into other Fidelity funds, redeem their shares, or remain in the fund until the liquidation, at which time they will receive the value of the shares they hold in cash.

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[33] Of course, for every security that a fund sells, there is a buyer who sees an investment opportunity and an effective transfer of the risk associated with that security from the selling fund to the buyer.
[34] *See, e.g.*, Basel Committee on Banking Supervision, "Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement," July 2013, at 2-3, *available at* http://www.bis.org/publ/bcbs255.pdf.
[35] *See, e.g.*, *id.* at 2; FSB, *supra* note 8, at 1.
[36] *See* FSB, *supra* note 8, at 2.
[37] *See Proposal*, *supra* note 2, at 30.
[38] *Id.* at 29-30.

Funds that experience heavy redemptions or liquidate actually achieve one of the FSB SIFI Framework's primary goals without the need for designation or a special resolution mechanism – they "resolve" themselves in an orderly fashion with no discernable market impact. Liquidation follows an orderly process with minimal impact on shareholders and no discernible impact on the markets. As the FSB and IOSCO acknowledge, "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the [2000-2012] observation period."[39] In fact, "liquidations and consequent closures of CIS entities… represent an ordinary phenomenon that results more from gradual changes in investor sentiment (with consequent outflows) than as a deterministic response to an external shock."[40]

A Consistent Standard

The Proposal conveys regulators' intention that the NBNI G-SIFI methodology be consistent with the G-SIFI methodologies for banks and insurers. This desire for consistency seems to be borne of a recognition that all of these entities are part of the same global financial system and must threaten it in substantially the same way in order to be Systemically Important. The methodologies have all been "specifically designed to focus on the distress and failure of institutions and the mechanisms by which risks may be transmitted from entity to entity." Under the FSB SIFI Framework, SIFIs must share essential characteristics (i.e., be able to fail and transmit risk) regardless of industry. [41]

Long-Term Capital Management ("LTCM"), a highly leveraged hedge fund not regulated under the Investment Company Act, and the Reserve Primary Fund, a money market fund registered under that act, are the two examples commonly cited in this context. These funds both possessed characteristics that differentiate them from most mutual funds. Those differences, including the use of excessive leverage and the characteristics of some U.S. prime, stable net asset value, money market funds before the SEC reforms in 2010, are instructive.[42] The dearth of funds whose demise can be said to have disrupted the financial system is even more instructive. When compared to the number and severity of banking crises that have occurred, the absence of fund-related crises or even notable fund failures demonstrates that asset management regulation is effective and that a SIFI assessment methodology for investment funds is a solution in search of a problem.

Unfortunately, the FSB and IOSCO appear to assume that investment funds are capable of failing and transmitting risk like other candidates for designation despite recognizing that fund risk profiles are vastly different.[43] For example, funds enjoy no government support that would create moral hazard risk and, as discussed above, liquidations have required no special government resolution mechanism. Section 6.2 is incomplete for failing to consider fully the implications on the Proposal of the fact that these differences largely preclude funds (and their managers) from causing "*significant disruption to the global financial system and economic activity across jurisdictions.*"[44]

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[39] *Id*. at 30 n.38.
[40] *Id*. at 31 n.39.
[41] *See id.* at 1-2, 1 n.5.
[42] We believe that the important lessons from these examples are: (i) excessive leverage can present systemic risk, (ii) the combination of characteristics of money market funds that differentiate them from other investment funds and warrant different regulation, and (iii) existing regulation of leverage and pending reforms regarding money market funds demonstrate the appropriate structural approach to regulating asset management.
[43] *See Proposal*, *supra* note 2, at 3, 29.
[44] *Id*. at 2.

<u>Q2-1</u> - Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

As we discussed in Part One of this letter, in order to be able to answer the first question in Q2-1, Fidelity believes that the FSB and IOSCO must first define and propose measures for the terms 'significant disruption', 'wider financial system' (or, as used elsewhere in the Proposal, 'global financial system') and 'economic activity.'

With respect to the second and third questions in Q2-1, Fidelity believes that excessive leverage should be a top level impact factor rather than just an indicator of interconnectedness. Fidelity agrees with the FSB and IOSCO that the failure or distress of a highly leveraged entity can cause harm to others in the broader financial system. We also believe that excessive leverage is itself a strong marker for the probability an entity will fail.

Fidelity also believes that existing regulatory scrutiny should be an impact factor. While we believe that there is no theoretical or empirical support for SIFI designation in the asset management sector broadly, we are confident that the comprehensive body of regulations that already governs U.S. mutual funds prevents them from being Systemically Important. These regulations effectively mitigate many of risks that concern the FSB, BIS, IOSCO and national regulators, such as leverage, liquidity, concentration, and lack of transparency. When considering whether a fund is Systemically Important, it is critical to consider whether that fund is already subject to constraints that effectively eliminate the possibility that it will fail or disrupt the global financial system.

Excessive Leverage

Leverage should be elevated to an impact factor for investment funds in recognition of the close connection between an entity's leverage and its systemic risk. All banks use leverage to varying degrees and so the G-SIB methodology does not need to be designed to identify banks that have leverage, but rather to evaluate the degree and nature of that leverage. Because investment funds do not universally employ leverage, it cannot automatically be assumed to exist. Therefore, any methodology designed to identify potential NBNI G-SIFI's should put a strong emphasis on excessive leverage, as well as evaluate the degree and nature of that leverage.

Fidelity agrees that the "greater a fund's leverage, the greater its potential impact on counterparties that have provided finance (counterparty channel) and on markets in the event of a disorderly and rapid de-leveraging (market channel)."[45] When an excessively levered entity experiences financial distress, the impacts of that distress can ripple through its many creditors. If those impacts are widespread and significant, they can disrupt the broader financial system.

Further, Fidelity believes excessive leverage is itself a proxy for a fund's probability of failure. Leverage allows a fund to augment its assets by multiples over its equity capital. Each dollar of capital

[45] *Id*. at 34; Fidelity also agrees with the sentiments expressed elsewhere in the Proposal that leverage among finance companies and market intermediaries can also create stress on the broader financial system. *See id*. at 18 ("Leverage can amplify the impact of a finance company's distress on other financial entities") and at 24 ("The greater a market intermediary's leverage, the greater the potential impact of its distress or failure on the financial system").

can be transformed via leverage into much greater market exposure. That greater market risk can produce significant gains, but can also magnify losses. If the market price of a leveraged asset declines, the degree of loss is much greater than if the asset were unlevered. Likewise, a fund with a highly-leveraged capital structure can suffer financial distress or even failure from the cumulative effects of market price declines across its book of leveraged assets.

The near collapse of LTCM in 1998 exemplifies the degree to which excessive leverage can contribute to a fund's financial distress and magnify the effects of that distress in the broader financial system. Just prior to its near failure, LTCM's leverage ratio was more than 25-to-1.[46] Market volatility caused by Russia's devaluation of the ruble in August 1998 led it to suffer losses that were magnified because of the degree of leverage the firm employed.[47] In its post-mortem report on LTCM, the President's Working Group on Financial Markets ("PWG") found that:

> "In a volatile market, high levels of leverage increase the likelihood that a leveraged entity will fail, in part because the size of potential losses can seriously deplete and even wipe out the entity's net worth. When leveraged investors are overwhelmed by market or liquidity shocks, the risks they have assumed will be discharged back into the market. Thus, highly leveraged investors have the potential to exacerbate instability in the market as a whole."[48]

Recognizing the dangers that excessive leverage can pose outside of the investment fund sector, the PWG observed that other "financial institutions, including some banks and securities firms, are larger, and generally more highly leveraged, than hedge funds….The near collapse of LTCM illustrates the need for all participants in our financial system, not only hedge funds, to face constraints on the amount of leverage they assume."[49] Since excessive leverage can precipitate a fund's failure and cause harm to other firms, and that risk of failure is central to the FSB SIFI Framework, Fidelity believes that excessive leverage should be a separate impact factor, with significantly more weight given to it than to the other factors.

Existing Regulatory Scrutiny

Fidelity believes that the extent and nature of existing regulatory scrutiny should also be an impact factor. In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[50] requires that the Financial Stability Oversight Council ("FSOC") consider "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies" when evaluating a non-bank financial company for potential designation.[51] Existing regulations set the boundaries for the activities in which an entity may engage. Activities that regulators believe could pose a risk may already be sufficiently restricted in some funds. Therefore, an analysis of the regulations by which an entity is bound must inform an assessment of the probability and impact of its failure.

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[46] *See* President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," Apr. 1999, at 12.
[47] *See id.*
[48] *Id.* at 23.
[49] *Id.* at viii.
[50] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) [hereinafter *Dodd-Frank*].
[51] *Dodd-Frank* §113(a)(2)(H).

For example, U.S. mutual funds are subject to uniform limits on the amount of leverage they can employ.[52] The Investment Company Act of 1940 limits the amount of cash borrowings mutual funds can undertake by imposing a 300% asset coverage requirement.[53] Also, a series of pronouncements by the Securities and Exchange Commission has limited the degree to which funds can take on excessive leverage through the use of derivatives.[54] We believe these restrictions have worked effectively for many years, have served the interests of mutual fund shareholders and have enhanced financial stability. We also note that these restrictions are much more stringent than the new requirements being imposed on banks generally[55] and G-SIBs in particular.[56]

The regulations applied to U.S. mutual funds constitute a comprehensive layer of substantive limitations on activities that address a multitude of risks and include requirements regarding: liquidity, daily mark-to-market valuation,[57] redemption,[58] transparency (disclosure),[59] governance,[60] conflicts of interest, and transactions with affiliates, among many others.[61] The targeted, industry-wide regulation of the entities that constitute the mutual fund industry serves many purposes, including investor protection and market integrity, but it also promotes financial stability. As with other heavily regulated industries, if risks to the global financial system are detected in the investment fund industry and not already mitigated by the existing regime, the regime can be enhanced to address those risks. To the extent such risks are found in other segments of the capital markets, this structure should serve as a model for their effective and efficient regulation.

Q3-2 - In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial

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[52] Mutual funds are limited by Section 18 of the Investment Company Act to very low levels of leverage. For example, open-end mutual funds are limited to a maximum debt-to-equity ratio of 1 to 2. *See* 15 U.S.C. § 80a-18. By contrast, traditional financial institutions historically could have a 9 to 1 or greater debt-to-equity ratio and still qualify as "well-capitalized" for regulatory purposes. In practice, most mutual funds operate with little leverage, if any, which the Senate Banking Committee recognized in its report on S. 3217 by noting that "a typical mutual fund could be an example of a nonbank financial company with a low degree of leverage." *See* S. REP. No. 111-176, at 48 n.14 (2010).

[53] 15 U.S.C. § 80a-18(f)(1).

[54] *See Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 18, 1979), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf. S*ee also Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Investment Company Act Release No. 29776 (Aug. 31, 2011) (Commission Release), *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf ("A fund that invests in derivatives ... must consider the leverage limitations of section 18 of the Investment Company Act").

[55] *See* Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirement," *supra* note 27. S*ee also Regulatory Capital Rules*, 78 Fed. Reg. 62018 (bringing the United States substantially into compliance with the Basel III capital framework).

[56] *See* Basel Committee on Banking Supervision, *supra* note 34 at 12 (detailing the higher loss absorbency requirements for G-SIBs). In the United States, large banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in foreign exposures are subject to more stringent requirements under the "advanced approach." *See Regulatory Capital Rules*, 78 Fed. Reg. 62,018.

[57] *See* 17 C.F.R. § 270.22c-1.

[58] Except in extraordinary circumstances, most mutual fund shareholders may redeem their investments on a daily basis.

[59] Mutual funds are required to describe their investment strategies in detail in prospectuses, statements of additional information, and semi-annual and annual shareholder reports. Furthermore, funds must disclose their entire portfolios four times per year. *See, e.g.*, 15 U.S.C. § 80a-29(e); 17 C.F.R. § 270.30b1-5. This disclosure typically describes each security held, including the issuer/issue, shares/principal amount, and fair value. If a fund holds derivatives contracts, the reference assets/indices notional values, fair values, number of contracts, counterparties and expiration dates are described.

[60] *See, e.g.*, 15 U.S.C. § 80a-10.

[61] In addition to the SEC's oversight of mutual funds' compliance with regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act and the Advisers Act, the Internal Revenue Code sets requirements regarding a mutual fund's portfolio diversification and distributions of earnings and the Financial Industry Regulatory Authority oversees most mutual fund advertisements and sales materials.

universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

Q6-11 - Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritisation.

Size alone is not useful for identifying potential systemic risk in any entity, but it is especially unhelpful for investment funds that lack the combination of characteristics that must be present to be Systemically Important. The $100 billion level proposed is arbitrary, and, given its insignificance relative to the global financial system, not useful for identifying any funds that could disrupt that system.

Furthermore, the pool of funds resulting from only a size-based screen will be both over- and under-inclusive. It is likely to miss potential sources of risk and will cause national regulators to waste resources examining funds that are not Systemically Important, such as U.S. registered mutual funds. Instead, we propose a multi-factor materiality threshold that couples a modified size metric with at least one other factor, such as excessive leverage.

Arbitrary

The Proposal states that the "materiality threshold figures are broadly consistent with the G-SIB and G-SII methodologies."[62] We disagree. The G-SIB methodology only requires banks with more than €200 billion in assets and those classified as G-SIBs the previous year to report on the 12 G-SIB indicators.[63] Most G-SIBs have more than $1 trillion in assets. Even the largest investment funds are small relative to the largest G-SIBs and the global financial system.[64] They also operate with little or no leverage and fund their asset portfolios almost entirely with equity capital.[65]

The Proposal provides no support for applying a materiality threshold to investment funds that is less than half that applied to banks, especially because the probability and impact of failure for a typical bank are inherently much greater than for an investment fund. Further, banks present significant moral hazard risk because they receive explicit government support. The size threshold for NBNI's should, therefore, be set no lower than €200 billion and should be indexed for inflation to ensure that the methodology continues to provide meaningful results.

Size Alone Is an Inappropriate Materiality Threshold

The size of an investment fund alone is not indicative of materiality to the global financial system or potential systemic risk. Unless a size metric is calibrated appropriately and combined with other, more useful metrics, the methodology is likely to miss areas of potential risk and force regulators to expend

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[62] *Proposal*, *supra* note 2, at 9.
[63] *See*, Basel Committee on Banking Supervision, *supra* note 34, at 2 ("Reporting guidance has been added that will require all banks with an overall size exceeding EUR 200 billion (as measured by the Basel III leverage ratio measure of exposure), as well as bank that have been classified as a G-SIB in the previous year, to make publicly available the 12 indicators used in the assessment methodology").
[64] *See* Investment Company Institute, *supra* note 20.
[65] This stands in stark contrast to G-SIBs. For example, the largest U.S. G-SIB reported $2.2 trillion in total liabilities at year-end 2013, including nearly $1.3 trillion in deposits. *See* JPMorgan Chase & Co., Annual Report (Form 10-K), at 75 (Feb. 20, 2014).

scarce resources on areas not deserving attention. For example, this threshold would have missed the Reserve Primary Fund, which had only $62 billion in assets under management when it "broke the buck." On the other hand, a regulated fund with $100 billion primarily in high quality, highly liquid assets, such as U.S. Treasuries or large-cap equities, and little or no leverage would not warrant a detailed review – let alone designation – and yet would be identified by this threshold.

Further, a size threshold will result in a pool that is only as good as the day the data was gathered. A fund's size is a function of both asset values and investor flows and can change significantly in short periods of time. The prices of a fund's underlying securities move daily. Flows are based on investor preferences at a given time and change in response to a variety of factors, sometimes rapidly. As a result, funds that are above $100 billion today may be much smaller in the future, while funds that are smaller today could have more than $100 billion in less than a year. If this assessment takes place annually, it will necessarily be lagging.

We have not seen any data demonstrating a causal relationship between the size of an investment fund and the probability or impact of its failure. This may explain why other methodologies have adopted multi-factor materiality screens. For example, the first stage of the U.S. process is designed to narrow the universe of companies to a smaller subset, much like the process the FSB and IOSCO are proposing.[66] Stage 1 contains six thresholds for size, interconnectedness, leverage, and liquidity risk and maturity mismatch. A company is subject to further evaluation only "if it meets both the size threshold and any one of the other quantitative thresholds."[67] Although the FSOC process has a number of conceptual flaws, it correctly recognizes that size alone is not an indicator of systemic risk but, instead, is relevant only to the extent it magnifies the potential impact of the other factors in the framework.

Excessive Leverage

We believe that regulators should use a materiality screen that couples size with excessive leverage when determining whether any funds warrant further review. Assuming *arguendo* that any investment fund could be Systemically Important, that fund would need to be both large and excessively leveraged and not simply large. Excessive leverage is indicative both of the probability a fund will fail and of the disruptions that failure could have on the broader financial system.[68] As the FSB and IOSCO note in the Proposal, size and leverage both have the same relationship to the same transmission channels

[66] *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637, 21641-42 (FSOC Apr. 11, 2012).
[67] *Id*. at 21642.
[68] Many of the entities that have experienced severe financial distress and failed during previous crises employed excessive leverage. *See* The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011), at xix, *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf ("In the years leading up to the crisis, too many financial institutions . . . borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly. For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1…"); *see also* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, Speech at the Peterson Institute for International Economics, Washington, D.C. (June 8, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20090608a.htm ("By 2007… high leverage had pervaded the financial system. Systemic risk arose not because the illiquidity or insolvency of one firm would directly bring down another, but because of parallel hedging or funding strategies practiced by highly leveraged firms with substantial short-term liabilities that threatened large segments of the market").

– namely, the greater a funds' size or leverage, the greater the potential for a fund to impact its market or counterparties.[69]

The initial stage of the methodology to identify potential NBNI G-SIFIs should screen the universe of investment funds for excessive leverage and size separately, and then look for overlap between the two populations. This would result in a better starting point for further analysis than any pool of funds identified by using either factor alone as a screen.

This approach is also consistent with similar approaches endorsed by the FSB and its members.[70] For example, the FSOC has adopted a leverage ratio of 15:1 as one of several numerical indicators to identify companies for further evaluation and potential designation.[71] The Basel Committee on Banking Supervision, however, sets a simple, transparent, non-risk-weighted leverage ratio of 3% for banks, which are inherently more likely to be Systemically Important than investment funds.[72] As noted above with respect to the size threshold, we see no justification for holding investment funds to a higher standard than the internationally agreed upon standard that is applied to banks. We believe, therefore, that a materiality threshold should be set at 33:1, but certainly no lower than 15:1.

Transparency

Ultimately, however, no matter how well a methodology is designed, it is unrealistic to expect that it will identify a subset that includes all of the entities engaging in activities that could pose risk. It is imperative that the FSB and IOSCO be transparent with their final methodology, especially if they continue to focus on entities, by publishing any thresholds they will use when applying the relevant factors and indicators. Clarity on how regulators will determine whether an investment fund is Systemically Important will allow investors and asset managers to evaluate the costs and benefits of engaging in these behaviors.

We believe that this impact on investors and managers would be a benefit to the system and not, as the Proposal seems to indicate, "potential arbitrage."[73] If the goal of this exercise is to reduce risk in the global financial system, then regulators should strive to have as few funds as possible engaged in activities that could disrupt it. Full transparency would allow fund managers to factor potential systemic risk impacts into their decisions, both reducing risk across the system and helping to mitigate the risk that regulators miss something when applying the factor-based screens.

Q6-3 - Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.

[69] *See Proposal*, *supra* note 2, at 33-34.
[70] We also believe that excessive leverage should be an impact factor that is measured on a risk-weighted basis. Please see our responses to Q6-5 below.
[71] *See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. at 21643.
[72] *See* Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirement," *supra* note 27. S*ee also* our response to Q6-2 above.
[73] *Proposal*, *supra* note 2, at 11.

Among the four levels of focus listed in the Proposal, Fidelity believes that the individual investment fund level is the most appropriate. Although a focus on activities would be far superior (as we discuss more fully in response to Q6-4 below), focusing the methodology on individual investment funds is better than the alternatives.

Asset managers on a stand-alone entity basis

We support the Proposal's recognition that asset managers on a stand-alone basis inherently lack many of the key characteristics that must be present for a company to be a G-SIFI.[74] In fact, the Proposal supports our conclusion that asset managers as stand-alone entities *cannot* be Systemically Important. The FSB and IOSCO do, however, briefly mention two possible reasons to focus on asset managers as stand-alone entities: (i) managers may conduct certain firm-level activities, such as risk management or securities lending and repo transactions and (ii) managers are exposed to operational and reputational risks.[75] The Proposal does not provide any support for the notion that these factors could make an asset manager a SIFI and we do not believe that asset managers as stand-alone entities merit focus as possible SIFIs.

(i) Services performed by adviser

First, the activities that an asset manager conducts on behalf of investment funds do not increase the probability or impact on the global financial system of the *manager's* failure.[76] Asset managers are hired by investment funds to serve as their agents and to provide a range of services in that capacity in exchange for a fee. The services may include portfolio management, trading, compliance, and, in some cases, back office administration. The investment risk associated with the fund's portfolio of assets, along with any gains, belongs to fund investors and not to the manager.

Second, the assets of the fund never become assets of the manager nor are they commingled with assets of another fund. The assets are not available to the manager to use for its own purposes, nor are they available to the manager's creditors or to investors in (or creditors of) other funds. In fact, most funds employ third-party custodians to hold fund assets for their investors, as required by regulation or as a best practice.

The Proposal acknowledges many of these considerations, which "distinguish the risk profile of a fund from that of its manager."[77] In support of their decision to exclude managers from the methodology, the FSB and IOSCO note that the services that a manager performs create no exposures between the manager and the financial system.[78]

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[74] Sections 6.2.1 and 6.2.2 of the Proposal explore the nature of the asset management business, the differences between asset management and banking, and the implications of those differences for the FSB SIFI Framework, including the rationale for focusing the proposed assessment methodology on investment funds asset managers and not on asset managers on a stand-alone basis. In our response to Q6-2 above, we highlight a number of those statements with which we agree.

[75] *See Proposal*, *supra* note 2, at 32.

[76] The fact that the FSB and IOSCO focus on *activities* conducted by the asset manager lends support for our discussion below in response to Q6-4 that the FSB and IOSCO should identify those activities that it views as risky and then apply targeted, industry-wide regulation to mitigate any potential harms, rather than selectively applying regulation to a small subset of investment funds or their managers.

[77] *Proposal*, *supra* note 2, at 29-30.

[78] *See*, *e.g.*, *id.* at 30 ("It is therefore the portfolio of assets that creates the respective exposures to the financial system") and at 30 n.36 ("Any interconnectedness does not emanate from the manager's balance sheet, but is the consequence of the manager's activities in relation to the management of assets held in the portfolio").

The manager directs the investment of the fund's assets but does not guarantee their value or performance results. The manager's discretion to invest fund assets is also subject to a host of regulatory, legal and contractual limits. Those limits come from a variety of sources, such as the fund's governing documents, securities laws, market conduct regulations, and corporate laws that create fiduciary duties to investors. The FSB and IOSCO acknowledge that the investment manager must manage a fund's assets "on behalf of investors according to its investment objectives, strategy and time horizon" and within the limits set by applicable regulations.[79] In the case of U.S. mutual funds, those limits are enforced by many, including the SEC, states' attorneys general, independent trustees, and the investors themselves who can redeem their investments on demand.

The limited discretionary authority managers have over investment fund assets stands in stark contrast to the broad discretion banks have to take proprietary risk for their own accounts. A bank borrows money from its depositors and invests it for its own benefit. A bank's investments and financing model create direct exposures between the bank, its creditors, the governments that support it, and companies in the financial system with which it transacts.

Those interconnections differentiate banks from asset managers because any economic exposures and connections with others in the financial system exist only at the fund level and have no ties to the manager's balance sheet. Because investors bear "both upside rewards and downside risks from movements in the value" of fund assets, fund performance cannot threaten a manager's solvency in the way that a bank can be threatened by its investments.[80] Given the legal separation between managers and their funds, any losses to the fund would not impact the balance sheet of the adviser or *vice versa*. Likewise, because of the legal separation between managers and their funds, regulators should not attribute managed assets to investment managers in order to make the managers seem worthy of further scrutiny.

(ii) Operational and Reputational Risk

The Proposal suggests that operational and reputational risks may support a decision to focus on asset managers on a stand-alone basis. We disagree. All companies face these risks and asset managers are no different. Elsewhere in this letter, we discuss why operational problems or reputational damage suffered by an individual asset manager could not disrupt the global financial system via runs on investment funds. We also point out that even if one assumed such a scenario were possible, SIFI designation would not prevent it.

Groups of Entities: Funds and Their Managers or Families of Funds

Fidelity supports the decision by the FSB and IOSCO not to focus on groups of funds or funds and their managers collectively. To analyze them collectively, one would be required to ignore legal, management and ownership separations as well as operational distinctions among individual funds and

[79] *Id*. at 29-30.
[80] *See*, *e.g.*, *id.* at 29. As Fidelity has described in other comment letters, the inherent differences between the business of investment management (built on the agency model) and the business of banking explain why they are, and should continue to be, regulated differently. *See* Letter from Scott C. Goebel, Senior Vice President and General Counsel, Fidelity Mgmt. & Research Co. to Elizabeth M. Murphy, Secretary, U.S. Sec. and Exch. Comm'n (Nov. 1, 2013), at 23-27, *available at* http://www.sec.gov/comments/am-1/am1-19.pdf; Letter from Scott C. Goebel, Senior Vice President and General Counsel, Fidelity Mgmt. & Research Co. to the Financial Stability Oversight Council (Dec. 19, 2011), at 3-7, *available at* http://www.regulations.gov/contentStreamer?objectId=0900006480f85ce6&disposition=attachment&contentType=pdf.

their managers. Further, the results of such an analysis would be misleading and would not provide any meaningful insight into systemic risk. Collective analysis also would not enable national regulators to overcome the many practical and legal impediments to collective regulation.

(i) No Basis to Support Collective Analysis

We do not believe there is a sound basis for collective analysis. The Proposal asserts that it "may be necessary to examine the asset manager and all assets under its management" collectively because, it claims, the asset manager determines "the investment management strategy and risk management practices."[81] This statement suggests that all funds managed by an asset manager may be acting in concert, which is untrue for any diversified manager.

First, as stated earlier in the Proposal, *investors* select funds based in large part on their investment strategies and that, if a given strategy fails to attract sufficient interest or performs poorly, investors will withdraw their money.[82] Although a manager may launch a fund with a given strategy, the manager cannot control someone's decision to invest or redeem. If a fund does not appeal to investors, whether because of poor performance or otherwise, investors will leave. Furthermore, the manager is bound by "a fund's objectives and the regulations to which it is subject."[83] The manager makes buy, sell and hold decisions within those parameters and has no discretion to alter those characteristics without investor consent and, in the case of U.S. mutual funds, the consent of the fund's independent trustees.

Second, there is not a single strategy for all assets under management. With few exceptions, managers with any significant amount of assets under management are diversified. They offer a wide array of funds that employ different strategies, in different asset classes, focus on different industry sectors and geographies and appeal to diverse investor populations. For example, Fidelity offers to both retail and institutional shareholders a comprehensive line-up of equity, fixed income and high yield mutual funds. Further, Fidelity offers different types of mutual funds within each category. Within its line-up of equity mutual funds, for example, Fidelity offers funds ranging from broad-based, large-cap funds to funds that focus on a particular sector (e.g., biotechnology, consumer staples, health care or telecommunications).

The type of concerted action suggested by the Proposal is inconsistent with our experience. At Fidelity, decisions to buy, sell or hold securities are made independently by each portfolio manager, without firm-level direction. Each portfolio manager decides whether a security is best suited for a fund given its investment objectives and prospectus limitations. Many times, portfolio managers at Fidelity take opposing views on one security or another. For example, in 2013, there were more than 100,000 security trades between Fidelity mutual funds and accounts. In each case, at least one Fidelity portfolio manager placed an order to buy a security while another Fidelity portfolio manager placed an order to sell that same security contemporaneously. Of course, because lot sizes and trading days do not always correspond, and because regulations restrict some funds and accounts from trading between each other, there were even more instances in which two Fidelity funds traded in the opposite direction in the same security during the period.

Third, blending the assets of individual funds for the purpose of collective analysis could mask the concentration of risk in an individual fund. For example, if a highly leveraged, illiquid fund were

[81] *Proposal*, *supra* note 2, at 32.
[82] *See id*. at 30.
[83] *Id*. at 29.

analyzed together with a group of unleveraged highly liquid funds, the concentration of risk in the single fund would be hidden rather than highlighted.

Fourth, portfolio managers embed risk control into each fund as part of the security selection and portfolio construction processes, which will differ depending on each fund's shareholder expectations, risk tolerance and investment mandate (e.g., large, mid, value, growth, international, emerging market, etc.). For example, equity value fund managers usually build in considerable margin of safety (i.e., downside protection) as they analyze what to own. Equity growth fund managers, on the other hand, tend to adjust position sizes according to the potential upside opportunities balanced by the risks inherent in new products, technologies or services. Investors expect this differentiation to be evident in the management of each fund.

(ii) U.S. Regulatory Impediments

Collective designation and regulation would be impossible in the United States because the authority to designate non-bank financial companies for heightened regulation is entity-specific. Regulators may not disregard the differences among funds or funds and their managers or to treat them as if they were subsidiaries of a single holding company. Although the FSOC is empowered to designate a firm by designating the holding company of a conglomerate and thereby subjecting it and its subsidiaries to consolidated supervision,[84] it is not empowered to make a single designation determination for multiple, legally separate asset management entities such as groups of funds or funds and their managers.[85]

Likewise, Section 165 of Dodd-Frank does not allow the Federal Reserve Board to disregard or overcome these facts when regulating a designated entity. Even if the FSOC were permitted to designate a group collectively, the legal, regulatory and operational separations among funds and their advisers would render unworkable any effort to treat the designated entities as a group when applying the enhanced standards and supervision required for designated companies.[86]

These impediments to collective designation and regulation are relevant because national regulators will be expected to implement the methodology by designating and regulating any G-SIFIs. The G-SIFI methodology will have no practical effect, however, if it cannot be applied at the national level, by national regulators, in compliance with domestic law.

