The Honorable Jacob J. Lew
Secretary of the
U.S. Department of Treasury
1500 Pennsylvania Avenue N.W.
Washington, DC 20220

Submitted electronically through http://www.sec.gov

Re: Comments Summarizing the Financial Stability Oversight Council's May 19, 2014 Conference on Asset Management, SEC File No. AM-1

Dear Secretary Lew:

The Asset Management Group of the Securities Industry and Financial Markets Association[1] and the Association of Institutional INVESTORS[2] ("we") are grateful that the Financial Stability Oversight Council ("FSOC") organized the May 19, 2014, conference on asset management (the "May 19 Conference" or the "Conference"). The Conference was an important and illuminating first step in fostering an open dialogue about whether, and to what extent, asset management creates or reduces risks to U.S. financial stability. It also clearly illustrated the extent of existing regulation of the industry and the substantial work required to determine whether regulators should take additional action to reduce any potential risks or increase the systemic benefits of asset management.

We also welcome the statement in the FSOC Release of July 31, 2014 that the "Council directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry." We submit this letter to memorialize what the academic and industry experts at the Conference had to say about what is known and not known regarding asset management and its potential impacts on the U.S.

[1] The Asset Management Group ("AMG") of the Securities Industry and Financial Markets Association'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 Association of Institutional INVESTORS ("AII") is an organization of the oldest, largest, and most trusted federally registered institutional investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through more than 80,000 public and private pension plans, foundations, and registered investment companies. Collectively, our member firms manage ERISA pension, 401(k), mutual fund, and personal investments on behalf of more than 100 million American workers and retirees.

financial system, Tr. 10,[3] in the hope that it may be useful to the staffs of FSOC and its individual members in planning a more focused analysis of industry-wide products and activities.

The speakers and panelists at the Conference presented a diverse array of perspectives and expertise. First, FSOC invited a number of academics, whose selection presumably reflects a level of respect on the part of FSOC for their expertise and insight into the U.S. financial system, including the capital markets and the roles of investors and asset managers in those markets. Second, there were senior executives from companies representing a broad spectrum of business models within the asset management industry. Third, there were a number of regulators from the U.S. and abroad that served as panelists and moderators and submitted questions for the panels. For ease of reference, we have attached as Appendix A to this letter a list of the speakers, moderators, and panelists, with their affiliations.

Three important themes permeated the entire Conference.

First, participants described the many ways in which fundamental attributes of the asset management business – its economic effects, structure, and regulation – significantly reduce the potential for it to create systemic risk. One participant after another explained how the legal and economic separation of investors, managers, funds, and accounts, the strict regulation of liquidity and leverage in much of the industry, and the practices for mitigating various other investment and operational risks effectively diminish, if not eliminate, any potential threat to U.S. financial stability. Potential sources of risk are mitigated by the structures and business models of funds and their managers or strictly controlled by regulation and contract.

Second, asset management often affirmatively reduces systemic risk and enhances financial stability in a number of ways, such as by facilitating diversification and long-term investment, financing assets with equity, programmatic investing through retirement savings accounts, countercyclical rebalancing, and opportunistic buying of assets whose prices are falling. Indeed, Conference panelists noted that movement of assets away from banks with leveraged balance sheets and the federal safety net to "real money" fund investors advised by professional asset managers is a net gain from a financial stability perspective.

Third, and of particular note in connection with FSOC's upcoming "focused analysis," when participants did identify hypothetical risks that they deemed worthy of study with respect to certain asset management activities, they acknowledged that the potential risks themselves have not been proven to exist, let alone at a magnitude sufficient to threaten U.S. financial stability. They emphasized the need for significantly more study before any meaningful discussion of the need for or design of potential remedies can productively take place.

I. The Panelists Provided Helpful Insight into the Asset Management Business, Suggested Next Steps and Raised Questions About Regulatory Priorities.

A. Key Statements and Conclusions from Panelists

[3] FSOC has not provided to the public an official transcript of the May 19 Conference proceedings. References to "Tr. __" are to the attached certified transcript made from the video posted on FSOC's website.

Before describing the details of what was said about all of the important topics of discussion at the May 19 Conference, we want to highlight some of the key statements made by Conference panelists, focusing primarily on statements made by the academics invited by FSOC.

First, the panelists supported the view that any regulation of asset management be activity-based, as opposed to designation of particular funds or managers as systemically important financial institutions ("SIFIs"). As stated by Professor Kim Schoenholtz of NYU: "as pragmatists[,] we probably agree that activities are a better way to regulate our capital markets." Tr. 157.

