asset management group

February 2, 2017

European Banking Authority
One Canada Square (Floor 46)
Canary Wharf
London
E14 5AA

Re: **European Banking Authority, "Designing a new prudential regime for investment firms" (EBA/DP/2016/02), 4 November 2016**

Dear Sirs/Madams:

The Asset Management Group (**AMG**)[1] of the Securities Industry and Financial Markets Association (**SIFMA**) appreciates the opportunity to respond to the discussion paper entitled *Designing a new prudential regime for investment firms* (the **Discussion Paper**), published by the European Banking Authority (**EBA**), dated 4 November 2016. The AMG's members are primarily U.S. based asset management firms, many with a global footprint, and our response focuses on the investment fund and asset management issues arising from the Discussion Paper.

We appreciate that the development of any new prudential regime is not simple or straightforward. We also wish to stress that positions set forth in this response derive from our commitment to serving the interests of our clients. As fiduciaries, asset managers are obligated to put the best interests of their clients ahead of their own. This bedrock principle guides the activities and practices of the members of our organization. Accordingly, our responses to the Discussion Paper incorporate and reflect this principle.

With the above in mind, our specific comments in response to the Discussion Paper are set out below. We have opted not to respond to the individual questions within the Discussion Paper and have instead selectively chosen a number of key thematic issues relevant to the asset management industry to present an overarching response to the Discussion Paper. For ease of reference, we have linked these responses to the specific questions within the Discussion Paper where possible. Our goal is for the EBA to use these responses to further inform their approach to and views of asset management as: (i) unique and not analogous to the banking industry; and (ii) well-equipped to continue its track record for successfully meeting shareholder redemptions through normal and stress conditions without presenting a significant undisclosed risk to customers, markets or regulators.

Before providing our comments in response to the Discussion Paper, we begin with an executive summary.

[1] The AMG's members represent primarily 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.

1. EXECUTIVE SUMMARY

The current prudential regime applicable to investment firms is outdated and inappropriately tailored for the range of investment firms to which it applies. Our view is that a new regime has the potential to produce a sensible result for investment firms, provided it is designed in a way which appropriately addresses the critical distinctions and operational technicalities of the wide range of investment firms to which it will apply.

While we are broadly supportive of the mandate to redesign the regime, we are concerned that some of the EBA's proposals are at odds with the unique characteristics of the asset management industry. Specifically, the categorization of investment firms and the capital proxies (or 'K-factors'), which represent the risk of harm to others, together with their associated metrics, are not appropriate for asset management firms.

1.1 Categorization

We are concerned by the suggestion that asset managers may be considered as systemically important and therefore subject to prudential requirements based on this designation. Our strong view, and one which we have maintained in letters to the Financial Stability Board (**FSB**) and other regulators, is that asset managers do not, by their very nature, have the relevant characteristics to be designated as systemically important.[2]

It is investors, not the fund or the asset manager, who ultimately bear the investment risk in pooled vehicles thereby significantly limiting the potential threat to markets or to the customer. If an asset manager ceases to conduct business, its clients' assets will remain with their custodians and be subject to investment advice by a new manager, or managed by the clients themselves. The FSB and the International Organization of Securities Commissions (**IOSCO**) recognized this critical point in their first consultative document.[3] In particular, they noted 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 be claimed by creditors of the investment fund's manager.[4]

1.2 K-factor criteria

We also have a number of concerns as to the applicability of the K-factor criteria to asset managers. We particularly disagree with the suggestion that one of the metrics for risk to customers should be assets under management (**AUM**). Size is not correlated to risk in the asset management sector like it is in the banking sector. As we have noted to the FSB, unlike banks, there is no evidence or record that asset management firms or investment funds have failed due to operational deficiencies, are reasonably likely to fail due to such deficiencies, or that such deficiencies are relevant to global financial stability.[5] Therefore, size should not be a consideration in discussions concerning potential systemic risk of funds, asset management firms and other similarly situated investment firms.

