sifma
Invested in America

asset management group

May 28, 2015

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

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

Dear Sirs/Madams:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to comment on the March 4, 2015 consultative document, entitled *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (the "**Second Consultative Document**"),[2] published by the Financial Stability Board (the "**FSB**") and the International Organization of Securities Commissions ("**IOSCO**"). The members of the SIFMA AMG are primarily U.S.-based asset management firms, and our letter will focus on the investment fund and asset management assessment methodologies set forth in the document.

We are encouraged by recent indications that FSB/IOSCO may be shifting their focus to a products and activities approach to evaluating potential issues in capital market and asset management activities.[3] We believe that FSB/IOSCO should redirect attention to such a

[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed 30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

[2] FSB/IOSCO, *Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Mar. 4, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf [hereinafter Second Consultative Document].

[3] *See* Letter from Mark Carney to G20 Finance Ministers and Central Bank Governors, *Financial Reforms – Progress on the Work Plan for the Antalya Summit* (Apr. 9, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chairs-letter-to-G20-April-2015.pdf. As indicated by Mr. Carney, "the FSB is prioritising work to understand and address vulnerabilities in capital market and asset management activities. This will comprise two linked projects. The first will examine the likely near-term risk channels and the options that currently exist for addressing these. The second will

products and activities examination and away from the current initiative that has focused on establishing methodologies for identifying individual funds or managers as systemically important. Such a revised approach would better reflect the nature of the asset management business, recognize the differences between asset management and other financial services firms, and better align FSB/IOSCO and enable them to support and learn from efforts currently underway by U.S. and other regulators, including the U.S. Securities and Exchange Commission ("**SEC**"), which is the primary regulator for investment funds and asset managers that would initially be captured under the methodology set forth in the Second Consultative Document.[4] In doing so, FSB/IOSCO can play a useful role in looking at different regulatory approaches across jurisdictions, facilitating coordination of policies and sharing information.

SIFMA AMG responded to the prior version of the consultative document issued by FSB/IOSCO on January 8, 2014 ("**First Consultative Document**")[5] in a 34-page letter[6] that included extensive comments on the issues raised by the First Consultative Document. Although the Second Consultative Document makes some mention of responses we and other commenters provided, there is no acknowledgement of many of our key observations nor of those offered by other stakeholders on fundamental misunderstandings in the First Consultative Document. We and our members typically engage in rigorous and thoughtful dialogue in the regulatory exercises initiated by our regulators, including the SEC, which has just commenced a significant set of rulemaking initiatives involving areas touched upon in the FSB/IOSCO workstreams. As a result, the silence that greeted many of the concerns and arguments we and

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consider the longer-term development of these markets and whether additional policy tools should be applied to asset managers according to the activities they undertake with the aim of mitigating systemic risks." *Id.* at 3.

[4] *See, e.g.*, Letter from the AMG to Jacob J. Lew, Mary Jo White, Janet L. Yellen and Timothy G. Massad (Apr. 1, 2015), *available at* http://www.sifma.org/comment-letters/2015/sifma-amg-submits-comments-to-multiple-agencies-regarding-the-fsb-iosco-consultation-documents/. A copy of this letter is attached in the Appendix. As summarized in that letter, "[o]ur comments and those of others have demonstrated that the designation of asset managers and investment funds as SIFIs would be unjustified, because they do not present the type or scale of risk required for SIFI designation, and would be an ineffective structure for their regulation. The Financial Stability Oversight Council (the "Council") appears to have recognized those facts and shifted its attention to a more constructive review of products and activities in the sector, and away from individual firms or funds identified on the basis of their size. Because this is the only sensible approach to analyzing and regulating the asset management sector and the capital markets more broadly and because the Second Consultative Document is irredeemably flawed, we urge you, in your capacities as the U.S. members of the FSB and/or IOSCO, to reject the proposals in the Second Consultative Document and oppose any further attempts by the FSB and IOSCO to create a methodology for designating asset managers and investment funds as SIFIs." *Id.* at 2.

[5] FSB/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), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf [hereinafter First Consultative Document].

[6] Letter from the AMG to the Secretariat of the Financial Stability Board (Apr. 4, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140423an.pdf. A copy of this letter is attached. *See* Appendix.

others raised in our letters has left us to wonder why these comments appear to have been disregarded.

In addition, the Second Consultative Document reverses several key positions initially taken by FSB/IOSCO, particularly with respect to the First Consultative Document's original determination *not* to propose a methodology for asset managers, a decision supported in our response and by a wide range of other commenters. FSB/IOSCO offered no rigorous justification for disregarding comments supporting their original position; they simply said that they elected a "more inclusive" approach.[7] This lack of a reasoned explanation for this reversal left us challenged as to how best to meaningfully engage in the consultative process. Regrettably, these and other infirmities that characterize the Second Consultative Document might have been avoided if FSB/IOSCO had paid closer attention to comments we and others offered on the First Consultative Document and redirected efforts to focus on an analysis of products and activities in the asset management industry instead of a firm- or fund-specific methodology. We are also disappointed that the data and analysis about the asset management industry that commenters provided in response to the recent Financial Stability Oversight Council ("**FSOC**") request for information were similarly disregarded by FSB/IOSCO. This is a point we strongly emphasized earlier this year when we urged that the consultation be halted to await feedback on the FSOC process.[8]

Before addressing various concerns raised by the Second Consultative Document, we begin by briefly underscoring key positions that we continue to maintain are laid out at length in our response to the First Consultative Document. They now apply to asset managers as well as investment funds.

1. **No specific mandate requires G-SIFI designation of investment funds or asset managers.**

The G20 did not instruct the FSB to develop methodologies to label every type of entity that participates in the global financial system as systemically important. Nor did the G20 direct the FSB/IOSCO to develop a methodology that would apply the globally systemically important financial institution ("**G-SIFI**") label specifically to investment funds, asset managers or any other type of company in circumstances where the label clearly does not fit. FSB/IOSCO clearly demonstrated that there is no such mandate by not even proposing a designation methodology for asset managers in the First Consultative Document.

It is sensible that there is no mandate from the G20 to designate investment funds or asset managers as G-SIFIs because no individual fund or manager possesses the necessary mix of characteristics to threaten global financial stability in the manner or to the degree that a G-SIFI must. We are pleased to read of recent acknowledgements by senior officials at IOSCO that

[7] Second Consultative Document at 30.

[8] *See* AMG, *supra* note 4, at 6-7.

funds and advisers may not present the same risk profile as other entities in the financial system.[9] Whatever the outcome of deliberations by national regulators or international coordinating bodies, it is essential to lay an adequate factual and theoretical predicate for any potential action relating to funds or advisers. To date, no disciplined effort has been made to do so, and the current process of establishing methodologies simply leapfrogs this necessary prerequisite that would be mandated if this exercise were being conducted under U.S. law — and, as proposed, these methodologies would presently capture only U.S. funds and advisers. If affected entities were domiciled elsewhere, similar due process requirements would be imposed under local laws in those other constituent jurisdictions.

2. Investment funds and asset managers lack key characteristics possessed by other G-SIFIs.

As noted in our previous letter, investment funds have fundamentally different risk profiles than banks and insurers, lacking many of the characteristics that were cited to support the designations of bank and insurance company G-SIFIs.[10] So do asset managers. Furthermore, as assets can easily and fluidly shift from one fund or manager to another, the G-SIFI designation would also be ineffective and simply prompt unwarranted disruption as participants seek to avoid designation.[11] The Second Consultative Document makes no mention of these very real distinctions nor of the potential collateral issues that we pointed out.[12] Absent an explanation, we do not know whether FSB/IOSCO have chosen to ignore facts and academic literature that support the views we and others expressed, or fail to appreciate their importance and implications for regulatory policy. We underscore that designation of individual funds and asset management firms would be ineffective and potentially destructive.[13]

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[9] As IOSCO Chair Greg Medcraft acknowledged recently, "[t]here has been a lot of discussion about the systemic risk of fund managers. My personal view is that while fund management has grown significantly, I think the jury is still out in terms of whether it is a systemic risk or not. I think an area we've certainly got to work on is identifying where fund managers could cause systemic risk, but I don't think at this stage the case has been proven." Michelle Price and Lisa Jucca, *Top securities regulator says no proof big funds pose systemic risks*, REUTERS (May 12, 2015), *available at* http://www.reuters.com/article/2015/05/12/us-regulation-summit-funds-risks-idUSKBN0NX1Q920150512.

[10] *See* AMG, *supra* note 6, at 5-7.

[11] *Id.* at 6.

[12] *Id.*

[13] *See* Michael S. Piwowar, *Remarks Before the Exchequer Club of Washington, D.C.* (May 20, 2015), *available at* http://www.sec.gov/news/speech/remarks-before-exchequer-club-washington-dc.html ("Trying to mitigate risks on a macro level likely would result in a narrowing of the differences in the way assets are managed, which could result in all financial firms having similar investments. If all firms are invested in the same types of assets, then during a period of market stress the entire financial system is more likely to collapse. Surely this would be a terrible result.."). *See also* James Freeman, *Government Warns of Systemic Risks It Created*, WALL STREET JOURNAL (May 21, 2015), *available at* http://www.wsj.com/articles/government-warns-of-systemic-risks-it-created-1432214171 (asserting that post-crisis regulatory reforms have already had significant negative unintended consequences).

3. Effective regulation of investment funds is activities-based and not selective

A broad approach that focuses on risks associated with an activity or product on an industry- or market-wide basis would be more effective and efficient than selective designation of individual entities. This approach fits with existing regulation of investment funds and the capital markets, which is activities- or product-based.[14] We note that U.S. regulators are following this approach in evaluating the risk profile of funds and advisers.[15] FSB/IOSCO will be decidedly out of step with this trend if they continue to advance a methodology that focuses on individual firms and funds. We urge evaluating products and activities of asset managers instead of the current costly and ineffectual effort.

4. FSB/IOSCO should consider jurisdictional and regulatory implications of G-SIFI designation for investment funds and asset managers.

Jurisdictional infirmities pervade both the First and Second Consultative Documents.[16] FSB/IOSCO, and its U.S. members in particular, cannot ignore these fundamental issues and advance a methodology for investment funds or asset managers in circumstances where doing so would ignore existing regulation (a primary consideration U.S. regulators must engage in before suggesting any new regulations) or evade U.S. requirements by relinquishing policymaking authority to an international process.

5. FSB/IOSCO Should Abandon their Methodologies for Investment Funds and Asset Managers

Both the First and Second Consultative Documents have been created without due rigor or sufficient data to make the methodological decisions that have been outlined. We remain concerned that there appears to be no scientific or empirical analysis underlying the investment fund assessment methodology contained in the document. We have additional concerns emerging from the inclusion of a new methodology for asset managers in the Second Consultative Document. This approach differs from that with which we have become accustomed among our primary regulators. In particular, the SEC has adopted an increasingly data-driven approach to its rulemaking initiatives. As discussed throughout this response, commenters have shown how the methodologies would be inappropriate for asset managers or funds, and the current initiative should be focused instead on better understanding the activities and products of asset managers and other participants in the markets. This is the process that is already being followed by U.S. and other national regulators. Likewise, FSB/IOSCO should

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[14] *See* AMG, *supra* note 6, at 2.

[15] *See id.* ("[FSOC] appears to have recognized those facts and shifted its attention to a more constructive review of products and activities in the sector, and away from individual firms or funds identified on the basis of their size."). Treasury Secretary Jack Lew has directed staff to "undertake a more focused analysis of industry-wide products and activities to assess rights associated with the Asset Management industry." *See Minutes of the Financial Stability Oversight Council* (July 31, 2014) at 4, *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031,%202014.pdf.

[16] *See* AMG, *supra* note 6, at 9-10.

follow through with Mr. Carney's recent indications that the FSB will more usefully and appropriately focus attention on products and activities that have a bearing on risk in the global financial system in fulfillment of the G20 mandate.[17]

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Rather than further recounting these arguments or reiterating other specific comments provided in our response to the First Consultative Document, all of which remain valid though not addressed by the Second Consultative Document, our response instead focuses on jurisdictional, process, and methodological infirmities that characterize the current approach undertaken by FSB/IOSCO, pointing to elements of the Second Consultative Document that illustrate flaws in both its conception and execution. Until these fundamental issues are addressed, and in light of the manner in which our prior comments and those of others have been largely disregarded, we believe that there is little point in providing detailed comments on the Second Consultative Document.[18] Instead, we respectfully urge constituent members of FSB/IOSCO to step back from the current process and reassess their mandate and the advisability of pursuing this initiative in light of the shortcomings in its conception and execution. We strongly urge FSB/IOSCO to lay out a transparent and inductive initiative to analyze products and activities in the global asset management industry, one that is informed by lessons to be learned from the jurisdictional, process, and methodological infirmities of the present endeavor and one that looks first to the work of primary regulators on these important topics.

As we noted in our letter recommending that FSB/IOSCO review other regulatory developments and redirect its efforts in connection with the Second Consultative Document, the SEC is actively evaluating potential regulatory actions for investment funds and asset managers. The Chair of the SEC, in whose jurisdiction all or essentially all of the entities that would be initially captured under the methodologies outlined by Second Consultative Document are registered, announced this reform agenda in December 2014 and took the first public steps very recently.[19] On May 20, 2015, the SEC proposed a series of five rulemakings to, among other things, expand the information reported by registered investment companies and investment advisers in order to enhance the SEC's ability to monitor portfolio composition and risk exposures in investment funds (particularly mutual funds, closed-end funds, and exchange traded funds ("**ETFs**")), and separately managed accounts ("**SMAs**"). Among other requirements, the proposals would require most funds to report monthly on all investments, eliciting detailed information about individual investments including data related to the pricing of portfolio securities; information regarding repurchase agreements, securities lending activities, and counterparty exposures; and terms of derivatives contracts. Funds would also be required to

[17] *See* Carney, *supra* note 3.

[18] We continue to endorse positions laid out in our prior letter and responses. *See* Appendix for copies of our prior comment letters.

[19] U.S. Securities and Exchange Commission Press Release, *SEC Proposes Rules to Modernize and Enhance Information Reported by Investment Companies and Investment Advisers* (May 20, 2015), *available at* http://www.sec.gov/news/pressrelease/2015-95.html.

disclose portfolio level and position level risk measures so that the SEC and investors can better understand exposure to potential changes in market conditions.[20] The proposals also seek tailored information on separately managed accounts, particularly their assets held and use of borrowings and derivatives.[21]

These proposals will require close attention and remain subject to comment and further refinement; however, they are more constructive than this latest round of FSB/IOSCO proposals concerning non-bank, non-insurer ("**NBNI**") G-SIFI designation. This is due in large part to the fact that they are being promulgated by a regulatory authority that is required to conduct a rigorous, inductive process of evaluating potential regulations to confirm that they appropriately serve the regulatory goals underlying the initiative without unduly burdening affected entities, investors and markets.

For the benefit of FSB/IOSCO members, and in particular for the U.S. regulators that belong to these bodies, we outline below some of the more significant jurisdictional, process, and methodological infirmities that still characterize the Second Consultative Document and provide illustrative examples of some of those shortcomings. Once again, we urge FSB/IOSCO members to exclude investment funds and asset managers from the G-SIFI process and work with the industry's primary regulators to focus any evaluation of asset management and the capital markets on products and activities, not entities. For the time being, FSB and IOSCO Workstream 3 should yield time and space to the efforts being conducted by the SEC and other national and international agencies while regulators with responsibility for funds, managers, and capital markets in those jurisdictions execute their own efforts.

I. Jurisdictional Issues

The Second Consultative Document embarks upon an evaluation of potential methodologies for assessing the systemic risk profiles of asset managers, investment funds, and other market participants without adequately establishing the jurisdictional rationale for doing so. In its introduction, the Second Consultative Document lays out the background that led to the drafting of the assessment methodologies for NBNI G-SIFIs.[22] That introductory language closely mirrors the introductory language in the First Consultative Document[23] and raises the same jurisdictional questions, as well as some new issues that warrant attention. The key difference is that, in the interim, we and other market participants discussed in our responses to the First Consultative Document that the scope of the G20 mandate does not require or explain

[20] *See* Securities and Exchange Commission, *Investment Company Reporting Modernization*, Release Nos. 33-9776; 34-75002; IC-31610; File No. S7-08-15 (May 20, 2015), *available at* https://www.sec.gov/rules/proposed/2015/33-9776.pdf.

[21] *See* Securities and Exchange Commission, *Amendments to Form ADV and Investment Advisers Act Rules*, Release No. IA-4091; File No. S7-09-15 (May 20, 2015), *available at* https://www.sec.gov/rules/proposed/2015/ia-4091.pdf.

[22] *See* Second Consultative Document at 1.

[23] *See* First Consultative Document at 1.

why there should be a proposal to consider investment funds or asset managers for potential designation as NBNI G-SIFIs.[24]

FSB/IOSCO are acting under no specific direction from the G20 to prepare methodologies that would specifically include these types of entities, nor was any sound policy rationale articulated to include such entities in either the First or Second Consultative Documents.[25] In fact, the Second Consultative Draft leaves entirely unanswered key issues raised in our 2014 response, including that other regulatory bodies "openly concede that the industry generally does not present systemic risk."[26] In light of such acknowledgements, it is troubling that no clear justification was provided in the First Consultative Document for the inclusion of investment funds; nor is there an attempt to justify their inclusion in the Second Consultative Document.

The Second Consultative Document also fails to address the *expansion* of the consultation to include asset managers more broadly, despite points we and others raised in our responses to the First Consultative Document supporting the then-apparent decision of FSB/IOSCO *not* to include them. It is a basic legal principle and a foundational tenet of administrative law in the United States that there should be an adequate articulation of a jurisdictional nexus preceding action by a regulatory body.[27] Where, as here, there is no solid regulatory authority nor a clear articulation of a rationale for why the systemic risk exercise has been broadened to include the asset management industry and focuses almost exclusively on U.S. funds and managers, the regulator – or consortium, as it were – should state that rationale and ground the initiative in relevant facts and data, or at least establish it upon a sound theory. To date, this has not happened.

As noted above, the proposed materiality thresholds for inclusion in the methodology and further assessment – whether for investment funds or asset managers – that are articulated in both consultative documents suggest that this is presently a U.S.-focused exercise, not an international one. This presents an additional jurisdictional question: on what basis would

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[24] See AMG, *supra* note 6, at 3 ("The G20 Leaders' request… does not express a view regarding whether investment funds possess the necessary mix of characteristics to be considered G-SIFIs….").

[25] *See id.* at 3-4.

[26] *Id.* at 3, n. 8. As noted by the Committee on Economic and Monetary Affairs, "[t]he size and business model of the asset management sector does not typically present systemic risk," and asset segregation and custodian arrangements provide a "substantial safeguard." European Parliament Committee on Economic and Monetary Affairs, *Motion for a European parliament resolution on recovery and resolution framework for non-bank institutions* (Oct. 22, 2013), cited in AMG, *supra* note 6, at 3, n. 8. As noted recently by IOSCO Chair Greg Medcraft, "[t]here is an issue globally about liquidity risk which is driving a lot of discussion about fund management, but at the end of the day if there is a run on a fund, most funds have the ability to suspend redemptions and have an orderly pay down." Price and Jucca, *supra* note 9.

[27] *See Motor Vehicle Mfrs. Ass'n of U.S., Inc. v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983), citing *Burlington Truck Lines, Inc. v. United States*, 371 U. S. 156, 168 (1962) ("… the agency must examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'").

an international body, as a matter of first impression, attempt to set standards over a group of entities already comprehensively overseen by a U.S. regulator and currently engaged in an evaluative process conducted by the SEC to determine whether additional regulatory measures might be warranted? This issue has caught the attention of commentators as well as appointees who serve at member agencies.[28]

We articulated the concern less directly in our prior response, where we stated that "the threshold question for G-SIFI designation… should be whether existing national regulation effectively addresses systemic risks…."[29] Nevertheless, the point is a fundamental one, and under U.S. law it is in fact a statutory requirement, reaffirmed under Section 113 of the Dodd-Frank Act, which requires FSOC to evaluate the effectiveness of existing regulation when considering whether to designate any non-bank as systemically important.[30] Simply put, FSB/IOSCO make no acknowledgement of this issue in the Second Consultative Document, but instead move forward with methodological thresholds that capture investment funds – and now asset managers – that already operate under the thorough regulatory oversight of the SEC without actually identifying shortcomings with that regime. This process ignores and effectively leaps over a key regulatory threshold question required to be evaluated under U.S. law before an entity is subject to systemic risk evaluation.

We do not need to review in detail here the materiality thresholds proposed for investment funds,[31] but it has been observed by numerous analysts and watchdogs that the funds captured will be almost entirely U.S. entities that already answer to the SEC as their primary

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[28] *See, e.g.*, Peter J. Wallison and Daniel M. Gallagher, How Foreigners Became America's Financial Regulators, WALL STREET JOURNAL (Mar. 19, 2015), *available at* http://www.wsj.com/articles/peter-wallison-and-daniel-gallagher-how-foreigners-became-americas-financial-regulators-1426806547 ("The authority of [the FSB] should be of pressing concern to Congress and the American public, both for its effect on the U.S. financial system and more so on the power of Congress under the U.S. Constitution."); *see also* Michael S. Piwowar, *Remarks at the 2015 Mutual Funds and Investment Management Conference* (Mar. 16, 2015), *available at* http://www.sec.gov/news/speech/031615-spch-cmsp.html ("It is a troubling notion that, without having undergone the notice and comment process required by the Administrative Procedures Act and without adherence to any other applicable standards… policies and other commitments can be agreed upon at the FSB with the expectation that all member jurisdictions… should follow."); Piwowar, *supra* note 13 ("External parties — chiefly the banking regulators — are calling for the imposition of new regulatory requirements for nonbank financial institutions and on certain activities by all financial actors. Unfortunately, those proposals seem to be premised on a misunderstanding of the capital markets and show little appreciation for the SEC's mission.").

[29] *See* AMG, *supra* note 6, at 9.

[30] *See* Section 113(a)(2)(H) of the Dodd-Frank Act, requiring the FSOC to consider "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies" when considering whether to designate a non-bank financial entity a SIFI.

[31] *See* Second Consultative Document at 35-36; *see also* AMG, *supra* note 6, at 21-23 (discussing our concerns with the materiality thresholds as proposed in the First Consultative Document).

regulator.[32] Moreover, we note that where the document appears to give on one hand by seemingly raising certain thresholds, it takes with the other by establishing new metrics (*e.g.*, substitutability and fire sale ratios) that would capture an even broader spectrum of funds whose profiles in terms of potential systemic significance would seem even less at issue. Similarly, the newly proposed materiality thresholds for asset managers will almost solely capture advisers regulated by the SEC.[33] This point was recently noted by the Committee on Capital Markets Regulation.[34] Viewed in this context, the jurisdictional questions come even more clearly into focus: what role do FSB/IOSCO have in establishing standards for the regulation of U.S. funds or managers where the SEC already provides effective, comprehensive oversight? What purpose is served by FSB/IOSCO supplanting obligations or establishing alternative pathways for (or on behalf of) other regulatory bodies groups like FSOC? In light of newly initiated SEC rulemakings and ongoing FSOC assessments, there is no basis for FSB/IOSCO to proceed with a consultation of its own—especially one that is so far out of step with these other initiatives.

Given the fact-finding inquiry that FSOC has initiated focusing on products and activities[35] and regulatory initiatives that the SEC has begun that would affect investment funds and asset managers,[36] why would U.S. regulators defer to an international process that is out of sequence with these efforts, particularly given the relatively short-term time frame articulated by Chair White for next steps by the SEC Division of Investment Management and the agency? Why are international entities seeking to occupy the space when they have other arguably more pressing issues relating to systemic risk within their remit to attend to?[37] We have made this

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[32] *See* Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Secretariat of the Financial Stability Board (Apr. 7, 2014), *available a*t http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf, at B-1 (summarizing funds captured under a USD $100 billion materiality threshold).

[33] *See generally* Second Consultative Document at 50-51.

[34] Committee on Capital Markets 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 ("…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 US regulators rather than for the FSB." *Id.* at 1.).

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

[36] *See, e.g.*, Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Remarks at The New York Times DealBook Opportunities for Tomorrow Conference Held at the One World Trade Center, New York, N.Y. (Dec. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722; *see also* David Grim, Acting Director, Division of Investment Management, *Remarks to PLI Investment Management Institute 2015*, New York, N.Y. (Mar. 5, 2015), *available at* http://www.sec.gov/news/speech/remarks-pli-investment-management-institute-2015.html#.VQH3QTvD9aQ; Chair Mary Jo White, *Chairman's Address at SEC Speaks 2015*, Washington, D.C. (Feb. 20, 2015), *available at* http://www.sec.gov/news/speech/2015-spch022015mjw.html#.VQH3uzvD9aQ.

[37] We note in this regard OFR Director Richard Berner's recent remarks focusing greater attention by his office on clearinghouses, which are one such pressing issue. *See* Douwe Miedema, *Clearing houses are big risk, top*

point in a separate letter to U.S. FSB and IOSCO members, [38] but we repeat it for the record here as well.

With regard to the SEC, which has a successful 75-year track record of effective regulation of the asset management industry, even through times of market stress,[39] we note in particular active work streams Chair White first described in a December 2014 speech.[40] They include modernizing and enhancing data collection related to asset managers; identifying and managing risks related to portfolio composition, including liquidity management and use of derivatives; and planning for circumstances of market stress or circumstances where advisers can no longer manage an entity or program.[41] In evaluating each of these initiatives, the goal is to cover areas that could present potential exposures for investors. Individual asset managers and investment funds do not present the risk necessary to be a SIFI; but if the SEC takes any of these proposals to adoption, it could impose regulatory enhancements on institutions and participants that are themselves already well regulated. As importantly, we would expect that the SEC's initiatives, unlike the methodologies outlined in both the First Consultative Document and the Second Consultative Document, will be tailored and calibrated specifically to address the profiles of asset managers and investment funds instead of recreating an inapposite imitation of requirements imposed on banks or bank-like institutions.[42]

U.S. federal researcher says, REUTERS (May 15, 2015), *available at* http://www.reuters.com/article/2015/05/15/us-regulation-summit-berner-idUSKBN0O024O20150515 ("They are very much on the (priority) list… There have been lots of discussions and I think there will continue to be lots of discussions about risk and (clearing houses) and I think that's totally appropriate.").

[38] *See* AMG, *supra* note 4, at 5-7 ("At a minimum, the decision not to heed those requests and the simultaneous participation in these two conflicting regulatory endeavors has created confusion about how the global SIFI designation and FSOC Notice processes relate to one another, as well as concern about whether comments on the FSOC Notice will be considered thoughtfully. This would appear to undermine the validity of the notice and comment process for the FSOC Notice and raises concerns about the possibility that non-U.S. regulators could attempt to dictate a regulatory approach for U.S. funds and managers that is established without the benefit of the procedural protections afforded to interested parties under U.S. law and is in conflict with the approach pursued by U.S. regulators." *Id.* at 7.).

[39] *See* Piwowar, *supra* note 13 ("The Fed apparently believes that because asset managers and investment companies have been so successful, they somehow pose a systemic threat to the financial system and therefore have earned an additional layer of regulation — 'prudential market regulation.' Of course, what they ignore is that those entities have been subject to extensive and highly effective regulation by the Commission for 75 years. Moreover, they did not precipitate the 2008 financial crisis and in fact continue to flourish today.").

[40] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 36.

[41] *See Investment Company Reporting Modernization*, *supra* note 20; *see also Amendments to Form ADV and Investment Advisers Act Rules, supra* note 21.

[42] As noted by the Director of the Division of Investment Management, David Grim, such calibration is an essential element and value-add of SEC action: "[t]he stress-testing approach in the banking world, you can't just pick it up and drop it on asset managers. It's not going to work." Ed Beeson, *SEC's Asset Manager Stress Tests Won't Copy Bank Model*, LAW360 (Mar. 5, 2015), *available at* http://www.law360.com/articles/628143/sec-s-asset-manager-stress-tests-won-t-copy-bank-model.

Common to each of the SEC regulatory initiatives is the important process of gathering pertinent data to be assessed *before* any further steps are taken. In this context, it is curious that FSB/IOSCO have not awaited the completion of rulemaking and subsequent collection of information before determining whether steps are warranted, particularly as the United States may be the only jurisdiction where its methodology would be employed at the outset and while other member jurisdictions are themselves assessing what next steps are appropriate in the context of their own approaches to systemic risk assessment. In particular, FSB/IOSCO published the Second Consultative Document *before* the conclusion of the comment period on the recent FSOC information request, expressing an unwillingness to wait for the evaluation of questions posed by FSOC before taking next steps. FSOC covered four key topics in its request for information and received thoughtful, cogent responses that are directly relevant to many of the issues raised in the Second Consultative Document. If FSB/IOSCO had taken time to review the responses before deciding whether to issue its Second Consultative Document, then it might have redirected the present initiative toward products and activities or simply awaited the outcome of FSOC's work, the SEC's own work, and other jurisdictions' efforts. In this regard, we refer to SIFMA AMG's response to the FSOC request[43] as well as to our first G-SIFI letter.[44]

In the best circumstances, we (particularly entities under the jurisdiction of U.S. regulators) expect to see a sequential, logical approach to action by regulatory authorities as generally contemplated by the U.S. Administrative Procedures Act.[45] First comes the identification of issues; second, the gathering of information to assist in the determination of whether regulation of some group of entities or practices is needed or likely to address effectively and efficiently the issues of concern; third, the initiation of rulemaking by the regulatory body charged with primary oversight for the entities or practices at issue; fourth, a colloquy among affected stakeholders, adjustment of the proposal, and – if warranted – adoption of rules determined to serve the underlying regulatory aim; and last, after some period of implementation of the rule and some experience of its effect on markets and various stakeholders, there is a process by which to encourage international harmonization and reconciliation of international norms if there is an imperative to do so. Such an approach stands in stark contrast to the FSB/IOSCO process to date in setting methodologies in the consultative documents, which begins with a set of norms expounded without a meaningful empirical basis nor an adequate articulation of the underlying rationale, a common understanding of what the actual problems actually are, or whether the entities in question even present those issues of concern.

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[43] Letter from the AMG and the Investment Adviser Association to Patrick Pinschmidt, Deputy Assistant Secretary, Financial Stability Oversight Council, Re: Financial Stability Oversight Council Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001 (Mar. 25, 2015), *available at* http://www.sifma.org/comment-letters/2015/sifma-amg-and-iaa-submit-comments-to-fsoc-on-notice-seeking-comment-on-asset-management-products-and-activities/. A copy of this letter is attached in the Appendix.

[44] *See* AMG, *supra* note 6.

[45] 5 U.S.C. § 533.

Indeed, FSB/IOSCO seem to be out of step with other related regulatory initiatives both in the United States and in other international contexts. In broad terms, neither of the consultative documents seems able to define or measure systemic risk, which is a primary step necessary to regulate it.[46] In addition, SIFI risk is a very specific type of risk. It posits both that a company has to be able to fail, and its failure has to threaten to disrupt global financial stability.[47] It is the same risk regardless of the industry of the company in question. In other words, in order to be a SIFI, a bank, insurance company or asset manager must present the same type and magnitude of risk. There is no justification for applying lower thresholds to funds and managers. Clearly, asset managers and investment funds do not present the same type or magnitude of risk as global systemically important banks ("**G-SIBs**"), especially when they are already more tightly regulated than banks in many key respects (*i.e.*, in areas such as capital, liquidity, and transparency). Thus, an objective assessment methodology would produce a null set for funds and managers. Any attempt to lower or distort SIFI thresholds to artificially capture funds and managers will not mean that they actually are SIFIs and, as importantly, such an exercise will also not reduce systemic risk. On the contrary, because the FSB/IOSCO methodology ignores the basic structure, economics and regulation of the asset management industry, it is likely to increase systemic risk by damaging well-regulated funds and managers, driving assets elsewhere, channeling funds and managers into narrower, more homogenous instruments and investment patterns, and distorting markets.[48] The G20 did not task FSB/IOSCO with creating a new form of risk.[49]

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[46] *See, e.g.*, Matthew Richardson, *Asset Management and Systemic Risk: A Framework for Analysis* (Mar. 19, 2015), at 5 ("In 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.").

[47] *See, e.g.*, AMG, *supra* note 6, at 5 ("The Consultative Document explains that the FSB's and IOSCO's 'overarching objective' in developing the proposed assessment methodologies was to identify NBNI financial entities that met the definition of G-SIFI: an institution 'whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions.'"); Letter from Scott C. Goebel, Senior Vice President and General Counsel, Fidelity, to Secretariat of the Financial Stability Board, Re: Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Apr. 7, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140423s.pdf, at 2 ("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.").

[48] Rather than rehearse these facts, commonly acknowledged in academic literature and elsewhere, we refer you to relevant passages in our comment letters, *supra* notes 4, at 4 ("… [W]e are deeply concerned that the FSB and IOSCO are set on a path that could very well have a significant negative effect on U.S. investors, businesses and capital markets without reducing systemic risk.") and 6, at 10 ("We believe that, because investors in registered investment funds (and, to a lesser extent private investment funds) can easily redeem their interests and move their assets to new investment opportunities, and because asset managers can replicate investment strategies easily to meet a new investor's mandate, it is likely that G-SIFI designation will have a negative impact on designated investment funds. This may be the result even if the only immediate consequence of designation is uncertainty about the regulatory impact").

[49] *See* Piwowar, *supra* note 13 ("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

In more specific terms and merely by way of illustration, FSB/IOSCO are proposing parameters that are more stringent than those contemplated by FSOC – a point that seems odd given that the initial subjects of the FSB/IOSCO endeavor would be U.S.-based firms. For example, the thresholds proposed by the FSB/IOSCO initiative bear no rational relationship to key international metrics: the Basel III minimum total leverage ratio for G-SIBs requires capital of 3% on a non-risk-weighted basis (*i.e.*, banks can be leveraged 33:1 and still comply),[50] while the FSOC-established materiality screen for domestic threats to financial stability contemplates a leverage ratio of 15:1.[51] The FSB-proposed leverage ratio is drastically lower at 3:1, but with no explanation offered to explain the differences.[52] Given that the primary jurisdiction where entities that would be captured are currently operating has established evaluation thresholds, and most if not all of the players potentially implicated are domiciled in that jurisdiction, why would an international body propose such a metric as an initial matter? Furthermore, where other jurisdictions are conducting assessments of their own markets, what relationship do the proposed ratios bear to systemic risks in those markets?

As discussed in more detail in the procedural section below, even the FSOC's approach to these issues would afford potential subject entities certain procedural rights to present data and evidence and to appeal preliminary or secondary determinations. By contrast, there is no process outlined in the FSB/IOSCO methodologies to provide target entities an opportunity to appeal any determinations under the methodology set forth in the Second Consultative Document. Potential targets of FSOC designation have detailed the infirmities of that process, but the FSB/IOSCO process around methodologies is even more arbitrary and capricious in both its design and execution.

U.S. regulators are not the only national or international authorities currently undertaking independent efforts in the area of systemic risk assessment whose work would be supplanted by pursuing the present FSB/IOSCO methodologies. For example, in September 2013, the government of Canada and the provincial governments of British Columbia and Ontario signed an agreement in principle to establish a new cooperative capital markets regulatory system.[53] They were joined by the provincial governments of New Brunswick and Saskatchewan in July 2014,[54] with the full group releasing a consultation draft capital markets

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Commission, not the banking regulators, that should be regulating the capital markets."); *see also* Freeman, *supra* note 13.

[50] *See* Basel Committee on Banking Supervision, *Basel III leverage ratio framework and disclosure requirements* (Jan. 2014), at 1, 14.

[51] *See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. at 21643.

[52] *See* Second Consultative Document at 11.

[53] Cooperative Capital Markets Regulatory System, *About the Cooperative System*, http://ccmr-ocrmc.ca/about/.

[54] *Id.*

legislation[55] and consultation draft complementary federal legislation[56] in September 2014. As stated in *The Cooperative Capital Markets Regulatory System Governance and Legislative Framework*, the proposed uniform provincial Capital Markets Act ("**PCMA**") "modernizes existing provincial securities legislation and harmonizes the regulatory approaches taken by" participating provinces' securities acts.[57] The federal *Capital Markets Stability Act* ("**CMSA**") "empowers the Authority to collect data and manage systemic risk related to capital markets on a national basis and modernizes capital markets-related criminal offences," with the key objective of creating enhanced oversight and protection of Canada's capital markets, leveraging resources across participating jurisdictions to achieve consistent, cohesive and timely regulation.[58] The authority would then have broad discretion to designate a market entity, product or practice as systemically important if "the activities or material financial distress of the trading facility of or disruption of its functioning could pose a systemic risk related to capital markets," potentially impacting investment funds.[59] Efforts associated with this Canadian regulatory initiative could be interrupted and overtaken by the FSB/IOSCO initiative.

In addition, in January 2015 the European Commission launched a project to create a Capital Markets Union ("**CMU**") for all 28 member states.[60] The CMU aims to create a single market for capital by removing barriers to cross-border investment and lowering costs of funding within the EU.[61] In February 2015, the European Commission released a Green Paper soliciting feedback by May 13, 2015,[62] calling for input from the European Parliament, national parliaments, member states, citizens, small and medium-sized enterprises, the non-governmental sector and the financial sector on issues including institutional investment in the European asset management industry[63] and preserving investor trust in the financial sector through increased regulation and supervision.[64] In consideration of the work currently underway by these critical

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[55] *Provincial Capital Markets Act: A Consultation Draft* (Aug. 2014), *available at* http://ccmr-ocrmc.ca/wp-content/uploads/PCMA-Engl.pdf.

[56] *Capital Markets Stability Act – Draft for Consultation* (Aug. 2014), *available at* http://ccmr-ocrmc.ca/wp-content/uploads/CMSA-English-revised.pdf.

[57] Ontario Ministry of Finance, *The Cooperative Capital Markets Regulatory System Governance and Legislative Framework*, http://www.fin.gov.on.ca/en/budget/ontariobudgets/2013/commentary.html.

[58] *Id.*

[59] *Capital Markets Stability Act*, *supra* note 56, at 14.

[60] European Commission – Press Release, *Commission launches work on establishing a Capital Markets Union* (Jan. 28, 2015), http://europa.eu/rapid/press-release_IP-15-3800_en.htm.

[61] *Id.*

[62] European Commission, *GREEN PAPER: Building a Better Capital Markets Union* (Feb. 18, 2015), *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=COM:2015:63:FIN&from=EN.

[63] *See* European Commission, *supra* note 60.

[64] *See* European Commission, *supra* note 62, at 19-20.

European regulators, themselves members of FSB/IOSCO, it would not be appropriate for them to cease their initiative or cede responsibility to another coordinating party before their own assessment work is completed. Just as notably, the Second Consultative Document takes an approach that contradicts key goals of the CMU project, which among other considerations focuses on achieving greater long-term investment into the real economy by institutional investors and reducing the costs of investment funds to increase their efficiency. Additional 'SIFI' capital requirements for asset managers or investment funds would undermine these objectives, add costs rather than reduce them, and potentially tie up capital unnecessarily.

We call on FSB/IOSCO members to abandon the current consultation and acknowledge and address these jurisdictional issues *before* any affirmative measures are taken that would supplant primary regulators or relieve them of their own individually established mandates, or before steps are taken by constituent regulators that would result in them relinquishing their responsibilities (and attendant accountability) to a diffuse group of international standard setters. FSB/IOSCO should not dictate how national regulators do their jobs, as the methodologies would do, but should instead support individual national efforts that will better assess how products and activities executed by asset managers and other financial market participants might have a bearing on systemic risk.

Further, we ask that the U.S. members of FSB/IOSCO – in any circumstances where they consult or coordinate with international bodies – ensure that any redirected efforts undertaken by those groups (ideally, efforts focused at better understanding products and activities) afford affected parties the protections that are provided by the basic tenets of U.S. administrative law, which requires a transparent rulemaking process, and the U.S. Constitution, which requires due process. The current FSB/IOSCO effort at establishing methodologies lacks the rigor and accountability that characterize regulatory undertakings by U.S., Canadian or European authorities, and if further pursued would do so at great cost and waste to its member states and the firms that operate within these individual jurisdictions.

II. Process Issues

The Second Consultative Document also repeats the First Consultative Document's phase-based approach for designating financial institutions with G-SIFI status and implementing policy measures to which such entities will be subject. Each of the proposed phases continues to raise serious concerns both in terms of process and timing. We address these issues briefly.

Phase 1

Phase 1 requires FSB, in consultation with IOSCO, to revise the proposed methodologies with the expectation that they be completed "by the end of 2015."[65] This is an unreasonable timeline, and if not suspended would strongly suggest that FSB/IOSCO have already arrived at their own conclusions and that the consultation process itself is illusory. The timeline is also inappropriate because the SEC, the member regulator whose registrants will form

[65] *See* Second Consultative Document at 2.

most if not all of the group that would initially be most affected by the methodology outlined in the Second Consultative Document, has already launched its own set of initiatives to determine whether certain targeted changes are warranted to monitor and address risks among investment funds and asset managers, and more importantly, how to conduct such an assessment.[66] FSOC also continues to engage with the market about risks that may be attendant to specific investment products and strategies.[67] Other jurisdictions, as noted above, have their own workstreams underway. The FSB/IOSCO timeline contemplated by the Second Consultative Document is particularly bewildering in light of the addition of an asset manager methodology that was not even proposed in the First Consultative Document. Indeed, that prior document strongly suggested that asset managers were not among the entities appropriate to consider for a methodology – a point endorsed by numerous commenters.

The Second Consultative Document makes clear that, despite comments and offers to provide further data and assistance that we and others have conveyed, FSB/IOSCO are still working to better establish an understanding of the basic structure, operations and economics of the asset management industry and are not yet in a position to endorse fundamental changes to regulation. Notwithstanding this, the document makes clear that these bodies are working to develop and implement regulatory steps based on an urgent but artificial timeline. This haste and misplaced attention have already wasted time and resources among regulators and regulated entities. If they continue to pursue asset management G-SIFI designation, they will waste more and risk damaging funds, managers, and markets (and, of course, investors) while failing to identify and reduce systemic risk.

As noted above, there are several alternative national and international regulatory workstreams that will render a variety of options for investment funds and asset managers that should be evaluated in detail before FSB/IOSCO can reasonably conclude that any overarching regulatory scheme or harmonizing mechanism is appropriate. Assembling and assessing data (as the SEC, FSOC, and other regulators are doing) takes time but provides the necessary foundation for sound regulation. With comments on the Second Consultative Document due at the end of May, a scant week after the SEC proposed targeted rules in this area for which it is seeking comments by late summer, it appears that staff supporting FSB/IOSCO are afforded little opportunity to do more than prepare a summary report for approval by authorities who are themselves not yet in a position to understand the consequences of (much less fairly establish the basis for) an additional regulatory regime for a group of market participants that are already well regulated and likely to see additional requirements imposed by their primary regulators. Put simply, the global analysis of what entities, activities and practices might present systemic risk has just begun. More time is required to collect data, analyze it and base any recommended

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[66] *See* Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 36 ("While the SEC's regulation of asset management is strong and comprehensive, the source of that strength has been our willingness to take stock of our rules with a clear vision and implement the necessary changes to make effective regulation that fits current market realities. We have done that many times since 1940, and it is essential that we do so again in 2015."). *See also Investment Company Reporting Modernization*, *supra* note 20; *Amendments to Form ADV and Investment Advisers Act Rules, supra* note 21.

[67] *See generally* Financial Stability Oversight Council, *supra* note 35.

changes on that data and analysis. Recommendations for any further action must be subject to meaningful notice and comment as opposed to an illusory process such as the current effort.

Phase 2

Once the assessment methodologies are finalized (at some point over the next seven months, according to the timeline in the Second Consultative Document), Phase 2 requires the FSB, in cooperation with IOSCO and "other standard setting bodies," to develop the "incremental policy measures needed to address the systemic and *moral hazard risks* posed by NBNI G-SIFIs"[68] (emphasis added). The invocation of the term "moral hazard" underscores that global regulators are applying inapposite banking concepts of government support and "failure" to the asset management industry. Among financial service businesses, moral hazard is a risk unique to banking institutions, which benefit from government guarantees. Asset managers, on the other hand, do not benefit from such guarantees, and implying that they do suggests that regulators are distorting the fundamentals of the industry and presupposing a regulatory scheme that rests on a false premise. We were particularly surprised to see a broad reference to "moral hazard" in the Second Consultative Document because the First Consultative Document took care to note the differences between asset managers and banks as they relate to risk profiles.[69] The fact that this discussion was omitted—without explanation—from FSB/IOSCO's most recent document is frustrating. Had FSB/IOSCO engaged with the materials we and others submitted in connection with the First Consultative Document where we discuss the limitations of this frame of reference, they might have produced a more informed proposal.[70]

Phase 3

In Phase 3, FSB/IOSCO expect to establish an "International Oversight Group" (the "**IOG**") to (i) coordinate a process to maintain international consistency "in applying the NBNI G-SIFI methodologies" and (ii) "begin the process for determining the list of NBNI G-SIFIs." We are alarmed by this proposal. From our vantage point, FSB/IOSCO are establishing an unaccountable shadow group under the aegis of a confederation charged with implementing a mandate born out of a vague expression of will by G20 executives, who in 2011 were concerned about banking institutions that served as accelerants during the financial crisis, not investment funds or asset managers.

