Via e-mail: fsb@bis.org

September 21, 2016

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

Re: FINANCIAL STABILITY BOARD, "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (June 22, 2016)

The Financial Services Roundtable ("FSR")[1] extends its appreciation to the Financial Stability Board (the "FSB") for providing an opportunity for us to comment on the consultative document, "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (the "Proposed Policy Recommendations"). FSR recognizes the challenge of the tasks of evaluating potential financial stability risks from structural vulnerabilities associated with asset management activities ("Financial Stability Risks") and developing policy recommendations related to the same.

The Proposed Policy Recommendations relate to four Financial Stability Risks (as identified by the FSB): (i) a liquidity mismatch between fund investments and redemption terms and conditions for open-ended funds (excluding money market funds); (ii) the use of leverage; (iii) operational risks and challenges in transferring investment mandates under stressed conditions (in the context of asset managers[2] that are large, complex and/or provide critical services); and (iv) securities lending activities of asset managers and funds (with a focus on asset managers' agent lender activities).

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[1] The Financial Services Roundtable represents the largest integrated financial services companies providing banking, insurance, payment and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs. Learn more at FSRoundtable.org.

[2] Certain asset managers have affiliates that may be engaged in other financial services activities (such as banks, broker-dealers and insurance companies). However, references to "asset managers" in this letter relate specifically to entities conducting asset management activities and only to the extent of those activities. Further, in providing our comments in this letter, in the context of non-asset management services, we have not distinguished between affiliated and unaffiliated service providers (as such a distinction would not have a substantive impact on our comments).

In reviewing the Proposed Policy Recommendations, we commend the FSB on the significant thought and effort that it has afforded the issues, and we believe that effective policy recommendations can be developed through close cooperation between the FSB and national regulators. To that end, we are pleased to present our thoughts and comments on the Proposed Policy Recommendations, and we would welcome future opportunities to assist the FSB in its effort to develop policy recommendations that effectively address potential financial stability risks from structural vulnerabilities associated with asset management activities.

I. Executive Summary

- At this time, an empirical foundation to support the existence of the Financial Stability Risks has not been developed. In order to establish such an empirical foundation, (i) policy recommendations should focus on continuing to gather information about potential financial stability risks arising from asset management activities, as opposed to proposing requirements and regulations and (ii) the FSB should provide leadership to, and work with, national regulators to develop the same.[3]

- Any requirements and regulations should be recommended only if they are based on a clear correlation between an asset management activity and disruption to the global financial system.

- Consistent with the FSB's risk-based approach, the FSB should continue to take into account both existing and proposed regulations by national regulators when formulating policy recommendations, recognizing that national regulators have already acted (and are currently acting) to address potential structural vulnerabilities.

II. Liquidity Mismatch

The FSB believes that a key structural vulnerability from asset management activities is the potential mismatch in open-ended funds between the liquidity of fund investments and the daily redemption of fund units. More specifically, the FSB believes that, during periods in which highly accommodative monetary policies affect asset valuations, investors may reach for yield and under-price credit and liquidity risks (and that this could interact with a decline in secondary market liquidity, so that a shift in market expectations could produce the repricing of assets, liquidity strains in certain markets and the potential for contagion across asset classes). In response to this Financial Stability Risk, the FSB proposes, among other things, that authorities should: (i) collect information on the liquidity profile of open-ended funds in their jurisdictions (proportionate to the risks that they may pose from a financial stability perspective); (ii) make certain liquidity risk-management tools (such as notice periods and swing pricing) available (or more widely available) to open-ended funds; and (iii) provide guidance and direction regarding open-ended funds' use of extraordinary liquidity risk management tools.

[3] *See* the Office of Financial Research's August 23, 2016 Working Paper, "A Pilot Survey of Agent Securities Lending Activity," *available at* https://financialresearch.gov/working-papers/files/OFRwp-2016-08_Pilot-Survey-of-Securities-Lending.pdf, which emphasizes the importance of continuing to collect data covering securities lending activities.