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[2] *See* Letter from AMG to the FSB (Sept. 21, 2016), *available at* http://www.sifma.org/issues/item.aspx?id+8589962265.

[3] 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.

[4] *Id*, at 29-30.

[5] *See* Letter from AMG to the FSB, *supra* note 2, at 49.

2. THE CATEGORIZATION OF INVESTMENT FIRMS

The Discussion Paper sets out three proposed categories of investment firms: (i) systemic and bank-like investment firms (**Class 1**); (ii) investment firms that are not systemic and bank-like (**Class 2**); and (iii) very small, non-interconnected investment firms (**Class 3**).

2.1 Class 1: Systemic and bank-like investment firms *(Question 1)*

The Discussion Paper states that, in the EBA's view, only a very small sub-set of investment firms in the EU will be deemed to be both systemic and bank-like. Asset managers, regardless of size, are not systemic for the reasons referred to throughout this response, nor are they bank-like.

The following characteristics of investment funds and asset managers demonstrate that they operate differently than Class I firms:

- Their structural, operational and behavioral features mean that they are not sources or amplifiers of systemic risk. On the contrary, asset management activities are a stabilizing force in financial markets, facilitating long-term investment in financial assets, distributing risk broadly across asset holders and geographies, and promoting retirement security for millions. The FSB supports this point in its consultative document titled *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* by acknowledging that "the different structure of the asset management sector offers some important stabilizing features to the global financial system".[6]

- Asset management is a fiduciary business, and the asset manager's performance is overseen by multiple parties, including its own management, auditors and regulators, as well as the management, auditors, regulators, fiduciaries and other representatives of the fund or other entity for which it is providing the service.

- Asset managers do not manage all assets identically. An asset manager with a large amount of AUM is really a collection of many smaller, diverse accounts, each with its own characteristics, objectives and risk profiles.

- Investment advisers and funds regularly shut down or have assets migrate from fund to fund and/or manager to manager with little market impact.

- Asset managers do not "fail" in a manner that requires regulatory intervention, because, unlike banks, asset managers have an agency relationship with their clients, meaning they do not take proprietary positions or absorb investor losses.

- Client assets are custodied and segregated, they are not part of the asset manager's balance sheet and therefore do not create balance sheet risk. The FSB has acknowledged this as well, stating, "asset managers usually do not use their balance sheets in transactions between their clients and the broader marketplace, since an asset manager itself generally does not enter into financial market transactions as a principal. Given that an asset manager's balance sheet is generally very small relative to the size of assets managed, distress at the level of the asset manager should generally pose less of a risk to the financial system than distress across its funds".[7]

These characteristics have historically ensured that even large liquidations have been managed in an orderly fashion. For example, in late 2015, Third Avenue's Focused Credit Fund (**FCF**) faced heavy

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[6] Consultative Document, Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, at 7-9.

[7] *Id.*

redemptions against a background of underperformance. On 16 December 2015, the Securities Exchange Commission (**SEC**) issued a temporary order granting FCF's request to temporarily suspend redemptions until FCF's orderly liquidation. As noted by the Financial Stability Oversight Council (**FSOC**), FCF's actions "came at a time of heightened volatility in the high-yield credit market, and other high-yield mutual funds also saw significant outflows" and yet, the FSOC acknowledged that "no other high-yield funds were forced to suspend redemptions".[8] This serves as just one example of how even significant redemptions leading to a mutual fund winding down did not result in contagion to other funds or runs on the market requiring the firm to be classified in Class 1.

As historical precedent establishes, customers are adequately protected under the existing regulatory regime, and any risk to the customer would not be solved by increasing the amount of capital held by the investment firm. Funds and managers regularly enter and exit the market each year.[9] In the U.S., the characteristics of these entities and of the asset management industry enable these to occur in large numbers with no discernable impact on financial stability and no need for a special resolution regime or capital to facilitate liquidation. The fundamental features of the manager/fund relationship differ significantly from the banking regime, 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. Customers are adequately protected under the regulatory regime, and any risk to the customer would not be solved by increasing the amount of capital held by the investment firm. Therefore, it would be inappropriate to apply a prudential regime to asset managers that is the same as, or analogous to, that applicable to firms whose business models are inherently a source or an amplifier of systemic risk.

