CAPITAL GROUP℠

The Capital Group Companies, Inc.
333 South Hope Street
Los Angeles, California 90071-1406

April 7, 2014

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH - 4002
Basel, Switzerland
Email: fsb@bis.org

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

Dear Sir or Madam:

The Capital Group Companies is one of the oldest asset managers in the United States. We, through our investment adviser subsidiaries, manage assets in various collective investment vehicles and separate accounts. A large majority of these assets consist of the American Funds family of mutual funds, which are U.S. regulated investment companies (RICs) held by individuals and institutions. We welcome the opportunity to comment on the recent Consultative Document issued by FSB and IOSCO - "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (the "Report"). As a global asset manager we have a significant interest in policies that promote a well-functioning financial system; one that can withstand the periodic shocks that are an inevitable part of our complex, global market place.

Capital Group fully supports appropriate activities-based regulation to address any systemic risks that exist across industries or markets; however, we do not believe that individual investment funds or asset managers should be singled out for a higher level of regulatory scrutiny merely because of their status or size. We do not believe that the U.S. asset management industry poses a significant systemic threat to the global economy. The industry is highly regulated today, and will undoubtedly face further regulation and oversight in the coming years.

The Report recognizes many of the characteristics of RICs that lead one to the conclusion that they do not present a systemic risk to the global economy. Among these are the nature of the relationship of funds with their adviser and shareholders, the structural characteristics of funds and the fact that funds are highly substitutable. Even if, after all of these considerations, one could argue that a fund may contribute to systemic risk, the focus on size as a measure of a fund's potential impact on the global economy is misplaced. The size of a fund reveals very little about whether an investment fund could pose risks to the global financial system. To this end, the leverage of a fund would be a far better indicator for regulators to look at as an initial measure.

We discuss a number of the more important considerations in the Report below.

Different nature of funds and asset managers

The Report appropriately acknowledges the different nature of investment funds' risk profiles in contrast with banks and insurance companies. Fund assets are held by the fund on behalf of shareholders, and are invested by the fund's asset manager in accordance with the fund's objectives, strategies and guidelines. Importantly, the fund's assets are not owned by the asset manager. The funds are separate legal entities owned by the fund's shareholders, and, in the case of U.S. RICs, are overseen by a board of directors made up predominately of people who are independent from the asset manager. These independent directors have a fiduciary duty to protect the best interests of the RICs shareholders. A fund's asset manager may not use fund assets for any purpose outside of investing them for the benefit of the fund's shareholders. Further, if the asset manager were in financial distress, it could not look to the assets of the funds it manages to support its business.

Funds do not guarantee any type of return for shareholders who understand that their account may increase or decrease in value. Shareholders enjoy the gains and bear the risk of loss as the fund increases or decreases in value due to the increase or decrease in the value of the underlying investments of the fund. In this way, funds do not fail like banks or insurance companies who invest for their own accounts and promise a stated return to the investor or provide guarantees of a certain level of income. The Report acknowledges this difference in its text:

> "Unlike banks, for instance, where capital is set aside to protect depositors and other creditors against the risk of losses, investment management is characterised by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund's invested portfolio. As such and at least in theory, fund investors decide, based on full disclosure, to take on investment risk. In addition, from a purely systemic perspective, funds contain a specific 'shock absorber' feature that differentiates them from banks. In particular, fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, *thereby mitigating the eventual contagion effects in the broader financial system.*" (*emphasis* added)

The Report also asks the question whether asset managers should be viewed as part of the mix when assessing entities that are systematically significant. Asset managers act primarily as agents to the funds they manage, managing assets on behalf of clients as opposed to investing on the manager's behalf. We actively invest for fund shareholders and separate account clients in an agency capacity. In performing this function we employ active management to invest shareholder and client money in stocks, bonds and other securities of companies around the world in compliance with the objectives and strategies of the applicable fund or account. We do not guarantee any type of return for shareholders or clients. In this regard, there is no explicit or implicit promise to shareholders or clients that our balance sheet is available to support the funds or accounts we manage.