(iii) Runs

The Proposal also hypothesizes that reputational risk to a manager or one of its funds "may create runs both on the asset manager as well as on its funds" or within a family of funds, but does not provide any further details or support.[87] As explained in our response to Q6-2 above, the concept of a run is inapplicable to most funds. Likewise, the concept is inapplicable to asset managers. When speculating about the possible danger of a run on funds, the Proposal acknowledges that "there is no run on the

[84] *See Dodd-Frank* § 165(a)(2)(A) (2010) (in prescribing more stringent prudential standards, the Federal Reserve Board may consider companies' "financial activities (including the financial activities of their subsidiaries)").
[85] See *Dodd-Frank* § 102(a)(4)(B)(i) (limiting the definition of "U.S. Nonbank Financial Company" to a company that is "incorporated or organized under the laws of the United States or any State"). Additionally nothing in Section 113 of Dodd-Frank authorizes group designations.
[86] *See, e.g.*, Letter from Paul Schott Stevens, President & CEO, Inv. Co. Inst., to the Financial Stability Oversight Council (Feb. 25, 2011), *available at* http://www.ici.org/pdf/24994.pdf.
[87] *Proposal*, *supra* note 2, at 32, 30 n.36.

manager."[88] Further, it is highly unlikely that an idiosyncratic event would cause investors to lose faith in both a manager and all of its funds' strategies. If investors abandon a particular asset manager's funds, they are likely to pursue the same strategies by investing in the funds of another manager or directly in the underlying assets.

Families of Funds in Particular

The FSB and IOSCO request comment on whether it would be appropriate to focus on "families/groups of funds following the same or similar investment strategy that are managed by the same asset manager."[89] We do not believe such a focus is appropriate. First, the practical and procedural impediments to analyzing, designating and regulating a group of funds collectively would remain. Second, the group of funds would need to be acting in concert, which, as we addressed above, is unlikely at best. Further, establishing the existence of a family of funds would require evidence beyond simply being managed by the same asset manager, having similar names, following a similar investment strategy or investing in the same asset class.

Individual Investment Funds

Among the four options presented in Q6-3, Fidelity believes that the focus on investment funds is most appropriate. We agree with much of the rationale for the proposed focus on funds and the related statements in the Proposal, especially those in Section 6.2.1. Focusing on asset managers is inappropriate for the very same reasons that focusing on funds is appropriate. These reasons, which we describe more fully above, include (i) the agency nature of the business, (ii) the ownership of fund assets by the fund and its shareholders with strict legal separation from the asset manager, (iii) the fact that investment risk and reward are borne by the fund shareholders, and (iv) the fact that any economic exposures or connections with others in the financial system are created at the individual fund level.

Q6-4 - Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

Yes, Fidelity believes that the methodology should be designed to focus on activities rather than entities. Any risk associated with an investment fund is most likely to be created by a practice that is (or could easily be) employed by many other funds and participants in the capital markets. It will not be unique to a small subset of individual funds. As discussed in the response to Q2-2, we note that funds are not the only market participants engaging in investment activities. Individual investors, sovereign wealth funds, corporate and municipal pension and benefit plans, endowments, corporate treasurers and many others are simultaneously engaged in similar investment activities, many of which are larger in asset size than investment funds.

We believe, therefore, that analysis and regulation focused on activities are the only effective means for the FSB and IOSCO to identify and mitigate such a risk. Selective application of an undefined body of additional regulation to a subset of investment funds will not mitigate those risks effectively. Further, doing so ignores the wealth of experience that national regulators have in overseeing the capital markets.

[88] *Id*. at 30 n.36.
[89] *Id*. at 31.

(i) Key characteristics of investment fund business make designation ineffective

In response to Q6-2 and Q6-3 above, we highlight a number of the statements in the Proposal that underscore the unique characteristics of the investment fund business. These characteristics include: (i) funds hire advisers to serve as their agents or contractors, (ii) there is a strict legal distinction between a fund and its adviser, and (iii) the business is fee-based with no principal risk-taking.

Further, as the FSB and IOSCO acknowledge by excluding the Substitutability Channel from their discussion in Section 6 of the Proposal, the investment fund business is intensely competitive with highly substitutable products and highly mobile assets and participants. Funds are aggregation points for individual investors. Investors' goals and risk tolerances drive their investment decisions, such as fund selection. Investors may choose to invest in individual securities directly or instead to take advantage of the diversification, scale and expertise that a fund manager can offer.

Assets flow in and out of funds due to changing investor preferences as well as the relative performance of funds against their peers. We measure fund fees and performance in single basis points *because customers are highly attuned to those metrics.* Investors can (and will) elect to move their investments elsewhere in the face of high fees or lagging fund performance.

For example, the Investment Company Institute ("ICI") reports that over 700 sponsors managed mutual fund assets in the United States in 2012; and intense competition has prevented any single firm or group of firms from dominating the market.[90] Competition to attract funds from investors has also affected the number and types of funds offered by fund sponsors. Fund sponsors create new funds to meet investor demand, and they merge or liquidate (or reposition) funds that do not attract sufficient investor interest. There is no shortage of choices and, if one sponsor launches a successful fund, there are typically low barriers to other sponsors that wish to launch similar funds. The ICI reports that over 8,000 mutual funds were available to U.S. investors at the end of 2012.[91] Of course, mutual funds are just one product within the broader asset management sector and the United States is just one market for investors. There were over 73,000 mutual funds available worldwide.[92] U.S. mutual funds must also compete with other products, including almost 10,000 hedge funds.[93]

Because of these characteristics, selective application of requirements to individual funds designated as G-SIFIs would be an ineffective way to mitigate systemic risk in the capital markets, no matter what those requirements are. If an investment fund were designated, that fund would be subject to added costs and other constraints that would not apply to its competitors. While the requirements that would be imposed on investment funds as G-SIFIs have not yet been proposed, it is instructive to consider the consequences of both G-SIB designation and the designation of nonbanks in the U.S. Requirements such as enhanced capital, leverage, liquidity and other regulatory tools are, perhaps, appropriate for banks and other entities that employ significant leverage and take proprietary risks, but are wholly inappropriate for nonbank agency businesses that do not require capital to absorb losses. For investment funds, those new requirements would be entirely irreconcilable with their structures and business models.

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[90] *See* Investment Company Institute, *supra* note 20, at 24.
[91] *Id.* at 18 (figure 1.11).
[92] *Id.* at 202 (table 61.
[93] *See* Hedge Fund Research, Inc., "HFR Global Hedge Fund Industry Report – Year End 2013" (Jan. 2014) at 22.

As the Proposal recognizes, funds have very different risk profiles from other financial entities:

> "Unlike banks, for instance, where capital is set aside to protect depositors and other creditors against the risk of losses, investment management is characterised by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund's invested portfolio."[94]

Businesses that act primarily as their customers' agents manage or service assets on behalf of their customers, as opposed to borrowing from them and taking proprietary positions with those funds as banks do with their deposits. So while bank depositors generally neither benefit from bank profits nor bear the risk of default within the limits of deposit insurance, "fund investors bear both upside rewards and downside risks from movements in the value of the underlying assets."[95]

If regulators designate a short list of funds, the costs and other regulatory burdens applied to them and not to their competitors would likely render the designated funds uncompetitive and prompt investors to redeem a substantial portion of their assets.[96] Shareholders could (and likely would) simply move their assets to another undesignated fund employing a similar management strategy without the uncertainty and costs of designation, thereby recreating the same undesirable set of conditions elsewhere. In fact, if most shareholders redeem, regulators will have precipitated the liquidation of a fund they had just designated as important to the global financial system. Even redemption short of liquidation would result in the designated fund becoming too small to threaten the stability of the system. An annual process focused on evaluating and designating individual investment funds will inevitably put regulators in a position of trying, and failing, to chase assets as they move from fund to fund.

(ii) Methodology and regulation should employ existing regulatory models to focus on activities

The activities in which investment funds engage often are not unique to a particular fund, a small subset of funds or even limited to investment funds. Even if one fund or a few funds employ strategies that make them uniquely risky, others could easily follow suit. The significant number of funds available to investors, the intense competition in the industry and the high degree of substitution, mean that particular activities (e.g., securities lending, repo, etc.) are not limited to a small subset of the largest funds, but, rather, are conducted by a host of funds and other market participants.

If the goal is to reduce risk across the global financial system, then regulators must deal with the activities that create that risk consistently across the system. Regulators must restrict those activities not only across *all* funds, but across all market participants. If instead, regulators insist on selecting a handful of funds for different regulation, investors will flee and seek the same risk exposure in another fund with fewer restrictions and less cost, while other market participants continue to conduct the same activities.

Designating individual funds will not decrease the amount of risk in the system. As a result, Fidelity believes that the methodology should focus on activities rather than entities. Doing so will help

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[94] *Proposal*, *supra* note 2, at 29.
[95] *Id.*
[96] In contrast, bank funding, based on core deposits, is relatively sticky. Increased costs to banks due to enhanced prudential standards are also incremental, with relatively small differences among banks. It is therefore unlikely that a bank could face a rapid downsizing as customers seek other financial intermediaries.

regulators to design targeted market-wide solutions for identified risks and will build on the experiences that national regulators have developed over many years in regulating the capital markets effectively.

For example, the SEC, as the primary regulator for registered mutual funds and their advisers, has used an activity-based framework successfully for over 70 years, focusing industry-wide regulations on specified risks. As discussed in our response to Q2-1 above, the regulations applied to mutual funds collectively address a multitude of risks, such as leverage, liquidity, transparency, governance, conflicts of interest, and diversification, among many others. Although these regimes were designed to protect investors and create efficient, robust markets, they also enhance the stability of the financial system by addressing many of the topics that preoccupy the FSB, IOSCO and national regulators today.

There are numerous examples of regulatory reforms that apply broadly to products, markets and activities. Although already robust, both the U.S. and Europe took steps to strengthen their activity-based regulatory schemes in the wake of the 2008 crisis. They also worked to fill gaps that previously existed between functional regulators, thereby enabling both new supervisory bodies and existing functional regulators to detect and mitigate many risks, including threats to financial stability. New regulations have addressed linkages that could transmit losses rapidly among financial institutions in their new provisions on payment, clearing and settlement. Enhanced regulation of the derivatives markets applies central clearing and minimum margin requirements broadly instead of to a few large market participants. In the U.S., for example, Dodd-Frank extended certain regulatory requirements to previously unregulated segments of the industry, requiring private fund advisers to register with the SEC and to comply with extensive reporting requirements, including non-public reporting of portfolio holdings.

Beyond the sweeping changes that were made in the wake of the crisis, regulators have continued to use this model to address issues as they arise. In some cases, the means to address issues has been to increase transparency. For example, the European Commission (EC) recently released a proposal that would impose reporting requirements on Securities Financing Transactions (SFTs), which include lending or borrowing of securities and commodities, re-hypothecation of collateral, repo transactions, and reverse repo transactions. The EC determined that it was not necessary to limit or prohibit the use of SFTs as such by specific restrictions. The EC believes that by refraining from regulation beyond introducing transparency, the proposal "is limited to the measures necessary to allow for an effective removal of the risks posed by shadow banking entities."[97]

In other cases, regulators have elected to impose extensive restrictions on certain activities in order to address issues in the capital markets. For example, the Reserve Primary Fund broke the buck after Lehman's bankruptcy induced a market-wide liquidity shock in September 2008. Some other money market mutual funds also experienced stress, as did every participant in the financial system. Although the Reserve Primary Fund may have worsened the financial crisis by contributing to the overall negative market sentiment, it certainly did not cause the crisis. Instead, the fund's difficulties resulted from multiple regulatory and business failures that originated in highly leveraged banks and similar businesses.

Those market events would not have been prevented and their impacts would not have been lessened by designating the Reserve Primary Fund a G-SIFI. Appropriately, regulatory reforms adopted in response to the stress experienced by money market funds during the crisis apply broadly and enhance

[97] European Council, "Proposal for a Regulation of European Parliament and of the Council on reporting and Transparency of Securities Financing Transactions," Jan. 1, 2014, at 6, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0040&qid=1396292413178&from=EN.

existing regulation of money market funds. Specifically, the 2010 changes to SEC Rule 2a-7 targeted liquidity, maturity, risk, transparency, and the ability to suspend redemptions. The amendments to Rule 2a-7, in combination with other significant changes to the regulatory structure of our capital markets, have increased the ability of money market funds to absorb large, unexpected redemptions. The SEC has also proposed additional options to strengthen further the resiliency of certain types of money market mutual funds. Those proposals would not apply to only a few money market funds or their managers, but would instead apply to all funds of the type or types that the SEC believes present unaddressed risks.

We believe any methodology designed to identify and address systemic risk in any segment of the investment fund industry should follow a similar approach. In a speech last year, Governor Tarullo stressed that, "international efforts to develop new regulatory mechanisms or approaches should build on experience derived from national practice in one or more jurisdictions."[98] If regulators identify a risk, they should look first to the existing regulatory structures to solve it, leveraging the wealth of experience that national regulators have developed in overseeing the capital markets effectively for many years. Further, by restricting an activity, or set of activities, in a product or across the industry or relevant market, regulators can address the risk effectively in total rather than incompletely and ineffectively in a few funds.

(iii) An alternative approach

If the FSB and IOSCO are determined to use a factor- and indicator-based framework to identify a small subset of investment funds for analysis, the analysis could and should still result in (i) the identification of an activity, or combination of activities that creates systemic risk and (ii) an industry-wide solution. As we mentioned above in response to Q3-2, entities engaging in potentially risky activities will inevitably be missed no matter how well this methodology is designed. The subset of funds examined should be viewed as a sample that can be used to identify potentially risky activities rather than simply a list of potentially risky entities.

In the process envisioned by the FSB and IOSCO, regulators will look closely at each fund identified by the initial materiality thresholds (which, as we have suggested in Q3-2 above, should be both leverage and size). Assuming *arguendo* that they identify a few funds whose activities threaten the global financial system, we believe that regulators should *not* designate each of these funds individually because G-SIFI designation will be ineffective.

Instead, regulators should analyze specifically how these particular funds could disrupt the global financial system. What are the characteristics of each fund that make it unique from others in the initial subset that did not end up on the final list? In what activities does each fund on the final list engage that create systemic risk? Once regulators have identified the fund activities that could threaten the system, they should propose regulations that would restrict those activities in all investment funds and other market participants that could conduct them. This is the most effective approach to regulating risk in

[98] Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, "International Cooperation in Financial Regulation," Remarks at the Cornell International Law Journal Symposium: The Changing Politics of Central Banks (Feb. 22, 2013), at 12, *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20130222a.htm. Governor Tarullo went on to observe that the, "challenges encountered during the initial effort to devise an LCR in the Basel Committee, with little or no precedent of national quantitative liquidity requirements from which to learn, should counsel caution in trying to construct new regulatory mechanisms from scratch at the international level." *Id.*

asset management and risk in the capital markets more broadly. It is also consistent with the principles for international regulatory coordination espoused by leading policymakers.[99]

Q2-2 - Is the initial focus on (i) finance companies, (ii) market intermediaries, and (iii) investment funds in developing sector-specific methodologies appropriate? Are there other NBNI financial entity types that the FSB should focus on? If so, why?

As discussed in our response to Q6-4, the methodology should be revised to focus on identifying activities that could present systemic risk. If the FSB and IOSCO continue to focus on individual entities in the asset management sector, they should broaden the scope of the assessment to consider the largest pools of investable assets, including public pension funds, sovereign wealth funds, and government sponsored entities, such as Fannie Mae and Freddie Mac. Some of those pools, such as pension funds, have fixed obligations. Because these entities can be much more significant to the markets in which they invest than individual investment funds, they should be included in any analysis of NBNI asset management entities.

Q6-5 - Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.

Although we believe that the methodology should be abandoned in favor of an assessment of activities, we offer comments on several indicators in the event the FSB and IOSCO continue to develop a methodology focused on individual entities in the asset management sector. Regardless of its focus, any methodology employed by the FSB and IOSCO to identify systemic risk should be objective, rigorous, consistent and transparent.

Unfortunately, the Proposal falls short of that standard, in part because some of the indicators are not indicative of systemic risk or are too ambiguous to be applied consistently. We request that the FSB and IOSCO revise the framework to include more information and rationale for these indicators and publish it for a comment.

Indicator 1-1: Net assets under management (AUM or NAV) for the fund – A simple measurement of fund size will not be indicative of the fund's systemic importance. We disagree with the theory that a larger fund will necessarily have a greater impact on counterparties and markets.[100] Liquidating a large portfolio of short-term U.S. Treasury bills would be easier and would have less market

[99] *See generally* Exec. Order No. 13,609, Promoting International Regulatory Cooperation, 3 C.F.R. 255 (2013), available at http://www.gpo.gov/fdsys/pkg/CFR-2013-title3-vol1/pdf/CFR-2013-title3-vol1-eo13609.pdf; Kathleen L. Casey, Commissioner, U.S. Securities and Exchange Commission, "The Role of International Regulatory Cooperation and Coordination in Promoting Efficient Capital Markets," Speech at the Instituto Bruno Leoni, Milan, Italy (June 12, 2012), *available at* http://www.sec.gov/news/speech/2010/spch061210klc.htm ("A benefit of [international] cooperative efforts for national regulators is that, to the extent they choose to implement [international] principles in accordance with their governing law, the underlying analysis of a broad array of experts worldwide significantly enhances the transparency and credibility of the resulting law or regulations"); Mary Miller, Assistant Secretary for Financial Markets, U.S. Department of the Treasury, Remarks at the Annual Washington Conference of the Institute of International Bankers, *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1442.aspx ("We should strengthen international coordination and always keep in mind our collective goals to protect the safety and soundness of our markets; to achieve a level playing field globally; and to realize the economic benefits of global finance ... To protect our economy from risks that arise outside the United States, and to provide a fair and level playing field for U.S. firms, we need comparable international standards. And it's important to realize the benefits of setting high standards, not just in terms of reducing risks and promoting financial stability but also in terms of attracting investors and capital").

[100] *See Proposal*, *supra* note 2, at 33.

impact than liquidating a portfolio of other assets. Therefore, we recommend using a risk-adjusted measure of size. The Basel III methodologies for risk-weighting bank assets and for bank liquidity analysis provide examples of such an approach.[101] For example, risk-adjustments should be made to account for (i) the diversification, interest rate, credit, liquidity and other market risks of a fund's portfolio, and (ii) the way it is funded (i.e., characteristics and provider).

Indicator 2-1: Leverage Ratio – For the reasons discussed in response to Q2-1, we believe that leverage in an investment fund should be an impact factor, not simply an indicator of interconnectedness. Furthermore, it would be inappropriate to use a gross leverage ratio like the one suggested in the Proposal to *analyze* leverage in order to determine a fund's systemic importance. Although in our response to Q3-2 we recommend a simple, non-risk-weighted, leverage ratio as a *materiality threshold* to narrow the universe, a risk-weighted leverage ratio should be used during any additional analysis. The Basel III risk-weighting methodology for bank assets is one example of such an approach.

Indicator 3-1: Turnover of the fund related to a specific asset / daily volume traded regarding the same asset

Indicator 3-2: Total fund turnover vs. total turnover of funds in the same category/classification

These proposed indicators may be more useful if used to monitor for sudden changes. A sudden shift in either direction may signal a problem, whereas a high stable ratio may not. A fund may represent a large percentage of daily trading volume in an asset, but that does not mean it lacks substitutability unless one assumes an absence or scarcity of other buyers, which may be inaccurate. These ratios also do not account for the synthetic exposure to many assets that is available to investors.

These indicators also raise questions about definition and implementation. How will they be measured and over what time period? How is "asset" defined? Does it mean an individual security or will it be defined more broadly? Will assets like exchange-traded derivatives and mortgage-backed securities that roll regularly be included? How relevant is turnover in an index fund?

Further, as we discuss in response to Q6-8 below with respect to "investment strategies," we believe that it will be difficult if not impossible to categorize or classify funds appropriately across jurisdictions, product types and investor demographics. Funds may be labelled, marketed and regulated differently but employ similar strategies and invest in many of the same assets.

Indicator 5-1: Number of jurisdictions in which a fund invests

Indicator 5-2: Number of jurisdictions in which a fund is sold / listed

Indicator 5-3: Counterparties established in different jurisdictions

[101] Although the G-SIB methodology includes only one indicator of size, "the measure of total exposures used in the Basel III leverage ratio," that is not simply a measure of gross exposures. *See* Basel Committee on Banking Supervision, *supra* note 34, at 6. For example, it permits some netting of securities finance obligations and the application of the standardized credit conversion factors from the Basel risk-based capital framework to calculate a bank's exposure to off-balance-sheet items in order to reflect more accurately their potential risk than a gross measure would. *See, e.g.*, Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirements," *supra* note 27. The risk-based analyses of a bank's assets and its liquidity risk profile, for purposes of calculating its capital and liquidity requirements – both of which are intended to reduce the probability and impact of a bank's failure – are much more finely calibrated and risk-sensitive.

There is no evidence of direct correlation between the *number* of jurisdictions to which a fund is exposed and the probability or impact of its failure. Simple totals of the number of jurisdictions in which a fund invests, is sold, or is exposed are not indicative of the relevance of that fund to those jurisdictions or the global financial system. Furthermore, these proposed indicators ignore the benefits of diversification, which may reduce both the probability and impact of a fund's failure. In fact, if applied, these indicators could discourage geographic diversification.

The Proposal assumes that "[f]unds that invest globally may have a larger global impact than funds that invest in the securities of only a few jurisdictions,"[102] but the opposite is at least as likely, if not more so, to be true. For example, a fund with a diverse portfolio of small investments in large liquid markets may have a much smaller global impact than a more concentrated fund.

In addition, the concept is not clearly defined and so will be difficult to operationalize and unhelpful in identifying systemic risk. What is meant, for example, by "invest globally" and "securities of only a few jurisdictions"? Does it mean to invest in (i) securities traded in foreign jurisdictions, (ii) issued by entities incorporated in foreign jurisdictions, or (iii) issued in a fund's domestic jurisdiction, by entities incorporated in that jurisdiction, that have significant international operations, sources of revenue or other securities listed in foreign jurisdictions?

Beyond the ambiguity of the concept, Indicator 5-1 appears to weight equally all jurisdictions and all levels of investment in or exposure to those jurisdictions. Even if this were a valid indicator of systemic importance, it would be inappropriate to weight minimal exposure to a small jurisdiction equally with significant exposure to a jurisdiction that is more integral to the global financial system. Similarly, it would be inappropriate to weight diversified exposure to an asset in that jurisdiction equally with concentrated exposure.

We believe that regulations already limit the number of jurisdictions in which most funds are sold / listed so we question the value of Indicator 5-2. We also question the value of Indicator 5-3, as we disagree that a fund's liquidation will be more complex if a fund's *counterparties* are located in different jurisdictions. The fund itself is only organized under the law of a single jurisdiction and the bankruptcy and other laws of that jurisdiction will govern its liquidation.

Q6-7 - Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?

We believe that size alone is not indicative of systemic risk regardless of how it is measured. Assuming that it is coupled with leverage, a measure of size as an indicator must be risk-weighted. Please see our responses to Q6-5.

Q6-8 - Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator 3-3)?

We believe that indicator 3-3 is flawed conceptually. If a strategy or an asset class has fewer than "10 market players globally," it is not likely to be important to the global financial system. Given the high substitutability and level of competition in asset management, an asset class or strategy with so few

[102] *Proposal*, *supra* note 2, at 36.

investors will be too small to matter. For the same reasons, a fund is unlikely to corner an important market.[103]

We also believe that "investment strategy" is and will continue to be too difficult to define and implement. In conducting a global assessment, it will be impossible to consistently identify and describe the strategies employed by funds across jurisdictions, product types and investor demographics. Funds may be labelled, marketed and regulated differently but employ similar strategies and invest in many of the same assets.

For example, a dividend and income fund, a sector equity fund (e.g., natural resources or utilities) and a global market neutral fund may hold many of the same securities but have very different investment strategies. On the other hand, three global large cap growth funds registered in different jurisdictions and marketed to different types of investors may manage their assets very differently even though they appear to pursue the same strategy.

Q6-9 - Would collecting or providing any of the information included in the indicators present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

A significant amount of data is already reported to regulators. For example, U.S. investment funds and their managers report vast amounts of data to U.S. regulators. Fidelity and/or the funds it manages file information such as financial statements, comprehensive holdings (including derivatives exposure), and custody information with the SEC on forms such as 13D, 17h, ADV, NCSR, N-MFP, N-Q, N-SAR, and PF. One can get a sense of the scope and scale of the data already available by considering the amount of information reported on just one of these forms. Based on a recent report by SEC staff, over 2,300 advisers covering over 18,000 private funds have filed Form PF, pertaining to nearly $7.3 trillion in private fund assets.[104] We believe that any additional request for information should be made only after carefully reviewing available information and using any comparable data already provided. Regulators should conduct a cost-benefit analysis before requesting new information that imposes significant reporting burdens.

Q1-1 - In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

The three transmission channels accurately describe how the failure of a financial entity could adversely impact other financial firms and markets. The three channels are not, however, equally applicable to all types of entities. As we discuss above, it is extremely unlikely that an investment fund could be Systemically Important. The limited applicability of these channels to investment funds supports our position and our explanation in response to Q6-4 that attempting to regulate funds through SIFI designation is inappropriate.

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[103] *See id.* at 35.
[104] *See* U.S. Securities and Exchange Commission, "Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports," July 25, 2013, *available at* http://www.sec.gov/news/studies/2013/im-annualreport-072513.pdf.

We appreciate the opportunity to comment on the Proposal. Fidelity would be pleased to provide any further information or respond to any questions that the FSB or IOSCO may have.

Sincerely,

cc: Jacob J. Lew, Secretary of the Treasury and Chairman of the Financial Stability Oversight Council
Richard Berner, Director of the Office of Financial Research
Richard Cordray, Director of the Consumer Financial Protection Bureau
Thomas J. Curry, Comptroller of the Currency
John Ducrest, Commissioner of the Louisiana Office of Financial Institutions
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
John Huff, Director of the Missouri Department of Insurance, Financial Institutions and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
Debbie Matz, Chairman of the National Credit Union Administration
Michael McRaith, Director of the Federal Insurance Office
Melvin Watt, Director of the Federal Housing Finance Agency
Mark Wetjen, Acting Chairman of the Commodity Futures Trading Commission
Mary Jo White, Chair of the Securities and Exchange Commission
S. Roy Woodall, Jr., Independent Insurance Expert
Janet Yellen, Chair of the Board of Governors of the Federal Reserve System

Luis Aguilar, Commissioner, Securities and Exchange Commission
Daniel Gallagher, Commissioner, Securities and Exchange Commission
Kara Stein, Commissioner, Securities and Exchange Commission
Michael Piwowar, Commissioner, Securities and Exchange Commission

APPENDIX B

March 25, 2015 Letter from Scott C. Goebel, Senior Vice President & General Counsel, Fidelity Management & Research Company to the Financial Stability Oversight Council

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March 25, 2015

Submitted electronically

Financial Stability Oversight Council
Attn: Patrick Pinschmidt
Deputy Assistant Secretary
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: Docket Number: FSOC-2014-0001
Notice Seeking Comment on Asset Management Products and Activities

Dear Mr. Pinschmidt:

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to respond to the Financial Stability Oversight Council's (the "Council" or "FSOC") notice seeking comment concerning asset management products and activities (the "Notice").[2] The Notice seeks comment on four primary topics: liquidity and redemptions, leverage, operational risk and resolution.[3] Our responses to the questions in the Notice focus on floating net asset value ("NAV") open-end mutual funds, which comprise the vast majority of Fidelity's assets under management, as well as their managers and other service providers.

The Council has recognized the diversity of the asset management industry and the important contributions the industry makes to economic growth and financial stability. We support the Council's shift in focus from reviewing individual asset management entities in the context of SIFI designation to a broader focus on products and activities, as well as the Council's decision to solicit public comment on the questions in the Notice, which is sound administrative practice. In particular, we believe that this approach has the potential to bring greater focus on the question of which asset management activities present actual risks worth addressing through new regulation, and also to illuminate the risk that overbroad policy measures will curtail desirable and beneficial capital markets activities.

We are nevertheless concerned that the Council's effort appears to consist primarily of questions organized around a series of hypothetical risks, with notably rare acknowledgment of the benefits of asset management to the economy and the capital markets, or the strong

[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses. Fidelity generally agrees with the views expressed by the Securities Industry and Financial Markets Association ("SIFMA") and the Investment Adviser Association ("IAA"), Investment Company Institute ("ICI") and Association of Institutional Investors ("AII") in their comment letters. We submit this letter to supplement the SIFMA and IAA, ICI and AII letters on specific issues.
[2] Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014) (hereinafter, the "Notice"), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-30255.pdf.
[3] *Id.*

regulatory framework that governs the asset management industry, and the mutual fund business in particular. Given Fidelity's long history and substantial experience with managing mutual funds, we have chosen to focus our substantive comments on the structure, operation and management of mutual funds as we consider the questions posed in the Notice. However, we also have significant concerns with the Council's overall approach to the inquiry of whether asset management activities present a systemic risk to the capital markets. Rather than mix these two discrete sets of concerns in a single response, we have opted to submit two letters. In this letter we focus on whether mutual funds or their managers present risks that could be systemic, framed by the four areas identified by the FSOC. In a companion letter filed today, we make a series of suggestions to enhance the inquiry the FSOC has begun.[4]

I. Introduction and Overview

As we have emphasized in prior letters,[5] mutual funds and their managers do not create or concentrate risk in a manner or on a scale that could threaten U.S. financial stability.[6] On the contrary, mutual funds promote financial stability and economic growth and help investors to meet their personal financial goals. They are a preferred investment vehicle for personal, family and retirement savings, and are a source of efficient funding for corporate and government issuers, both of which create jobs and drive U.S. economic growth.