Second, the panelists agreed that the primary risk sought to be addressed by SIFI designation – failure, followed by disorderly liquidation – is simply not presented by asset management in the absence of significant leverage. In the words of Professor Andrew Metrick of Yale: "[i]n the absence of leverage, . . . [t]he failure of a long-only manager from an orderly liquidation perspective is just a nonissue." Tr. 236-37.

Third, while some panelists withheld judgment on money market mutual funds pending promulgation of the SEC's new regulations, which were adopted on July 23, there was consensus that traditional, floating NAV mutual funds do not create "run" risk. According to Professor Itay Goldstein of the University of Pennsylvania: "Certainly, I don't think that level of fragility exists in . . . traditional mutual funds" with a "floating NAV" where "when you redeem, you get the current market." Tr. 57.

Fourth, the panelists discussed the historical evidence regarding the susceptibility of floating NAV mutual funds to problems arising from substantial redemptions, which they referred to as "runs."[4] In the words of Professor Goldstein, "there haven't been big problems in the past. . . . [B]y and large, we did not see [the] sort of runs on mutual funds that put the whole financial system at risk like we had with bank runs." Tr. 82. In light of the fact that our markets have recently endured their greatest "stress test" since the Great Depression, that historical evidence speaks volumes.

Fifth, the only examples offered at the Conference of asset managers or funds that anyone thought had contributed to systemic risk were Long Term Capital Management ("LTCM") and money market mutual funds. Both of these examples are outdated and largely inapplicable. With regard to LTCM, it is generally undisputed that excess leverage was the principal cause of the distress it experienced and transmitted to the market.[5] As discussed in detail below, much of the asset management industry makes very limited use of leverage, and certainly not on the scale employed by LTCM. Also, as noted at the Conference, the rules that would govern even a

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[4] We note that the concept of a bank-style run is inapplicable to collective investment vehicles with variable net asset values and little or no leverage. They do not share the characteristics of the banking business model that make banks susceptible to "runs" and redemptions from such funds, even on a large scale, do not constitute a "run."

[5] *See, e.g.*, *Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management*, Report of the President's Working Group on Financial Markets, at Transmittal Letter p. 1 (April 28, 1999) ("The principal policy issue arising out of the events surrounding the near collapse of LTCM is how to constrain excessive leverage.").

highly-leveraged hedge fund today have been changed dramatically since LTCM's failure. *See* Tr. 150-51. As for money market funds, the lessons from the 2008 experience cited by panelists must be updated to reflect the regulatory reforms adopted by the SEC in 2010 and 2014. The reforms the SEC has adopted since Reserve Primary Fund "broke the buck" have fundamentally changed the salient characteristics of money market mutual funds. Moreover, the lessons of Reserve Primary Fund do not apply to floating NAV vehicles, which, again, comprise the large majority of collective investment funds.

B. What Was Not Said at the Conference

Furthermore, what was *not* said at the Conference may be as important as what was said. None of the speakers, moderators, or panelists – whether academics, regulators, or industry professionals – concluded or even expressed an opinion that asset managers or funds create systemic risk. Although a number of panelists recommended that further research be conducted on issues related to systemic risk, none of the speakers or panelists suggested that the studies necessary to evaluate these questions had already been done. No support for SIFI designation or bank-style prudential standards was voiced by any speaker or panelist as a response to even hypothetical risks associated with asset management or the relevant capital markets. At the most, some panelists identified potential concerns about the industry – concerns that may or may not prove, on examination, to exist at a material level if at all, and to which a sound response may not be any new regulation (especially when weighed against unintended consequences). We note that Under Secretary for Domestic Finance Mary Miller opened the conference with the observation that, following further analysis, the FSOC may determine that the prudent course of action with respect to funds and their managers is "to take no action." Tr. 8

C. Next Steps: Transparent, Objective and Credible Research That Analyzes the Systemic Benefits of Asset Management as Well as Potential Risks

What the Conference provided is, in essence, the beginning of a research agenda. Accordingly, we endorse FSOC's determination that its next step should be to conduct the research necessary to increase its understanding of the industry, rather than to engage in policy discussions based on inadequate information and speculation. The May 19 Conference demonstrated that there is no academic, regulatory, or industry evidence proving the existence of a material problem, much less a consensus as to a regulatory solution. As the experts invited by FSOC believe that we are still at the stage of formulating a research agenda that may or may not yield information supportive of any particular regulatory response, it seems fair to say that the case for any such response has not been made.

The recommendations of the panelists that research be conducted necessarily presume that the research would be pursued in a transparent, objective, and credible manner; that is, using valid data, and testing that data rigorously, and using an analytic framework developed with input from those with knowledge of the industry and those who have expertise with respect to the applicable economic principles. Any serious research effort must, at a minimum, identify the data needed, retrieve that data, analyze it objectively, and publish the results for peer review. A genuine, transparent dialogue with experts from regulatory agencies, academia, and industry can only improve the work of FSOC staff and is strongly to be encouraged. We stand ready to engage in such an empirical open process.