2.2 Class 2: Investment firms that are not systemic and bank-like *(Questions 2 and 11)*

We agree that the purpose of a prudential regulatory regime for investment firms is not to provide the same level of assurance as is provided for firms that are systemic and bank-like. We also welcome the suggestion that a less complex prudential regime would be appropriate for these firms.

We do however have concerns in respect of the overarching principles which the EBA sets out at paragraph 12 of the Discussion Paper:

(a) We disagree with the suggestion that an investment firm could be 'systemic', while not being 'bank-like'[10], an example of which could, as suggested by the EBA, be an "extremely large portfolio manager".[11] Funds and advisers do not present the same risk profile as other entities in the financial system. No individual fund or manager possesses the necessary mix of characteristics to threaten global financial stability like a G-SIFI does. Furthermore, as assets can easily and fluidly shift from one fund or manager to another, G-SIFI designation would also be ineffective and simply prone to unwarranted disruption as participants seek to avoid designation and the ill-suited regulation that comes with it.

The debate around whether asset managers should be designated as G-SIFIs has been ongoing for some time and has to date produced no compelling evidence to substantiate this designation. The FSB has acknowledged that historical evidence suggests that investment

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[8] *See* FSOC, 2016 Annual Report, available at https://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2016- Annual-Report.aspx, at 86

[9] See, for example, ICI 2016 Investment Company Fact Book (2016), which states at 18-19 "[I]n recent years, the number of [fund] sponsors has risen once again as the economy and financial markets have recovered, with a net increase of 191 from year-end 2009 to year-end 2015 (440 entering and 249 leaving) (Figure 1.8). Macroeconomic conditions and competitive dynamics also affect the number of funds offered in any given year. Fund sponsors create new funds to meet investor demand, and they merge or liquidate those that do not attract sufficient investor interest. A total of 594 funds opened in 2015, fewer than the year before and less than the 2007 peak of 725 and the 2005–2015 average (Figure 1.11). The rate of fund mergers and liquidations increased significantly from 365 in 2014 to 462 in 2015, leading to the annual net increase being close to the average of the prior 10 years." Available at http://www.ici.org/pdf/2016_factbook.pdf.

[10] Paragraph 12(a) of the Discussion Paper.

[11] Paragraph 81 of the Discussion Paper.

funds have not created global stability concerns.[12] Consistent with this finding, we are not aware of any evidence to support a claim that the investment management industry has ever experienced significant problems meeting investor redemption requests.[13] Nor is there any evidence to support a hypothetical connection between liquidity risk in open-end funds and systemic risk to global financial markets.[14] We therefore consider that it would be inappropriate to categorize an asset manager as systemic under any prudential regime. Imposing additional and unnecessary requirements, particularly requirements that are applicable to the very different risks associated with banking activities but irrelevant for asset management, will produce counterproductive results and negative consequences.

We also consider that the EBA's intention in respect of Class 2 firms is not sufficiently clear. In particular, it is unclear as to whether these 'systemic' firms would be subject to requirements over and above those applicable to, for example, an average sized portfolio manager. We would entirely disagree with such an approach being taken and would therefore welcome clarification on this point.

(b) We also disagree that the failure of investment firms may have the level of impact on customers and markets suggested within the Discussion Paper.[15] As stated throughout this response, asset management activities do not create financial instability or market concerns, nor do they pose a significant risk to customers. See our comments at paragraph 2.1 above in this regard. We therefore have deep reservations as to the suggestion that the capital requirements applicable to Class 2 investment firms should extend to ensuring that these firms can absorb a degree of loss which includes correcting any harm caused to customers and markets. We also disagree with the EBA's suggestion for aggregating assets of investment firms that are part of a banking group[16] as this again implies that size is indicative of risk, a conclusion which we strongly dispute.