Mutual funds provide significant benefits to both investors and issuers. At the same time, it is important to put their role in the U.S. economy in context. Mutual funds and their managers are a subset of the highly substitutable asset management industry, which itself represents a fraction of participants in the capital markets and the owners of financial assets. Current regulatory context is also important. Over the past 75 years, mutual funds, their managers, and related service providers have been thoroughly and well regulated: the Securities and Exchange Commission (the "SEC") has designed and refined a "comprehensive federal regulatory framework" that has "grown and adapted" to "address ever-evolving markets" and reflect the

[4] Companion Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council (Mar. 25, 2015).

[5] *See* Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council, 10 (Dec. 19, 2011); *see also* Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council (Nov. 5, 2010).

[6] We note that the questions about money market mutual funds that arose after the Reserve Primary Fund broke the buck in 2008 have inspired much of the broader regulatory interest in the asset management industry. The concerns regarding money market mutual funds ultimately resulted in two subsequent rounds of SEC regulations, the second of which appropriately focused on funds that experienced stress during the crisis. We believe that money market mutual funds do not merit further attention as part of this inquiry. As a result, Fidelity's comments focus on other products in our diverse industry, but the SEC's money market mutual fund regulatory process is illustrative of the sort of focused, deliberate and public process we believe should apply to any consideration of additional regulation of the asset management industry. The SEC articulated its concerns clearly, explored the differences among funds empirically and analyzed their implications for the SEC's concerns and potential responses. Given the aforementioned recent reforms, we do not believe that money market mutual funds are meant to be the subject of the Council's inquiries and thus our comments focus on traditional open-end variable NAV mutual funds, their managers and other service providers.

lessons learned during that time.[7] This regulatory framework is "strong and comprehensive."[8] Its effectiveness has been proven repeatedly both by the resilience of mutual funds in past crises, including the 2008 crisis, without any contribution to systemic risk,[9] and by the success of mutual funds in helping investors meet their long-term savings goals.[10] That regulatory framework remains the optimal way to regulate mutual funds, their managers and other service providers. It should serve as a model for the regulation of similar products, activities and service providers to which it does not already apply.

In the subsequent four sections of this letter, we expand on the following high-level points, organized around the areas of inquiry identified by the FSOC.

Liquidity and Redemptions

Liquidity management practices employed by portfolio managers provide stability to the markets; they do not amplify risk. Mutual fund regulation, structure, pricing, and management all serve to mitigate any "first-mover advantage" that the Council may be concerned about. Mutual funds by statute offer daily redemptions to investors, and are accordingly required to value their underlying portfolio assets daily and to price their shares daily.

Redemption requests are processed at the share price next determined after transaction requests are received by a fund, which prevents arbitrage. Mutual funds must disclose their NAVs each day and must frequently disclose their holdings. Mutual funds have highly liquid portfolios and must limit their holdings of illiquid securities to 15 percent of net assets. Portfolio managers employ robust liquidity management to minimize any risks associated with meeting redemptions. These liquidity and redemption practices, combined with the attributes of mutual fund investors and their long-term investment objectives, have resulted in low levels of mutual fund redemption rates, industry-wide, even during periods of significant market stress.

Leverage

We believe that excessive leverage may result in systemic risk, in some circumstances. However, given Federal law and regulation, mutual funds simply cannot take on leverage that

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[7] Mary Jo White, Chair, Sec. & Exch. Comm'n, Speech at the New York Times DealBook Opportunities for Tomorrow Conference: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

[8] *Id.*

[9] *See, e.g.*, Nellie Liang, Dir., Program Direction Sec. of the Off. of Fin. Stability Pol'y & Res., Bd. Of Governors of the Fed. Res. Sys., Remarks at the Brookings Institution Asset Management, Financial Stability and Economic Growth Conference (Jan. 9, 2015), *available at* http://www.brookings.edu/events/2015/01/09-asset-management-financial-stability-economic-growth (Mutual funds have "weathered all kinds of adverse market conditions without noticeably contributing to systemic risk. Indeed, they may provide a diversity of sources of funds for borrowers and may have had stabilizing influences on aggregate credit.").

[10] White, *supra* note 7 ("Investors, and retail investors in particular, have increasingly come to rely on advice from investment advisers and investments in mutual funds to meet their financial needs. In 2013, 57 million households, or 46 percent of all U.S. households, owned mutual funds. American households invest in mutual funds, and hope their investments will grow, for many important reasons, including making a down payment on a house, saving for a college education, and ultimately providing income for retirement.").

presents significant risks. Mutual funds typically have little debt and usually obtain 100 percent of their capital from equity investments.

Mutual funds are permitted to invest in derivatives, but the SEC requires funds that use certain derivatives to cover potential future obligations, either by segregating assets or engaging in an offsetting transaction. This practice greatly limits the ability of a mutual fund to take on outsized economic exposure through such instruments.

Operational Risk

Like any business, asset management industry participants face operational risks, though these risks do not threaten U.S. financial stability. Fidelity closely manages its operational risks to fulfill statutory and fiduciary responsibilities, and also to respond to client demand and the attendant business consequences of any lapse in operations. We keep detailed plans to address potential disruptions, frequently test those plans and maintain redundancy in essential services. Because asset managers are highly substitutable and fund assets are held at custodian banks, the failure of one asset manager to provide services in a timely manner leaves investors with myriad other options for obtaining the same services.

Resolution

Mutual funds and their managers are highly substitutable and regularly enter and exit the market through normal processes with no measurable impact. The focus on resolution and resolution planning originated in the need for a special resolution regime for the largest banks that were regarded by both policymakers and the market as "too big to fail" in the recent financial crisis. Policymakers and regulators consider special resolution planning necessary to mitigate systemic risks from a company that (i) provides a critical function or service within the financial system and is not easily substitutable, and (ii) cannot be resolved through normal processes without threatening financial stability. Mutual funds and their managers do not meet either of these criteria.

II. Liquidity and Redemptions

Introduction

The Council has asked for information concerning liquidity and redemptions in pooled investment vehicles in an effort to understand whether investing through such vehicles rather than directly in securities influences investor behavior in a way that could impact U.S. financial stability.[11]

[11] Notice, 79 Fed. Reg. at 77,490.

A. Mutual Fund Assets are Highly Liquid.

The SEC requires that most open-end funds invest at least 85 percent of net assets in "liquid securities,"[12] which are defined as any asset that can be disposed of within seven days at approximately the value at which the asset is valued by the fund.[13]

Many mutual funds operate more conservatively than SEC guidance requires. For example, most Fidelity mutual funds limit illiquid holdings to 10 percent of net assets. This liquidity standard is fully disclosed in the applicable funds' registration statements and promotes sound liquidity management practices by Fidelity portfolio managers to ensure that they maintain fund liquidity at or above the disclosed level.[14] Fidelity also constantly monitors the liquidity levels of the funds to ensure compliance with both SEC limits and internal limits. Compliance with these liquidity thresholds is subject to regular internal compliance checks, independent Board oversight and periodic SEC examinations.

B. Existing Regulation and Resulting Management Practices of Mutual Funds Have Ensured Sufficient Liquidity Even in Times of Market Stress.

Mutual fund valuation, pricing, and liquidity policies, designed to ensure full compliance with the Investment Company Act of 1940, as amended (the "1940 Act") and SEC rules, regulations, and guidance, effectively eliminate incentives for redemptions that might otherwise arise from the structure of a pooled investment vehicle.

Variable NAV mutual funds carry none of the "run risk" that affects banks and other businesses that employ a similar business model. On the asset side of the balance sheet, a mutual fund's assets are highly liquid, marked to market or fair valued daily, and publicly disclosed in detail regularly;[15] whereas many assets that banks hold, such as mortgage loans, are illiquid, hard to value and rarely, if ever, disclosed to the public in detail. On the liability side of the balance sheet, the repayment obligation of a mutual fund is derived from the aggregate value of the assets

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[12] Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 20, 1992).

[13] *Id*. at 9829; *see also* Investment Company Act § 22(e). A security's liquidity is initially determined at the time of purchase. Over time, various factors and developments can change a liquid security into an illiquid security and vice versa. Yakov Amihud, Haim Mendelson & Lasse Heje Pedersen, *Liquidity and Asset Prices*, 1 FOUND. & TRENDS IN FIN. 269, 270-72 (2005). While determinations regarding the liquidity of a particular investment may present challenges in some circumstances, the SEC's liquidity requirements compel fund companies to meet those challenges by making good faith judgments.

[14] The following disclosure appears in our mutual funds' registration statements: "The fund does not currently intend to purchase any security if, as a result, more than 10 percent of its assets would be invested in securities that are deemed to be illiquid because they are subject to legal or contractual restrictions on resale or because they cannot be sold or disposed of in the ordinary course of business at approximately the prices at which they are valued. For purposes of these limitations, an asset generally is considered liquid if it can be sold or disposed of in the ordinary course of business within 7 days at approximately the value at which the asset is valued by the fund. Although a security's liquidity determination is usually made at the time of purchase, over time various factors and developments can change a liquid security into an illiquid security and vice versa. In addition, under certain circumstances, a presumptively illiquid security may be reclassified as liquid."

[15] In addition to the holdings disclosed in annual and semi-annual shareholder reports, mutual funds are required to file a schedule of their portfolio holdings as of the end of the first and third fiscal quarters with the SEC on Form N-Q (within 60 days after the quarter end). *See* 17 C.F.R. § 270.30b1-5.

available to meet redemptions. This is unlike a bank, which promises to repay the full amount of a customer's deposit on demand. A mutual fund promises to redeem only the current value of a shareholder's investment in the fund, based on the fund's NAV next determined after the redemption request is made (typically as of the close of trading). That current value at which the shareholder must be redeemed must, by regulation, be based on the daily value of the fund's portfolio assets, either marked to market or fair valued.[16] These two features – the absence of a fixed repayment obligation competing for a limited amount of assets, combined with market/fair value pricing – eliminate the conditions necessary for a "run" and effectively limit the incentive for investors in a mutual fund to redeem shares in response to market events, because the impacts of those market events are reflected in the NAV that a redeeming shareholder will receive, whether the shareholder is a "first-mover" or a later mover.

When faced with substantial redemption demands,[17] portfolio managers can sequence sales of fund assets to minimize the impact of selling illiquid assets, while ensuring that a fund remains invested at its target allocation.[18] Portfolio managers consider many data points when making decisions about which assets to sell, including how a security has performed against expectations, how liquid a security is, the size of a fund's exposure to that security, company, industry or region, and similar attributes of other securities in the fund's portfolio. In addition, portfolio managers have the ability to buffer the impact of redemptions by using cash to meet redemptions or by selling a proportionate share of all fund assets. Portfolio managers do not take a single approach to managing redemptions (*e.g.*, selling liquid assets first, as the FSOC has suggested),[19] and instead balance redemption management with fiduciary duties to remaining shareholders to retain a portfolio composition that is optimal, competitive, and in line with a fund's investment guidelines.

In addition to liquidity management tools used by portfolio managers, funds have several other mechanisms to accommodate redemption demands. Redemption proceeds also may be paid in securities or other property, rather than in cash. This mechanism is rarely used for retail investors; and is more commonly used for other purposes, such as to manage large institutional redemptions (*e.g.*, retirement plan changes), because it allows for transfers at current market values, does not impact asset prices and may minimize or eliminate fund transaction costs of liquidating portfolio assets. Although mutual funds normally process redemption requests by the next business day, they can delay payment of proceeds for up to seven days, if making immediate payment would adversely affect the fund.[20] Because there is no way for investors to

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[16] 17 C.F.R. § 270.2a-4(a)(i).

[17] Importantly, securities do not need to be sold every time a redemption order is placed. Sale of fund assets is necessary only when gross redemptions significantly exceed net inflows.

[18] *See, e.g.*, Mary Childs, *Pimco's Biggest Fund Had Record Redemptions on Gross Exit*, BLOOMBERG (Nov. 5th, 2014), *available at* http://www.bloomberg.com/news/articles/2014-11-04/pimco-total-return-lost-27-5-billion-after-gross-s-exit (explaining how despite record levels of redemptions, Pimco's Total Return Fund had been and continues to be managed to maintain adequate liquid assets to meet redemption requests, without necessitating a change in investment strategy).

[19] Notice, 79 Fed. Reg. at 77,490.

[20] Investment Company Act § 22(e), 15 U.S.C. § 80a-22(e). As a practical matter, three-day settlement requirements under Exchange Act Rule 15c6-1, 17 C.F.R. § 240.15c6-1 (imposing maximum time period on broker dealers for the payment of funds and delivery of securities), effectively take most fund investments to a T+3 settlement timeline.

know, *ex ante*, what steps a fund may take to meet redemptions, these redemption management techniques may mitigate rather than contribute to a "first-mover advantage" for investors who might anticipate that a fund will incur substantial redemptions.

C. There is No Historical Evidence that Mutual Funds have Faced Elevated Redemptions at a Level that Could Create Systemic Risk.

Mutual funds have historically experienced very low levels of redemptions, even during times of market stress. An Investment Company Institute ("ICI") study of equity fund flow data from 1955 through 2013 reveals that in the 17-month period from November 2007 to March 2009 (during the worst of the financial crisis), net outflows from equity funds were only 4.1 percent.[21] During other periods of market stress, including the 1987 stock market crash and the bursting of the internet bubble in 2000, the largest average net outflows in any month were only 3.2 percent.[22] This data is confirmed by a similar analysis performed by Strategic Insight on equity and balanced funds.[23] ICI has also studied outflows from bond funds during periods of market stress between 1990 and 2014. During that entire period, even during the 2008 crisis and the so-called "Taper Tantrum" in 2013, average monthly outflows from bond funds never exceeded 2.5 percent of assets.[24]

The empirical evidence is inconsistent with a hypothesis that the structure of mutual funds might incentivize investors to engage in "runs" on mutual funds to reduce their exposure to underlying assets. The available data suggest the opposite. ICI data reflect that mutual fund investors traded far less during the 2008-2009 market turmoil than did other market investors.[25]

This should not be surprising. Mutual fund investors tend to be investing for long-term goals such as retirement.[26] ICI data reflect that 72 percent of mutual fund shareholders indicate

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[21] *See* Letter from the Investment Company Institute to the Secretariat of the Fin. Stability Bd., F-6 to F-7 (Apr. 7, 2014) (hereinafter, the "ICI Letter"), *available at* http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.
[22] *See id*. at F-6.
[23] *See* Letter from Avi Nachmany, Dir. of Res., Strategic Insight, *A Perspective on Mutual Fund Redemption Activity and Systemic Risk* to the Sec. Exch. Comm'n, 4 (Nov. 1, 2013), *available at* http://www.sec.gov/comments/am-1/am1-25.pdf (using a slightly different set of data, Strategic Insight found that monthly inflow and outflow rates for equity and balanced funds typically fluctuate in a narrow range, around 2-3 percent of assets, with very few spikes over 4 percent).
[24] *See id*. at F-11; *see also* Sean Collins, *Why Long-Term Fund Flows Aren't a Systemic Risk: Past is Prologue*, ICI VIEWPOINTS (Feb. 18, 2015), *available at* http://www.ici.org/viewpoints/view_15_fund_flow_01.
[25] ICI reports that mutual funds hold approximately a quarter of the equities traded on the NYSE and NASDAQ. Nonetheless, mutual fund sales accounted for only approximately 6 percent of the market trading volume during the market downturn in 2008 and 2009. In other words, in proportion to their market holdings, mutual funds were far less likely to trade their securities than were other market investors. *See* ICI Letter, *supra* note 21, at F-15.
[26] Regulators have drawn the same conclusion regarding the likelihood that mutual fund investors' long-term investment perspective likely helps explain why mutual funds have had a stabilizing effect on the financial system and not threatened its stability. *See, e.g.*, Fin. Stability Bd. & Int'l Org. of Sec. Comm'ns, *Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, 30 n.38 (Jan. 8, 2014) (hereinafter, the "FSB/IOSCO Consultative Document"), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf ("[E]ven when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the [2000-2012] observation period. Part of the explanation may be that many US investors hold mutual fund shares for retirement purposes. As such, these

that retirement savings is their primary goal, and that 50 percent of U.S. mutual fund assets are held by retirement-related accounts (*e.g.*, defined contribution plans and individual retirement accounts "IRAs").[27] Such long-term investors are less likely to sell in response to short-term market fluctuations, and often will have automated investment programs, such as defined contribution plans (*e.g.*, 401(k) plans), that result in fund inflows even during market downturns.

D. Mutual Funds that Invest in Less Liquid Assets Do Not Threaten U.S. Financial Stability.

Mutual funds holding less liquid asset classes are a very small part of the total market.[28] They are not representative of the majority of mutual funds and hold too few assets individually or in the aggregate to threaten U.S. financial stability. For example, high yield bond mutual funds hold only 28 percent of total traded high yield bonds.[29] The high yield bond market itself is small relative to the global debt market, accounting for approximately two percent of total global debt.[30] Redemption rates for these funds, even during periods of crisis, have historically never threatened U.S. financial stability.

Portfolio managers of funds holding less liquid asset classes have been able to use redemption and liquidity management tools to meet redemptions without difficulty, even during periods of market stress. These tools include holding sufficient cash, maintaining a diverse portfolio (including holding some assets in investment grade bonds), and maintaining bank lines of credit to bridge timing differences between redemption payments and receipt of proceeds from sales of securities.

E. Speculation that Investors Will "Rush to Redeem" is Unsupported.

The FSOC suggests that liquidity risks could arise in mutual funds based on the premise that the costs of expected future redemptions may be predictable, large and borne by investors whose assets remain in a fund, which supposedly could prompt investors to rush to redeem their shares, in an attempt to avoid the expected future costs.[31] There is little academic literature to support this vision of investor behavior and even less to suggest that such a dynamic, if it were to materialize, could threaten U.S. financial stability. If the FSOC is basing its hypothesis about liquidity risk in mutual funds (or any other hypothesis) on its own research, it should publish that for comment. If the FSOC is relying on academic research, it should make that clear so that commenters can examine the methods used to produce the research as well as the assumptions and limitations that qualify the researchers' findings.

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investors' investment horizon could be long-term, whereby they would prefer to remain invested rather than cash-out during a market downturn.").

[27] INVESTMENT COMPANY INSTITUTE, 2014 INVESTMENT COMPANY FACT BOOK, 118, at 107 (2014) (hereinafter, the "ICI FACTBOOK"), *available at* http://www.icifactbook.org/.

[28] *See* Barbara Novick et al., *Who Owns The Assets? A Closer Look at Bank Loans, High Yield Bonds and Emerging Markets Debt*, BLACKROCK VIEWPOINT, 2 (Sept. 2014), *available at* https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf.

[29] *Id.* at 11.

[30] *Id.* at 10.

[31] Notice, 79 Fed. Reg. at 77,490.

To illustrate the importance of that examination, we review the assumptions and limitations of one paper analyzing mutual fund outflows (the "Flows Paper")[32] that some policymakers have cited in support of the FSOC's liquidity risk hypothesis.[33] Many who have cited the Flows Paper appear not to have accounted for the limitations in the authors' research or the assumptions about mutual fund management and shareholder behavior that qualify its conclusions. If they had, we believe they would recognize that the paper does not support such a sweeping hypothesis about liquidity risk in mutual funds.

At the outset of the Flows Paper, the authors recognize that there is no existing body of empirical evidence that establishes the relationships postulated.[34] Further, the Flows Paper does not purport to identify the relation in all mutual funds or to describe the behavior of the average mutual fund investor.[35] Taken at face value, at most it describes supposedly "illiquid" funds and investor behavior at the margin of the industry.

When one considers who mutual fund investors are and why they invest, and compares those attributes to how those investors would have to behave *en masse* in order for the FSOC's hypothetical liquidity risk to materialize, there are good reasons to dismiss it as not just improbable or very unlikely, but completely unrealistic. Non-money market mutual fund investors are almost exclusively individual investors.[36] Almost all of those households, 92 percent, are investing for retirement.[37] Although they may have multiple goals, as noted above, retirement savings is the primary goal for 72 percent of them.[38]

Now consider that the Flows Paper, which is cited frequently by policymakers speculating about this hypothetical liquidity risk, including by Andrew Haldane in his speech "The age of asset management?"[39] *excludes retirement shares*.[40] Research has shown that

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[32] Qi Chen, Ital Goldstein, & Wei Jiang, *Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows*, 97 J. OF FIN. ECON. 239 (2010).
[33] *See, e.g.*, Andrew G. Haldane, Exec. Dir. of Fin. Stability, Bank of Eng., Speech: The Age of Asset Management? (Apr. 4, 2014), *available at* http://www.bankofengland.co.uk/publications/Pages/news/2014/068.aspx; Jeremy C. Stein, Member, Bd. of Governors of the Fed. Res. Sys., Remarks at the 2014 U.S. Monetary Policy Forum (Feb. 28, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/stein20140228a.htm.
[34] Chen, *supra* note 32, at 239. The authors state explicitly that "virtually no empirical study identifies [the] relation in data" that they are attempting to observe. *Id.*
[35] *Id.* at 244 (classifying roughly 28 percent of the funds in the authors' sample as "illiquid" and not all of those experiencing poor investment performance).
[36] ICI reports that institutional investors held less than 5 percent of long-term mutual fund assets at year-end 2013. ICI FACTBOOK, *supra* note 27, at 118, Figure 6.17. At year-end 2013, nonfinancial businesses, financial institutions, nonprofit organizations, and other institutional investors held $584 billion in non-money market mutual funds, compared to household holdings of $11,715 billion in non-money market mutual funds. *Id.*
[37] *Id.* at 107 ("In 2013, 92 percent of mutual fund–owning households indicated that saving for retirement was one of their household's financial goals.").
[38] *Id.* at 107 ("Seventy-two percent indicated that retirement saving was their household's primary financial goal."); *see also id.* at i (showing that, of the $23 trillion invested in the U.S. retirement market, $6.5 trillion is invested in retirement accounts that provide tax advantages like individual retirement accounts and defined contribution retirement plans like 401(k) plans).
[39] Haldane, *supra* note 33, at 6.
[40] Chen, *supra* note 32, at 243-4 ("We also exclude retirement shares that are usually issued for defined-contribution plans, such as 401(k) and 403(b) plans.").

investors saving for retirement trade infrequently.[41] Furthermore, the authors are aware that retirement plan sponsors sometimes limit the number of trades that participants can make in a given time period.[42] Thus, they have explicitly excluded from analysis a large fraction of mutual funds and investors that, for structural reasons, are unlikely to display the hypothesized performance sensitivity relationship.

The authors' exploration of the alleged relationships among mutual fund liquidity and investor behavior is also limited in a number of other important ways that policymakers should consider. It includes only equity funds, not bond funds. The attempt to distinguish between institutional and retail investors, based in part upon the names of share classes, does not appear to appreciate the extent to which "institutional" share classes can include retail investors purchasing directly or through intermediaries (*e.g.*, omnibus accounts). The authors also only examine data that is 10-20 years old (from 1995-2005). That is especially problematic for anyone trying to use it to predict future behavior of mutual fund investors given: (i) the substantial enforcement activity and reforms by the SEC regarding mutual fund pricing practices and disclosures around the end of that period,[43] (ii) the relevance of investors' behavior during the 2008 crisis, and (iii) the regulatory reforms that have been adopted since the crisis.

Even if we disregard these limitations, the Flows Paper at most suggests that illiquid equity mutual funds that are not held through retirement share classes may experience net outflows of approximately two percent of assets in response to the poorest performance, compared with outflows of approximately 0.75 percent in similarly performing funds holding liquid equities.[44] Thus, the results themselves do not support an argument that the alleged increased redemptions would lead to anything that could be described as systemic risk and the data limitations preclude extrapolation from the study to argue that such a risk exists.

Beyond the explicit limitations on the results of the Flows Paper, consider the questionable assumptions about how mutual funds are managed and how their investors would have to behave in order for the hypothetical liquidity risk to materialize.[45] Lots of investors in

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[41] Julie Agnew, Pierluigi Balduzzi, & Annika Sundén, *Portfolio Choice and Trading in a Large 401(k) Plan*, 93 THE AM. ECON. REV. 193, 194 (2003*), available at* https://mason.wm.edu/faculty/agnew_j/documents/portfoliochoice.pdf (showing study results that 87 percent of the 401(k) participants from a large brokerage house do not conduct any trade in a year).

[42] Chen, *supra* note 32, at 243-4.

[43] *E.g.*, Sec. & Exch. Comm'n, Final Rule: Disclosure Regarding Market Timing and Selective Disclosure of Portfolio Holdings, 69 Fed. Reg. 22,300 (Apr. 23, 2004); Sec. & Exch. Comm'n, Final Rule: Disclosure of Breakpoint Discounts by Mutual Funds; 69 Fed. Reg. 33,262 (June 14, 2004); *see also* Press Release, Sec. & Exch. Comm'n, *Putnam Agrees to Pay $55 Million to Resolve SEC Enforcement Action Related to Market Timing by Portfolio Managers* (Apr. 8, 2004); Press Release, Sec. & Exch. Comm'n, *Prudential to Pay $600 Million in Global Settlement of Fraud Charges in Connection With Deceptive Market Timing of Mutual Funds* (Aug. 28, 2006).

[44] *See* Chen, *supra* note 32, at 247, Figure 1.

[45] The study relies on several invalid assumptions about mutual funds, including that: (i) mutual fund portfolio managers either have little intraday visibility into redemption activity or otherwise do not have the ability to act on this information ("[T]rades made by mutual funds in response to redemptions happen only after the day of the redemptions and thus their costs are not reflected in the NAV of that day." *Id.* at 242.); (ii) retail mutual fund investors can predict significant redemptions and are willing to act on that information to save relatively small sums of money, yet mutual fund portfolio managers are unable to predict the same redemption activity and/or have no

many different mutual funds would have to employ an arbitrage strategy designed only to avoid an expected future decline in their funds' NAVs resulting from other shareholders redeeming their investments. These future redemptions and resulting declines in NAV would have to be predictable by retail investors and also provide a strong enough incentive not to be overridden by other investment decision-making factors such as the terms of the fund and portfolio management. Importantly, mutual fund investors would have to be monitoring their investments closely and prepared to trade out of their funds to avoid a decline in NAV that they predict. In other words, to generate market-wide effects, a substantial percentage of individual investors would have to make similar predictions across multiple "illiquid funds" contemporaneously and act on them by selling their mutual fund shares.

Are those realistic assumptions about how mutual fund shareholders will behave? Not based on our experience, the substantial data on mutual fund flows during all sorts of market conditions,[46] or other regulations based on the behavior of retail investors.[47] Remember, these are millions of middle class investors, not a few hedge fund managers pursuing an arbitrage strategy with billions of dollars.[48] The median mutual fund assets of a fund-owning household are $100,000 and the median number of mutual funds owned is three.[49]

Using those figures to illustrate the point, does the FSOC or anyone else really think that lots of individual men and women are monitoring each of their three funds closely in an attempt to predict and avoid changes in future NAVs associated with other shareholders redeeming from one of them? If the costs investors could avoid were one percent of fund assets, it would amount to $1 on every $100 invested. If an investor held $100,000 spread evenly across three funds, one of which was "illiquid" and the investor knew it and was ready to act, the one-time loss avoidance opportunity would be $333. Of course, any loss avoided by the redeeming investor would be offset by other risks that he or she would bear (like the risk of missing gains) and other costs incurred (like the transaction costs of investing in another fund or directly in the underlying assets). As noted above, most mutual fund investors are saving for long-term goals like retirement; not pursuing arbitrage strategies based on short-term trading.

An investor buys shares in a mutual fund to begin with because he or she wants to own the assets the fund holds. That presents another question for those exploring the hypothetical liquidity risk to answer – what happens after the investor redeems? A decision to redeem necessarily involves a decision to do something with the proceeds of the redemption.

Many mutual fund redemptions are triggered by an anticipated expense (to pay for a house, education or other expenses). If the redemption proceeds are not spent, the investor is

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access to actual redemption requests intraday and are unable to make adjustments to mitigate its impacts; and (iii) the fund manager's only option to redeem shares is to pay out of cash or other liquid assets (*i.e.*, fund managers never sell assets in proportion to fund holdings, nor do they attempt to minimize or mitigate the impacts of selling illiquid assets). In reality, as we describe in this letter, portfolio managers have much more information and many more options available to them to respond to redemptions than are imagined by this model.

[46] *See supra* Section II.C (citing market data from historical periods of stress).

[47] *See, e.g.*, Money Market Fund Reform: Amendments to Form PF, 79 Fed. Reg. 47,736, 47,774 (Aug. 14, 2014).

[48] ICI FACTBOOK, *supra* note 27, at 103, Figure 6.2 (stating that 96.2 million individuals are mutual fund investors).

[49] *Id.*

either making a short-term trade out of a fund and back into the same asset class (either directly or through another fund); or, the investor is making an asset allocation decision to move the investor's money out of that asset class altogether. If the trade is temporary, how can a short-term trade in and out of an asset class create fire sale risk and threaten U.S. financial stability? After all, the seller soon becomes a buyer. If the investor is making an asset allocation decision and does not want to own the fund's assets any longer, the liquidity risk hypothesis is irrelevant because the decision to trade is motivated by a desire to sell those assets, not to avoid trading costs or respond to predicted mispricing within a fund.