Moreover, any research agenda should include not only a study of potential systemic risk, but also a rigorous analysis of the systemic benefits created by asset management products and activities and the likely consequences of future regulation on both. An effort to avoid a largely speculative harm in asset management may create real harm for investors, issuers, and the long-term investment that drives U.S. economic growth and job creation.

D. Priorities

Finally, in a world of limited resources, we ask FSOC to consider whether there is a sound rationale for prioritizing the search for potential systemic risks in asset management over the many other systemic risk agenda items already before FSOC and its members, such as adopting sound regulations for non-bank SIFIs and financial market utilities that have already been designated, reducing risk in short-term wholesale fund markets broadly, creating an effective domestic and cross-border resolution planning process, and reforming the U.S. mortgage markets. Certainly, no rationale for prioritizing asset management was presented at the May 19 Conference.

II. The May 19 Conference Confirmed That Core Traits of the Asset Management Business Limit the Potential for It to Create Systemic Risks and Often Affirmatively Reduce Them.

At the May 19 Conference, it quickly became clear that the participants agreed that fundamental attributes of asset management distinguish it from banking and help prevent it from creating the types and scale of bank-like systemic risks that FSOC and the SIFI designation authority in particular were created to address. *See* Tr. 7 (Miller: "the Council . . . clearly recognizes that asset managers are different from banks and other financial service companies"). Multiple Conference participants described how those fundamental attributes of funds, accounts and their managers not only mitigate potential systemic risks but actually promote financial stability.

A. Asset Management Is an Agency Business Where Investors Choose the Risks.

A topic that framed much of the discussion at the May 19 Conference is the fact that asset management is an agency business in which clients – rather than asset managers – own the invested assets and choose to take the economic risks of their investments. Several panelists emphasized how the agency model both makes asset managers an unlikely source of systemic risk and makes SIFI designation an ineffective regulatory tool. As will be discussed in detail below (*see* Section I.E), the agency model in fact enhances stability.

Norm Champ – the Director of the SEC's Investment Management Division – summarized how the agency business model used in asset management works. Tr. 15-16. "[A]sset managers . . . serve as agents that invest [the] money of their clients on behalf of those clients." *Id.* They "follow prescribed investment mandates and strategies that are delineated by contract . . . or in disclosure that is provided to investors through offering memoranda or prospectuses." *Id.* They "are not generally taking investment risks with their own balance sheets" or "investing their own money." *Id.* They "do not make promises such as to return

principal, earn a prescribed rate of return, pay a fixed level of interest or make prescribed payments into the future." *Id.* Accordingly, "[w]hen an investor places money with an asset manager that investor is consciously taking on investment risks." *Id.*

Federal law dictates this agency relationship between asset managers and their client investors. As Mr. Champ noted, "[m]uch of [the] asset management regulatory regime has been focused on establishing a fundamental separation between the investment advisers on the one hand, and the assets of their clients on the other, whether those assets are in funds or managed accounts." Tr. 22. It requires that "[m]utual funds and other investment companies" be "legal entities separate and apart from the asset management firms that manage their assets." Tr. 19. Each fund also must be separate from other funds that have the same manager. Peter Stahl from Fidelity spoke to this issue: "[Mutual] funds are separate legal entities. They have separate owners. They're overseen by independent trustees. They have contractual relationships with their managers . . . . But they do stand on their own. And that's not only true in the corporate sense, that's also true in the way that they are managed." Tr. 220-21. William De Leon of PIMCO underlined the importance of keeping each fund separate: "It is illegal for one fund to benefit at the disadvantage of another. . . . Each fund needs to be managed on its own." Tr. 68.

Panelists at the May 19 Conference recognized that these elements of the agency relationship at the heart of asset management limit the potential creation and transmission of risk and have important consequences for any regulatory policy analysis, systemic risk analysis in particular. First, the separation of each fund from both its manager and other funds makes the manager's amount of assets under management largely irrelevant. Those assets do not belong to the manager and are spread over numerous distinct funds and, in turn, their investors. As Barbara Novick of BlackRock observed without dissent, "the size of an individual manager or an individual fund is actually one of the least relevant factors in looking at risk." Tr. 118.[6]