FSR acknowledges that there is a potential mismatch in the context of open-ended funds with daily redemption provisions that hold illiquid assets. However, FSR believes that there is no clear market evidence or academic research supporting a hypothesis that individual investment funds may, through a contagion effect in the capital markets, impact global financial stability.[4] Moreover, as the FSB acknowledges, national regulators have imposed various requirements and restrictions on asset managers of open-ended funds to ensure that their funds can satisfy redemption requests in accordance with their defined policy.[5] For example, under the U.S. Investment Company Act of 1940, as amended (the "1940 Act"), redemption proceeds must be paid within seven days,[6] and, under current U.S. Securities and Exchange Commission (the "SEC") guidance, mutual funds may not invest more than 15% of their net assets in illiquid securities.[7] Further, the SEC has proposed a rule that would require a mutual fund to adopt and implement a written liquidity management program based on specified parameters.[8] In the absence of specific regulatory requirements and restrictions applicable to open-ended funds (for example, in the context of hedge funds), as the FSB acknowledges, asset managers are subject to fiduciary duties which require them to act in the best interests of their clients.[9]

There are also existing regulatory requirements for asset managers to make disclosures to potential investors in the context of the offering of securities. For example, mutual funds are required to disclose to potential investors the principal risks associated with investing in a particular security,[10] and U.S. securities laws require the disclosure to potential investors of all material facts related to an investment in a security.[11] Investment advisers registered with the SEC are required to make disclosures regarding material risks associated with those methods of analysis and investment strategies that are used in formulating investment advice for clients, and those types of securities that are recommended to clients.[12] In addition, investors actively assume the risks of investing in securities (as fluctuation in value is part of the nature of

[4] In its July 18, 2016 comment letter to the Financial Stability Oversight Counsel ("FSOC") (regarding FSOC's review of asset management products and activities), *available at* https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf, the Investment Company Institute noted that, over the years since the mid-1940s, "there is no empirical evidence of destabilizing redemptions by stock and bond funds" notwithstanding several periods of severe market stress.

[5] *See* Proposed Policy Recommendations at 11.

[6] *See* Section 22(e) of the 1940 Act.

[7] *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (March 12, 1992).

[8] Proposed rule 22e-4 under the Investment Company Act; *see* Investment Company Act Release No. 31835.

[9] *See* Proposed Policy Recommendations at 11.

[10] *See* Form N-1A, Item 9(c).

[11] *See* Section 10(b) and Rule 10b-5 of the U.S. Securities Exchange Act of 1934, as amended.

[12] *See* Form ADV Part 2A (Form ADV Part 2As for investment advisers registered with the SEC are publicly available on the SEC's website at http://www.adviserinfo.sec.gov/IAPD/Default.aspx).

securities) and losses of principal in a down market are borne by investors (unlike in the bank context, where bank depositors expect a return of principal).

In recognition of the foregoing considerations, FSR believes that the FSB's policy recommendations should focus on information gathering (which should allow the FSB to further refine its policy recommendations to eliminate those that are duplicative or impractical in the context of current regulations and/or market conditions). One of the Proposed Policy Proposals that FSR believes is impractical for some jurisdictions given current operational practices is the proposal that authorities make available to open-ended funds certain risk management tools, such as swing pricing. FSR believes that the implementation of swing pricing for funds in the United States is not feasible at this time, given the current market structure and funds' reliance in intermediaries and omnibus accounts held by such intermediaries. However, in order to allocate transaction costs, FSR supports making swing pricing available (but not required) when it is feasible, and encourages policymakers to address the impediments to make it feasible.

III. Leverage

The FSB believes that the use of leverage can create and/or amplify risks to the global financial system through direct and indirect channels, for example, through counterparties, financial intermediaries and investors. In response, the FSB proposes that: (i) IOSCO develop simple and consistent measure(s) of leverage in funds by 2018; (ii) IOSCO develop more risk-based measures to enhance the monitoring of leverage across funds and at a global level; and (iii) national regulators collect data on, monitor the use of, and, when appropriate, take action with regard to, leverage by funds not subject to leverage limits or which pose significant leverage-related risks to the financial system.