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[68] *See* Second Consultative Document at 2.

[69] *See* First Consultative Document at 3 ("… it is important to note that [non-bank non-insurer] entities have very diverse business models and risk profiles that in many respects are quite different from banks and insurers.").

[70] *See, e.g,* AMG, *supra* note 6, at 2 ("The requirements that every G-SIFI must have the same essential risk characteristics and must be subject to consistent identification frameworks creates a tension that is clear in the Consultative Document between the need for a regulatory approach that is consistent across multiple industries and market sectors and a regulatory approach that recognizes that NBNI financial entities, including investment funds, possess unique risk characteristics and operate in ways that are fundamentally different than banks and insurance companies, the types of entities that have already been designated as G-SIFIs.").

There is no obvious rationale, much less an imperative, for inserting another body of limited accountability between FSB/IOSCO and the businesses ultimately subject to their positions and mandates. Moreover, it is unclear what kind of oversight by FSB, IOSCO, or national authorities the IOG's operations will be subject to. Without knowing how it is formed, how it operates, who its members are, to whom they report, or whether it is possible to interact with them directly, the IOG is unaccountable to stakeholders, the public and political leaders. In this regard, we note that the Second Consultative Document describes no right to appeal or other clear due process standards by which subject entities can respond to decisions made by the IOG.

Even if our comments on this point were to yield some reform to the FSB/IOSCO plan to establish an IOG, our more fundamental objection to this construct remains that FSB/IOSCO continue to lack the data necessary to adequately inform the IOG's proposed functions. And where some of this data is available, it is nevertheless in the hands of national regulators, many of whom are proscribed from sharing it with peers in other jurisdictions. In some cases, the data have yet to be collected by any authority. The SEC's recent proposals suggest it will soon have data at its disposal unlike that collected in any other jurisdiction. Without a sufficient data set, common approaches to data collection, or information sharing protocols, we question how national regulators can institute the IOG's process and—more importantly—how the IOG can oversee that process. Furthermore, without such data, it is impossible to review key areas described as sources of potential risk or to determine whether or how to appropriately address them or benchmark them across jurisdictions. At bottom, we do not believe that the IOG would have the means to be able to defend any decision it makes or assess the consequences of its actions. It is inappropriate, indeed it could be illegal, for U.S. regulators to participate in or take direction from such a group or process.

Other process-related shortcomings

Other processes outlined by the Second Consultative Document are similarly worrisome. In some instances, this is because the evaluation process appears to be rigged to lead to outcomes inconsistent with the purported concerns FSB/IOSCO seek to address.

For example, the FSB now proposes to exclude from the NBNI G-SIFI methodologies certain public financial institutions (*e.g.,* multilateral development banks and national export-import banks), sovereign wealth funds, and pension funds.[71] While we do not necessarily dispute these proposed limitations, the rationales for excluding these entities are inconsistent with the justification for subjecting asset managers and investment funds to the methodologies and ignore the relevant facts about sovereign actors.

In particular, the Second Consultative Document excludes public financial institutions and sovereign wealth funds because "they are owned and fully guaranteed by a government."[72] This rationale ignores the fact that certain sovereign governments, which

[71] Second Consultative Document at 5.

[72] *Id.*

sponsor such funds, have at times defaulted on their obligations[73] and may do so again.[74] Not all sovereign wealth funds enjoy government guarantees. Moreover, these funds inject significant amounts of capital into the marketplace, and decisions by such funds to move precipitately from one asset class or sector to another must be managed like any other big investment decision and monitored carefully. For example, the China Investment Corporation ("**CIC**") was a large investor in the Reserve Primary Fund in September 2008. CIC's decision to redeem its interests in the fund shortly before it "broke the buck" accelerated some of the fund's challenges and contributed to its ultimate liquidation.

Similarly, the idea that a government guarantee should serve as a rationale for the exclusion of sovereign wealth funds from the methodologies seems an odd result when one recognizes that a government guarantee means simply that a country's taxpayers will be called upon to bail out the fund in the event of a failure. Given that a key purported reason for the entire exercise is to reduce taxpayer exposure and moral hazard risk, the exclusion of sovereign wealth funds would appear to be at odds with what FSB/IOSCO are charged with addressing.

Likewise, the Second Consultative Document proposes to exclude pension funds from the methodologies because "they pose low risk to global financial stability…due to their long-term investment perspective."[75] The irony of the rationale for excluding these entities is that "long-term investment perspective" is precisely the justification that many retail and institutional investors have for allocating capital to mutual funds and other products managed by traditional asset managers. Indeed, mutual funds are the primary savings vehicles for retirement income.[76] About two-thirds of the total assets in all U.S. equity and balanced mutual funds are held in retirement accounts; and a significant portion of fund investments in taxable accounts are oriented toward long-term savings and retirement, often through defined contribution and asset allocation programs.[77] It is widely recognized that investors' long-term perspectives help explain why long-term funds have never been subject to a "run" in the past and why one cannot

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[73] *See, e.g.*, Shane Roming, *Argentina's Long History of Economic Booms and Busts*, WALL STREET JOURNAL (Jul. 30, 2014), *available at* http://blogs.wsj.com/moneybeat/2014/07/30/argentinas-long-history-of-economic-booms-and-busts/ (discussing Argentina's history of debt defaults); Ben S. Bernanke, *Inflation in Latin America: A New Era?*, Remarks at the Stanford Institute for Economic Policy Research Economic Summit (Feb. 11, 2015), *available at* http://www.federalreserve.gov/BOARDDOCS/Speeches/2005/20050211/default.htm (discussing macroeconomic problems including the Latin American debt crisis of the 1980s).

[74] *See, e.g.*, Mike Patton, *A Greek Default Could Be Closer Than We Think*, FORBES (May 18, 2015), *available at* http://www.forbes.com/sites/mikepatton/2015/05/18/a-greek-default-may-be-close-at-hand/ (discussing the potential pending Greek default).

[75] Second Consultative Document at 5.

[76] *See* AMG, *supra* note 43, at 12 (discussing the stability of the mutual fund investor base).

[77] *See Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, Strategic Insight (Nov. 13, 2013), at 5.

reasonably be expected to occur in the future.[78] Had FSB/IOSCO reviewed comments in response to the FSOC request for information prior to publishing the Second Consultative Document, it might have led to a more informed assessment and discussion in this regard. The Second Consultative Document takes a logically inconsistent position. We expect the FSB/IOSCO to leverage the information contained in those responses, in addition to the responses they receive to the present consultation, to conclude what other regulators have: that designation is inappropriate for asset management entities and would be ineffective in mitigating systemic risk.

The Second Consultative Document also indicates that it is developing sector-specific methodologies for finance companies, market intermediaries, investment funds, and asset managers due to "their relatively large size in the non-bank financial space."[79] This justification is meaningless. It is unsurprising that these four NBNI entity types are viewed as relatively "large" compared to the "non-bank financial space" because these four entity types comprise the bulk, if not the entirety, of service providers in that space – *i.e.*, they are being measured against themselves. Any reasonable measurement of their relative sizes would compare them to the global financial industry at large, since FSB's principal concern is the potential impact that an institution might have on the global financial system, not on a subset thereof. This measure is also misleading since the methodologies would not result in the regulation of all finance companies, market intermediaries, investment funds, and asset managers, but only a few of the largest entities.

More generally, it appears that the Second Consultative Document treats investment funds and asset managers as conclusively within the scope of the FSB's regulatory scheme, despite the lack of a mandate to address them, despite the detailed analysis we and others provided in our response to the First Consultative Document demonstrating that they should not be, and notwithstanding the more constructive approach of evaluating products and activities that the FSOC and the SEC are taking. Concluding that investment funds and asset managers should be subject to the methodologies based on a rudimentary and ill-devised "relative size" metric suggests that the FSB has determined not to critically evaluate the information or arguments presented in the letters that we and others have submitted.

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[78] Morgan Stanley and Oliver Wyman, *Wholesale & Investment Banking Outlook – Liquidity Conundrum: Shifting risks, what it means* (Mar. 19, 2015), *available at* http://www.oliverwyman.com/content/dam/oliver-wyman/global/en/2015/mar/2015_Wholesale_Investment_Banking_Outlook.pdf , at 4 ("To ground our work and assess the risks from stress tests, we have analysed the periods of worst mutual fund redemptions in the last 35 years from market shocks. Contrary 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. The worst period for industry-wide fixed income mutual fund outflows was in 1994 when we saw on average ~5% outflows across the industry in the worst 3 months and ~13% in the worst 12 months. What was striking was that even in the most recent financial crisis bond fund redemptions were only ~4% in the worst 3 months. This compares to average cash holdings of 4% to 7% today across all US corporate bond and high yield funds on latest data, suggesting asset managers are managing risks prudentially today and risks are manageable.") (emphasis added).

[79] Second Consultative Document at 8.

The Second Consultative Document outlines a seven-part process for "assessing the global systemic importance of NBNI financial entities."[80] As proposed, the process is characterized by vagaries and hamstringed by bureaucratic red tape. The process also lacks an essential appeal procedure for affected entities and firms to provide feedback or dispute their status determinations even though U.S. law requires these. The process will rely on "relevant national authorities" to use "supervisory judgment" to assess NBNI G-SIFI status, all while submitting to the oversight of the IOG. The chief problem with this approach (among several) is that the notion of "supervisory judgment" is fundamentally at odds with the rules-based process that the SEC employs in overseeing investment funds and asset managers in the United States. Regulatory discretion of this kind is an unwarranted, unfamiliar and insufficient basis for regulation. It is a "know-it-when-you-see-it" model that the U.S. could not employ and no capital market should employ because the uncertainty it creates would damage markets and stifle investment. Substituting "supervisory judgment" for a rule-based process will inject needless uncertainty and erode the industry's and investors' ability to look to its primary regulator to apply objective standards to its activities and products.

The process also requires "national authorities" to create for each potential NBNI G-SIFI a "Narrative Assessment" based on an evaluation of indicators and "transmission mechanisms," which will then be used to determine whether to apply the NBNI G-SIFI designation.[81] Notably, the Second Consultative Document indicates the Narrative Assessments are necessary because "appropriate data/information on the relevant NBNI financial entity is often difficult to obtain…."[82] This justification amounts to an admission that FSB/IOSCO have not assembled sufficient data to support an informed, analytical process; nor do they anticipate doing so. Regulation must be based on more than anecdotes or—worse—conjecture. Difficulty surrounding data collection is not a valid excuse for guessing. If regulators do not have the necessary data, the answer is to collect it – as the SEC is proposing to do – not to guess. The stakes are far too high for the latter.

In referring to limitations regulators face in obtaining appropriate data or information for assessing systemic risks of NBNI G-SIFIs, the Second Consultative Document also ignores data-generating endeavors that are currently underway, including prominent initiatives in the U.S. and also within Europe.[83] Regulators should review and synthesize data that are already being collected or soon to be collected in these jurisdictions.

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[80] *Id.* at 12-15.

[81] *Id.* at 14.

[82] *Id.*

[83] National competent authorities in most relevant EU jurisdictions already gather or are seeking to gather considerable information on both asset managers and investment funds for various supervisory purposes. Some prominent examples currently in place include the Transparency Directive (TD), the Regulation on Venture Capital Funds (VECA), the Directive on Alternative Investment Fund Managers (AIFMD), the Regulation on OTC Derivatives, Central Counterparties and Trade Repositories (EMIR), as well as the prospective legislation on Money Market Funds (MMFR), Securities Financing Transactions (TSFT), the Shareholder Rights Directive (SRD), as well as the Directive/Regulation on Markets in Financial

We also have grave concerns about the process for making preliminary and final determinations regarding an entity's SIFI status. As proposed, a provisionally designated entity has no opportunity to submit data or engage in a dialogue with regulators between the preliminary and final determination stages. Moreover, as we note above, there is no opportunity for a entity to appeal its status after a final determination has been made. We repeat our calls for the investment fund and asset management methodologies to be abandoned and for U.S. members of FSB/IOSCO to insist that any regulatory scheme in which they participate follows a sound administrative process and, consistent with U.S. laws, affords due process protections for affected entities.

Finally, we again note that the seven-part process presumes that information and analyses will be freely shared among national regulators and the IOG. This belies a long history of challenges that national regulators have faced when seeking information from their international counterparts and ignores the various safeguards that jurisdictions have implemented to ensure the safekeeping of their constituents' data. FSB/IOSCO must address the realities of information-sharing before creating methodologies or expectations around international assessment processes. Industry participants must likewise be confident that their proprietary data will be maintained in confidence and in keeping with national legal requirements in each constituent jurisdiction.

III. Methodological Questions:

Similar to the jurisdictional and process-related shortcomings we have described, there are a variety of methodological infirmities that characterize the Second Consultative Document. In arriving at the various components of that methodology, the report includes little concrete data, cites to scant and cherry-picked academic literature that does not support the proposals, and establishes arbitrary threshold numbers. It would never stand as a predicate for regulatory action under U.S. standards or those of the other constituent jurisdictions, and should be set aside in favor of the products and activities approach that we have supported and which was recently suggested by Mr. Carney.[84] Rather than provide a point-by-point recitation of its shortcomings, we focus on just a few of the more troubling examples.

For example, in discussing the sector-specific methodology it seeks to apply to investment funds, the report makes brief mention of the First Consultative Document, providing

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Instruments (MiFID2/MiFIR). These different initiatives require or will require asset managers to provide authorities with information on financial instruments traded, risk concentrations, aggregate positions in financial instruments and liquidity arrangements (under AIFMD), material information on derivatives contracts (under EMIR), regular financial, management and risk statements (under TD), portfolio and performance details (under VECA), information on investment decisions including on portfolio turnover, portfolio costs and securities lending (under SRD), quarterly reporting on the total value of assets, net asset value, maturity and asset liquidity (under MMFR), transactions details for authorized repositories (under TSFT), and post-trade data disclosure on transactions and market participant positions in commodity derivatives and emission allowances (under MiFID2/MiFID).

[84] *See* Carney, *supra* note 3.

only a few lines of summation of the general tenor of responses received.[85] There is cursory acknowledgment and no real evaluation or analysis of the comments – not just ours, but those generated by over 50 commenters on the First Consultative Document. This stands in stark contrast to the approach followed by the SEC and mandated under the Administrative Procedures Act.[86] As discussed above, all or almost all of the potentially affected funds and managers under the currently proposed methodologies are U.S. registrants who would be afforded administrative procedural protections and Constitutional due process rights before being subjected to processes or rules promulgated by U.S. authorities. Funds or managers operating in other jurisdictions would similarly expect a more exacting procedure to accompany the development of methodologies that would affect their operations. The quality of the summation of comments and the level of engagement with the arguments compares with the 2013 OFR report on asset managers,[87] which was itself rightly criticized for its poor speculative approach[88] and widely discredited by the comments that followed.[89] At least with respect to the OFR Report, there appears to have been an attempt to absorb the comments that followed its publication after the SEC sought comments on that document.[90] Here, we can discern no appreciable evolution in

[85] *See* Second Consultative Document at 30-31.

[86] 5 U.S.C. § 533.

[87] *See* Office of Financial Research, *Asset Management and Financial Stability* (Sept. 2013), *available at* http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf.

[88] *See, e.g.*, Piwowar, *supra* note 13 ("The banking regulators' lack of understanding of the capital markets is best exhibited by their confusion surrounding the very industry that the Fed has identified as its priority for application of "prudential market regulation" — the asset management industry. In September 2013, the Office of Financial Research ("OFR") released a much maligned report that laid the groundwork for the Fed and other banking regulators to subject the asset management industry to enhanced prudential standards and supervision. From the report, it was clear that banking regulators do not understand the asset management industry or that asset managers and investment companies are already subject to comprehensive regulation by the Commission. Investors have the benefit of disclosures mandated by the Commission in making their decisions. And the Commission can evaluate the disclosures of a firm as part of its oversight function.").

[89] *See generally, e.g.*, Letter from the AMG and IAA to the Securities and Exchange Commission, re: "Asset Management and Financial Stability" Study by the Office of Financial Research (Nov. 1, 2013), *available at* http://www.sifma.org/comment-letters/2013/sifma-amg-and-iaa-submit-comments-to-the-sec-on-asset-management-and-financial-stability/ (critiquing the study for its lack of rigorous analysis); Letter from Pau Schott Stevens, President & CEO, Investment Company Institute to Elizabeth M. Murphy, Secretary, U.S. Securities and Exchange Commission, Re: Public Feedback on OFR Study on Asset Management Issues (SEC File No. AM-1) (Nov. 1, 2013), *available at* http://www.ici.org/pdf/13_ici_ofr_asset_mgmt.pdf (highlighting the OFR Study's shortcomings and failure to meet standards expected for such an undertaking); Letter from John R. Gidman on behalf of the Association of Institutional INVESTORS to Elizabeth M. Murphy, Secretary, Securities and Exchange Commission, Re: Office of Financial Research of the Department of Treasury Report on Asset Management and Financial Stability (Nov. 1, 2013), *available at* https://www.sec.gov/comments/am-1/am1-22.pdf (discussing why the OFR Report should not serve as the basis for any policymaking or regulation as it pertains to the institutional investment advisory industry).

[90] *See Comments on OFR Study on Asset Management Issues*, *available at* https://www.sec.gov/comments/am-1/am-1.shtml.

analysis between the First Consultative Document and the Second Consultative Document. To put it colloquially, FSB/IOSCO seem merely to have "doubled down" on their original positions. And based on our experience to date, we have concerns that we and other commenters would not expect substantive engagement with comments offered on the methodologies outlined in the Second Consultative Document.

By way of example, the Second Consultative Document sets forth three channels to evaluate whether risks are posed by investment funds or asset managers: (1) exposures/counterparty channel; (2) asset liquidation/market channel; and (3) critical fund or services/substitutability channel.[91] These are the same three channels used in the First Consultative Document. The drafters of the report do not appear to have engaged with many of the comments or enhanced their evaluation of the channels. If anything, they have dispensed with any data or analysis that would suggest why asset managers and funds do not present a systemic risk profile as contemplated by any of these channels.

More specifically, the first two channels require material amounts of leverage and actual failure to be germane considerations. By contrast, most investment funds do not use material amounts of leverage – a point made in response to the First Consultative Document,[92] in various responses to the OFR report, in the most recent OFR report itself,[93] and in our response to the FSOC consultation.[94] There appears to be no acknowledgement of any of these observations in the Second Consultative Document. Simply put, and stated now once more, investment funds are not levered sufficiently to warrant inclusion in a systemic risk matrix. Further, in the asset liquidation channel, there is no valid economic reason to distinguish investment funds from other kinds of asset owners. Investors that own assets directly and self-manage can sell them just as easily as collective funds or separately managed accounts. Without leverage, there is no reason that investment funds (and certainly not asset managers) create risk or transmit it. They are just one subset of the overall group of investors that comprise the larger market and do not warrant especial attention.

As for the third channel, relating to substitutability, FSB/IOSCO have recognized that this area of inquiry is largely irrelevant to investment funds and, by extension, to their managers.[95] In the First Consultative Document, FSB/IOSCO indicated that substitutability is

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[91] Second Consultative Document at 32-35.

[92] *See* AMG, *supra* note 6, at 6 ("Many investment funds, including U.S. mutual funds and other registered funds, use relatively little or no leverage.").

[93] OFR found that the ratio of gross assets (assets under management based on the current market value of assets and uncalled commitments) to net assets (gross assets under management minus outstanding indebtedness or other accrued but unpaid liabilities) for most types of hedge funds (macro, multi-strategy, equity, credit, event driven) hovered just above or below 2.0 from June 2012 through March 2014. OFR, *2014 Annual Report*, *available at* http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf, at 114, Figure 6-6.

[94] *See* AMG, *supra* note 43, at 28-30.

[95] *See* AMG, *supra* note 6, at 14 ("Although we recognize the significance of the final transmission channel, 'Critical function or service I Substitutability,' to other types of financial entities, we agree with the FSB's

not an issue for most funds and managers, and nothing has changed in the interim.[96] Again, this point has been made repeatedly in various responses to the First Consultative Document and in our response to the recent FSOC consultation.[97] And, again, this message seems to have been ignored in the preparation of the Second Consultative Document.

Similar to the way the evaluation channels bear little resemblance to the facts on the ground and have not been refined in light of comments offered by respondents, we also find it bewildering how FSB/IOSCO, armed with feedback from the First Consultative Document, have gone about establishing the materiality thresholds for inclusion of investment funds ("traditional funds" and "hedge funds").[98]

As a threshold matter, FSB/IOSCO have made no attempt to establish a correlation between size and risk in entities with little or no leverage. To take a simple example, we do not understand how a single index fund with $100 billion in AUM should be viewed as more risky than four funds with $25 billion in AUM that track the same index. To take another example, would a single $100 billion fund that is unlevered present a greater risk than four funds that each have $25 billion in equity investments that invest those assets in the same assets as the large fund, but also add leverage to their investments (*i.e.*, assume 3x leverage so that each of the smaller funds holds $75 billion in assets)? Obviously, the four funds with $300 billion in leveraged assets present a greater risk profile than the $100 billion fund, but the size metric would not capture them.

Although not at issue here, the example is borne out in the money market fund context as well. The FSB/IOSCO size threshold would not have captured the Reserve Fund, which peaked at around $62 billion in AUM. Notably, no one proposed designation of individual funds or managers for purposes of reducing risk in money market funds because, as was acknowledged in various quarters,[99] such an approach would not have worked. Rather, money market fund reforms were implemented by the SEC and focused on products and

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and IOSCO's determination that it is not applicable to investment funds because they are highly substitutable."); *see also* First Consultative Document at 30 ("…[T]he investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable).").

[96] *See* First Consultative Document at 34 ("…most investment funds are generally substitutable in that investors have multiple (asset class) options for making their investment.").

[97] *See* AMG, *supra* note 43, at 58 ("The products and services offered by asset management firms serve specific needs of investors, different from other aspects of the financial service industry. Because managed assets are held differently, there is ready substitutability of one asset management firm for another.").

[98] *See* Second Consultative Document at 35-37.

[99] *See* Governor Daniel K. Tarullo, Speech, *Regulating Systemic Risk* (Mar. 31, 2011) *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm ("… to a considerable extent, potential contagion effects are best contained by directly addressing them, rather than by trying to indirectly address them through designating large numbers of nonbank-affiliated institutions under section 113 of the Dodd-Frank Act.").

activities, not individual entities, in keeping with the SEC's regime for successfully managing its regulatory oversight of mutual funds for the past 75 years. By contrast, the numerical methodological approach to identifying SIFIs that FSB/IOSCO are pursuing is not only unjustified, it simply would not work. If steps are to be taken, there is a better option in focusing on products and activities,[100] and no rationale has been offered for not pursing that course instead.

Taken at face value, there is also no explanation or even an indication why the particular thresholds identified in the methodology were chosen in light of other standards in use or in contemplation by other authorities. For example, the BIS reporting thresholds for international banks are set at EUR 200 billion.[101] Why would FSB/IOSCO set size thresholds for designating investment funds as G-SIFIs at less than half the level set for mere reporting by international banks? Further, there is no indication on the face of the document as to the process informing how these thresholds were selected, the number of funds that would be included, or a supporting rationale for establishing the thresholds where they have been proposed. For example, if the fund threshold is set at $100 billion, have FSB/IOSCO calculated how many funds would be captured? Similarly, why has this threshold been deemed to be indicative of potential systemic importance if global financial assets are currently measured at around $300 trillion?[102] At no point does the Second Consultative Document articulate an empirical nexus between its materiality thresholds and the global financial system or its stability. This is an important predicate for any action, but FSB/IOSCO have ignored this essential step.

There is also no indication or an acknowledgment on the face of the document that the jurisdiction in which these funds are primarily registered is the United States, nor is there an assessment of existing regulation to which they are already subject. As noted in responses to the First Consultative Document and as discussed above, if these entities are primarily operating in the United States and under a well-regulated regime that is itself actively contemplating additional regulatory measures, why the need for international norms that outspan those measures already in place or in contemplation by national authorities? By way of comparison, the methodology would potentially capture a $30 billion fund (note that $30 billion is a net number – the fund would be $90 billion) with a 3:1 leverage ratio as compared to FSOC's approach to evaluation of domestic entities, who must hit a threshold of $50 billion and 15:1 leverage before being considered for designation at the U.S. domestic level.[103]

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[100] *See Minutes of the Financial Stability Oversight Council*, *supra* note 15, at 3-4; *see also* page 1 *supra*, note 3.

[101] *See* Basel Committee on Banking Supervision, *Global systemically important banks: updated assessment methodology and the higher loss absorbency requirement* (July 2013), at 2, 11.

[102] *See* Financial Stability Board, *Data Underlying the Exhibits in "Global Shadow Banking Monitoring Report 2014*, 2, Exhibit 2-1, LHS (Oct. 30, 2014), *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 $304.5 trillion.).

[103] *See* Financial Stability Oversight Council, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, Federal Register Vol. 77, No. 70 (Apr. 11, 2012), at 21643.

Similarly, the focus on gross notional exposure ("**GNE**") as a metric for measurement is confounding. As set forth in the methodology, the use of derivatives could bring a vastly greater number of funds into scope. This portion of the methodology also ignores netting arrangements that make the effective leverage exposure of the subject entities even less significant. The Second Consultative Document even concedes that *adjusted* GNE "may reflect better the actual risks posed"[104] but then advances *unadjusted* GNE as the measurement for purposes of the methodology. The analysis offered on this point is, at best, superficial. The primary justification for insisting on the use of GNE is a preference for simplicity over accuracy, which does not strike us as a compelling reason to use a metric that is not otherwise fit for a purpose.

GNE ignores not only netting, but also the material differences in the risk profile of a derivatives position or portfolio based on such indicia as asset class, duration, margin/collateral, and clearing status. In other words, the measure posited is crude and lacks any real bearing on the actual risk profile of the positions at issue. If this measure is pursued, funds that employ derivatives will be primary drivers of GNE. While derivatives can be used to employ leverage, oftentimes they are used in an effort to maximize liquidity, to hedge exposures, or to more accurately reflect a specific view (*e.g.*, to gain exposure to a certain part of the Treasury yield curve); this is especially the case in mutual funds, which broadly restrict the use of leverage. As such, the proposed GNE threshold of $400 billion and gross AUM threshold of $200 billion should be viewed in the context of the overall size of the OTC derivatives market, which BIS reported had a gross notional value of $690 trillion (after the first half of 2014).[105] It is anomalous to suggest that positions representing 0.06% of a market would be indicative of a material footprint, but FSB/IOSCO nevertheless aver that the use of GNE is the appropriate (indeed the best) indicator of a fund's market footprint. Finally, the consultation states that "[t]he main advantage of GNE is its simplicity and the fact that it cannot be gamed through risk mitigating techniques" (emphasis added) and that GNE is "less exposed to manipulation."[106] We find it disheartening that FSB/IOSCO would label prudent, well-established, and otherwise regulator-endorsed risk mitigation and hedging techniques as theoretical efforts at gaming a regulatory census initiative.

More broadly, we note that the various indicators for assessing systemic importance posed by investment funds remain largely unchanged from First Consultative Document. The questions that are posed about thresholds in the Second Consultative Document seek to potentially lower, not raise, the threshold level for inclusion. Thus, comments we and others provided to assist FSB/IOSCO appear to have gone unheeded. On this point, the silence

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[104] Second Consultative Document at 39.

[105] A Bank for International Settlements Statistical Release notes that the notional value of all outstanding OTC derivatives was about $690 trillion halfway through 2014. Bank for International Settlements, *OTC derivatives statistics at end-June 2014: Monetary and Economic Development* (Nov. 2014), *available at* http://www.bis.org/publ/otc_hy1411.pdf, at 17, Table 1. Notably, this figure translates to much lower figures when other more sensitive measures such as gross market value or gross credit exposures (via netting) are employed instead.

[106] Second Consultative Document at 39.

with which our feedback was greeted makes it difficult to know if it was simply ignored or discarded as inconvenient for purposes of adopting methodologies regardless of the evidence. In either event, we respectfully request that comments we and others previously provided receive a meaningful response before subsequent steps are taken.[107]

In addition to the methodologically flawed approach proposed for investment funds, the Second Consultative Document now includes asset managers as a distinct category for assessment, unlike the scope of the review proposed in the First Consultative Document. There are various infirmities with the sector-specific methodologies, risk channels, materiality thresholds, and indicators for assessing systemic importance of asset managers. More fundamentally, it is not clear why FSB/IOSCO are now proposing a methodological framework for asset managers when they rejected that option in their first proposal. In fact, the First Consultative Document noted numerous characteristics of asset managers supporting their exclusion,[108] acknowledged the significant limitations on the authority and mandate provided to managers with respect to managed assets,[109] and made significant note of why it chose to focus on funds, not advisers, in language that exonerates both funds and advisers from what should reasonably be the scope of a systemic regulation inquiry:

> In many jurisdictions, other considerations further distinguish the risk profile of a fund from that of a fund manager. For the purposes of this consultation, the methodology is designed to focus on the fund level for the following reasons outlined below:
>
> Economic exposures are created at the fund level as they emanate from the underlying asset portfolio held by the fund. It is therefore the portfolio of assets that creates the respective exposures to the financial system.
>
> A fund is typically organised as a corporation or business trust under national law, and, as such, is a separate legal entity from its manager.

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[107] In light of how little has changed between the drafts, we note for your attention on these topics our comments in our response to the First Consultative Document, *supra* note 6 (*See, e.g.*, "…[W]e propose that the FSB and IOSCO add three new impact factors to the assessment methodology for investment funds: leverage; maturity transformation; and inadequate existing regulation… Indicators related to leverage, interconnectedness, maturity transformation and inadequate existing regulation should be prioritized in assessing the systemic importance of investment funds ." *Id*. at 7). *See* Appendix.

[108] *See* First Consultative Document at 29 ("[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.").

[109] "Whether funds are managed by an operator (usually investment advisers/managers) or are self-managed (i.e. managed by a board), the manager acts as an "agent", responsible for managing the fund's assets on behalf of investors according to its investment objectives, strategy and time horizon." First Consultative Document at 29-30.

> The assets of a fund are separated and distinct from those of the asset manager and as a result, the assets of a fund are not available to claims by general creditors of the asset manager. There are also practical reasons for focusing on funds. Certain data (such as data collected through the SEC/CFTC Form PF/PQF in the US and the Alternative Investment Fund Managers Directive (AIFMD) transparency reporting requirements in the EU) is or will be available to supervisors in a per entity format.[110]

There is no explanation for the "volte face" from this position offered in the Second Consultative Document. Instead, the many reasons acknowledged by the First Consultative Document for not including asset managers in the scope of the exercise seem to have been summarily swept away. Moreover, as described in our response and those of others to the First Consultative Document, the various reasons offered for including funds in the evaluation could as easily themselves be offered for their exclusion.

Bearing in mind that the section of the Second Consultative Document devoted to asset managers represents largely new material and offers a contrasting and unreconciled rationale when compared to the grounds for the exclusion of asset managers set forth in the First Consultative Document, we note again that the planned timing for next steps in the process outlined by FSB/IOSCO suggests the inclusion of asset managers appears to be a foregone conclusion. As noted above, the jurisdiction that would be most affected at the outset is the United States, and the SEC is working on regulations that bear directly on these issues. And as also discussed above, other national bodies, including Canadian and EU authorities, have similar workstreams underway that should be given time to develop more fully in their own contexts and in keeping with the demands of their own federal laws. We respectfully urge that FSB/IOSCO (both its U.S. and other international members) set aside this deeply flawed and wasteful endeavor, permit the SEC and other national authorities to go through their own current rulemaking processes, and (in the meantime) focus on products and activities conducted by financial firms, including asset managers, that may warrant further evaluation for potential global systemic concerns. In this capacity, FSB/IOSCO have a valuable role to play in analyzing regulatory approaches across jurisdictions, facilitating the coordination of policies and disseminating key information.

[110] First Consultative Document at 30.

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We appreciate the opportunity to comment afforded to us by FSB/IOSCO and stand ready to provide any additional information or assistance the FSB or IOSCO might find useful. Should you have any questions, please do not hesitate to contact Tim Cameron at 202-962-7447 or tcameron@sifma.org.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director
Asset Management Group – Head
Securities Industry and Financial Markets Association

APPENDIX

sifma

Invested in America

asset management group

April 4, 2014

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

Re: "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions"

Dear Sirs/Madams:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to comment on the consultative document entitled "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (the "**Consultative Document**") published by the Financial Stability Board (the "**FSB**") and the International Organization of Securities Commissions ("**IOSCO**"). The AMG's members are U.S. asset management firms and our letter will focus on the investment fund assessment methodology.

We appreciate the FSB's and IOSCO's efforts to understand the asset management industry's perspective and appreciate the challenge the FSB and IOSCO face as they attempt to create an assessment methodology without a clear understanding of the additional regulation that will be imposed on non-bank non-insurer ("**NBNI**") global systemically important financial institutions ("**G-SIFIs**"). It is difficult, if not impossible, to design a methodology for identifying companies that may warrant different regulation without knowing what that regulation will be. We also appreciate the FSB's and IOSCO's interest in developing uniform assessment methodologies for all G-SIFI financial entities.

In the Consultative Document, the FSB and IOSCO take the position that, in order to be a G-SIFI, a company must present essentially the same threat to the global financial system, and be subject to a "broadly consistent" G-SIFI assessment framework, regardless of its industry.[2] We generally agree with the FSB and IOSCO that a consistent regulatory approach will lead to regulation that is consistent

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1 The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

2 FSB and IOSCO, Consultative Document, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions," January 8, 2014 (the "Consultative Document"), at 1-2.

with the objective of the "SIFI Framework": "to address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as [too-big-to-fail]."[3] We also recognize that designing a uniform assessment methodology for all potential G-SIFIs is not an easy task.

As the FSB and IOSCO correctly recognize, investment funds have fundamentally different risk profiles than banks and insurers and lack many of the characteristics that were cited to support bank and insurance company G-SIFI designations. The requirements that every G-SIFI must have the same essential risk characteristics and must be subject to consistent identification frameworks creates a tension that is clear in the Consultative Document between the need for a regulatory approach that is consistent across multiple industries and market sectors and a regulatory approach that recognizes that NBNI financial entities, including investment funds, possess unique risk characteristics and operate in ways that are fundamentally different than banks and insurance companies, the types of entities that have already been designated as G-SIFIs.

The collective view of our members is that risk among investment funds, and in the asset management industry and the capital markets more broadly, is not concentrated in individual entities. Rather, it is broadly distributed and migrates across sectors of the industry as markets shift and respond to exogenous factors. The FSB and IOSCO seem to be sensitive to the fact that risk is distributed broadly among investment funds when they ask, in Q6-4, whether the investment fund assessment methodology should focus on whether particular activities or groups of activities, rather than individual investment funds, pose systemic risks. We believe it would be more productive to assess and regulate activities in which investment funds and other capital markets participants engage than it would be to try to identify individual entities that represent concentrated risk to such a degree that they warrant different regulation than their competitors.[4] Therefore, we request that the FSB and IOSCO shift the focus of the investment fund assessment methodology from investment funds to their activities.[5]

The assessment methodology should focus on activities (such as engaging in uncollateralized credit or other unsecured derivatives transactions, high frequency trading, engaging in securities finance transactions and related activities (*e.g.*, cash collateral reinvestment) or employing highly leveraged investment strategies) rather than a few quantifiable characteristics of individual investment funds (such as size and number of jurisdictions in which an investment fund invests). In industry sectors, such as asset management, where risk is broadly distributed and easily transferred among many participants, risk is unlikely to be concentrated in individual entities as we believe it must be in

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[3] FSB, Report of the Financial Stability Board to the G-20, "Progress and Next Steps Towards Ending 'Too-Big-To-Fail' (TBTF)," September 2, 2013, at 7, available at http://www.financialstabilityboard.org/publications/r_130902.pdf (the "SIFI Framework Document") (The "SIFI Framework" seeks to meet its objective "by reducing the probability of SIFIs failing through requirements for additional loss absorbency and increased supervisory intensity, and by reducing the impact of failure through effective resolution regimes...").

[4] Regulators have employed an activities- or product-based approach to regulating many aspects of the asset management industry. For example, since the financial crisis, regulators have proposed a new scheme to regulate money market funds and adopted new rules to regulate derivative trades (*e.g.*, central clearing and minimum margin requirements). Regulators seem to have recognized that they would not have been able to address risks associated with those products and activities effectively by regulating only the largest players in the relevant markets.

[5] If the FSB and IOSCO revise their investment fund assessment methodology to focus on any other class of entity or consolidated group of entities, we think the revised methodology should consider the activities of those entities or consolidated groups of entities. See also our response to Q6-3.

order to justify G-SIFI designation.[6] Furthermore, we believe G-SIFI designation cannot effectively apply to individual investment funds because, even if risk does concentrate at one or more funds at a particular point in time, investors could (and likely would) move their assets away from designated investment funds to other un-designated investment funds pursuing the same or similar strategy. Thus, G-SIFI designation of a few large investment funds is not likely to reduce the overall level of risk associated with the activities of investment funds and other capital markets participants because entities that are not designated will continue to engage in the same activities. Accordingly, we believe that the FSB and IOSCO should modify their assessment methodology to focus on the activities of the participants in the capital markets. Regardless of whether the FSB and IOSCO shift their focus to activities, or remain focused on individual entities, we request that they publish any revised methodology for additional consultation.

We believe that a productive discussion of assessment methodologies should consider the regulatory and potential market implications of designation, and, throughout our letter, we explain our view that G-SIFI designation and selective regulation of a small number of investment funds would likely have perverse and negative regulatory and market consequences. We fundamentally believe that G-SIFI designation of a few large investment funds would not reduce the overall level of risk associated with global asset management activities. ***Throughout this letter, we emphasize our position that the appropriate structural approach for regulation of investment funds (and capital markets participants generally) is to seek to address the risks arising from the activities they conduct and products they offer on an industry-wide basis (regulatory approaches we refer to as "activities-based" and "products-based," respectively, throughout this letter) and is not restricted to a small number of entities.***

Regardless of whether the FSB and IOSCO ultimately develop an activities-based assessment methodology or continue to develop an entity-specific assessment methodology, we believe that the final investment fund assessment methodology must be transparent, clearly defined, objective, based on reliable data and applied consistently across jurisdictions. We believe that the proposed investment fund assessment methodology fails to meet that standard and we identify in this letter aspects of the proposed methodology that we believe should be clarified or revised in order for it to do so.

INTRODUCTION

I. No Specific Mandate Requires G-SIFI Designation of Investment Funds.

The FSB mandate from the G20 does not include an instruction to designate investment funds regardless of whether they possess the necessary mix of characteristics to be designated NBNI G-SIFIs. In their 2011 Cannes Summit Final Declaration, the G20 Leaders asked the FSB in consultation with IOSCO to "prepare methodologies to identify systemically important non-bank financial entities."[7] The G20 Leaders' request, which has been affirmed since 2011, does not express a view regarding whether investment funds possess the necessary mix of characteristics to be considered G-SIFIs and does not instruct the FSB to develop an assessment methodology that necessarily captures them in its definition of G-SIFIs.[8]

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6 *See generally* SIFI Framework Document.

7 G20 Leaders, Cannes Summit Final Declaration, "Building Our Common Future: Renewed Collective Action For The Benefit Of All," November 2011.

8 We note that publications by other regulatory bodies that evaluate whether the asset management industry is a source of systemic risk openly concede that the industry generally does not present systemic risk. For example, the Committee on Economic and Monetary Affairs recently published a motion regarding a

We understand that the FSB and IOSCO decided to develop assessment methodologies for investment funds, finance companies and broker-dealers because of their "relatively large size in the non-bank financial space" and in light of "historical examples of financial distress or failures in these three sectors that had an impact on the global financial system." Although investment funds regularly close with little market impact[9] (as the FSB and IOSCO acknowledge in the Consultative Document[10]), they fail very rarely. An investment fund (like any other financial entity) "fails" when it becomes insolvent or is unable to meet its obligations to its creditors and other counterparties. Unless credit and counterparty relationships cause an investment fund to become insolvent and expose its creditors and counterparties to the risk of loss, even severe declines in the value of an investment fund's assets that may cause the fund to close will be borne by the fund's investors and will not cause the fund to fail.

It is uncontroversial to presume failure and employ a "loss given default" model when considering banks because bank failures have occurred with some frequency historically and as banks have a business model based on leverage, they are typically highly leveraged. Presuming failure is more controversial with respect to companies that fail infrequently but can fail, such as insurance companies. It is unrealistic, however, to presume that a fund with no leverage – that is effectively 100% equity capital with no fixed obligations to investors – could fail for purposes of designing the G-SIFI assessment methodology. We are concerned that the Consultative Document may encourage inappropriate regulation of investment funds because it rests on such a presumption.

We think, particularly in light of the nature of the most prominent historical examples of investment fund "failures" that are cited as having raised systemic impact concerns (the near-failure of Long-Term Capital Management ("**LTCM**") in 1998 and the losses suffered by the Reserve Primary Fund in 2008, both discussed below) and the lack of specificity with respect to investment funds in the G20 mandate, that the FSB and IOSCO should not design a methodology to capture specific, predetermined investment funds and, instead, should design a methodology that applies equally to all NBNI financial entities.[11]

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proposed recovery and resolution framework for non-bank institutions in which it explains "[t]he size and business model of the asset management sector does not typically present systemic risk" and observes that asset segregation and custodian arrangements are a "substantial safeguard" and that "an effective securities law regime could mitigate many of the issues involved in case of failure of a large crossborder asset manager." European Parliament Committee on Economic and Monetary Affairs, Motion for a European parliament resolution on recovery and resolution framework for non-bank institutions (Oct. 22, 2013).

9 For example, a recent Morningstar study found that 41% of U.S. mutual funds operating ten years ago closed before 2014. Tepper, Taylor, "Mutual Funds Gone Down the Drain," in Money Magazine, March 7, 2014, *available at* http://money.cnn.com/2014/03/01/investing/mutual-funds.moneymag/.

10 Consultative Document at 30 ("funds close (and are launched) on a regular basis with negligible or no market impact" and "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the observation period [(from 2000 to 2012)]").

11 In Q6-3, the FSB and IOSCO asked for feedback on their decision to focus their assessment methodology on individual investment funds, rather than families of funds, asset managers or asset managers and their funds on a consolidated basis. Although we encourage the FSB and IOSCO to shift their focus to activities rather than entities, we believe that, of the alternatives mentioned, focusing on individual investment funds is the most appropriate. If the FSB and IOSCO elect to focus on a different "level," we request that they publish another consultative document so that industry participants have an opportunity to comment and offer detailed feedback. See our response to Q6-3 below.

The Consultative Document explains that the FSB's and IOSCO's "overarching objective" in developing the proposed assessment methodologies was to identify NBNI financial entities that met the definition of G-SIFI: an institution "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause *significant disruption to the global financial system and economic activity across jurisdictions.*"[12] The assessment methodologies the FSB develops should be crafted to help regulators determine *whether* NBNI financial entities exist whose distress or disorderly failure could damage the global financial system to the extent described in the G-SIFI definition. The assessment methodology should not be designed, or reverse-engineered, to make sure that certain NBNI financial entities are designated regardless of whether they can fail or whether their failure would cause significant disruption to the global financial system and economic activity across jurisdictions.[13]

During the recent financial crisis, regulators' efforts to prevent damage to the global financial system and to limit the impact of certain financial institution failures prompted government intervention that was costly, increased moral hazard, and ultimately motivated the G-SIFI designation program. We agree with the observation of the Basel Committee on Banking Supervision (the "**Basel Committee**") of the Bank for International Settlements ("**BIS**") that "the financial and economic costs of these interventions and the associated increase in moral hazard mean that additional measures need to be put in place to reduce the likelihood and severity of problems that emanate from the failure of [G-SIFIs]."[14] It follows from the Basel Committee's observation that if no systemic problems of this type are likely to emanate from a class of NBNI financial entities, these additional measures may not be warranted. As we explain in detail below, investment funds do not possess the risk characteristics of G-SIFIs and should not be subject to G-SIFI regulation.

II. Investment Funds Lack Key Characteristics Possessed by Other G-SIFIs.

The FSB has published several reports that consider proposals to reduce moral hazard problems that may be associated with G-SIFIs and eliminate "too big to fail" and has developed methodologies to evaluate potential G-SIFIs. In these reports and methodologies, the FSB has indicated that G-SIFIs have certain characteristics present in combination, including limited ability to absorb losses (often associated with high balance sheet leverage ratios), limited substitutability with other entities, risk of complex and protracted resolution proceedings, and risk of widespread economic harm in the event of

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12 Consultative Document at 2 (emphasis added).

13 We acknowledge that the Consultative Document asserts that "the methodologies' emphasis is on identifying indicators that point to systemic impact on failure, rather than an institution's likelihood of failure" but we think that the FSB, as it composes the methodology for investment funds, must consider the low likelihood of fund failure both in absolute terms and when compared to banking and insurance entities. Consultative Document at 2.