We consider that these suggestions go beyond the scope of what a prudential requirements regime should seek to establish and has the potential to place an onerous customer redress capital contingency on fund managers. Risks of this nature are already addressed via a conduct regime that is already being considered and updated as appropriate by securities regulators. We believe it is imperative for the EBA to understand and recognize the current and pending legal, regulatory and compliance framework when analyzing the risks presented by asset managers. For example, there are a number of significant EU regulations which directly and indirectly impact asset managers from a conduct perspective, including MiFID II[17], EMIR[18] and PRIIPS[19] which add to existing conduct requirements such as those set out in UCITS and AIFMD. Additionally, in the U.S. the SEC recently finalized regulations on data collection and liquidity risk management, and is still considering additional regulations on issues such as derivatives usage and operational risks. In our view, an extensive conduct regime is the more appropriate forum for such risks to be managed.

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12 In its consultative document entitled Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities, dated 22 June 2016 at 8.

13 *See* Letter from Investment Company Institute to SEC (Jan. 13, 2016), available at https://www.ici.org/pdf/16_ici_sec_lrm_rule_comment.pdf: see also Paul Hanouna, Jon Novak, Tim Riley, Christof Stahel, Staff Economists, SEC, "Liquidity and Flows of U.S. Mutual Funds," Division of Economic and Risk Analysis (Sept. 2015), available at http://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf.

14 *See*, e.g., Jeremy C. Stein, 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 Federal Reserve 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."

15 Paragraph 12(b) of the Discussion Paper.

16 Paragraph 18 of the Discussion Paper.

17 Which came into force on 2 July 2014 takes effect from 3 January 2018.

18 Which came into force on 16 August 2012.

19 Which came into force on 29 December 2014 and applies from 1 January 2018.

The Discussion Paper also states that the prudential regime applicable to investment firms should address the specific risks associated with holding client money[20]. Asset managers do not hold client assets and, in most cases, nor do they hold client money. Instead, the client assets are held and administered by a third party custodian, typically a bank. In these circumstances the asset manager would have no claim on the assets as the assets and money belong to the customer which will be reflected in the records of the third party custodian. Third party custody arrangements also facilitate the substitution of asset managers, which can be effected without the actual movement of assets. We therefore disagree that the failure of an asset manager, or its exit from the market, would have an impact on client assets as they are not in the business of taking balance sheet risk. They may exit the business if their funds are unsuccessful or services are unpopular, but the process for these exits is orderly, already well understood and requires no special capital regime. As such, it appears that the proposal fails to take into account the technicalities as to how asset managers operate in practice.[21]

2.3 Class 3: Very small, non-interconnected investment firms *(Question 3)*

The EBA suggests that a simplified regime should be applied to those firms falling within this category, which we expect would be only a minority of asset management firms. We are concerned by the proposal that this simplified regime could be based on fixed overhead requirements and initial capital, which would, in the EBA's view, result in sufficient capital set aside to ensure the safe and sound management of their risks.[22] We maintain throughout this response that that the risks identified by the EBA are not applicable to asset managers. This is undoubtedly the case for Class 3 firms. Our view is that the drawback to the identification and prudential treatment of Class 3 firms is clear; it would be unreasonable and excessive to impose a prudential regime which could serve to increase their cost of capital significantly when the EBA acknowledges in the Discussion Paper that these firms are low risk to both customers and markets[23].

3. PRUDENTIAL REGIME FOR INVESTMENT FIRMS

The Discussion Paper identifies a range of K-factors which can be split into two broad types: risk to customers (**RtC**) and risk to market access, liquidity or integrity (**RtM**). There is a third additional element, described in the Discussion Paper as the risk to firm (**RtF**). While we do not object to the general premise of the K-factor approach, we have a number of reservations in respect of the individual K-factors, which we comment on in turn below.