The agency relationship maintained by asset managers is vastly different than the principal relationship maintained by banks and insurance companies. Consequently, banks and insurance companies carry a very different risk profile than that of asset managers. In such capacity, a bank or insurance company client may look to the balance sheet of the banking or insurance institution to satisfy its investment. In times of perceived financial distress for an insurance company or bank it is foreseeable that clients would want to withdraw their investments before the entity's assets are depleted - a 'run on the bank.' In times of actual distress, a bank may not have sufficient funds to support the client's initial deposit and guaranteed return by the bank due to losses in its lending and investment activities. It is obvious in a situation where an entity is acting in a principal capacity that the implementation of capital requirements, and other prudential standards, designed to ensure that a banking or insurance firm has adequate cash to protect its obligations to clients can be effective.

In contrast, by the nature of the agency relationship, when an asset manager is experiencing financial distress, fund and client assets would be easily portable to another asset manager without any harm to the shareholder or client. In addition, shareholders have the option to redeem shares and clients to move their assets at any time. In the situation where the fund or client account is losing value, the asset manager is not expected to backstop the fund or account.

Even during the extreme stress of the recession beginning in 2008, most of the asset management industry operated smoothly. The exception to this may be found in the money market fund area where one money market fund 'broke the buck' and others were supported by their investment advisers to maintain a stable net asset value. We note, however, that subsequent to the 2008 recession money market funds have been subject to further regulation and more regulation is currently being considered. It is important to note that even in the money market fund context, the managers of the funds do not "guarantee" investors that they will receive $1.00 per share upon redemption. Many other investment funds' net asset values declined significantly, yet there was no evidence of structural deficiencies. The industry did not require bailouts from the federal government (recognizing that in the money market fund context the U.S. Treasury provided a guarantee program) and did not face failures similar to those seen in the banking and insurance industries with wide systemic implications. An investment fund or client or its asset manager may lose assets, but the impact of such a loss would not have the same systemic repercussions.

Regulatory regime

The Report acknowledges that national regulation may dampen the global systemic impact of a fund failure when it states that "depending on national regulation, asset managers may temporarily implement specific liquidity management tools such as swing pricing, anti-dilution levies, redemption gates, side-pockets, redemptions in kind or temporary suspensions." We, as an asset manager, are currently subject to regulation and oversight by multiple regulators, including in the United States where a vast majority of our funds reside, the Securities and Exchange Commission ("SEC") and, more recently, by the Commodity Futures Trading Commission ("CFTC"). The U.S. mutual funds we manage are also subject to all four of the major federal securities laws and the rules and regulations of the SEC and, for those that invest more than a de minimis amount in commodity interests, the CFTC. Our mutual funds are among the most highly regulated and transparent financial vehicles in the United States.

This regulatory framework protects shareholders and clients through a system of compliance and disclosure requirements. It creates a system whereby we, as the adviser, must act in a fiduciary capacity to protect the best interests of our funds' shareholders and our clients. The Investment Company Act of 1940 sets out stringent requirements that registered funds must adhere to, including requirements related to liquidity, leverage, capital structure, diversification and concentration of investments. We are also subject to a framework that regulates, among other things, how the funds are valued on a daily basis, custody of fund and client assets, and transactions between our affiliated entities. All of these rules and regulations provide strong systemic risk-limiting provisions and are in place to provide protection for shareholders and clients.

The disclosure component of the regulatory framework also provides protection for shareholders. The funds we advise must clearly disclose their objectives and strategies and the risks of its investments and of investing in the fund, including the fact that a shareholder can lose money by investing in the fund. Funds must also clearly disclose the expenses associated with investing in the fund and historical results. Additionally, we, as the adviser, are required to disclose the risks related to the securities and other investments we invest in on behalf of the funds and clients we advise. All such disclosure requirements are designed to fully inform a shareholder or client about the investment they hold. Shareholders and clients are fully informed of the potential risk that they may lose some or all of their invested assets.