14 BIS, Basel Committee on Banking Supervision, *Global Systemically Important Banks: Updated Assessment Methodology and the High Loss Absorbency Requirement,* 2, *available at* http://www.bis.org/publ/bcbs255.pdf (the "G-SIB Methodology").

distress or failure of the entity, that could compel taxpayer bailouts.[15] The FSB has defined this G-SIFI mix of characteristics in the bank and insurance company contexts.[16]

As we describe below, and as the Consultative Document acknowledges, investment funds lack certain of these characteristics and, as a result, we believe that the FSB and IOSCO are not likely to find investment funds that are G-SIFIs and that G-SIFI designation of any investment fund thus is not warranted. In fact, not only would such a designation fail to mitigate market risk, it is also likely to cause much more damage and market distortion than it could reasonably be expected to prevent.

We appreciate that the Consultative Document acknowledges that certain characteristics of investment funds differentiate them from other types of financial entities. In particular, the Consultative Document notes that investment funds are highly substitutable, that asset managers are agents of their clients, that investors provide investment funds a "shock absorbing" function that differentiates investment funds from banks and that an investment fund's assets are not available to claims by creditors of the investment fund's manager.[17] We are concerned, however, that the Consultative Document does not appear to recognize fully that these characteristics make investment funds highly unlikely to meet the standard necessary for designation and that, even if they did, those same characteristics would make the selection of a small number of large investment funds for different, additional regulation an ineffective method of reducing any risks that may be associated with investment funds' activities. For example, annual G-SIFI determinations would quickly become stale because investment funds are "highly substitutable," the investment fund industry is "highly competitive," and investment activities of one investment fund are easily replicated by other investment funds.[18]

In addition to the characteristics of investment funds the FSB and IOSCO acknowledge, the following characteristics reduce the systemic risk associated with any individual investment fund and cause any risk to distribute throughout the asset management industry and to re-allocate continuously among investment funds of various size and investment strategy:

- Many investment funds, including U.S. mutual funds and other registered funds, use relatively little or no leverage. Without leverage, an investment fund cannot become insolvent or "fail." An unleveraged investment fund consists of 100% equity capital;

- Neither investment funds nor their managers guarantee investment results or backstop losses;

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15 FSB defines SIFIs as "institutions whose distress or disorderly failure, because of their size, complexity *and* systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity." Consultative Document at 1 (emphasis added).

16 *See* G-SIB Methodology; and International Association of Insurance Supervisors, *Global Systemically Important Insurers: Initial Assessment Methodology, available at* http://www.iaisweb.org/view/element_href.cfm?src=1/19151.pdf.

17 Consultative Document at 29-30.

18 Consultative Document at 30. We know that the FSB is employing a comparable annual review process in its G-SIB Methodology to evaluate banks, which are generally not substitutable. (G-SIB Methodology at 11.) We caution the FSB that, although we understand its desire to create similar assessment methodologies for various financial entities, the market for investment funds is too fluid and investment funds are too easily replaced, for annual classification to yield effective, consistent or meaningful regulation.

- Investment funds offer investors important benefits, including risk reducing benefits, such as transparency, scale and diversification;

- From an investor's perspective, investment funds are interchangeable vehicles; and

- Investors control their assets and select investment funds with strategies that meet their investment needs.

Investment funds are very different from risk and regulatory perspectives than banks which generally (i) have very high balance sheet leverage, (ii) engage in maturity transformation,[19] (iii) guarantee deposits and, in some products, interest on deposits, (iv) are not substitutable because they have businesses that are less easily replicated by competitors, and (v) are less interchangeable, relative to investment funds, because they provide essential functions and because high barriers to entry, regulatory restrictions on business activities and the capital intensive nature of the banking business create obstacles for new market entrants. We believe that it is not appropriate to view investment funds through a bank regulatory lens and are concerned that the proposed investment fund assessment methodology takes that approach. Certain impact factors that are relevant to banks do not translate meaningfully to investment funds. Similarly, certain characteristics that can be assumed with respect to banks should not be assumed with respect to investment funds.[20]

In our response to Q2-1, we propose that the FSB and IOSCO add three new impact factors to the assessment methodology for investment funds: leverage; maturity transformation; and inadequate existing regulation. We believe that leverage and interconnectedness, which is included in the proposed assessment methodology, are the most important risk factors for determining whether investment funds present the combination of characteristics required for G-SIFIs. After leverage and interconnectedness, we believe that maturity transformation and inadequate existing regulation are secondary factors, and that size is an impact factor to consider only if these other factors are present. Indicators related to leverage, interconnectedness, maturity transformation and inadequate existing regulation should be prioritized in assessing the systemic importance of investment funds.

We argue that the different characteristics of banks, insurance companies and investment funds make certain impact factors (such as substitutability) that are predictive of risks for banks and insurance companies less predictive of risk for investment funds. We also argue that the different characteristics of banks, insurance companies and investment funds make it inappropriate to assume investment funds possess certain impact factors (specifically, leverage and maturity transformation) that are implied risks for all banks and insurance companies. Evaluation of leverage, maturity transformation and existing regulation will help balance the investment fund assessment methodology with the bank and insurance company assessment methodologies in order to determine whether there are any investment funds that meet the G-SIFI standard in a manner that is consistent with the bank and insurance company methodologies.

III. Effective Regulation of Investment Funds is Activities-Based and Not Selective.

Even if the FSB and IOSCO identify one or more investment funds that may meet the G-SIFI standard, which we think is highly unlikely, the characteristics of investment funds outlined above

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[19] We discuss "maturity transformation" (the difference between the terms of an entity's assets and liabilities) in our response to Q2-1.

[20] See also our response to Q6-2.

and the types and levels of risk that may be posed by their investment activities indicate that ***effective regulation of investment funds would best be achieved through a broad activities-based approach and should not single out individual entities deemed to be G-SIFIs for disparate treatment.***[21] A broad approach that focuses on risks associated with an activity or product on an industry- or market-wide basis would be more effective and efficient than selective designation. There are good examples of the successful application of activities-based regulation in many jurisdictions, including the United States.

Existing regulation of investment funds and the capital markets in the United States is activities- or product-based. These existing regimes already address many market risks associated with the asset management industry and the capital markets generally. These regulatory regimes reflect the characteristics of the industries and markets they regulate. As with many regulatory regimes, they have been reformed substantially since the recent financial crisis and are subject to ongoing reform. The investment fund assessment methodology must, in our view, consider existing regulation.[22]

As the Consultative Document acknowledges, existing regulation of investment funds seeks to ensure compliance with a variety of regulations that create multiple benefits "not only from an investor perspective, but also from a systemic perspective."[23] These regulations protect investors from fraud and create a high degree of transparency in the industry – both for investors and for regulators. Asset managers and investment funds are currently subject to extensive reporting requirements.[24] In addition to investor protection and transparency, existing regulation addresses market risk by monitoring and imposing restrictions and conditions on certain trading activities and investment contracts that could contribute to financial instability.

We believe that the assessment methodology for investment funds should include a careful evaluation of the existing regulation that comprehensively regulates investment funds, their managers, the trading activities in which they engage, and the securities, derivatives and other investment

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21 Governor Daniel K. Tarullo, Speech, "Regulating Systemic Risk," March 31, 2011, *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm ("March 2011 Speech by Governor Tarullo") ("The potential for systemic risk from contagion effects really reflects the potential failure of an asset class or business model more than a firm. . . . potential contagion effects are best contained by directly addressing them, rather than by trying to indirectly address them through designating large numbers of nonbank-affiliated institutions.").

22 In this regard, we note that Section 113(a)(2)(H) of the Dodd-Frank Act requires the United States Financial Stability Oversight Council (the "FSOC") to consider "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies" when considering whether to designate a non-bank financial entity a SIFI and that FSOC included "Existing Regulatory Scrutiny" in the methodology it developed to evaluate whether a nonbank financial company should be subject to heightened regulation. Under Section 113 of the Dodd-Frank Act, the FSOC may determine that a nonbank financial company will be supervised by the Board of Governors of the Federal Reserve System and be subject to enumerated prudential standards if either (i) material financial distress at the nonbank financial company, or (ii) the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company, "could pose a threat to the financial stability of the United States." *See* Final rule and interpretive guidance, FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (April 11, 2012) ("FSOC Final Rules Release").

23 Consultative Document at 29.

24 SIFMA AMG and Investment Adviser Association, "'Asset Management and Financial Stability' Study by the Office of Financial Research", Nov. 1, 2013, available at: http://www.sec.gov/comments/am-1/am1-16.pdf (the "SIFMA AMG OFR Response Letter").

instruments in which they invest. We are concerned that the Consultative Document does not sufficiently consider existing risk regulation, including instances where the regulation was recently proposed or implemented to address systemic risk and threats to financial market stability. As we discuss in more detail in our response to Question 2-2, we believe that investment funds are not appropriate for G-SIFI designation because they are subject to extensive regulation that is more effective than any regime based on selective regulation, such as the G-SIFI Framework, could be.

It is instructive that current reform initiatives also reflect an activities-based approach to regulation. In particular, money market fund reform, tri-party repurchase agreement ("**repo**") reform, swaps regulatory reforms pursuant to Title VII of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**") (including *e.g.*, margin requirements, central clearing and exchange trading), and securities lending regulation (including collateral requirements) all reflect an activities-based regulatory approach and all seek to address market risk. We note that the G20, in its discussions of regulation of "shadow banking" activities (including those of money market funds and the repo market) appears to take an activities-based approach to certain topics that overlap with risks the Consultative Document associates with investment funds.[25] The assessment methodology should consider whether additional regulation of investment fund G-SIFIs would duplicate other regulatory efforts, whether G-SIFI regulation would be less effective than other existing and proposed regulation, and whether sufficient regulatory benefit can be identified to justify the additional costs (which are likely to be significant) that would be associated with G-SIFI designation of investment funds. It is not clear to us, and no data has been presented that suggests, that any of these benefits will materialize as a result of G-SIFI designation of investment funds.

IV. The FSB Should Consider Jurisdictional and Regulatory Implications for Investment Funds of G-SIFI Designation as it Develops its Assessment Methodology.

The Consultative Document does not acknowledge the jurisdictional implications for investment funds of the proposed assessment methodology and we believe that it should. For example, designation as a systemically important financial institution in the United States has a very specific meaning under Title I of the Dodd-Frank Act. As drafted, the assessment methodology seems to qualify only U.S. investment funds for review.

As we propose in Section III of this Introduction, we believe that a threshold question for G-SIFI designation of any investment fund should be whether existing national regulation effectively addresses systemic risks related to the investment fund. For example, we believe that the FSB should consider whether U.S. registered investment companies, which are already subject to a comprehensive regulatory regime that limits their investment activities, and U.S. money market funds, which in addition to that comprehensive regulatory regime are also subject to an even more restrictive regulatory scheme designed to address systemic risk, should be subject to the assessment methodology and potentially subject to duplicative regulation as G-SIFIs. It is not clear to us, and no data has been presented suggesting, that individual NBNI investment funds meet the G-SIFI standard or that selective regulation of investment funds will produce any benefits. We are concerned that G-SIFI designation of these entities would create substantial costs and market distortions that would adversely impact individual investment funds, investors, the financial markets and the economy. Given the potential adverse consequences and

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[25] G20 Leaders, Cannes Summit Final Declaration, "Building Our Common Future: Renewed Collective Action For The Benefit Of All," November 2011 (explaining that "shadow banking activities" include "money markets funds, securitization, securities lending and repo activities"). *See also* Financial Stability Board, Interim Report of the FSB Workstream on Securities Lending and Repos, "Securities Lending and Repos: Market Overview and Financial Stability Issues," April 27, 2012.

likely significant costs of selective regulation, G-SIFI designation and regulation of investment funds requires a rigorous objective analysis of costs, benefits and alternatives. We believe that such an analysis would demonstrate that G-SIFI designation of investment funds would be unjustifiable. Thus, we believe the FSB and IOSCO should conduct that analysis and present the results prior to designating any investment fund a G-SIFI.

We believe that, although it may reduce risks associated with other types of financial institutions, selective regulation will not reduce risks associated with the activities of investment funds. After all, there are multiple ways that investors can achieve the market/risk exposure they want. Investors can invest their own assets directly or can move their assets into an investment fund or account managed by a professional manager who is able to provide their desired exposure. Large, established asset managers can easily terminate underperforming products and launch new investment funds (and do so regularly), competition among investment funds is intense, and investment funds and managers are highly substitutable. We believe that, because investors in registered investment funds (and, to a lesser extent private investment funds) can easily redeem their interests and move their assets to new investment opportunities, and because asset managers can replicate investment strategies easily to meet a new investor's mandate, it is likely that G-SIFI designation will have a negative impact on designated investment funds. This may be the result even if the only immediate consequence of designation is uncertainty about the regulatory impact.[26] It will certainly be the result if G-SIFI designation subjects investment funds to increased costs, investment or redemption limitations, or new operational restrictions.

V. The FSB and IOSCO Should Revise their Investment Fund Assessment Methodology to Clearly Define Terms and Provide the Data it Analyzed to Determine Quantitative Thresholds.

We are concerned that there appears to be no science or empirical analysis underlying the investment fund assessment methodology. Key terms used in the assessment methodology are also undefined. These include: "*failure* of NBNI financial entity" and "*significant disruption* to the *wider financial system* and *economic activity.*" In order to be applied consistently and achieve its objectives, an assessment methodology must include well defined terms based on objective criteria.

For example, what does "failure" of an investment fund mean if it does not mean insolvency? Insolvency is the "failure" that the FSB SIFI Framework seeks to address.[27] Sudden insolvency of an investment fund is rare and generally is associated with investment funds that have fixed obligations that represent a substantial percentage of their assets (such as pension funds) or that use highly leveraged investment strategies. Traditional mutual funds and UCITS funds that use little or no leverage do not possess the insolvency risk that other types of financial institutions possess. Without leverage or substantial fixed obligations, we do not believe that an investment fund can "fail" – its investments may lose all or substantially all of their value and the investment fund may close but it will not become insolvent and investors, who knowingly accept the risk of loss, will bear the investment fund's losses.[28]

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[26] Alternatively, although less likely in our view, G-SIFI designation might cause assets to migrate to investment funds deemed to be G-SIFIs because they are perceived to be safe investment opportunities, thereby inadvertently increasing the concentration of investors' assets, distorting markets and increasing asset concentration in a fund that regulators deem to be a threat to financial stability.

[27] *See* SIFI Framework Document.

[28] *See* Consultative Document at 29.

In addition, the only numerical criteria provided in the Consultative Document are seemingly arbitrary quantitative thresholds, such as total assets and number of jurisdictions in which a fund invests. There is no explanation of how these quantitative thresholds indicate potential systemic risk and no data provided that could support such an assertion. The importance of data is underscored by the fact that the FSB and IOSCO ask commenters to provide quantitative support for any alternative thresholds they may propose. We are struck by the fact that the FSB and IOSCO provide no support for the thresholds it proposes.

In fact, the FSB and IOSCO cite lack of data in support of their assertion that more regulatory discretion is warranted in the design and application of their assessment methodologies. We believe, if one lacks sufficient data to inform a decision, the only reasonable conclusion is that more data is needed – not that the lack of data justifies increased discretion or use of arbitrary criteria. As noted above, given the potential adverse consequences and likely significant costs of selective regulation, it is crucial that any materiality threshold, which will ultimately lead to the identification of particular investment funds for potential designation, be based on sufficiently detailed data that supports the use of the particular threshold. The stakes are far too high for individual funds, investors, the financial markets and the economy for such determinations to be arbitrary and subject to the significant discretion of regulators.

Failure to define systemic risk succinctly and apply clear quantitative thresholds to any measurement of systemic risk could undermine the assessment of regulatory initiatives to mitigate such risk.[29] Lars Peter Hansen, an economist and Nobel laureate, in his study of systemic risk measurement and regulation, observed:

> The need to implement new laws with expanded regulation and oversight puts pressure on public sector research groups to develop quick ways to provide useful measurements of systemic risk. This requires shortcuts, and it also can proliferate superficial answers . . . . Stopping with short term or quick answers can lead to bad policy advice and should be avoided.[30]

In essence, the proposed assessment methodology amounts to an arbitrary size threshold plus regulatory discretion. We do not believe that it represents a valid "methodology" and are concerned that the proposal is an inadequate basis for any regulatory action. It certainly cannot justify regulatory action that is intended to have a substantial impact on individual entities and the global financial system.

We understand the FSB's and IOSCO's view that, because NBNI financial entities are generally subject to activities-based regulation and confidential reporting requirements that vary across jurisdictions, "supervisory judgement likely needs to play a bigger role in methodologies for indentifying NBNI G-SIFIs compared to G-SIB or G-SII methodologies,"[31] but caution that no matter how well-intentioned, the exercise of essentially unlimited regulatory discretion will not result in consistent, objective identification of systemically important NBNI financial entities or effective mitigation of systemic risk and is likely to do more harm than good.

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

30 Hansen, *supra* note 29 at 2.

31 Consultative Document at 6.

If the FSB and IOSCO develop entity-specific assessment methodologies for NBNI financial entities, the methodologies should be objective, rigorous, consistent and transparent. If the FSB and IOSCO clearly communicate to participants in capital markets their concerns about the activities and products that create systemic risk and the consequences of engaging in such activities or developing such products, market participants will be able to evaluate the costs and benefits of doing so and to make informed choices about their businesses. We believe that many market participants would seek to manage the extent of their activities and products deemed to create systemic risk, especially if they knew that doing so would impact the amount of additional regulation and costs that they face. This result would do far more to reduce risk in the system than designating a few companies for disparate regulation for reasons that are unclear or highly discretionary.

Finally, the ambiguity in the methodology and the absence of data impede the public's ability to comment in a meaningful way and prevent the proposal from having the beneficial effects that a transparent, objective, methodology would have. All participants in the asset management industry are stakeholders in this discussion and have an interest in its outcome. It is incumbent upon the regulators to proceed transparently and provide sufficient detail (including data) to enable stakeholders to understand and comment on their proposal. Those comments, and the transparent, objective, consistent methodology we believe they will encourage, will help the regulators achieve the outcome that we all desire – an efficient, resilient financial system that meets the needs of its participants and supports economic growth.

RESPONSES TO CONSULTATIVE QUESTIONS

1. Systemic risk and transmission mechanisms

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?

We believe that the transmission channels identified in Section 1 of the Consultative Document are relevant to transmitting financial distress of certain NBNI financial entities, but that the channels are not equally relevant to all NBNI financial entities. In particular, mitigating factors make them less relevant to investment funds. We have no additional channels to recommend.

The first channel identified in the Consultative Document, "Exposures / Counterparty," refers to the risks that may occur "when distress or failure of an investment fund leads to losses or other impairment incurred by banks, brokers and other counterparties (not including equity investors)."[32] The FSB explains that risks may occur if an investment fund that has received debt financing through counterparties or direct trading linkages fails and suffers extensive losses that, in turn, destabilize its creditors.[33] We believe that the Exposures / Counterparty channel will be much less relevant for many investment funds than it is for other types of financial entities. Investment funds that use little or no leverage, such as U.S. mutual funds and other registered funds, will transmit relatively little risk to creditors and counterparties (if any) compared to highly leveraged private funds. We also note that existing regulation applicable to registered and private investment funds, including rules implemented since 2010 under the Dodd-Frank Act, seeks to address counterparty risk. In particular, new margin and collateral requirements for certain derivative instruments (discussed more fully in our response to Q2-2 below) seek to reduce counterparty risk relevant to investment funds.

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[32] Consultative Document at 29.

[33] Consultative Document at 29.

The second channel, "Asset liquidation / Market," refers to the indirect impact on other market participants, including other investment funds and entities with similar holdings, that could be caused by the sudden liquidation of an investment fund's assets. The FSB explains its concern that "individual funds may be significant investors and/or providers of liquidity in some asset classes. In times of stress (when there might be an increase in correlations between asset classes), forced liquidation of positions by investment funds could cause temporary distortions in market liquidity and/or prices that cause indirect distress to other market participants."[34] We note that the risk of forced asset liquidation is relatively low for investment funds compared to other types of financial entities. The concepts of "forced liquidation" and "market distortion" are not relevant to investment funds that mark-to-market the assets in their portfolio on a daily basis and that are not leveraged. The Consultative Document notes that "the potential for forced liquidations and market distortions may be amplified by the use of leverage" but the assessment methodology should also recognize that investment funds that are not leveraged and mark to market daily have no risk of insolvency and forced liquidation because they have no credit exposure and provide no first-mover advantage.[35] We are aware of very large outflows from registered mutual funds that have occurred without causing any systemic effect in capital markets and without causing these funds to fail.

In Section 6, the Consultative Document correctly notes that investors in investment funds will absorb losses that result from the decline in the value of a fund's portfolio of assets and contrasts investment fund investors' "shock absorber" function with the requirement that banks set aside capital to protect depositors who do not absorb losses associated with a bank's portfolio of loans and whose assets are insured against loss.[36] The FSB and IOSCO also highlight that a comprehensive disclosure regime seeks to assure that investors in investment funds are aware that their investments may lose value and that investment results are not insured or otherwise guaranteed.[37] The Consultative Document does not, however, acknowledge that, even though investors accept investment risk, stringent liquidity requirements play a role with respect to registered mutual funds that is analogous to bank capital requirements.

The liquidity requirements applicable to registered mutual funds seek to protect investors and seek to assure that investors are able to redeem shares on each business day and that even significant redemption requests will not impair investors' ability to redeem their investments. In the United States, mutual funds, including exchange traded funds ("**ETFs**"), are required to maintain at least 85% of their portfolios in liquid securities[38] and money market funds must comply with even more stringent liquidity requirements.[39] The risk of forced liquidation is also low for other types of investment funds as a result of

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34 Consultative Document at 29.

35 *See also* Tarullo, Speech, *supra* note 21.

36 Consultative Document at 29-30.

37 Consultative Document at 29.

38 The SEC has taken the position historically that a registered open end fund must limit its holdings of illiquid securities (that is, those that cannot be sold within seven days at current value) to no more than 15% of the fund's assets. *See* Revisions of Guidelines to Form N-1A, 57 Fed. Reg. 9828 (Mar. 20, 1992). In addition, mutual funds are required to pay out redemptions within seven days.

39 A money market fund must limit its holdings of illiquid securities (that is, those that cannot be sold within seven days at current value) to no more than 5% of the fund's assets. Rule 2a-7(c)(5) under the Investment Company Act of 1940.

certain characteristics generally applicable to investment funds. For example, investment funds are generally able to distribute their assets in kind to meet investors redemption requests, an option that helps minimize the market impact of fund dissolution. Finally, we note that for every seller of a distressed asset at a loss, there is a buyer with the potential to realize a gain, perhaps significant, over time once the value of such asset recovers.

Although we recognize the significance of the final transmission channel, "Critical function or service / Substitutability," to other types of financial entities, we agree with the FSB's and IOSCO's determination that it is not applicable to investment funds because they are highly substitutable.[40] We discuss in our responses to Q3-3 and Q6-1 our concern that the proposed assessment methodology does not appear to appreciate fully the significance of the high degree of substitutability of investment funds. For example, in order for an entity to be a G-SIFI, its distress or disorderly failure has to "cause significant disruption to the global financial system and economic activity across jurisdictions." This type of significant disruption can only occur where the entity in question is highly interconnected (*e.g.*, via significant contracts with financial institution counterparties and creditors, generally associated with a high level of leverage) and not substitutable. As we discuss throughout this letter, certain characteristics of investment funds and asset managers make them highly substitutable. For example, third-party custody arrangements facilitate the substitution of asset managers. In the case of separate accounts, clients may easily change asset managers in the event of unsatisfactory performance or in order to pursue different investment strategies by removing trading discretion from one manager and granting it to another. In those cases, assets may never move from an existing custody bank and there may be no immediate sales of assets in the market.

2. High-level framework for identifying NBNI G-SIFIs

Q2-1. 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?

We appreciate the difficulty the FSB and IOSCO face as they attempt to design a high-level framework for identifying NBNI G-SIFIs that (i) will relate to a wide range of different types of NBNI financial entities and (ii) is "broadly consistent" with the impact factors used to evaluate banks and insurance companies.[41] The Consultative Document notes that the very different nature of risk and regulation among sectors of the financial markets complicate any attempt to design a single, uniform assessment methodology for all financial entities. As we describe in Section II of the Introduction to this letter, we believe that it is inappropriate to assume that investment funds possess certain impact factors (specifically, leverage and maturity transformation) that are implied risks for all banks and insurance companies and that such characteristics, which are taken for a given with respect to banks and insurance companies, should be considered specifically with respect to investment funds. We believe that uncertainty about how to identify specific investment funds that may pose higher risk than other investment funds reflects the fact that ***G-SIFI designation may not be a useful tool in the asset***

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40 Consultative Document at 29 and 30.

41 Consultative Document at 2 and 5.

management industry where effective regulation is activities-based, and not necessarily concentrated in or linked over time to specific entities.[42]

We do not suggest that any impact factor in the proposed assessment methodology be removed, but believe that "size" should not be a high priority impact factor or used as a materiality threshold and believe that three new impact factors should be added to the methodology. We believe that "size" is not indicative of systemic risk for an investment fund; and the assertion that "the importance of a single entity for the stability of the financial system generally increases with the scale of financial activity that the entity undertakes"[43] is not supportable in the context of investment funds. As a stand-alone materiality threshold, size will capture too many large but not systemically important investment funds and may miss highly leveraged but relatively small investment funds that could be sources of systemic risk. We believe that size is a counterintuitive impact factor because small investment funds that hold concentrated portfolios can create higher risk, while large, diversified investment funds are likely to be less risky. We propose that a size impact factor, if considered, should not be the assessment methodology's primary impact factor or stand-alone materiality threshold.

Interconnectedness (an impact factor in the proposed assessment methodology) and three new impact factors (leverage, maturity transformation and inadequate existing regulation) should take priority over size in the assessment methodology.[44] We believe that interconnectedness and leverage are the most important impact factors for determining whether investment funds present the combination of characteristics required for G-SIFIs. After interconnectedness and leverage, maturity transformation and inadequate existing regulation are secondary impact factors, and size should be considered only if these impact factors are present. We note that the U.S. Financial Stability Oversight Council (the "**FSOC**") included leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny among the evaluation factors in its systemic risk evaluation framework.[45] As we discuss in our response to Q3-2, the materiality threshold for investment funds should consider size only if leverage and inadequate existing regulation are present.

Interconnectedness

We strongly agree with the FSB's and IOSCO's decision to include interconnectedness among the impact factors relevant to investment funds. While leverage, which we believe should be an impact factor (rather than an indicator under interconnectedness[46]), helps determine an investment fund's susceptibility to failure, interconnectedness measures whether an investment fund's failure could harm other financial entities – the critical element of any systemic risk analysis. In this regard, we think that the focus on "total net counterparty credit exposure," defined as the "total sum of all residual uncovered

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42 FSB and IOSCO acknowledge that NBNI financial entities "are primarily and traditionally regulated from a conduct of business (or investor/consumer protection) perspective." Consultative Document at 6. As we demonstrate throughout this letter, we believe that this conduct of business or activities-based regulatory approach reflects the character of the asset management industry.

43 Consultative Document at 5.

44 Although we do not discuss them in our response letter, we believe that the "complexity" and "global activity" impact factors in the proposed assessment methodology are appropriate, although lower in priority than leverage, interconnectedness, maturity transformation and inadequate existing regulation.

45 FSOC Final Rules Release.

46 See our response to Q6-5.

exposures that the fund positions represent for its counterparties, after considering valid netting agreements and collateral/margin posted by the fund to its counterparties," appropriately focuses on uncollateralized positions as potential avenues under which an investment fund's creditors and contract counterparties could be exposed to harm if the investment fund defaults. The total number of an investment fund's counterparties, and whether such counterparties are G-SIFIs themselves, is less important from a systemic risk perspective than the extent to which positions are collateralized. The evaluation should focus on the potential exposure of an investment fund's counterparties to the investment fund's credit risk. We also note that an evaluation of an investment fund's interconnectedness should focus on an investment fund's relationships with its creditors and contract counterparties, and not with issuers of debt securities in which the investment fund may invest.

U.S. regulators considered interconnectedness and systemic risk in defining "major swap participant" and "major security-based swap participant" (collectively, "**MSPs**"), new categories of registrants created in Title VII of the Dodd-Frank Act, and their guidance strikes us as relevant and helpful to the FSB and IOSCO as they design NBNI G-SIFI assessment methodologies. Pursuant to a Dodd-Frank Act mandate to reduce risk and regulate participants in swap markets, the Securities and Exchange Commission (the "**SEC**") and the Commodity Futures Trading Commission (the "**CFTC**") designed standards to evaluate whether an entity's "substantial position" in swaps or security-based swaps pose market risks or whether an entity's "outstanding swaps or security-based swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the U.S. banking system or financial markets."[47] Entities that fall within the definition of "major swap participants" or "major security-based swap participants," are subject to registration requirements and heightened regulation. The definitions focus on uncollateralized counterparty exposures and default-related credit risks, consider whether swap contracts are cleared or subject to daily mark-to-market margining requirements, and account for netting arrangements that may reduce a counterparty's exposure.[48] We suggest that the FSB and IOSCO take a similar approach as the MSP tests in measuring interconnectedness.

Leverage

We believe that leverage should be an impact factor used to evaluate whether an investment fund is a G-SIFI. A high level of leverage can create risk of failure of an investment fund (as it can with any company) and will increase the risk of forced liquidation and insolvency that otherwise might not exist with respect to an unleveraged investment fund. National regulators recognize that leverage is a primary source of risk in the asset management industry and certain activities-based regulation already helps address the risks associated with high levels of leverage. For example, U.S. registered investment companies are subject to strict leverage limits[49] and U.S. investment funds are

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47 SEC and CFTC, Joint Final Rule, "Further Definition of 'Swap Dealer,' 'Security-Based Swap Dealer,' 'Major Swap Participant,' 'Major Security-Based Swap Participant' and 'Eligible Contract Participant,'" 77 Fed. Reg. 30,596 (May 23, 2012) (the "MSP Release").

48 MSP Release at 30,661-30,697.

49 Under Section 18 of the ICA, registered funds generally may not incur indebtedness or otherwise issue "senior securities" without having an asset coverage of at least 300 percent (including the amount borrowed). Registered closed-end funds also must comply with this asset coverage requirement with regard to issuances of debt securities and must have at least 200 percent asset coverage in the event of issuances of preferred stock (including the involuntary liquidation preference of such preferred stock). In addition, the SEC and its staff generally view any transaction that exposes a registered fund to a risk of loss greater than the amount of the investment as raising senior security concerns. *See* SEC, General Statement of Policy, "Securities Trading Practices of Registered Investment Companies," 44 Fed. Reg. 25,128 (April

subject to regulation, including new rules adopted under Title VII of the Dodd-Frank Act (*e.g.*, margin and collateral requirements), that limit the amount of leverage embedded in derivative instruments that they can incur.

The Consultative Document explains that the FSB sought to select impact factors for NBNI financial entities that are broadly consistent with the impact factors used to identify systemically important banks and insurance companies.[50] The impact factors set out in the Consultative Document, which do not expressly include leverage, reflect that approach. We believe that the impact factors for banks and insurance companies do not include leverage because those companies are inherently highly leveraged and exposed to liquidity risk and, therefore, leverage is an implied impact factor with respect to those companies. In the case of investment funds, leverage may not be present and should not be assumed. Consequently, we believe that it should be an explicit impact factor for investment funds.

Maturity Transformation

We believe that maturity transformation should be an additional impact factor. Maturity transformation (*i.e.*, the difference between the maturities of a company's assets and liabilities) can be a source of risk for investment funds (and other types of financial entities) because, like high levels of leverage, maturity transformation exposes investment funds to liquidity risk and risk of distress and possible failure. The strict liquidity requirements applicable to U.S. registered investment funds limit maturity transformation risk for those funds.

Banks, as financial intermediaries, engage in maturity transformation when they accept demand deposits and make longer-term loans. Bank are subject to risk associated with the different terms of their deposits and loans because they are obligated to return the full amount of their customers' deposits at any time on demand. Unlike an investment fund's investors, depositors will not absorb the bank's balance sheet losses. Investment funds may be exposed to maturity transformation risk if they are leveraged, hold illiquid investments or engage in a large amount of certain types of transactions. Investment funds, however, generally seek to manage redemption risk by either maintaining a high percentage of liquid assets or employing other liquidity management tools (including redemption gates, redemptions in kind and the other tools mentioned in the Consultative Document[51]) depending on the type of investment fund. They are also not exposed to the same level of maturity transformation risk as banks because, as the FSB and IOSCO acknowledge, investment fund investors bear the risk of loss of their investments.

Investment funds that are subject to maturity transformation risk, such as investment funds that engage in a significant amount of securities lending and repo transactions, engage in activities that differentiate them from other investment funds. We believe that investment funds that are subject to maturity transformation risk are best regulated on an activities- or product-basis, and not by selective G-SIFI designation. We note that current regulation, such as liquidity requirements applicable to registered

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27, 1979). Without resolving whether certain derivatives transactions that create leverage are senior securities, the SEC staff generally will not treat leveraged transactions as senior securities provided that a fund enters into a fully offsetting transaction (*e.g.*, owning a security that the fund has sold short) or by segregating or earmarking on its custodian's books liquid assets equal in value to the fund's potential exposure from the leveraged transaction.

50 Consultative Document at 2.

51 Consultative Document at 30.

investment funds, addresses and proposed regulation, such as money market fund reform, seeks to address, risks associated with these activities.

Inadequate Existing Regulation

We believe that the extent to which investment funds are currently regulated should be an additional impact factor because existing regulation may effectively address and monitor the types of risk exposure that G-SIFI designation would seek to address and monitor, and new regulation should be avoided if it would be duplicative and/or ineffective. For example, registered investment companies in the United States are subject to extensive regulation, including leverage limits and liquidity requirements among other rules, that prevents them from acquiring the characteristics necessary to meet the G-SIFI standard. We provide more detail about the impact of existing regulation in our response to Q2-2.

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?

The assessment methodology does not focus on certain significant market participants that engage in potentially high risk investment activities on their own behalf and may hold large investment portfolios on their own balance sheets. Entities that invest directly without engaging an investment adviser to manage their assets, including some real estate investment trusts, sovereign wealth funds, family offices, central banks, and highly leveraged private entities, may be sources of potential systemic risk and may be subject to a lower level of regulation than "investment funds" as defined in the Consultative Document. We do not understand why these entities would not be captured by the proposed assessment methodology while investment funds would be.

We believe that the FSB and IOSCO should focus their efforts to identify NBNI G-SIFIs on NBNI financial entities that are likely to meet the G-SIFI standard and could be regulated effectively by entity-specific designation. U.S. investment funds and asset managers are subject to extensive regulation that is generally activities-based and prevents any of them from possessing certain characteristics that are necessary for entities to be considered G-SIFIs. Moreover, as discussed above, selective regulation also would not effectively reduce risk among investment funds because risk could easily migrate to undesignated investment funds. The high degree of substitutability of investment funds and the ease with which asset managers can enter new markets and deploy new investment funds that pursue new strategies makes investment funds inappropriate for G-SIFI designation.

We believe that existing and proposed regulation effectively and comprehensively regulates U.S. investment funds. We summarize certain current regulation applicable to U.S. investment funds, asset managers and market activities in the following subsections of our response to Q2-2.

Regulation of U.S. Investment Funds

U.S. investment funds that are registered with the SEC are subject to extensive regulation under the Investment Company Act of 1940 (the "**ICA**") and related rules. Under the ICA, registered funds must comply with asset safekeeping and custody requirements, recordkeeping requirements, leverage restrictions, restrictions on transactions with affiliated persons, conflicts of interest rules, diversification and liquidity requirements, among other things. Investment fund managers are subject to inspection and examination by the SEC for compliance with its rules. U.S. investment funds are also subject to reporting and disclosure requirements under the ICA and the Securities Exchange Act of 1934.

Additionally, the Dodd-Frank Act created MSPs, a new category of registrant which may include investment funds, to address concerns that certain nondealer market participants can create a high level of risk that could significantly impact the U.S. financial markets if left unregulated.[52] MSPs are additions to the category of dealers which captures traditional entities that make a market in swaps and security-based swaps. Congress tasked the CFTC and the SEC with further defining key concepts in the definition of MSP used in the Dodd-Frank Act. The final rule release indicates that the CFTC and SEC determined that it would not be appropriate to regulate investment advisers as MSPs since no risk associated with swap positions is attributable to them. Instead, the CFTC and SEC clarified that the MSP test should be performed on a fund-by-fund basis.[53] These rules would apply to investment funds that create excessive amounts of swap exposure by requiring them to post additional margin and hold additional capital, as well as to make additional reporting and take other measures to mitigate risk.

Regulation of U.S. Asset Managers

Asset managers are subject to regulation by multiple regulators under multiple regimes worldwide. In the United States, under the Investment Advisers Act of 1940 (the "**Advisers Act**") and related rules, a large majority of asset managers must register with the SEC and comply with an extensive set of conflict of interest, record keeping, disclosure, custody, reporting and other requirements. Registered investment advisers are subject to inspection and examination by the SEC. Registered investment advisers are required to file a report on Form ADV, which is made public, that describes their business activities, total assets under management, ownership, disciplinary history, and extensive private fund information, among other things. Investment advisers to private funds with at least $150 million in assets under management must file Form PF with the SEC to provide the regulators detailed information about their geographic, market, credit and liquidity risk exposures. Asset managers that direct investments in listed equities and exchange-traded options over a certain threshold must register with the SEC as "large traders." Broker-dealers, in turn, must record trading information and report such information to the SEC upon request.

The CFTC also regulates asset managers that offer investment advice with respect to commodity interests such as futures, commodity options and swaps and/or sponsor collective investment vehicles that trade such instruments. Asset managers that direct investments in futures and options, and in certain swaps, above certain thresholds are subject to the CFTC's large trader reporting regimes and must report the positions that they take on behalf of their clients promptly upon demand. In addition, exchanges maintain position limits and accountability levels that are designed to cap the size of the trading positions that asset managers and accounts deemed to be within their control can take in certain commodity futures contracts, on an aggregate basis, in order to curb any single trader's ability to

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52 *See* MSP Release.

53 MSP Release at 30,689-30,690. The final rules provide numeric tests regarding whether an investment fund or other entity exceeds certain thresholds in its amount of swap exposure to determine whether these entities should be regulated as MSPs by the CFTC and/or the SEC. In the final rules defining MSP, the CFTC and the SEC stated that they chose certain thresholds to capture an entity before it reaches a level of risk that could be deemed systemic. MSP Release at 30,666. We believe that these thresholds may be instructive for the FSB and IOSCO with respect to assessing NBNI entities.

influence or control a market.[54] The CFTC is also in the process of proposing new rules relating to position limits for other commodity futures and swaps contracts.[55]

The CFTC rules also impose reporting, recordkeeping and disclosure requirements on certain asset managers and certain affiliated entities that fall within the commodity pool operator ("**CPO**") or commodity trading advisor ("**CTA**") registration requirements. A substantial number of operators of both private funds and registered funds, including asset managers, are registered as CPOs and/or CTAs. Significant periodic reporting requirements are imposed on registered CPOs and CTAs in Form CPO-PQR and Form CTA-PR, respectively, which require registered CPOs and CTAs to provide detailed schedules of their investments and other information to the CFTC. The reporting obligations for CTA registrants require disclosure relating to separate accounts managed by registered CTAs.

Regulation of Market Activity in the United States

The CFTC and SEC have proposed and/or implemented a number of rules pursuant to Title VII that are transforming certain aspects of trading in derivatives. The Title VII regulations are designed to address risks, including systemic risks associated with excessive leverage at certain financial institutions and the lack of transparency in derivatives trading, that played a role in the financial crisis. The new initiatives include:

(a) mandatory clearing and execution on new trading platforms of certain swaps designed to increase transparency and limit counterparty risk in standardized contracts,[56]

(b) margin requirements for both uncleared and cleared swaps designed to limit counterparty risk in derivative contracts and limit the amount of leverage created by these instruments,[57]

(c) capital requirements for swap dealers and MSPs to reduce the likelihood of insolvency,[58] and

(d) new data reporting and recordkeeping requirements to give the CFTC and SEC greater transparency into trading in derivatives and improve their ability to monitor trading activity.[59]

Each of these measures is intended to reduce leverage, increase transparency, aid in monitoring trading activity, and mitigate risk in derivatives transactions and each measure addresses a

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54 *See* Section 737 of the Dodd-Frank Act.

55 *See* Section 737 of the Dodd-Frank Act; Commodity Futures Trading Commission, Proposed Rule, "Position Limits for Derivatives," 78 Fed. Reg. 75680 (Dec. 12, 2013); and Commodity Futures Trading Commission, Proposed Rule. "Aggregation of Positions," 78 Fed. Reg. 68946 (Nov. 15. 2013).

56 *See* Sections 723 and 763(a) and (c) of the Dodd-Frank Act.

57 *See* Sections 731 and 764(a) of the Dodd-Frank Act.

58 *See* Sections 731 and 764(a) of the Dodd-Frank Act.

59 *See* Sections 728, 763(i) and 766 of the Dodd-Frank Act.

potential source of risk to the financial markets and its participants. These regulations do not apply only to a handful of entities identified once each year as the NBNI G-SIFI requirements would; rather, they apply to all entities that engage in certain activities. These new regulations are designed to help protect the financial system, including investment funds and accounts and their investors.

In addition to CFTC and SEC derivatives regulation, other efforts are underway to mitigate the market risks that arose during the financial crisis. For example, the Treasury Market Practices Group ("**TMPG**") of the Federal Reserve Bank of New York ("**FRBNY**") recently implemented revised settlement guidelines to support more timely trade confirmations in the tri-party repo market.[60] Further reforms required by FRBNY will mitigate intraday credit risks, enhance transparency and mitigate risks related to defaulted securities.[61] Similar to the margin requirements for swaps, TMPG also has required margining for forward-settling mortgage-backed securities, which will mitigate risk inherent in these instruments and limit any leveraging effect of investments in securities that settle at a later date. Recently, the Financial Industry Regulatory Authority ("**FINRA**") also proposed changes to its rules, formalizing these requirements for FINRA member broker-dealers and the counterparties they trade with, which include investment funds and accounts.[62]

3. Operational Framework for NBNI G-SIFI Methodologies

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 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).

We do not believe that size on a standalone basis is an appropriate materiality threshold for, or a meaningful indicator of risk related to, investment funds. Investment funds' risk is related to portfolio composition and investment strategy. It may concentrate at relatively small investment funds with highly leveraged portfolios or highly concentrated investment strategies or be dispersed across a large number of small unaffiliated firms that pursue the same strategy or engage in the same activities. ***We believe that the materiality threshold for investment funds should consider size only if other risk factors, including leverage and inadequate existing regulation, are present.***

We are concerned that the proposed materiality threshold for investment funds (USD 100 billion in net assets under management ("**AUM**"), or, in the case of hedge funds, USD 400-600 billion in Gross Notional Exposure ("**GNE**")) seems to qualify only U.S. investment funds for designation. The threshold appears to be arbitrary and the FSB and IOSCO offer no evidence that it is indicative of potential systemic risk in investment funds. As we discuss in Section IV of the Introduction to this letter, the Consultative Document should acknowledge the jurisdictional implications of the proposed assessment methodology for investment funds.

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60 *See* Treasury Markets Practice Group, "Best Practices for Treasury, Agency Debt, and Agency Mortgage-Backed Securities Markets," Revised May 2013, *available at* www.newyorkfed.org/tmpg.

61 TMPG, "TMPG Announces Market Practice Recommendations to Support More Timely Trade Confirmation in the Tri-Party Repo Market" (May 23, 2013).

62 *See* FINRA, *FINRA Requests Comment on Proposed Amendments to FINRA Rule 4210 for Transactions in the TBA Market, FINRA Regulatory Notice 14-02*, Jan. 2014, available at http://www.finra.org/web/groups/industry/@ip/@reg/@notice/documents/notices/p439087.pdf.

We do not believe that GNE is a good measure of hedge fund risk. Leverage risk is related to the character of a hedge fund's underlying assets and the type of leverage employed by the fund. The definition of GNE does not account for the fact that all leverage does not create the same level or type of risk. For example, interest rate swaps will create a high level of GNE but do not create a high level of risk. We believe that an appropriate measurement of exposure would be risk-weighted. Finally, the assessment methodology should clarify how hedged investments would be counted towards GNE. Because derivatives generally settle on a net basis, including the notional value of derivatives in GNE could limit the utility of the metric and is likely to obscure the actual risk level of the fund.

Leverage should be one element of the materiality threshold for investment funds. We think that the quantitative thresholds the FSOC will apply to evaluate nonbank financial companies under Section 113 of the Dodd-Frank Act in the first stage ("**Stage 1**") of its three-stage evaluation process are a valuable model for the FSB's NBNI assessment methodologies. Like the materiality threshold in the FSB assessment methodologies, the FSOC's Stage 1 factors are an initial filter of financial entities eligible for designation. Stage 1 of the FSOC process "is designed to narrow the universe of nonbank financial companies to a smaller set [of entities] . . . by applying uniform quantitative thresholds that are broadly applicable across the financial sector to a large group of nonbank financial companies."[63] Any entity with $50 billion or more in total consolidated assets and any one of five different quantitative indicators, including a 15:1 or higher leverage ratio, will be evaluated in the second stage of the FSOC analysis.[64] We think a 15:1 leverage ratio is an appropriate materiality threshold and that the FSB should design a materiality threshold that, like the FSOC Stage 1 factors, acknowledges that size, unless present in combination with other risk factors, should not qualify an investment fund for G-SIFI designation.