As a general point, although the EBA acknowledges the differences, we consider that inadequate consideration has been given as to the ways in which asset managers fundamentally differ from banks and insurance companies. See our comments above at paragraph 2.1 on this point. We would therefore encourage the EBA and the European Commission to better consider these distinctions and amend the new prudential regime as appropriate to reflect the differences in business models and regulatory regimes.

3.1 Risk to Customers *(Question 5)*

The description of RtC within the Discussion Paper raises a number of issues for asset managers and we do not consider that the K-factor metrics have taken adequate account of the features of the asset management industry.

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[20] Paragraph 12(c) of the Discussion Paper.

[21] *See*, for example, *supra* note 9 and our comments above at paragraph 2.1 and specifically the example provided of Third Avenue's Focused Credit Fund.

[22] Paragraph 14 of the Discussion Paper.

[23] Paragraph 15 of the Discussion Paper.

The Discussion Paper states that for the vast majority of investment firms, and especially those which operate on an agency basis, the most important element of risk will be the potential for harm that the firm may pose to its customers. The Discussion Paper goes on to state that a range of observable K-factors for the RtC are required, which includes AUM, assets under advice (**AUA**), assets safeguarded and administered (**ASA**), client money held (**CMH**), liabilities to customers (**LTC**) and customer orders handled (**COH**). We have set out our reservations in respect of the proposed K-factors below.

As a general point, we do not agree that the RtC is especially relevant to those investment firms which operate on an agency basis. 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. Taking this into account, the EBA has failed to explain or provide any justification as to why it considers the agency nature of the relationship would, or could, increase the level of risk to customers and we would welcome the EBA's clarification on this point.

(a) **Assets under management**

Size is not an indication of risk (systemic or otherwise) for an asset management firm. There is no material difference between a single index fund with €100 billion in AUM and five funds tracking the same index, each with €20 billion in AUM. Therefore it is inadvisable to design a prudential regime that treats them differently based on the amounts of their AUM. The amount of AUM attributable to a particular asset management firm or investment fund does not equate to customer and/or systemic risk and is not a factor in a firm or fund's risk profile.

(b) **Assets safeguarded and administered and client money held**

The ASA and CMH K-factors fail to appreciate the importance or relevance of how the asset management industry operates in respect of the safeguarding of client assets. 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 that is already subject to the oversight of prudential regulators.

Custodians have an important role in maintaining control of client funds. Effective oversight of these entities is critical to the resilience and integrity of asset managers' operations and the safekeeping of their clients' assets. Assets held by custodians are segregated both from the banks' balance sheet and other customers', and are therefore fully recoverable in the event an asset manager exits the business. All major custodians are subject to the heightened prudential standards for systemically important financial institutions. In addition to heightened prudential standards, all such banks are subject to regulatory stress testing, which tests their ability to sustain severe economic shocks. These banks are also subject to living will requirements; for custody banks, the ability to seamlessly provide critical custody services is a key factor in the living will. Custodians are therefore an important element in protecting the interests of asset managers and their clients

and so, contrary to the assertions made in the Discussion Paper[24], we consider that this distinction should absolutely matter in designing a new prudential regime.

(c) **Customer orders handled**

While we do not consider that this K-factor is particularly relevant to asset managers as they operate an agency model, we disagree with the EBA's suggestion to apply a "broad view" of the customer. In addition, each of the customer's interactions in the order chain are separate and should not be viewed as a whole in order to drive a larger capital requirement. Given the custodian's role in safeguarding and maintaining physical control over clients' funds, here again, we wish to emphasize that the role of the asset manager is limited to simply giving instructions to the transacting agent and, notifying the custodian regarding the nature of a trade. The transacting agent is generally a highly-regulated broker-dealer. The broker-dealer and the custodian thereafter exchange securities for cash or collateral of equal value.