We believe that the regulatory framework we are subject to adequately protects shareholders and clients. History has borne this out and no evidence is offered to support the idea that the existing regulatory framework governing the U.S. asset management industry has been deficient. The existing regulatory framework governing asset managers and funds has worked well during times of stress such as the stock market crash in 1987, the bond market distress in 1994, problems in emerging markets in 1997 and 1998, the bursting of the dot.com bubble in 2000, the 9/11 attacks and, most recently, as discussed in more detail above, the worst financial market crisis since the Great Depression. Further, the SEC continues to enhance its risk monitoring and data analytics activities. In a speech given on February 21, 2014, SEC Chairwoman, Mary Jo White, noted that the SEC increasingly relies on technology and specialized expertise in these areas and that the SEC has established a dedicated group of professionals to provide enhanced monitoring of large-firm asset managers, including more robust data reporting.

We further believe that the designation of individual companies and funds for heightened supervision should be reserved for those circumstances, presumably quite limited, when regulators have determined that a specific company or fund poses significant risks to the financial system that clearly cannot be adequately addressed through enhancements to the existing regulatory framework.

Activities-based regulation

We believe that activities-based regulation is an appropriate tool to address any systemic risks that may exist. Risks enumerated in the Report and attributed to funds and the asset management industry, such as leveraging, securities lending, investments in derivatives, counterparty risk, etc., are more appropriately regulated as an activity. These are examples of activities that are utilized by other entities, not just funds, and certainly not just by large funds. By subjecting certain large funds to enhanced regulatory standards rather than regulating activities that may cause systemic risk you create a moral hazard issue. Funds that are subject to enhanced regulatory scrutiny will likely incur higher costs, costs that are passed on to shareholders in the form of lower investment results. When shareholders realize that these larger funds that are subject to enhanced regulation are incurring higher costs, they may move their investments to funds that are not subject to such enhanced regulation. These funds will grow while being able to participate in the exact activities that regulators are worried about.

Regulators are consistently looking at the financial system and the risks that are potentially posed by different activities. For example, regulators are currently looking at potential additional regulation relating to money market funds and the functioning of money markets, tri-party repurchase agreements, securities lending and derivatives and counterparty risk. This is an area where organizations like FSB and IOSCO can be most helpful in helping regulators around the world to implement consistent rules and guidelines with respect to specific activities that are deemed to pose systemic risks.

Substitutability

Investors in funds have complete control over which vehicles they use for their investments. If a shareholder is dissatisfied with a mutual fund for any reason (investment results, fees, etc.), that shareholder may withdraw his or her investment and place it in another fund or investment vehicle at any time. Further, as previously mentioned, by the nature of the agency relationship, when an asset manager is experiencing financial distress, fund and client assets would be easily portable to another asset manager without any harm to the shareholder or client.

The Report acknowledges this to be true, "funds close (and are launched) on a regular basis with negligible or no market impact. In other words, the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (*funds are highly substitutable*)." (*emphasis* added) The fact that funds are highly substitutable is an important factor in the analysis of whether or not they are "too big to fail" and/or could have a systemic effect on the global financial system. It serves to distinguish funds and their managers from the large interconnected banks and insurance companies that have previously been designated as systemically important.

Size as an indicator

The Report indicates that regulators should look further at any investment fund with more than $100 billion in assets as a potential source of systemic risk. Applying this metric results in a review of 14 funds worldwide. All 14 of these funds are U.S. RICs (mutual funds) that are highly regulated.

As stated earlier, we believe that activities-based regulation is the right approach to addressing systemic risks in the financial system. However, if regulators are intent on examining individual investment funds as potential causes for systemic risk, focusing primarily on size alone will not provide regulators with the a subset of funds that could cause systemic financial risk. The size of an investment fund does not, on its own, reveal very much about the extent to which such fund could pose a systemic risk. While size could be a secondary factor in the determining the scope of the systemic financial stress a fund could cause, it only becomes a factor if the fund is engaged in other activities that lead to risk such as excessive leverage within the fund. Leverage would be a far better indicator for regulators to focus on as a primary factor in determining a fund's potential systemic risk. Financial instability results from excessive leverage, not merely size. Leverage also increases the interconnectedness of the fund with other parts of the financial system. A large fund that invests with a long-only equity focus presents a far lower risk profile than a much smaller fund that makes excessive use of leverage in its investment strategy.