The FSB and IOSCO should also adopt a higher size threshold for their investment fund assessment methodology than the FSOC has adopted in its Stage 1 non-bank financial entity evaluation process under Section 113. The Basel Committee has determined a leverage threshold applicable to banks that are systemically important and we do not think that investment funds should be held to a different standard.[65] The FSB's bank assessment methodology uses a €200 billion materiality threshold.[66] We are not aware of any evidence that suggests that investment funds are a greater source of systemic risk than banks and do not think that investment funds should be held to a lower materiality threshold than banks. Evidence that banks may be a significantly larger source of systemic risk than investment funds suggests to us that the investment fund materiality threshold should be significantly higher than the threshold applicable to banks. Finally, the assessment methodology must include existing regulation in the materiality threshold for investment funds. We think that consideration of existing regulation early in the G-SIFI evaluation process will help the FSB and IOSCO focus their concern on investment funds, if any exist, that may be sources of unmitigated and unregulated systemic risk. ***We believe that the FSB and IOSCO should adopt a materiality threshold composed of (i) a 15:1 or higher leverage ratio, (ii) inadequate existing regulation, and (iii), only if elements (i) and (ii) are present, assets above €200 billion.***

Q3-3. Are there any practical difficulties in applying the materiality thresholds?

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63 FSOC Final Rules Release at 21,642.

64 FSOC Final Rules Release at 21,643.

65 *See* G-SIB Methodology at 11.

66 The G-SIB Methodology requires "all banks with a leverage ratio exposure measure exceeding €200 billion . . . to ensure that the 12 indicators used in the assessment methodology are made publicly available" and to be subject to annual G-SIB review and, potentially, classification. G-SIB Methodology at 11.

Because assets are highly mobile and asset managers and investment funds are easily substitutable, the investment funds that are in the NBNI G-SIFI assessment pool at any point in time could change quickly if size is the initial materiality threshold. In fact, we believe the initial assessment pool would be likely to change quickly if investors were to perceive classification as a NBNI G-SIFI as a negative status because investors might withdraw from investment funds that have AUM or GNE above the threshold.

The Consultative Document proposes creating a "buffer" below the materiality threshold to assure that investment funds that attempt to avoid designation are captured by the methodology. It proposes that national authorities would have discretion to add investment funds in their jurisdiction that are below the materiality threshold.[67] We are concerned that increasing regulators' discretion will lead to non-transparent and inconsistent regulation and that asset mobility and manager substitution could undermine any regulatory regime that attempts to regulate specific investment funds based on their AUM or GNE. Moreover, identifying investment funds annually is not likely to be a sufficiently flexible mechanism due to the easy mobility of investment funds' assets.

Q3-5. Do you think that it would be beneficial to set additional materiality thresholds based on "global activity"? If so, please explain the possible indicator and the level on which materiality thresholds should be set (with reasons for selecting such indicator, the level and any practical challenges).

We do not believe that it would be beneficial to set additional materiality thresholds based on "global activity" because: (i) if a manager sponsors investment funds in multiple jurisdictions, each investment fund will be organized separately in those jurisdictions and losses in one investment fund will not necessarily have any impact on the performance of an investment fund in another jurisdiction; (ii) the global investment activities of a single investment fund do not complicate the resolution of the investment fund because, unlike banks and other types of financial entities, investment funds do not branch; and (iii) global diversification could be a risk mitigating factor for investment funds and should not necessarily be viewed as a source of additional risk.

6. Sector-Specific Methodologies: Investment Funds

Q6-1. In your view, does the proposed definition of investment funds provide a practical basis for applying the specific methodology (i.e. indicators) to assess the systemic importance of NBNI financial entities that fall under the definition?

The definition captures many types of funds and investment products that are subject to different levels and types of regulation and that attract different types of investors with different risk appetites. For example, the definition captures both money market funds and hedge funds. We believe that the definition is so expansive that it is difficult to believe that a coherent set of regulations could be developed to apply if any individual investment funds were captured by the assessment methodology. We understand that the methodology may call on national authorities to identify and assess the investment funds in their jurisdiction, and that it may give national authorities discretion to include investment funds that are not captured by the assessment methodology. It is critical that the assessment methodology be applied consistently and that data be collected and analyzed in a consistent manner across jurisdictions. In particular, we believe that it will be important to standardize the definition of "hedge fund" to avoid regulatory arbitrage.

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67 Consultative Document at 11.

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?

The description of the systemic importance of asset management entities correctly acknowledges many characteristics of investment funds (and the asset management industry generally) that mitigate potential systemic risks and differentiate investment funds from other types of financial entities (and differentiate the asset management industry from other sectors of the financial industry). For example, we agree with the FSB's summary of factors that "dampen the global systemic impact of a fund failure" including: (i) investment funds contain a "shock absorber" feature because investors absorb an investment fund's losses; (ii) investment managers are agents of their clients; (iii) investment funds and asset managers are highly substitutable and investment fund assets are highly mobile; and (iv) investment funds may use one or more liquidity management tools, such as in kind redemption, temporary suspensions, gates and side-pockets. However, the description also overstates certain risks.

We are concerned that the description overemphasizes the risk of forced liquidation of (or a "run" on) an investment fund or a family of investment funds. The risk of fund liquidation described in the Consultative Document is inconsistent with the experiences of our members and includes no supporting data to substantiate the concern. The Consultative Document similarly overstates risks associated with highly correlated trading strategies (i.e., "herding" or "crowded trades").

We do not think that the description of systemic importance of investment funds acknowledges the low likelihood of a destabilizing liquidation of an investment fund's assets, particularly in the context of U.S. registered investment companies. The Consultative Document asserts, without providing supporting data, that investment funds may experience a run on their financing through redemptions or increased margin calls that could cause forced liquidations and market distortions, and claims that "the loss of investor confidence in one specific asset class as a result of the distress of one particular fund" could lead to runs on other funds "presenting similar features or conducting a similar strategy."[68] We are concerned that, in these statements, the Consultative Document is referring to market theories previously alleged about one area of the asset management industry (money market funds) to support a conclusion that these fact patterns and market theories describe the entire asset management industry, without providing data or a theoretical basis to support that leap or, at a minimum, explaining why these patterns and theories have equal applicability in other contexts.

The Consultative Document exaggerates the potential for redemption risk in individual investment funds, the connections among investment funds and the risk that significant redemptions in one investment fund will cause other investment funds to suffer significant redemptions. As we discuss in our response to Q1-1, leverage limits and liquidity requirements applicable to U.S. registered investment companies that generally use little or no leverage and do not have fixed liabilities, including mutual funds, ETFs and registered closed-end funds, give these types of investment funds a different risk profile than the risk profile of highly leveraged private funds. We are concerned that the description of systemic risk related to investment funds does not appear to consider the risk mitigating impact of existing regulation and recent regulatory initiatives relevant to many types of investment funds.[69]

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[68] Consultative Document at 29. Likewise, in the description of its rationale for the proposed focus on funds in the assessment methodology, the FSB explains that "second round effects on the financial system may occur due to a run on a fund."

[69] See our response to Q2-2.

The Consultative Document asserts, without providing clear or conclusive supporting data, that "during turbulent market conditions, if an investment fund or a group of investment funds in distress is forced to unwind positions that in turn could lead to a spiral of self-reinforcing movements for other investment funds (whose strategies may be identical or highly correlated – i.e. the so-called 'crowded trade' phenomenon), their counterparties and prime brokers, and the wider market, possibly exacerbated by an increase in investor redemptions." This statement does not reflect the fact that investment funds will react differently to periods of market stress based on their differing investment mandates, restrictions, investor demographics and other factors. Investment funds provide investors access to professional asset management resources and opportunities to direct and specify how their assets are invested. Fund managers provide advice to, and act as agents on behalf of, investors seeking exposure to certain investment strategies and their attendant investment results. We believe that investment funds, managed by professional asset managers, may lead to greater diversity of opinion in evaluating investment options in particular assets or asset classes and more thoughtful response in periods of market turbulence and, in that sense, may serve as a counter to herding behavior. As fiduciaries, asset managers must invest their clients' assets pursuant to investment mandates determined by their clients. Asset managers actively manage risks within the particular investment mandates of their clients and, therefore, function more as risk reducers than as risk takers. The Consultative Document does not explain how G-SIFI designation of a select number of investment funds would cure the risks it claims are associated with highly correlated investment patterns across a large number of investment funds. We do not believe that selective regulation would cure any risk of "crowded trades."

The description of risk associated with investment fund failure is not consistent with our understanding of historical examples of fund failures. The Consultative Document's description of hedge fund failures[70] focuses on a very specific type of hedge fund failure that perhaps most famously occurred when LTCM failed in 1998, but not all hedge fund strategies involve the type of highly-leveraged arbitrage investment strategies that contributed to the failure of LTCM. The failure of LTCM illustrates the fact that excessive use of leverage by investment funds can present systemic risk. Recent regulatory initiatives that seek to address risk related to leverage embedded in derivative instruments and liquidity risk, including the regulations (such as margin requirements and MSP designation) summarized in our response to Q2-2, also help address the types of leverage and liquidity risk that affected LTCM.

Finally, we understand that the losses experienced by the Reserve Primary Fund, a large money market fund, in 2008, without analysis, may seem to link large investment funds to systemic risk. Nonetheless, we believe it is important to distinguish the Reserve Primary Fund from other types of investment funds. The important lessons from the losses experienced by the Reserve Primary Fund are that characteristics of some money market funds, including a fixed net asset value and certain of their investor demographics, present unique risks that differentiate money market funds from other investment funds and that money market funds consequently warrant different regulation. We believe that the regulatory reforms already made and currently pending in the money market fund sector demonstrate an appropriate structural approach to the regulation of money market funds.

Money market fund regulation seeks to address all investment funds that engage in money market activities (*i.e.*, it is activities-based). It seeks to identify a type of investment fund believed by regulators to be more susceptible to systemic risk and to regulate them, as a class, in a manner that is appropriate for the class and different from investment funds that are less exposed to risk. An approach that targeted only large money market funds would be less effective than the comprehensive, activities-based regulations currently in place and under review.

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[70] Consultative Document at 31.

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.

As we discuss in our response to Q6-4 and in the Introduction to this letter, we believe that FSB and IOSCO should revise the investment fund assessment methodology to focus on the activities of investment funds and other participants in the capital markets. If, however, FSB and IOSCO elect to focus on asset management entities, we agree with the FSB's and IOSCO's proposal to focus the assessment methodology on investment funds rather than families of funds, asset managers on a stand-alone entity basis or asset managers and their funds collectively. We agree with the FSB's and IOSCO's assessment that investment-related economic exposures are created at the investment fund level and appreciate their important observations that "the assets of a fund are not available to claims by general creditors of the asset manager" and funds are organized as separate legal entities from their managers.[71] Investment funds are also separate entities from one another.

We appreciate FSB's and IOSCO's recognition that information is currently made available to regulators at the fund level.[72] A substantial amount of information about the activities and investments of investment funds is already made available to regulators in a multitude of forms. It is our view that multiple entities should not be viewed on an aggregated basis merely because they have the same asset manager. Rather investment funds are legally separate, have different investment mandates, portfolio managers, contractual relationships and pools of investors, and they separately custody their assets.

We feel strongly that asset managers on a stand-alone basis would be an inappropriate class of financial entity to subject to G-SIFI designation and commend FSB and IOSCO for their determination to focus their assessment methodology on investment funds. As we discuss in our response to Q6-2 and the proposal acknowledges, asset managers are agents of their clients and are bound to abide by their clients' investment mandates in their investment activities. The distinction between managers and investment funds is key to understanding how and where risk exists in the asset management industry. In the United States, pursuant to applicable regulation, investment fund assets are not commingled with the assets of other investment funds or the proprietary assets held in the asset manager's name and are typically held by independent custodians. An asset manager's balance sheet is relevant to its financial wherewithal and its ability to operate its business, but is irrelevant with respect to its clients' investment experiences, whether gains or losses, and the potential impact of investment fund losses on financial markets. Consequently, we believe that focusing the assessment methodology on asset managers would not meaningfully evaluate systemic risk related to investment activities.

Finally, if the FSB and IOSCO decide to evaluate asset managers or asset managers and their funds collectively, we request that they publish a revised draft assessment methodology and provide the industry an opportunity to comment.

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.

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71 Consultative Document at 30.

72 Consultative Document at 30.

The Consultative Document notes that, although the approach would be inconsistent with the approach taken in the assessment methodology designed to evaluate banks and insurance companies, "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. Under this approach, the methodologies would consider how particular activities or group of activities might pose systemic risks." The differences between banks and insurance companies, on the one hand, and asset management entities, on the other, warrant a different approach to assessing risk. ***We believe that an assessment methodology that seeks to identify risk that may arise from the asset management industry, and from the capital markets broadly, should focus on investment activities and not specific entities because risk is highly unlikely to be concentrated in individual asset management entities and effective regulation of investment funds, other asset management entities and the capital markets is activities-based.***

An assessment methodology that identifies investment funds under an arbitrary set of impact factors (such as size on a standalone basis) designed to evaluate banks and insurance companies, and any selective regulation of entities identified under such assessment methodology, are not likely to identify or meaningfully reduce systemic risk that may arise from investment funds' activities as capital markets participants. An investment fund or other financial entity of almost any size that employs a very high level of leverage and engages in very high risk investment activities could theoretically have a systemic impact. The proper regulatory response to the risk posed by investment funds is activities-based regulation – and is not G-SIFI designation of a select number of investment funds.[73] To properly evaluate investment funds and address systemic risk, the assessment methodology must focus on investment funds engaged in high risk activities. We are concerned that this question highlights the challenges inherent in designating G-SIFIs without understanding what additional regulation will be applied to designated entities.

An activities-based assessment methodology will move away from entity designation which would be an outcome consistent with our understanding of how risk may arise from investment funds, the asset management industry and the capital markets generally. An activities-based approach would not lead to selective regulation of designated G-SIFIs. It would lead to regulation designed to mitigate risk associated with certain investment activities and types of investment funds, which we believe would be an effective and appropriate structure for regulation.

We believe that examples of concentrated risk at large institutions are far less prominent in the asset management industry than in other sectors. Because risks are more closely linked to specific investment activities and specific types of investment instruments than to particular entities, the asset management industry is best regulated on an activity basis, without heightened regulation imposed on a subset of the largest firms. Existing regulation of asset managers, investment funds and investment activities is generally composed of industry-wide and activity- and investment product-focused requirements – an approach that is responsive to the diffuse nature of risk in the asset management industry.[74] We note that certain ongoing regulatory initiatives, discussed in our response to Q2-2, reflect

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[73] Tarullo, Speech, *supra* note 21 ("[T]he rationale for regulation provided by the potential for contagion effects is really an argument for sound regulation of the type of financial firm or instrument under consideration. If a small money market fund's travails can provoke a run on the entire industry, then all such funds should be subject to requirements that reduce the fragility of their business model. The potential for systemic problems would be essentially as great in an industry structure with many mid-sized funds as in one with a smaller number of large funds.")

[74] See our response to Q2-2.

an activities-based approach to regulation including: (i) derivatives regulatory reform; (ii) securities lending reform; (iii) money market fund reform; and (iv) repo market reform.

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.

Generally, we believe that certain of the proposed indicators are appropriate but that the focus on size on a standalone basis is misplaced because risk may concentrate in relatively small investment funds or across a large group of market participants of various sizes that that employ the same practices. We propose that leverage should be an impact factor, and a materiality threshold criterion, in the methodology, and not merely an indicator under "Interconnectedness" for investment funds. As we note in our response to Q3-2, we believe that the materiality threshold for investment funds should consider size only if other risk factors including leverage and inadequate existing regulation are present.

More granularly, the following indicators seem to miss the mark:

Indicator 1-1: Net assets under management (AUM or NAV) for the fund. We disagree with the assertion that the larger the size of an investment fund, the greater its potential impact on counterparties and markets. As discussed above, we believe that a size indicator on a standalone basis will identify too many large but not systemically important investment funds.[75]

Indicator 1-2: For hedge funds, GNE as an alternative indicator. The FSB and IOSCO are correct to identify use of leverage by private funds as a factor that distinguishes private funds from registered funds and increases their risk profile relative to registered funds with the same AUM. We do not support the proposal to measure hedge funds' size by GNE as a substitute for evaluating leverage. As discussed above, we do not believe that GNE is a good measure of a hedge fund's risk level because it is not risk-weighted. Rather than relying on GNE as a proxy for leverage, the investment fund assessment methodology should incorporate risk-weighted leverage as a stand-alone impact factor.[76]

Indicator 2-1: Leverage Ratio. The measure of an investment fund's leverage should be a stand-alone impact factor and should be risk-weighted to accurately measure the possible impact on counterparties of the investment fund and financial markets in the event of distress or failure of the investment fund.

Indicator 3-1: Turnover of the fund related to a specific asset / daily volume traded regarding the same asset. We do not believe that portfolio turnover related to a specific asset or trading regarding the same asset is a meaningful reflection of an investment fund's substitutability and are concerned that proposed Indicator 3-1 does not account for the fact that, in many instances, high portfolio turnover rates have no relevance to an evaluation of an investment fund's systemic risk level (for example, high turnover may reflect investments in assets that turnover naturally, such as fixed income securities, or portfolio rebalancing transactions). The FSB and IOSCO do not explain why they believe turnover related to a specific asset or trading regarding the same asset is relevant

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75 See our response to Q2-1.

76 See our response to Q3-2.

to their evaluation of investment funds. We also note that the Indicator does not provide a relevant period for measuring turnover and should be clarified to do so.[77]

Indicator 3-2: Total fund turnover vs. total turnover of funds in the same category/classification. We do not believe that proposed Indicator 3-2 is a meaningful reflection of an investment fund's substitutability or necessarily relevant to the systemic risk associated with an investment fund. The FSB and IOSCO do not provide support for their assertion that "[t]he higher the ratio of fund turnover to total turnover of funds in the same category, the higher the potential systemic risk of the fund." Without additional explanation and support, we believe that the Indicator is not clearly relevant to an assessment of an investment fund's systemic risk profile and will be applied inconsistently.[78]

Indicator 3-3: Investment strategies (or asset classes) with less than 10 market players globally. Please see our response to Q6-8 below.

Indicator 4-1: OTC derivatives trade volumes at the fund / Total trade volumes at the fund. It is not necessarily true that investment funds that engage in a significant volume of OTC derivatives transactions in comparison to their total trading activity will be exposed to higher counterparty risk. An investment fund's level of counterparty risk will depend on the credit risk profiles of its counterparties and whether, and to what extent, counterparty risk is diversified across a number of counterparties. We are concerned that the Consultative Document makes this statement without offering any data or other support for it.

Indicator 4-4: Weighted-average portfolio liquidity (in days) / Weighted average investor liquidity (in days). We agree that portfolio liquidity and investor liquidity are important risk indicators, but propose that maturity transformation (i.e., the difference between the maturities of a company's assets and liabilities) be a primary impact factor in the investment fund assessment methodology rather than a subpart of the "Complexity" indicator.

Indicator 4-5: Ratio of unencumbered cash to GNE (or gross AUM). We do not believe that an investment fund's ratio of unencumbered cash to GNE (or gross AUM) is a meaningful measure of an investment fund's systemic risk, and, in particular, do not believe it is relevant to registered investment funds. Other regulatory regimes, including new derivatives margin requirements, seek to address the concerns the FSB and IOSCO raise regarding an investment fund's ability to satisfy margin calls or post collateral. We are concerned that a flat ratio would not be a useful metric and that it may be misleading.

Indicator 5-1: Number of jurisdictions in which a fund invests. It is not necessarily true that investment funds that invest globally may have a larger global impact than investment funds that invest in the securities of only a few jurisdictions. In fact, global investment strategies provide investment funds and their investors a risk mitigating diversification benefit that may not exist with respect to more concentrated funds. Moreover, a simple tally of the number of jurisdictions in which a fund invests will not

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77 See our response to Q6-9.

78 See our response to Q6-9.

provide regulators meaningful information about systemic risk. Such a metric values all jurisdictions equally without regard for their relative political and regulatory risk levels, or relative levels of importance to the global financial system. It also values all investment activity equally without considering whether the investment activity in a given jurisdiction is important to the asset classes or markets in which the fund is invested or to the fund itself, and without considering whether that market is important to the financial system as a whole.

Indicator 5-2: Number of jurisdictions in which the fund is sold/listed. Just as with Indicator 5-1, a simple tally of the number of jurisdictions in which a fund is sold or listed will not provide regulators meaningful information about systemic risk. Because it does not account for the risk levels associated with the various relevant jurisdictions, the metric seems arbitrary and meaningless.

Q6-6. For "crossjurisdictional activities", should "the fund's use of service providers in other jurisdictions (e.g. custody assets with service providers in jurisdictions other than where its primary regulator is based)" be used?

We do not believe that using service providers in foreign jurisdictions should be an additional risk factor in the assessment methodology. Although investment funds routinely rely on foreign custodians, their relationships with foreign custodians are often managed and guaranteed by local custodians. We also note that separate account clients often select their own custodians. Q6-6 seems to suggest that an investment fund's custodian could be a source of risk. If that is the case, appropriate regulation should address custodians rather than a handful of investment funds that are their customers. We also believe that, in some instances, foreign service providers may insulate investment funds from risk and offer a diversification benefit to investment funds.

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

We do not believe that GNE is appropriate measure of a hedge fund's size or an appropriate substitute for leverage in evaluating a hedge fund's potential systemic risk. Please refer to our response to Q3-4 above regarding GNE.

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

"Investment strategy" is not clearly defined in Indicator 3-3. The Consultative Document does not make clear whether an investment fund's "investment strategy" means the assets in which the investment fund invests, or the assets in which the investment fund invests and the investment fund's particular investment approach and/or trading style. For example, a merger arbitrage investment fund and a targeted single-industry long-only investment fund may invest in the same securities and have comparable portfolios at certain points in time but clearly should not be deemed to have the same investment strategy.

We are concerned that national authorities would encounter significant difficulty in evaluating investment funds on the basis of their investment strategies even if the term were clearly defined, and do not think that national regulators in different jurisdictions are likely to define or regulate investment funds' strategies consistently. Many investment funds' investment mandates, while targeted to achieve a certain market exposure or capture a specific strategy, permit the investment funds to invest in a wide range of asset classes so that reviewing an investment fund's disclosure regarding its investment

mandate may not provide regulators a meaningful understanding of the fund's investments. Reviewing investment funds' portfolios to determine their investment strategy also is not a realistic regulatory process. National authorities would have to spend a tremendous amount of time and consume extensive resources to determine and evaluate, on a case by case basis, the investment strategies of investment funds in order to evaluate whether an investment fund uses an investment strategy sufficiently unique to make it not substitutable. In particular, it would be difficult to determine the investment strategies of private funds that generally do not publicize their offering documents and report only summary information to their regulators.

The Consultative Document asserts, without offering any data or other support for the statement, that "there may be particular niche markets where a large fund invests heavily, either cornering or occupying a significant portion of the market, and where like substitutes may not be available."[79] We note that proposed position limits may in part address, in a systematic and measureable way, the systemic risk concern that the Consultative Document attempts to address in this indicator. We also note that, in many market sectors, investment funds' ability to achieve synthetic exposure to investment opportunities may create a type of substitutability that may be overlooked by evaluating the assets in which an investment fund invests.

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.

In addition to the difficulties highlighted in our response to Q6-8 that we believe would make any attempt by national authorities to evaluate, on a case-by-case basis, the investment strategies of investment funds a useless assessment process, we think that the indicators related to substitutability lack clearly defined terms and we are concerned that national authorities will not be able to identify and compare investment funds consistently based on the indicators. The description of *Indicator 3-1: Turnover of the fund related to a specific asset / daily volume traded regarding the same asset* in the Consultative Document explains that "attempts to measure a fund's substitutability by its turnover related to a specific asset, as measured by the fund's percentage of daily trading volume with respect to that asset's underlying market."[80] The description of *Indicator 3-2: Total fund turnover vs. total turnover of funds in the same category/classification* in the Consultative Document explains that "the higher the ratio of fund turnover to total turnover of funds in the same category, the higher the potential systemic risk of the fund."[81] None of the terms underlined in the preceding descriptions of Indicators 3-1 and 3-2 are defined or clear in context. We are concerned that the absence of clear definitions in the methodology will provide insufficient guidance to national authorities and may lead them to make improper assumptions and recommend investment funds for designation inappropriately. We are also concerned that the assessment methodology would be deployed inconsistently in each jurisdiction subject to it.

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79 Consultative Document at 35. We think this Indicator 3-3 is flawed conceptually. Given the intense competition among investment funds and the ease with which large asset managers launch and close new investment funds, if a few funds dominate a market, the market is likely to be much too small to be relevant to the global financial system. The discussion in the Consultative Document of Indicator 3-3 seems to assume that "financial entities" are the only potential investors in a market and to ignore other market participants including wealthy individuals, family offices, and government sponsored entities like sovereign wealth and pension funds.

80 Consultative Document at 34 (emphasis added).

81 Consultative Document at 34 (emphasis added).

As we explain in the Introduction to this letter, we feel strongly that the assessment methodology be revised so that the impact factors and indicators are clear, the assessment process is transparent, clearly defined, objective, based on reliable data and applied consistently across jurisdictions so that national authorities are not given unlimited discretion to identify investment funds that exceed an arbitrary materiality threshold. U.S. investment funds provide an enormous amount of information about their businesses to U.S. regulators.[82] We believe that any additional request for information should be made only after carefully reviewing available information and using any comparable data already provided. New requirements to provide data to regulators, which impose significant burdens on asset management companies, should be preceded by a careful cost-benefit analysis.

Q6-10. Are there additional indicators that should be considered for assessing the relevant impact factors? For example, should "the fund's dominance in a particular strategy (as measured by its percentage of net AUM as compared to the total AUM" also be considered for "substitutability"? Similarly, should "leverage" or "structure" of a fund also be considered for assessing "complexity"? Please explain the possible indicators and the reasons why they should be considered.

In our response to Q2-1, we propose that leverage, maturity transformation and inadequate existing regulation should be additional impact factors in the investment fund assessment methodology. We think that, if the FSB and IOSCO add the new impact factors we propose, *leverage ratio* should be an indicator related to the new leverage impact factor and *weighted-average portfolio liquidity (in days) / Weighted average investor liquidity (in days)* should be an indicator related to the new maturity transformation impact factor.

We do not think that "the fund's dominance in a particular strategy (as measured by its percentage of net AUM as compared to the total AUM)" should be considered for "substitutability" because merely having a focused strategy or a sizeable share of a particular market is not indicative of a high-level of risk. At a minimum, an indicator that seeks to measure risk associated with an investment fund's dominance in a particular investment strategy would have to define "strategy" and then be risk-weighted to assess the level of risk that may be associated with an investment fund's underlying assets. We are concerned that the case-by-case analysis that would be required to evaluate an investment fund under such an indicator is not a practical or clear regulatory tool. "Dominance in a particular strategy" has no clear meaning and it is not likely that national authorities will interpret or apply the indicator in a consistent manner. As we have noted in preceding sections of this letter, we believe that the assessment methodology should be revised to include clear and specifically measurable standards to reduce the level of discretion given to national authorities and increase the transparency of the methodology.

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.

We believe that leverage and interconnectedness are the most important impact factors for determining whether investment funds present the combination of characteristics required for SIFIs. As we explain above, leverage can be taken for granted for banks and insurers so it is understandable that it would be considered an indicator rather than an impact factor for those businesses. Many investment funds employ little or no leverage and should not be presumed to employ it. The assessment methodology should reflect the fact that leverage must be employed by an investment fund in order for it to be able to fail and present the types of risk the FSB SIFI Framework seeks to address. After leverage and interconnectedness, we believe that maturity transformation and inadequate existing regulation are

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82 *See* SIFMA AMG OFR Study Response Letter.

secondary factors. Indicators related to these risk factors should be prioritized in assessing the systemic importance of investment funds. As we have discussed above, size should be a component of the materiality threshold but should not be used to evaluate investment funds without first considering leverage and inadequate existing regulation. As we noted above, we do not believe that size, considered without other portfolio-related risk factors, is a meaningful indicator of risk.

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We appreciate the opportunity to comment afforded to us by the FSB and IOSCO, and stand ready to provide any additional information or assistance that the FSB or IOSCO might find useful. Should you have any questions, please do not hesitate to contact Tim Cameron of AMG at 212-313-1389, Matt Nevins of AMG at 212-313-1176 or Maria Gattuso of Willkie Farr & Gallagher LLP at 212-728-8294.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director and Asset Management Group, Head
Securities Industry and Financial Markets Association

Matthew J. Nevins, Esq.
Managing Director and Associate General Counsel, Asset Management Group
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cc: Mary Jo White, Chairman, Securities and Exchange Commission
Luis A. Aguilar, Commissioner, Securities and Exchange Commission
Daniel M. Gallagher, Commissioner, Securities and Exchange Commission
Kara M. Stein, Commissioner, Securities and Exchange Commission
Michael S. Piwowar, Commissioner, Securities and Exchange Commission
Norm Champ, Director of the Division of Investment Management, Securities and Exchange Commission
Jacob J. Lew, Secretary of the Treasury, Department of the Treasury
Mary J. Miller, Under Secretary for Domestic Finance, Department of the Treasury
Richard Berner, Director of the Office of Financial Research

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IAA INVESTMENT ADVISER ASSOCIATION

March 25, 2015

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

Re: Financial Stability Oversight Council Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001

Dear Mr. Pinschmidt:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") and the Investment Adviser Association (the "**IAA**")[2] appreciate the opportunity to respond to the Notice Seeking Comment on Asset Management Products and Activities (the "**Notice**") published by the Financial Stability Oversight Council (the "**Council**").[3] The members of the SIFMA AMG and the IAA are primarily U.S.-based asset management firms. Our response will focus on the operation, structure, and controls of the products and services offered by our member firms as they relate to the Council's consideration of potential risks to the U.S. financial system.

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[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

[2] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the SEC. Founded in 1937, the IAA's membership consists of more than 550 firms that collectively manage approximately $14 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

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

We value the Council's efforts to better understand the asset management industry and to focus its inquiries. We also appreciate the challenges the Council faces as it seeks to fulfill its mandate to identify and monitor risks to U.S. financial stability across the entire financial system. Our financial markets occupy a strong position relative to other markets around the world. They are governed by regulations that have adapted to market advancements in those markets through the years to make them efficient, resilient and transparent. These qualities encourage investment and enable investors to contribute to, and enjoy the growth of a thriving economy. We believe this regulatory regime should continue to evolve alongside financial and technical innovations, market growth and increasing globalization.

Our industry and the broader financial markets are currently adapting to a tremendous amount of new regulations that the Dodd-Frank Act and other U.S. and international work streams have produced. There are more regulations to come as those efforts have not yet finished. In that context, regulators and participants must work together to evaluate what, if any, further regulatory changes should be considered. To frame our response to the Notice, we respectfully offer three overarching and interrelated observations that inform our comments:

1. **The SEC and the Council have distinct but complementary roles, and the SEC is already assessing issues raised in the Notice. The SEC should lead further inquiries into these issues.**

We acknowledge the Council's present effort to evaluate whether any of the asset management industry's activities or products warrant the collection of additional information by regulators or otherwise require closer monitoring or action by the Council. It is important to emphasize, however, a point that the Council itself has acknowledged: the primary responsibility and expertise for assessing whether new data, regulations or other tools are necessary for asset management industry oversight should remain with the industry's primary regulator, the Securities and Exchange Commission (the "**SEC**" or the "**Commission**").

The SEC's professional staff in the Division of Investment Management ("**IM**"), economists specializing in asset management assessment in the Division of Economic and Risk Analysis ("**DERA**"), and market experts in the Office of Compliance Inspections and Examinations ("**OCIE**"), are best positioned to evaluate whether there may be potential information gaps related to the industry and to propose to the Commission appropriately tailored responses to emerging areas of focus. Although the SEC's regulatory regimes for investment funds and their managers are robust, it is reasonable to consider whether they can be improved in any way. Of the agencies represented on the Council, the SEC is the logical choice to conduct those evaluations and the agency best positioned to fashion and implement any enhancement for most of the industry.

The Commission has already embarked on a program to evaluate each of the issues outlined in the Notice. As SEC Chair Mary Jo White and other SEC officials have noted in a series of recent speeches,[4] the SEC has ably regulated advisers and funds for nearly 75 years,

[4] *See* Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Remarks at The New York Times DealBook Opportunities for Tomorrow Conference Held at the

guided by the SEC's three-fold mission: to protect investors; to maintain fair, orderly and efficient markets; and to facilitate capital formation. The SEC has consistently adhered to that regulatory mission, implemented mainly through rules and guidance promulgated under the Investment Advisers Act of 1940 ("**Advisers Act**") and the Investment Company Act of 1940 ("**Investment Company Act**") and has created a robust adaptable framework for addressing market developments and changes in the asset management industry. The process of determining whether further refinements are warranted and, if so, how they should be shaped, is a continual one that benefits from the SEC's unique experience and expertise, the notice and comment obligations under the Administrative Procedures Act,[5] and the focus on economic analysis and empirical data that guides the Commission's rulemaking process.

In this context, the Council plays an important role, but we emphasize that the Council should consider its role at this juncture as supportive of the SEC. As Chair White has noted, the Council is "an important forum for studying and identifying systemic risks across different markets and market participants."[6] To date, the Council has not offered any data or analyses to suggest that the asset management industry presents systemic risks. Nor has the analytical work performed by the Office of Financial Research ("**OFR**"), based on data collected by the SEC, uncovered structural or behavioral patterns of systemic concern.

As discussed throughout our response, we believe it is appropriate to look first to the SEC as it launches the Chair's initiatives to consider potential new tools to "enhance and strengthen" our industry's regulatory program through a process "driven by long-term trends in the industry and [informed by] the lessons of the financial crisis."[7] If the Council has performed thorough analyses on which it is basing the hypothetical risks described in the Notice, it should follow the example of the SEC's rulemaking process and publish that analysis so that commenters can address it directly. Similarly, if the Council is extrapolating from academic research, it should make that clear so that commenters can assess the conclusions in the research, the methods used to conduct it, and the assumptions and limitations that qualify it. Transparency will promote better discussion and enable the Council to determine whether any such research provides a reasonable basis for extrapolation or speculation regarding potential systemic risk.

One World Trade Center, New York, N.Y. (Dec. 11, 2014), *available at* (http://www.sec.gov/News/Speech/Detail/Speech/1370543677722; *see also* Chair Mary Jo White, *Chairman's Address at SEC Speaks 2015*, Washington, D.C. (Feb. 20, 2015), *available at* http://www.sec.gov/news/speech/2015-spch022015mjw.html#.VQH3uzvD9aQ (highlighting increased efforts in risk monitoring and plans to continue rulemaking under Dodd-Frank); David Grim, Acting Director, Division of Investment Management, *Remarks to PLI Investment Management Institute 2015*, New York, N.Y. (Mar. 5, 2015), *available at* http://www.sec.gov/news/speech/remarks-pli-investment-management-institute-2015.html#.VQH3QTvD9aQ (discussing regulatory initiatives on which IM will be focusing attention in 2015); Chair Mary Jo White, *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request*, Testimony before the U.S. House of Representatives Committee on Financial Services (Mar. 24, 2015), *available at* http://www.sec.gov/news/testimony/2015-ts032415mjw.html#.VRJtSTvD-M8 (testimony regarding the SEC's recent activities and initiatives and fiscal year 2016 budget request).

[5] 5 U.S.C. § 553.

[6] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4.

[7] *Id.*

We appreciate that the Council acknowledges the SEC's initiatives to evaluate the hypothetical risks described in the Notice as they apply to regulated investment companies and investment advisers.[8] Based on the list of activities identified in the agency's unified agenda[9] and the scope of the measures outlined in Chair White's speech, the SEC's regulatory program for the asset management industry comprehensively addresses the areas outlined in the Notice. The Council plays a very important role in evaluating overall risks in the U.S. financial system, but we believe it is essential for the Council to rely on the expertise of the agencies its individual members represent. The SEC, as the primary regulator of the asset management industry, should lead the assessment of the issues raised in the Notice. If the SEC proposes measures to address any of them, it will do so with appropriate notice and comment. The Council should fully evaluate the SEC's analysis and the measures taken by the SEC to address issues raised in the Notice before considering any further specific action of its own with respect to the asset management industry.

Our member firms are meeting individually and collectively with the SEC staff and providing factual information, data, and experience-rich feedback on the issues under consideration. We look forward to continuing to work with our industry's primary regulator to provide relevant data and assist the SEC in determining the scope of potential proposals.

2. The scope of the Council's assessment of "systemic risk" must be appropriately defined and circumscribed.

The Council recognizes that "investment risk is inherent in capital markets, representing a normal part of market functioning."[10] In its work to study, monitor, and assess potential risks to the U.S. financial system as well as in the Notice itself, the Council and its staff have noted that there is a difference between market or investment risk and systemic risk.[11] As Chair White recently noted, "[the Council's] objective . . . is not to eliminate all risk. Far from it. Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors."[12]

Indeed, in Assistant Secretary Patrick Pinschmidt's remarks at a recent Brookings Institution event, he noted the importance of market risk to a vibrant economy; and he made

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[8] *Notice*, *supra* note 3, at 4.

[9] *See* Unified Agenda of Regulatory and Deregulatory Actions (Fall 2014), *available at* http://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235 (describing the SEC's intention to pursue initiatives relating to derivatives use by investment companies, fund liquidity management programs, transition plans for investment advisers, stress testing for large asset managers and large investment companies, and information reporting by investment advisers).

[10] *Notice*, *supra* note 3, at 4.

[11] *Notice*, *supra* note 3.

[12] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4.

clear that, by distinction, the Council is not interested in regulating market risk itself but, rather, circumstances where risk might be transmitted across sectors in such a way that it causes threats to the U.S. financial system.[13] The scope of the Council's mandate as it relates to the asset management industry (as with other more critical participants in the financial sector) is as a "forum for studying and identifying systemic risks across different markets and market participants."[14]

In this sense, we note that the Notice does not offer convincing predicates to explain how the various hypothetical risks it describes would, in the context of the asset management industry, be converted into systemic risks. Instead, many of the Notice's questions include vague terms as "fire sale", "stressed markets", and "stressed conditions" without defining them. The lack of clear definitions of these and other critical terms makes the exercise of responding to the questions in the Notice more difficult. Commenters can interpret the definitions in many different but equally plausible ways. This, in turn, will reduce the comparability of comments and impede the development of clear definitions and uniform objective standards.

The Notice also presents an imbalanced depiction of the industry. Financial stability can be both enhanced and reduced. As the Council explores asset management products and activities, it should consider the extent to which they enhance financial stability, not just the hypothetical ways in which they might threaten it. Unfortunately, the Notice does not account for the features of pooled vehicles and separate accounts that absorb or diffuse potential risks to the system throughout market cycles. Far from being a source for creating or exacerbating systemic risk, the asset management industry engages in activities and performs functions that consistently moderate such risks.

In addition, we are concerned that the Notice does not recognize the diversity in the industry that distinguishes activities and practices from client to client, account to account, and mandate to mandate. Given these significant variations, asset management activities even within the same investment adviser are not homogenous as they are applied to different portfolios of managed assets. A bank with a single consolidated balance sheet is very different from an asset manager acting as an agent for a variety of clients and whose own balance sheet is largely irrelevant. Although a top-down single point of view might be appropriate for considering banking firms, it is an inappropriate way to think about the asset management industry.

Investment funds and asset managers operate differently than other types of financial entities. Their structural, operational, and behavioral features make it inappropriate to

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[13] Patrick Pinschmidt, Deputy Assistant Secretary, Financial Stability Oversight Council, *Asset Management, Financial Stability and Economic Growth* (Transcript), The Brookings Institution Conference (Jan. 9, 2015), 53-58, *available at* http://www.brookings.edu/~/media/events/2015/01/09-asset-management/20150109_asset_management_transcript.pdf; *see also Remarks of Deputy Assistant Secretary of FSOC Office Patrick Pinschmidt at the Investment Adviser Association's (IAA) 2015 Compliance Conference* (Mar. 5, 2015), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl9988.aspx.

[14] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4.

focus on these entities as sources or amplifiers of systemic risk. Asset managers do not manage all of the assets identically. An asset manager with a large amount of "assets under management" is really a collection of many smaller and diverse accounts, each with its own characteristics, objectives, and risk profiles. Investment advisers and funds regularly shut down or have assets migrate from manager to manager with little market impact, but they very rarely fail. As noted elsewhere in this letter, these fundamental attributes of the asset management industry mitigate systemic risks, and we caution against measures that would diminish those positive benefits.

It is investors – not the fund or the asset manager – who ultimately own the assets and bear the investment risk in pooled vehicles. This limits the potential threat to financial stability. If an asset manager leaves the business, its clients' assets will be transitioned to a new manager or managed by the clients themselves, but there is no fundamental economic risk to the underlying client/investor and no threat to the stability of the financial system. The Financial Stability Board ("**FSB**") and International Organization of Securities Commissions ("**IOSCO**") recognized this critical point in their first consultative document, entitled *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemic Financial Institutions* ("**2014 Consultative Document**").[15] In particular, they noted that investment funds are highly substitutable, that asset managers are agents of their clients, that investors provide investment funds with a "shock absorbing" function that differentiates investment funds from banks, and that an investment fund's assets are not available to claim by creditors of the investment fund's manager.[16] Additionally, neither investment funds nor their managers guarantee investment results or backstop losses, and investors control their assets and select investment funds with strategies that meet their investment needs. These fundamental features of investment funds should inform the scope of the Council's assessment of systemic risk in the asset management industry.

Given the lack of clear definitions and concrete parameters in the Notice for the assessment of the asset management industry, we expect this exercise to be the first step in a lengthy and deliberative process to gather relevant and tangible information about whether there is any potential systemic risk in asset management products or services, and if so, to what extent. The next steps will be to define key concepts, establish a balanced framework for analyzing known systemic benefits as well as potential risks, and to gather relevant and tangible information necessary to take those steps.

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[15] FSB/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), at 5, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf. In its second consultative report, FSB/IOSCO makes similar acknowledgements of the safeguards relating to asset managers and pooled vehicles*; see also* FSB/IOSCO, *Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Mar. 4, 2015) at 47, *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf /.

[16] *See* FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies, supra* note 15, at 29-30.

3. Thorough data analysis and appropriate coordination among regulators are essential steps to the formation of any potential regulatory responses.

Any next steps in regulating the asset management industry should be undertaken only after obtaining and evaluating data to enable a more thorough and nuanced understanding of the products and services that comprise this heterogeneous industry. This theme is acknowledged in the Notice and has been underscored in recent papers and remarks by the Council and SEC staff. Not only is such a process an imperative under U.S. federal administrative law, but it also stands in stark contrast to the approach FSB/IOSCO more recently appears to be taking in its second consultative document on *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemic Financial Institutions* ("**2015 Consultative Document**"), where it has proposed arbitrary thresholds for identifying individual funds, asset managers, and other market participants for regulatory scrutiny without premising its methodology on any data.[17]

In recent remarks at the Brookings Institution, Mark Flannery, the SEC's chief economist and director of the DERA, noted his skepticism about the Council and FSB/IOSCO inquiries into asset management as a source of potential systemic risk. He suggested there are difficulties associated with the evaluation of systemic risk, as least as the inquiry has been framed by some regulatory bodies, and cautioned against new regulatory requirements absent better definitions, data, and analysis.[18] We note that the OFR has been collecting data on private funds since the enactment of Form PF, and registered investment company data has been publicly available for many years.[19] The analyses performed by the OFR to date may not be taking advantage of all available data and may not be sufficiently tailored to the unique characteristics of the asset management industry.

Until data is appropriately analyzed, reviewed, and presented in ways that permit regulators and the public to better identify information gaps and specific areas of potential systemic concern, it is premature for the Council to seek to propose changes to the current regulatory environment. Investment funds, their managers and other service providers, like many other market participants, have experienced a remarkable amount of regulatory change

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[17] *See* FSB/IOSCO, *Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Mar. 4, 2015), *supra* note 15. A review of the defects of the 2015 Consultative Document is beyond the scope of this letter.

[18] Mark Flannery, Chief Economist and Director of the Division of Economic and Risk Analysis, U.S. Securities and Exchange Commission, *Asset Management, Financial Stability and Economic Growth* (Transcript), Brookings Institution Conference (Jan. 9, 2015), 58-62. Mr. Flannery also noted that diversification of investments in pooled vehicles seems to spread and reduce market shocks/systemic risks and that roughly every 45 days the capital markets sustain losses equal to 25% of bank capital and those losses are absorbed without comment or issues. *Id.*

[19] The OFR's 2014 Report indicates that they will be "developing a suite of additional monitors and dashboards, focused on money market funds, hedge funds, and credit default swap markets." OFR, *2014 Annual Report*, at 4, *available at* http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf; *see also id.* at 15.

over recent years, the final elements of which are not yet written and cumulative effects of which are not yet apparent. A prudent systemic risk analysis should empirically evaluate the impacts of changes that have followed the recent credit crisis. There may be additional opportunities to design tailored data-gathering initiatives (indeed, both the SEC and the OFR have publicly discussed such possibilities),[20] but we suggest that an analysis of existing available data over a reasonable period of time should be the Council's focus at this stage.