The hypothesis that mutual fund liquidity and redemption risks could threaten U.S. financial stability is unsupported by realistic assumptions or empirical data. To our knowledge, the FSOC has never quantified the amount of hypothesized redemption costs, demonstrated that they would be substantial enough to motivate redemptions at a level that would cause asset sales to impact asset prices materially, or modeled the effects of these hypothetical dynamics on U.S. financial stability and economic growth. As former Fed Governor Jeremy Stein has observed, regulators do not "know enough about the empirical relevance of the AUM-run mechanism, to say nothing of its quantitative importance, to be making recommendations at this point."[50]

F. Additional Regulation to Prescribe Mutual Fund Liquidity Could Harm Investors and Capital Markets.

Even if one were to ignore all of the evidence that the hypothetical liquidity risk does not exist and take action to try to reduce it, neither the FSOC nor anyone else has defined or endorsed any macroprudential policy tools that might address any of the "liquidity risks" that apparently concern the FSOC, much less tested such tools in practice or modeled their effects. For example, some regulators have suggested that the market liquidity risk they allege mutual funds might present could be managed through the imposition of gates and fees on mutual funds.[51] Yet others have warned that such tools might be counterproductive.[52] Indeed, Esther George, the President and CEO of the Federal Reserve Bank of Kansas City, has noted that such macroprudential tools are untested, and that the use of macroprudential policy as "the 'first line of defense' for maintaining financial stability…expects too much of tools for which our understanding is imperfect," and may "place a large burden on our regulatory infrastructure."[53] The use of untested regulatory tools not only risks regulatory failure, but also threatens to injure mutual fund investors and interfere with capital markets. For example, if the FSOC imposed redemption gates on funds investing in less liquid assets, this might prevent small investors from withdrawing their investments from funds at the times of greatest market turmoil, potentially imposing hardships on (typically retail) mutual fund investors. Cash requirements or redemption

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[50] Stein, *supra* note 33.
[51] *See, e.g.*, *id.*
[52] *See, e.g.*, Marco Cipriani et al., *Gates, Fees, and Preemptive Runs*, FED. RES. BANK OF N.Y. STAFF REPS. (Apr. 2014), *available at* http://www.newyorkfed.org/research/staff_reports/sr670.pdf.
[53] Esther L. George, President & CEO, Fed. Res. Bank of Kan. City, Speech at the Financial Stability Institute/Bank for International Settlements Asia Pacific High Level Meeting: Monetary and Macroprudential Policy: Complements, Not Substitutes (Feb. 10, 2015), *available at* http://www.kansascityfed.org/publicat/speeches/2015-George-Manila-BIS-02-10.pdf.

gates for funds investing in less liquid assets may reduce the attractiveness of those mutual funds to investors, reducing the overall investment and liquidity in those markets.

Question 1: How does the structure of a pooled investment vehicle, including the nature of the redemption rights provided by the vehicle and the ways that such vehicles manage liquidity risk, affect investors' incentives to redeem? Do particular types of pooled investment vehicles, based on their structure or the nature of their redemption management practices, raise distinct liquidity and redemption concerns (*e.g.*, registered funds, private funds, or ETFs)?

The structure of mutual funds does not enhance incentives for investors to redeem in a way that could result in a threat to U.S. financial stability. This is true for several reasons, most of which have been discussed above.

First, and perhaps most importantly, unlike bank depositors, who expect to receive the value of their deposit in a bank upon withdrawal (plus any interest accrued), mutual fund investors expect to receive only the current value of their investment.

Second, mutual fund investors tend to be retail investors saving for long-term investment purposes, such as education and retirement. Many shareholders invest through 401(k) retirement accounts and 529 accounts, both intended for long-term savings.[54] These investors tend not to redeem in response to short-term market moves. In fact, due to automated investment processes, these investors often provide a buffer to large market movements because they will be buying when other investors are selling. ICI research demonstrates that during the 2008 market downturn, mutual funds traded far less than their proportionate holdings of shares,[55] meaning that heavy sales of equities during that period was driven by investors other than mutual fund investors. As Brian Reid, Chief Economist for the ICI has commented, "the reason that you tend to have a great deal of stability is that…these retail investors are long term investors…so as a result, that money is staying there."[56]

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[54] *See* ICI FACTBOOK, *supra* note 27, at 103, Figure 6.2 (noting that 92 percent of mutual fund investors are saving for retirement). ICI reports that in 2013, out of the total $11.715 trillion that was invested in U.S. non-money market mutual funds, $6.5 trillion was held by IRAs and defined contribution plans like 401(k)s. The $6.5 trillion in mutual fund assets held by IRAs and defined contribution plans represented 28 percent of the $23.0 trillion U.S. retirement market and 43 percent of all mutual fund assets at year-end 2013. While retirement savings accounts held half of long-term mutual fund assets industrywide they held a much smaller share of money market fund assets industrywide (14 percent). Similarly, mutual funds held in defined contribution plans and IRAs accounted for 52 percent of household long-term mutual funds but only 21 percent of household money market funds. *See id.* at 147. *See also id.* at 152 ("Twenty-five percent of households that owned mutual funds in 2013 cited education as a financial goal for their fund investments. As of year-end 2013, there were 10.4 million Section 529 savings plan accounts with [over $205 billion in assets].").

[55] *See* ICI Letter, *supra* note 21, at 5 (stating that "across a range of adverse market events and conditions, sales of stocks and bonds by regulated US funds represent a modest share of overall market activity—a fact that reflects the nature today of their largely retail investor base and the long-term financial goals of most fund investors").

[56] Brian Reid, Chief Economist, Investment Co. Inst., Presentation at the Brookings Institution Asset Management, Financial Stability and Economic Growth Conference (Jan. 9, 2015), *available at* http://www.brookings.edu/events/2015/01/09-asset-management-financial-stability-economic-growth (noting that while individual funds can have large outflows in any given month, even in a [volatile] market, overall net fund flows tend to be stable: "For

Third, as Professor Matthew Richardson has explained, "in a setting in which assets are fairly priced by funds with floating NAVs, it is not apparent why mutual fund investors are more likely to redeem (*i.e.*, leading to asset sales) than other investors in those assets."[57] All mutual funds are required to ensure that assets are fairly priced, and Fidelity goes to great lengths to meet these requirements for its mutual funds. These steps include:

- Daily Pricing and Daily Redemptions. Mutual fund investors are able to redeem shares on a daily basis, based on the current market value of the fund's portfolio securities. Daily pricing, using well regulated pricing mechanics, assures investors that whenever they decide to redeem they will receive an accurate NAV for their shares. For portfolio securities that are difficult to value, or for which a reliable price is not available, fair value pricing is used. Fidelity has comprehensive fair value pricing policies and procedures that are subject to oversight and monitoring by the funds' Boards of Trustees. Knowing that they have ready access to their assets, at a fair value, investors in mutual funds have no different incentives to redeem in response to short-term market fluctuations than investors who buy the same assets directly.

- Forward Pricing. SEC rules require that all shareholder transactions be processed at the NAV per share determined at the end of the day on which a transaction request is placed.[58] As shareholders place trades throughout the day into or out of a fund, they do not know what that end-of-day NAV will be. Forward pricing prevents shareholders from redeeming in order to avoid short-term market fluctuations because the NAV a shareholder receives will reflect those fluctuations.

- Monitoring and Oversight. The valuation of fund assets and pricing of fund shares are monitored and evaluated regularly by Fidelity, including oversight by the mutual fund boards and their independent trustees, and are subject to inspection and examination by the SEC as well. This monitoring and oversight ensures strict compliance with our valuation and pricing procedures, and in turn provides a high degree of confidence in the accuracy of our mutual fund pricing.

Reliable valuation and pricing procedures means that, if it were to occur, any mispricing of a mutual fund would be very small, and corrected quickly, and there is little reason to believe that investors would be aware of it or seek to redeem shares, *en masse*, to take advantage of any such unforeseeable pricing anomaly.

Question 2: To what extent do pooled investment vehicles holding particular asset classes pose greater liquidity and redemption risks than others, particularly during periods of market stress? To what extent does the growth in recent years in assets in pooled

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instance, in October 2008, 10 percent of the funds had outflows of 8 percent or more. But 10 percent of the funds had inflows of 4 percent or more. And effectively, the net of those inflows and outflows was about 1.5 percent.").

[57] *See* Matthew Richardson, Prof. of Applied Econ., NYU Stern Sch. Of Bus., *Asset Management and Systemic Risk: A Framework for Analysis*, 20 (Mar. 19, 2015) (on file with the Fin. Stability Oversight Council, Docket No. FSOC-2014-0001).

[58] *See* 17 C.F.R. § 270.22c-1.

investment vehicles dedicated to less liquid asset classes (such as high-yield bonds or leveraged loans) affect any such risks?

Almost by definition, mutual funds invested in less liquid asset classes potentially present greater liquidity and redemption risks to shareholders than other mutual funds. But liquidity management for those funds also receives special attention. Fidelity takes extra precautions in managing funds that invest in less liquid assets to ensure sufficient liquidity to meet redemptions. A portfolio manager will likely maintain a higher level of cash for a fund holding a less liquid asset class, and will likely increase this level during a period of market stress.[59] Portfolio managers also have available all of the other liquidity management strategies described in the response to Question 5 in this section.

Even if portfolio managers had to sell illiquid assets in response to heavier than normal redemption demands, it is unlikely that the sales of such assets would meaningfully impact the financial system. Mutual funds account for only 18-28 percent of the most-relevant markets for illiquid assets – high yield bond funds, bank loan funds, and emerging market debt funds.[60] Even if redemptions across all mutual funds invested in those markets were twice as large as the greatest historical level of redemptions from bond funds (2.5 percent), this would only account for 0.9-1.8 percent of the markets for these assets. Additionally, these three markets together account for only 6 percent of the global debt market.[61] It is hard to imagine how redemptions in funds that account for such a small portion of these markets could pose a plausible systemic risk to U.S. financial stability.

Question 3: To what extent might incentives to redeem shares in a pooled investment vehicle or other features of pooled investment vehicles make fire sales of the portfolio assets, or of correlated assets, more likely than if the portfolio assets were held directly by investors?

For the reasons stated in our response to Question 1 above, we do not think investing in mutual funds creates different incentives to redeem than if an investor were to hold the portfolio assets directly. Even if mutual funds were to experience unprecedented levels of redemptions, this would not lead to "fire sales" of portfolio assets—and we define a fire sale to occur when prices are pushed substantially below their fundamental value due to price pressure resulting from excess sales.[62] There are several reasons these redemptions would not lead to "fire sales":

- Liquid Assets. A "fire sale" is most likely to occur in less liquid markets where there are fewer willing buyers and sellers. Mutual funds, however, do not hold high percentages of illiquid or hard-to-value assets. Mutual funds are subject to SEC

[59] *See* Novick, *supra* note 28, at 13, Exhibit 23.
[60] *Id.* at 6, 11 and 17.
[61] *Id.* at 6, 10 and 15.
[62] We are adopting this formulation from Professor Richardson. We would note, however, that such a broad definition of a fire sale is likely inadequate as a guide for regulatory action, and if FSOC regulatory action were driven by preventing fire sales, the FSOC will need to more precisely define what a fire sale is, determine how to measure it empirically, and figure out how it would differentiate a fire sale *ex ante* from a market correction in order to design effective and efficient preventative measures.

requirements and cannot hold more than 15 percent of their assets in illiquid securities. Although it is possible in a time of market stress that other market investors may stop trading even with respect to more liquid securities, given the high percentage of liquid assets and the diversity of fund holdings, it is unlikely that a mutual fund portfolio manager would be forced to sell assets into such a market. In any event, the sales of portfolio securities that result from investor redemptions are no different than sales of the same securities by other asset owners directly into the markets.

- Leverage Limits. Faced with liquidity constraints, a highly leveraged investment vehicle would be more prone to create, and more vulnerable to, "fire sale" risks because the losses associated with market volatility would be amplified. Mutual funds typically do not hold direct debt and have strict limits on the amount of leverage they can employ.[63] Unlike banks or other institutions, mutual funds would not face the kinds of margin calls that would force them to sell assets into an illiquid market.

- Liquidity Management Tools. Even if mutual fund shareholders redeem in large numbers, portfolio managers have more than sufficient liquidity management tools at their disposal to be able to avoid a "fire sale" of assets. Fidelity mutual funds have several liquidity facilities to supplement each individual fund's liquidity management, including bank lines of credit and interfund lending.[64] Portfolio managers facing increasing market volatility will typically adjust their cash holdings and holdings of liquid securities and strategically sell portfolio securities to provide additional liquidity as appropriate.[65]

Question 4: To what extent does the potential for terminations of securities loans that would trigger redemptions from cash collateral reinvestment vehicles or other asset sales pose any distinct financial stability concerns? To what extent do investment vehicles reinvest cash collateral in assets with longer maturities relative to the lender's obligation to repay the collateral, which may increase liquidity risk? How much discretion do lending agents have with respect to cash collateral reinvestment? To what extent do lending agents reinvest cash collateral in vehicles managed by the same firm that manages the investment vehicle lending the securities?

Fidelity mutual funds engage in securities lending to a limited extent, and our securities lending programs do not pose material investment risk to the funds, let alone the financial stability of the United States. Our programs operate in a conservative manner, subject to strict oversight, according to well-developed policies and procedures. Fidelity primarily lends equity securities through a third-party agency lending program ("Agency Lending Program"). In that program, funds lend equity securities, and reinvest cash collateral in a Fidelity 2a-7 money

[63] The 1940 Act imposes strict leverage limits on mutual funds by imposing a 300 percent asset coverage requirement. *See* 15 U.S.C. §80a-18(f)(1).
[64] See our response to Liquidity and Redemptions Question 5 for more detail.
[65] See our response to Liquidity and Redemptions Question 5 for more detail.

market mutual fund.[66] For loans of fixed income securities Fidelity funds enter into loan agreements directly with counterparties ("Direct Lending Program");[67] cash collateral is invested in overnight repurchase agreements. A limited amount of lending to an affiliated broker-dealer occurs under the Agency Lending Program, pursuant to an exemptive order from the SEC and policies and procedures approved by the funds' Boards of Trustees.[68]

Both our Agency Lending Program and our Direct Lending Program have a number of oversight and compliance features that illustrate our mutual funds' conservative approach to securities lending. These features help to safeguard the funds from potential losses and risks as described in the question.

- Approved Counterparties. The funds may execute lending transactions with only those borrowers that have been approved by Fidelity's Counterparty Risk Department.

- Excess Collateral that is Marked to Market. Domestic securities loans are collateralized at 102 percent of the market value of the loaned securities and international securities loans are collateralized at 105 percent of the market value of the loaned securities. Securities on loan and collateral are marked to market daily to ensure securities loans are collateralized appropriately.

- Conservative Collateral Management. Aggregate collateral investment amounts are monitored daily. Collateral is always invested in overnight vehicles – a Fidelity money market fund for the Agency Lending Program and overnight government repurchase agreements for the Direct Lending Program, so there is no maturity mismatch other than the obligation to repay the collateral. The agents in our Agency Lending Program have no discretion in the reinvestment of cash collateral.

- Fund Lending Limits. Although the regulatory limit on securities lending is 33 1/3 percent of a fund's total net assets, Fidelity limits securities lending in its funds to a level far below this limit.[69]

- Oversight. Fidelity's Treasurer's Office and the funds' Boards of Trustees play different but complementary roles in approving policies and procedures regarding securities lending and monitoring lending activity including: loan data, recall fails,

[66] The Fidelity Securities Lending Cash Central Fund is available for investment only by other Fidelity mutual funds.
[67] Under our Direct Lending Program the only fixed income securities lent by the funds are United States Treasury securities or securities issued by agencies of the United States Government.
[68] Under the exemptive relief, certain Fidelity funds are permitted to lend securities to affiliated broker-dealers, including National Financial Services LLC and its institutional trading division, Fidelity Capital Markets ("FCM"), subject to certain conditions. These conditions include: a 10 percent cap on net assets loaned to FCM by any individual fund; restrictions on the profitability of loans to FCM; minimum annualized return on loans requirements; strict Board oversight and reporting; recordkeeping requirements; and collateral requirements – funds will only accept cash or U.S. government securities as collateral for securities loaned to FCM.
[69] As of December 31, 2014, in the aggregate, Fidelity funds participating in securities lending programs had less than six percent of potential assets to loan actually out on loan.

revenue generated, service agreements with lending agents, credit limits and approval of counterparties.

- Indemnification. The Fidelity funds participating in the Agency Lending Program are contractually indemnified by both the lending agents and any sub-agents.

Question 5: How do asset managers determine whether the assets of a pooled investment vehicle are sufficiently liquid to meet redemptions? What liquidity and redemption risk management practices do different types of pooled investment vehicles employ both in normal and stressed markets, and what factors or metrics do asset managers consider (*e.g.*, the possibility that multiple vehicles may face significant redemptions at the same time, availability of back-up lines of credit) in managing liquidity risk?

The FSOC states in the Notice that "some investment vehicles maintain a portion of assets in cash or highly-liquid assets to meet redemption requests and may modify their portfolio composition based on market conditions to manage redemption requests."[70] The FSOC correctly assumes that monitoring cash levels while adapting liquidity management practices to changing market conditions are related processes that portfolio managers utilize to ensure sufficient ability to manage portfolio cash flows. Liquidity management is always a dynamic process that encompasses a spectrum of considerations and tools to help ensure a fund's assets are managed prudently. Portfolio managers have fiduciary duties to both redeeming shareholders and remaining shareholders. Managing liquidity levels to fulfill these fiduciary obligations benefits both sets of shareholders as well as the broader financial markets.

There are several regulatory parameters that govern liquidity levels. The SEC mandates that a mutual fund cannot hold more than 15 percent of its total net assets in illiquid securities.[71] Liquid securities are defined as securities that can be sold or disposed of in the ordinary course of business within 7 days at approximately the value at which the asset is valued by the fund.[72] As a threshold matter, at least 85 percent[73] of a fund's assets will be held in liquid securities. Additionally, a mutual fund's portfolio manager must adhere to the fund's stated and disclosed investment mandate. For example, an equity fund with a principal investment strategy to invest at least 80 percent of its assets in equity securities will not be investing a large portion of its assets in cash and short-term bonds, but all funds maintain enough flexibility to allow a portfolio manager to manage liquidity efficiently in line with their overall portfolio construction strategy.

Fidelity employs a number of internal practices that have been effective in ensuring sufficient liquidity in our mutual funds, even during times of market stress:

- Portfolio Composition. The decision to meet redemptions with cash or the sale of securities is the responsibility of each fund's portfolio manager and reflects a

[70] Notice, 79 Fed. Reg. at 77,490.
[71] *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 20, 1992).
[72] *See* Investment Company Act § 22(e), 15 U.S.C. § 80a-22(e).
[73] *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 20, 1992).

portfolio manager's view of securities prices together with expectations for prospective shareholder flows. In addition, each portfolio manager can adjust a fund's overall exposures to higher liquidity securities within its mandate.

- *Equity*: Along with cash available, the overall portfolio composition of equity funds is a key to liquidity management. Equity funds can hold some highly liquid broad market futures positions on indices that have a high correlation or R-squared to their benchmark. Positions such as these can help provide both liquidity and short settlement cash to address short-term redemptions that might be close to or above existing cash levels.

- *Fixed Income*: Broad market bond funds generally hold significant positions in highly liquid government securities to diversify less liquid non-government positions.

- *High Yield*: High yield bond funds will hold some bank loans because sometimes funds can get a better bid on bank loans than on high yield bonds.

- Cash Management. Cash available is reported daily, as is a projected cash available amount based on shareholder activity throughout the day. A fund may hold uninvested cash or may invest it in cash equivalents such as money market securities, repurchase agreements, or shares of short-term bond or money market funds. Bank loan funds typically manage a higher cash percentage than other high yield bond funds – the longer settlement on bank loans makes it prudent to keep additional cash on hand.

- Private Equity Limits. Private equity holdings (unregistered securities that do not trade on a public market) are considered *per se* illiquid. Fidelity mutual funds operate under strict limits on the percentage of fund assets that can be invested in private equity investments; these levels are monitored by our compliance and special situations groups, and all private equity investments are subject to CIO approval. These controls help ensure that a Fidelity mutual fund's exposure to private equity is well below stated prospectus limits and is indicative of our conservative approach to exposure to illiquid securities.

- Temporary Defensive Policy. Each Fidelity fund reserves the right to invest without limitation outside of their stated principal investment strategy for temporary, defensive purposes. For example, equity funds reserve the right to invest in preferred stocks and varying duration investment-grade debt instruments and cash equivalents.

- Interfund Lending. The Fidelity funds may borrow from and lend to each other for temporary purposes, such as managing a difference in timing between settlements on sales of securities and redemptions, pursuant to an SEC interfund lending ("IFL") exemptive order. The IFL program is designed to ensure that borrowing is less costly than borrowing from a bank, and that lending will result in lending funds receiving a

higher return than they could otherwise achieve by investing in overnight investments on any given day. If those conditions are not met, then no loan can be made.

- Uncommitted Lines of Credit. Eight banks provide liquidity to Fidelity funds on a purely discretionary basis. There are no administrative fees associated with the uncommitted lines, and the funds pay interest to the banks only when they draw upon the lines, which is infrequent and normally occurs only to manage the difference in timing between settlements on sales of securities and redemptions.

- Committed Line of Credit. The Fidelity funds have a committed bank line of credit syndicated among approximately 20 banks. The committed bank line of credit is a guaranteed source of liquidity that may be used when other sources are exhausted or otherwise unavailable. The funds pay a commitment fee on undrawn amounts, agency and closing fees, and interest on drawn amounts, as negotiated annually. During the time period since its inception in 2001, the committed bank line of credit has never been used.

- Compliance Monitoring and Oversight. Funds are subject to oversight in addition to the regular portfolio review, with senior investment management executives reviewing portfolio positioning, risk exposures and trading activity, particularly in illiquid securities.

- Short-term Redemption Fees. Our goal across all asset classes is to cultivate longer-term investors. While much less important in most large domestic markets, in some smaller capitalization and international markets, redemption fees are effective features for discouraging short-term investing. Fidelity offers over 130 funds with redemption fees (primarily small cap stock, international equity, sector equity and high income funds) which range from 0.50 percent to 2.00 percent on shares redeemed within 30-90 days of purchase. The size of fee and the holding period for shares is generally dependent on the type of fund, and vary based on the relative liquidity level of a fund's underlying asset class. Redemption fees incentivize investors to take a longer-term horizon when considering an investment in a fund.

- Dealer Inventories. For fixed-income markets, dealer inventories can be an indicator of liquidity. The level and aging of dealer inventories may indicate likely shifts in market liquidity, but dealer data must be interpreted against an understanding of each dealer's overall risk management practices.

- Research. Understanding the intrinsic value of securities, based on factors including a company's overall capital structure, business model, industry and competition, is crucial to investment decisions a security and its place in a fund's portfolio. This foundational research allows our portfolio managers to be prepared to assess the relative valuation of securities in managing and addressing redemptions in both pre-stress and stress scenarios for the markets.

Liquidity management is linked to portfolio managers' attention to market risks indicated by overvaluation and market stress signals, such as falling security prices, increasing market- and security-specific volatility, increased and elevated security-price movement correlations, heightened market impact costs (as indicated by widening bid/ask spreads), and shrinking transaction volumes which exacerbate the impact cost for additional trading. We have transparent and real-time investment tools that allow portfolio managers and senior investment management to monitor position exposures as they relate to specific weights, by security, industry, sector, country, currency and standard risk factors. This information is also historical, which allows analysis and observation of the changes in these positions over time.

When facing stressed markets and shareholder redemptions, a portfolio manager must decide whether to: (i) maintain current portfolio composition and sell a cross section of holdings; (ii) meet redemptions with cash and/or index futures if held, with the result being increasing concentrations in non-cash positions; or (iii) reposition a portfolio's composition by selling a mixture of holdings and cash and/or index futures, thereby realigning holdings in response to shifting market prices and expectations.

Balancing liquidity needs with desired portfolio positioning is a daily focus of portfolio managers. During times of market stress, trade-offs may be made because the price impact of selling securities may be enough to shift a portfolio manager's strategy preference among holdings. Fully substituting cash liquidation for security sales is a very short-term strategy if redemptions are persistent. Similarly, back-up credit lines and interfund lending are typically used only to bridge the days between redemptions and settlement of asset sales. Periods of sustained redemption activity are normally handled via active management of security holdings. During periods marked by shareholder redemptions, the portfolio management and oversight process closely monitors the alignment of portfolios to investment objectives to ensure proper positioning.

Question 6: To what extent could any redemption or liquidity risk management practices (*e.g.*, discretionary redemption gates in private funds) used in isolation or combination amplify risks?

Redemption gates applied beyond money market funds could serve to amplify systemic risk, depending on the mechanism by which the gates are imposed, disclosed and applied. If a mutual fund were subject to temporary redemption gates during periods of market stress, lack of certainty as to when and for how long the gates would be imposed could lead investors in a fund to exit the fund before a gate became effective. Investors outside of particular mutual funds, to the extent the gates were applied to a subset of the market, would have an opportunity to scrutinize the securities held by those funds subject to gates and anticipate which securities might be under selling pressure if and when the gates are lifted. This might create precisely the kind of "first-mover advantage" that today does not exist.

These challenges could make redemption gates largely ineffective, because investors would make their investments outside of the funds to which the gates applied. Investors who would be uncomfortable investing directly in the market without the management and diversification benefits of a mutual fund may simply forego such investments altogether. Thus,

the imposition of redemption gates, or other regulations that could be perceived by investors as putting mutual fund investors at a disadvantage to other investors, may cause a reduction of the very liquidity that the financial system needs.

Question 7: To what extent can competitive pressures create incentives to alter portfolio allocation in ways that may be inconsistent with best risk management practices or do not take into account risks to the investment vehicle or the broader financial markets?

The Notice states that "competitive pressures to increase returns and outperform benchmarks may provide disincentives to holding cash or highly-liquid assets."[74] We disagree. Funds are judged on a variety of metrics, including on a risk-adjusted basis, relative benchmark performance, absolute performance, performance against peers and many others. It is not correct to imply that competitive pressures push managers toward less risk management; in fact those pressures push funds to improve their risk management practices.

The FSOC overestimates the degree of flexibility that portfolio managers have under stated investment mandates, while underestimating the oversight structures in place to monitor adherence to both the mandates and governing regulations. Portfolio managers operate under SEC regulations, must remain invested consistent with their fund's investment mandates, are subject to senior management, compliance and board oversight, and are bound by fiduciary obligations to their funds' shareholders. The long-term success of a mutual fund requires adherence to both investment objectives and regulations. Periods of market volatility expose a manager who deviates from his or her mandate, and the industry's competitive landscape rewards those who deliver consistent, longer-term results.

It is important to note that most mutual funds are not designed as a one-size solution for shareholders, although the industry has developed and offers funds, such as target-date funds, that are available as a "single-fund" solution. More typically, however, a fund's investment mandate is set forth in its prospectus; if that mandate calls for investment in securities that present a high degree of risk, then those are the securities in which the mutual fund is committed to invest. A particular investor may be well-advised to balance an investment in a higher risk mutual fund with other investments in cash or in more conservative mutual funds, but regulators should not enforce such balancing *within each fund*. Investors who seek mutual funds that balance aggressive securities with more conservative securities have many such funds to choose from, but most investors invest in multiple funds, in addition to cash management accounts, to create an overall portfolio that best fits their individual risk tolerance and investment objectives.[75]

Question 8: To the extent that liquidity and redemption practices in pooled investment vehicles managed by asset managers present any risks to U.S. financial stability

[74] Notice, 79 Fed. Reg. at 77,491.
[75] *See* ICI FACTBOOK, *supra* note 27, at 103, Figure 6.2. The ICI reports that mutual funds investors hold shares in a median of three mutual funds. *Id.*

(*e.g.*, increased risks of fire sales or other spillovers), how could the risks to financial stability be mitigated?

Liquidity practices and shareholder redemption rights in mutual funds do not present risks to U.S. financial stability.[76] Even in times of market stress, there is no evidence that liquidity and redemption practices have contributed to, or have the capacity to contribute to, systemic risk.[77] Existing SEC regulations and market practices described above adequately mitigate any potential risks that liquidity and redemption practices might present. Liquidity and redemptions are subject to various SEC regulations and guidance including those surrounding transparency, disclosure and limits on illiquid holdings. Despite this extensive regulation, ample evidence that there is no systemic risk, and a lack of evidence that there is systemic risk, the SEC is currently considering rules[78] regarding fund liquidity, including liquidity standards and disclosure of liquidity risks, to determine whether any updates or additions are needed. Whether or not these measures are necessary, we believe the SEC is the correct regulatory body to address these questions.

III. Leverage

Introduction

Fidelity's mutual funds do not use leverage in a way that could create systemic risk. We believe the Council is right, however, to ask questions about the use of leverage in the asset management industry.[79] A highly leveraged entity experiencing significant losses or liquidity constraints could transmit that distress to its creditors and counterparties, which under certain circumstances, may threaten U.S. financial stability.

For precisely that reason, banks and certain hedge funds that employ high leverage as a central feature of their business models can create systemic risk. For instance, Long-Term Capital Management ("LTCM"), a highly leveraged hedge fund not regulated under the 1940 Act, nearly collapsed in 1998 when its losses on Russian ruble investments, magnified by its 25-1 leverage ratio, threatened to make the fund insolvent.[80] Because many Wall Street firms

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[76] *See* Richardson, *supra* note 57, at 1-3, (outlining that in order for mutual funds to transmit systemic risk to the broader financial system, several significant theoretical hurdles would have to be overcome, including that (i) fund NAVs be misvalued, (ii) the misvalue would cause excess redemptions, (iii) these excess redemptions would cause a material drop in the prices of underlying assets, and (iv) resulting fire sales of portfolio assets would lead to a capital shortfall, necessary for systemic impact).

[77] *See, e.g.*, Collins, *supra* note 24 (showing modest outflows from bond funds even during times of market stress); *see also* Sean Collins, *Why Long-Term Fund Flows Aren't a Systemic Risk: Plus Ça Change, Plus C'est La Même Chose*, ICI VIEWPOINTS (Feb. 19, 2015), *available at* http://www.ici.org/viewpoints/view_15_fund_flow_02 ("[O]utflows from long-term funds have in the past been muted in the face of financial market shocks. And while 'things have changed,' many other things—including a range of investor, market, or tax law characteristics—remain and are likely to mitigate fund outflows during future stress periods.").

[78] White, *supra* note 7.

[79] For purposes of responding to the Council's questions on leverage, Fidelity considers a fund to be levered if its market exposure (market value of securities, etc.), divided by its net assets, exceeds 1.0.