Second, because funds pursue different mandates for different investors, at the direction of those investors, investment risks that some have attributed to asset managers (such as herding into popular assets or contributing to fire sales of unpopular assets) are not created by managers or controllable at that level.[7] On the contrary, they are properly traced to individual client decisions. "The asset manager does not control the assets owner's decision to allocate assets to a particular strategy or to allocate assets to a different strategy." Tr. 119 (Novick). Managers instead "manage the portfolios to the risk desires of the investor." Tr. 40 (Mendelson). In fact, the need to manage assets in accord with the investment guidelines for a particular fund or account "mak[es] it actually impossible for all of [a firm's] portfolio managers on any given day to make the same investment decision and to act at the same time in the same way." Tr. 121 (Novick). Mr. Stahl gave the telling example of how "[i]n 2013 there were more than a hundred thousand security trades between Fidelity mutual funds and accounts," each involving "portfolio managers moving against each other in the same security." *Id.* Indeed, when one panel moderator asked about "correlations among either redemptions or asset sales," the question was

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[6] *See also* Tr. 222 (Stahl: "it's critical to remember that there is that level of differentiation at the fund or the portfolio level, and that is lost frequently when somebody looks at a gross AUM number").

[7] As was noted at the Conference, asset managers of course have the ability to close funds to new investment to protect existing shareholders and they do in fact close funds for this reason. *See* Tr. 96 (Rogers). This is another example of managers acting in a countercyclical fashion.

met with “dead silence,” which Ms. Novick attributed (without objection) to the lack of “evidence of correlation across fund[s].” Tr. 121-22.

Third, customer control of the assets in managed funds and accounts means that selective regulation of particular managers, funds, or accounts, of the sort that would come with SIFI designation or apply only to funds of a certain size or structure, *cannot* reduce that risk. Ms. Novick explained why that is the case: “It’s the practice itself you have to either be comfortable with or set rules to get comfortable with or eliminate. But you can’t pick one and another from a firm-specific perspective. *The business will simply move*.” Tr. 156 (emphasis added). To illustrate the point, she gave the example of investments in high-yield bonds: “If you don’t like junk bonds in a mutual fund, then move to a wrap account. If you don’t like them in a wrap account, then move to individual ownership. The money is still going to be invested, but you are going to change how it’s invested because the asset owners at the end of the day still want to make investments and they are going to find a way to make[] their investments, whether it’s through an asset manager or not.” Tr. 156.[8]

In light of these facts, the consensus at the Conference that “it’s pretty tough to regulate what investors are putting their money in” is unsurprising. Tr. 170 (Prof. Scharfstein).[9] The ability of fund customers to render narrow regulatory action, such as a SIFI designation, completely ineffective by managing their own investments or moving their money to a different fund, a different manager, or a different product that offers the same investment risk led Professor Schoenholtz to conclude that “as pragmatists we probably agree that activities are a better way to regulate our capital markets.” Tr. 157. Not one of the May 19 Conference panelists disputed that conclusion, and we were encouraged to learn that the FSOC seems to have reached the same conclusion following the Conference.[10]

B. Leverage Poses Little, if Any, Risk in Most Segments of the Asset Management Business.

The May 19 Conference also explored whether the excessive leverage that made both commercial and investment banks a threat to U.S. financial stability during the 2008 financial crisis is a concern in the asset management business. The consensus was that such excessive

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8 *See also* Tr. 137-38 (Griffin: “If we look at high yield bond markets, for example, if we restrict mutual funds’ ability to satisfy the redemption demands of their investors, investors will . . . ask us to wrap accounts. If we restrict the ability of the wrap account managers to liquidate high yield portfolios that they manage, we will find investors will just go to a major e-brokerage site or one of their banks and say give me a portfolio of a hundred bonds that match the index performance of some given tracking. So we will simply keep pushing how the assets are accumulated by investors further and further away from the specialists who today play a very important role in the asset management business serving the interest of their clients”); BlackRock, *Who Owns The Assets? Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation* (May 2014), available at http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf.

9 *See also* Tr. 171 (Prof. Schoenholtz: “if it’s truly investors that are driving, . . . standard macro prudential rules just don’t apply”); Tr. 79 (DeLeon: “you can’t stop people from selling things if they don’t like it anymore”).

10 *See* the “readout” from the FSOC meeting on July 31, 2014, available at http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031%202014.pdf.

debt relative to assets is not an issue at all in the vast majority of managed funds, let alone a threat to U.S. financial stability, particularly for traditional mutual funds, exchange-traded funds ("ETFs"), closed-end funds, and separate accounts.