3.2 Risk to Market *(Question 5)*

We disagree that the failure of an asset manager or the exit of an asset manager from the market (whether this occurs suddenly or not), would result in a temporary dislocation in market access or market liquidity and, as a consequence, that market confidence or integrity could be questioned. Such a suggestion would by its nature draw an analogy between asset managers and those entities which are designated as G-SIFIs, as in order for an entity to be designated as a G-SIFI, its distress or disorderly failure has to "cause significant disruption to the global financial system and economic activity across jurisdictions". We do not consider that the exit of an asset manager from the market would have any such impact.[25] This view is supported by comments from the FSB and IOSCO which have stated "[F]unds 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)."[26]

The type of significant disruption described above 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. It is our view (and that of the FSB and IOSCO per the preceding comment) that certain characteristics of investment funds and fund managers mitigate any RtM. These characteristics are described below.

(a) **Resilience**

First, the asset management industry is highly resilient and has successfully weathered adverse market conditions for many decades. Fund investors, unlike bank depositors, consider and use their investments as at-risk capital. Fund investors are therefore comparatively likely to maintain diverse asset portfolios and to manage proactively the risk of loss in the value of individual fund investments. The risks associated with losses passed through to fund investors are substantially less than the systemic risks associated with, for example, a bank failure.

(b) **Substitutability**

Second, it is not extraordinary for an asset manager or an investment fund to enter or exit the market and it is clear that the asset management industry is not overly reliant on any one

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24 Paragraph 37(d) of the Discussion Paper.

25 *See supra* note 9 and our comments above at paragraph 2.1 and specifically the example provided of Third Avenue's Focused Credit Fund.

26 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, available at http://www.fsb.org/wp-content/uploads/r_140108.pdf.

"large" or "complex" asset management firm. Far from being a "vulnerability", the structure of the asset management industry facilitates such events and transitions without creating systemic risks. In fact, it is the substitutability of asset managers and investment funds that operates as a unique characteristic of asset management firms, one that differentiates our industry from that of the banking and insurance industries. This is largely attributable to the agency relationship of asset managers managing the assets on behalf of their clients and, as discussed above, the regulatory framework supporting this relationship. As a result, asset managers and investment funds routinely enter and exit the market without creating systemic disruptions. To illustrate, as of year-end 2015, 43 U.S. fund sponsors entered the business and 37 U.S. fund sponsors left the business[27]. Also as of year-end 2015, 594 U.S. mutual funds opened and 462 merged or liquidated.[28] In addition, the SEC acknowledges that it is "aware of instances of non-routine disruptions at large advisory businesses that have resulted in transitions to new advisers or new ownership without appearing to have a significant adverse impact on clients, fund investors, or the financial markets."[29] 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 sale of assets in the market.

Given these key distinctions between asset management activities and banking and insurance activities, and specifically the fact that assets are separately custodied and therefore investment risk is borne by the client, we would request that the EBA clarifies which aspect of the RtM element they consider appropriate for asset managers. We also request that the EBA acknowledges that RtM is not relevant where client assets are segregated.

3.3 Risk to Firm *(Question 5)*

We do not consider that RtF (which we understand is designed to capture any risks which have not already been included within RtC or RtM) is particularly relevant to firms, such as asset managers, which are operating under an agency model.

There are various protections afforded to asset manager clients, such as the custodial practices and other features described within this response. 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 the 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 are prohibited from using a client's assets for their own purposes. 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 which it acts as agent to provide investment advice. As with any business, of course, a 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's failure would also be irrelevant to the stability of the financial system since any "interconnectedness does not emanate from the manager's balance sheet"[30].

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[27] *See* ICI, 2016 Investment Company Fact Book (2016), available at http://www.ici.org/pdf/2016_factbook.pdf, at 16.

[28] *Id.* at 19.