[80] *See* PRESIDENT'S WORKING GRP. ON FIN. MARKETS, HEDGE FUNDS, LEVERAGE, AND THE LESSONS OF LONG-TERM CAPITAL MANAGEMENT, 12 (Apr. 1999), *available at* http://www.treasury.gov/resource-center/fin-mkts/Documents/hedgfund.pdf.

were exposed to LTCM, there were concerns over the potential impact on those firms and, by extension, the financial markets, if LTCM were to fail.[81]

A. Mutual Funds' Use of Leverage is Strictly Controlled by Existing Regulations.

It would be impossible for a mutual fund to find itself in a similar situation to the one LTCM encountered in 1998. In contrast to hedge funds like LTCM (and banks that similarly rely on high leverage), mutual funds cannot employ leverage in a magnitude sufficient to create systemic risk. The 1940 Act imposes strict leverage limits on mutual funds by imposing a 300 percent asset coverage requirement.[82] As a result, mutual funds normally have little or no debt and typically obtain 100 percent of their capital from equity investments.

The SEC also limits the degree to which funds can employ synthetic forms of leverage, for example, through derivatives transactions.[83] Fidelity mutual funds use derivatives within the confines of the SEC's regulations and guidance usually to hedge or manage risk, such as interest-rate risk, or to gain more timely or convenient exposure to a market consistent with a fund's investment guidelines. Fidelity funds limit the leverage they create by segregating assets constituting good cover pursuant to SEC guidance in an amount greater than or equal to the total market exposure creating leverage.

Mutual funds must disclose their use of derivatives, both in their registration statements and in holdings and shareholder reports, so that investors have timely and accurate information regarding the risks and exposures of their investments. Some funds may provide more frequent holdings disclosure on their websites as well.

The use of derivatives by mutual funds has been extensively regulated to date, although we understand that the SEC has been considering updating its regulatory framework. As discussed further in response to Question 7, regulation of the use of derivatives has benefitted from recent market-wide improvements, such as central clearing requirements and the use of electronic trading platforms, as required by Title VII of the Dodd–Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"). We believe that these changes will help to reduce systemic risk that could arise in the derivatives markets, regardless of who holds the actual derivatives positions.

In addition to improvements such as these, Fidelity believes that existing regulations regarding the use of leverage and derivatives could be further strengthened by imposing a uniform definition of leverage and providing better guidance on leverage calculations and coverage requirements. In addition, Fidelity believes its ability to evaluate derivatives counterparties would be further enhanced by the Global Financial Markets Association's Legal Entity Identifier ("LEI") initiative, as discussed in the response to Question 3. Although helpful

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[81] Kevin Dowd, *Too Big to Fail? Long-Term Capital Management and the Federal Reserve*, CATO INST. BRIEFING PAPERS, at 3-4 (Sept. 23, 1999), *available at* http://www.cato.org/publications/briefing-paper/too-big-fail-longterm-capital-management-federal-reserve.

[82] 15 U.S.C. §18a-18(f)(1).

[83] *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. IC-10666, 44 Fed. Reg. 25,128 (Apr. 27, 1979).

to market participants, these initiatives are not necessary to prevent a threat to U.S. financial stability.

B. Mutual Fund Leverage Is Not a Source of Systemic Risk.

It is widely recognized that entities lacking any material leverage, such as mutual funds, are unlikely to present systemic risk. At the FSOC's May 19, 2014 conference on asset management (the "May 19 conference"), Yale Professor Andrew Metrick acknowledged that "[b]anks fail all the time" because they are "levered," but "[i]n the absence of leverage" the "failure of a long-only manager" is "not something we need to worry about."[84] In writing about the 2008 financial crisis, Federal Reserve Chairman Alan Greenspan observed that while "[s]ubprime[] [mortgages] were indeed the toxic asset," if those assets "had been held by mutual funds or in 401(k)s, we would not have seen the serial contagion we did," because those vehicles are not leveraged.[85] Economist Burton Malkiel explained that "[l]everage is . . . the critical factor that differentiates situations where sharp declines in financial asset prices are absorbed by the economy from those in which widespread economic dislocations follow."[86]

The lack of leverage that characterizes mutual funds actually reduces systemic risk by allowing mutual funds to serve a shock-absorbing function in times of market distress. Because nearly all of a mutual fund's capital comes from equity investments rather than debt, losses are absorbed by the fund's shareholders. The value of the fund's shares drops, but the fund does not become insolvent, it stays in business, and it continues to honor all of its financial obligations. A mutual fund thus can absorb large losses without becoming distressed itself, or passing distress to other financial institutions. The Financial Stability Board ("FSB") and the International Organization of Securities Commissioners ("IOSCO") have recognized this shock-absorbing function of mutual funds: "[F]rom 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."[87]

Question 1: How do different types of investment vehicles obtain and use leverage? What types of investment strategies and clients employ the greatest amount of leverage?

It is important to note that there is no standard definition of leverage for the asset management industry. For purposes of responding to the Council's questions, Fidelity considers a fund to be leveraged if its market exposure (market value of securities, etc.), divided by its net assets, exceeds 1.0. By any measure, the mutual funds that Fidelity manages are not highly leveraged. Fidelity does not manage any products that borrow money for purposes of investment. Certain Fidelity funds do use derivatives that can create leverage.

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[84] Andrew Metrick, Deputy Dean & Prof. of Fin. & Mgmt., Yale Sch. Of Mgmt., Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C., 236-37 (May 19, 2014).
[85] Alan Greenspan, *How to Avoid Another Global Financial Crisis*, AM. ENTERPRISE INST. (Mar. 6, 2014), *available at* http://www.aei.org/publication/how-to-avoid-another-global-financial-crisis/.
[86] Burton Malkiel, *Mutual Funds Not Guilty of Systemic Risk Charge*, FIN. TIMES (May 21, 2014), *available at* http://www.ft.com/intl/cms/s/0/d5652d18-d9de-11e3-b3e3-00144feabdc0.html#axzz3UkyJP6cQ.
[87] FSB/IOSCO Consultative Document, *supra* note 26, at 29.

Most of Fidelity's mutual funds are permitted to engage in various types of derivatives transactions, though many use them rarely or not at all. For example, Fidelity's high yield bond fund portfolio managers typically do not use derivatives as part of their fundamental strategies, although they have the ability to use derivatives to hedge credit risk. By contrast, Fidelity's investment grade bond funds often use derivatives to hedge interest rate risk, because those instruments are typically liquid (sometimes even more liquid than the bonds being hedged) even in times of market stress. International funds may use forward currency contracts to hedge currency risk, including to protect against a decline in the value of existing investments denominated in a foreign currency.

The SEC limits the degree to which mutual funds can employ synthetic forms of leverage, such as through derivatives transactions. Section 18 of the 1940 Act limits the use of leverage by investment companies through prohibitions on the issuance of "senior securities."[88] The SEC has interpreted "senior securities" to include certain derivatives transactions because the fund could owe more in the future than the amount of its initial investment.[89] Accordingly, the SEC has set forth coverage requirements that funds may follow to avoid the creation of a senior security: funds that use such derivatives must cover the obligation, either by segregating assets (which must be cash or certain liquid assets) or engaging in an offsetting transaction. For example, the SEC has stated that a fund with a long position in a futures contract must establish a segregated account containing cash and/or liquid assets equal to the price of the contract (less any margin on deposit).[90] Alternatively, the fund could purchase a put option on the same futures contract with a strike price as high as, or higher than, the price of the futures contract held by the fund.[91]

Fidelity mutual funds take a conservative approach to limit the leverage they create by owning assets constituting good cover pursuant to SEC guidance in an amount greater than or equal to the total market exposure creating leverage. Per mutual fund board-approved policies, Fidelity fixed income funds are allowed to hold only the following assets as good cover: cash, net receivables, repurchase agreements (all types and maturities with a 7-day put), money market and investment grade bond funds dedicated for internal Fidelity use only, certain liquid floating rate securities and liquid investment grade securities. Fidelity equity funds are allowed to hold only cash, net receivables, repurchase agreements (all types and maturities with a 7-day put), money market funds dedicated for internal Fidelity use only, U.S. Government securities with maturities of less than 397 days, and liquid equity securities, but only for the value of short positions in long/short portfolios, and for equity securities subject to written covered calls.

Question 2: To what extent and under what circumstances could the use of leverage by investment vehicles, including margin credit, repos, other secured financings, and derivatives transactions, increase the likelihood of forced selling in stressed markets? To

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[88] Investment Company Act § 18, 15 U.S.C. § 80a-18.
[89] *See* Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. IC-10666, 44 Fed. Reg. 25,128 (Apr. 27, 1979).
[90] *See* SEC Staff No-Action Response Letter, Dreyfus Strategic Investing and Dreyfus Strategic Income, 1-2 (pub. avail. June 22, 1987), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/dreyfusstrategic033087.pdf.
[91] *Id.*

what extent could these risks be increased if an investment vehicle also offers near-term access to redemptions?

Leverage always creates the risk of forced selling, but because mutual funds are required to cover their leveraged exposure with high quality liquid securities, funds are unlikely to engage in forced selling in a stressed market. Any entity that uses leverage can be forced to liquidate its positions if it does not have sufficient liquidity to meet demands (*e.g.*, because it is impossible to precisely forecast the market value of portfolio securities at the expiration of a foreign currency forward contract, a fund may be required to buy or sell additional currency on the spot market, if predictions regarding the movement of foreign currency or securities markets prove inaccurate). Entities with substantial equity and low leverage, such as most mutual funds, are typically at low risk of forced liquidations. To the extent there is any risk, the magnitude of such risk will depend on the entity's asset mix, the liquidity demands on the entity, and the options the entity has for meeting those liquidity demands. Additionally, funds that enter into derivatives transactions are required to segregate liquid assets sufficient to cover the fund's obligations that may arise in connection with the market exposures.

Mutual funds typically maintain low levels of leverage or none at all. Indeed, of the ten biggest traditional U.S. mutual funds, more than half have leverage ratios of 1.00-to-1 or 1.01-to-1.[92] The most highly leveraged of the ten biggest funds has a ratio of only 1.18-to-1.[93] To put that in context, the average U.S. global systemically important bank has a leverage ratio over 10.00-to-1, meaning that one dollar of equity in the bank is leveraged with debt to support more than ten dollars of assets.[94] The leverage ratios at the five big investment banks that played a central role in causing the 2008 crisis—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were as high as 40-to-1 in 2007.[95]

With respect to repurchase transactions, which the SEC has deemed to create leverage, Fidelity funds take collateral such that the funds engaging in these transactions are not leveraged at all. In a repurchase agreement ("repo") transaction a fund agrees to purchase certain securities for cash and to sell those securities back to the original seller counterparty at an agreed-upon repurchase price (which reflects the original sale price, plus an agreed-upon coupon rate). As protection against the risk that the counterparty will not fulfill its repurchase obligation, the counterparty is typically required to provide securities with a value at least equal to the repurchase price plus excess collateral in an agreed margin amount (unrelated to the coupon rate or maturity of the purchased security). All securities collateralizing a repo trade are held in a separate account at a custodian bank for the benefit of the fund, where such securities are marked to market daily. The seller is required to provide additional collateral to the extent the value of the collateral securities declines and creates a margin deficit.

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[92] *See* ICI Letter, *supra* note 21, at B-2.
[93] *Id*.
[94] *See id.* at B-3.
[95] FIN. CRISIS INQUIRY COMM'N, THE FINANCIAL CRISIS INQUIRY REPORT: FINAL REPORT OF THE NATIONAL COMMISSION ON THE CAUSES OF THE FINANCIAL AND ECONOMIC CRISIS OF THE UNITED STATES, xix (2011), *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf.

Question 3: How do asset managers evaluate the amount of leverage that would be appropriate for an investment strategy, particularly in stressed market conditions? To what extent do asset managers evaluate the potential interconnectedness of counterparties? How do lenders or counterparties manage their exposures to investment vehicles?

When considering a new strategy that may use derivatives, or allowing existing funds to use instruments they have not invested in before, Fidelity will pilot the strategy/investment in advance, to ensure that the new strategy or investment will not create operational issues for service providers (*e.g.*, custodian, pricing and bookkeeping agent, etc.) and to ensure that Fidelity can comply with the 1940 Act and fund policies. Fidelity assesses anticipated results relative to market benchmarks under a wide range of market scenarios through proprietary risk modeling. We recognize the limitations of risk modeling and emphasize the importance of allowing for a variety of assumptions and an evolution over time of modeling factors.

Fidelity also devotes significant resources to counterparty research and monitoring, and considers both fundamental and quantitative research inputs as part of this process. When assessing and rating counterparties, Fidelity considers a range of factors and information, including a counterparty's audited financial statements, regulatory and legal filings, and information from due diligence meetings, all of which can provide insight on the interconnectedness of the counterparty. Fidelity believes its ability to evaluate counterparties would be further enhanced by the LEI initiative, and commends the Global Financial Markets Association for its work in this area.[96] The development of a global LEI system would allow for accurate and consistent identification of parties to financial transactions, and allow for a more precise, consistent and integrated view of exposures.

Question 4: What risk management practices, including, for example, widely-used tools and models or hedging strategies, are used to monitor and manage leverage risks of different types of investment vehicles? How do risk management practices in investment vehicles differ based on the form of leverage employed or type of investment vehicle? How do asset managers evaluate the risk of potential margin calls or similar contingent exposures when calculating or managing leverage levels? How are leverage risks managed within SMAs, and to what extent are such risks managed differently than for pooled investment vehicles?

Fidelity's primary objective is to have portfolio risk managed at the portfolio level by those who are closest to the investment process, including portfolio managers and groups with direct oversight responsibility. This process is the same for all product types that Fidelity manages, including separately managed accounts. The products Fidelity manages are required to comply with applicable regulations, fund investment policies and guidelines, and client limits and agreements. Fidelity's compliance department monitors all products on a daily basis for compliance with these requirements, including restrictions on leverage, and Fidelity funds rarely

[96] *See* GLOBAL FIN. MARKETS ASS'N, REQUIREMENTS FOR A GLOBAL LEGAL ENTITY IDENTIFIER (LEI) SOLUTIONS (May 2011), *available at* http://www.sifma.org/lei-industry-requirements/. For updates on the LEI initiative, see http://www.gfma.org/initiatives/Legal-Entity-Identifier-(LEI)/Legal-Entity-Identifier-(LEI)/.

fail to comply with the requirements, because the funds are held to internal limits that are stricter than SEC limits. In the event of such a breach, the fund's portfolio manager and chief investment officer would be notified, and Fidelity would remediate the issue.

Question 5: Could any risk management practices concerning the use of leverage by investment vehicles, including hedging strategies, amplify risks?

Risk management practices that use leverage can create or amplify risk. A good example is basis risk: the risk that the price of the instrument used to hedge an exposure fails to act as predicted. If an instrument used to hedge an exposure does not experience price changes in the opposite direction of the asset it is hedging, a greater loss to the portfolio can result than if the position was not hedged. The near failure of LTCM in 1998 was brought about in part because it had exposure to a particular type of basis risk and this exposure was magnified greatly through the use of leverage.

One of LTCM's core strategies was to engage in "convergence trades," so named because they involved taking offsetting long and short positions in very similar securities whose prices, though initially different perhaps due to technical market factors, were expected to converge over time as market participants took advantage of the apparent arbitrage opportunity. A typical trade of this type involved taking a long position in an "off-the-run" 29-and-three-quarter-year Treasury bond and, simultaneously, a short position in the newly issued ("on-the-run") 30-year Treasury bond, which was generally more liquid and therefore had a higher price, but which otherwise provided a nearly perfect interest-rate hedge to the first bond. With the passage of time, as the 30-year bond aged into off-the-run status, its price would usually decline to match that of the other off-the-run bond, thus consistently producing a profit for the overall trade.[97]

In the latter half of 1998, when the Russian government defaulted on its debt, panicked investors quickly fled to the Treasury market, thereby causing the price discrepancy between "on-the-run" and "off-the-run" bonds to become much larger, not smaller as predicted. There was not ample time for the convergence trade to work, and LTCM was forced to unwind many of its leveraged positions at a loss to satisfy margin calls on other positions it held. As we noted in the introduction to this section, it would be impossible for a mutual fund to find itself in a similar situation, because of the strict limits on the use of leverage under the 1940 Act.

Question 6: To what extent could termination of securities borrowing transactions in stressed market conditions force securities lenders to unwind cash collateral reinvestment positions? To what extent are securities lenders exposed to significant risk of loss?

Although a fund is exposed to risk of loss in any securities lending transaction, the risk of loss to Fidelity's mutual funds is minimal given the limited extent to which Fidelity funds

[97] *Cf.* U.S. Gen. Acct. Off., *Long-Term Capital Management: Regulators Need to Focus Greater Attention on Systemic Risk*, REP. TO CONG. REQUESTERS, 42 (Oct. 29, 1999), *available at* http://www.gao.gov/assets/230/228446.pdf.

engage in securities lending[98] and the safeguards in place, including over-collateralization of the loans, the investment of collateral in short-term, conservative investments, and the provision of indemnification by agents where applicable. In our experience, the risk is insignificant at the fund level when compared to the risk of loss on investments in securities, and certainly not a threat to the stability of the U.S. financial system even in the aggregate.

Our securities lending programs are subject to conservative limits and standards, which limit the risk of loss to the lending funds, and the programs are subject to robust oversight by the Fidelity funds' Treasurers, Boards of Trustees, independent auditors, and the lending program agents, if applicable. The funds may enter into lending transactions with only those borrowers that have been approved by Fidelity's Counterparty Risk Department. The majority of lending by the Fidelity funds is through the Agency Lending Program, for which the agents provide indemnification to the funds in the event of borrower defaults.

Question 7: To the extent that any risks associated with leverage in investment vehicles present risks to U.S. financial stability, how could the risks to financial stability be mitigated?

To the extent that there may be concerns with the use of leverage by collective investment vehicles that are not subject to the 1940 Act or SEC limits on leverage and derivatives, regulators could consider designing similar limits for those vehicles. Even outside the registered fund context however, the experience of LTCM, a large, highly leveraged hedge fund that was in danger of failing and spreading distress beyond its investors to its lenders and their counterparties, is notable because it is such a rare exception to the general rule that investment funds do not present such risks. LTCM is cited so frequently in discussions of systemic risk because it is the only example of such an incident. The absence of similar fund-specific distress threatening U.S. financial stability in the recent financial crisis is instructive.

The recent improvements in derivatives regulation, many of which were mandated by Title VII of the Dodd-Frank Act, including central clearing requirements and the use of electronic trading platforms should also be acknowledged in this discussion. We believe that when the impacts of these reforms are combined with the rarity of the circumstances surrounding LTCM, it is reasonable to doubt that the leverage or derivatives exposures of one fund, or even a group of funds, could threaten the stability of the U.S. financial system.

Question 8: What are the best metrics for assessing the degree and risks of leverage in investment vehicles? What additional data or information would be useful to help regulators and market participants better monitor risks arising from the use of leverage by investment vehicles?

We believe that a standardized definition of leverage in the asset management industry and better guidance regarding leverage calculations could be helpful. The SEC has provided interpretive guidance over the years, and has made public statements regarding the potential for future rulemaking in this area.

[98] See the information provided in our response to Question 4 in the Liquidity and Redemptions section.

As an example, the SEC could consider requiring mutual funds to calculate their average leverage ratio in a specific manner over the period covered by a shareholder report and disclose it in the report. We caution, however, that such disclosure would need to be carefully crafted to be valuable to investors, given that mutual funds generally have such low levels of leverage, and the investment risks of derivatives are similar to investment risks in other instruments and have been clearly disclosed to and accepted by shareholders.[99]

IV. Operational Risk

Introduction

As the Council notes, all industries face operational risks. The asset management business is no different. But operational risks in asset management do not threaten U.S. financial stability.

Consistent with others in the asset management industry, Fidelity aggressively manages operational risks in accordance with its regulatory obligations and fiduciary duties. We design, test and monitor our procedures, systems and service providers continually to ensure their robustness and resilience. This planning and oversight includes developing detailed plans to address a wide variety of potential disruptions in standard operations. Our planning is not merely a hypothetical exercise in which the plans are never tested. On the contrary, operational challenges arise with some regularity from geopolitical events such as wars and terrorist attacks, natural disasters such as blizzards, hurricanes and tsunamis, and system outages due to execution failures, software problems and power outages. These events test our plans and systems and motivate us to ensure that risks are identified, highly controlled and subject to contingency plans that are updated frequently.

When operational problems do occur within a fund, its manager, or a non-bank affiliate, they are typically remedied without any disruption in service. Even if there is a temporary disruption resulting from a power outage, software problem, storm or similar event, it is likely to be confined to no more than a few highly substitutable entities and result in no direct financial losses to the investors they serve or those companies.[100] For example, if a mutual fund's shareholders cannot redeem their shares temporarily due to a system outage at the fund's manager or transfer agent, their assets have not disappeared. They remain safe with the custodian bank that holds that fund's assets. The temporary unavailability of their assets does not create a systemic capital shortfall.

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[99] A leverage ratio could potentially be misleading to investors because leverage itself is not an independent risk factor, but comprises several risks, including credit risk and market risk. A leverage ratio would need to factor in the duration of the exposure as well—for example, an equity fund that does not otherwise use derivatives could receive a large cash investment and temporarily equitize the cash by purchasing a futures contract, resulting in a leverage ratio above 1.0 when the fund normally does not use derivatives as part of its investment strategy.

[100] It may result in indirect losses if revenue declines or companies make customers whole for losses on their own initiative or because they are required to do so. But revenue declines are gradual and companies obtain insurance to cover potential operational losses. In any event, will not result in a sudden capital shortfall and financial disintermediation.

Nevertheless, asset managers take those potential interruptions in service very seriously because they could displease our customers who can easily replace us. "The investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable)."[101] If a fund starts performing poorly on the operational front, investors may withdraw their assets and the fund may close. Investors are attuned to operational performance measures such as the ease with which information can be accessed and transactions completed. As a result, we and our competitors expend significant time and resources designing, testing and monitoring our operations to ensure that we can provide the high level of service our clients expect in any contingency.

Rather than answering individual questions posed by the Council, we have provided general information as to how we think about, manage and mitigate operational risks at Fidelity. The processes we employ in these areas are firmly in line with best practices among other asset managers and companies with similar operational risk profiles in other industries. Furthermore, we agree with the statements made in the SIFMA and IAA comment letter filed in response to the Notice[102] with regard to operational risks and the Council's questions.

A. Business Continuity Plans.

Fidelity devotes significant time and resources to ensuring that we can provide the services our clients expect even in exigent circumstances. Fidelity is compliant with ISO 22301:2012, which "specifies requirements to plan, establish, implement, operate, monitor, review, maintain and continually improve a documented management system to protect against, reduce the likelihood of occurrence, prepare for, respond to, and recover from disruptive incidents when they arise. The requirements specified in ISO 22301:2012 are generic and intended to be applicable to all organizations, or parts thereof, regardless of type, size and nature of the organization. The extent of application of these requirements depends on the organization's operating environment and complexity."[103]

Fidelity considers criticality ratings, associate locations, recovery strategies, hardware requirements, and connection requirements to help us prioritize functions and ensure that our most critical functions are identified and the appropriate redundancy plan or back up is implemented to continue operations in case of potential problems. We rate functions with the highest priority to provide focus and funding in our continuity management support. We review our program annually to try to improve on our approach, methodology, assumptions, logic and execution of plans, given what we have learned from the prior year's events at Fidelity, our peers and other enterprises.

The business continuity plans include testing for both people and technology. All employees participate in training for various contingencies, which is tracked to ensure employees understand what is expected of them and what to do in the case of an unplanned event.

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[101] FSB/IOSCO Consultative Document, *supra* note 26, at 30.
[102] Letter from Asset Mgmt. Grp. of the Sec. Indus. & Fin. Markets Ass'n and Inv. Adviser Ass'n to the Fin. Stability Oversight Council (Mar. 25, 2015).
[103] ISO 22301:2012, *available at* http://www.iso.org/iso/catalogue_detail?csnumber=50038.

Performance is also measured to gauge the recoverability of key components of our operations and how well our plans have worked during exercises and actual events.

Fidelity performs integrated disaster recovery testing. Most critical functions have hot sites to allow the staff to quickly move to a different location nearby to continue operating. These hot sites provide instant availability of all functions and data to perform critical tasks, and staff use hot sites frequently during contingency events or as part of regular testing. Fidelity also has redundancy across various locations, including international sites, to help ensure that Fidelity is able to support our clients and manage their funds no matter what asset class or location is impacted. There are site leaders for each location who are responsible to act as the central point of contact to help manage potential problems in a location and ensure a coordinated effort.

B. Asset Managers Are Highly Substitutable.

The possibility that operational risks in an investment fund, its manager or similar service provider could threaten U.S. financial stability is further diminished by the fact that they are highly substitutable. If one asset manager fails to provide satisfactory services, there are many available replacements. The ICI reports that approximately 800 sponsors managed mutual fund assets in the United States in 2013;[104] and almost 9,000 mutual funds were available to U.S. investors.[105]

It is relatively simple for an individual investor or a fund to move from one manager to another. Fund assets are held at custodian banks where they can move from one manager to another with ease. In addition, asset managers have similarly robust options when choosing among alternative providers of crucial pricing, trading, custodial, and other services. Some managers, Fidelity included, can perform many of those services internally as well, and all managers can obtain the necessary services from multiple third-parties.

C. FSOC Concerns Regarding Transition Management and Service Providers.

The Council singled out two operational risks as potential sources of systemic threats: (1) "risks that may be associated with the transfer of significant levels of client accounts or assets from one asset manager to another:"[106] and (2) "risks that may arise when multiple asset managers rely on one or a limited number of third parties to provide important services."[107] In Fidelity's experience, the probability that those risks will materialize and the magnitude of their impacts to U.S. financial stability are low and they are already well managed. They have not threatened financial stability in previous crises and there is no reason to believe that they would do so in future crises. Indeed, events over the last two decades have repeatedly confirmed that such risks neither create nor transmit threats to U.S. financial stability.

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[104] ICI FACTBOOK, *supra* note 27, at 27.
[105] *Id.* at 20, Figure 1.11.
[106] Notice, 79 Fed. Reg. at 77,492.
[107] *Id.* at 77,492-93.

1. Transition Management

Regarding the risks associated with significant asset transfers, those transfers occur on a regular basis for various reasons, including client dissatisfaction with a manager that leads them to select other managers or a manager's voluntary or involuntary exit from the business. The transfers happen without impact to financial stability, including in times of market stress. John Rogers, President and CEO of the CFA Institute correctly observed at the May 19 conference that even during the worst week of the 2008 financial crisis, people could and did transfer managers in simple fashion and could redeem from one fund and put it in another seamlessly.[108] Also at the May 19 conference, Alan Greene, Executive Vice President, U.S. Investor Services, State Street Bank Corporation recounted State Street's experience as a custodian during the crisis: "[W]e transferred portfolios from managers that wanted to move entire funds from their complex to another complex. We did one of them in six days. We coped with redemptions under very stressful conditions."[109]

2. Service Providers: Custodian Banks and Pricing Vendors

As for the risks associated with reliance on service providers, investment funds and their managers do rely heavily on service providers. As we have noted, that reliance creates no systemic risk. The risks of serious disruption are low because asset managers and other service providers spend significant time and resources developing contingency plans and redundancies that ensure quick service recoveries and enable transfers to backup service providers. Asset managers have sufficient service options such that a disruption with one provider would neither cause industry-wide problems nor materially impair an affected asset manager's operations. Fidelity carefully screens and continually monitors vendors who provide goods and services integral to business operations. In order to protect our information, assets and market reputation, we have a policy that defines global standards for vendor oversight, and we maintain a consistent framework for managing vendors used throughout the enterprise.

Independent custodian banks are some of the most important service providers to the mutual funds Fidelity manages. Their services are governed by robust regulation and extensive oversight by groups responsible for the administration of the Fidelity mutual funds, other clients of the custodian banks, and those responsible for the custodian banks themselves.[110] We describe key elements of that regulation and the selection and oversight of custodians below to

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[108] John Rogers, President & CEO, CFA Inst. & Member, Systemic Risk Council, Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C., 203 (May 19, 2014).
[109] Alan Greene, Exec. Vice President, U.S. Investor Services, State Street Corp., Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C., 210 (May 19, 2014).
[110] Service providers to mutual funds are overseen by multiple internal and external groups. Custodian banks are a good example. In addition to internal oversight and oversight by the fund manager, custodian banks are also scrutinized by various external parties, such as auditors, other clients, consultants, independent trustees and a multitude of regulators. As Alan Greene of State Street pointed out, in addition to the regulations governing asset managers, there are numerous layers of regulation governing their service providers "over virtually everything [they] do," including "independent auditors, internal auditors, [the] Fed, SEC, OCC, chief compliance officers, and then the SSAE 16 internal controls review." *Id.* at 197.

illustrate the ways in which operational risks associated with service providers are effectively mitigated.

To preserve fund assets and protect them from fraud and abuse, Section 17(f) of the 1940 Act requires that a mutual fund's assets generally must be held in custody by a U.S. bank, foreign sub-custodian or securities depository.[111] Accordingly, each Fidelity fund maintains an account at one of the six custodian banks that Fidelity has approved for use by the mutual funds. Each custodian, in turn, maintains its own accounts at securities depositories and sub-custodians in the United States and abroad.

Fidelity funds place all investments and related assets under custody with their respective custodian banks. The funds do not maintain custody relationships with other entities or engage in the "self-custody" of assets. Although managing multiple custodian banks requires a significant commitment by Fidelity and each fund's trustees,[112] Fidelity believes that using multiple custodian banks allows the funds to leverage each bank's strengths and select the custody banks that best align with their diverse service requirements. In addition, having multiple existing custodian banks makes it easier to change service providers in the event a bank were unable to continue providing services.

The custodians that service the Fidelity mutual funds have implemented extensive contingency plans to help ensure continuity of service. The custodians generally have contingency sites in the United States and/or abroad and are able to operate uninterrupted in the event of a natural disaster or terrorist attack. These contingency sites permit their systems to remain up and running to obviate the need to resort to manual processing if their primary site is not functioning. The custodians perform regular testing of these contingency sites and include the results of the testing in their quarterly updates to Fidelity.

The Council is also interested in understanding the risks involved if service providers relied on by asset managers, such as pricing and other vendors used in connection with the fair value process,[113] provide services in a flawed manner. As mentioned above, like other operational risks, Fidelity and other asset managers incorporate contingency plans and redundancies to mitigate such risks. Just as Fidelity mutual funds mitigate the risk of reliance on third parties by maintaining relationships with multiple custodian banks, Fidelity also elects to receive redundant data from various pricing vendors to ensure the accuracy of pricing information for the Fidelity funds. Fidelity strives to have two automated independent vendor

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[111] Investment Company Act § 17(f), 15 U.S.C. § 80a-17(f).