Several panelists agreed that "financial history tells us that at the scene of every great financial crisis, going back through history, there's always been leverage." Tr. 83 (Rogers).[11] The panelists also agreed that "[t]he vast majority of funds are not levered vehicles." Tr. 37 (De Leon).[12] John Rogers of the CFA Institute described leverage practices in the asset management business. For mutual funds, federal law "limits total leverage" by requiring "300 percent asset coverage" so that at most "you could only leverage about a third of the fund." Tr. 85. And "most U.S. mutual funds have bylaws . . . which will limit leverage" to much lower levels, "typically to about 5 percent, which is only used for liquidity purposes." Tr. 85-86. Closed-end funds are subject to the same "300 percent coverage ratio" as mutual funds unless they issue preferred shares, in which case the coverage ratio is "lowered to 200 percent." Tr. 86. In practice, "the average leverage ratio for these funds [is] about 27 percent." Tr. 86. Separate accounts "generally don't include leverage." Tr. 84. In ETFs, "with the exception of a small sliver of that industry, which is clearly labeled as geared positive or negative plays on asset classes," "you won't find leverage." Tr. 84-85. Hedge funds are at the "most leveraged end of the spectrum," with average "gross leverage . . . at two times the fund's capital." Tr. 86-87.

Michael Mendelson of AQR Capital Management put these leverage figures into context, explaining (without contradiction) that "across all [asset management products], there's much less leverage generally than there is in, let's say, the banking system," where leverage ratios routinely exceed 10-to-1. Tr. 51. And an asset manager, itself, typically "doesn't have leverage at the company level." Tr. 180 (Novick). The use of minimal leverage in the asset management industry (and especially among mutual funds) sharply reduces, if not completely eliminates, any risk that asset management could threaten U.S. financial stability. As Professor Metrick concluded: "[i]n the absence of leverage, . . . [t]he failure of a long-only manager from an orderly liquidation perspective is just a nonissue." Tr. 236-37.

C. Managed Funds Maintain Ample Liquidity.

Liquidity – a company's ability to promptly pay short-term liabilities – was another topic of discussion at the May 19 Conference. Everyone agreed, however, that liquidity has not been a problem in asset management generally. For mutual funds in particular, existing regulation plays a crucial role in ensuring that they always have more than enough liquidity to satisfy investor redemptions. Mr. Champ explained that under federal law "mutual funds must keep at least 85 percent of their assets in securities that can be readily sold." Tr. 22.

Even Sarah Breeden of the Bank of England – who voiced concerns about liquidity risk for certain narrow types of funds – conceded that liquidity risk has been well managed in the asset management business. In her words: "Asset managers have done a pretty good job of

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[11] *See also* Tr. 180 (Novick: "leverage is at the heart of every financial melt down").

[12] *See also* Tr. 230 (Stahl: "[T]he way most mutual funds operate and are financed, is with equity capital investments. So most of the mutual funds that you all know and in which you invest don't rely on borrowed money. They rely on equity capital investments.").

managing this risk to date. We've got no obvious episode in the past to point to where redemptions have created risks for the system as a whole. Asset managers hold liquid assets. They ensure their portfolios are diversified, they're able to adjust pricing—all of those things." Tr. 129-30.

D. For Most Managed Funds, the Risk of Problems from Massive Redemptions Is Extremely Low.

Panelists at the May 19 Conference also addressed whether large-scale redemptions in a particular fund might cause financial distress. As the panelists explained, large-scale redemptions are not "runs," and the conditions for a bank-style run do not exist where funds have floating NAVs, modest (if any) leverage, and transparent pricing. Indeed, no one identified any instance of a "run" on a floating NAV fund or account.

To begin with, the panelists recognized that significant redemptions are not "runs." To the contrary, when "people make a . . . shift out of one asset class to another, that doesn't mean . . . it's a run on a fund." Tr. 53 (De Leon). It "means people are changing assets." *Id.* Even Professor Goldstein, who advocated further study of the potential for run risk in managed funds, "completely agree[d] . . . that in many cases when we see massive redemptions of mutual funds, this is not indication of a run, just a fundamental shift . . . from one asset class to another asset class." Tr. 56. This, of course, is typical investor behavior.

Panelists further explained that limited leverage and floating net asset values make the possibility of a run in managed assets quite remote. Bill De Leon explained: "A run is when you have a mismatch of the value of the assets versus your liabilities. By construction, if there's no leverage, you can't have that because the assets are the value of the fund. So as people sell things down, the mark to market will reflect what's in there. It is not a run, it is a liquidation." Tr. 93-94. And Professor Goldstein conceded the limited risk of a run for any floating-net-asset-value fund: "Certainly, I don't think that level of fragility exists in . . . traditional mutual funds" with a "floating NAV" where "when you redeem, you get the current market." Tr. 57.