We believe that Chair White and the OFR have outlined important steps that should be taken initially to enable the Commission and the industry to better monitor for risks at the fund level and across the asset management industry. But a clearer analysis of data and deference to the SEC as the primary regulator for the asset management industry are essential prerequisites to any concrete regulatory steps that might be considered by the Council. The SEC has the subject matter expertise to initiate and lead this effort to ensure that any additional proposals are evaluated effectively. Changes to the regulation of the asset management industry, unless appropriately tailored, could themselves create systemic risks. In light of the significant regulatory changes that asset managers continue to incorporate into their businesses since the adoption of Dodd-Frank and other international regulations, we urge the Council to refrain from making specific recommendations for the asset management industry until a more appropriate time, and by no means before the SEC's rulemaking agenda for asset managers and funds has been implemented.

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I. Liquidity and Redemptions[21]

The first section of the Notice asks whether there are features of asset management products and services that might create first mover advantages, especially for products investing in less liquid assets. In particular, the Notice states that "the Council is focused on exploring whether investments through pooled investment vehicles that provide redemption rights, as well as their management of liquidity risks and redemptions, could potentially influence investor behavior in a way that could affect U.S. financial stability differently than direct investment."[22]

Different pooled vehicle structures have different redemption profiles and thus different liquidity requirements, ranging from funds that offer daily liquidity (e.g., open end

[20] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4; *see also* Richard Berner, Director, OFR, Remarks at the Financial Regulation Summit: Data Transparency Transformation (Mar. 24, 2015), *available at* http://financialresearch.gov/public-appearances/2015/03/24/financial-regulation-summit/.

[21] Each of the following sections offers general observations in connection with the four topics of the Council's inquiry before addressing the specific questions posed in the Notice.

[22] *Notice*, *supra* note 3, at 6-7.

mutual funds) to other types of funds that provide liquidity via listing on an exchange with correspondingly lower liquidity profiles in their portfolios (e.g., listed closed-end funds). In addition to being highly redeemable and liquid, from a pure size perspective, mutual funds have the most assets available for ready redemption of any category of pooled investment.[23] As a result, a focus on mutual fund liquidity and redemptions is understandable. Indeed, mutual fund managers and the SEC have always been focused on the implications of liquidity in the management of such vehicles. In the ordinary course, a certain amount of sales to manage activity is to be expected, as the purchase and sale of underlying assets is part of overall portfolio management. In times of more significant redemptions, a certain amount of additional transaction activity, to respond to increased redemption demands, may be inevitable. The questions are whether these sales: (i) are economically any different from sales by investors who hold the same assets directly or through other structures; and (ii) would cause asset price movements that threaten the stability of the financial system, not just investment performance. For reasons discussed below, we believe the answers to those questions are "no" and that regulatory intervention designed to address hypothetical systemic risks may itself be more harmful than beneficial.

We also note that the landscape of pooled investment vehicles is much broader and more varied when private funds are considered. Private funds can bring multiple investors together – often institutional investors and other sophisticated investors. Private funds can focus on specific strategies, sectors, risk tolerances, or leverage profiles. Some are actively traded and some follow a long-term buy and hold strategy. These funds have their own liquidity profiles, investor objectives, and tools to manage redemptions. While these funds are not registered investment companies, they bring a significant amount of heterogeneous investor interest and liquidity into the capital markets. The variation of strategies and instruments and approaches also helps to illustrate that investors in accounts and funds – registered or private – are not a standardized group.

In addition, it is important to emphasize that different investors have different investment objectives, time horizons, and risk tolerances. Retail investors may manage fund investments in a brokerage account differently than they manage funds in their retirement plan. Institutional investors may have a longer time horizon and more internal investment processes to make methodical decisions. Aside from the investment vehicle itself, the variation in investor behavior supports the point that pooled investment vehicles investors do not tend to act in concert.

From an economic perspective, there is no material difference between the liquidity profile of a direct investment in securities and an investment in those same securities through a pooled fund. There is considerable evidence, explained by sound theory, effective regulation and market practices, that investors do not redeem en masse from variable net asset

[23] As of January 2015, mutual funds represented $15.73 trillion (including $2.69 trillion in money market funds), and ETFs and closed-end funds represented $1.955 trillion and $289.14 billion respectively. Investment Company Institute, "Statistics," *available at* http://www.ici.org/research/stats/trends/trends_01_15, http://www.ici.org/research/stats/etf/etfs_01_15, and http://www.ici.org/research/stats/closedend/cef_q4_14.

value ("NAV") investment funds.[24] Risks associated with liquidity and redemptions in collective funds and other asset management products have never posed a threat to U.S. financial stability.[25] Nor are we aware of any empirical evidence that would show this to be the case for separately managed accounts. The suggestion that they might under some speculative circumstances is an untested hypothesis that is at odds with that empirical data, theory, and experience and assumes that investors make investment decisions without regard to other factors, such as their financial circumstances, needs and goals (e.g., investing in a diversified portfolio to seek to achieve their retirement savings goals).

Speculation is not enough to justify regulatory intervention in capital markets. The stakes are too high for that, and there is always a risk that regulatory intervention would not work as intended or would create unintended negative consequences – both of which could be harmful to efficient and orderly markets and capital formation. On this point, we agree with Federal Reserve Governor Jerome Powell's recent warning that "the Fed and other prudential and market regulators should resist interfering with the role of markets in allocating capital to issuers and risk to investors unless the case for doing so is strong and the available tools can achieve the objective in a targeted manner and with a high degree of confidence."[26]

There is a substantial risk that regulatory intervention targeting asset prices and investor behavior in unknown future market conditions could get it exactly wrong. Regulatory intervention could create unintended consequences that could harm individual investors saving for long-term goals like retirement, increase issuers' cost of capital, negatively impact the diversity and resiliency of markets, and slow U.S. economic growth as a result. Rather than reducing the hypothetical risk, these effects may create other risks that regulators will feel obligated to "solve."[27] This outcome is made more likely if new regulation covers only part of the capital markets and some of its participants (i.e., investors in funds but not other asset

[24] *See, e.g.*, Sean Collins, *Why Long-Term Fund Flows Aren't a Systemic Risk: Multi-Sector Review Shows the Same Result*, ICI Viewpoints (Mar. 4, 2015), *available at* http://www.ici.org/viewpoints/view_15_fund_flow_04 (noting that outflows from funds tend to be muted, even during periods of financial market turmoil; and that even during periods of stress when funds in aggregate are seeing outflows, some funds typically are seeing inflows).

[25] Note that, in our response to the Notice, we are not addressing issues that may relate to money market funds, which have been the subject of considerable regulatory activity since 2008.

[26] Governor Jerome H. Powell, *Financial Institutions, Financial Markets, and Financial Stability*, Speech at the Stern School of Business, New York, N.Y. (Feb. 18, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/powell20150218a.htm. Governor Powell's view is consistent with the views of other current and former policymakers at the Federal Reserve, including Ben Bernanke and Esther George, as discussed in note 28, *infra*.

[27] A commonly cited example is the reduction in fixed income liquidity that many attribute to the institution of the Volcker Rule and Basel III capital requirements. *See, e.g.*, Robert Stowe England, *Basel II, Banks, Bond Trading and the Volcker Rule*, Institutional Investor (Dec. 12, 2013), *available at* http://www.institutionalinvestor.com/Article/3288912/Basel-III-Banks-Bond-Trading-and-the-Volcker-Rule.html#.VRHiCjvD-M8.

owners) and relies on untested and, with respect to liquidity risk and redemptions in collective funds, undefined "macroprudential tools."[28]

Risks related to liquidity and redemptions in funds are already mitigated by regulation and market practices. A distinguishing feature of collective investment products is that they are designed to take into account anticipated liquidity and redemption pressures. Collective investment vehicles are structured in different ways, presenting varied redemption incentives and profiles. These heterogeneous features have evolved over time, and the range and mix of existing products have inured to the benefit of both investors and the markets. This evolution has been accompanied by the development of regulations and market practices that are calibrated to protect investors and market integrity.

Not surprisingly, there is very little academic research on the subject of liquidity risk and investor behavior. What little there is should be reviewed carefully in this context to account for the methods by which it was produced and the assumptions and limitations that qualify its results.[29] We are aware of no research that substantiates the hypothetical connection between liquidity risk in collective investment funds and the stability of the U.S. financial system.[30]

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[28] *See* Governor Ben S. Bernanke, *Remarks by Governor Ben S. Bernanke*, Speech before the New York Chapter of the National Association for Business Economics, New York, N.Y. (Oct. 15, 2002), *available at* http://www.federalreserve.gov/Boarddocs/Speeches/2002/20021015/default.htm ("...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."); *see also* Esther L. George, President and Chief Executive Officer, Federal Reserve Bank of Kansas City, *Monetary and Macroprudential Policy: Complements, not Substitutes*, Speech at Financial Stability Institute/Bank for International Settlements, Asia-Pacific High-Level Meeting, Manila, Philippines (Feb. 10, 2015), *available at* http://www.kansascityfed.org/publicat/speeches/2015-George-Manila-BIS-02-10.pdf (cautioning people not to rely too heavily on untested macroprudential tools to mitigate the risks the central banks are creating with their monetary policies).

[29] In one of the few attempts at an empirical analysis of investor behavior based on historical mutual fund outflow data, the evidence presented does not itself suggest effects of systemic consequence. *See* Qi Chen, Itay Goldstein, Wei Jiang, *Payoff Complementarities and Financial Fragility—Evidence from Mutual Fund Outflows* (Jan. 2008), *available at* https://faculty.fuqua.duke.edu/~qc2/bio/Chen%20Goldstein%20Jiang%20Fund%20Run%20200801.pdf. Among this study's limitations, its authors reviewed data from 1995-2005; excluded retirement shares; only reviewed equity funds, not bond funds; and it appears as if they consider institutional share classes to represent institutional investors exclusively and did not realize that those can be purchased by intermediaries that aggregate retail investors' investments (i.e., omnibus accounts).

[30] *See, e.g.*, Jeremy C. Stein, Member, Board of Governors of the Federal Reserve System, Comments on "Market Tantrums and Monetary Policy," a paper by Michael Feroli, Anil K. Kashyap, Kermit Schoenholtz, and Hyun Song Shin, Remarks at the 2014 U.S. Monetary Policy Forum (Feb. 28, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/stein20140228a.pdf. Former Fed Governor Stein concluded that 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." *Id.* at 6.

Pooled funds provide many individual investors exposure to asset classes that they could not reach without investing collectively. Pooled vehicles provide opportunities for diversification for investors, and these varying exposures held by millions of diverse investors with similarly diverse personal circumstances and investment objectives can serve as a bulwark against systemic pressures.[31] The breadth of different types of investors with different needs, objectives, and limitations provides greater resiliency than if all market participants took the same approaches to investing. FSB and IOSCO have recognized that distributing losses broadly to investors mitigates systemic risk, noting 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…." [32]

The most commonly held investment companies, mutual funds, are required to hold at least 85 percent of their assets in securities that can readily be sold.[33] In addition, with very limited exceptions, mutual funds must provide shareholders with redemption proceeds within seven days of any redemption request.[34] At the same time, mutual fund investors do not tend to redeem en masse. In part, this is because these funds are the primary savings vehicles for retirement income; about two-thirds of the total assets in all U.S. equity and balanced mutual funds are held in retirement accounts; and a significant portion of fund investments in taxable accounts are oriented toward long-term savings and retirement, often through defined contribution and asset allocation programs. Where such investments are made pursuant to such programs, particularly defined contribution plans, fiduciaries are managing the plans and evaluating key elements of the investments, including their liquidity profiles. Analysis suggests that mutual fund investors, even when they are not participating in asset allocation or defined benefit programs, do not act with a herd mentality, and some investors make countercyclical investment decisions.[35] Accordingly, portfolio trading is not driven by redemption pressures.

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[31] If an investor sells $2000 of a stock, there is $2000 of selling in the market that needs $2000 of buying in turn. Collective funds allow such sales to be conducted by a pool and in a diversified context, minimizing risk and broadening access to markets among investors.

[32] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at 29.

[33] *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992), *available at* https://www.sec.gov/rules/other/1992/33-6927.pdf; SEC Division of Investment Management, IM Guidance Update No. 2014-01 at 6, n. 12 (Jan. 2014), *available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf (explaining that the 1992 Guidelines are Commission guidance and remain in effect).

[34] Investment Company Act § 22(e). As a practical matter, three-day settlement requirements under Exchange Act Rule 15c6-1 (imposing a 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. The SEC staff has instructed funds to assess the mix, including level of cash reserves, lending and credit facilities and percentage of holdings to determine whether, under normal circumstances, funds will be able to facilitate compliance with the three-day settlement standard. *See* Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (May 26, 1995).

[35] *See Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, Strategic Insight (Nov. 13, 2013), at 5. When asked what would cause them to invest more of

Indeed, monthly turnover ratios from 1986 through 2013 fluctuated within a predictable range of 2-3% of assets including during periods of market volatility.[36]

Other pooled investment products address redemption and liquidity in other ways. Closed-end funds are structured differently and offer a different redemption profile than open-end (mutual) funds. While mutual funds continuously offer new shares to the public, closed-end funds may only occasionally offer new shares. Investor liquidity is usually found through the exchange listing process rather than from direct redemptions from the fund. Closed-end funds may also engage in periodic repurchase offers as well.

Some private funds maintain daily liquidity, while others may permit only periodic redemptions. Private funds may also be structured with the ability to suspend or manage redemptions with more flexibility than mutual funds. Private funds may also use gates which can provide that, if aggregate redemption requests for a period exceed a designated percentage, each investor's redemption will be honored pro rata up to the aggregate amount permitted to be redeemed. As with other types of funds, private funds can make in-kind distributions, dissolve the fund and liquidate or seek to renegotiate instead of suspending redemptions or selling into a down market. As with other types of advisers, private fund advisers act as fiduciaries to their fund clients and are subject to anti-fraud provisions under the Advisers Act. In addition, private funds disclose all of these features to their funds' investors so they are aware of the possibility of limited liquidity, which they take into account in making their investment in a private fund.[37]

We note that Chair White has stated that she has directed SEC staff to consider whether a supplemental set of risk management programs should be required for mutual funds and exchange traded funds ("**ETFs**") to address potential risks related to their liquidity and derivatives use, as well as to ensure comprehensive oversight of these programs.[38] The SEC staff is considering options for specific requirements, such as updated liquidity standards and disclosures of liquidity risks.[39] The Chair's direction to the SEC staff and the staff's evaluation that is currently underway are the appropriate starting points for determining whether any potential action related to the liquidity or redemption features of pooled vehicles is warranted. The SEC could then conduct the necessary rigorous empirical evaluation through a transparent process informed by public comment.

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their savings, 14% of respondents (U.S. investors) to the Center for Applied Research, Folklore of Finance, 2014 survey responded that they would do so when "markets [were] falling significantly." *See generally* State Street Center for Applied Research Study 2014, *The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry*, available at http://www.statestreet.com/ideas/articles/folklore-of-finance.html.

[36] *Id.*

[37] Many of the responses below focus primarily or address the inquiries from a regulated fund perspective; however, certain responses provide additional context for other forms of collective investment pools.

[38] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4.

[39] *Id.*

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)?**

Pooled investment vehicles have varied structures and present different redemption incentives and profiles. In all cases, however, the nature of and controls imposed by statute or contract over funds mitigate concerns about risks associated with liquidity and redemptions in collective funds, as evidenced by the behavioral patterns of investors (as observed over decades of activity). These controls also effectively eliminate the potential for shareholder redemptions in pooled vehicles to threaten U.S. financial stability. Further regulations to limit or remove the ability of various vehicles to allow investors to take market risks would diminish investor choice, reduce liquidity in the markets whose relative illiquidity regulators are concerned about, and harm capital formation and the overall growth of markets and the U.S. economy.

Mutual funds have features designed to offer investors the ability to purchase and redeem interests at net asset value on a daily basis. To ensure that they can meet such requests, mutual funds can invest no more than 15 percent of their assets in illiquid investments.[40] Overseeing an investment adviser's management, a mutual fund's board has a duty to monitor funds' liquidity and pricing practices. Section 22(e) of the Investment Company Act forbids suspension of the right of redemption or postponing the date of payment more than seven days after the tender of mutual fund shares, absent limited circumstances. Investment advisers structure and manage mutual fund portfolios carefully in order to ensure that the fund has assets available to satisfy redemption requests. Liquidity management practices include maintaining cash or cash equivalents, investing in liquid securities, and making arrangements for standby or emergency sources of liquidity to meet large or unexpected redemptions, including lines of credit (committed or uncommitted). Funds advised by related advisers might share lines of credit when funds otherwise share costs. Access to such credit is afforded on a pro rata or otherwise equitable basis, but liabilities are several (i.e., one fund is not liable for another's borrowing).

Given these structural and practical characteristics, mutual fund portfolio managers are able to accommodate investor redemptions, even in periods of market volatility. Historical analysis of fund flows shows that over the past three decades, during every financial crisis, capital preservation net withdrawals by mutual fund investors were consistently limited in magnitude. Net outflows averaged under 2% of assets monthly, and atypical high redemptions were very short in duration.[41] During October 2008, stock fund portfolio managers sold on a net

[40] *See Revisions of Guidelines to Form N-1A*, *supra* note 33.

[41] *Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, *supra* note 35, at 1.

basis an amount equal to only 0.4% of all assets held in such funds.[42] The typical profile of mutual funds and fund complexes, where investors have diverse investment objectives and preferences, has contributed to the fact that the asset management industry has never encountered harmonized redemption behaviors that could be associated with the notion of "herding" or forced sales.[43] Such characteristics have also contributed to mutual funds' exceptional resilience and have also enhanced financial stability. As Nellie Liang of the Federal Reserve stated recently,

> [M]utual funds in their current form have been around for a long time – 75 years now. And they've weathered all kinds of adverse market conditions without noticeably contributing to systemic risk. Indeed, they have provided a diversity of sources of funds for borrowers and may have had stabilizing influences on aggregate credit.[44]

ETFs have many of the same basic features of open-end mutual funds, with some distinctions. The assembly of ETFs in initial creation units by authorized participants and the function of market makers regularly seeking to arbitrage differences between the basket and share NAV serves to add liquidity and stability to the price of the product. Concerns have been raised from time to time that liquidity in ETFs relies on these participants, especially for bond ETFs. A recent Investment Company Institute ("**ICI**") study concluded, however, that only about one-fifth of total activity in bond ETFs is transacted in the primary market (i.e., through creations and redemptions with authorized participants).[45] The majority of the trading activity in bond ETFs occurs in the secondary market, and these trades are accomplished without any intermediation by authorized participants.[46] These secondary market transactions do not create transactions in the underlying bonds, because only the ETF shares are changing hands. [47] The same study reported that, over the first seven months of 2013 (when bond prices moved sharply downward in response to indications that the Federal Reserve might begin to curtail its buying program), and the nominal interest rate on the 10-year Treasury bond rose 90 basis points, there was ample liquidity in secondary market trading in ETFs, and by some measures liquidity actually rose.[48]

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[42] *Id.* "During that month, stock net liquidations by portfolio managers equaled to less than one-third of stock fund investors' net redemptions. Such investor net redemptions were under 2% of all stock fund assets under management during the same month." *Id.*

[43] *Id.*

[44] Nellie Liang, Director, Program Direction Section, Office of Financial Stability Policy and Research, Board of Governors of the Federal Reserve System, *Asset Management, Financial Stability and Economic Growth* (Transcript), The Brookings Institution Conference (Jan. 9, 2015), at 48.

[45] Shelly Antoniewicz, *Plenty of Players Provide Liquidity for ETFs*, ICI Viewpoints (Dec. 2, 2014), *available at* http://www.ici.org/viewpoints/view_14_ft_etf_liquidity.

[46] *Id.*

[47] *Id.*

[48] *Id.*

Private funds are typically structured in ways that offer different redemption opportunities for their investors. For some private funds, daily liquidity is offered and funds operate similar to a registered investment company. Others, particularly hedge funds, use a variety of methods to impose limits on the ability to redeem. For example, some private funds specify windows where they honor redemption requests (typically ranging from 15 to 180 days). These notification requirements enable the manager to efficiently raise capital to cover redemption requests or to sell assets in an orderly fashion to raise cash to fund such requests.[49] As noted above, private funds can suspend redemption requests or invoke other tools in the event of anticipated redemption pressure, and the more sophisticated investors who purchase these funds are apprised of these features as they make their investments.

In evaluating the liquidity characteristics and redemption features of various pooled investment vehicles, we believe it is important not to look at any one type of product in isolation or to look at pooled funds that might own certain assets and ignore the other potential purchasers of the same assets. It is more appropriate to acknowledge that the variety of pooled investment vehicles offered by participants in the asset management industry provides investors with a range of choices and promotes investment opportunities bringing additional capital into the market. The fewer barriers to entry for fund sponsors and investors, the more likely investors will be incentivized to allocate capital into the financial markets. Discouraging certain structures based on presumptions about hypothetical investor reactions to market dislocations without any evidence of a threat to financial stability and/or imposing further restrictions on investments in certain types of pooled funds, could affect capital formation and the smooth functioning of the markets. Likewise, investors may choose to invest in individual securities and lose the benefits of diversification and professional management offered in connection with asset management products.

On any given day, a fund will likely have subscriptions as well as redemptions. If circumstances arise that encourage a movement from one type of investment by one group of investors, there may be an attendant round of opportunistic purchasing by other investors or pooled investment vehicles that want to gain exposure to the same sector. Thus, markets themselves typically stay in equilibrium. One fund's decision to sell an investment will not typically lead to crisis in a product line, sector, region or industry.[50] Taken together, movements are typically effected in orderly ways.[51] For purposes of the Council's review and as acknowledged by a former Federal Reserve Chair, there is an efficiency provided by the diversity of funds, products with different features, and portfolio managers with different

[49] Hedge funds often have a "lock up" commitment. This further helps the manager engage in orderly, predictable cash management.

[50] *See* Sean Collins, *Why Long-Term Fund Flows Aren't a Systemic Risk: Past is Prologue*, Investment Company Institute (Feb. 18, 2015), *available at* http://www.ici.org/viewpoints/view_15_fund_flow_01 (describing a "closed-loop system" wherein some bond fund outflows are recycled as inflows into other bond funds).

[51] *See, e.g.*, Hanjiang Zhang, *Asset Fire Sales, Liquidity Provision, and Mutual Fund Performance* (Dec. 2009). Forced trades by distressed funds generate temporary downward price pressure on securities held in common by these funds, but other fund managers are able to consistently identify and purchase "fire sale" stocks and benefit from providing liquidity to distressed funds. *Id.* at 2. Overall performance remains robust in such circumstances. *Id.*

investment theses that cannot be matched by planning by central bankers or the substitution of other blunt regulatory tools.[52]

Regulation should instead encourage innovation, which can often attract new capital into asset classes that have been distressed. Banks are not as active in making markets; thus, the counterweights of market ebbs and flows are diminished, and it is increasingly important to find ways to attract capital into those areas of the market in order to normalize markets and provide buyers when others wish to sell. Such movements at times may represent volatility, but ultimately can work to reduce systemic risk rather than increase it. Such incentives cannot be managed or coordinated by central regulation or oversight, as the market's incentives are strong and self-effecting.

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

Different kinds of vehicles holding different asset classes pose different liquidity or redemption profiles, but we have not seen evidence to suggest that this is a problem, much less one of systemic significance. A review of recent market performance presents illustrative data for the Council's consideration on this question. High yield and leveraged loan funds have seen periods of lagging returns and steep withdrawals relative to other asset classes since early 2014.[53] Significant redemption activity, however, has not caused problems either for particular funds, their class of funds as a whole, or the underlying assets in these funds.[54] No material effects have been felt across the wider financial system in spite of sometimes record migrations or outflows. This trend is consistent with historical patterns observed by asset management

[52] *See* Governor Ben S. Bernanke, *Remarks by Governor Ben S. Bernanke*, Speech before the New York Chapter of the National Association for Business Economics (Oct. 15, 2002) ("I think for the Fed to be an 'arbiter of security speculation or values' is neither desirable nor feasible . . . . First, the Fed cannot reliably identify bubbles in asset prices. Second, even if it could identify bubbles, monetary policy is far too blunt a tool for effective use against them . . . . But there is the additional difficulty that the prices of equities and other assets are set in competitive financial markets, which for all their undeniable foibles are generally highly sophisticated and efficient.").

[53] *See, e.g.*, Matthew Fuller, *Outflows From Leveraged Loan Funds Deepen For 22nd Consecutive Withdrawal*, Forbes (Dec. 11, 2014), *available at* http://www.forbes.com/sites/spleverage/2014/12/11/outflows-from-leveraged-loan-funds-deepen-for-22nd-consecutive-withdrawal/ (discussing deepening cash outflows from bank loan funds); and Kristen Haunss and Luca Casiraghi, *Leveraged Loan Funds Seen Plunging 41% After Record Year*, Bloomberg (Dec. 15, 2014), *available at* http://www.bloomberg.com/news/articles/2014-12-16/leveraged-loan-funds-seen-plunging-40-after-record-year (highlighting the record twenty-second week of withdrawals ending December 10, 2014).

[54] *See* Peter Eavis, *Mutual Fund Industry May Face New Rules*, DealBook/NY Times (Dec. 11, 2014), *available at* http://dealbook.nytimes.com/2014/12/11/mutual-fund-industry-may-face-new-rules/?_r=0 (discussing $24 billion in orderly retail outflows from leveraged loan funds from April through December 2014).

industry market analysts.[55] It should be noted that the market for these assets and the markets for the investment vehicles holding these assets are small compared to overall debt markets and therefore do not have the capacity to have an impact on financial stability.[56]

As described more generally in response to Question 5, asset managers manage liquidity and redemptions using a variety of tools, including maintaining cash or other highly liquid instruments on hand, establishing lines of credit, redemption fees, interfund lending arrangements, or other tools to deal with withdrawals. These tools serve to dampen the potential effects on performance and other investors in the funds, but also serve to enhance stability. Certain asset classes might not be highly liquid, but managers have a wide gamut of tools available at their disposal to manage exposures in times of significant redemptions.

When assessing whether there is a threat to financial stability, whether additional regulation is needed, and whether it could be addressed effectively and efficiently, regulators must also analyze the effectiveness of existing regulatory limitations and tools (including cash, loan facilities, and in-kind redemption) that have evolved to manage their liquidity. Funds typically provide disclosures for investors outlining the risks, including liquidity risks, that can be associated with investing in pools of less liquid assets such as high-yield bonds and leveraged loans. Importantly, imposing additional requirements on these or other particular types of funds would encroach on investor choice and result in harmful effects on participants in other sectors of the U.S. financial system. In some circumstances, pooled vehicles provide an important means of financing for issuers and sectors that might otherwise find difficulty in securing capital as a result of other regulatory changes. Moreover, in some market conditions, these types of funds might even present lower risk profiles than other, more liquid fund classes.[57] Investors need to be able to take risks into account and decide whether they believe they will be paid for taking on those risks. Imposing additional leverage or liquidity requirements on funds that invest in less liquid asset classes would have a negative effect on capital formation and (ironically) reduce liquidity in markets whose relative illiquidity already concerns regulators.

Additionally, we note that Chair White has asked the SEC staff to consider potential mechanisms to provide more transparency about portfolio holdings and the liquidity

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[55] *See generally Perspectives on Taxable Bond Fund Redemption Patterns*, Strategic Insight (Nov. 6, 2009) (analyzing historical redemption patterns of taxable bond funds over 20 years and determining redemption rates remained within a narrow band).

[56] Other recent examples of periods of heavy redemptions that were handled without creating systemic risk include the "Taper Tantrum" of June 2013, loan fund redemptions in 2011 and 2014, and the municipal bond disturbance in December of 2010 fueled by analyst Meredith Whitney's forecast of "hundreds of billions" of municipal defaults. Because of Volcker rule and Basel capital changes, banks are acknowledged to have decreased their inventories and participation in the bond markets, and yet all the bond market disturbances noted above were handled by asset managers without dislocation. There were large price and yield movements, but no failure of the market to clear.

[57] *See, e.g.*, Thomas M. Idzorek, James X. Xiong, and Roger G. Ibbotson, *The Liquidity Style of Mutual Funds*, Financial Analysts Journal, Volume 68, Number 6 (June 2012), at 38 (discussing the outperformance of mutual funds that held less liquid stocks and attributing this characteristic to superior performance in down markets, especially market crashes).

risks associated with various types of funds.[58] She has also asked the staff to review options for specific requirements, such as updated liquidity standards and disclosures of liquidity risks. We welcome a dialogue with the Commission on what, if any, further steps may warrant additional evaluation.

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?

We recognize that the Council is focusing on pooled investment vehicles in the Notice, but it is worth noting that the OFR in its September 2013 Report appears to acknowledge that separate accounts[59] pose no real forced sale concerns.[60] No systemic risks result from such an incentive to redeem. The primary reasons some investors, particularly institutional or high net worth investors, prefer separate accounts over commingled investment vehicles include the ability to negotiate fees, tailor investment guidelines, and avoid tax inefficiencies (part of which comes from owning assets outright rather than as partial interest in the assets of a fund that may see purchases and redemptions). Such account owners are not holding the assets to avoid forced sales or seek first mover advantages. We also note that asset managers with management of many separate accounts will not manage each account in the same way. Each account may have its own strategy, risk appetite, return objectives, investment guidelines, cash flows and other attributes. Accordingly, even though all of those separate account assets may be under the management of a single asset manager, there is no basis to assume that all will be managed in the same way. This is particularly true in a time of market distress when each client may be communicating its own desires about how its account is managed.

At the same time, we note that, for reasons discussed above, the most widely held pooled vehicles typically do not see precipitous redemptions, and there is no reason to believe they will in the future. Retail funds are held by millions of account holders who have never acted in harmonized redemption patterns associated with the "herding" theory mentioned in the

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[58] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

[59] As a general matter, for questions that touch on the subject of separate accounts, we refer you to SIFMA AMG's April 2014 letter to the Secretariat of the Financial Stability Board and the accompanying survey of some of the key characteristics of separate accounts. *See* Letter from Timothy Cameron to Secretariat of the Financial Stability Board, Re: "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions"; "Asset Management and Financial Stability" Study by the Office of Financial Research (Apr. 4, 2014), *available at* http://www.sifma.org/comment-letters/2014/sifma-amg-submits-comments-to-the-fsb-and-sec-in-response-to-ofr-study-and-in-regards-to-separate-accounts/ ("Separate Account Letter").

[60] *See* OFR Report, *Asset Management and Financial Stability* (Sept. 2013) at 15, *available at* http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf ("Redemption risk is not prevalent in separate accounts . . . . However, significant securities sales from separate accounts could still amplify a market impact.").

Notice and its implication of systemic risk concerns.[61] Even when pension plans or other institutional investors determine to transition to a new asset manager resulting in a large redemption request, such significant redemptions are managed aptly by asset management firms using liquidity management techniques described in our response or by making use of professional services offered by transition managers.[62] All the market participants involved in such transitions have an interest in avoiding disruptions to the value and performance of the assets involved. Incentives are aligned between investors and their asset managers to seek to minimize the impact of the sale into the market and avoid downward pressure on price.

Even in circumstances of volatility or stress, where pooled vehicles see outflows that result in sales of underlying assets, academic literature indicates that, despite exerting greater price pressure on sales of less liquid stocks, those price differences typically revert in subsequent months.[63] This dynamic illustrates markets functioning efficiently and the lack of a systemic issue. More broadly, even when funds close, they do so without necessitating a forced sale of portfolio assets. The FSB and IOSCO have acknowledged in their 2014 Consultative Document that "funds close (and are launched) on a regular basis with negligible or no market impact" and that "even when viewed in the aggregate, no mutual fund liquidations led to a system market impact [from 2000 to 2012]."[64]

[61] *Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, *supra* note 35, at 1.

[62] *See* Section III, *infra*, "Operational Risk" (discussion relating to substitutability and ready transferability of funds and mandates).

[63] *See, e.g.*, Azi Ben-Rephael, *Flight-to-Liquidity, Market Uncertainty, and the Actions of Mutual Fund Investors* (Mar. 2014), at 2-3 ("We find that, on average, following the beginning of the crisis, illiquid stocks experience a larger price decline relative to liquid stocks, which accumulates over a period of two months. We find that these differences are temporary and revert during the subsequent three months.").

[64] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies, supra* note 15, at 30, note 38; *see also* FSB/IOSCO, *Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies, supra* note 15, at 34 (new consultation noting that "[r]esponses to the January 2014 Consultative Document… argued that fire sales by investment funds do not pose a global systemic risk" and "that asset sales from redemptions are not likely to materially impact market prices under normal conditions…").

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?

Securities loans are collateralized, and the collateral is invested conservatively. The value of collateral is always at or greater than 100% of the value of the loan, and it is marked to market daily.[65] Although the termination of a securities loan generally causes the lender to unwind the investment of its cash collateral, given the conservative nature of those investments, the liquidation of positions is not systemically significant.

For asset managers that engage in securities lending,[66] these programs are executed under carefully circumscribed conditions. Lenders are typically large institutional investors who often employ a lending agent[67] to arrange, manage, and report on lending activity. Borrowers are typically large institutions such as broker-dealers, investment banks, and market makers. Hedge funds, which are often significant participants in securities lending markets, usually borrow from a broker-dealer. A lender looks to its agent to take collateral from a borrower, plus margin. The collateral position is monitored daily, and margin is maintained above market value. Typically, securities lending positions are overcollateralized by 2 to 5%. Collateral is often reinvested in money market funds or similar conservative investment pools, with those reinvestments limited by the terms of lending agreements.[68] Asset managers and fund boards monitor these programs, and the end result is that the lender fund receives an incremental return with an appropriately modest amount of risk. It is not unusual for affiliates to act as lending agents under the same strict controls governed by contracts.[69] For affiliated lending programs, asset managers and boards have to administer and ensure that these programs are executed in keeping with the SEC exemptive orders under which they are permitted to operate. Lending entities typically obtain certificates of compliance from agents or borrowers to ensure programs are complying with the governing exemptive orders.

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[65] For additional discussion on collateralization, please see Section II ("Leverage"), *infra*.

[66] According to a February 2015 SIFMA AMG member survey, 57% of respondents engage in securities lending across a wide variety of fund types. *See infra* Appendix B, at B-3.

[67] Often these agents are large custodial banks; for funds within large asset management complexes, the manager might fulfill this role.

[68] Of respondents to the SIFMA AMG survey, all firms engaging in securities lending give instructions with regard to the types of vehicles in which collateral can be reinvested, most set guidelines around maturity and other considerations, and for more than half securities lending is limited to 2a-7 funds. *See infra* Appendix B, at B-3.

[69] All respondents engaging in securities lending report utilizing a third party agent or affiliate. *See infra* Appendix B, at B-3.

There may be counterparty and cash collateral investment risks associated with securities lending programs, but these are both investment risks for the lending fund. That same fund exists to take investment risk, and its manager has incentives to manage risk in keeping with the objectives and agreements under which it operates. In the event of a securities loan termination, the lending agent would act on behalf of the lender to enforce rights under the securities lending agreement. Collateral is used to buy back securities, and the borrower is responsible for any penalties or charges for a late return. The lender is typically indemnified under a lending agreement to account for losses due to a default or shortfall to cover the borrower's obligations. During the financial crisis, several securities lending counterparties faced challenges; however, lending agents were able to liquidate collateral, which was sufficient to repurchase replacement securities without disrupting the markets and without significant losses to lenders.

Academic surveys of securities lending practices in stressed circumstances have identified no appreciable effects on returns, volatility, skewness, or bid-ask spreads.[70] Likewise, maturity mismatches do not present an issue. This is because client agreements restrict the types of securities available to lend, borrowers must be approved, and agents are limited in the types of instruments in which they may invest cash collateral. The type of reinvestment made with cash collateral is typically money market or similar instruments of extremely high quality and with relatively brief durations that are highly liquid and tightly regulated. We note that the OFR has described "data gaps in the repo and securities lending markets" as a "top priority for the OFR" and has laid out plans for voluntary collection of data relating to both bilateral repo activity and securities lending during the course of 2015.[71] We will be happy to continue to provide information to the SEC and the OFR if it might be helpful in this regard. Of note, the report acknowledges the SEC's obligations under Section 984(b) of the Dodd-Frank Act, mandating that the SEC adopt rules to increase the transparency of information available to brokers, dealers, and investors about securities lending. We look to assist the SEC as it conducts additional evaluation in this area.

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?

As described above, asset managers manage pooled vehicles that present a variety of liquidity profiles and operate under a variety of requirements. Managers of mutual funds are

[70] *See, e.g.*, Steven Kaplan, Tobias Moskowitz, and Berk Sensoy, *The Effects of Stock Lending on Security Prices: An Experiment* (Aug. 2012). Conducting a randomized stock lending experiment using data sets from stressed periods in September 2008 and from June to September 2009, researchers found no evidence that removing sizable quantities of lendable shares had effects on returns, volatility, skewness, or bid-ask spreads. *Id.*

[71] OFR, *2014 Annual Report*, *supra* note 19, at 107; *see also* Berner, *supra* note 20.

under an obligation to invest no more than 15% of any fund's assets in illiquid securities.[72] The test typically applied is that an asset is considered liquid if it could be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the asset is valued by the fund. This determination is made with respect to the fund's ability to sell individual securities. The ultimate duty to oversee this evaluation rests with directors of the mutual fund. Typically, the board delegates the evaluation and ongoing monitoring of liquidity to the asset manager. Asset managers use various risk management tools to actively monitor and evaluate liquidity profiles of accounts they manage, including assessing the diversification and liquidity of holdings, conducting stress tests with market shocks or interest rate movements, and examining past redemption history. Indeed, daily liquidity management is an essential function of the risk management regime for most asset managers. The specific tools and approaches vary widely, and there is no single correct approach; however, the objective is the same: to prudently manage liquidity to accommodate redemption demands under all market environments. Historically, mutual fund managers have done well at meeting this objective.

Fund procedures and investment guidelines lay out what the mutual fund's tolerance may be to deal with stressed markets and large redemptions. Some funds have established approaches that inform how they reduce illiquid assets and increase cash in appropriate circumstances. Delegation to the manager is circumscribed by a fund's investment guidelines, prospectus disclosure, and board oversight.

More broadly, different funds (both mutual funds and other pooled vehicles) use a number of different liquidity management tools, including cash, lines of credit, and other facilities, to manage redemptions.[73] In anticipation of potential volatility, some fund complexes have increased their funds' ability to borrow to meet withdrawals.[74] Credit lines can be asset specific or omnibus. Depending on the fund's governing documents, interfund lending facilities (in the case of mutual funds, subject to regulatory limits via SEC exemptive orders) can help an asset manager manage credit needs of individual funds while providing well-controlled investment opportunities to lending funds.[75] Funds also have the ability to deliver in-kind redemptions to investors. For ETFs, institutional funds, or private funds, providing redemptions in kind can be a useful tool.

A fund's portfolio manager is obligated as a fiduciary to manage the fund in the best interest of all shareholders when processing redemptions. If the manager deems the best

[72] The number is lower for money market funds, but these products are not discussed in this response. Private funds may have different restrictions as well, depending on their investment thesis and the governing documents under which they operate.

[73] 79% of SIFMA AMG survey respondents report having access to a line of credit to manage outflows from their mutual funds, with lines of credit ranging from 0.3 up to 14.30 percent of the AUM of the funds. Around 64% have drawn on that line at some point within the last five years. *See infra* Appendix B, at B-1.

[74] Miles Weiss, *BlackRock Leads Funds Raising Credit Lines Amid Review*, Bloomberg (Jan. 21, 2015), *available at* http://www.bloomberg.com/news/2015-01-21/blackrock-leads-funds-raising-credit-lines-amid-review.html.

[75] Only 8% of SIFMA AMG members surveyed state that they engage in inter-fund lending to address liquidity issues. *See infra* Appendix B, at B-1.

outcome for the shareholders will be to sell assets immediately, it will do so; if selling over more days will achieve the best price for shareholders, the manager will do this instead. Some mutual funds have guidelines to indicate how much cash the fund can hold in ordinary and challenging times. Funds investing in less liquid asset classes, such as bank loans or high yield debt, typically hold relatively higher levels of cash and liquid assets to meet redemptions during stressed market conditions. Historical redemption levels in a fund may factor into a fund manager's decision about what level of cash and liquid assets is appropriate to hold. Some funds disclose these holdings guidelines, which can assist shareholders in assessing whether a fund is meeting its objectives.

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?**

We do not believe that the use of these liquidity management tools, whether in isolation or combination, serves to amplify risks. In fact, we believe liquidity management tools serve to mitigate such risks. We note generally our previous remarks in the introduction to this section and in response to the first question where we discuss the historical data that supports our view. Private funds may be structured to permit temporary suspensions of redemptions or the imposition of redemption fees or gates that limit redemptions in times of stress. In fact, the added flexibility that private funds have to manage redemptions beyond limitations that apply to mutual funds can provide a moderating influence in circumstances where they are experiencing selling pressure. Such funds also have access to lines of credit to manage flows during redemption periods.

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?**

At a fundamental level, investors invest in funds to gain a particular exposure consistent with the fund's investment objectives, policies, and restrictions, all of which are disclosed in relevant fund documents. There are thorough controls surrounding portfolio management: policies and procedures, investment guidelines, adherence to the strategy as set forth in a prospectus or disclosure document and contractually agreed upon by a manager, internal controls over risk management, fiduciary duties, and contractual liability. Further, complexes with multiple funds or separate accounts must allocate investment opportunities equitably, or they risk regulatory consequences. SEC-registered investment advisers have a fiduciary obligation of fair allocation at all times; any purchase or sale decisions are always made within that overarching fiduciary duty.

Within the confines of an investment mandate and in keeping with applicable regulatory limitations, an asset manager seeks a return it believes can be reasonably obtained on its investment portfolios. As witnessed by examples of orderly migration of assets from complex

to complex and the entry and exit of managers and funds from the asset management industry, the competitive pressure and variety of approaches undertaken by asset managers across the industry has its own disciplining approach.[76] The manager's success rises and falls with the vehicle. Firms are therefore incentivized to take risks into account when constructing portfolios. In a market environment where 81 percent of investors own mutual fund shares offered through investment professionals (outside of employer-sponsored retirement plans),[77] investors are being served by professionals who operate under obligations to seek appropriate investment opportunities for their clients.

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

We do not believe that liquidity and redemption practices pose a threat to financial stability. The asset management industry is very diverse in terms of the managers themselves as well as the types of funds and investments managed. At one end of the spectrum are daily liquidity mutual funds, and on the other end are private equity funds that restrict investor redemptions for the term of the fund. Similarly, the types of investments range from highly to less liquid. We would ask the Council to describe with greater specifically the circumstances in which there are concerns that the dynamics underlying the practices we have discussed might arise and their connection with U.S. financial stability. We would then welcome an empirical study to evaluate the validity of the underlying assumptions.

Meanwhile, from a regulatory perspective, given the breadth and complexity of both the types of funds as well as the investments of such funds, a prescriptive rules-based approach is not necessary, and would in fact be ill suited to addressing systemic risk. For example, a prescriptive rule requiring fund managers to hold a certain percentage of cash or cash equivalents may reduce the liquidity of the assets that were of concern in the first place, as managers would have fewer funds available to buy and sell such assets.

Our view is that there are no obvious regulatory proposals relating to liquidity and redemption that would have more than a marginal benefit and actually mitigate risks. There are a variety of good practices that are currently observed in the industry, but requiring managers to adopt them will likely only impose costs while potentially creating unanticipated adverse side effects.

[76] *See* discussion *infra* Section IV, Resolution.

[77] *2014 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*, 54th edition, *available at* http://www.ici.org/pdf/2014_factbook.pdf, at 96.

9. What additional information would help regulators or market participants better assess liquidity and redemption risks associated with various investment vehicles, including information regarding the liquidity profile of an asset class or of a particular type of investment vehicle?

Pooled products vary considerably but are subject to a range of protections and controls overseen by fiduciaries. Advisers must manage assets in accordance with the provisions of a prospectus, contract, or offering memorandum while making use of their skills, experience, and tools to retain their mandate and to not lose the engagement to a competitor.