[112] The Boards of Trustees play an important role in overseeing the funds' custodian banks including the approval of each fund's custodian bank, the contract and fee schedule and the appointment of the custodian bank as a foreign custody manager for each fund. The boards also approve the allocation of their respective funds to specific custodian banks.

[113] The 1940 Act states that a fund must use a readily available and reliable market quote for securities to value a mutual fund. The 1940 Act further requires that in the absence of such a market quote, the fund must fair value the security as determined in good faith by the board of trustees. The Boards of Trustees for the Fidelity funds have delegated responsibility for fair valuation to a fair value committee, which is chaired by the funds' treasurer and made up of members from the treasurer's office, compliance, and pricing operations, as well as appropriate investment personnel. The fair valuation process ensures that a fund's NAV is appropriately valued as of the close of the New York Stock Exchange (typically 4PM ET) or at the time specified in the fund's prospectus.

prices per security. If pricing vendors are unavailable for a security or have been deemed unreliable, we obtain the price from broker-dealers making a market for that security. To ensure the accuracy and reliability of the prices for the securities held by Fidelity funds, we have implemented nightly pricing validation and a vendor/broker challenge process.

V. Resolution

Introduction

In this section, we respond to the FSOC's questions related to whether "there are specific financial interconnections that could present risks if an asset manager, investment vehicle, or affiliate were to become insolvent, declare bankruptcy, or announce an intent to close and liquidate."[114] At the outset, we note that it is common for asset managers to be replaced or wound down and for funds to merge or liquidate as part of the normal business cycle, without any effects on the stability of the financial system, regardless of its state at the time. Indeed, the FSOC, the FSB and many others recognize that the closure of asset managers and investment funds has not threatened the stability of the financial system.[115] Substantial empirical evidence along with a common sense understanding of the mutual fund business support their conclusion.

Mutual fund assets are financed almost exclusively with equity, and as a result most mutual funds are not capable of "failure" as that term is used in this context. The principal financial interconnections that have caused certain banking firms to pose systemic risk, and make their resolution through normal processes destabilizing, simply do not exist in mutual funds and their managers. Mutual funds have very few material financial interconnections of any kind with other entities. They operate as legally separate entities, with separate balance sheets, different shareholders, independent boards of trustees, and separately custodied assets. To the extent they share services provided by their manager, those services are not at risk of disruption in the event of severe market events, and in any event those services are readily substitutable.

Mutual fund managers similarly pose no systemic risk. They operate in an agency model, compensated with fees based on services rendered to the assets under management and their owners. Managers' business models do not require, and they rarely employ, leverage or economic exposure to the funds they manage (*i.e.*, they do not provide guarantees and rarely provide indemnities). These attributes explain why they have historically proven to be economically resilient. Even when fund managers have faced adverse circumstances and closed, the fund assets have been easily moved with little impact to investors and no impact to the financial system.

As we more fully describe below, we do not believe that the resolution of asset managers or funds could cause or magnify any known or possible systemic risk. In this section, we provide a general description of the fundamental characteristics of mutual funds and their

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[114] Notice, 79 Fed. Reg. at 77,494.

[115] *See, e.g.*, *id.* ("The Council recognizes that asset management firms and investment vehicles have closed without presenting a threat to financial stability."); *see also* FSB/IOSCO Consultative Document, *supra* note 26, at 30 ("Moreover, funds close (and are launched) on a regular basis with negligible or no market impact.").

managers, relevant regulations, and the business and market practices that explain why asset management entities have been and will continue to be wound down in an orderly fashion, before, during and after financial crises, without the need for a special resolution regime to protect either the parties involved or the stability of the financial system. We then respond to the specific questions set forth in the Notice.

A. Why is special resolution planning required for some financial institutions?

Most non-financial companies and many financial companies, including mutual funds and their managers, are resolved (as the FSOC defines it in the Notice)[116] through merger, liquidation, or normal bankruptcy proceedings if their liabilities exceed their assets. "Resolution" as relevant to the question of systemic risk, however, is a narrower concept, the application of which is inappropriate for mutual funds and their managers. Certain types of financial services companies require special resolution regimes because of the nature of their businesses and the claims against them. These include banks, insurance companies and broker-dealers,[117] entities that may employ substantial leverage. If one of these entities were to default on its liabilities, it could have a direct, material adverse effect on its creditors, in particular entities such as banks whose business models depend on leveraged maturity transformation or funding long-term assets with shorter-term liabilities like deposits. These entities that are prone to sudden failure and susceptible to the failure of others also rely on governmental guarantees or insurance of their liabilities in recognition of the fragility of their business model, the critical functions they perform, and the difficulty of replacing them quickly.

Those measures were insufficient during the financial crisis to prevent the failures of the largest banking firms and others with similarly risky business models. Policymakers also believed that they could not be allowed to go through a normal bankruptcy process because they were regarded by both policymakers and markets as "too big to fail." Legislators and regulators have focused on special resolution planning since then in an effort to eliminate that status and ensure that those large banking firms and similar companies can be resolved in an orderly fashion without taxpayer assistance.[118] The resulting special resolution regimes focus on companies that (i) provide a critical function or service within the financial system (*e.g.*, central counterparties ("CCPs") that provide essential payment, clearing and settlement services) and are not easily substitutable, or (ii) could not be resolved through the normal resolution processes without threatening financial stability (*i.e.*, a highly disruptive or disorderly resolution).[119] In all

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[116] *See* Notice, 79 Fed. Reg. at 77,494, n.20 ("For the purposes of this Notice, resolution refers to the commencement of proceedings in bankruptcy or, if bankruptcy is not appropriate, other proceedings or processes for the resolution, reorganization or liquidation of a legal entity.").

[117] The Bd. of Governors of the Fed. Reserve Sys., *Study on the Resolution of Financial Companies Under the Bankruptcy Code*, 3 (July 2011), *available at* http://www.federalreserve.gov/publications/other-reports/files/bankruptcy-financial-study-201107.pdf.

[118] *See, e.g.*, Jeffrey M. Lacker, President, Fed. Res. Bank of Richmond, Speech at the Federal Reserve 2013 Resolution Conference: Toward Orderly Resolution, (Oct. 18, 2013), *available at* http://www.richmondfed.org/press_room/speeches/president_jeff_lacker/2013/pdf/lacker_speech_20131018.pdf.

[119] *See, e.g.*, Fin. Stability Bd., *Key Attributes of Effective Resolution Regimes for Financial Institutions*, 3 (Oct. 15, 2014), *available at* http://www.financialstabilityboard.org/2014/10/r_141015/.

cases, the goal is to enable resolution through the normal bankruptcy or other applicable insolvency process without "emergency governmental assistance."[120]

B. Mutual funds and their managers do not require special resolution planning or mechanisms.

In contrast to "too big to fail" institutions, mutual funds and their managers are regularly resolved through normal processes and receive no governmental guarantees or insurance of their liabilities. Emergency financial governmental assistance has *never* been required to facilitate an orderly resolution for a mutual fund or a mutual fund manager. In her December 2014 speech regarding the SEC's regulation of the asset management industry, Chair White reminded her audience that "the risks associated with winding down an investment adviser are different than those associated with other kinds of financial firms."[121] She noted the benefits of planning for the transition of client assets in the event of a "severe disruption in the adviser's operations," (*i.e.*, what Chair White called "transition planning") not a bank-style resolution plan premised on a sudden insolvency.[122] There are no historic patterns of disorderly or disruptive resolution of mutual funds or their managers, no demonstrated need for a special resolution regime (like the Federal Deposit Insurance Corporation (the "FDIC") for banks) and, after 75 years of experience under the 1940 Act and in all market conditions, no reason to believe that such a regime would be needed in the future.

Mutual funds and their managers share none of the characteristics that justify special resolution planning for the biggest banking firms. Mutual funds and their managers carry little or no leverage and are not complex; rather, they have simple and transparent corporate and capital structures. For traditional floating-NAV open-end mutual funds, their short-term obligations (redemptions) correspond directly with their available assets. The probability that either funds or their managers would suddenly become insolvent and file for bankruptcy protection is extremely low and easily dismissed as a potential threat to financial stability. Empirically, fund mergers and liquidations have happened regularly, even in times of market stress, and there is no evidence that they have had a systemic impact on the market in the past. Given their attributes described above and the fact that they do not provide a critical function or service without ready substitutes, there is no sound theory as to why they might in the future.

1. *Low Probability: Mutual funds and their managers are not at risk of sudden insolvency.*

It is highly unlikely for most asset management entities to fail.[123] Most mutual funds cannot become insolvent because they employ little or no leverage. Asset managers similarly

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[120] *See, e.g.*, DAVID H. CARPENTER, CONG. RESEARCH SERV., R43801, "LIVING WILLS": THE LEGAL REGIME FOR CONSTRUCTING RESOLUTION PLANS FOR CERTAIN FINANCIAL INSTITUTIONS (2014), *available at* http://fas.org/sgp/crs/misc/R43801.pdf.

[121] White, *supra* note 7.

[122] *Id.*

[123] In this section of the Notice, Fidelity is responding to the FSOC's exploration of whether "there are specific financial interconnections that could present risks if an asset manager, investment vehicle, or affiliate were to become insolvent, declare bankruptcy or announce an intent to close and liquidate." Notice, 79 Fed. Reg. at 77,494.

employ little or no leverage and are at little or no risk of sudden insolvency.[124] Fluctuations in asset values within fund portfolios do not threaten a manager's solvency the way similar fluctuation in the values of a bank's assets can threaten its solvency because asset managers do not bear the credit or market of fund portfolios.[125]

Fund managers conduct an agency business in which they manage a fund's assets and provide ongoing services that the fund needs to operate in exchange for fees.[126] Asset management fees are tied to assets under management ("AUM") and are paid by funds out of fund assets. Managers rely on fee-based income rather than "investing on behalf of the firm to obtain the potential for positive performance with high-risk assets."[127] This is a fundamental difference from banks and broker-dealers that borrow money to make leveraged proprietary investments on their own behalves.[128]

Unlike those businesses, asset management is resilient and managers have proven to be financially stable. Managers with a large amount of AUM in particular are typically highly diversified with multiple investment products across multiple strategies. Thus, their overall results tend not to depend on any particular segment of the market. Steady sources of client assets, such as 401(k) contributions, continue to flow into funds during times of stress, mitigating outflows that may occur during the same conditions. Investors and funds also rebalance their portfolios by periodically buying or selling assets to maintain their desired level of asset allocation, which has a similar countercyclical effect for managers and markets.[129]

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[124] Haldane, *supra* note 33 ("[A]sset managers are essentially unlevered"; and "[a]sset managers are, to a large extent, insolvency-remote.").
[125] *Id.* ("As an agency function, asset managers do not bear credit, market and liquidity risk on their portfolios. . . . Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank.").
[126] ICI Letter, *supra* note 21, at A-2.
[127] *Id.* at A-3.
[128] *See* Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to Secretariat of the Fin. Stability Bd., 7 (Apr. 7, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140423s.pdf. Another important difference between asset management firms and banks is that asset management firms do not rely on government support. That is, while bank deposits are insured by the FDIC, asset managers explicitly disclose to clients that investment performance, and the original principal invested, are not guaranteed by any entity. *See* Douglas J. Elliot, Systemic Risk and the Asset Management Industry, BROOKINGS INST., 3 (May 2014), *available at* http://www.brookings.edu/research/papers/2014/05/systemic-risk-asset-management-industry-elliott.
[129] John Gidman, Chief Info. Officer, Loomis, Sayles & Co., Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C., 211-212 (May 19, 2014) ("[O]ur experience with sophisticated institutional investors is markedly countercyclical. When we have a good quarter, we get redemptions. When we have a bad quarter, we get more inflows. And that really relates to asset allocation decisions made by the end asset owner. They are not runs. They are putting risk on the table and taking risk off the table based on a predetermined asset allocation strategy they have that they're well able to manage and monitor.").

2. Low Impact: Mutual funds and their managers do not provide a critical function or service; they are highly substitutable and largely self-resolving; and, when no longer viable, are easily resolved through normal processes.

In the introduction to this section, we note that the FSOC, the FSB, IOSCO and many others have recognized that the resolutions of funds, mutual funds in particular, and their managers have had no impact on financial stability. In this section, we outline a few of the reasons that is true and can reasonably be expected to remain so.

(a) Mutual funds and their managers do not provide any critical functions or services, without ready substitutes, that would require special resolution planning.

Professional asset management is a valuable service but it is not unique or critical to the stability of the financial system. Asset owners can manage their assets themselves, outsource to asset managers, or both. McKinsey & Company estimates that more than three quarters of financial assets are either unmanaged or managed internally by asset owners.[130]

Competition to manage assets is intense, with multiple managers offering highly substitutable products and services to highly mobile assets and asset owners.[131] With respect to mutual funds in particular, the ICI reports that over 800 sponsors managed mutual fund assets in the United States in 2013; and intense competition has prevented any single firm or group from dominating the market over the past fifteen years.[132] This competition is evident in other measures as well, such as the Herfindahl-Hirschman Index, which measures market concentration and "weighs both the number and relative sizes of firms in the industry. Index numbers below 1,000 indicate that an industry is unconcentrated. The mutual fund industry had a Herfindahl-Hirschman Index number of 481 as of December 2013."[133]

In 2013, there were just over 16,400 investment companies in the United States alone.[134] Of course, mutual funds are just one product within the broader asset management sector and the United States is just one market for investors. For example, U.S. mutual funds must compete with other products as well, including just fewer than 10,000 hedge funds globally at year-end

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[130] McKinsey & Company, *Strong Performance but Health Still Fragile: Global Asset Management in 2013: Will the Goose Keep Laying Golden Eggs?* 8, Exhibit 2 (July 2013), *available at* http://www.btinvest.com.sg/system/assets/17804/2013%20asset%20management%20brochure%20final.pdf (showing that the asset management industry managed a market share of 23.9 percent of total global financial assets in 2012).

[131] On this point, we agree with the observation by the FSB and IOSCO that "the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable)." FSB/IOSCO Consultative Document, *supra* note 26, at 30.

[132] *See* ICI FACTBOOK, *supra* note 27, at 27.

[133] *Id.* at 28.

[134] The ICI reported 16,457 investment companies, including traditional open-end mutual funds (as well as mutual funds that invest primarily in other mutual funds), closed-end mutual funds, ETFs, and UITs based on investment companies that report statistical information to the ICI. *Id.* at 20, Figure 1.11.

2013.[135] Those collective investment funds participate in the capital markets with other investors including central banks, corporate, state and municipal benefits plans, foundations and endowments, sovereign wealth funds, and wealthy individuals, among others.

The same competition that has led to the large volume and variety of funds has led to the development of robust systems and processes to make transfers easy for investors. Substitutability requires both options for substituting and ease of transfer. The asset management industry offers market participants both. For example, in each of 2013 and 2014, our defined contribution business had over 7,000 instances in which a plan sponsor moved assets out of one fund or share class and into another. These transitions involved over 87,000 funds and share classes and almost $109 billion in assets in 2013 and over 108,000 funds and share classes and over $148 billion in assets in 2014.[136] These figures do not capture individual plan participants' decisions to re-allocate or re-balance their individual 401(k) accounts. Those transfers can be made simply through a brokerage or other record-keeper's website or over the phone.

Any individual searching for a particular strategy or risk profile for their investments could find it offered by multiple managers and the process of switching is easy. So long as managed assets continue to be easily transferrable, given the high substitutability of managers and funds, most, if not all investors will take their assets elsewhere via redemptions or termination of a distressed manager long before the manager is actually resolved. At the point of resolution, the manager is systemically irrelevant because it will manage few assets, if any.

(b) Mergers and liquidations of funds and asset managers are common.

In many cases, a fund or manager that experiences underperformance or other difficulties never even reaches the point of actual resolution. Long before liquidation becomes necessary, they pursue merger and acquisition opportunities.

Fund launches, mergers and liquidations are common, as sponsors create new funds to meet investor demands and merge or liquidate those that do not attract sufficient investor interest.[137] From 2003 through 2013, over 6,100 mutual funds were merged or liquidated.[138] These commonplace transactions illustrate the substitutability and lack of impact that the continued existence of any one mutual fund has on the market.

Because asset management is not a capital intensive business and has the potential of generating high returns on investment, there are many potential bidders for a fund management business with significant AUM should it be put up for sale, as managers have a "strong incentive to acquire assets under management and thereby diversify their offerings to achieve greater

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[135] Hedge Fund Research estimated that there were 9,966 hedge funds and fund of funds in 2013 and 10,102 in 2014. *See* HEDGE FUND RESEARCH, INC., HFR GLOBAL HEDGE FUND INDUSTRY REPORT – YEAR END 2014, 22 (2015).
[136] Fidelity Investments. These transitions involve both Fidelity and non-Fidelity funds.
[137] ICI FACTBOOK, *supra* note 27, at 16 ("A total of 660 funds opened in 2013, slightly fewer than the year before and below the 2007 peak of 726—but near the 2003–2013 average. . . . The rate of fund mergers and liquidations declined . . . to 424 in 2013 from 501 in 2012.").
[138] *Id.* at 17, Figure 1.9 (reporting 6,171 mutual funds merged or liquidated during that period).

economies of scale."[139] According to Sandler, O'Neill & Partners, 66 asset management transactions were announced in the first six months of 2014 (down 12 percent from 2013) with an aggregate disclosed deal value of $12.9 billion (up from $7.7 billion in 2013).[140] The largest deals included: (i) the purchase of Nuveen Investments by TIAA-CREF ($6.25 billion), (ii) the purchase of F&C Investment Management Plc by Bank of Montreal ($1.2 billion), and (iii) Northwestern Mutual's sale of Frank Russell Company to London Stock Exchange Group ($2.7 billion).[141]

Importantly, historical experience has shown that the mergers and acquisitions ("M&A") market for asset management remains robust even during times of severe market stress.[142] Although the Lehman Brothers bankruptcy prompted much of the focus on resolution planning to mitigate systemic risk, its asset management division including Neuberger Berman continued to operate and was promptly sold. Neuberger Berman not only survived the Lehman Brothers bankruptcy, it continues to flourish.[143] In fact, the global M&A activity in the asset management industry was strong during the crisis, totaling $16.3 billion and $31.7 billion in transaction value and $1,148 billion and $3,300 billion in transacted AUM in 2008 and 2009, respectively.[144]

Of course there may be no buyer and a manager may simply exit the business. Fund managers routinely enter and exit the business for a variety of reasons including failing to attract or maintain sufficient AUM.[145] From year-end 2009 to year-end 2013, the number of mutual fund sponsors increased modestly from 682 to 801, with 181 sponsors exiting the business and 300 entering it.[146] In 2013 alone, 48 mutual fund sponsors left the business.[147]

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[139] Investment Company Institute, *"Orderly Resolution" of Mutual Funds and Their Managers*, 5 (July 15, 2014), *available at* http://www.sec.gov/comments/am-1/am1-55.pdf ("Although a fund manager's assets under management can grow organically, acquiring more assets under management through the acquisition of another manger'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 their 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.").

[140] Aaron Dorr & Christopher Browne, *Asset Manager Transactions Review – 1H 2014*, SANDLER, O'NEILL & PARTNERS, L.P., 1 (July 22, 2014), *available at* http://www.sandleroneill.com/Collateral/Documents/English-US/Asset%20Manager%20Review%201H14.pdf.

[141] *Id.*

[142] Investment Company Institute, *supra* note 139, at 2-3.

[143] "Neuberger Berman At a Glance" reported that the firm managed $250 billion in AUM as of December 31, 2014. *See* About Neuberger Berman, NEUBERGER BERMAN, WWW.NB.COM (last visited Mar. 18, 2015) http://www.nb.com/pages/public/global/our-firm.aspx.

[144] Berkshire Capital Securities LLC, *Investment Management Industry Review – 2012*, 4 (2012), *available at* http://www.berkcap.com/libraries/research_pdf/2012_imir_final.sflb.ashx.

[145] Investment Company Institute, *supra* note 139, at 2.

[146] ICI FACTBOOK, *supra* note 27, at 16, Figure 1.7.

[147] *Id.*

(c) Mutual funds are inherently self-resolving; managers can be easily sold or unwound.

Mutual funds are typically self-resolving through shareholder redemptions because of their simple capital structures and equity financing. As fund performance deteriorates, investors withdraw assets and total net values decline. Frequently, such a fund will be merged into another fund with a similar investment objective. The fund may also close to new investments to liquidate in an orderly fashion to ensure fair treatment of all remaining shareholders.

Funds that experience redemptions and then subsequently liquidate actually achieve one of the FSB SIFI Framework's primary goals without the need for a special resolution mechanism – they "resolve" themselves in an orderly fashion with no discernable market impact or government intervention. As the FSB and IOSCO acknowledge, "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the [2000-2012] observation period."[148] In fact, "liquidations and consequent closures of [collective investment scheme] entities . . . represent an ordinary phenomenon that results more from gradual changes in investor sentiment (with consequent outflows) than as a deterministic response to an external shock."[149]

When U.S. mutual funds liquidate, they follow an established and orderly process "by which the fund liquidates its assets, distributes the proceeds pro rata to investors and winds up its affairs,"[150] all without consequences to the financial system at large. The diagram in Annex A sets out the straightforward process for liquidating a mutual fund at a high level.[151] Mutual funds are required to return to investors only their pro rata share of a fund's NAV and are thus not susceptible to the kinds of "run risks" posed by banks and other financial companies. Mutual funds have no employees, pension, insurance or other benefits obligations, or other liabilities and constituencies that must be accounted for when a typical operating company is resolved.[152]

The simplicity with which mutual funds and their managers are resolved contrasts starkly with the difficulty of resolving complex banking firms. The amount and complexity of liabilities and the number and variety of creditors, both inside and outside of a bank holding company complex, make the orderly resolution of such a firm especially challenging. On the contrary, a traditional open-end mutual fund has a simple capital structure, issuing only equity, and is prohibited from issuing senior securities. Its only liabilities will be any accrued but unpaid expenses of running the fund, which will be paid out of fund assets – not a complex web of indebtedness to different classes of creditors. Their asset managers have similarly simple transparent balance sheets. These characteristics make resolution easy.

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[148] FSB/IOSCO Consultative Document, *supra* note 26, at 30 n.38.
[149] *Id.* at 31 n.39; *see also* Goebel, *supra* note 128, at 10.
[150] ICI Letter, *supra* note 21, at E-1.
[151] For a more detailed explanation, see Jack Murphy, Julien Bourgeois and Lisa Price, *How a Fund Dies*, 43 REV. OF SEC. & COMMODITIES REG. 283 (2010).
[152] Although managers may have some or all of these, the ease with which managers are replaced by investors ensures that, in the unlikely event they encounter financial difficulty, they will be managing an insignificant amount of assets by the time they resolve those obligations in liquidation or a normal bankruptcy process if their liabilities exceed their assets.

(d) Mutual funds are legally distinct from their managers and other funds advised by a common manager.

The FSOC acknowledges the separateness of funds and managers, and funds from other funds (*e.g.*, separate legal structures, shareholders, portfolio managers and governance, including multiple fund boards).[153] This separateness is required by law and reinforced by broad prohibitions against financial interconnections, with certain limited exceptions. The prohibitions arise from concerns that led to the creation of the 1940 Act and the Investment Advisers Act of 1940 (the "Advisers Act")[154] and from similar concerns that gave rise to modern law on corporate governance.

Although a cursory assessment might lead one to equate $2 trillion in assets on a bank holding company's balance sheet with $2 trillion in assets held by hundreds of mutual funds managed by the same asset management company[155] and assume that their resolutions would involve similar issues, that is a false equivalence. Each fund is independent from its manager and the other funds it manages; and they are owned by different shareholders. Those mutual funds would not be covered by a manager's bankruptcy filing the way subsidiaries of a bank holding company would be covered if it were to declare bankruptcy. Similarly, the liquidation of one fund would have no direct effect on other funds with the same manager.

A mutual fund manager's relationships with the fund (or funds) it manages are constrained by: (i) statutory law, including the Advisers Act and corporate law, which impose separate fiduciary duties to each fund, (ii) advisory contracts, (iii) each fund's investment guidelines and (iv) the legal restrictions applicable to each fund set forth in the 1940 Act.[156] Although the main purpose of these constraints was initially investor protection, they also enhance the stability of the financial system by making mutual funds resilient[157] and simplifying

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[153] "The Council notes that an investment vehicle has a separate legal structure from the asset manager, any parent company, or any affiliated investment vehicles under the same manager. In addition, the assets of the investment vehicle are not legally available to the asset manager, its parent company, or affiliates for the purpose of satisfying their financial obligations or those of affiliated investment vehicles." Notice, 79 Fed. Reg. at 77,494.

[154] "The Investment Company Act and Investment Advisers Act . . . establish a comprehensive federal regulatory framework that addresses a wide range of activities and focuses on many complex areas of regulation. Three of the most significant tools provided are: controls on conflicts of interest; a registration, reporting a disclosure regime; and controls on fund portfolio composition risk and operational risk." White, *supra* note 7.

[155] Fidelity's registered investment advisers currently manage over 500 different mutual funds.

[156] For example, the 1940 Act contains a number of provisions designed to prevent specific conflicts of interest between an adviser and a fund or its shareholders. Section 17(a) of the 1940 Act generally prohibits transactions between a registered fund and one of its affiliates, including its investment adviser, or an affiliate of an affiliate of the fund (collectively, "Affiliates"). *See* 15 U.S.C. § 80a-17(a). Section 17(d) and Rule 17d-1 restrict joint transactions between a mutual fund and its Affiliates. *See id.* § 80a-17(d). Section 17(e) restricts the compensation that an Affiliate of a mutual fund may receive when acting as an agent of or broker for a mutual fund. *See id.* § 80a-17(e). Finally, Section 10(f) restricts a mutual fund's acquisition of securities from an underwriting syndicate in which an Affiliate is participating. *See id.* § 80a-10(f). Therefore, although the adviser may manage a variety of funds, it is bound by a strict fiduciary duty and numerous other obligations to each of them that are well documented and enforced.

[157] *See, e.g.*, Liang, *supra* note 9 (Mutual funds have "weathered all kinds of adverse market conditions without noticeably contributing to systemic risk.").

their resolution. These protections are safeguarded by multiple layers of oversight by internal and external groups.

Legal and operational requirements dictate that the manager provide investment management services to each fund on an agency basis. A manager is hired to exercise investment control over those assets subject to the restrictions described above but, as the Council recognizes, the assets of a fund do not become assets of the manager and they are not available for the manager or its affiliates to use to satisfy their own obligations. For the same reason, the performance of a mutual fund's assets cannot threaten its manager's solvency the way the performance of proprietary assets of a bank or other subsidiary can threaten the solvency of a bank holding company.[158]

The separation between asset managers and their advised funds is subject to monitoring and oversight by fund shareholders, consultants representing shareholders, regulators (such as the SEC and the Department of Labor), both internal and external auditors, and the funds' boards of trustees. A fund's board of trustees is typically composed of a super-majority of independent trustees[159] and plays one of the most prominent oversight roles.[160] The 1940 Act was designed to have unaffiliated directors serve as "independent watchdogs . . . to supply an independent check on management and provide a means for the representation of shareholder interests in investment company affairs" and thereby manage conflicts of interest that could arise.[161] The main role of a fund's board, including the independent trustees, is to oversee the fund's management, operations and investment performance with a particular focus on conflicts of interest and the monitoring of those transactions involving the fund and its affiliated persons, such as the manager, permitted (and not permitted) by the 1940 Act.[162]

(e) Strict custody requirements safeguard fund assets and facilitate transfer or payout in redemption or liquidation.

The 1940 Act and SEC rules, which regulate how assets of funds may be held, impose significant barriers that prevent an investment adviser or affiliate from seizing, abusing or commingling fund assets.[163] In practice, nearly all mutual funds use U.S. bank custodians to

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[158] That is not to suggest that an adviser or other fund service provider may not face liability for failing to perform its duties under the relevant contract; rather, the adviser has no obligation to make investors whole for declines in the values of the investments and investors have no such expectation. *See* Goebel (Dec. 19, 2011), *supra* note 5, at 3.
[159] Most Fidelity mutual fund boards are at least 75 percent independent.
[160] ICI reports that, as of year-end 2012, 85 percent of mutual fund complexes had at least 75 percent independent directors of their fund boards. Investment Company Institute, *supra* note 139, at 4. For a more detailed explanation, see generally INVESTMENT CO. INST. & INDEP. DIRS. COUNCIL, OVERVIEW OF FUND GOVERNANCE PRACTICES, 1994 – 2012 (2013), *available at* http://www.idc.org/pdf/pub_13_fund_governance.pdf.
[161] *Burks v. Lasker*, 441 U.S. 471, 484 (1979).
[162] We discuss certain trustee responsibilities in response to Question 1 below. Some trustee responsibilities not discussed in depth in this letter include overseeing fund operations, such as authorizing the issuance or sale of fund shares, monitoring the performance of the adviser, authorizing NAV determinations, including the method, time and frequency of such determinations, overseeing fair valuation determinations, proxy voting activities and compliance functions and overseeing the process by which fund disclosure is prepared, reviewed, revised, and updated.
[163] Section 17(f) of the 1940 Act and Rules 17f-1 through 17f-7 thereunder, require a fund to keep assets in the custody of a federal or state regulated bank or certain other specified entities such as a futures commission merchant

comply with these regulations.[164] These rules safeguard the assets and facilitate their transfer to a replacement manager or payout in redemption or liquidation.

(f) Even in stressed markets, funds and managers can be liquidated or sold quickly and without any effects on the wider economy.