There was no dispute that funds with floating net asset values have historically not had a problem with runs. As Mr. Stahl noted, "mutual fund investors, many of which are saving for retirement or education or to purchase a home, other long-term goals like that, they actually rode out the stress during '07, '08, '09 quite well." Tr. 212 ("while the S&P 500 slid 53 percent, net mutual fund outflows [for stock funds] in the same period were 4.1 percent of assets"). Again, Professor Goldstein agreed that "there haven't been big problems in the past[:] . . . [B]y and large, we did not see [the] sort of runs on mutual funds that put the whole financial system at risk like we had with bank runs." Tr. 82. Professor Goldstein also observed that there is "a lot of evidence that funds are taking some actions to alleviate [run-risk] issues"—such as "holding cash" and "holding more liquid securities"—"[s]o those issues do not necessarily call for regulation." Tr. 60.

E. The Asset Management Business Counteracts Market Exuberance and Panic.

The Conference further revealed that, far from enhancing systemic risks related to herding and fire sales, ***the asset management business naturally tends to counteract those risks.*** Many funds and accounts can and do move against the prevailing direction of the market.

Mr. Rogers described how rebalancing by "institutional investors and retirement savings plans" has a countercyclical effect:

> [I]ncreasing amounts of assets managed by the largest U.S. managers are defined contribution, defined benefit, endowment [and] foundation assets. . . . Now, these investors tend to rebalance in a disciplined way, so . . . when the equity market goes down relative to other asset classes, they will rebalance by buying more equities and vice versa. And . . . so-called hybrid, and also target date funds . . . [which] are becoming the default option for most U.S. defined contribution plans, . . . will automatically rebalance based on their prospectus. So, in other words, you have increasing amounts of assets, which lean against the direction of market trends. When stocks go down, they rebalance back into stocks. When stocks go up, they rebalance by shaving down on the equity holdings. . . . And so I would argue that there is at least as strong a counter-cyclical force that exists inherently in the U.S. asset management industry.

Tr. 61-62. John Gidman of Loomis, Sayles likewise observed that his firm's "experience with sophisticated institutional investors is markedly countercyclical." Tr. 211-12. As he put it: "When we have a good quarter, we get redemptions. When we have a bad quarter, we get more inflows. And that really relates to asset allocation decisions made by the end asset owner." Tr. 212.

Even when investment mandates or client decisions are not driving asset managers to trade in a countercyclical fashion, managers still have the ability to do so when, for instance, asset sales drive down prices to attractive levels. Mr. De Leon described this phenomenon: "[I]n fact, you will probably see certain funds acting as shock absorbers because they have the liquidity or ability to invest, to step up" when others are selling. Tr. 53. Ken Griffin of Citadel provided actual examples of this countercyclical dynamic, stating that his fund was able to step in and purchase the distressed portfolios of Amaranth and Sowood which were going through "periods of difficulty." Tr. 182. Amaranth's "resolution was completed in roughly 36 hours by two private parties acting in their own self-interest" and did not require the intervention of any governmental entity. Tr. 183.

Asset managers also have the ability to stop inflows from forcing them to buy securities in a pro-cyclical way. As Mr. Rogers explained, "an important feature of this industry . . . with respect to systemic risk" is that a manager is "able to close products [to new investors or investments] and regularly does close products, where the market impact of additional assets would inure to the detriment of existing shareholders." Tr. 96.

F. Securities Lending Practices Are Well-Managed.

Potential risks related to securities lending were also discussed at the May 19 Conference. Panelists explained that securities lending practices incorporate many safeguards, especially in the wake of changes implemented since the 2008 financial crisis.

Securities lending consists of "a collateralized loan with portfolio securities in return for cash." Tr. 224 (Greene). When a managed fund wants to loan its portfolio securities, "it has to be approved by the board [of the fund and] has to be disclosed in a prospectus." *Id.* The "agent puts the securities out on loan, and then takes in cash collateral." *Id.* And it "takes in more collateral than the loan amount." Tr. 147 (Novick). "That cash collateral is invested and . . . the majority of [the resulting] income, 80 to 90 percent, goes back to the fund." Tr. 224 (Greene). "Both the loan and the collateral are mark[ed] to market every day." *Id.* And the entire securities lending process is "very straightforward," "easily controllable," "well managed," and "frequently audited." Tr. 224-25 (Greene). As a result, the risk of any loss is significantly reduced. "[F]or there to be a loss in the system, first, the [borrower], which is . . . generally [a] highly rated financial institution[], . . . would have to default, and then the collateral which was cash would have to have been mark[ed] to market incorrectly." Tr. 147 (Novick).