As noted above, from Chair White's December 2014[78] and February 2015 speeches,[79] SEC Acting Director of the Division of Investment Management David Grim's March 2015 speech,[80] and our interactions with SEC staff, we understand that the SEC is exploring whether there may be appropriate additional steps to take surrounding liquidity and redemption practices and risks associated with asset management products, including stress testing. We have already briefed the SEC staff on various steps taken by some asset management firms to engage in stress testing and will continue to provide information and briefings as the SEC staff evaluates potential recommendations. We further understand that the OFR is reviewing and has announced plans to gather other relevant data from volunteers over the course of 2015. We look forward to constructive engagement with the SEC and to providing data to inform the staff's evaluation and consideration of whether additional steps need to be taken, and if so, the appropriate approach.[81]

Reducing risk is not a costless exercise. Risk is rarely reduced without either transferring it (potentially to less-regulated spaces) or imposing a cost somewhere else in the system. We strongly encourage a view that does not see risk as inherently bad, but recognizes that some degree of risk is necessary to encourage innovation, investment and capital formation. Additional requirements relating to liquidity and redemptions may stymie innovation and/or lead to higher fees and fewer choices for investors. Because pooled vehicles are major contributors to financial markets and come in many forms, it is not appropriate to view them through a single lens or as inherently "risky."

II. Leverage

We appreciate the Council's effort to better understand and evaluate ways in which pooled investment vehicles make use of leverage. For further information more generally

[78] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4; *see also* White, *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request*, *supra* note 4.

[79] *See* White, *Chairman's Address at SEC Speaks 2015, supra* note 4.

[80] *See* Grim, *supra* note 4.

[81] We note, too, that the CFTC and the Council have access to similar data on commodity pools (which may include certain mutual funds) through Form CPO-PQR.

on this subject, we refer the Council to SIFMA AMG's November 2011 letter in response to the SEC's concept release and request for comments on the use of derivatives by pooled investment vehicles and similar accounts, along with SIFMA AMG's April 2014 letter to the FSB and IOSCO on its 2014 Consultative Document.[82]

As the Notice defines the term, leverage is created when an investor effects a transaction that results in exposure[83] that exceeds the amount of equity capital used to initiate the investment. In this sense, leverage is not itself inherently "good" or "bad", but it can boost potential investment returns and magnify losses. Such losses can increase the potential for forced asset sales to meet redemption requests or address collateral needs arising from credit terms. In theory, extreme amounts of leverage may increase the quantity of risk and limit a fund's ability to survive significant market fluctuations. In rare circumstances, these risks may also have potential implications for U.S. financial stability, as evidenced by the 1998 failure of hedge fund manager Long Term Capital Management ("**LTCM**"), itself an anomalous and singular instance of high leverage and flawed duration management.[84]

As the Council is aware, leverage can be thought of in terms of, or established through, a variety of different instruments and strategies with different profiles. Strategies that can result in leverage include secured financings, margin credit, prime brokerage financing arrangements, borrowings from banks, issuances of preferred shares by closed-end funds, and securities lending transactions.[85] Derivative instruments such as futures, options, swaps, and swaptions can be utilized to create leverage, but those same instruments may also be utilized in an unlevered strategy if sufficient coverage is retained to offset future obligations. Leveraged transactions can be further differentiated based on whether the investor's potential losses are capped or not. For example, transactions such as the purchase or sale of futures contracts can result in an investor incurring future liabilities that exceed the investor's initial contributed capital. Unless sufficient assets are maintained to cover the resultant liabilities, these transactions can create what is sometimes referred to as "indebtedness leverage." Yet even for this kind of leverage, only the assets of the fund are at risk since it is the legal entity that took on the obligation. Other transactions can increase the investor's market exposure without incurring future liabilities and subjecting it to contingent losses, such as the purchase of a call option. These transactions are sometimes referred to as "economic leverage" because the investor's potential gain is known but its liability is capped at the value of its initial contributed capital. These varied instruments present different ways to manage and disperse risk and, if judiciously deployed, can enhance investment returns both absolutely and on a risk-adjusted basis.

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[82] *See* Letter to Elizabeth Murphy, Secretary, SEC, from Timothy W. Cameron, Esq., *Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (Release No. IC-29776, File No. S7-33-11)* (Nov. 23, 2011), *available at* http://www.sec.gov/comments/s7-33-11/s73311-51.pdf; and Separate Account Letter, *supra* note 59.

[83] Exposure for a foreign currency is not regarded as a separate "exposure" for this purpose.

[84] As discussed below, even with the leverage problems involved with Long Term Capital Management, the firm's resolution was managed in an orderly way and did not lead to systemic issues. *See, e.g.*, Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long Term Capital Management* (2001).

[85] *Notice*, *supra* note 3, at 13.

Furthermore, we believe that the use of various, sometimes countervailing leverage strategies by multiple market participants provides safeguards against systemic market risk and serves as an incentive for growth, innovation, and risk transfer.

As the Council notes, many pooled investment vehicles significantly limit their use of leverage to comply with statutory as well as self-imposed investment restrictions. Chief among the statutory limitations is Section 18 of the Investment Company Act (and the associated SEC guidance thereunder), which limits a registered investment company's ability to issue or sell "senior securities" which often take the form of indebtedness. Section 18(f)(1) prohibits an open-end mutual fund from incurring indebtedness other than certain types of borrowings, and then only if the fund maintains at least 300% "asset coverage".[86] Similarly, Section 18(a)(1) prohibits a closed-end fund from incurring indebtedness unless the fund maintains at least 300% asset coverage.[87] An investment company's use of derivatives is subject to a separate set of restrictions. If a registered fund invests in a derivative, it must cover its exposure to the instrument by holding liquid assets equal to the leveraged exposure or hold an offsetting position equal to the leveraged exposure.[88]

Some registered funds have adopted written investment policies that impose more conservative leverage limits than those mandated by the Investment Company Act. For example, some funds require that indebtedness leverage (i.e., borrowing) be used solely for liquidity management purposes (e.g., to satisfy anticipated investor redemptions or backstop trade failures). In general, most mutual funds operate and are financed with equity capital and do not rely on borrowed money.[89]

Hedge funds have historically employed more leverage than registered funds and other types of private funds, but many private funds do not use leverage at all, and funds that use leverage typically maintain average gross leverage ratios of 2.0 or less. A 2011 Columbia University Business School working paper found that the average gross leverage ratio for the hedge fund industry was 1.5 as of October 2009 and 2.1 for the period December 2004 through

[86] "Asset coverage" in this context means the ratio of: (i) the value of the total assets of the fund less all liabilities other than the subject indebtedness to (ii) the value of the subject indebtedness. We note that there are many nuances as to how coverage should be calculated.

[87] Under Section 18(f)(1) of the Investment Company Act, a closed-end fund can employ additional leverage through the issuance of preferred stock, provided that the fund maintains at least 300% asset coverage. Listed closed-end funds are not subject to redemption terms and as such have an asset base that is less volatile and able to manage larger amounts of leverage, as permitted under the Investment Company Act. *See* Investment Company Act § 18(f)(1).

[88] *See, e.g., Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf , 44 FR 25128 (Apr. 27, 1979) ("Release 10666"); *see also Registered Investment Company Use of Senior Securities–Select Bibliography* ("Senior Security Bibliography"), *available at* http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

[89] *See, e.g.*, Release 10666, *supra* note 88; Senior Security Bibliography, *supra* note 88.

October 2009.[90] By contrast, the gross leverage ratio for investment banks during the same period was 14.2 and for the broader financial sector was 9.4.[91] Even the more recent general data reviewed by the OFR, taken from Form PF reports filed by private funds with net assets of at least $500 million representing more than 80 percent of private fund assets, paint a picture of limited leverage across most kinds of funds. Indeed, OFR found that the ratio of gross assets (assets under management based on the current market value of assets and uncalled commitments) to net assets (gross assets under management minus outstanding indebtedness or other accrued but unpaid liabilities) for most types of hedge funds (macro, multi-strategy, equity, credit, event driven) hovered just above or below 2.0 from June 2012 through March 2014.[92] We note that many private funds are not, in fact, operated as levered funds at all. Some private funds operate with similar leverage limitations as registered investment companies. Those same private funds create liquidity and encourage investment and ultimately contribute to stability.

That same analysis noted the decreased use of borrowing by hedge funds and, where there is borrowing, the prevalence of using reverse repos or other secured borrowing sources, primarily obtained from prime brokers.[93] In addition, haircuts on term securities financing transactions have increased since the crisis.[94] In relative terms, these figures are far lower than in the banking system where leverage ratios are routinely in excess of 10 times net assets. For hedge funds, leverage exposures affect the underlying fund, not the adviser, so leverage does not have the same broad contagion reach as in the case of a bank. Furthermore, the risk of another LTCM – regularly and often singularly cited by the Council and other bodies in connection with evaluating the broader industry – is remote. LTCM's leverage ratio of 30 in 1998 stands out today as a distinct anomaly in the asset management industry, both in historical and current terms.[95] Leverage ratios at comparable hedge funds during the same time were far

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[90] Andrew Ang, Sergiy Gorovy & Gregory B. van Inwegen, *Hedge Fund Leverage* (Jan. 25, 2011), 17, *available at* https://www0.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf. For these purposes, we have adopted the simple "gross leverage ratio" definition used in the working paper, which is the ratio of: (i) the sum of long and short exposure to (ii) net asset value. *Id.* at 4. The illustrative example used in the paper presents a hedge fund that obtains $10 in cash from its investors, uses the cash proceeds to purchase $10 worth of long securities, then borrows $50 and uses those proceeds to purchase an additional $50 worth of long securities. *Id.* at 30. In this case, the net asset value of the hedge fund is $10, or the difference between its assets ($60 in securities) and its liabilities ($50 in borrowed cash). *Id.* The fund's gross leverage ratio is 6.0, or: (i) the sum of its long and short exposures ($60) (i.e., $60 in long position plus $0 short position) to (ii) its NAV ($10). *Id.*

[91] *Id.* at 25.

[92] OFR, *2014 Annual Report*, *supra* note 19, at 114, Figure 6-6. For relative value funds the ratio has been higher, "but has been declining [to around 4] since 2012." *Id.* at 114.

[93] *Id.* at 115.

[94] *See* ICMA European Repo Council, *Haircuts and Initial Margins in the Repo Market,* (Feb. 8, 2012), 13, Table 6.1, *available at* http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts%20and%20initial%20margins%20in%20the%20repo%20market_8%20Feb%202012.pdf .

[95] Lowenstein, *supra* note 84, at 234.

lower[96] and remain at low levels, as discussed above. What is more, certain banks loaned to or executed derivatives contracts with LTCM with virtually no visibility into the fund's portfolio, driven in part by the desire to gain more of LTCM's business.[97] The failure of LTCM is therefore as much about the challenges of since-improved underwriting processes as it is about the challenges of a single exorbitantly levered investment vehicle.

Although the Notice focuses on pooled vehicles, it also poses general questions about separate accounts. These accounts are not subject to regulatory leverage restrictions, but a 2014 survey that SIFMA AMG conducted of 12,197 accounts at nine managers indicated that a mere 1.7% of them employed leverage, and the average gross leverage ratio for such accounts was 1.35. [98] As a complement to the quantitative separate account data requested in the survey, respondents were also asked to describe the risk management processes that they employ in the management of separate accounts. The survey found that that 100% of respondents monitor counterparty risk for their separate accounts and employ robust procedures to this end. We also note that the counterparty risk landscape has changed with the introduction of central clearing and SEF platforms, as discussed in greater detail elsewhere in this letter. Similarly, we observed that separate account managers often monitor a number of traditional portfolio risk measures in the course of separate account management, including duration, convexity, volatility, concentration risk, and liquidity risk. Specific approaches and metrics will vary by manager and by instrument and mandate, but some degree of portfolio risk management is common. Many of the asset managers responding to the survey also reported using stress test analyses to observe the sensitivities of portfolios to particular factors, as well as value-at-risk models.[99] Nevertheless, we acknowledge Chair White's desire to obtain additional information regarding the investment activities of separate accounts, and we look forward to working with the SEC and its staff to offer efficient and practical ways to provide such information as may be useful to the staff's evaluation.[100]

The use of derivatives more generally has been one of the most significant areas of regulatory action in recent years.[101] Changes in the wake of Dodd-Frank include moving from

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[96] *See id.* at 25.

[97] *Id.* at 46-48, 106.

[98] Separate Account Letter, *supra* note 59.

[99] *See id.*

[100] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4.

[101] *See, e.g.*, Concept Release on *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, 76 Fed. Reg. 55237-01 (Sept. 7, 2011); *see also* Norm Champ, Director, Division of Investment Management, *Remarks to the Practising Law Institute, Private Equity Forum* (June 30, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542253660#.VP38zzvD9aQ (providing an approach to 1940 Act regulatory issues associated with leverage); Andrew J. Donohue, Director, Division of Investment Management, *Remarks Before the Practising Law Institute's Investment Management Institute 2010* (April 8, 2010), *available at* http://www.sec.gov/news/speech/2010/spch040810ajd.htm (discussing the Commission's review of methods to obtain leverage in the context of Section 1(b) of the 1940 Act); Andrew J. Donohue, Director, Division of Investment Management, *Investment Company Act of 1940: Regulatory Gap Between Paradigm and Reality?*, American Bar Association Spring Meeting (April 17,

bilateral to cleared swaps, accompanied by further capital and margin requirements. The cumulative goal is to reduce the contagion risk that a counterparty default might have on multiple market participants. All market participants will need to see if this is borne out as this transformation is being effected. An unavoidable consequence of the new regulations is that counterparty risk will now be concentrated among a few central counterparty clearinghouses ("**CCPs**"). Without downplaying the benefits of the new CCP regime, we believe that the industry and regulators must carefully consider the impact that even a single CCP failure would have on the larger marketplace and prioritize measures to reduce the probability and impact of such a failure.

Nevertheless, we note Chair White's decision to evaluate funds' use of leveraged investment exposures and the obligations that such instruments can create.[102] In particular, we understand that SEC staff are reviewing options for specific requirements that could include new measures to "appropriately limit the leverage created by a fund's use of derivatives."[103] Such changes should only come after meaningful dialogue and must be premised on notice and comment rulemaking and informed by careful evaluation of data during the agency's evaluation of any potential proposal.

Similarly, we welcome the opportunity to evaluate and assist any further analysis from the SEC, the Council or OFR on the use of leverage by private funds. To date, the information collected by the SEC and other regulatory bodies and evaluated by OFR includes assets under management and basic information on the use of leverage, counterparty credit risk exposure and trading practices; but at this point we have seen relatively little publicly from OFR by way of analysis on the issue of leverage. The data we have seen on leverage (including its relatively low levels and its sourcing from secured sources) does not present a portrait of practices that raise systemic concerns. We hope that any such inquiry will look first and in more depth to Form PF or other currently accessible data to better understand current leverage practices and whether they are actually problematic from a systemic risk perspective. Any next steps should come first from the SEC and be informed and calibrated by experiences and lessons derived from regulatory experiences with Form PF data.

Even as we acknowledge the Commission's evaluation of next steps toward more comprehensive data on the use of leverage, we caution, echoing previous remarks we have made on the use of leverage,[104] that the transformation of the regulatory structure applicable to the U.S. derivatives markets is still in its infancy. We expect that evolution of this regulatory area and market will continue to change conventional wisdom about derivatives transactions. We believe

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2009), *available at* http://www.sec.gov/news/speech/2009/spch041709ajd.htm (discussion of leverage under the 1940 Act and the Commission's analysis and concerns related to leverage and derivatives).

[102] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4; White, *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request, supra* note 4.

[103] *Id.*

[104] *See* Letter from Timothy W. Cameron, Esq. to Elizabeth Murphy, Secretary, SEC, Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (Release No. IC-29776, File No. S7-33-11) (Nov. 23, 2011).

that it is still too early—not just for the SEC, but for the Council as well—to fully, much less adequately, assess the effect or reach of new regulations mandated under Title VII of the Dodd-Frank Act. While the SEC has made progress to implement final rules under Title VII and the Title VIII clearing regime as of the date of this letter, the entire structure remains several years from completion. We believe common and uniformly understood legal standards around these regimes will result in better data and, by extension, better regulation.

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?

The Notice provides a good general survey of some of the typical instruments used by pooled investment vehicles to obtain and deploy leverage. Funds and fund managers vary their approaches to obtaining levered exposure in response to investor demands, portfolio investment objectives and restrictions, and changing market conditions.[105] Instruments do not necessarily create leverage on their own but rather operate in relation to other portfolio holdings. We also note that instruments that create "leverage" are not always used to increase risk. Funds may utilize derivatives to create economic exposure or to isolate and hedge certain risk factors, which can be done more efficiently through derivatives than through the traditional securities market.

We caution that simple measures of levered exposure (e.g., gross notional) can be crude and misleading. For example, short-term Eurodollar futures contracts are a leading form of laying on a hedge; such transactions require high notional amounts, so there are significant open interests and volumes. Yet such transactions do not really represent "leverage" if they are used to reduce interest rate risk in the portfolio, and they are relatively low risk because these instruments are very liquid and have low volatility. For example, to reduce the duration of a fund by 1 year using Eurodollar futures, the notional principal amount of such futures would need to equal 400% of the fund's assets. Such a strategy gives the appearance of leverage but in fact results in risk reduction. Accordingly, we caution that using gross or net notional amount outstanding as simple measures of leveraged exposure could generate misleading data and have

[105] Just a partial list of typical transactions – borrowings, preferred stock issuances, bank credit lines, prime broker credit lines, tender option bond inverse floaters, reverse repurchase agreements, "to be announced" (TBA) mortgage backed securities, or "when issued" bonds, total return swaps to purchase an equity or fixed income asset, fixed income or equity purchased futures or forward contracts, foreign exchange forward contracts (buying a currency other than the fund's base currency), credit default swaps, or sold put options (where the higher the strike price as a percentage of current prices, the more this is tantamount to a simple purchase of an asset) – gives a sense of the available range of instruments or transactions that may result in levered long asset positions in the absence of offsetting exposures. In addition, short asset exposure could be undertaken in a variety of ways, including total return swaps where the return stream attributable to an asset the fund does not own is sold, sold call options on an underlying asset that the fund does not own, fixed income or equity sold futures or forwards where the underlying asset is not owned, or foreign exchange forward contracts (selling currency other than the fund's base currency, where the currency in question is not owned).

unintended consequences. Moreover, in light of the recent focus on derivatives, we fear that a regulatory regime that channels pooled investment vehicles into a more limited array of instruments or strategies could have deleterious effects on the industry as a whole, including lulling investors into a false sense of security, stifling innovation, and preventing investors from properly hedging or reducing risks.

In terms of which types of products tend to use the most leverage, we note that closed-end funds typically employ the greatest amount of structural leverage among registered investment companies and disclose this practice clearly to investors. Because a closed-end fund is not subject to subscription/redemption requests, its capital base has stability that allows the closed-end fund to employ a higher degree of leverage. A majority of closed-end funds that use leverage are fixed-income funds that incur short-term indebtedness through committed credit facilities or issue preferred stock. Such closed-end funds invest the proceeds of this leverage in long-term or otherwise higher yielding assets. Rarely are the funds designed to use leverage to exploit an arbitrage trading relationship between different assets. The committed credit facilities employed by closed-end funds typically have stated maturity terms to avoid the need for de-leveraging and are structured to reflect the nature and risks of the fund's particular assets. We note that closed-end funds have regulatory leverage limits, so even as they may use more leverage than open-end mutual funds, they do not employ unlimited leverage.

Open-end funds that may use a credit facility might do so primarily to manage redemption requests that are either significant in size or received in a volatile market. Importantly, a fund's ability to sell assets in a controlled manner and make use of other tools to meet redemption requests can limit overall market volatility. Credit facilities are typically committed facilities provided by banks with stated maturity dates rather than "on-demand" facilities.

The SEC has announced plans to develop recommendations to modernize and enhance data reporting relating to the use of leverage. As outlined by Chair White, such proposals include reporting and disclosing fund investments in derivatives. We look forward to interacting with the staff on these issues and, if the Commission determines any further regulatory provisions may be appropriate, we also believe that the SEC would be well positioned to undertake careful economic analysis and to engage in appropriate notice and comment proceedings to determine whether rulemaking might be appropriate. As described above, any further regulatory processes should be informed by and reflect lessons incorporated from the agency's experiences with Form PF data.

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

We do not agree with the premise that investment vehicles experience forced sales; there is no historical evidence or fact-based data to support this concern. Various features of investment vehicles, including the statutory provisions and risk management techniques

described above, make the likelihood of forced selling remote. As conditions change, different firms deploy various risk tools. Likewise, different firms and the products they oversee have different tolerances, and the whole system itself exists as a dynamic equilibrium. New participants come into sectors of the market when others leave because they have reached a risk limit or subjective risk tolerance or otherwise see better opportunities elsewhere.

If the Council were to indicate more specifically the circumstances in which it believes the dynamic described might arise and its connection to U.S. financial stability, we would be pleased to provide information to address this issue. We would likewise invite a study based on empirical evidence related to what appears to be the question's underlying hypothesis.

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?

As a threshold matter, we note that leverage is one investment tool among many available to asset managers. The use of the tool depends on the investment opportunities, the monetary costs of the leverage, and the client's risk appetite. For example, a mutual fund's board may have approved the use of leverage but may not be comfortable using it in the current environment. A different board, however, may want to use leverage to the maximum. The use of leverage at any given time must be weighed with the attendant risks and costs, just like any other investment tool at the manager's disposal.

If leverage is a structural component of an investment product's overall strategy, the asset manager should (and generally does) conduct extensive analysis before formulating appropriate leverage targets and limits, including by evaluating the following:

- Historical volatility of the product's asset class and potential likelihood the product will reach a point where de-leveraging is required. This analysis may include stress testing (focused on the particular type of fund at issue) as well. This analysis will be used in establishing the appropriate amount of "cushion" between the target and/or maximum amount of permitted leverage and any statutory, regulatory or contractual maximum.

- The relative liquidity of the asset class in normal markets and in hypothetical stressed markets. Such evaluations would suggest, for example, very different leverage limits for highly liquid large-cap equity strategies as compared to lower-liquidity emerging market fixed-income strategies. Liquidity evaluations often consider anticipated selling volumes and the likelihood that forced sales would be effected in a crowded marketplace alongside other distressed sellers.

- Anticipated credit covenants or borrowing base restrictions imposed by the lenders or counterparties.

- Whether the potential gains from deploying leverage justify the added NAV and liquidity risk.

- With respect to traditional borrowings, the stability of the anticipated credit facility and the likely logistical hurdles of replacing the facility in response to unanticipated events.

As described in the Notice and referred to above, regulations and contracts impose various limitations on the types and amounts of leverage that asset managers of registered funds, unregistered funds, and managed separate accounts may deploy. As we discussed above, some of these are imposed under the Investment Company Act or regulations thereunder,[106] while others are imposed by investment advisory agreements, the terms of the leveraging instruments themselves, and the fund's or separate account's other governing documents.

In the context of open-end funds, the combination of statutory requirements and the obligation to follow the investment policies laid out in the fund prospectus typically require the fund to be mindful of relevant regulatory leverage ceilings, particularly in non-stressed markets. The precise manner of managing these positions will vary depending on the preferences of a manager and the relative volatility of the underlying asset that is being levered: the greater the potential volatility of the asset, the greater the cushion below the statutory/regulatory leverage limit within which the manager is required to operate. Additionally, managers carefully monitor their exposures among different counterparties and lenders.

Although asset managers have minimal visibility into the interconnectedness of their counterparties, they address potential risks posed by such interconnectedness in several ways. To the extent any registered or unregistered fund, including a fund that provides exposure to an alternative asset class, invests in derivative investments, the fund's manager would consider the credit risk of the derivative counterparty when determining the appropriate maximum limit of exposure to that counterparty. A manager's evaluation of counterparties often takes into account the compliance requirements associated with the Investment Company Act, which, among other things, prohibits registered investment companies from purchasing or

[106] For example, as we noted above, Section 18 of the Investment Company Act limits a registered mutual fund's ability to issue or sell "senior securities" (i.e., incur indebtedness in the case of open-end mutual funds). *See* Investment Company Act § 18. Other Investment Company Act provisions impose indirect limits on leverage by restricting portfolio concentration. Under Section 5, for example, mutual funds must designate themselves to be "diversified" or "nondiversified" and must adjust their portfolios to comply with specified limits applicable to such designations. *See* Investment Company Act § 5. The SEC has stated that a fund generally is concentrated in a particular industry or group of industries if the fund invests or proposes to invest more than 25% of the value of its net assets in a particular industry or group of industries. Securities and Exchange Commission, Concept Release, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, 17 CFR Part 271 (Aug. 31, 2011), *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf, at 65.

otherwise acquiring any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under the Advisers Act.[107] Funds and managers also seek to reduce counterparty risk through careful review and negotiation of contractual protections, robust collateral exchange agreements, and clear termination provisions. Many also use multiple counterparties to limit credit exposures and apportion risk.

Similarly, managers take care in sourcing the leverage facilities for their products. Managers often will have a stable of available leverage providers offering similar types of facilities so that, in the event a leverage provider terminates a facility, a replacement can easily be substituted rather than subjecting the fund to forced sales of the relevant levered asset.

While we understand that lenders and derivative counterparties adopt risk management techniques similar to those employed by asset management firms, they are also managing larger books of exposures and doing so using very sophisticated internal and external modeling and monitoring tools. For example, we believe broker-dealers with OTC derivatives exposure continually net in-the-money and out-of-the-money contracts to ensure a balanced book. Indeed, a series of OCC reports indicate that broker-dealers were able to reduce more than 80% of their derivatives exposures through netting from 2007 through the first quarter of 2011, a period that encompasses the financial crisis.[108] In accordance with International Swaps and Derivatives Association ("**ISDA**") protocols, broker-dealers also require asset managers to post various types of margin, including initial margin and variation margin calculated on net exposure. Broker-dealers also enter into separate derivatives contracts with each other to offset exposures presented by customer loans. To affirm our beliefs, we would strongly recommend that the Council direct this question to these market participants and the SEC as well.

Similarly, lenders almost always require that a fund either pledge specific collateral, which is often in excess of the loan amount, or grant the lender a first priority lien on the fund's assets. For registered mutual funds, lenders are further protected by the statutory limitations on the amount of leverage that fund may use.

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[107] *See, e.g.*, Investment Company Act § 12(d)(3). Rule 12d3-1 provides that, notwithstanding Section 12(d)(3), a registered investment company may acquire any security issued by a person that, in its most recent fiscal year, derived more than 15 percent of its gross revenues from securities related activities, provided that immediately after the acquisition of any security, the investment company: (1) may not have invested more than 5 percent of the value of its total assets in the securities of the issuer; (2) may not own more than five percent of the outstanding securities of that class of the issuer's equity securities; and (3) may not own more than 10 percent of the outstanding principal amount of the issuer's debt securities. *See* Rule 12d3-1 under the Investment Company Act.

[108] *See* ISDA, *Counterparty Credit Risk Management in the US Over-the-Counter (OTC) Derivatives Markets* (August 2011), *available at* http://www2.isda.org/attachment/MzQzMQ==/CounterpartyCreditLossesAug2011.pdf, at 4.

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?

Asset managers employ a variety of tools and models to evaluate their products' risk exposures and thus their actual or effective leverage levels. For example, traders in the fixed income markets have traditionally measured their exposure to changes in market interest rates in terms of duration-equivalence, while also evaluating market exposure to account for different volatilities and correlations. More generally, managers often evaluate, among other risk measures, tracking error relative to a pre-specified benchmark index and Value at Risk ("**VaR**"), each of which factors in leverage exposures.

For various instruments, asset managers might simulate changes in market and global macro conditions to assess the potential impact on leverage. Stress tests and so-called "scenario analyses" are common tools, calibrated to the particular type of fund being evaluated, used to see how margin and leverage levels and cash flow needs would change in the case of adverse or volatile market conditions. Stress test and scenario analysis models typically address leverage exposures on an instrument-by-instrument basis *and* on a portfolio-wide basis, since risk-reducing transactions can increase leverage exposure in parts of a portfolio while decreasing leverage exposure in others.

Outside of the fund context, SIFMA AMG's 2014 survey of separate accounts indicated that less than 4% of the separate accounts with over $75 million in assets employed leverage and less than 2% of all separate accounts did. The average gross leverage for separate accounts that employ leverage was 1.35.[109] As we noted above, the survey also elicited information about risk management processes used in the management of separate accounts. It found that that 100% of respondents monitor counterparty risk for their separate accounts and employ robust procedures to this end. Similarly, the survey observed that separate account managers monitor a number of traditional portfolio risk measures in the course of separate account management, including duration, convexity, volatility, concentration risk, and liquidity risk. Many of the responding asset managers also reported using stress test analyses to observe the sensitivities of portfolios to particular factors, as well as VaR models.[110]

[109] Separate Account Letter, *supra* note 59. For purposes of SIFMA AMG's survey, leverage was defined as long market value that exceeds NAV for equities or gross market exposure minus margin for derivatives. Long-only accounts that used derivatives for hedging or benchmark replication purposes were excluded.

[110] *Id.*

Pooled vehicles and separately managed accounts employ the same general variety of risk management tools and are monitored in similar ways, examined individually and collectively, by the firms that manage them.

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

A strength of the asset management industry is that individual firms and managers use different tools and take different approaches to managing risks related to leverage. This heterogeneity strengthens markets in two ways. First, the heterogeneity makes for more access to capital and fosters growth of markets. New risk management products beget new markets and new market participants. Second, risk management heterogeneity ensures that the attendant risks of leverage are not as systemic as they would be if risk management practices were homogeneous. For example, if an asset manager is forced to sell a leveraged instrument due to an ill-devised strategy or in response to global macro changes, other market participants will capitalize on the opportunity to buy the instrument at a discounted price, thus ensuring that the net impact of the sale is limited to the selling manager. Additionally, all asset managers should not be required by regulation to use the same risk metrics and employ the same risk tolerances.

Nevertheless, the existence of multiple risk management products and strategies suggests that regulators must carefully consider how leverage is measured. In particular, the liquidity, volatility and duration of the underlying levered assets are critical variables in assessing the impact of leverage. For example, a fund whose sole assets are three month Eurodollar futures levered five-to-one will likely have a much lower risk profile than a fund whose sole assets are three-month emerging markets index futures levered just two-to-one.

Asset managers, as a best practice, adjust leveraged exposures carefully and incrementally in response to small market movements, rather than waiting until leverage ceilings are breached before taking drastic remedial action. And leverage ceilings, just like leverage strategies and products, may vary from firm to firm among asset managers. We believe this is a positive characteristic.

6. To what extent could the 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?

We appreciate the Council's focus on securities lending practices, especially in light of Dodd-Frank's mandate that the SEC develop rules designed to increase the transparency of information available to brokers, dealers and investors with respect to securities lending practices.[111] The termination of a securities loan compels the lender to satisfy its liability for the

[111] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 984, 124 Stat. 1376, 1932- 33 (2010). Notably, in over 30 years, we are aware of only four instances of borrower default in the industry.

cash collateral. In almost all cases, the lender will unwind its investment of the cash collateral, redeeming its investment in the money market fund or collateral investment pool, and use the redemption proceeds to return the cash collateral. But the premise of this question seems not to acknowledge that overcollateralization and the conservative nature of the investments involved in securities lending mitigate any systemic risk concerns. In a securities lending transaction, an investor lends its portfolio securities to a borrower who is obligated to return identical securities to the investor at a future date.[112] As security for the loan, the investor receives collateral, which is typically, but not always, cash.[113] For pooled vehicle lenders, such as mutual funds, securities lending transactions are often effected by an agent that lends the securities on the fund's behalf and takes in and administers the collateral.[114] The loan is over-collateralized at amounts ranging from 102%-105% of the value of the loaned securities.[115] When the loan is collateralized with cash, the cash collateral is generally invested in short-term money market instruments, in Rule 2a-7 money market funds, or in similarly conservative investment pools. The income generated from the investment of the cash collateral is returned to the lender, after deducting fees due to the agent and the rebate rate due to the borrower (which is essentially interest paid to the borrower on the cash collateral). Loans and collateral are marked to the market every day, with the borrower generally being required to deposit additional collateral if the collateralization level falls below 100%. From start to finish, the securities lending transaction is straightforward, controlled, managed, and audited to reduce risk. Borrowers are typically highly rated financial institutions. The use of collateralization levels greater than 100% is intended to permit the lender to repurchase its loaned securities in the unlikely event of a borrower insolvency or in the event that a borrower fails to return loaned securities.

Securities lending does not result in significant leverage, but it does carry four observable and controllable risks: counterparty risk, reinvestment risk, market/liquidity risk, and operational risk. Counterparty risk is the risk that the borrower defaults and fails to return borrowed securities, triggering the process of liquidating collateral and repurchasing lent securities. Although the failure of multiple counterparties could lead to systemic consequences, counterparty risk is mitigated by lending to well-capitalized, high quality borrowers, extensive and ongoing credit reviews, daily collateral mark to market, and indemnification from lending agents in the event of a default. Reinvestment risk is the risk that invested cash collateral incurs losses or underperforms relative to other investment options. This risk is mitigated by establishing conservative reinvestment guidelines, monitoring weighted average maturity, credit quality, sector allocations, and issuer diversification; maintaining sufficient ongoing liquidity; in-

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[112] *See, e.g., Securities Lending by U.S. Open-End and Closed-End Investment Companies* and relevant SEC No-Action Letters cited therein, *available at* http://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm; *see also* Mutual Fund Directors Forum, *Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on the Oversight of Securities Lending* (May 2012), *available at* http://www.mfdf.org/images/uploads/newsroom/Board_Oversight_of_Securities_Lending_May_2012.pdf.

[113] *See, e.g., Securities Lending by U.S. Open-End and Closed-End Investment Companies*, *supra* note 112.

[114] *See, e.g., id.*

[115] Mutual Fund Directors Forum, *supra* note 112, at 3.

house cash management; and obtaining non-cash collateral. Market/liquidity risk, or the risk that market movements affect security value following default causing difficulties or deficiencies related to liquidation, is mitigated by overcollateralization and collateral schedules with limits on credit quality and concentration limits. Finally, operational risk, which derives from potential processing, bookkeeping or other errors related to compliance or other actions, is mitigated by daily reconciliations, control and confirmation procedures, review of SAS 70 or SSAE 16s, and due diligence of agents.

The Investment Company Act and the SEC guidance issued thereunder impose additional constraints on the securities lending practices of registered mutual funds. For example, a registered fund: (1) is not permitted to lend securities without the approval of its boards and then only in accordance with robust policies; (2) must be entitled to terminate its securities loans at any time; (3) may only accept collateral in the form of cash, U.S. government or agency securities, or irrevocable letters of credit; and (4) may not loan securities with a total value in excess of one-third (33 1/3%) of the mutual fund's gross asset value, which includes collateral received under the loans (i.e., 50% of net assets).[116]

We acknowledge the plans announced by SEC Chair White to consider enhanced reporting and disclosure requirements related to securities lending practices.[117] Disclosures related to securities lending practices, if appropriately tailored, could potentially assist investors and counterparties in making informed choices about where they deploy their assets and how they engage in lending practices. However, if such potential disclosures are considered, care must be taken to not permit changes to turn securities lending into a one size fits all practice, which could lead to concentration, stifle innovation, and foster risks that do not currently exist.

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?

Our answers to questions 7 and 8 of this section are combined below.

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?

Issues surrounding leverage have been an area of particular focus for U.S. financial regulators since the financial crisis in 2008. Dodd-Frank enacted numerous measures

[116] *See, e.g., Securities Lending by U.S. Open-End and Closed-End Investment Companies*, *supra* note 112; *see also* Mutual Fund Directors Forum, *supra* note 112.

[117] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

to control instruments deemed to have been harmful or potentially problematic. Similarly, measures like the Volcker Rule have been used to try to address systemic risk concerns.

These measures are still in their infancy, and at least some have not been codified by rulemaking, including many of the Dodd-Frank Title VII rules at the SEC and the Commodity Futures Trading Commission ("**CFTC**"), and many of the clearing-related measures under Title VIII. There is much unfinished work to do on that agenda, including streamlining data quality, aggregating across swap data repositories, and dissecting data from Form PF.

As a first step toward evaluating risk mitigation and determining best metrics for measuring leverage, we refer again to the initiatives announced by Chair White this past December and reaffirmed in other recent remarks by SEC staff to enhance data reporting and risk management related to portfolio composition. The SEC has dedicated staff in IM, DERA, and OCIE developing analytical tools in each area outlined by the Chair.

We further invite the SEC and OFR to share more detailed analysis of the results of Form PF data, including any findings, to evaluate the adequacy of those tools. This should be instructive in developing appropriately tailored metrics or mitigation techniques for pooled investment vehicles.

We also recommend that the Council enlist its international counterparts to evaluate the merits of various approaches for measuring leverage exposures. Many asset managers are subject to multiple international regimes that employ different leverage metrics. For example, the European Union's AIFM Directive and its UCITS guidelines set forth two distinct methodologies for calculating leverage,[118] while the Basel III concept of gross "notional" exposure results in yet another methodology.[119] These different metrics present challenges for asset managers' operations, and also make it very difficult for international regulators to learn from one another while regulating our markets. In that regard we encourage the Council to continue to support the Global Financial Markets Association's ("**GFMA**") Legal Entity Identifier ("**LEI**") initiative. This program has already enhanced the industry's ability to identify and monitor global market participants, and it promises to facilitate a consistent and integrated view of exposures.

Finally, leverage metrics must also account for the fact that there are different ways to measure leverage for different types of instruments or investment strategies. Indeed,

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[118] European Commission, *Commission Delegated Regulation (EU) No. 231/2013* (Dec. 19, 2012), *available at* http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf; Committee of European Securities Regulators, *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (July 28, 2010), *available at* http://www.esma.europa.eu/system/files/10_788.pdf. Notably, some managers have pointed to the AIFMD commitment leverage measure as a better representation of economic exposure than the UCITS approach because it takes into account netting arrangements and the use of derivatives for hedging purposes.

[119] *See* Basel Committee on Banking Supervision, Basel III Leverage Ratio Framework and Disclosure Requirements (Jan. 2014), *available at* http://www.bis.org/publ/bcbs270.htm, 12-13. Some managers note the limitations of the Basel measures, which were designed for banks, in the context of asset managers.

leverage is not an independent risk factor; it is a component – a multiplier, in a sense – of the aggregate impact of several component risks, including credit risk, market risk, liquidity risk, and volatility. For example, it is extremely difficult to compare, in a useful manner, the impact of levering a long-duration illiquid instrument with the impact of levering an exchange-traded short-duration instrument, and portfolio managers rarely manage a portfolio thinking in terms of levering on an instrument-by-instrument basis.

III. Operational Risk

Products and services offered by asset management firms are structured in ways that minimize the risk of disruptions associated with operational risk, even under conditions of extreme market volatility. Managers do not themselves hold the assets of fund companies or separate accounts that they oversee; rather, those assets are held at a third-party custodian, typically a bank subject to the oversight of prudential regulators. Furthermore, managers and funds routinely enter and exit the asset management industry.[120] Clients and investors also routinely enter and exit the market and reallocate assets among strategies and products. Such departures and changes, even in periods of stress, do not lead to fire sales or disorder.[121] In fact, the flexibility inherent in the structure of asset management firms may help dampen or limit operational risk because the overall industry is not dependent on any firm or small subset of firms as single points of stress or failure, and the frequency of such changes on a continual basis means that transition processes are familiar and predictable.

Asset management firms, operating in a highly competitive environment, invest considerable resources to manage operational risks that could adversely affect the assets they manage or prompt clients to move their assets to a new manager. Even if an isolated manager were to fail to adequately address one or more risks, it would not in itself create a systemic risk event. Indeed, operational risk management is a highly developed area in the asset management industry, characterized by seasoned internal practices and controls and often supported or evaluated by experienced third-party providers. Potential disruptions can come from a variety of evolving sources, and managers recognize that they must be vigilant in identifying potential issues and planning how to prevent or mitigate them. In part, this attentiveness reflects the highly competitive environment in which asset managers operate and the demands of clients who want to ensure that these managers are delivering consistent, reliable services.

Some asset management firms, in addition to compliance and audit functions, have well developed enterprise risk management ("**ERM**") practices built upon widely followed frameworks. The Committee of Sponsoring Organizations ("**COSO**") ERM framework, consisting of key components and strategic objectives, is a typical evaluation and monitoring tool

[120] In 2013 alone, 424 mutual funds were merged or liquidated, and 48 mutual fund sponsors left the business without any impact or distress. Investment Company Institute, "*Orderly Resolution" of Mutual Funds and Their Managers* (July 15, 2014), *available at* http://www.ici.org/pdf/14_ici_orderly_resolution.pdf, at 2.

[121] *See id.* at 3 (summarizing the number of mutual funds that have been merged or liquidated in each year from 1996 through 2013).

employed by many fund complexes.[122] In larger and more sophisticated asset managers, operational risks can be addressed by an ERM framework that works to identify key risk elements within the firm and how those elements are monitored and risks mitigated.

Most of the internal tools for operational risk associated with client changes are focused on organizing efficient and effective communication, identifying potential issues, and ensuring appropriate coordination and escalation among internal and external parties. While individual firms organize their processes in different ways depending on their business model and size of operations, successful management of operational risk comes from project management that relies on a common set of associated tools and controls to facilitate the process. Firms may gather metrics on such information as performance of brokers in the settlement process, performance of the firm in continuity exercises, and root cause analysis of issues that may arise. Many firms have executive dashboards to provide trend analysis on a variety of metrics. These types of metrics are usually monitored and made available to management on a periodic basis with immediate escalation of any significant issues. In order to be effective, these approaches must be tailored to each firm's operations, which inherently means that they will differ from firm to firm. One approach will not be appropriate or sustainable for all investment managers. This means that attempting to impose such a framework by rulemaking will likely not be effective.

Of potentially more significant interest, asset managers are keenly focused on business continuity planning, disaster recovery, data protection, and cybersecurity issues – not just because of regulatory requirements,[123] but also as a business imperative. To this end, there are a variety of measures in place, both regulatory and market driven, to control operational risks. In addition, we note that there is a wide raft of regulations and guidance from the SEC, OCC, and others relating to operational risk procedures of asset managers and requirements

[122] *See* COSO, *Enterprise Risk Management – Integrated Framework, Executive Summary* (Sept. 2004), available at http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf ("[e]nterprise risk management is a process, effected by an entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives" (internal emphasis omitted)).

[123] Rule 206(4)-7 under the Advisers Act requires each investment adviser to adopt and implement written policies and procedures reasonably designed to prevent the adviser from violating the Advisers Act. These policies and procedures should include business continuity plans because an adviser's fiduciary obligation to its clients includes taking steps to protect the clients' interests from risks resulting from the adviser's inability to provide advisory services after, for example, a natural disaster. *See* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003), *available at* http://www.sec.gov/rules/final/ia-2204.htm (discussing the need for advisers to establish a reasonable process for responding to emergencies, contingencies, and disasters, and that an adviser's contingency planning process should be appropriately scaled, and reasonable in light of the facts and circumstances surrounding the adviser's business operations and the commitments it has made to its clients); *see also* "SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year," National Exam Program Risk Alert, Vol. II, Issue 3 (Aug. 27, 2013) available at https://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf. .

related to ensuring compliance by service providers and other vendors.[124] They include redundancies among essential systems and back-up trading sites.[125]

Similarly, in the aftermath of the May 2010 Flash Crash, asset managers worked with exchanges and other market intermediaries as the SEC and self-regulatory organizations established more finely calibrated "limit up-limit down," circuit breaker, and halt mechanisms that now assist asset management firms by limiting precipitous movements in the markets. The practical result of regulatory requirements, existing business imperatives, and the competitive incentives of asset managers is that the industry has successfully weathered market glitches, hurricanes, blizzards, floods, and terrorism.[126] However, that success is not taken for granted, as evidenced by the money invested by firms to prevent or mitigate the effects of these or other potential impairments.

There are a variety of third-party service providers offering essential services such as custody, pricing or other functions on which asset managers rely. Mutual funds, with independent boards, have fiduciary duties to select service providers including advisers, sub-advisers, pricing agents, transfer agents, custodians and accountants. In many cases, however, investment advisers only operate as sub-advisers and do not have primary responsibility for the selection and oversight of custodians. For example, most institutional separate account clients select and retain their own custodian, so the investment adviser has no direct role in the oversight of that relationship. In either case, market participants often work with and through third parties and service providers, and there are ongoing communications, contractual provisions, and diligence seeking to provide comfort about the quality and resiliency of the services being provided.[127]

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[124] *See, e.g.*, Rule 206(4)-7 under the Advisers Act; *see also* Inv. Adv. Act Rel. No. 2204 (outlining requirements relating to investment advisers); Rule 38a-1 under the Investment Company Act; Inv. Co. Act Rel. No. 26299 (requirements relating to registered investment companies); Comptroller's Handbook on Asset Management Operations and Controls (Jan. 2011), at 14 (describing outsourcing and vendor oversight, business continuity and contingency planning, and information security requirements for bank-sponsored asset management operations); FINRA Rule 4370 (describing business continuity requirements for FINRA member firms); NFA Rule 2-38 (describing similar requirements for NFA member firms).