A fund merger or liquidation is typically not caused by unusual circumstances.[165] Rather, funds merge or liquidate in the ordinary course, which allows the process to unfold over a time period that the fund manager and fund board deem appropriate.[166] If a liquidation or merger requires an expedited timetable, however, the fund manager and fund board typically have the ability to act quickly to close or sell a fund, and "[e]ven 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."[167] In the event that a fund should face the combination of unusually heavy redemptions and difficult market conditions, the SEC has authority under Section 22(e) of the 1940 Act to enable a fund to suspend redemptions for a period of time.[168] There are many examples of funds or fund managers that have liquidated or merged under extraordinary circumstances without impacting financial stability.

We submit that, after reviewing comments in response to the Notice and considering all of the evidence, it should be apparent that the hypothesis that asset management entities require special resolution planning to mitigate systemic risk is unfounded. Threats to financial stability have not arisen from the structure or business models of mutual funds or asset managers or their activities in the past, and cannot reasonably be expected to arise from them in the future.

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or foreign sub-custodians, and impose strict limitations intended to prevent personnel of the investment adviser from misapplying fund assets. *See* 15 U.S.C. § 80a-17(f). The use of bank custodians also insulates assets of a fund from the other funds managed by the same asset manager. The SEC's custody rules under the Advisers Act impose robust requirements designed to ensure the safekeeping of client assets, including the requirement of Rule 206(4)-2 that an investment adviser maintain any assets over which it has custody at a qualified custodian. *See* Sec. & Exch. Comm'n, Final Rule, Custody of Funds or Securities of Clients by Investment Advisers Release No. IA-2968 (eff. Mar. 12, 2010).

[164] Investment Company Institute, *supra* note 139, at 4.

[165] *See* FSB/IOSCO Consultative Document, *supra* note 26, at 31, n.39 (Liquidations "represent an ordinary phenomenon that results more from gradual changes in investor sentiment (with consequent outflows) than as a deterministic response to an external shock.").

[166] Investment Company Institute, *supra* note 139, at 5.

[167] *Id.* at 7.

[168] *Id.*

RESPONSES TO FSOC INQUIRIES REGARDING RESOLUTION

Question 1: What financial interconnections exist between an asset manager and the investment vehicles it manages, between an asset manager and its affiliates, or among investment vehicles managed by the same or affiliated asset manager(s) that could pose obstacles to an orderly resolution? To what extent could such interconnections result in the transmission of risk? Are any financial interconnections sufficiently documented to allow for an orderly continuation of operations in the event of resolution?

We do not believe there are any financial interconnections that exist between an asset manager and the investment vehicles it manages, between an asset manager and its affiliates, or among investment vehicles managed by the same or affiliated asset manager(s) that could pose obstacles to orderly resolution. The few financial interconnections that do exist are strictly limited, well documented, and carefully monitored. As a result, they would not pose obstacles to an orderly resolution. On the contrary, the robust documentation would facilitate it.

A. Financial interconnections are limited and none would impede orderly resolution.

As discussed in the introduction to this section, a mutual fund has a simple capital structure. It is transparent and much less complex than that of a large banking firm. Mutual fund managers generally do not have many financial interconnections with the funds they manage or their affiliates, and funds themselves generally do not have financial interconnections with other vehicles managed by the same or affiliated managers. However, there are certain limited exceptions to this general separation. These exceptions are well documented, governed by established regulations and subject to conservative management and comprehensive oversight, all of which facilitate orderly resolution. The exceptions include:

- Interfund lending: As discussed in Section II (Liquidity and Redemptions), Fidelity funds have been granted an SEC exemption, subject to stringent limitations, from the prohibition on lending to other Fidelity funds under Section 17(a)(3) of the 1940 Act.

- Seed funding and corporate investing: The 1940 Act requires a newly registered investment company to have at least $100,000 of seed capital before distributing its shares to the public. At Fidelity, we can redeem seed capital on the same terms as any other redeeming shareholder. Fidelity redeems its seed investments once the fund has sufficient investors and capital to operate efficiently and at a scale that allows it to achieve its investment objectives. From time to time, Fidelity makes other corporate investments in an account or fund managed by a Fidelity adviser. These include, for example, investment of Fidelity excess working capital in funds managed by a Fidelity adviser and investment of corporate liquidity in an account with a specific mandate that is managed exclusively for the benefit of Fidelity and not open to clients.

- Services: Any other financial interconnections are created only through the provision of services related to fund management, distribution and administrative servicing. Expenses related to these provisions of services are variable and highly correlated to

fund assets and activities. As assets and activities rise and fall, so do services and expenses for them.

B. Transmission of Risk Due to Interconnectedness; Documentation.

Except as noted above, a fund is legally and economically separate from its manager, as well as the manager's other funds. Accordingly, investment and other financial risks do not transfer between one fund and another or directly between the manager or another service provider and the fund. The relationships between asset managers and the investment vehicles they manage, between asset managers and their affiliates, or among investment vehicles managed by the same or affiliated asset managers are fee-for-service, not credit or principal investment transactions.

The primary risk to funds from their interconnectedness with service providers is operational, including delays or ability to process securities transactions, shareholder activities and timely maintaining accounting and financial records, and not direct financial risk. Asset manager affiliates sometimes provide funds with transfer agency, administration accounting and bookkeeping services. Such services are provided pursuant to agreements reviewed and approved by independent trustees of the mutual funds and are regulated, documented, and monitored internally and externally.

Mutual funds are required to file copies of all material contracts with their registration statements, including investment management and custodian agreements.[169] Importantly for the topic of resolution, the fund board has discretion to hire and fire a fund's manager.[170] Further, the possibility that the advisor/client relationship will terminate, and the key terms governing any such termination, are agreed to at the outset of such relationship. All advisory contracts must be terminable by the fund board or shareholders on not more than 60 days' notice, with no penalty.[171]

In addition to reviewing and approving the investment advisory contract annually, a fund's board also reviews and approves the selection of service providers, the terms on which they provide services to the funds and their performance under the agreements documenting these relationships.[172] Trustees also approve and monitor the effectiveness of the fund's brokerage policies (*e.g.*, brokerage allocation and best execution). For funds that use affiliated brokers as permitted by Rule 17e-1, the fund's board is required to review affiliated broker transactions to ensure compliance with the fund's procedures on a quarterly basis. Fund trustees also select and monitor foreign custodians or delegate this responsibility to a foreign custodian

[169] Rules 31a-1 and 31a-2 under the 1940 Act set forth the primary recordkeeping and record retention for mutual funds. *See* 17 C.F.R. §§ 270.31a-1, a-2.
[170] *See* 15 U.S.C. § 80a-15. The 1940 Act requires that every new advisory contract with a mutual fund and any renewal of that contract be approved by a majority of independent trustees at an in-person meeting. After an initial term of up to two years, a contract must be approved every year to remain in effect.
[171] *See* Investment Company Act § 15(a)(3), 15 U.S.C. § 80a-15.
[172] These agreements include: transfer agent agreements, service agent agreements, agreements for other administrative services like pricing and recordkeeping, securities lending services, terms and procedures, Rule 12b-1 plans and plan-related agreements.

manager. Rule 17f-5 requires a fund's board to obtain regular reports from the foreign custody manager regarding the placement of foreign assets and any material changes in the status of the fund's foreign custody arrangements.

These existing regulations and market requirements have created a strong network of controls and reporting obligations that produce comprehensive documentation describing the roles, rights and responsibilities of every party involved in providing services to mutual funds. To satisfy their fiduciary duties and provide required reporting to regulators, investors, investors' representatives, and fiduciaries such as independent mutual fund trustees, managers document their relationships with clients, as well as their own relationships and the relationships their funds may have with other market participants in detail.

We understand that regulators are concerned that a lack of documentation would impede resolution of banks and similar firms. Regulators have shown a lack of comfort with other organizations' living wills, requiring significant increases to documentation between affiliates, with service providers and with other market participants.[173] These concerns are not warranted for mutual funds and their managers because their limited financial interconnections are thoroughly documented and that documentation would facilitate an orderly resolution.

Question 2: Could the failure of an asset manager or an affiliate provide counterparties with the option to accelerate, terminate, or net derivative or other types of contracts of affiliates or investment vehicles that have not entered insolvency?

No, the failure of an asset manager or an affiliate would not provide counterparties with the option to accelerate, terminate, or net derivatives or other types of contracts of Fidelity mutual funds or investment vehicles that Fidelity manages that have not entered insolvency. For example, the failure of a manager or affiliate would not trigger or accelerate or unwind any swap or derivative transactions governed by standard ISDA documentation to which a Fidelity mutual fund is a party. Additionally, there are no cross-defaults or cross-entity provisions involving the asset manager or affiliate, on the one hand, and a mutual fund, on the other. Similarly, there are no obligations of this type for which funds are jointly liable for their collective performance.

Question 3: In what ways, if any, could the potential risks associated with liquidity and redemption or leverage impact the resolution of an asset manager or investment vehicle in times of financial stress?

The process of resolving a mutual fund or its manager does not change based upon the level of market stress. Furthermore, liquidity and leverage are portfolio-level issues that would

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[173] *See* Press Release, Bd. of Governors of the Fed. Reserve Sys. & Bd. of Dirs. of the Fed. Deposit Ins. Corp., *Agencies Provide Feedback on a Second Round Resolution Plans of "First-Wave" Filers: Firms Required to Address Shortcomings in 2015 Submissions* (Aug. 5, 2014), *available at* http://www.federalreserve.gov/newsevents/press/bcreg/20140805a.htm. The agencies identify several common features of the various resolution plans' shortcomings, specifically: (i) assumptions that the agencies regard as unrealistic or inadequately supported, such as assumptions about the likely behavior of customers, counterparties, investors, central clearing facilities and regulators and (ii) the failure to make, or even to identify, the kinds of changes in firm structure and practices that would be necessary to enhance the prospect for orderly resolution. *Id.*

have no impact on the resolution of an asset manager because each is insulated from any direct exposure to the financial risk of the other.

Entities with significant leverage, illiquid assets and complex capital structures can be difficult to resolve in normal times and more so in times of financial stress. Mutual funds and their managers have none of these characteristics.

In the Notice, the FSOC expresses concern that there may be a "first-mover advantage" in redemptions during times of stress, which could cause asset managers to sell assets at a discount to meet redemptions and negatively affect investors who are not quick to redeem.[174] This issue is more fully discussed in Section II (Liquidity and Redemptions) of this letter. In the context of resolution, if many investors were redeeming at once due to a perceived "first-mover advantage," the fund would self-resolve to a large degree through redemptions, and the liquidation of remaining assets would be straightforward and orderly.

Question 4: Are there interconnections that exist between asset managers and other financial market participants that in times of financial stress could transmit risk?

For a number of reasons previously discussed, we do not believe there to be any meaningful interconnections between asset managers and other market participants that could transmit risk in times of financial stress. On this point, we agree with the observation the FSB and IOSCO have made that asset managers are not financially interconnected to any material degree with other market participants.[175] They certainly are not connected to any material degree through financial exposure, which is the only identified means of transmitting systemic risk. If the FSOC believes that any such interconnections exist, it should specifically identify them and provide empirical evidence of their potential effects on U.S. financial stability so that industry participants can address them specifically.

We also believe that using the "transmission of risk"[176] as a benchmark for regulatory concern in the context of asset management is not helpful and likely to be misleading. Funds are collective investment vehicles that provide professionally managed exposure to investment risk. Their purpose is to transmit specific investment risk to investors. Investors determine their desired exposures and levels of risk tolerance in selecting funds. Neither the manager nor the fund makes that choice for the ultimate owner of the asset – namely the investor.

Once the choice is made, asset managers provide a service to investors and play a valuable role in the capital markets. They manage funds so that they "transmit" the investment risk fund investors are seeking accurately and efficiently as they allocate capital to issuers and

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[174] Notice, 79 Fed. Reg. at 77,490.
[175] FSB/IOSCO Consultative Document, *supra* note 26, at 30, n.36 ("[I]nterconnectedness does not emanate from the manager's balance sheet."). The FSB/IOSCO Consultative Document proposed to focus on funds instead of fund managers in its analysis because "[e]conomic exposures are created at the fund level as they emanate from the underlying asset portfolio held by the fund" and "[t]he assets of a fund are separated and distinct from those of the asset manager." *Id.* at 30.
[176] Notice, 79 Fed. Reg. at 77,494.

manage market risk.[177] Therefore, rather than asking whether funds or managers "transmit" risk, the real question should be whether the use of an asset manager or investment in a collective fund *creates or amplifies* risk with sufficient probability and magnitude that it would threaten the stability of the U.S. financial system. Absent excessive leverage, there is no evidence that it does.

Question 5: In what ways could cross-border resolution complicate an orderly insolvency or resolution in one or more jurisdictions? Do contracts with service providers (*e.g.*, custodians or prime brokers) allow for assets to be custodied at offshore entities and what are the implications of this for resolution?

There are no cross-border issues that would complicate an orderly insolvency or resolution of a mutual fund or its manager. U.S. mutual funds are organized under the laws of a U.S. state and are generally offered only within the United States. The application of foreign laws to foreign service providers and contracts with them would not complicate a resolution process that is simple and systemically irrelevant for the reasons described in the introduction to this section. Contracts with foreign service providers can be amended, terminated and transferred just as contracts with U.S. entities can be. Mutual fund assets that are serviced by foreign entities are still held by independent custodians and regulated as described below.

Funds rely primarily on U.S. custodians, which guarantee the same standards of performance of a sub-custodian for any assets held overseas. If a custodian or sub-custodian bank with a contractual obligation fails, the fund is typically indemnified and can switch to another custodian. That remedy is not just a theoretical option. Fidelity and its customers have changed custodians many times in the past ten years, as have others.

With regard to custody of fund assets outside of the United States, there is a strong federal regulatory regime already in place, which has resulted in standard operating procedures becoming ingrained in the industry. Rules 17f-5 and 17f-7 under the 1940 Act regulate a fund's use of a foreign bank custodian (Rule 17f-5) and restrict a fund's ability to maintain assets with a foreign securities depository to only certain depositories that meet minimum requirements (Rule 17f-7). Additionally, Rule 17f-7 requires that a fund's primary global custodian "must provide the fund or its advisor with an analysis of the custodial risks of using an eligible depository, monitor the depository on a continuing basis and notify the fund of any material changes in risks associated with using the depository."[178] The primary custodian must be a U.S. bank or a qualified foreign bank that contracts directly with the fund.[179] A fund's custodian, which is

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[177] *See* Peter R. Fisher, Senior Lecturer & Senior Fellow, Center for Global Bus. & Gov't, Tuck Sch. Of Bus. at Dartmouth, Remarks at the Brookings Institution Asset Management, Financial Stability and Economic Growth Conference (Jan. 9, 2015), *available at* http://www.brookings.edu/events/2015/01/09-asset-management-financial-stability-economic-growth ("So I think the efficiency question for the economy is; do the assets end up in the hands of those who can take that slice of risk most efficiently? And the asset manager is the switching station in that. You have some clients who have very longer rated investment horizons, and others that have very short, and some that have very high volatility willing to take, and others very low, and you are trying to allocate among them.").

[178] Sec. & Exch. Comm'n, Final Rule, Custody of Investment Company Assets Outside the United States, Release Nos. IC-24424, IS-1221 (eff. June 12, 2000).

[179] *Id.*

typically guaranteeing performance of foreign sub-custodians and indemnifying the fund against losses if they do not perform, takes great care when establishing and documenting these relationships, which also promotes stability in the cross-border space.

Finally, we note that this question is of minimal relevance to Fidelity and Fidelity mutual funds generally. The Fidelity investment advisers and other affiliates that service Fidelity mutual funds are primarily domiciled in the United States and would be resolved under U.S. law. In certain limited cases in relation to investment strategies that include exposure to issuers located in markets outside of the United States, Fidelity investment advisers may, to the extent permitted by their advisory contracts, delegate investment discretion over all or a portion of a portfolio to one or more sub-advisors located outside of the United States, including sub-advisors located in the United Kingdom, Hong Kong and Japan. The sub-advisory agreements between the Fidelity investment adviser and the sub-advisor located outside of the United States are also subject to the approval by the trustees of each mutual fund.

Question 6: What contingency planning do asset managers undertake to help mitigate risks—from firm-specific and market-wide stress—to clients?

Given that mutual funds and their managers are at little or no risk of insolvency, any "firm-specific stress" is most likely to arise from operational issues related to the fund, its manager or another service provider. In response to this question, we refer to the range of best practices and protocols discussed in the Operational Risk section of this letter and emphasize that we have highly developed management tools in place to mitigate operational risks and ensure that we can deliver the services our customers have hired us to provide. We also refer to our experience transferring assets in and out of Fidelity mutual funds and accounts in all market conditions without disruption, and highlight the array of contractual, fiduciary and market requirements, and other federal and state regulations that are enforced regardless of market conditions. In any event, we do not believe that additional regulations are necessary to improve upon the contingency planning that Fidelity already conducts in this area in light of the incentives we have to design and test it. Finally, we do not believe that idiosyncratic operational risks that originate in a fund, its manager or a non-bank affiliate, could threaten U.S. financial stability.

The FSOC's reference to "market-wide stress" could be interpreted to refer to asset-price volatility, illiquidity, or the inability of an important market to function normally. These effects could result from unanticipated monetary policy actions,[180] unintended consequences of regulation,[181] the operational or financial failure of a CCP,[182] a geopolitical crisis or some other

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[180] *See, e.g.*, Stephen Brown and Noah Barkin, *IMF's Lagarde Sees Monetary Policy Risks*, REUTERS (Mar. 11, 2015), *available at* http://www.reuters.com/article/2015/03/11/us-imf-lagarde-risks-idUSKBN0M727I20150311 ("The head of the International Monetary Fund (IMF) said during a visit to Berlin on Wednesday that diverging monetary policies posed a risk to the global economy."); Ira Josebashvili et al., *Surge of Swiss Franc Triggers Hundreds of Millions in Losses*, WALL ST. J. (Jan. 16, 2015), *available at* http://www.wsj.com/articles/swiss-franc-move-cripples-currency-brokers-1421371654 ("Banks, brokers and individual investors were left with hundreds of millions of dollars in losses a day after an unexpected surge in the Swiss franc sent shock waves through markets.").

[181] *See, e.g.*, İnci Ötker-Robe & Ceyla Pazarbasioglu, *Impact of Regulatory Reforms on Large and Complex Financial Institutions*, 26 (Nov. 2010), *available at* https://www.imf.org/external/pubs/ft/spn/2010/spn1016.pdf

source. If the issue is primarily operational, we refer you again to our responses in the Operational Risk section of this letter. If the issue is primarily financial, our investment professionals weigh the probabilities and consequences of possible sources of stress as part of the portfolio management process for each Fidelity mutual fund and client account.

We understand that the SEC may be considering some form of stress testing as required by the Dodd-Frank Act. We note that considering the consequences of possible market stress is common practice at the portfolio level, and we reiterate our recommendation that no one-size-fits-all test be applied to asset management vehicles or their managers.

Such uniformity could not appropriately account for the diversity in the industry. On the contrary, it would threaten the asset management industry. We recommend eschewing a formulaic test, which would reduce efficiency and competition and produce homogeneity that would increase susceptibility to a common shock. Publication of best practices could be helpful. Those could increase the overall preparedness of the industry and be applied in a tailored fashion that reflects the variety of investors, structures, managers, and service models in the industry and fosters the diverse diversification that makes our capital markets more competitive, efficient and resilient.[183]

Question 7: To the extent that resolution and liquidation in the asset management industry present risks to U.S. financial stability, how could such risks be mitigated?

There is no empirical evidence or theoretical support for the premise that *resolution*, including by liquidation, in the mutual fund industry presents risks to U.S. financial stability. Mutual funds and their managers are resolved individually, through normal processes, without impacting U.S. financial stability, regardless of the market conditions. Thus, there is no threat to stability that has given rise to a need for living wills and the rest of the special resolution planning regime that is under development for large banking firms. To the extent that there are any hypothetical difficulties in resolution, their probability and magnitude are far too low for them to be reasonably expected to *impact* U.S. financial stability, let alone threaten it. Both historical evidence and the fundamental characteristics of the mutual fund business support that assertion.

("Some activities may move toward the less regulated shadow banking sector, as the regulatory cost to banks to undertake such activities increases (e.g., certain types of loans, leases, trading, and derivatives).").

[182] *See, e.g.*, Daniel K. Tarullo, Member, Bd. Of Governors of the Fed. Res. Sys., Speech: Advancing Macroprudential Policy Objectives, at the Office of Financial Research and Financial Stability Oversight Council's 4th Annual Conference on Evaluating Macroprudential Tools: Complementarities and Conflicts (Jan. 30, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm ("If the CCP fails, the adverse effects on the financial system could be significant.").

[183] Nicholas Beale et al., *Individual Versus Systemic Risk and the Regulator's Dilemma*, 108 PNAS 12,647 (Aug. 2, 2011), *available at* http://www.pnas.org/content/108/31/12647.

Question 8: What data currently are available or should be collected to monitor activities that may affect a resolution?

We do not believe that additional data collection or analysis are required in order to monitor activities that may affect the resolution of mutual funds and their managers.

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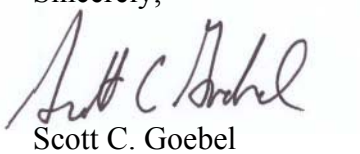
We appreciate the opportunity to comment on the Notice. Fidelity would be pleased to provide any further information or respond to any questions that the Council may have.

Sincerely,

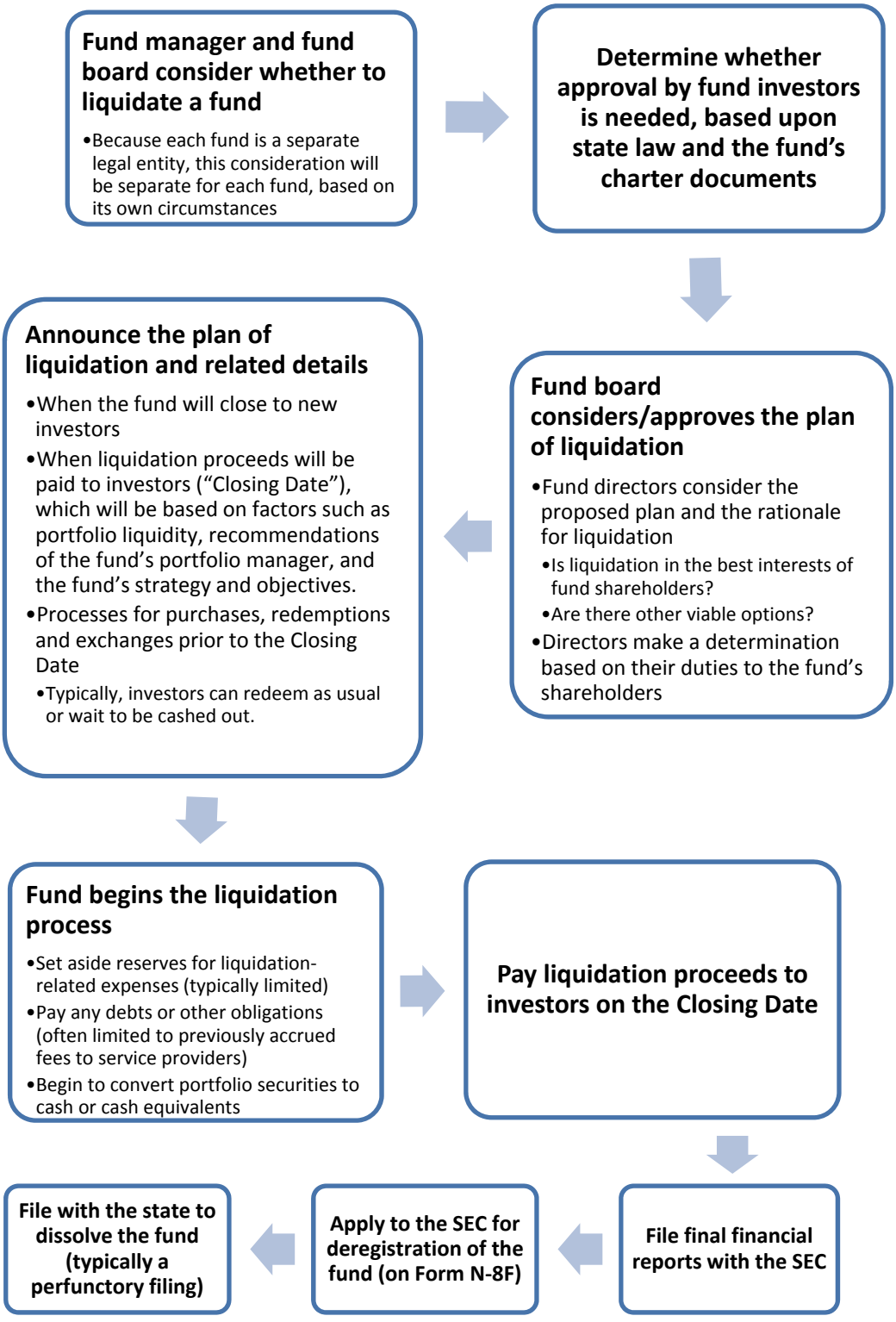


Scott C. Goebel

cc:
Chairman Jacob J. Lew, Secretary of the Treasury
Thomas J. Curry, Comptroller of the Currency
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
Timothy G. Massad, Chairman of the Commodity Futures Trading Commission
Debbie Matz, Chairman of the National Credit Union Administration
Melvin L. Watt, Director of the Federal Housing Finance Agency
Mary Jo White, Chair of the U.S. Securities and Exchange Commission
S. Roy Woodall, Jr., Independent Insurance Expert
Janet L. Yellen, Chair of the Board of Governors of the Federal Reserve System
Richard Berner, Director of the Office of Financial Research
John P. Ducrest, Commissioner of the Louisiana Office of Financial Institutions and Chairman of the Conference of State Bank Supervisors
Adam Hamm, Insurance Commissioner, North Dakota Insurance Department
Michael T. McRaith, Director, Federal Insurance Office, Department of the Treasury
Mark Carney, Chair, Financial Stability Board
Greg Medcraft, Chairman, International Organization of Securities Commissions
David Wright, Secretary General, International Organization of Securities Commissions
Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union, European Commission
Secretariat of Financial Stability Board (c/o Svein Andresen, Secretary General, Financial Stability Board)
Secretariat of International Organization of Securities Commissions (c/o David Wright, Secretary General, International Organization of Securities Commissions)

Annex A

Process for Liquidating a Mutual Fund



APPENDIX C

March 25, 2015 Companion Letter from Scott C. Goebel, Senior Vice President & General Counsel, Fidelity Management & Research Company to the Financial Stability Oversight Council

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March 25, 2015

Submitted electronically

Financial Stability Oversight Council
Attn: Patrick Pinschmidt
Deputy Assistant Secretary
1500 Pennsylvania Ave., NW
Washington, DC 20220

Re: Docket Number: FSOC-2014-0001
Notice Seeking Comment on Asset Management Products and Activities

Dear Mr. Pinschmidt:

Fidelity Investments ("Fidelity")[1] appreciates the opportunity to respond to the Financial Stability Oversight Council's (the "Council" or "FSOC") notice seeking comment concerning asset management products and activities (the "Notice").[2] Given Fidelity's long history and substantial experience managing mutual funds, we have focused on the structure, regulation, operation and management of mutual funds in responding to the Notice. In a companion letter, filed today, we provide responses to the questions posed in the Notice.

In this letter we describe our concerns with aspects of the Council's overall inquiry into whether asset management products or activities threaten U.S. financial stability and, because we believe that the FSOC is right to ask these questions in order to better understand the industry and the capital markets in which it operates, we make suggestions to improve the inquiry. Our suggestions include that the Securities and Exchange Commission (the "SEC") should lead the effort to evaluate the asset management industry.

The FSOC's present analysis requires both rigor and balance. The contributions that a product or activity makes to economic growth and financial stability must be balanced against the probability and magnitude of any threat that it could possibly pose. So must the intended benefits of a potential regulatory response be weighed against the costs and unintended consequences that it will create.

Necessarily, a thorough analysis will be a long and empirical process. The issues are complex and the roles that investors, funds and managers play in the capital markets are important to millions of individual investors, businesses, the financial system and the U.S. economy. Errors in this analysis have the potential to harm, rather than protect. The stakes are too high to rush to judgment or to apply inappropriate policy measures that curtail the benefits of asset management without increasing financial stability. With the goal of facilitating productive

[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.

[2] Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014) (hereinafter, the "Notice"), *available at* http://www.gpo.gov/fdsys/pkg/FR-2014-12-24/pdf/2014-30255.pdf.

outcomes, we describe our concerns with the current approach and recommend several improvements.

The FSOC should define key concepts precisely.

The Council's inquiry is clearly at the formative stage. The Notice leaves many key concepts undefined, and it includes no data or analyses that could illuminate their meanings. Given the ambiguity in many of the questions, we recommend that the Council and other regulators refine any questions or hypotheses that warrant further exploration. Without that refinement, regulators will be unable to conduct the rigorous empirical analysis that must support any conclusions and policy recommendations.

The Notice is rife with ambiguities that impede a meaningful discussion of the topics it addresses. In some cases, the Notice is silent on the definition of crucial terms. For example, "times of financial stress," "periods of financial market stress," "risks to U.S. financial stability," and variations thereof are used dozens of times throughout the Notice, without definition.[3] The Notice is ambiguous in its treatment of more narrow topics as well. For example, there is no standard definition of leverage for the asset management industry, and the Council proposes none.[4]

In some cases the Notice provides definitions, but the meanings are ambiguous or create no standard that can be implemented before a risk is realized.[5] For example, the Council defines "liquidity risk" as "the risk that an investor will not be able to buy or sell an asset in a timely manner without significantly affecting the asset's price."[6] Of course, every purchase or sale of a security could potentially affect the security's price, but what is a significant impact? What is timely? Do these metrics vary across asset classes? Without common definitions or metrics, these definitions are susceptible to many equally plausible and reasonable interpretations. As a result, each commenter on the Notice must develop his or her own definition for these terms, which at best will result in confusion and a lack of comparability across commenters.