During times of financial stress the long-only fund may lose value and there may be some redemption activity, but the fund will not be overly stressed. As mentioned above, history has borne out that the mutual fund industry has performed well through times of major stress. A Capital Group subsidiary manages two of the 14 investment funds with over $100 billion in assets. Both of these funds saw negative investment results and larger than normal redemption activity during the recession of 2008-2009, however, neither fund was ever in distress and both were able to easily meet redemptions. In times of stress the regulatory regime governing the US mutual fund industry has proved to sufficiently safeguard funds and their investors. Of course there are investment losses, but the risks are fully disclosed to the investor.

In contrast, during times of stress highly leveraged funds could face a drastically different result. These funds rely on lending facilities and the liquidity of investments to fund maturing debt obligations. In times of crisis, lending facilities dry up and many of the investments made by these funds may become much more illiquid. Current loans are likely collateralized by the investments that are losing value and become illiquid. As the lenders get nervous, they call in their collateral. The fund may have to sell securities at fire sale prices causing a loss in value of the fund. When this happens investors start to redeem and a vicious cycle begins because the fund cannot meet redemption requests and lenders requirements. This is, in simplistic terms, what happened in the case of the Long Term Capital Management hedge fund collapse in 1998. The unregulated Long Term Capital Management Fund was a fraction of the size of the funds managed by Capital Group's subsidiary at the time.

Leverage is an activity that could, and should, be regulated as an activity rather than on a firm by firm basis. For example, the Investment Company Act of 1940 allows mutual funds to borrow only an amount that is one-third a fund's assets. However, none of our mutual funds borrow for investment purposes.

Enhanced regulation

It is not clear, nor has it been proposed, what enhanced regulation of investment funds would look like if a fund is identified as a Non-Bank Non-Insurer Systemically Important Financial Institution. As a first step, regulators should determine what steps would be effective in regulating investment funds that they believe to be a systemic risk to the global financial system. We believe that regulators would come to the conclusion that, unlike banks and insurance companies, prudential standards and enhanced capital requirements do not make sense in the context of investment funds. Further, we believe that if regulators look hard enough they will find that enhanced regulation of investment funds will not provide any additional protections to the financial system because there is already extensive mitigating regulation in place and systemic risks are not present as they are in other industries.

Applying enhanced regulation to some funds will put those funds at a competitive disadvantage. Any form of enhanced regulation, but particularly capital requirements, will impose additional costs on all funds subject to those regulations. These factors will likely combine to drive investors away from these funds and into funds not subject to enhanced regulation.

Conclusion

We urge FSB and IOSCO to appreciate that all financial market activity involves some degree of risk and that the ability of market participants to spread, share or take on risk through the financial markets is a prime characteristic of robust and innovative economies. Accordingly, the goal of systemic risk regulation should be to balance the need to eliminate abuses and excessive risk that can endanger the financial system, while at the same time, encouraging acceptable levels of risk taking that is necessary for innovation and economic growth.

In striking this balance, we strongly assert that the asset management industry and the funds which it manages do not pose a threat to global financial stability due to the agency nature of the relationship between asset managers and the funds and accounts they advise. We also firmly believe that the U.S. regulatory framework governing asset managers and the funds or accounts they manage already adequately protect the interests of investors and are updated regularly to take into account new issues that arise. Fund shareholders are fully aware that they bear the risk of loss when a fund decreases in value, but also enjoy the gains. Further, it is not clear to us what enhanced regulation could be applied to the asset management industry that would guard against any perceived systemic threat. Given the way in which funds and asset managers operate, coupled with the comprehensive regulatory framework, funds should not be considered systemically important financial institutions. FSB and IOSCO should work closely with regulators to help identify activities that may pose systemic risks and to implement global guidelines so any such regulation is applied consistently across different jurisdictions.

Thank you for considering these comments. Please contact Paul Roye (213-615-0418) or Michael Triessl (213-615-4024) if you have questions or would like additional information.

Sincerely,

James F. Rothenberg
Chairman