[125] In February 2015, OCIE issued its preliminary observations on its examinations of 57 registered broker-dealers and 49 registered investment advisers to better understand how broker-dealers and advisers address the legal, regulatory and compliance issues associated with cybersecurity. The vast majority had adopted written security policies, and many use external standards and other resources to model their information security architecture and processes. Office of Compliance Inspections and Examinations, *Cybersecurity Examination Sweep Summary*, National Exam Program Risk Alert, Vol. IV, Issue 4 (Feb. 3, 2015), *available at* http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

[126] In particular, the August 27, 2013 National Exam Program Alert (*see "*SEC Examinations of Business Continuity Plans," *supra* note 123) tallied a review of 40 advisers in areas affected by Hurricane Sandy and noted a range of practices to address critical systems issues, continuity of operations, and contingency practices among the firms. Among their observations, the staff noted that advisers generally switched to back up sites or systems in advance of issues.

[127] As part of such an engagement, an asset management firm would seek assurances related to the services of a third party in the form of an auditor's report evaluating the service provider's operations and controls provided in a standard protocol known and presented as an SSAE 16 report (formerly a SAS 70 Report).

To ensure that they can continue to provide services through varying market conditions, service providers conducting critical functions such as custody services or who serve as central counterparties must themselves be supervised. As mentioned previously, some of these are banks that are already subject to the oversight of prudential regulators. Nevertheless, with increasing regulatory demands, these third parties are themselves going through periods of consolidation, and asset managers are finding that they must rely on a smaller pool for certain critical services. We understand that this is an area of some focus by the SEC and the other supervisory regulators of the entities at issue. Moreover, we appreciate that evaluating the obligations and challenges presented by these entities requires grappling with complicated, and in some ways contradictory, considerations. On one hand, it might be helpful to lower some of the barriers to entry to permit more entities to enter the service provider space in order to increase competition and offer managers more choice. New entrants may need regulatory flexibility that recognizes their specific risks and needs as they develop infrastructure, expand their platforms, and service new clients. At the same time, strong infrastructure and risk controls around resiliency and redundancy, testing, substitutability, and transition and resolution planning are important considerations in connection with the critical functions that key service providers perform.

We note that the Chair and the SEC's chief economist have referred to the newly promulgated Regulation Systems Compliance and Integrity ("Reg SCI"), which sets basic resiliency and continuity requirements for certain market participants (such as exchanges and clearing agencies) deemed to be performing critical functions, as a potential model for further regulatory expectations for other market participants.[128] Reg SCI already has market-wide testing requirements for SCI entities to designate members and participants to engage in annual testing exercises. We believe it will be advisable for regulators and market participants to work together to address these risks prudently and appropriately.

Custodians, market infrastructure providers such as central securities depositories ("**CSDs**") and international central securities depositories ("**ICSDs**"), and CCPs have an important role in maintaining control of client funds and securities. Effective oversight of these entities is critical to the resiliency and integrity of asset managers. Assets held by custodians are segregated from both the banks' balance sheet and other customers', and are therefore fully recoverable in the event of insolvency. Custodians typically used by U.S. asset managers are large banks, subject to prudential regulation and supervision by the U.S. banking regulators. All major U.S. custodians are subject to the heightened prudential standards for systemically important financial institutions under the Dodd-Frank Act, and four of the largest providers of such services are among the eight U.S. banks designated as G-SIBs (Globally Systemically Important Banks) by the FSB, and thus subject to even higher levels of regulation. In addition to heightened prudential standards, all such banks are subject to U.S. regulatory stress testing, which tests their ability to sustain severe economic shocks. These banks are also subject to U.S. living will requirements; for custody banks, the ability to seamlessly provide critical custody services is a key factor in the living will. Effective regulation of financial market utilities ("**FMUs**"), such as CSDs and ICSDs, is also critical to addressing possible operational risks for

[128] *See* 17 CFR Parts 240, 242 and 249, "Regulation Systems Compliance and Integrity" (Feb. 3, 2015); *see also* Flannery, *Asset Management, Financial Stability and Economic Growth* (Transcript), at 62.

the asset management industry. Such utilities hold the register of shares on behalf of investors and serve as the book of record for assets held, regardless of the custodian used, and ensure the clearing and settlement of securities transactions. As a result, such utilities, in combination with custodians, are important elements in protecting the interests of asset managers and their clients (beneficial owners). Similarly, asset managers' reliance on the resiliency of other FMUs, particularly CCPs, continues to increase, as regulatory mandates and market practice shift many formerly over-the-counter transactions to central clearing.

In the United States, FMUs are regulated under Title XIII of the Dodd-Frank Act; eight firms have been designated by the Council as systemically important, and therefore subject to enhanced regulatory standards under Title XIII. The effective regulation and supervision of these, and similar, entities, is critically important to the asset management industry.

We note that Chair White has announced that the SEC staff will be focusing attention on transition planning by asset management firms and potentially developing recommendations to require investment advisers to create transition plans to prepare for major disruptions in their business.[129] The goal of ensuring that asset managers and clients are prepared to deal with transition management is a shared priority and, as discussed more thoroughly below, an already well-advanced and sophisticated professional field within the industry. We further note that Chair White also announced plans around potential rulemaking relating to annual stress testing by large asset managers and large funds, as required under the Dodd-Frank Act.[130] Stress testing is a tool used by some asset managers. Members of SIFMA AMG have already briefed SEC staff on key aspects of the stress testing programs at asset management firms and look forward to further dialogue with the staff as they consider these issues.

Finally, as the Council evaluates operational risks at asset management firms and their potential effects on the wider financial system, we urge the Council to consider the multiple operational testing practices already underway or that may be instituted for asset managers. Taken together, the time that will be devoted to market-wide testing under Reg SCI, any additional Reg SCI-like requirements in contemplation for other market participants such as asset managers themselves, as well as additional Dodd-Frank related stress testing that the SEC is considering, will require considerable resources. Asset management firms already engage in

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[129] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4 ("The staff is therefore developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business. The process of creating such a plan in advance of an actual severe disruption in the adviser's operations could better prepare advisers and their clients to deal with a transition and its attendant risks if one were required.").

[130] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4, at note 27, citing Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, section 165(i)(2), 124 Stat. 1423 (2010) (codified at 12 U.S.C. § 5365) ("The Dodd-Frank Act requires the Commission to establish methodologies for this stress testing of financial companies such as broker-dealers, registered investment companies and registered investment advisers with $10B or more in total consolidated assets—including baseline, adverse, and severely adverse scenarios—and to design a reporting regime for this stress testing, which must be reported to the Commission and the Federal Reserve Board.").

extensive testing through their normal business continuity planning and disaster recovery efforts, as well as from maintenance of or upgrades to existing systems, or from conducting other of their own idiosyncratic testing to ensure continuity and resiliency. Any additional requirements should be carefully considered within this context. We look forward to working collaboratively with the SEC and other market participants on the various forms of testing that may be appropriate. We view interaction between asset management firms and their primary regulator as a first and fundamental set of steps before the Council considers any further action.

1. **What are the most significant operational risks associated with the asset management industry and how might they pose risks to U.S. financial stability? What practices do asset managers employ to manage operational risks (e.g., due diligence, contingency planning)?**

Asset managers are highly incentivized to avoid potential operational risks. As described above, asset managers engage in substantial planning and diligence to safeguard their operations from risks across a spectrum of issues. If a single or even multiple firms encounter challenges, other firms are available to compete to assume responsibility and manage the assets and liabilities.[131] Further, operational challenges facing a single manager or set of managers do not in themselves present risks to U.S. financial stability. The inherent structure of the asset management industry provides a degree of flexibility and resilience that does not depend on any particular investment adviser. A change of investment adviser requires no change of custodian and no transfer of assets.

Nevertheless, we acknowledge that new sources of risk are being identified within the financial system and that asset managers are re-allocating or refocusing resources on these risks. A very current example of an operational risk to the financial services industry is the threat of cyberattack. This is not a unique risk to asset managers and, in fact, asset managers likely have a lower risk profile than banks or broker-dealers given the nature of client information retained and external access points. That said, spending at many firms has risen precipitously in recent years to address this risk. Historically, technology budgets have been mostly spent on tools, with an ever-expanding array of staff required to operate and use them. More recently, budgets are also being spent on incident planning (including gap analyses, formalizing policies and procedures, and training exercises) to enable asset management firms to defend themselves against not only the attacks themselves, but from regulatory and reputational risks that could follow in the wake of an incident.

[131] For example, at the May 2014 FSOC Roundtable, Citadel described the process of purchasing distressed portfolios from two firms, a resolution effected within 36 hours by two private parties acting in their own interests and without the intervention of any government entity. Letter from Timothy W. Cameron, Asset Management Group, Head, and Managing Director, Securities Industry and Financial Markets Association, and John Gidman, President, Association of Institutional Investors, to Jacob J. Lew, Secretary of the U.S. Department of the Treasury, Re: Comments Summarizing the Financial Stability Oversight Council's May 19, 2014 Conference on Asset Management, SEC File No AM-1, at 10, *available at* http://www.sifma.org/comment-letters/2014/sifma-and-investors-group-submit-letter-to-us-treasury-summarizing-the-fsoc-s-conference-on-asset-management/.

Adequately addressing cybersecurity risk is a topic that also benefits from governmental support and coordination. In this regard, we acknowledge the important role played by other agencies, including the FBI, Treasury, and Federal Financial Institutions Economic Council ("**FFIEC**"), in providing better information and standard-setting guidance to aid in the prevention of cyberattacks. To date, the work of coordination across the financial sector has been episodic and limited, but it is improving. Although asset management firms, like other financial services industry participants, are already devoting significant resources to this issue, there are greater efficiencies that could be captured by better coordination and information sharing. As a coordinating body for other financial regulators, the Council should consider playing a more active role in fostering information sharing and best practices across the broader financial services sector to address this issue; this is an area of core competency for the Council and reflects a risk that can be transferred between sectors of the economy.

Another area of focus relates less to asset managers themselves than to the service providers on which they rely. As noted above, there are a relatively limited number of custodians of sufficient size to service the assets of larger asset management firms. In the case of FMUs, there may be a single provider in any particular market. There has been and will continue to be a dramatic shift toward a more central role performed by CCPs as various Dodd-Frank provisions come into effect. The Council should continue to monitor and encourage improvements to this part of the regulatory system to avoid unintended risks. While asset managers conduct diligence and develop contracts for service level expectations, asset managers do not have unlimited transparency into third parties or the authority of a regulator. Regulators should continue to consider whether expectations are sufficient or appropriate for the risks involved.

Like other market participants, asset managers also face the demands of increasing operational complexity that comes from programming systems to reflect the promulgation of new rules and agency expectations focused on data handling and reporting requirements, clearing mandates, execution, management, and analysis. If the SEC creates a tick pilot or alters fee structures, if it sets new margin requirements, or if regulators like the SEC and the CFTC create disparate requirements for swaps and securities-based swaps, then such changes and complexity can themselves pose operational risks. We provide these examples as a general cautionary note to the SEC and the Council regarding any additional significant new requirements, particularly before the completion of Dodd-Frank rulemaking or the SEC's or CFTC's market structure initiatives and Title VII rulemaking. We urge the Council to refrain from recommending any further requirements where Chair White has announced plans to evaluate potential initiatives for asset management firms across each area described in the Notice.

2. What are the risks associated with transferring client accounts or assets from one manager to another and how do these risks vary depending on the nature of the client, the asset types owned by the client (e.g., derivatives), or how the asset type is traded or cleared? For certain asset classes or strategies, are the number of asset managers offering a comparable strategy so concentrated that finding a substitute would present challenges? How rapidly could investment management accounts be transferred, including during a time of financial market stress?

Client or asset transfers are a well-managed part of the asset management business, and clients routinely instruct firms that have been given a management mandate to transfer the management of assets to another firm. As client custodians maintain the client funds and securities, there is typically no actual movement of assets – only a change in the authority to make investment decisions. Transition management strategies are a well-developed area of expertise, as leading asset management firms and other service providers routinely assist in the restructuring or migration of assets. This process is a common cycle, effected every day as clients reallocate assets. As was noted by one participant in the May 2014 Council roundtable, in the industry "the process of being hired and fired happens thousands of times a day."[132]

Asset management businesses are very familiar with and are able to conduct transition management efficiently and quickly when necessary. There are firms that provide transition management services specializing in helping asset owners minimize transaction costs while managing investment and operational risks. Additionally, transition managers help asset managers minimize costs to the rest of the client base and to the clients entering and leaving commingled funds. Investment funds also close regularly with little market impact. A recent Morningstar study found that 4 in 10 U.S. mutual funds operating ten years ago closed before 2014.[133] Similarly, the FSB and IOSCO acknowledged in their 2014 Consultative Document that "funds close (and are launched) on a regular basis with negligible or no market impact," and "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact [from 2000 to 2012]."[134]

Protections exist to insulate clients from harm during such transfers.[135] Custody arrangements facilitate the movement of accounts or funds between managers. In the circumstance of a mutual fund, the arrangements are governed by a contract between the fund and the custodian and in general the custodian would simply need instructions from the board authorizing a new adviser to transact on the fund's behalf. Because the clients themselves

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[132] John Gidman, quoted in Cameron, *supra* note 131, at 13.

[133] Taylor Tepper, *Mutual Funds Gone Down the Drain,* Money Magazine (Mar. 7, 2014), *available at* http://time.com/money/2795219/mutual-funds-gone-down-the-drain/.

[134] FSB/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), at 30 & at note 38.

[135] The "asset management infrastructure . . . really put[s] the end investors a very far distance away from the trials and tribulations of their asset manager." Ken Griffin, quoted in Cameron, *supra* note 131, at 13.

typically control the appointment and maintenance of a custodian, the clients merely provide an instruction to the custodian to indicate that a different asset manager now has authority to manage the mandate. The custodian itself segregates client assets and receives instructions for changes in adviser authority. Indeed, U.S. asset segregation and custodian arrangements are a "substantial safeguard" that European regulators have acknowledged and seek to imitate in designing their own recovery and resolution frameworks for non-bank institutions.[136] In times of stress, including 2008, enormous transfers were effected without incident. In most respects, the only "delay" associated with such transfers may be regulatory in nature or related to receiving confirmations of the movement of the assets.[137]

3. What market practices, processes, and systems need to be in place to smoothly effect transfers of client accounts or assets by asset managers and/or custodians? What differences exist in information technology systems, processes, or data formats that could pose operational risk, particularly when markets are stressed? Are there specific risks related to foreign clients, foreign custodians, foreign assets, or the use of offshore back-office operations?

Most of the transfer work related to the movement of client accounts is effected by a custodian. The assets are segregated at the custodian; they belong to the client, not the manager. Asset managers are acting as agents, and creditors of the asset manager would have no claim on the assets of the client.

Transitions can take a variety of forms. In some cases, a client may request that the existing manager liquidate assets and the client can reallocate the cash or designate another asset manager to invest the cash. In other cases, a client will ask a successor manager to review the list of assets and determine which should be retained and which should be liquidated. In other cases, the custodian or sometimes a transition manager will be retained for the purpose of managing a transition to minimize friction. For example, if a client wants to move a significant amount of assets in S&P 500 stocks from one manager to another, it would not be unusual for each manager simply to update its own internal books to manage the changes, while the custodian makes note that it will receive investment instructions from a different manager. Standard portfolio accounting systems are designed to handle changes in contributions and redemptions of securities, sales and purchases, cash flows, and other standard data. For larger managers, portfolio accounting systems routinely handle institutional-level volumes. In general, firms do not face challenges related to systems themselves. Rather, they must take care in coordinating who is doing what and when. For example, moving an account as of a certain date

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[136] *See* Kay Swinburne, European Parliament Committee on Economic and Monetary Affairs, *Report on Recovery and Resolution Framework for Non-Bank Institutions* (Oct. 22, 2013), *available at* http://www.europarl.europa.eu/document/activities/cont/201310/20131023ATT73307/20131023ATT73307EN.pdf.

[137] Alan Greene, cited in Cameron, *supra* note 131, at 13. Although most securities can be transferred without difficulty, the transfer of OTC derivatives requires asset owners to call upon legacy advisers for assistance, which can increase costs and expose asset owners to some market risk. As more products move from an OTC to a cleared environment, we expect this challenge to be further alleviated.

requires care in planning and preparation, but a simple Excel spreadsheet may be all that is needed to share asset lists and project plans among asset managers, clients and custodians. In a transfer, recordkeeping is carefully maintained under requirements set by the Investment Company Act and the Advisers Act and under the terms governing custodial agreements, and transfers can proceed quickly. The optionality of effecting a change of investment adviser helps to mitigate the associated risks. As noted above, in some cases, a transition may not even require sales of assets. In circumstances where assets are actually to be sold, there may be additional incidental time associated with effecting the transactions advantageously and clearing the trades.

With regard to risks for foreign clients, custodians or operations, we note that most large custodians have global operations, and this aids significantly in the ability of asset management firms to oversee smooth transfers. We acknowledge that interactions with some foreign entities or service providers can bring delays as records and instructions are verified and firms meet the requirements of other jurisdictions. There are additional operational requirements associated with local country accounts, setting up to trade some currencies, or working with a new and unfamiliar custodian, but these processes are routine for managers dealing with any new client or client that is changing a mandate. Thus, these features of international work do not raise significant issues, but call for additional time that may be required for resolving issues. While such challenges are not always easy, they are part of daily operations for firms with an international overlay.

4. **While asset liquidation is not required for, and is not typically associated with, the transfer of client accounts, are there any significant risks of asset liquidations in the event of a large-scale transfer of accounts or assets from an asset manager?**

No. Although such circumstances would rarely present themselves (that is, transfers are often effected without the need for assets to be liquidated), asset managers are fiduciaries subject to a duty of care in managing client assets, including, if necessary, liquidating appropriately. As discussed in several places throughout this letter, significant numbers of pooled vehicles and separate accounts are transferred regularly and seamlessly – irrespective of size (we question what is meant by "large-scale" in an industry where institutional clients allocate assets in the billions) and complexity (the industry has seen managers merge with others or relinquish a mandate without disruption). If circumstances should warrant liquidations (for example, if a client seeks that outcome), it is in the interest of both the asset manager and the client to liquidate in an orderly, responsible fashion.

5. **To what extent do asset managers rely on affiliated or unaffiliated service providers in a concentrated or exclusive manner for any key functions (e.g., asset pricing and valuation, portfolio risk modeling platforms, order management and trade processing, trading, securities lending agent services, and custodial services)? What would be the impact if one or more service providers ceased provision of the service, whether due to financial or operational reasons, or provide the service in a seriously flawed manner? To what extent do potential risks depend upon the type of service provided, whether the provider is affiliated with the asset manager, or whether the**

service provider is non-U.S. based? What due diligence do firms perform on systems used for asset pricing and valuation and portfolio risk management?

Asset managers use the services of various affiliated or unaffiliated service providers. Typical business-continuity planning and disaster relief programs articulate the importance of back-ups and explicitly lay out contingency plans around service providers. The issue of finding alternative service providers does present challenges. There has been significant consolidation in the wake of regulatory and accounting pressure, and there are steep barriers to entry for new providers to join the ranks of existing custodians, accountants, and pricing services. While such consolidation raises general challenges for the industry (including limitations on the number of service providers industry members are able to turn to and rising costs associated with a small array of providers), this changing dynamic could be viewed by regulators as a positive change (fewer entities to regulate), a risk (an increase in single points of failure and a concentration of operational risk for the broader financial system), or a combination of both.

In the aftermath of the credit crisis, there has been considerable diligence imposed on the pricing process by the SEC and the Public Company Accounting Oversight Board ("**PCAOB**"), which has raised the bar for public accounting firms in the preparation of financial statements. As a result, pricing vendors are under much more scrutiny and provide much more transparency into their analyses. Most funds and advisers conduct regular diligence efforts on pricing vendors, and major vendors are regularly meeting with boards and managers.

There is less concentration among, and less reliance on, vendors to provide portfolio risk management, and firms vary widely in their use of such service providers. There are vendor applications to help gather and analyze data, but the key is how the data is used. The diligence that a client conducts is chiefly about the portfolio risk program rather than a particular system.

For its part, the SEC has embarked upon a review in the market structure space of single points of failure. The agency and market intermediaries are working on a series of resiliency standards and redundancy requirements relating to service providers. We also reiterate that Chair White recently announced that the SEC has launched an initiative regarding transition planning and stress testing,[138] which we expect will also evaluate the role of service providers. We will welcome the opportunity to provide input on any potential regulatory assessment the agency conducts.

[138] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4 ("The staff is therefore developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business…. The staff is also considering ways to implement the new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act.").

6. **What operational interconnections exist between the asset manager and the investment vehicles it manages, among investment vehicles managed by the same asset manager or affiliated managers, or between the asset manager and its affiliates? For example, to what extent do asset management firms rely on shared personnel, technology, or services among affiliates? Could any of those interconnections result in operational risk transmission among affiliated investment vehicles or asset managers in the event of a failure and resolution of an affiliate? Do market practices ensure that operational interconnections are sufficiently documented to allow for an orderly continuation of an investment vehicle's operations if the asset manager or affiliated or independent third-party service providers were to declare bankruptcy?**

Most asset management firms make use of shared personnel, technology and services among affiliates as a matter of course. Interconnectedness is inherently an issue of scale. Given that fixed costs are high, it is typically uneconomical to launch and advise a single pooled vehicle. Accordingly, an adviser would more customarily provide services to multiple funds or accounts to overcome high fixed costs. In theory, this raises the risk that a single issue at one entity would affect other funds or market participants; but in fact the added scale and specialization also mitigates risk, because each party is stronger and more sophisticated than it might be if it were acting on its own. An integrated business model that houses adviser, sub-adviser, distributor and custodian under one corporate roof potentially has greater internal coordination as well.

7. **What are best practices employed by asset managers to assess and mitigate the operational risks associated with asset management activities performed by service providers, whether affiliated with the asset manager or not, and how common are these practices across the industry? What agreements or other legal assurances are in place to ensure the continued provision of services? What are asset managers' contingency plans to deal with potential failures of service providers, and how might these plans be impacted by market stress?**

Asset managers seek assurances for activities performed by service providers by conducting due diligence prior to hiring and entering into service level agreements ("**SLAs**") with their service providers. Asset managers may also engage or otherwise rely on third parties to assess service providers and implement controls to mitigate potential weaknesses. For key services, many asset managers require SSAE 16 (previously SAS 70) reports to evaluate the key internal controls of the service providers. Depending on the service provider or the service at issue, asset management firms also keep regular metrics (e.g., performance evaluations of custodians to review failed trades, overdrafts, or other issues) and maintain regular communication with service providers to mitigate issues as they arise. Most firms have regular interactions (e.g., with pricing vendors), but there are also more formal diligence visits that occur on a regular basis. Although legal assurances are built into contracts with such providers, the practical way in which issues are handled between asset managers and service providers is as a business matter: dissatisfied managers may seek out the services of another provider in

circumstances where a vendor underperforms or otherwise raises concerns on the part of the manager or a fund board, which typically has oversight responsibility for key relationships.

Where an asset manager uses the services of an affiliated vendor, the asset manager may have better visibility into operations and could have more control over that service provider, even if it exists as a separate entity. However, asset managers are under an obligation to act as fiduciaries to their clients; therefore, they must evaluate performance of affiliated service providers under the same standard as they would the services provided by an unaffiliated entity. As such, ultimate responsibility and accountability to clients cannot be outsourced by asset managers to service providers. In addition, a service provider is usually contractually liable to an asset manager if it does not perform according to the parties' agreement.

8. To the extent that any operational risks in the asset management industry present risks to U.S. financial stability, how could these risks to financial stability be mitigated?

We reiterate our remarks made earlier in this section of our response, and focus here on cybersecurity, concentration risk among certain service providers and intermediaries, and settlement delays of leveraged loans. Cybersecurity is a shared area of focus for all participants in the financial services industry. Asset management firms are taking those threats seriously, and we believe the Council is in a good position to foster information sharing on best practices and incident management across firms overseen by the Council's various members and the other agencies with which they interact.

Also important to any conversation about operational risks for the asset management industry is the role performed by certain service providers and intermediaries. As Dodd-Frank requirements come to maturity, market participants will come to look even more to central clearing parties, and there is considerable unfinished work among the Council member agencies in bringing that regime to completion. As it stands, there is also concentration risk created by the increased use of CCPs, and the increased regulatory costs to serve as a CCP (or a SEF or as other new or existing types of service providers or intermediaries) will mean fewer entrants to serve asset managers and other market intermediaries. Similarly, there is also concentration among other service providers relied on by the industry, such as custodians for pooled investment vehicles and prime brokers for hedge funds.

As one further matter for consideration, but one that does not rise to a level of systemic concern, we take the opportunity to note that settlement delays relating to leveraged loans currently affect both buyers and sellers of such loans. We raise it here as a potential example where further operational efficiency could mitigate risk, as the market has grown over

the past decade.[139] The settlement of trades in such instruments is still fairly manual and involves longer settlement times than many other financial instruments.[140]

There may be a number of reasons attributable for a delay in settlement of loans, including the nature of the underlying loan itself. For example, distressed loans or loans that are the subject of restructurings may require additional documentation (e.g., additional representations and warranties) and further diligence (e.g., a review of the court docket for documentation as well as a chain of title review) before the loan can be transferred. In addition, loan settlements may be delayed due to the occurrence of certain events under the credit agreement. These include but are not limited to interest rate changes, credit agreement amendments, or voting on consents. During such intervening periods, trades are not permitted to settle so that the respective administrative agents can adjust their books and records accordingly.

From a trading perspective, the market convention is that, despite the delays in settlement, trades may occur on a trade date irrespective of whether or not the actual settlement has occurred. While certain documentation (e.g., a multilateral netting agreement) has been developed by industry associations such as the Loan Syndications and Trading Association ("**LSTA**") to address the fact that a seller of a loan may not in fact own it at the time of sale, it would be prudent to work towards an industry solution to reduce the time delay in the settlement of loans. There have already been large steps taken by the industry through the establishment of independent, electronic, web-based platforms where all parties to a given loan trade may perform or verify key tasks related to effectuating settlement.[141]

There have been a number of recent initiatives to standardize the settlement and clearing process for bank loans, but these initiatives have not been widely supported due to concerns over costs and the potential loss of flexibility in structuring loans. We believe regulators should work in tandem with the asset management industry and arrangers of leveraged

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[139] Trading volume for leveraged loans in the United States reached a record level of approximately $153 billion for the fourth quarter of 2014 (*see* The Loan Syndications & Trading Association, *The 4Q 2014 LSTA Secondary Trading Study* (Feb. 4, 2015), at 24), with a total of $628 billion for 2014 annually. *See id.* at 20. Viewed in perspective, U.S. collateralized loan obligations ("CLOs") accounted for roughly 62% of non-bank institutional lending for the fourth quarter of 2014. *Id.* at 6.

[140] *See generally* MarketClear data, *available at* www.clearpar.com. ClearPar-reported settlement times for 2013 overall had an average settlement time of T+22.8, whereas for 2014 it was around T+21.1. ClearPar data suggests that, for the period beginning October 1, 2014 and ending December 31, 2014, agent banks (with 100+ trades) had settlement times ranging from 8 to 85 days, purchasers (with 100+ trades) in general had settlement times ranging from 10 to 45 days, and loan sellers (with 100+ trades) in general had settlement times ranging from 16 to 37 days. Further, LSTA data suggests that as of the end of 2014, settlement times for par loans reached a two-year low of T+15 from T+18 business days. *See* The Loan Syndications & Trading Association, *supra* note 139, at 25.

[141] Such tasks include trade affirmation (via allocation) and confirmation; matching of trade terms; communication of credit events; person contact information center; posting of know your customer ("KYC") documentation (administration and tax forms); review of documentation provisions; signature / execution of relevant documentation; corroboration with third parties (agent bank, LC issuer, counsel) for consent; coordination for agreement of settlement time; and retainer / repository for upstream (predecessor transfer documentation).

loans to encourage building on the existing electronic settlement framework, ultimately seeking to reduce settlement times for leveraged loans in line with those for bonds.

We understand from OFR's announced plans that data gathering efforts will continue in 2015. But we believe that the most appropriate initial steps are linked to the data gathering and evaluation announced by Chair White around transition planning and stress testing. Such initial review and the opportunity to evaluate and digest the wide-ranging set of new regulatory requirements impacted by Dodd-Frank and on primary regulators are important initial steps before determining what, if any, additional measures might be warranted.

IV. Resolution

We appreciate the Council's recognition that asset management firms and investment vehicles have wound down their affairs without presenting a threat to U.S. financial stability; that investment vehicles managed by asset managers have separate legal structures; and that the assets of such vehicles are not legally available to the asset manager, its affiliates, or parent for satisfying its financial obligations or those of any affiliate.[142] As the Council and other regulators and experts have noted in a variety of contexts, these characteristics distinguish the asset management business from banking and other financial products and service providers.[143] They also explain why the resolution of investment funds and investment advisers has historically had no discernible market impact, let alone threatened financial stability.[144]

The asset management business is inherently different from that of banks. There are fundamental differences between the concepts of deposits and investments. Depositors in banks are guaranteed immediate access to their money, so the risk parameters they undertake are different from investment-taking risks. Investors place money with asset management firms

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[142] *Notice*, *supra* note 3, at 23-24; *see also* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4 (discussing the Commission's focus on improving transition planning).

[143] *See, e.g.*, White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4, *see also* Pinschmidt, *supra* note 13, at 53-58.

[144] *See, e.g.*, FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at 29-30. As articulated by Scott. C. Goebel at Fidelity, "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 discernible 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.'" Letter from Scott C. Goebel, Senior Vice President, General Counsel, Fidelity Management & Research Co., to Secretariat of the Financial Stability Board, Re: Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, at 10 (Apr. 7, 2014), *available at* http://www.sec.gov/comments/am-1/am1-45.pdf (citing FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at note 38).

intentionally to take risk and receive full disclosure of the various risk factors. Custody concepts are very different, as asset managers are not in possession of client funds and securities. The structure of the business with separation among investment advisers, sub-advisers, funds, boards and custodians provides flexibility and resiliency; it also facilitates easy resolution through normal processes. There is less reliance on a single point of failure, and it is far easier for another market participant to step in if an entity can no longer provide services. For these and other reasons, the factors that require special resolution planning and a unique resolution mechanism in the banking context to preserve financial stability simply do not apply to the asset management business.

As established by Congress, the Council's mandate is to identify threats to U.S. financial stability, but the resolution of asset managers does not present such a threat. As discussed more fully below, investment funds, their managers and affiliated service providers have historically been resolved regardless of market conditions. Their resolutions through these processes have not threatened financial stability and there is no empirical support for an assertion that they are likely to in the future. Accordingly, there is no need for a new or special resolution regime for asset management entities of the sort that is under development for SIFIs.

Based on the experience of the 2008 crisis, Congress and other policymakers have deemed the resolution of certain entities to be an essential component in reducing a potential source of systemic risk.[145] But the entities to which this imperative was directed should not be confused with asset management firms and vehicles, which do not share the same fundamental characteristics as those entities. Indeed, the Council states this plainly in the opening paragraphs of the Resolution section of the Notice:

> 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.[146]

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[145] The Financial Stability Board (FSB) has also made proposals aimed to assure the availability of debt that is convertible into equity should a firm fail, thereby providing for absorption of losses and possible recapitalization without the need for injecting public capital. *See* Financial Stability Board, *Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution* (Nov. 10, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf. *See also* Governor Daniel K. Tarullo, *Dodd-Frank Implementation*, Speech before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Sept. 9, 2014), *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm ("We have also worked with the Financial Stability Board (FSB) to reach global agreements on resolution regimes for systemic financial firms and on a set of shadow banking regulatory reforms."); Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf ("We recommend the creation of a resolution regime to avoid the disorderly resolution of failing BHCs, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy," at 16.).

[146] *Notice*, *supra* note 3, at 23-24.

Funds and their managers enter and leave the industry routinely in all market conditions. By one estimate, excluding data for ETFs and closed-end funds, over 9,500 mutual funds were merged or liquidated between 1996 and 2013, or an average of 528 per year.[147] Between 2000 and 2013, 651 mutual fund sponsors left the business, or an average of 46.5 per year.[148] These mergers and liquidations happened through varying market conditions, but occurred with little notice and with no appreciable impact on U.S. financial markets. The breadth of the market in terms of many different advisers, sub-advisers, and varieties of funds and separate accounts also mitigates the effect and potential impact of any single actor on the systemic risk scale.

We do not believe there is theoretical support for the inquiry into resolution for asset managers: the differences between the structure, economics, regulation and oversight of banking institutions (on one hand) and asset managers and their pooled vehicle and separate account clients (on the other) help explain why resolution is a complex and potentially destabilizing endeavor for large banking firms and a routine matter for the asset management industry.

The products and services offered by asset management firms serve specific needs of investors, different from other aspects of the financial service industry. Because managed assets are held differently, there is ready substitutability of one asset management firm for another. There are various protections afforded to asset manager clients, such as the custodial practices and other features described throughout our response.[149] Investors are not promised returns on their investments, and investment results – whether gains or losses – are apportioned to pool investors on a pro-rata basis or borne exclusively by clients with separate accounts. Asset managers are fiduciaries to their clients acting as agents of the funds or separate accounts they manage. They provide services in exchange for a fee, take no balance sheet risk with respect to a fund's or an account's investment performance, and have no ability to use a client's assets for their own purposes.[150] Beyond ensuring that an adviser has sufficient resources to employ staff and purchase tools and systems in order to provide services, the actual balance sheet of an adviser is irrelevant. The assets of the adviser are separate from the assets of each client to

[147] Investment Company Institute, *supra* note 120, at 2-3.

[148] *Id.*

[149] For example, open-end mutual funds have a 300% asset coverage requirement. 15 U.S. Code § 80a–18(a)(1)(A), *available at* http://www.gpo.gov/fdsys/pkg/USCODE-2011-title15/pdf/USCODE-2011-title15-chap2D-subchapI-sec80a-18.pdf. *See also* Paul Scott Stevens, President and CEO, Investment Company Institute, *Financial Stability and U.S. Mutual Funds*, Mutual Fund Investment Management Conference (Mar. 17, 2014), *available at* http://www.ici.org/pressroom/speeches/14_pss_mfimc ("... mutual funds make little or no use of leverage"); SIFMA Press Release, *SIFMA AMG Survey Shows Separate Accounts Do Not Pose Systemic Risk* (Apr. 11, 2014), *available at* http://www.sifma.org/newsroom/2014/sifma_amg_survey_shows_separate_accounts_do_not_pose_systemic_risk/ ("Less than 4% [of Asset Managers surveyed] employed large SMAs surveyed employ leverage and the average leverage reported for these accounts is modest.").

[150] "[A]sset managers are essentially unlevered…." Andrew Haldane, Executive Director, Financial Stability and Member of the Financial Policy Committee, *The Age of Asset Management?*, Speech at the London Business School (Apr. 4, 2014), at 12, *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf.

which it acts as agent to provide investment advice. Of course, any particular asset manager could have poor investment performance or client service or otherwise fail to obtain or retain clients and investors. At that point, its business may wither. An investment adviser failure would also be irrelevant to the stability of the financial system since any "interconnectedness does not emanate from the manager's balance sheet."[151]

In fact, not only does the current process work well, but it also functions more seamlessly than normal bankruptcy processes.[152] Funds and managers are essentially self-resolving in the sense that clients can take their assets to another manager. When a fund does need to liquidate, it follows an established and orderly process by which the fund liquidates its assets, distributes the proceeds pro rata to investors, and winds up its affairs. This process is effected routinely and without consequences to the broader financial system.

More commonly, funds self-resolve or merge as opposed to liquidate. These mergers follow well-established practices outlined extensively in existing regulations. Rule 17a-8 of the Investment Company Act governs the merger of affiliated funds and provides safeguards to ensure that the transaction is in the best interests of the shareholders.[153] Under this rule, a merger of a registered investment company and one or more other registered investment companies is exempt from sections 17(a)(1) and (2) of the Investment Company Act if the "Surviving Company" is a registered investment company and if the board of the "Merging Company" determines that the merger is in the "best interests" of the company and that existing shareholder interests will not be diluted as a result.[154] This process happens regularly under Rule 17a-8 and takes place under board oversight. As an additional safeguard, in the event the transaction should happen under extraordinary conditions, the SEC may invoke its Section 22(e) authority to allow temporary suspension of redemptions.[155] Private funds have even more flexibility to manage such changes without some of the technical requirements of the Investment Company Act. Transitions for separate accounts are even more seamless, as the client merely instructs its custodian to take investment direction from a different investment adviser.

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[151] FSB/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),at 30, fn. 36. "Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank. Asset managers are, to a large extent, insolvency-remote." Andrew Haldane, "The Age of Asset Management?" speech at London Business School (Apr. 4, 2014), at 6, available at http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf.

[152] *See, e.g.*, Goebel, *supra* note 144, at 10 ("Liquidation follows an orderly process with minimal impact on shareholders and no discernible impact on the markets").

[153] *See* Rule 17a-8 under the Investment Company Act.

[154] *See id.* Sections 17(a)(1) and (2) of the Investment Company Act prohibit transactions of certain affiliated persons and underwriters. *See* Investment Company Act §§ 17(a)(1)-(2).

[155] *See* Investment Company Act § 22(e) (suspension of right of redemption or postponement of date of payment; "The Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection").

The simple fee-for-service agency model of an asset manager, independent custodians, monitoring (both fund specific and enterprise wide) conducted by managers, regulators, investors and their representatives (such as independent fund trustees, consultants, etc.), and disclosures offered to investors and their representatives ensure that potential problems are identified early and that their potential impacts on the services investors are receiving can be minimized or avoided by transferring assets long before anything resembling an actual resolution is required. By the point a fund or manager may be winding down its affairs, responsibility for its clients' assets likely would have been transferred to another investment adviser; therefore, it would be systemically irrelevant when its resolution commenced.

Likewise, transitions from one fund or manager to another are facilitated by technology, the extensive experience of investors (retail investors can often switch investments with a few clicks of a mouse), managers and other service providers such as custodians, and by a highly evolved and competitive range of transition management services used by mutual fund complexes to migrate client assets within a fund group or from one manager to another. A key objective for any transition protocol is protecting the best interests of clients and minimizing disruption or harm. Indeed, firms compete with one another for management mandates on their ability to bring assets over while minimizing volatility, friction, and expense, and to enable investors to move their assets seamlessly if they should determine to do so later.

In terms of any broader focus on practices by asset managers, we note that Chair White has called for regulatory enhancements to address the circumstance where an adviser is no longer able to serve its client, including the ongoing servicing of client needs while assets are "swiftly transferr[ed]" from one asset manager to another.[156] Importantly, Chair White has emphasized the differences between the risks involved in winding down an adviser's affairs and those of other financial firms or banking concerns.[157] She also made clear her appreciation for the fact that advisers routinely exit the market without significant impact.[158] More recently, Acting IM Director Grim has acknowledged that advisers operate in these circumstances in keeping with their fiduciary obligations and under provisions such as the Rule 206(4)-7 compliance program requirements relating to business continuity.[159] Nevertheless, they have

[156] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 ("A third focus of our regulatory enhancements is on the impact on investors of a market stress event or when an investment adviser is no longer able to serve its clients. There are several risks associated with such events. For example, during an adviser's dissolution or following the departure of key personnel, an adviser may face challenges in serving its clients' needs while also swiftly transferring its asset management services to another firm.").

[157] *See id.* ("…it is important to recognize that the risks associated with winding down an investment adviser are different than those associated with other kinds of financial firms.").

[158] *See id.* ("Client assets are not the assets of an adviser, and advisers routinely exit the market without significant market impact.").

[159] David Grim, Acting Director, Division of Investment Management, *Remarks to 2015 IAA Compliance Conference* (Mar. 6, 2015), *available at* http://www.sec.gov/news/speech/remarks-pli-investment-management-institute-2015.html#.VQH3QTvD9aQ ("For instance, as part of the compliance programs required by rule 206(4)-7 under the Advisers Act, registered investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent the adviser from violating the Investment Advisers Act.").

both focused attention on challenges that could occur if there are restrictions on investors' abilities to access or move assets away from an adviser or other de facto limitations imposed by illiquid assets or market conditions.[160] In pursuing any of the enhancements Chair White has discussed, the SEC changes may heighten focus on the process.

We expect to work closely with staff at the SEC as the Chair evaluates the need for and design of any potential enhancements, and we agree that good transition planning is in the interests of investors and markets alike. Such initiatives would need to contemplate what circumstances, beyond imprecise notions of "market conditions" or "periods of stress," would warrant putting such transition plans on standby or in motion. It will be critical that the SEC approach any evaluation of potential proposals for further regulatory steps with precision by identifying clearly what gaps need to be addressed and what tools of measurement will be used to establish baselines and evaluate progress, and by conducting careful economic analysis of the costs and benefits likely to be associated with any regulatory changes.

As with other areas of inquiry raised by the Notice, care should be taken to avoid overly prescriptive approaches to dictating practices at asset managers, as such measures could themselves create the risk of concentration that does not currently exist. Specifically, if managers are reduced to a constrictive range of assets or management tools, the risks associated with those tools are amplified because more managers are relying on them. In addition, a regulatory imperative that steers managers towards certain asset classes on the grounds of liquidity or relative ease of transferability may have the very adverse impact of drawing liquidity away from other parts of the market and exacerbating the very problem such directions intend to solve. The existence of discretion and diversity among investors, asset managers, other service providers and their respective practices are key reasons why the industry has been resilient through numerous economic downturns.[161] Indeed, this resilience has been acknowledged and cited as a source of U.S. resiliency and economic growth worthy of emulation, according to European Union and European Securities and Markets Authority ("**ESMA**") regulators.[162]

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[160] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4 ("For example, if there are restrictions on investors' ability to access or move assets away from an adviser – or, more generally, de facto limitations imposed by illiquid assets or market conditions – a clear transition plan for that adviser could benefit investors and the market.").

[161] *See* Liang, *Asset Management, Financial Stability and Economic Growth* (Transcript), 48-53, at 48 ("And they've 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.").

[162] "[Establishing the Capital Markets Union will] provide us with a deeper, safer, more liquid and more integrated capital market that can serve the economy much better and reduce our dependence on bank intermediated funding." Jonathan Hill, *Answers to the European Parliament Questionnaire to the Commissioner-Designate Jonathan Hill: Financial Stability, Financial Services and Capital Markets Union*, at 4, *available at* http://blogs.ft.com/brusselsblog/files/2014/09/Hillanswers.pdf; *see also* Jonathan Hill, *The Rule of Financial Markets Can Play in Growth and Jobs*, Speech at SIFMA, New York, N.Y. (Feb. 27, 2015), *available at* http://europa.eu/rapid/press-release_SPEECH-15-4523_en.htm ("[D]eveloping stronger and deeper capital markets [is a priority for the EU] . . . . Europe has traditionally been much more dependent on the banking system than you are in the US. Medium-sized companies here receive five times

We are nevertheless pleased to offer some observations on the subject of resolution and to respond to the specific questions posed by the Council in an effort to enhance its collective understanding of asset management products and services.

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 managers that could pose obstacles to an orderly resolution? To what extent could such interconnections result in the transmission of risk among asset managers and affiliated investment vehicles? Do market practices ensure that any financial interconnections are sufficiently documented to allow for an orderly continuation of operations if an asset manager, investment vehicle (e.g., private fund), or affiliate were to become insolvent, declare bankruptcy, or announce an intent to close?**

There are no financial interconnections among asset managers and their affiliates or the funds and accounts they manage that should impede a firm's orderly resolution. The limited financial interconnections that do exist are well documented. Asset managers serve as fiduciary agents to the funds or accounts they manage. The fundamental characteristics of the business, including its structure and economics, regulation, and independent oversight, help explain why there are no "obstacles to an orderly resolution" as posed as a question in this Notice.

As described throughout our response, asset management is a fiduciary business, where the manager and other service providers are hired to perform well-defined, regulated and documented services as agents for the fund or account. The asset manager's performance is overseen by multiple parties, including its own management, auditors and regulators, the management, auditors, regulators, fiduciaries and other representatives of the fund or other entity for which it is providing the service. Furthermore, the assets of a fund or account are separate structurally and economically from the manager and other service providers. Finally, to the extent that there are limited exceptions to the general rule of separation among these entities and financial interconnections beyond the fee-for-service, they are well regulated and documented, which would facilitate an orderly resolution.

Fundamentally, asset managers are fiduciaries to their clients, and the asset management industry is an agency business in which the investors are hiring specialists to provide portfolio management services. These services fit into a well-defined and comprehensive regulatory regime established and evolved from the 1940s onward. As a result, in keeping with its fiduciary duties under the Advisers Act and regulations promulgated thereunder, along with contractual obligations, an adviser manages any portfolio it oversees in accordance with the investment objectives and policies associated with the fund or account. Those relationships are governed by a robust regulatory regime aimed at protecting investors and supporting market integrity. Those regulatory obligations include general prohibitions on

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as much funding from capital markets as they do in the EU . . . the US venture capital market is five times bigger than it is in the EU.").

principal trading with clients. These features distinguish the "manager/fund" relationship from the regime overseen by banking regulators, where there is no agency relationship, and the assets and liabilities of customers are consolidated on the bank's balance sheet and used in the bank's business. Conversely, the asset management industry's existing regulatory structure and objectives mirror and cover as a practical matter many of the concerns the Council seeks to monitor. By circumscribing the freedom of the manager and limiting losses to investors, the structure both protects and limits harm to those same investors and mitigates threats to the U.S. financial system.