In addition, "the cash [collateral] investment rules . . . have changed since 2008 so that today the cash that you're investing in is actually very high quality, very short maturity." Tr. 147-48 (Novick). Philip Prince of Pine River Capital Management pointed out that the "problem in 2008 was not the loan, . . . it was the liquidity and maturity . . . intermediation that was being done," by investing collateral that needed to be highly liquid and available promptly in less liquid, longer-term vehicles. Tr. 226. But, as Mr. Prince confirmed, "changes have taken place to bring this sort of back to the old days where that liquidity intermediation wasn't being done in securities lending." Tr. 227.

G. Operational Risks Are Well Controlled.

Another topic of discussion at the May 19 Conference was operational risk at the asset-manager level. Operational problems at asset managers were not deemed by any panelist to have been a cause of – or to have been created by – previous crises. *See, e.g.*, Tr. 200, 210-11 (Greene); Tr. 200-01, 205-06 (Stahl); Tr. 201-02 (Gidman); Tr. 202-03 (Prince).

Furthermore, several panelists described the many protections in place to control operational risks and how those protections have proved effective through a wide variety of crises and disasters. Mr. Stahl explained the extensive planning to mitigate potential operational risks: a "key focus for us in our business is business continuity planning….[W]e need to be able to perform the services that our investors hire us to perform. And we think about what might prevent us from doing that and plan around it." Tr. 200. Asset managers have "plans for providing every essential service." Tr. 201. Those plans make "sure that there's redundancy" for "essential systems." *Id.* A "backup trading site" is one example. *Id.* The availability of "multiple third-party providers" for pricing, custody, and other services is another. Tr. 188-89.[13]

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[13] *See also* Tr. 190-91 (Gidman).

And managers "continually" test their business-continuity plans. Tr. 201. Among other things, they take their "systems off line to see how quickly [they] can get them back online." *Id.*

A manager's plans, and the testing of those plans, are subject to extensive oversight, "required or informed by regulation of both funds and advisers, . . . fiduciary duties, client demands and industry best practices." Tr. 196 (Stahl). That oversight comes from numerous internal sources, ranging from front-line managers to risk-management personnel to senior executives. *Id.* It also comes from external sources, such as "external auditors, multiple regulators, . . . clients[,] consultants and [fund] trustees." *Id.* As Alan Greene of State Street pointed out, in addition to the regulations governing asset managers there are numerous layers of regulation governing their service providers, including the financial institutions that custody the assets under management. Tr. 197. Mr. Gidman went on to emphasize how clients make management of operational risks a competitive imperative because they "want to know that [an asset manager has] the operational wherewithal to be able to execute [its] duties appropriately," and they and their auditors "want to see evidence of the testing" done by the manager to confirm that wherewithal. Tr. 191-92, 197-98, 201.

Events of the last two decades have shown that asset managers have their operational risks well under control. As Mr. Greene put it: "We've had hurricanes, blizzards, floods, acts of terrorism, and have come through all of those, I think, very well because we had detailed plans, [and] because those plans were tested in advance." Tr. 200. Mr. Gidman made the same point in talking about the massive electrical and telecommunications disruptions caused by Hurricane Sandy: "[W]hen you look at the cascading level of protections that were built into the system at that point, in the worst of all circumstances, they worked appropriately and no investor lost money." Tr. 202. From an operational standpoint, asset managers likewise navigated the 2008 financial crisis without problems. In Mr. Green's words, industry plans were "tested in great detail during '08," and the routine process of managing funds "worked very well, even under very stressed times." Tr. 210-11.

Mr. Griffin delivered an appropriate verdict on the notion that operational risks at an asset manager could threaten U.S. financial stability: "I can't seriously believe that [operational risk] is the key risk that we are worried about in the context of our financial market stability. The systems that a BlackRock or Fidelity or PIMCO, any large hedge fund, any large asset manager [has], the redundancies, the capabilities are stunning. And this just, at the end of the day, I don't think makes the top hundred things that we need to worry about as a society in terms of financial market stability." Tr. 166.

H. In the Asset Management Business, Failure Is Rare and Resolution Is Straightforward.

Panelists at the May 19 Conference also addressed whether systemic problems could result from the resolution of a failed asset manager or fund. Numerous panelists described why failure is highly unlikely and any resolution would not threaten the stability of the financial system.

Mr. Stahl explained that "[a] fund that is financed with equity capital can't fail" because it "doesn't rely on borrowed money" and therefore cannot become insolvent. Tr. 231-32. For

the many funds with little to no leverage, that means failure will not happen. As for asset managers, Mr. Stahl noted that "the probability of a manager failing . . . is incredibly low" because "the manager's balance sheet is distinct from and not connected to the fund's balance sheet," and a manager operates "a fee-for-service business," in which it has "an incredible amount of control over [its] costs," which are variable and highly correlated to client assets and activities. Tr. 232-33.