FSR agrees that leverage is an important factor for assessing risks to global financial stability. However, as a general matter, the amount of leverage incurred by investment funds is significantly less than the leverage incurred by financial institutions with different business models (such as banks).[13] Further, as the FSB has acknowledged, the use of leverage is subject to regulatory restrictions in many jurisdictions.[14] For example, Section 18(f) of the 1940 Act provides that it is unlawful for any registered open-ended fund to issue "senior securities," including any instrument evidencing indebtedness. Section 18(f) also requires a minimum level of "asset coverage" when a mutual fund borrows money from a bank.

In addition, FSR believes that a "simple" definition of leverage should seek to measure "economic leverage" (that is, debt or liabilities, expressed as a percentage of equity). If the definition of leverage employed is too simple and one-dimensional (such as gross notional

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[13] *See* Paul Schott Stevens, President and CEO of the Investment Company Institute, *Financial Stability and U.S. Mutual Funds* (speech given at the Mutual Fund and Investment Management Conference) (March 17, 2014), *available at* http://www.ici.org/pressroom/speeches/14_pss_mfimc (citing data showing that the average leverage for U.S. commercial banks is 9:1 and the average leverage for the 14 largest U.S. funds is 1.04:1).

[14] *See* Proposed Policy Recommendations at 23.

exposure which overstates the amount of leverage), FSR believes that the data produced by such definition could be misleading.

Finally, uniform standards for measuring leverage should be tailored to distinguish derivatives exposures that are clearly utilized to manage or mitigate risks from other derivatives exposures for purposes of assessing perceived financial stability risks to the global financial system. Funds' use of derivatives provides significant benefits to fund investors.[15] Although a fund may be able to achieve a certain level of risk mitigation through traditional securities (such as bonds), hedging risk through the use of derivatives is often faster, more cost-effective and tax-efficient, and may disrupt a portfolio's long-term investment strategies to a lesser extent than other risk mitigating strategies.[16]

IV. Risks and Challenges in Transferring Mandates and Accounts

The FSB believes that operational difficulties could potentially become a financial stability concern if they were to materialize during stressed market conditions, particularly if they affect asset managers of sufficient size or complexity. The FSB hypothesizes that, if asset managers were to encounter significant enough difficulties, investors or clients may lose confidence in the affected asset managers, potentially leading to redemptions or transfers of accounts (which could potentially affect the market prices of investment assets during a period of market stress). In response to these concerns, the FSB proposes that authorities impose requirements or provide guidance related to risk management frameworks and practices for asset managers that are large, complex and/or provide critical services.

FSR believes that, for the following reasons, the FSB's discussion of potential structural vulnerabilities arising from the distress of an asset manager overemphasizes the potential for disruption to the global financial system. While asset managers are fiduciaries, they are not generally the economic obligators of the financial instruments held by their clients. Asset managers do not have exposures to counterparties, except in cases when managing their own balance sheets, which the FSB has acknowledged are generally small,[17] and asset managers are unlikely to ever have a single exposure of significant size to any counterparty (or counterparties). Unlike banks (i) asset managers do not suddenly fail, and therefore do not create the potential systemic exposures that banks create as lenders and counterparties and (ii) an asset manager's balance sheet is not intertwined with those customers who are expecting a return of principal. Substituting asset managers can be achieved quickly because client separate accounts and fund

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[15] *See*, *e.g.*, Use of Derivatives by Registered Investment Companies and Business Development Companies, 80 Fed. Reg. 80,884 (Dec. 28, 2015) ("Proposing Release") at 80,885 ("Funds employ derivatives for a variety of purposes, including to: Seek higher returns through increased investment exposures; hedge interest rate, credit, and other risks in their investment portfolios; gain access to certain markets; and achieve greater transaction efficiency") (citing *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, 76 Fed. Reg. 55,237 (Sept. 7, 2011)("Concept Release")).

[16] Proposing Release at 80,886-87; Concept Release at 55,240-41; Board Oversight of Derivatives, Independent Directors Council Task Force Report (July 2008) at 11; Comment Letter of BlackRock on Concept Release (Nov. 4, 2011) (File No. S7-33-11) at 2.