Rules governing the nature of the relationship between advisers and funds limit the types of financial interconnections that exist and establish a robust compliance, regulatory, and monitoring environment. An adviser's obligations are spelled out under various regulations and by contract. As is well known to the Council, there are multiple layers of internal and external oversight of a fund, its service providers and their interactions with each other. Overseeing the entire process for mutual funds is a board that typically has a significant majority of independent members. The board also seeks to fulfill its fiduciary obligations and ensure compliance with mandates established under the federal securities laws.

In terms of the structure of typical mutual funds or separate accounts, each has a separate legal status distinct from that of its manager and any other funds or accounts managed by the same adviser. Under Rule 206(4)-2 of the Advisers Act, investment advisers that are deemed to have custody of client funds and securities must, among other things, maintain those interests with a "qualified custodian" (typically a bank or a broker-dealer) in an account either under the client's name or under the adviser's name as agent or trustee for its clients. Mutual funds are also required under the Investment Company Act to maintain custody of fund assets separate from the assets of the fund manager at an eligible custodian, typically at a bank.[163] These "qualified custodians" must maintain client funds in special accounts, subject to a variety of safeguards and regulations.[164] Losses are borne by the entity, not the manager, as the manager acts as an agent pursuant to a contract.

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?

Although managers leave the industry, failures of sizable asset managers are exceedingly rare and have not, by themselves, had an effect on other market participants. That is not to say that a failure of a large private or mutual fund may not have economic consequences for investors, the asset manager, counterparties or other market participants. However, economic risk is isolated to the particular fund or account facing the counterparty. Larger scale failures of note in the recent past have had materially different fact patterns. As noted above, the LTCM failure, for example, operated in a very different environment with very different derivative

[163] Rule 206(4)-2 under the Advisers Act.

[164] *See id.*

structures and counterparty risk oversight. While there may be larger questions about the role of money market funds in general, the Reserve Money Market Fund wind-down did not involve derivative contracts where acceleration or termination was at issue. More commonly, mutual funds or other clients will terminate an adviser, or the asset manager will lose its mandate and assist clients in moving assets to a new asset manager. For reasons discussed above, these types of movements do not invoke any resolution scenario of the type contemplated by the Council.

More broadly, however, the migration of assets from an asset manager or the closure of one of its affiliates would not typically result in affording counterparties with options to terminate, accelerate, or net derivative or other contracts, as the asset manager is not the principal in the trade. Rather, the client or fund is generally the principal. Consequently, as long as the dealer agrees that the underlying fund or account is a good credit, the relationship will continue despite the change in the manager.

To be clear, under typical bilateral derivatives protocols, if a manager to a fund undergoes a change in control, or if the fund is transitioning to entirely new management, the fund must obtain the consent of the counterparty, as this is a qualifying event that would permit the termination of the agreement. Typically, the counterparty is a well-capitalized bank or broker-dealer. Existing contracting standards govern agreements with these counterparties, such as the ISDA contracts for derivatives.[165] ISDA's Credit Support Annex ("**CSA**") outlines unilateral or bilateral collateral-posting requirements, and also contains provisions for material adverse changes.[166] The CSA also details rules for termination of contracts.[167] Based on our collective experiences, as a practical matter, we are unaware of any circumstances where counterparties have not agreed to continue with existing agreements where there have been changes of managers.

Likewise, there has been a considerable evolution in tri-party custodian and collateral agent holding arrangements since the crisis. The result of this work is that the pledgor, the secured party and the custodian set forth the custodian's obligations to comply with the instructions of the parties with respect to the collateral in the account based on negotiated parameters.

[165] Commonfund Institute, *Managing Counterparty Risk in an Unstable Financial System*, (Nov. 2012), 7, *available at* https://www.commonfund.org/InvestorResources/Publications/White%20Papers/2012%2011%20Managing%20Counterparty%20Risk%20(Belmont).pdf.

[166] *Id.*

[167] *Id.*

3. In what ways, if any, could the potential risks associated with liquidity and redemption or leverage discussed in Sections I and II, respectively, impact the resolution of an asset manager or investment vehicle in times of financial stress?

As discussed more broadly in sections I and II above, we do not agree that the risk factors discussed in previous sections raise concerns about the resolution (or, more practically speaking, the transition plans) of asset managers. It is not clear why an asset manager's resolution would be complicated by fund-portfolio-level risks as suggested by this question. Liquidity and redemption and leverage risks are managed within established conservative regulatory parameters as well as more specific limits set under the investment objectives of individual funds or mandates established by separate accounts. Moreover, as explained above, risks that do exist are borne by investors at the pooled vehicle or separate account level without systemic implications.

Investors need not wait for an asset manager's resolution. They can redeem their investment from a fund or fire the manager and manage their assets themselves or hire a replacement manager. More frequently, however, funds are resolved through mergers or liquidations. If funds are merged, the surviving fund assumes the assets and liabilities of the absorbed fund. If a fund is liquidated, there is likewise a process that encourages managers and mutual fund boards to seek the best returns for shareholders and requires that they apportion proceeds pro rata.[168] Although the question does not make clear what metrics would distinguish "times of financial stress," mergers and liquidations have been carried out routinely throughout varying investment cycles—including the recent financial crisis—without difficulty or particular incident. Our discussion above on leverage limitations under which funds operate and liquidity and redemption management practices applies in this context.

Existing safeguards established by regulations and contracts would also protect industry participants and investors should certain unlikely events actually occur. If a fund manager did face solvency issues, the board could exercise authority to terminate the contract. If an asset manager did need to go through a resolution, the process would require the firm simply to liquidate its own assets such as real estate and equipment, while its liabilities would be limited to leases, service contracts, and personnel expenses. Fund assets would remain with the fund custodian immune from creditors of the asset manager. If the asset manager happened to own shares of the fund it managed, it would receive pro rata proceeds like other shareholders. For separate accounts, assets would similarly be immune from the adviser's creditors, and the mandate and assets would migrate to the care of a new manager or simply be returned to the underlying clients.

We question the idea of importing the banking notion of resolution to asset management firms where it seems facially inapplicable. Meanwhile, we acknowledge that Chair White's determination to evaluate whether additional work is needed on transition planning, already a highly developed and well-known field within the industry, represents a distinct and

[168] For a more detailed survey of the liquidation process, *see* Jack Murphy, Julien Bourgeois, and Lisa Price, *How a Fund Dies*, The Review of Securities & Commodities Regulation, Vol. 43, No. 21 (Dec. 1, 2010).

appropriate area for further focus by our primary regulator.[169] We encourage the Council to defer to the SEC's leadership in this area for the asset management industry.

4. Are there interconnections that exist between asset managers and other financial market participants that in times of financial stress could transmit risks? For example, are there risks that securities lenders indemnified against borrower default by an asset manager lending agent may terminate their loans if the asset manager were to fail?[170] If so, could those terminations have disruptive consequences if counterparties face an unexpected requirement to return borrowed securities upon early loan terminations?

We do not believe that these interconnections exist between asset managers and other parties in any appreciable way to warrant concern. As acknowledged by the FSB and IOSCO in its 2014 Consultative Document, there are few, if any, direct financial interconnections between the manager and other financial market participants. According to the FSB and IOSCO, "[e]conomic exposures are created at the fund level as they emanate from the underlying asset portfolio held by the fund. It is therefore the portfolio of assets that creates the respective exposures to the financial system."[171] Further, the report acknowledges that "any interconnectedness does not emanate from the manager's balance sheet."[172]

In connection with securities lending activity specifically, the potential loss exposures that are being indemnified against are among the smallest risks confronting the funds. As noted by the FSB and IOSCO, "[I]ndemnification is not triggered unless the borrower's obligations exceed the value of the collateral plus margin obtained from the borrower during the most recent mark to market" in the range of 102 to 112 percent.[173] This collateral is also in itself of the highest credit quality.

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[169] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 ("The staff is therefore developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business.").

[170] Securities lending agents often indemnify lenders against borrower default, and under indemnification agreements must cover the shortfall between the value of the securities on loan and the value of the collateral pledged by the borrower (but typically not losses resulting from cash collateral reinvestment).

[171] FSB/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), *supra* note 15, at 30.

[172] *Id.* at 30, note 36.

[173] Cited in BlackRock, *Securities Lending: Balancing Risks and Rewards*, ViewPoint (May 2012).

5. For asset managers, investment vehicles, or affiliates that operate internationally, in what ways could cross-border resolution complicate an orderly insolvency or resolution in one or more jurisdictions? Do contracts with service providers, such as custodians or prime brokers, allow for assets to be custodied, or subcustodied, at offshore entities, and what are the implications for resolution?

No, the international operations of a fund or its manager would not appreciably "complicate" the orderly resolution of either, nor would the presence of an "affiliate." An asset manager and its fund client would be resolved under the laws of the jurisdiction in which it was incorporated, as would its manager. For the overwhelming number of our members and the funds or accounts they manage, U.S. law would apply. To the extent a fund or account invests in foreign assets, the asset manager typically hires a U.S. custodian that retains a foreign sub-custodian and guarantees its performance. In the event that a foreign sub-custodian fails to perform, the fund or account is typically indemnified by the U.S. custodian.[174]

Because assets are registered in the name of a fund instead of the manager, the transitioning of assets in pooled vehicles introduces a change of beneficial ownership. In developed markets, securities may transfer between accounts free of payment. However, some emerging markets do not allow this process. As a result, securities for those markets may need to be liquidated or purchased directly by the outgoing or incoming fund managers in the market. This transition process may reduce cost savings, and there could be delays associated with the uncertainties presented by a particular country's situation and circumstances. It should not, however, ultimately affect the resolution (whether by merger, liquidation, or transfer) of a fund.

6. What contingency planning do asset managers undertake to help mitigate risks to clients associated with firm-specific or market-wide stress?

Because funds and their managers are at little risk of insolvency, the concept of "firm-specific stress" most likely involves operational issues within the firm. In response to this aspect of the question, we refer to the range of best practices and protocols discussed in the operational risk section above, but underscore again that firms have highly developed management tools in place to mitigate risks, including the routine practice of transitioning firms in widely varying market conditions, and the array of SEC and other rules that are enforced irrespective of market conditions.[175]

The reference to "market-wide stress" could be interpreted to refer to asset-price volatility, illiquidity, an operational failure at a CCP, geopolitical crises or some other pressure.

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[174] Furthermore, with respect to U.S, mutual funds, there is a robust regulatory regime in place governing the custody of funds outside of the U.S. *See* Rule 17f-1 under the Investment Company Act; *see also* Rule 17f-7 under the Investment Company Act.

[175] Asked about their primary strategic business priorities over the next ten years, institutional participants (including asset managers, asset owners, and intermediaries) responding to the Center for Applied Research Influential Investor Survey 2012 responded that "expanded risk management capabilities" was their number one priority. *See generally* State Street Center for Applied Research Study 2014, *supra* note 35.

To the extent one or more of these circumstances arises and the issue is operational, asset management firms plan for and anticipate such events, and material risks are fully disclosed to any pool investor; once again, we refer you to our responses in the operational risk section. To the extent that the issue presented would have financial consequences, asset managers likewise plan for those circumstances as part of their portfolio management process.

7. To the extent that resolution and liquidation in the asset management industry present risks to U.S. financial stability, how could the risks to financial stability be mitigated?

Simply stated, resolution and liquidation in the asset management industry do not present risks to U.S. financial stability. Fund mergers and liquidations are a routine part of the industry and have been readily managed through various market cycles. In 2013 alone, 424 mutual funds were merged or liquidated, while 48 mutual fund sponsors left the business; these events occurred with little notice beyond the parties directly involved and created no distress in the markets.[176] Since the onset of the crisis, thousands of other mutual funds have been merged or liquidated, and hundreds of sponsors have left the business without incident. Separate accounts are launched, transitioned and terminated on a daily basis, and clients can easily move assets due to the independence of the client's custodian from their asset manager.

We appreciate the Council's efforts to monitor evolution in our financial markets and to look for collateral effects of changes since the onset of the financial crisis. One particular area where we agree the Council should be focusing its attention and could benefit the asset management industry is with respect to certain categories of service providers, particularly custodians and central counterparties. In this area, only a few large players offer services and concentrate market risk. Several elements currently restrict the number of players in this space; starting up new businesses in these areas is costly, and new regulatory requirements and other barriers to entry leave asset managers relying on a limited pool of entities.

In recent remarks, Governor Tarullo noted the imperative to complete certain reforms associated with central counterparties and the need to do more to complete certain reforms of these entities and banks charged with establishing viable resolution plans.[177] To the extent that asset managers will increasingly be called upon to transact derivatives and other financial transactions through central clearing parties, we agree that it is essential to ensure that those institutions are sound and stable and provide appropriate transparency to market participants. Further, in circumstances where a CCP experiences the failure of a member or a rapid change in the value of instruments it trades, it may look to clearing members for support. We acknowledge the work of the Committee on Payments and Market Infrastructures ("**CPMI**") at the Bank of International Settlements and by IOSCO, as well as by the SEC, CFTC, and the Federal Reserve to ensure the safety of CCPs. We note that CPMI and other international and

[176] Investment Company Institute, *"Orderly Resolution" of Mutual Funds and Their Managers* (July 15, 2014), at 2-3.

[177] *See* Tarullo, *supra* note 145.

U.S. regulators are continuing to discuss potential new reforms, including optimal default coverage standards. Those efforts are not without controversy; however, we support a robust dialogue and point to this as an area of core competency for the Council to assist in the gathering of information.

8. What data currently are available or should be collected to monitor activities that may affect a resolution?

We support the Council and OFR in their efforts to promote the LEI initiative. For years, the financial services industry has been challenged by the fragmented collection of identifiers used to designate an entity as a party to a financial transaction. The financial crisis of 2008 underscored the need for a single entity code so that transaction counterparties and regulators could analyze the monetary exposure and risk profile of counterparties. In this regard, we note the statement of policy from the OFR entitled "Statement on Legal Entity Identification for Financial Contracts," which is aimed at requiring financial counterparties to acquire and use LEIs when completing transactions.[178] That work continues at the Treasury, but we encourage the Council to promote the framework, governance, and implementation of a global LEI system.

We also believe that the Council should promote coordination and information reconciliation among CCPs who are still struggling with establishing norms for reporting to the CFTC and have yet to have a full regulatory framework in place at the SEC or in other jurisdictions. Such efforts will pay dividends not just for the asset management industry, but also for other financial markets participants who must look to these entities increasingly in the aftermath of the promulgation of Dodd-Frank's central clearing mandates.

We encourage the SEC and the OFR to make use of and appropriately share information gained from Form PF. To date, we have seen relatively little use made of the data that have been collected at considerable expense by asset management firms. To the extent that the information already collected provides either crude measures or misleading information on the health of or use of investment tools by these funds, we would like to work with the SEC to refine the evaluation methodology (recognizing that there are many variations, variables and systems issues that make changing or expanding such methodologies challenging) before taking steps to suggest any additional data collection requirements for existing reporting firms or a wider set of entities.

We note once again that Chair White announced in December that the SEC staff will be proposing recommendations for information and protocols affecting mutual funds, ETFs, separately managed accounts, and other investment management products and services.[179] We look forward to providing information to the SEC staff and working with them to appropriately evaluate these issues and suggest how the agency might shape its program. The SEC should be

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[178] *See generally* Department of the Treasury Office of Financial Research, *Statement on Legal Entity Identification for Financial Contracts*, Statement of Policy with Request for Comment (Nov. 23, 2010), *available at* http://www.treasury.gov/initiatives/Documents/OFR-LEI_Policy_Statement-FINAL.PDF.

[179] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

well positioned to learn a number of lessons from its program of collecting data from private funds and money market funds as it considers whether to seek additional information from funds and separately managed accounts.

We believe that there are other issues and participants in the markets that should be higher priorities for the Council than resolution in the asset management business. Pooled investment vehicles rely on or will increasingly rely on a number of these entities. CCPs are an example that we have noted, along with other service providers that stand as switching points along the investment process. We do not want to overstate concerns about custodians, whose practices are generally sound and who have the backing that comes with being a banking enterprise. But unlike the broader asset management industry, which is characterized by competition, substitutability, and regular instances of migration, mergers or liquidation, the pool of custodians and some other service providers – like CCPs – available to asset managers is relatively small. Consequently, their increasingly pivotal roles warrant careful attention. In contrast to the case for heightened interest in these entities, we see no empirical or theoretical support for concern regarding the resolution of investment funds or their managers.

* * *

We appreciate the opportunity to comment afforded to us by the Council and stand ready to provide any additional information or assistance the Council might find useful. Should you have any questions, please do not hesitate to contact Tim Cameron at 202-962-7447 or tcameron@sifma.org, or Karen Barr at (202) 293-4222 or karen.barr@investmentadviser.org.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director
Asset Management Group – Head
Securities Industry and Financial Markets Association

Karen L. Barr
President & Chief Executive Officer
Investment Adviser Association

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

APPENDICES

SIFMA AMG SURVEY
FSOC NOTICE SEEKING COMMENT ON ASSET MANAGEMENT PRODUCTS AND ACTIVITIES

The Financial Stability Oversight Council's ("FSOC" or "Council") Notice Seeking Comment on Asset Management Products and Activities states that, "the Council's analytical process will depend importantly on the existence and availability of high-quality data and information, which are essential to the ability of the Council to carry out its statutory purposes."[180] In order to assist the FSOC in its efforts, we asked members of SIFMA's Asset Management Group (the "AMG")[181] to respond to a survey on issues under consideration by the Council. This executive summary summarizes the questions asked in this survey and the findings.

The survey asked respondents to answer a number of questions about tools available to manage risks. Based upon the results of the survey, we note that asset managers utilize a wide range of tools to manage liquidity and redemption pressures. Firms have sophisticated tools and processes to monitor and analyze both intra-day and historical changes in shareholder activity in relation to the market environment, and the ability to analyze portfolios to determine which holdings could be efficiently liquidated at a reasonable cost to satisfy redemptions.

Our members reported that temporary cash funds and sweep vehicles provide the first layer of liquidity to manage shareholder redemptions. Asset managers also arrange committed lines of credit to be used across their funds in case of high levels of redemptions, or lines of credit dedicated to specific funds or a small set of funds.

Individual members provided details regarding the tool sets available to address liquidity and redemptions. They noted, for example, to enable the sale of securities when needed, investment guidelines determine minimum liquidity thresholds, including guidelines for loan funds requiring a minimum amount of assets that have contractual settlement periods, or a maximum amount of below investment grade bonds. Asset manager tools provide for qualitative driven liquidity "scores," which are informed by the experience of market practitioners as well as the security type, maturity, sector, credit quality, embedded optionality, and other attributes that influence investor demand. To address redemptions, our members reported that asset managers may also use redemptions-in-kind, staggered cash outflows, extended notification required for redeeming, redemption gates, and closing the pool to new investments.

The survey also asked our members about derivatives, including whether derivatives are used to replicate the performance of a benchmark for a cash component of the fund. In response, more than half of the surveyed asset managers (64%) reported that they use derivatives for this

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

[181] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

purpose, however at least one asset manager noted that this is done for equity funds but not fixed income funds.

The survey also asked asset managers how they manage outflows from mutual funds. In response, nearly 80% of surveyed asset managers noted that they have access to a line of credit, and 64% also noted that they have drawn on the line of credit within the last five years. Some asset managers, however, have only drawn down on the line a few times, while others noted that they have done so with some frequency.

More than half of the surveyed asset managers (62%) reported that they also stress test their funds. Of those asset managers that stress test, 89% stated that they test for the purposes of testing for a gain/loss profile of a portfolio. The number of factors the tests account for vary widely, from three factors to up to 2800 factors. Additionally, 57% of those that reported they stress test stated that they use additional metrics for funds that utilize leverage. Most (86%) indicated that the test varies by product. All asset managers who responded that they stress test their funds also stated that they report the test results to the Fund Directors. However, the frequency of these reports varies. Most firms noted that they report quarterly, but some firms responded that they report up to 8 times per year.

The survey also focused on securities lending. More than half of the surveyed asset managers (57%) responded that they engage in securities lending for many types of funds, including equity, fixed income, asset allocation, exchange traded funds ("ETFs"), and mutual funds. All of the firms who responded that they engage in securities lending also noted that they utilize a third party securities lending agent or affiliate, and all give instructions with regard to the type of vehicles in which collateral can be reinvested. Of those that engage in securities lending, 80% set guidelines around maturity and other considerations. For a subset of those engaging in securities lending, 63%, securities lending is limited to 2a-7 funds.

The AMG survey also gleaned information regarding the length of time it takes from start to finish to transfer an account from one asset manager to another. In the vast majority of cases, the transfer can be done in one day. For other asset classes (emerging market high yields, for instance), the transfer can take months. However, even in these situations, there is often a transition manager who takes over immediately upon notification of the change. The assets are in the possession of the client's custodian bank, and the asset manager authority is by appointment. As the assets are already in the client's name, or the custodian nominee name, there is little time needed operationally to make the change. The duration of the time it takes to transfer an account is a result of the change that is introduced to the portfolio. Respondents explained that there would first be discussions between the client and the new asset manager as to how much change should be introduced to the portfolio to bring it in line with the new manager's preferred portfolio models. If the client is changing the actual investment discipline of the portfolio, additional time is needed to restructure the investments from one asset class to another.

We, and the investment managers who participated in this survey, have provided this information to better inform regulator consideration of asset management products and activities. We welcome the opportunity to engage further on this topic if warranted. Should you have any questions, please do not hesitate to contact Tim Cameron at 202-962-7447 or Lindsey Keljo at 202-962-7312.

Survey of Asset Managers in Connection with Asset Management Products and Activities

Do your funds engage in interfund lending to address liquidity issues?	
NO 92%	**YES 8%**

Do you have access to a line of credit to manage outflows from your mutual funds?	
NO 21%	**YES 79%**
	The line of credit covers from 0.3 up to 14.30 percentage of the AUM of funds.
	1. 64% have drawn down on the line of credit in the last five years.
	From those that drew on the line of credit in the last five years, 67% said they did so more than 5 times; 17% said five times, and 17% said twice.

What tools do you use to manage liquidity and redemption pressures?
Futures, cash and line of credit.
All stocks considered for research must meet our minimum liquidity thresholds. When evaluating liquidity, we focus on how each stock would impact our ability to transact the entire portfolio. We use Bloomberg to obtain the trading volume data used in our analysis.
Investment guidelines that help ensure minimum liquidity, including guidelines in loan funds requiring a minimum amount of assets that have contractual settlement periods, or a maximum amount of below investment grade bonds. We measure ownership of equities with respect to daily average trading volume and monitor cases where a fund is relatively high against this measure; action steps can include closing funds to new investment. We arrange committed lines of credit to be used across the funds in case of high levels of redemptions; in some cases we arrange lines dedicated to a specific fund or a small set of funds. We monitor and provide information to portfolio managers of threats to liquidity including (a) investor concentrations in the funds they manage, (b) percentage of the fund holdings that are in challenging liquidity categories, such as equities that are a high percent of daily average trading volume, or below investment grade debt and (c) results of stress tests We apply a special framework called the “mobility measure” to a subset of our funds that simulates both stressed redemptions, stressed asset prices, and stressed cash requirements stemming from derivative products. The measure uses a 1 month, 99% worst case stress period, and require these funds to meet a threshold level for this measure. In the event of redemptions, we have the ability but do not expect to use: redemption in kind delays of up to a week in providing cash to the investor.
Temp Cash Funds/sweep vehicles provide the first layer of liquidity to manage shareholder initiated cash flows. Use of the line of credit follows this, along with the sale of underlying portfolio securities which, in our Funds, are generally very liquid.

Varies depending on funds but use following in different combinations: asset-in-kind transitions, stagger cash outflows, extended notification period before client allowed to redeem, NAV and dealing suspensions, close pool to new investments, liquidate pool, swing pricing, monitor cash flows, side pockets and redemption gates.
The successful management of liquidity to accommodate shareholder redemptions calls for at least two basic decision support capabilities: (1) the ability to characterize changes in shareholder activity as a function of the market environment; and (2) the ability to analyze current portfolio holdings to determine precisely which holdings could be liquidated at reasonable cost to satisfy redemptions. Our suite of portfolio analysis tools provides the first of these capabilities by allowing managers to monitor the status of intraday shareholder activity, as well as to examine historical shareholder patterns and to associate these patterns with underlying market conditions. Our tools provide the second capability in various forms, primarily by allowing managers to efficiently sort, filter, and group portfolio holdings according to key security attributes correlated with liquidity, including quantitative measures of market risk. Moreover, other components of our tool suite provide managers with the ability to construct a sector process resulting in a qualitatively driven liquidity "score," informed by the experience of various market practitioners, indicating the potential difficulty of selling a security as a function of its type, maturity, sector, credit quality, embedded optionality, and other attributes that may influence investor demand.
The portfolio managers for the funds may use ETFs and/or futures to equitize cash and to allow for more liquid execution. Additionally, they may utilize short settlement through brokers, access broker capital and/or maintain high cash levels or cash-like instruments as needed. The firm also has a Valuation & Liquidity Oversight Committee that is designed to provide oversight and administration of the policies and procedures governing the fair valuation and liquidity determination of securities held in the firm's portfolios. For institutional clients, the funds utilize large order notifications and may also redeem certain clients in kind under certain circumstances.
Historical flows analysis, stress testing, minimum liquidity requirements, risk factor exposure monitoring, and concentration limits.
2. Liquidity buffers, as determined by the portfolio managers 3. Various internal reports 4. The fund boards have approved redemption-in-kind procedures for extraordinary circumstances
Withdrawal restrictions, delayed payment, in kind redemptions, liquidity facilities (credit lines)
Note we have a committed and uncommitted line. Redemptions in kind. Monitoring our liquidity based on stress tests.
Generally speaking, liquidity and redemption risk is low for mutual funds. That said, we have developed internal reporting to monitor various factors - such as market risks and liquid asset holdings - with the aim to help prepare our funds for periods of market stress

Do you use derivatives to replicate the performance of a benchmark for a cash component of the fund?	
NO 36%	**YES 64%**

Do you stress test?	
NO 38%	**YES 62%**
	Of those that do stress test, 89% stress test for the

	purposes of testing the gain/loss profile of a portfolio.
	The stress tests account from 3 to up to 2800 different factors.
	57% utilize additional metrics for funds that utilize leverage.
	86% said that the test varies by product.
	100% of those that perform stress test report the stress test to the Fund Directors.
	The frequency of report to the Fund Directors varies. Most firms report quarterly, some firms report up to 8 times per year.

Do you engage in securities lending?	
NO 43%	**YES 57%**
	The types of funds engaging in securities lending: Equity, Fixed-income, Asset Allocation, ETFs, Mutual Funds, bank maintained collective and common trust funds, US RIC Funds, US Fiduciary Trust Funds.
	The percentage of funds engaging in securities lending ranges from 0.0048 to 80.
	100% give instructions with regard to the types of vehicles in which collateral can be reinvested when engaging in securities lending.
	80% set guidelines around maturity or other considerations.
	For 63% the reinvestment of securities lending collateral is limited to 2a7 funds.
	100% utilize a third party securities lending agent or affiliate.

How long from start to finish does it take for one asset manager to transfer an account to another asset manager?
Depends on asset class, for vanilla stocks and bonds it could be 1 day, for more esoteric products, it could be months.

Few days.
Typically 6 months for registered funds. The process often involves Board approval, shareholder approval and implementation.
The answer depends on the type of strategy, the account size, the markets in which the holdings are based, and whether the transfer will be in-kind or sell to cash, among other factors. For example, a $100 million International Equity account could be liquidated to cash in less than one day, with the average daily volume at 3%.
From one day to a few months, depending on the asset class.
This is not a function of our business, as such operations are performed by the firm's service providers.
Generally, once pre-execution planning and analysis is complete, it will only take a few days to transition a client account. In limited circumstances, the transition has taken longer due to a variety of factors including market impact. In those cases, the transitions could have been implemented much more rapidly, but a more deliberate and careful approach was developed, reviewed with, and approved by the clients involved.
A transition from one manager to another takes place essentially in a day. There would be discussions between the client and the new Asset Manager as to how much change should be introduced to the portfolio to bring it in line with the new managers preferred portfolio models. The key is that the assets are in the possession of the client's custodial bank and the manager authority is by appointment. If a client is changing the actual investment discipline of the portfolio, then of course there is some additional time needed to restructure the investments from one asset class to another. The duration of time is a result of the significance of the change. (For example Fixed Income to Global Small Cap Equity would require some time). Most events can take place over just a couple of trading days, and then the standard market settlement practices. The smaller cap markets tend to have less daily liquidity by name, and these transitions have taken longer should liquidation of the account be necessary versus a transfer of securities in kind. If a client is changing the actual investment discipline of the portfolio, then of course there is some additional time needed to restructure the investments from one asset class to another. The duration of time is a result of the significance of the change. (example Fixed Income to Global Small Cap Equity would require some time). In my experiences on transitions in general, most events can take place over just a couple of trading days, and then the standard market settlement practices. The smaller cap markets tend to have less daily liquidity by name, and this transitions have taken longer should liquidation of the account be necessary versus a transfer of securities in kind.
The time to transition an account to another asset manager varies based on the asset classes of the mandate. If the portfolio is in developed markets it may only take 3-5 days. As the assets are already in the client's name or the custodian nominee name, there is little time needed to operationally make the change.
One month if the new manager has an existing relationship with the client's custodian; three to six months if the new manager has no pre-existing relationship with the custodian.
Generally, a client should be able to instruct their bank to start taking instruction from a new manager/transition manager within one business day. Factors such as mandate changes, changes in beneficial owner or securities to be traded may impact the timeline.
A transfer could take place within 5 business days if all management and trading agreements are in place.
With traditional stocks and bonds 2- 4 days. The addition of derivatives and currency forwards would increase that time frame.

sifma
Invested in America

| asset management group

Via electronic mail

April 1, 2015

Mr. Jacob J. Lew, Secretary of the Treasury
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Ms. Mary Jo White, Chair
Securities and Exchange Commission
100 F Street NE
Washington, DC 20549

Dr. Janet L. Yellen, Chair
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue NW
Washington, DC 20551

Mr. Timothy G. Massad, Chairman
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street NW
Washington, DC 20581

Dear Secretary Lew, Chair White, Chair Yellen and Chairman Massad:

On behalf of the members of the Asset Management Group (the "AMG") of the Securities Industry and Financial Markets Association ("SIFMA"),[1] we write to express our significant concerns regarding the March 4, 2015 publication by the Financial Stability Board (the "FSB") and the International Organization of Securities Commissions ("IOSCO") of their second consultative document entitled *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (the "Second Consultative Document").[2]

In particular, we are deeply troubled by the lack of attention the Second Consultative Document evidences to the fundamental substantive concerns raised in our comments[3] on the FSB's and IOSCO's first consultative document (the "First Consultative Document"),[4] as

[1] SIFMA is the voice of the nation's securities industry, representing the broker-dealers, banks and asset managers whose 889,000 employees provide access to the capital markets, raising over $2.4 trillion for businesses and municipalities in the United States, serving retail clients with over $16 trillion in assets, and managing more than $62 trillion in assets for individual and institutional clients including mutual funds and retirement plans. With offices in New York and Washington, DC, SIFMA is the U.S. regional member of the Global Financial Markets Association. For more information, visit http://www.sifma.org.

[2] FSB and IOSCO, Consultative Document (2nd), *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, March 4, 2015, available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

[3] *See* Letter from the AMG to the Secretariat of the Financial Stability Board, April 4, 2014, available at *http*://www.financialstabilityboard.org/wp-content/uploads/r_140423an.pdf.

[4] FSB and IOSCO, Consultative Document, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, January 8, 2014, available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf.

well as the timing of the Second Consultative Document's release. The Second Consultative Document proposes methodologies for designating investment funds and their managers as global systemically important financial institutions ("SIFIs"). Our comments and those of others have demonstrated that the designation of asset managers and investment funds as SIFIs would be unjustified, because they do not present the type or scale of risk required for SIFI designation, and would be an ineffective structure for their regulation. The Financial Stability Oversight Council (the "Council") appears to have recognized those facts and shifted its attention to a more constructive review of products and activities in the sector, and away from individual firms or funds identified on the basis of their size. Because this is the only sensible approach to analyzing and regulating the asset management sector and the capital markets more broadly and because the Second Consultative Document is irredeemably flawed, we urge you, in your capacities as the U.S. members of the FSB and/or IOSCO, to reject the proposals in the Second Consultative Document and oppose any further attempts by the FSB and IOSCO to create a methodology for designating asset managers and investment funds as SIFIs.

Lack of Attention to Fundamental Concerns with First Consultative Document

While our review of the Second Consultative Document is continuing, it is apparent that the document does not address a number of the comments raised in connection with the First Consultative Document. Most importantly, as described in our comment letter on the First Consultative Document,[5] asset managers and investment funds have fundamentally different risk profiles than banks and insurers, making SIFI designation for individual asset managers and investment funds both inappropriate and ineffective at addressing any risks that may arise from activities in the asset management sector and the capital markets. Among other things, risk in the asset management sector and capital markets is broadly distributed and easily transferred among many participants, and thus is unlikely to be or remain concentrated in individual entities.[6] In addition, the designation of a few large entities but not others would be unlikely to reduce the overall level of risk associated with the activities of the designated entities, because investors could (and likely would) move their assets to un-designated entities

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[5] *See supra* n.3.

[6] As indicated in our comments on the First Consultative Document and in response to the Council's Notice Seeking Comment on Asset Management Products and Activities (see footnote 8 below), we do not believe that an investment fund can "fail," with the potential to trigger a collapse in an industry or economy that could have a systemic effect. An investment fund is designed to provide its investors with exposure to investment risk, and if the investments of a fund were to lose all or substantially all of their value, then investors, who knowingly accepted the risk of loss of their investments in choosing to invest and remain invested in the fund, would bear the fund's losses. Even if there were a concentration of risk in an individual fund, designating that fund would not be an effective way to address this risk given the factors we have noted previously, such as the competitive nature of the asset management sector, the availability of substitutes for different types of investments, and the ownership of investment assets by investors.

continuing to engage in the same activities. This would have the effect of distorting competition and making any designated U.S. funds or managers less competitive. Furthermore, investment funds and their managers are merely subsets of the much broader categories of asset owners and participants in global capital markets.

By continuing the misguided focus on large individual funds and managers and failing to appreciate that regulatory policy must reflect the characteristics of the regulated business or market, the Second Consultative Document is a significant step in the wrong direction. The FSB and IOSCO should first demonstrate that a risk exists and then consider ways to address that specific risk, rather than designating funds and managers and then leapfrogging ahead to a solution that they have not yet designed[7] and that may or may not be effective at addressing any risks actually posed by the activities of the designated funds and managers. There is no clear nexus between the proposed methodologies in the Second Consultative Document and global financial stability, and no explanation of how designation of funds and managers would enhance that stability. If the FSB/IOSCO proposal were implemented, it could do harm to investors, issuers, financial markets and the real economy while failing to reduce systemic risk. As we have stated previously, theory and history both demonstrate that it is more effective for the primary regulators of asset managers and investment funds to review the activities in which funds and their managers engage, on an industry-wide basis and in the context of the broader capital markets in which they participate; to consider whether those activities present a risk; and to analyze policy options to determine if additional regulation of those activities could address any such risk effectively and without doing more harm than good. This view is widely shared and well explained by the AMG and others in comments to the First Consultative Document.

As you are well aware, the Council has spent a significant amount of time considering these issues and analyzing the asset management sector. These efforts culminated in the Council's issuance of a notice seeking public comment on whether specific aspects of the asset management sector may pose potential risks to the U.S. financial system (the "FSOC Notice").[8] The issuance of the FSOC Notice represented a constructive shift with regard to the Council's assessment of the asset management sector and its relation to financial stability; and we believe a focus on products and activities is the only sensible approach for assessing and, if appropriate, addressing any risks to financial stability that may arise within the sector.[9]

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[7] *See* Second Consultative Document at p. 2, indicating that policy measures will follow the finalization of assessment methodologies.

[8] *Notice Seeking Comment on Asset Management Products and Activities*, 79 Fed. Reg. 77488 (Dec. 24, 2014) (notice).

[9] The Securities and Exchange Commission (the "SEC") pursued such an approach in 2010 and again in 2014 in reforming its regulation of money market funds in response to concerns about their resilience as a result of the financial crisis. *See Money Market Fund Reform*, 75 Fed. Reg. 10059, 10062 (March 4, 2010) (final rule) (following the "severity of the problems experienced by money market funds during 2007 and 2008," the SEC adopted new rules intended "to reduce the susceptibility of money market funds to runs and reduce the consequences of a run on fund shareholders"); Press Release, *SEC Adopts Money Market Fund Reform Rules*, July 23, 2014, available

We will review the Second Consultative Document with our members and submit a comment letter by the specified deadline; however, given the fact that the funds and managers that exceed the proposed size thresholds are almost exclusively based in the United States, we are deeply concerned that the FSB and IOSCO are set on a path that could very well have a significant negative effect on U.S. investors, businesses and capital markets without reducing systemic risk. As a result, we urge you, as members of the Council that are also members of the FSB and/or IOSCO, to reject the proposals in the Second Consultative Document and to oppose any further attempts by the FSB and IOSCO to create a methodology for designating individual asset managers and investment funds as global SIFIs.[10]

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at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542347679#.VQ907GfwuUk (announcing the adoption of structural and operational reforms to address risks of investor runs in money market funds, and describing the reforms as building on the 2010 amendments, due to the SEC's recognition when it adopted the 2010 reforms "that the 2008 financial crisis raised questions of whether more fundamental changes to money market funds might be warranted"); *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 47735 (August 14, 2014) (final rule).

[10] To the extent that U.S. members of the FSB and/or IOSCO are unsuccessful in opposing the current FSB/IOSCO approach, we urge the Council to reject any designation within the U.S. regulatory framework of specific asset managers and investment funds as systemically important. *See* the Council's *Nonbank Designations – FAQs*, at Q11 (**Q:** If international entities such as the Financial Stability Board (FSB) identify a U.S. firm as systemically important, does that mean that the FSOC will do the same? **A:** No. While the FSB and the FSOC are both focused on strengthening financial stability, their processes are distinct. Decisions reached in the FSB do not determine decisions made by the FSOC. In fact, **the FSOC is under no obligation to even consider a firm identified by the FSB for designation**.) (emphasis added), available at http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx#11. *But cf.* Peter J. Wallison and Daniel M. Gallagher, *How Foreigners Became America's Financial Regulators*, The Wall Street Journal, March 19, 2015, available at http://www.wsj.com/articles/peter-wallison-and-daniel-gallagher-how-foreigners-became-americas-financial-regulators-1426806547 (quoting memorandum from FSB Chairman and Governor of the Bank of England Mark Carney to members of the FSB, stating that FSB decisions must receive "full, consistent and prompt implementation" by member nations because that "is essential to maintaining an open and resilient financial system"; also noting that during the past year, "[i]n every case where the FSB made a decision or announced a policy, the [Council] followed"). If it were to be the case that the FSB process could determine decisions of the Council, that would raise a number of significant questions that should be answered, including why the U.S. members of the FSB and IOSCO would participate in an effort by international regulators to designate U.S. entities if these U.S. agencies disagree with that approach.

Questionable Timing for Release of Second Consultative Document

We are also troubled by the timing of the Second Consultative Document's release and its connection, or lack thereof, to the FSOC Notice process, given that all of the U.S. members of the FSB and/or IOSCO are also members of the Council. The Second Consultative Document was published on March 4, 2015, even though comments on the FSOC Notice were not due until March 25, 2015.[11]

As you know, the FSOC Notice was first published on December 18, 2014, following work over the preceding year to analyze the asset management industry.[12] During the meeting at which the Council considered whether to issue the FSOC Notice, Secretary Lew stated publicly that the Council "had no predetermined view about the conclusions to draw or actions to take" following the FSOC Notice.[13] The FSOC Notice reiterated this position,[14] as did Patrick Pinschmidt, Deputy Assistant Secretary at the Department of the Treasury and the Council's Executive Director, in a recent speech.[15] In particular, Deputy Assistant Secretary Pinschmidt stated:

> [R]egarding the Council's asset management work, I think it's worth echoing what Secretary Lew said in December when the Council issued the request for public comment—and this certainly remains true today: there is no predetermined outcome, and no final decisions have been made in terms of potential risks relating to asset management products and activities. Once the Council has an opportunity to review public comments, it will be in a better position to identify any risks that may exist, and—to the extent any risks exist—assess the nature of those risks to better

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[11] *See Notice Seeking Comment on Asset Management Products and Activities*, 80 Fed. Reg. 7595 (February 11, 2015) (notice; extension of comment period).

[12] FSOC Notice, 79 Fed. Reg. at 77489.

[13] Minutes of the Financial Stability Oversight Council Held December 18, 2014, at p. 13, available at http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/December%2018,%202014%20Meeting%20Minutes.pdf.

[14] FSOC Notice, 79 Fed. Reg. at 77490 ("The Council has not made any determination regarding the existence or nature of any potential risks to U.S. financial stability discussed in this Notice. Throughout this Notice, the Council asks questions regarding areas of potential risk in the asset management industry and will consider the input received in each case in evaluating whether any of these areas might present potential risks to U.S. financial stability. In the event the Council's analysis identifies risks to U.S. financial stability, the Council will consider potential responses.").

[15] Remarks of Deputy Assistant Secretary of FSOC Office Patrick Pinschmidt at the Investment Adviser Association's (IAA) 2015 Compliance Conference, March 5, 2015, available at http://www.treasury.gov/press-center/press-releases/Pages/jl9988.aspx.

understand how a particular product or activity could pose a risk to U.S. financial stability.

In this context, it was confusing, to say the least, to learn on March 4 that the FSB and IOSCO had released a new global SIFI proposal in the Second Consultative Document – at odds with the approach taken by the Council in the FSOC Notice and three weeks before comments on the FSOC Notice were due.[16] The approval by U.S. members of the FSB and IOSCO of a new global SIFI proposal before the end of the comment period on the FSOC Notice appears to conflict with statements that Secretary Lew and others have made. These statements stress that the Council has determined neither whether there is a risk to financial stability from asset management products and activities, nor whether a regulatory response is required to address any such risk. The FSOC Notice certainly did not propose – let alone endorse – a new and very specific regulatory approach to an as-yet-unidentified risk; but that is exactly what has been done to the extent that members of the Council approved the issuance of the Second Consultative Document.

Following the comment period on the First Consultative Document, the Council's analysis of risks associated with the asset management industry, and discussions between policymakers and the industry throughout 2014, members of the AMG were encouraged when it appeared the Council would pursue the recommended focus on products and activities through its issuance of the FSOC Notice – and would do so with an open mind and "no predetermined view." Furthermore, in our letter requesting an extension of the comment period for the FSOC Notice, we noted that the authors of the FSB/IOSCO document would benefit from consideration and analysis of comments on the FSOC Notice, and we therefore requested that the members of the Council involved in the FSB/IOSCO process defer any further action until after comments on the FSOC Notice had been reviewed and considered.[17] This request was made by other organizations as well in their requests that the comment period for the FSOC Notice be extended.[18]

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[16] We note, moreover, that Daniel K. Tarullo, a member of the Board of Governors of the Federal Reserve System, which is a member of the Council, chairs the FSB's Standing Committee on Supervisory and Regulatory Cooperation, which is the FSB committee responsible for addressing financial stability issues relating to the development of supervisory and regulatory policy. This makes the differences in approach between the Council and the FSB/IOSCO all the more troubling.

[17] *See* letter from the AMG to the Council, January 15, 2015, available at http://www.regulations.gov/#!documentDetail;D=FSOC-2014-0001-0003.

[18] *See* letter from the U.S. Chamber of Commerce to the Council, January 7, 2015, available at http://www.regulations.gov/#!documentDetail;D=FSOC-2014-0001-0002; letter from the Managed Funds Association to the Council, January 16, 2015, available at http://www.regulations.gov/#!documentDetail;D=FSOC-2014-0001-0006.

At a minimum, the decision not to heed those requests and the simultaneous participation in these two conflicting regulatory endeavors has created confusion about how the global SIFI designation and FSOC Notice processes relate to one another, as well as concern about whether comments on the FSOC Notice will be considered thoughtfully. This would appear to undermine the validity of the notice and comment process for the FSOC Notice and raises concerns about the possibility that non-U.S. regulators could attempt to dictate a regulatory approach for U.S. funds and managers that is established without the benefit of the procedural protections afforded to interested parties under U.S. law and is in conflict with the approach pursued by U.S. regulators. As noted above, we urge all of you, as the members of the Council that are also members of the FSB and/or IOSCO, to oppose any such efforts.

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We appreciate your consideration of the questions and concerns raised in this letter and would appreciate the opportunity to meet with you at your earliest convenience to discuss these matters. Please feel free to contact me at tcameron@sifma.org or 202.962.7447.

Sincerely,

Timothy W. Cameron, Esq.
Head, Asset Management Group
Securities Industry and Financial Markets Association

cc: Hon. Thomas J. Curry, Comptroller, Office of the Comptroller of the Currency
Richard Cordray, Director of the Consumer Financial Protection Bureau
Hon. Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
Melvin L. Watt, Director of the Federal Housing Finance Agency
Hon. Debbie Matz, Chairman of the National Credit Union Administration
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