In fact, simply discussing "liquidity risks" and "fire sales" at a very high level can set unreasonable expectations by creating the misimpression that these dynamics are easy to identify and regulate. On the contrary, reliably distinguishing asset bubbles, "liquidity risks" and "fire sales" from normal price discovery and market corrections, in real time, is likely to be difficult if

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[3] As Professor Matthew Richardson from the NYU Stern School of Business has noted, "[i]n order to regulate and manage systemic risk, one must be able to measure systemic risk. And in order to measure systemic risk, one needs to be able to define what it is." In his paper, Professor Richardson clearly defines the source of systemic risk and a framework that would enable the creation of objective metrics to measure it. Matthew Richardson, Prof. of Applied Econ., NYU Stern Sch. Of Bus., *Asset Management and Systemic Risk: A Framework for Analysis*, 5 (Mar. 19, 2015) (on file with the Fin. Stability Oversight Council, Docket No. FSOC-2014-0001).

[4] Balance sheet leverage is a well-understood concept that may not require specific definition, but the advent of derivative securities instruments that create synthetic leverage complicates the issue and invites a variety of approaches.

[5] The absence of an *ex ante* definition of a concept such as "liquidity risk" illustrates this shortcoming. If an asset manager cannot fully appreciate the liquidity risk of a security until it is actually sold and the price impact of the sale is observed, then the definition is of little or no value before the sale.

[6] Notice, 79 Fed. Reg. at 77,490.

not impossible for even the most knowledgeable policymakers.[7] After the internet bubble burst, the Federal Reserve Board (the "FRB") faced pressure to attempt to prevent (or at least limit) asset bubbles. In a speech on the topic, Ben Bernanke resisted this pressure and observed that the FRB "cannot reliably identify bubbles in asset prices."[8] Esther George, the President and CEO of the Federal Reserve Bank of Kansas City, recently echoed that sentiment.[9]

Although we readily acknowledge that it is quite difficult to develop definitions of and metrics for measuring systemic risk and related concepts, the alternative is, or should be, unacceptable. Identifying risks as "systemic" based solely on the opinions of regulators amounts to a "know it when you see it approach" that creates uncertainty amongst market participants and sets those regulators up for failure.[10]

The ambiguity in these terms prevents the FSOC and the public from determining whether systemic risk has been identified and reduced and "undermine[s] the assessment of alternative policies."[11] If the FSOC were to restrict the ability of funds to conduct certain activities in the name of reducing an undefined and immeasurable systemic risk, how if at all could the FSOC compare the risk-reducing benefits of such a policy to the costs it would impose on those funds, their clients and U.S. capital markets? Precise definitions and rigorous empirical metrics and models are essential. Without them, we cannot advance the general understanding of these issues or analyze the effectiveness and efficiency of policy options.

The FSOC should identify the assumptions and any research that underlie its hypotheses so that commenters can address them.

We are concerned that the Notice reflects a series of unstated assumptions that may or may not be identified by commenters. These include both assumptions made by the FSOC and

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[7] In many respects, a "fire sale" is merely the inverse of a bubble. If the Federal Reserve Board (the "FRB") cannot reliably identify a bubble, there is no reason to expect that the FSOC, or any other regulator, could reliably determine that declining asset prices are a "fire sale." If spotting bubbles and fire sales in real-time is difficult, designing narrowly targeted and effective measures to address them in all future market states is infinitely more so.

[8] *See* Ben S. Bernanke, Member, Bd. of Governors of the Fed. Res. Sys., Remarks before the New York Chapter of the National Association for Business Economics: Asset-Price "Bubbles" and Monetary Policy (Oct. 15, 2002), *available at* http://www.federalreserve.gov/Boarddocs/Speeches/2002/20021015/default.htm. In that speech, Mr. Bernanke explained that it is not realistic to expect that the FRB can "estimate the unobservable fundamentals underlying equity valuations" better that the financial professionals whose collective information is reflected in asset-market prices. He also noted that mere changes in asset prices are not good indicators that the new asset price is irrational or unjustified.

[9] *See* Esther L. George, President & CEO, Fed. Res. Bank of Kan. City, Speech at the Financial Stability Institute/Bank for International Settlements Asia Pacific High Level Meeting: Monetary and Macroprudential Policy: Complements, Not Substitutes (Feb. 10, 2015), *available at* http://www.kansascityfed.org/publicat/speeches/2015-George-Manila-BIS-02-10.pdf. ("[S]potting asset price bubbles or financial imbalances in real-time is notoriously difficult—something that is just as true today as in the past." and "It remains true that we can't identify bubbles in real time, or at least don't know the proper time and manner to intervene to stem their rise.").

[10] As the Nobel laureate Lars Peter Hansen observes when discussing systemic risk, the "know it when you see it approach" invites "a substantial amount of regulatory discretion," which can "lead to bad government policy, including the temptation to respond to political pressures." Lars Peter Hansen, *Challenges in Identifying and Measuring Systemic Risk*, 2 (Feb. 14, 2013), *available at* http://www.larspeterhansen.org/documents/FC_2012_Risk_BookSRMM_Challenges_in_Identifying.pdf.

[11] *See id.* at 2.

by theoreticians or researchers whose ideas may underlie the FSOC's hypotheses. If these assumptions are not identified, then of course they will not be addressed.

The questions in the section of the Notice on resolution, for example, seem premised on an assumption that there are, or are likely to be, financial interconnections among managers and the funds they manage or among managers and other financial market participants. One question asks whether there are "interconnections that exist between asset managers and other financial market participants that in times of financial stress could transmit risk?"[12] Fidelity does not believe there are any such financial interconnections. On this point, we agree with the Financial Stability Board ("FSB") and the International Organization of Securities Commissioners ("IOSCO") that asset managers are not financially interconnected to any material degree with other market participants.[13] They certainly are not connected to any material degree through financial exposure, which is the only identified means of transmitting systemic risk. If the FSOC believes that any such interconnections exist, it should identify them and provide empirical evidence of their potential effects on U.S. financial stability so that commenters can address them specifically.[14]

Similarly, if the FSOC is basing a hypothesis on ideas in academic research, it should identify the research. This would give commenters the opportunity to review the research and examine the methods that were used to produce it, as well as any assumptions and limitations that qualify its conclusions. We illustrate the importance of the opportunity for such a review in our companion letter in which we examine a paper[15] that has been cited by some policymakers in support of the liquidity risk hypothesis. There are material assumptions and limitations in that paper which demonstrate why it does not support that hypothesis.[16]

The FSOC bears the burden of proof.

As it proceeds with this inquiry into "whether asset management products and activities may pose potential risks to the U.S. financial system,"[17] the FSOC bears the burden of proof. It is incumbent on the FSOC to determine whether or not a *plausible* threat to financial stability

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[12] Notice, 79 Fed. Reg. at 77,494.

[13] Fin. Stability Bd. & Int'l Org. of Sec. Comm'ns, *Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, 30 n.36 (Jan. 8, 2014) (hereinafter, the "FSB/IOSCO Consultative Document"), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf ("[I]nterconnectedness does not emanate from the manager's balance sheet."). The FSB/IOSCO Consultative Document proposed to focus on funds instead of fund managers in its analysis because "[e]conomic exposures are created at the fund level as they emanate from the underlying asset portfolio held by the fund" and "[t]he assets of a fund are separated and distinct from those of the asset manager." *Id.* at 30.

[14] This question highlights the importance of clearly defining concepts. Without specific interconnections to consider, a clear definition of "times of financial stress" or an explanation of what it means to "transmit risk," it is impossible to (i) establish objective standards, (ii) model the stress or transmission of risk and the effects they would have on U.S. financial stability, or (iii) measure those dynamics empirically.

[15] Qi Chen, Ital Goldstein, & Wei Jiang, *Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows*, 97 J. OF FIN. ECON. 239 (2010).

[16] *See* Letter from Scott C. Goebel, Senior Vice President & Gen. Couns., Fidelity Mgmt. & Res. Co. to the Fin. Stability Oversight Council, 8-12 (Mar. 25, 2015).

[17] Notice, 79 Fed. Reg. at 77,488.

exists.[18] The FSOC must determine the probability and magnitude of any hypothetical threat based on robust empirical analysis.

Although commenters will provide their own data, analysis and expertise, which will be helpful to the FSOC, participation in this process does not shift the burden to the commenters. If the FSOC's standard is that industry must prove that there could never be a threat to financial stability arising from its products and activities, then it is using the wrong standard, and one that disserves investors, and indeed all citizens, who help drive the U.S. economy and benefit from its growth. Congress could not have intended that the FSOC devote its time and resources to remote probabilities and highly speculative risks or saddle the asset management industry and U.S. capital markets with costly, market-distorting regulation to address them. A realistic and objective assessment is required here. Thus, the FSOC properly bears the burden of proving that a threat to U.S. financial stability exists and that any proposed regulatory action could reduce it effectively and efficiently, without doing more harm than good.

A balanced inquiry.

In that vein, we emphasize the importance of balance in the FSOC's inquiry. We are concerned that the Notice consists primarily of questions organized around a series of hypothetical risks, with notably rare acknowledgment of the benefits of asset management to the economy and the capital markets, or the strong regulatory framework that governs the asset management industry and the mutual fund business in particular.

Six years after the financial crisis, many of the regulatory reform priorities – such as enhancing bank regulation and resolution planning, consumer protection, central clearing and myriad other improvements to the derivatives markets – have been addressed or are at least in process.[19] Now, regulators who are charged with identifying and regulating risk are turning to segments of the financial system that have performed well historically and did not play any significant negative role in the crisis – such as long-term mutual funds and their managers –

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[18] *See, e.g.*, Jerome H. Powell, Member, Bd. Of Governors of the Fed. Res. Sys., Speech at the Stern School of Business, New York University (Feb. 18, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/powell20150218a.htm ("[U]nless there is a *plausible* threat to the core of the system or potential for damaging fire sales, I would set a high bar for supervisory interventions to lean against the credit cycle. Such interventions would almost surely interfere with the traditional function of capital markets in allocating capital to productive uses and dispersing risk to the investors who willingly choose to bear it." (emphasis added)). That concept of probability has been notably absent from much of the unbridled speculation regarding systemic risk, but it should be an essential filter in the FSOC's inquiry.

[19] In its 2014 Annual Report, the Council described several recent regulatory reforms, stating: "The regulatory community reached a number of key milestones in financial reform implementation, including finalization of the Volcker Rule, bank capital rules, a supplemental leverage ratio for the largest banks and bank holding companies (BHCs), enhanced prudential standards for the U.S. operations of large foreign banks, and the advent of clearing, trading, and registration requirements for swaps markets. Policy developments continued with proposed rulemakings on money market funds (MMF) reform, risk retention for securitizations, and requirements for short-term liquidity coverage for large banking organizations. Also, there have been significant reductions in intraday credit exposures in the tri-party repurchase agreement (repo) market and significant progress on the strategy for resolution under the orderly liquidation authority (OLA)." FIN. STABILITY OVERSIGHT COUNCIL, 2014 ANNUAL REPORT, 3 (2014), *available at* http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf.

searching for hypothetical risks and asking whether they too need more, or different, regulation to mitigate them.

At the same time, much of the world is suffering from low growth or is actually in recession.[20] Thus, many policymakers are asking those regulators and economists whether the "disease" has been cured, at what cost, and what they should do to promote economic growth. In other words, are reforms working as intended or do the reforms themselves need fixing?[21] How should policymakers promote economic growth while preserving or enhancing financial stability? To be clear, they recognize the need for financial stability and growth[22] and they see that capital markets, asset management in particular, can help deliver both.[23]

On this point we agree with the observation recently made by Lord Jonathan Hill, the European Commissioner responsible for financial stability, financial services and the European capital markets union, when he said that "[w]e do not make the economy stronger by making our financial services weaker. We need to move from a position where the industry is seen as being part of the problem to one where it is seen as part of the solution."[24]

The International Monetary Fund (the "IMF") has described some of the ways in which asset management can be part of the solution, noting that "from a financial stability perspective, credit intermediation through asset managers and markets has advantages over that through banks."[25] In the same report, the IMF described other benefits that nonbanks, like mutual funds,

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[20] *See, e.g.*, INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK, 81 (Apr. 2014) ("Real interest rates worldwide have declined substantially since the 1980s and are now in slightly negative territory."); INT'L MONETARY FUND, WORLD ECONOMIC OUTLOOK, 17 (Oct. 2014) ("As discussed in [our April 2014 report], real interest rates on safe assets are likely to rise under the WEO baseline but remain below the average value of about 2 percent recorded in the mid-2000s before the crisis. However, the further declines in nominal and real interest rates on long-term 'safe' government bonds during the past few months—despite expectations of a strengthening recovery—underscore the fact that stagnation risks cannot be taken lightly."). In January 2015, the International Monetary Fund lowered its projections for global growth over the next two years, lowering projections issues in October 2014 by 0.3 percent to 3.5 this year and 3.7 percent in 2016. *See* Int'l Monetary Fund, *Global Growth Revised Down, Despite Cheaper Oil, Faster U.S. Growth*, IMF SURVEY MAGAZINE (Jan. 20, 2015), *available at* http://www.imf.org/external/pubs/ft/survey/so/2015/NEW012015A.htm.

[21] *See, e.g.*, Mark Carney, Governor, Bank of Eng., Remarks at the 29th Annual G30 International Banking Seminar: Regulatory Work Underway and Lessons Learned (Oct. 12, 2014), *available at* http://www.bis.org/review/r141015c.htm ("And we've learned about the unintended consequences of prudential capital and retention requirements on the securitisation market. Regulatory changes arguably treat asset-backed securities in ways that appear to be unduly conservative, particularly relative to other forms of long-term funding. Efforts to rebalance these incentives are now a priority.").

[22] *See, e.g.*, Jonathan Hill, Member, European Comm'n, Speech at the Finance Watch Conference: Finance at Your Service – Capital Markets Union as an Instrument of Sustainable Growth (Feb. 4, 2015), *available at* http://europa.eu/rapid/press-release_SPEECH-15-4144_en.htm ("[W]e need both financial stability and growth: we need sustainable growth. That is the new Commission's number one priority.")

[23] *See, e.g.*, *id.* ("Well-functioning capital markets also help encourage greater diversity in funding, which reduces concentration of risk so they not only free up capital for growth but also support and strengthen financial stability. After all, it's important to remember that 'capital markets' are not some abstract construct – they are someone's pension savings, someone's 'rainy day' money which is channelled to growth.")

[24] *See, e.g.*, *id.*

[25] INT'L MONETARY FUND, RISK TAKING, LIQUIDITY, AND SHADOW BANKING: CURBING EXCESS WHILE PROMOTING GROWTH, GLOBAL FINANCIAL STABILITY REPORT, 33 (Oct. 2014), *available at* https://www.imf.org/external/pubs/ft/gfsr/.

provide by enhancing the "efficiency of the financial sector," "enabling better risk sharing," and "deepening market liquidity."[26] Given these benefits, the IMF observed that "[t]he challenge for policymakers is to maximize the benefits…while minimizing systemic risks."[27] Other regulators have also recognized the ways in which asset management enhances financial stability and economic growth.[28] The Notice does not account for these benefits, but the FSOC should in its analysis.

There is a high standard to justify intervention in capital markets.

In addition to the widely recognized economic and financial stability benefits created by collective investment funds, their managers and the capital markets more broadly, there are other factors that require a high standard to be met in order to justify regulatory intervention in the name of mitigating hypothetical systemic risk. These include:

- The difficulty of correctly diagnosing "dangerous" conditions in asset markets and controlling asset prices and investors' behavior even in real time, let alone under future unknown market conditions,[29]
- Undeveloped and untested macroprudential tools,[30] and
- Unintended consequences of intervention that could damage financial markets, individual investors and issuers they serve, and economic growth.[31]

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[26] *Id*. at 240.
[27] *Id*. at 86.
[28] *See*, e.g., FSB/IOSCO Consultative Document, *supra* note 13, at 29 ("[F]rom a purely systemic perspective, funds contain a specific 'shock absorber' feature that differentiates them from banks."); *see also* Nellie Liang, Dir., Program Direction Sec. of the Off. of Fin. Stability Pol'y & Res., Bd. Of Governors of the Fed. Res. Sys., Remarks at the Brookings Institution Asset Management, Financial Stability and Economic Growth Conference (Jan. 9, 2015), *available at* http://www.brookings.edu/events/2015/01/09-asset-management-financial-stability-economic-growth ("Mutual funds in their current form have been around for a long time . . . without noticeably contributing to systemic risk."); Sir Jon Cunliffe, Deputy Governor Fin. Stability, Bank of Eng., Speech at the City of London Corporation and Open Europe Conference: Financial Stability, the Single Market and Capital Markets Union, 7 (Jan. 20, 2015), *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2015/speech789.pdf ("It is very probable that one of the reasons the US has recovered faster from its financial crisis than Europe is that in the US banks do not dominate the provision of finance to anything like the same degree as in the EU.").
[29] *See, e.g.*, Bernanke, *supra* note 8 ("[T]he Fed cannot reliably identify bubbles in asset prices. . . . [T]o declare that a bubble exists, the Fed must not only be able to accurately estimate the unobservable fundamentals underlying equity valuations, it must have confidence that it can do so better than the financial professionals whose collective information is reflected in asset-market prices. I do not think this expectation is realistic, even for the Federal Reserve.").
[30] *See, e.g.*, George, *supra* note 9, at 6 ("I often hear the view that macroprudential policy should be the 'first line of defense' for maintaining financial stability. Unfortunately, this approach expects too much of tools for which our understanding is imperfect."); Andrew G. Haldane, Exec. Dir. of Fin. Stability, Bank of Eng., Speech: The Age of Asset Management? (Apr. 4, 2014), *available at* http://www.bankofengland.co.uk/publications/Pages/news/2014/068.aspx ("This is the next frontier for macro-prudential policy – whether, and if so how best, to moderate excessive swings in risk premia across financial markets. . . . This will require new analytical techniques to measure risk premia and their impact. And it will require fresh thinking on new policy tools to moderate movements in these risk premia.").

Federal Reserve Governor Jerome Powell recently advocated restraint and set a high standard for regulatory intervention in capital markets: "[T]he 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."[32]

Governor Powell's statement is a reminder that one of the main functions of such markets is to allocate risk. SEC Chair Mary Jo White similarly observed in a recent speech that investment risk is not only inherent in markets but necessary for economic growth and that regulatory actions will affect those markets in ways that must be considered carefully.[33] Ben Bernanke expressed strong concerns about the unintended consequences of regulatory intervention following the bursting of the internet bubble, when many pressed the FRB to try to control market prices: "I worry about the effects on the long-run stability and efficiency of our financial system if the Fed attempts to substitute its judgments for those of the market. Such a regime would only increase the unhealthy tendency of investors to pay more attention to rumors about policymakers' attitudes than to the economic fundamentals that by rights should determine the allocation of capital." He went on to remind his audience that "[b]ecause risk-taking is essential for economic dynamism, we do not want an economy in which investors and businesspeople are not free to take bets that might turn out badly."[34]

His observations remain valid today. The FSOC's objective should not be to eliminate risk from the capital markets. Rather, the FSOC should (i) evaluate in a balanced manner the economic and financial stability benefits that various capital markets products and activities provide, together with any risks that they might create, and (ii) determine whether any new regulatory action would be warranted, effective, and sufficiently targeted to minimize collateral damage. Any recommendations of additional regulation of some or all of the asset management industry due to perceived threats to financial stability should be made only if based on valid data and robust economic analysis.

The FSOC should consolidate and analyze data collected by various financial regulators.

We believe that the FSOC could dramatically improve its collective understanding of the asset management business and the capital markets by prioritizing efforts to catalogue the significant data already collected by various financial regulators. The Office of Financial Research (the "OFR") has cited the need to fill data gaps across the financial system and has made it a high priority.[35] At the FSOC's May 19, 2014 conference on asset management, several

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[31] *See, e.g.*, Powell, *supra* note 18 ("An important threshold question is whether supervisors will be able to correctly and in a timely manner identify "dangerous" conditions in credit markets, without too many false positives and without unnecessarily limiting credit availability by interfering with market forces.").

[32] *Id.*

[33] Mary Jo White, Chair, Sec. & Exch. Comm'n, Speech at the New York Times DealBook Opportunities for Tomorrow Conference: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

[34] *See* Bernanke, *supra* note 8.

[35] Indeed, the OFR 2014 Annual Report devotes a chapter to the discussion of data gaps and importance of filling them. OFFICE OF FIN. RESEARCH, 2014 ANNUAL REPORT, 105-23 (Dec. 2, 2014), *available at* http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf ("[S]ignificant

academics discussed data gaps that they would like to see filled in order to analyze aspects of asset management and other capital markets activities.[36] Before requesting additional information, however, we encourage the FSOC and its individual members to inventory the information already available to them.[37] If additional information is required, we recommend that regulators work with the parties that would provide it to design a process that produces high quality data efficiently and avoids some of the problems that have afflicted some recent data collection efforts.[38]

To determine where risk is concentrating and how it is shifting, regulators also need to develop the analytics necessary to make the data intelligible and actionable. Form PF, swap data repositories and other initiatives are good starts, but they need to be augmented by efforts to (i) map exposures across the financial system, such as the Legal Entity Identifier project[39] and similar initiatives, and (ii) develop analytics to evaluate aggregate indicators of potential market risks in volumes, spreads, prices and executions on a real time basis. Substantial empirical work is required to develop the tools necessary to identify and quantify the probability and magnitude of threats to U.S. financial stability and allow policymakers to analyze potential responses objectively.[40] That work should be prioritized and conducted transparently via collaboration among market participants, regulators and academics.

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data gaps remain, and the OFR . . . [is] making it a high priority to fill data gaps in secured funding markets and asset management."). Additionally, the OFR has launched several initiatives to fill data gaps, including one with the Federal Reserve which focuses on repurchase agreements. *See, e.g.*, Richard Berner, *OFR Teams with Fed to Fill Key Gap in Financial Data*, FINANCIALRESEARCH.GOV (Oct. 8, 2014), *available at* http://financialresearch.gov/from-the-director/2014/10/08/ofr-teams-with-fed-to-fill-key-gap-in-financial-data/.

[36] *See generally* Remarks at the Financial Stability Oversight Council Conference on Asset Management in Washington D.C. (May 19, 2014).

[37] We note the OFR's acknowledgement of the importance of avoiding duplication and collecting data efficiently through a collaborative process. *See, e.g.*, OFFICE OF FINANCIAL RESEARCH, 2012 ANNUAL REPORT, at v (July 20, 2012), *available at* http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2012.pdf ("The OFR will not collect data for collection's sake. Indeed, the Dodd-Frank Act requires that the OFR not duplicate others' data collection efforts.").

[38] *See, e.g.*, Scott O'Malia, Comm'r, Commodity Futures Trading Comm'n, Keynote Address at The Future of Financial Standards Conference: Disruptive Date: Transforming Regulatory Oversight Through Technological Innovation (Mar. 25, 2014), *available at* http://www.cftc.gov/PressRoom/SpeechesTestimony/opaomalia-34 ("Over a year has passed since swap data reporting began in the United States. Yet, the CFTC still cannot crunch the data in [swap data repositories] to identify and measure risk exposures in the market. Lack of automation, inconsistent reporting, technical challenges, and poor validation and normalization have crippled our utilization of swaps data."); Silla Brush, *CFTC Begins Swaps-Data Overhaul in Effort to Boost Comprehension*, BLOOMBERG, Mar. 20, 2014, *available at* http://www.bloomberg.com/news/articles/2014-03-19/cftc-begins-swaps-data-overhaul-in-effort-to-boost-comprehension (quoting CFTC Acting Chairman Mark Wetjen as saying "[t]he data we've received frankly hasn't been clean enough for us to make sense of it as easily and as quickly as we need to be able to do" and that "[w]e're prepared to make corrections if we need to."); OFFICE OF FIN. RESEARCH, 2014 ANNUAL REPORT, *supra* note 35, at 114 ("Every new data collection initiative has growing pains, and Form PF is no exception. Filling data gaps begins with data collection, but ensuring complete and accurate data takes time and requires an ongoing assessment of data quality. Because Form PF collection is still new, caution is important in interpreting the information collected.").

[39] *See* GLOBAL FIN. MARKETS ASS'N, REQUIREMENTS FOR A GLOBAL LEGAL ENTITY IDENTIFIER (LEI) SOLUTIONS (May 2011), *available at* http://www.sifma.org/lei-industry-requirements/. For updates on the LEI initiative, see http://www.gfma.org/initiatives/Legal-Entity-Identifier-(LEI)/Legal-Entity-Identifier-(LEI)/.

[40] Hansen, *supra* note 10, at 3.

Next Steps: the SEC should lead this effort.

We recommend that the SEC take the lead in any further exploration of the topics raised in the Notice. The SEC is the Council member with the most expertise regarding the asset management industry, capital markets, and their regulation. Although the SEC's regulatory regimes for investment funds, asset managers and capital markets are robust, it is reasonable to consider whether they can be improved in any way. The SEC is the FSOC member best able to make that determination through rigorous, balanced, economic analysis. The SEC is also presently focused on many of the same issues raised in the Notice, including management of liquidity and redemptions in mutual funds, the use of derivatives by mutual funds, and ensuring that client assets can be transferred smoothly.[41]

It is a challenging undertaking to conduct the analysis required to determine whether financial stability is threatened and whether new regulatory action is advisable.[42] It requires an intimate knowledge of the asset management industry and capital markets, a comprehensive understanding of the substantial regulations that already govern their components, and consideration of the extensive empirical data on how market participants have responded to market, operational and systemic challenges in the past. The SEC is most capable of evaluating all of these factors.

The FSOC has taken the first step, toward a deeper understanding of the asset management business and capital markets more broadly, by inquiring whether asset management products and activities merit further regulatory attention and asking the public for information on topics of particular interest. The FSOC's efforts have the potential to create a more constructive process than the one the FSB and IOSCO have followed to produce a second fundamentally flawed proposal[43] for designating large investment funds and their managers as G-SIFIs. As Fidelity and other commenters demonstrated in our responses to the first FSB/IOSCO proposal, investment funds and their managers do not present the risk necessary to be G-SIFIs. Further, even if a fund or its manager could present that kind of risk to the global financial system, designating an individual fund or manager as a G-SIFI could not effectively mitigate it.[44]

In addition to its misguided substantive approach to asset management regulation, the timing of the G-SIFI proposal is concerning. We are disappointed by the decisions of the U.S.

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[41] *See, e.g.*, White, *supra* note 33 ("At the most basic level, the staff is considering whether broad risk management programs should be required for mutual funds and ETFs to address the risks related to their liquidity and derivatives use, as well as measures to ensure the Commission's comprehensive oversight of those programs. The staff is also reviewing options for specific requirements, such as updated liquidity standards, disclosures of liquidity risks, or measures to appropriately limit the leverage created by a fund's use of derivatives. Such changes could better protect investors, provide better transparency about the liquidity risks associated with various funds, and mitigate any broader market implications were funds forced to sell assets precipitously to meet redemptions.").

[42] *See, e.g.*, Hansen, *supra* note 10.

[43] Fin. Stability Bd. & Int'l Org. of Sec. Comm'ns, *Consultative Document (2nd): Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (Mar. 4, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf

[44] *See* Letter from Scott C. Goebel, Senior Vice President and Gen. Couns., Fidelity Mgmt. & Res. Co. to the Secretariat of the Fin. Stability Bd. (Apr. 7, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140423s.pdf.

members of the FSB and IOSCO, who are also members of the FSOC, to release a new proposal for designating large investment funds and fund managers as G-SIFIs three weeks before the comment deadline on the Notice. The proposal by the FSB and IOSCO is counterproductive and potentially inconsistent with the current FSOC effort, which has no predetermined outcomes and appropriately focuses on products and activities. We urge the U.S. members of those organizations to reject their G-SIFI proposal.

To take the next steps in evaluating asset management and capital market risks, the FSOC must define key concepts precisely and establish empirical metrics for measuring them. Only then can it determine: (i) whether or not there is a threat to U.S. financial stability arising from an asset management product or activity, (ii) the probability and magnitude of any such threat, (iii) the availability and suitability of regulatory tools to address it, and (iv) the likely consequences of regulatory action to determine whether such action is advisable.

We encourage the FSOC to rely on the SEC to lead this effort. In doing so, the FSOC would utilize the unmatched expertise that the SEC has in analyzing and regulating investment funds, their managers, and the capital markets. The FSOC would also ensure that its work is aligned properly with the SEC's initiatives on many of the same topics covered by the Notice, and benefit from the economic analysis and public notice and comment process that the SEC conducts whenever it considers new regulations.

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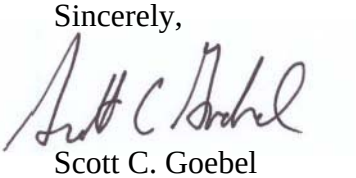
We appreciate the opportunity to comment on the Notice. Fidelity would be pleased to provide any further information or respond to any questions that the Council may have.

Sincerely,



Scott C. Goebel

cc:
Chairman Jacob J. Lew, Secretary of the Treasury
Thomas J. Curry, Comptroller of the Currency
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
Timothy G. Massad, Chairman of the Commodity Futures Trading Commission
Debbie Matz, Chairman of the National Credit Union Administration
Melvin L. Watt, Director of the Federal Housing Finance Agency
Mary Jo White, Chair of the U.S. Securities and Exchange Commission
S. Roy Woodall, Jr., Independent Insurance Expert
Janet L. Yellen, Chair of the Board of Governors of the Federal Reserve System
Richard Berner, Director of the Office of Financial Research
John P. Ducrest, Commissioner of the Louisiana Office of Financial Institutions and Chairman of the Conference of State Bank Supervisors
Adam Hamm, Insurance Commissioner, North Dakota Insurance Department
Michael T. McRaith, Director, Federal Insurance Office, Department of the Treasury
Mark Carney, Chair, Financial Stability Board
Greg Medcraft, Chairman, International Organization of Securities Commissions
David Wright, Secretary General, International Organization of Securities Commissions
Jonathan Hill, Commissioner for Financial Stability, Financial Services and Capital Markets Union, European Commission
Secretariat of Financial Stability Board (c/o Svein Andresen, Secretary General, Financial Stability Board)
Secretariat of International Organization of Securities Commissions (c/o David Wright, Secretary General, International Organization of Securities Commissions)