[29] *See* Adviser Business Continuity and Transition Plans, SEC Rel. No. IA-4439, File No. S7-13-16 (June 28, 2016), available at https://www.sec.gov/rules/proposed/2016/ia-4439.pdf, at 21.

[30] 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.

In fact, not only does the current process work well, but it also functions more seamlessly than normal bankruptcy processes. 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 whereby 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. We note the EBA's concerns that customers may suffer losses as a result of unreliable investment advice and its suggestion that the investment firm should have financial resources to help pay for correcting any such harm[31]. This suggestion runs counter to the understanding and the agreement that each investor has with his advisor and, thus, we wholeheartedly disagree with it. Absent a situation of fraud, negligence or breach of contract, investment losses would not be compensable in any event. And, broadly speaking, in the case of losses incurred by unintended errors or omissions, asset managers maintain insurance policies with highly regulated insurance companies to cover such unintended errors and omissions.

3.4 Capital adequacy framework for investment firms: Uplift factor *(Question 7)*

The Discussion Paper identifies two strands to determining a firm's minimum capital requirements under the new capital adequacy framework. The first strand is described as the sum of capital requirements derived from the RtC and RtM K-factors, which may then also be subject to an up-lift for RtF. For the reasons set out above in respect of the RtF K-factor, we do not consider this to be relevant to the asset managers who do not use their balance sheets in transactions between clients and the broader marketplace. In addition, given that an asset manager's balance sheet is generally very small relative to the size of assets managed, distress at the level of the asset manager should generally pose even less of a risk to the financial system than distress across its funds, which as noted throughout this letter, pose little risk.

3.5 Stress testing for investment firms *(Question 20)*

We do not consider that any common stress scenario for liquidity is necessary for investment firms. Implicating all funds in large-scale tests assumed to predict whether the asset management industry is capable of sustaining economic shock is inconsistent with what we do know: the asset management industry is highly diverse and resilient and has successfully weathered adverse market conditions for many decades.

Stress testing is typically used in the context of banks, whose balance sheets are assessed to determine whether or not they have sufficient capital to withstand various economic stress scenarios. We submit that there is a conceptual problem with the very notion of stress testing the capital adequacy of a fund, which operates with little or no leverage and is insensitive to many of the macroeconomic factors that impact a bank's financial health.

We believe that it would be premature to suggest that stress testing is appropriate for mutual funds when the objectives, methods, and costs and benefits are wholly undefined and therefore immeasurable. As we have previously stated to the FSB, we believe that any suggestion to stress test open-end funds reflects a central misunderstanding of the critical differences between the risk profiles of a bank and a mutual fund. When a bank fails, depositors lose the value of their deposits that exceed insured amounts and remaining assets and borrowers lose access to a source of capital. This, in turn, causes the amount of money and credit available in the markets to decline, creating the potential for systemic shock and pressuring government safety nets that support banks. Stress testing a bank consists of assessing its total balance sheet risk – its capital relative to its assets and exposures to creditors, borrowers, and counterparties. In contrast, when a mutual fund closes (or fails, which is a rare occurrence) or an asset manager ceases to provide investment advisory services to a fund, an investor's assets may be transitioned to a new fund or a new asset manager or self-

[31] Paragraph 27 of the Discussion Paper.

managed without creating a negative ripple effect on the financial markets. A mutual fund investor, not the fund, nor the asset manager nor the relevant government, knowingly and willingly, bears the market risk of his or her investment.