[17] *See* Proposed Policy Recommendations at 8.

assets are held with custodians who are contractually obligated to do so for the benefit of the asset owner (such as individual account holders or investment funds), not the asset manager. Custodians hold the assets regardless of which asset manager the asset owner selects to manage their assets. As such, clients can re-direct the management of an existing portfolio of securities to another manager. Importantly, assets are not required to physically move when there is a change of asset managers; assets remain with the custodian in client denominated accounts.

Further, the services provided by an asset manager (including asset management services, securities lending agent services and asset management technology) operate within a highly competitive landscape with multiple participants. We understand clients already manage a majority of global financial assets without the assistance of an asset manager. Given the high degree of substitutability, including the ability of clients to choose to manage their own assets without hiring an asset manager,[18] we believe that no individual asset manager provides a "critical" function or service to the financial markets.

In addition, investors regularly move assets between managers, and the liquidation of funds occurs regularly, without government intervention or a significant impact on the global financial system. Finally, as the FSB has identified, there are numerous requirements and restrictions put into place (or proposed) by national regulators that seek to address the potential risk identified by the FSB.[19] For example, the SEC recently proposed a rule that would require SEC-registered investment advisers to adopt and implement written business continuity and transition plans.[20]

V. Securities Lending Activities

The FSB believes that securities lending activities by asset managers and funds can generate various financial stability risks, especially in the context of agent lender indemnifications. Specifically, the FSB hypothesizes that a defaulted indemnification commitment could lead to widespread concern about the ability of other agent lenders to meet their indemnification obligations. In response to these concerns, the FSB proposes that authorities monitor indemnifications provided by agent lenders to clients in relation to their securities lending activities.

Based on currently available information, FSR does not agree that an asset manager's securities lending activities (including agent lender indemnification) may cause global financial stability risks. First, it should be borne in mind that the typical securities lending agent

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[18] As the FSB states in the Proposed Policy Recommendations (at 7), "most financial market participants prefer to manage their investments on their own without the help of third-party asset managers." In a 2013 paper, McKinsey estimated that, in 2012, more than three quarters of financial assets were managed directly by the client. *See* McKinsey & Company, "Strong Performance but Health Still Fragile: Global Asset Management in 2013. Will the Goose Keep Laying Golden Eggs?" (July 2013), *available at* http://www.asset-management-summit-2015.com/pdf/2013_Asset_management_brochure_20130723.pdf.

[19] *See* Proposed Policy Recommendations at 29-30.

[20] *See* Investment Advisers Act Release No. 4439 (June 28, 2016), *available at* https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

indemnification provision only requires indemnification by the asset manager when the borrower fails to return the securities that have been lent and there is a shortfall between the value of the collateral (which is marked-to-market daily) and the value of the security. Therefore, the amount to be indemnified by the asset manager will typically be at risk to grow to a sizable amount only if the asset manager does not follow through with marking the collateral to the market each day. Second, in any event, to the extent that the asset manager is obligated to provide indemnification, the amounts so indemnified are typically an obligation to be reimbursed to the asset manager by the borrower. Therefore, (i) indemnification amounts are generally very small, (ii) ultimately, the lender (and not the market) bears the risk of loss of an agent lender's default under indemnification and (iii) any risks to global financial stability are very remote.

Based on these reservations about the effects of asset managers' securities lending activities on global financial stability risk, we applaud the FSB's focus (in its Proposed Policy Recommendations) on information gathering by national regulators. We believe that additional information regarding the impact of asset managers in the context of any securities lending activities will be important in developing future policy recommendations.

VI. Conclusion

While the FSB has clearly expended significant thought and effort on identifying potential financial stability risks arising from asset management activities, as discussed above in respect of each Financial Stability Risk, at this time, an empirical foundation to support the existence of the Financial Stability Risks has not been developed. FSR believes that, through gathering more information about potential financial stability risks and existing and proposed regulations by national regulators, and cooperating with national regulators, the FSB will be in a better position to develop an empirical foundation that could provide support for further policy recommendations.

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FSR appreciates the opportunity to submit comments on the FSB's Proposed Policy Recommendations. If it would be helpful to discuss our specific or general views on the Proposed Policy Recommendations, please contact Richard Foster at Richard.Foster@FSRoundtable.org; or Felicia Smith at Felicia.Smith@FSRoundtable.org.

Sincerely yours,

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Financial Services Roundtable