Attempting to aggregate the impact of investment losses at the manager level would be misguided. In essence, an asset manager with a large amount of AUM operates as a collection of smaller accounts, each with its own characteristics, objectives, and risk profiles. The assets of one account cannot be used to pay redemptions of another account (unlike bank deposits). An asset manager's consolidated balance sheet does not include these managed assets and therefore fails to reflect the fact that each fund is unique in some or all of its key attributes, including investor demographics, regulation, operation, structure, and management. Put differently, credit institutions generally will have similar exposures to a credit event, whereas any given mutual fund's exposure to a particular credit event will depend on the composition of its portfolio, investment strategy, and investor base. As such, it is difficult to understand how a stress test that aggregates exposures of individual funds – and, by extension, millions of individual investors - would be reflective of realistic scenarios. Not surprisingly, it is widely acknowledged by industry groups and even by SEC staff that there is a false parallel to the process for stress testing a bank.[32]

We are also concerned that prescriptive rules in this area would result in stress tests that use a set of scenarios as inputs that would generate unrealistic results. Results that do not accurately reflect how any given fund or its investors would respond to changes in asset liquidity and redemptions during stressed markets would create a false foundation upon which to build stress testing policy. Accordingly, we believe that additional work needs to be done to assess how a particular stress testing methodology would support liquidity management practices and whether there is a link between those results and practices that would, in turn, have any bearing on global financial stability.

There is no available research or data which substantiates a call for system-wide stress testing in the mutual fund context. On the contrary, available research and data suggest that system-wide stress testing would not yield a useful set of data from which to glean results that speak to the asset management industry's capacity for maintaining (or detracting from) financial stability. To illustrate, it is imperative to understand the sharp distinction between an asset owner and an asset manager. Asset owners, which include pension plans, insurance companies, official institutions, banks, foundations, endowments, family offices, and individual investors, have a choice of managing their assets directly, outsourcing day-to-day management activities to asset managers, or opting for a combination of both. Many large institutional asset owners invest some or a portion of their assets directly, which serves to explain why approximately three quarters of financial assets are managed directly by asset owners, not asset managers.[33] Given this information, it is worthwhile to pause and consider whether inclusion of asset managers and their funds in system-wide stress tests would allow regulators to draw helpful conclusions that inform regulatory actions and liquidity risk management practices. We consider that it would be inappropriate to explore stress testing for funds until the requisite basic research has been completed on this issue.

[32] *See*, e.g., Melanie Waddell, Big RIAs May Face Stress Tests, THINKADVISOR (July 5, 2016), available at http://www.thinkadvisor.com/2016/07/05/big-rias-may-face-stress-tests?slreturn=1469316329 (noting that the SEC's chief economist, Mark Flannery, was quoted as saying, 'There's a problem that's really got us stuck, which is what does it mean to stress test a mutual fund…The parallel to bank stress tests is really extremely misleading.')

[33] See BlackRock ViewPoint, Who Owns the Assets? Developing A Better Understanding of the Flow of Assets and the Implications for Financial Regulation (May 2014) ("BlackRock Asset Owners Paper"), available at http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf, at 2 (finding that more than three quarters of financial assets are managed directly by asset owners, not asset managers)

4. OTHER CONSIDERATIONS

4.1 Large exposures risk to investment firms *(Question 25)*

We do not consider that large exposure risk is relevant to asset managers and our view is that the analysis of potential large exposures for investment firms does not adequately reflect the unique characteristics of the asset management industry. For asset managers, the potential for large exposures to arise is very limited and many of the examples listed by the EBA[34] are not relevant to the industry. Our view is that the relevant examples are exposures to fees owed by large clients and cash in bank. We consider these sorts of exposures to be very different to, for example, exposures on the trading book (which, for the avoidance of doubt, we do not consider to be relevant here).

4.2 Remuneration *(Question 33)*

We welcome the potential for a consistent remuneration regime for asset managers across MiFID, UCITS and AIFMD. However, we note that the proportionality wording in the EBA's opinion on proportionality which is referred to within the Discussion Paper[35] would benefit from a holistic review as the aim would no longer be to compare banks with asset managers.

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The AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the EBA might find useful. Please do not hesitate to contact either Timothy Cameron at 202-962-7447 or tcameron@sifma.org or Lindsey Keljo at 202-962-7312 or lkeljo@sifma.org with any questions.

Sincerely,

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[34] Paragraph 138 of the Discussion Paper.
[35] Paragraph 176 of the Discussion Paper.