If a fund or its manager needs to be liquidated or "resolved," it happens in a seamless way. Much of the work is done as a normal part of the business cycle by "clients taking their own assets back" through redemptions and moving their money to a new fund or manager. Tr. 120 (Novick). As Mr. Gidman explained, that "process of being hired and fired happens thousands of times a day." Tr. 235. It "is pretty simple and pretty easy" and "tends to have very little end-market impact." Tr. 70 (Mendelson).

Crucially, the process remains a simple one even when a manager may be in distress. Mr. Griffin described what has happened when a manager has experienced a blow to its reputation: "The assets move on the back of that. [But t]here's no fire sale, there's no distress sale, there's no panic." Tr. 181. The "asset management infrastructure . . . really put[s] the end investors a very far distance away from the trials and tribulations of their asset manager." Tr. 182 (Griffin). Indeed, the fact that "assets in almost all cases are custodied separately . . . from the asset manager" makes it a simple matter to substitute a new manager for an old one. Tr. 109-10 (Rogers: "A new manager can be brought in . . . and dropped in on top of those assets to manage an orderly process if there [are] significant withdrawal pressures taking place.").[14] Even during the worst week of the 2008 financial crisis people could and did "transfer[] managers . . . in si[mp]le fashion . . . , [a]nd you could redeem from one fund and put it in another seamlessly." Tr. 203 (Prince). Mr. Greene recounted State Street's experience as a custodian during the crisis: "[W]e transferred portfolios from managers that wanted to move entire funds from their complex to another complex. We did one of them in six days. We coped with redemptions under very stressful conditions." Tr. 210. Again, Professor Metrick confirmed that "[t]he failure of a long-only manager from an orderly liquidation perspective is just a nonissue." Tr. 237.[15]

III. The May 19 Conference Confirmed That More Study Is Needed to Determine Whether Potential Risks Exist, Whether They Require Any Regulatory Response, and What the Optimal Response Would Be.

The panelists who recommended additional study of various asset management activities agreed that the probability and potential impacts of hypothetical risks in this area are not well understood and require further study. Ms. Breeden, Professor Kent Daniel of Columbia, Professor David Scharfstein of Harvard Business School, and Professors Goldstein, Schoenholtz,

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[14] *See also* Tr. 235 (Greene: the custodian "will learn that someone had been fired and the assets had been moved over to a new manager. . . . [T]hey would open for business with [the custodian], and it would be business as usual.").

[15] Casting doubt on Professor Metrick's "long-only manager" qualification, Mr. Griffin explained that recent market improvements, such as central clearing, "have dramatically reduced the resolution costs and difficulties associated with the failure of even levered hedge funds." Tr. 182-83.

and Metrick concurred that there has been no research demonstrating that asset managers or the funds they manage present systemic risk, much less risks that could or should be mitigated by selective regulation such as SIFI designation. In fact, the May 19 Conference produced a steady stream of calls for careful examination before *any* regulatory action is taken. We support that approach. There is a substantial risk of unintended consequences where regulation that will significantly impact investors, markets and the economy is promulgated based on insufficient analysis. In view of those risks, it is imperative that rigorous analysis of hypothetical risks and both the intended and unintended consequences of additional regulation precede any regulatory response. We are hopeful that FSOC's July 31 announcement reflects an appreciation of the importance of that approach.

Exemplifying the hypothetical nature of the potential risks discussed on May 19, Professor Daniel postulated "the possibility of really run-like behaviors within the asset management industry." Tr. 41. But that concern merely led him to suggest it was ***"worth thinking about"*** the extent to which "asset managers have information that fully allows them to think about the possibility of when you can experience large redemptions." Tr. 41-42 (emphasis added). Professor Daniel likewise thought the "topic of investors pressuring managers . . . is a really important one," but, as important as the issue may be, he was "not sure what the right answer in terms of policy is for this." Tr. 74. He repeated the same conclusion when he opined that "there could be some potential problems" with "pressures from . . . clients . . . that push asset managers to invest in illiquid assets, yet still provide liquidity to their clients," saying that he was "not sure what the right answers are" and that the issue is ***"worth thinking about."*** Tr. 91-92 (emphasis added).

Professor Goldstein theorized that "in illiquid funds" there could be a "first mover advantage that could amplify the initial fundamental shock that led investors to take money out of the funds." Tr. 59-60. In recognizing that "those issues do not necessarily call for regulation," however, he concluded that "***we need to understand*** the extent to which funds are taking actions to alleviate the problem and the extent to which maybe some of it is not sufficient or maybe it is." Tr. 60 (emphasis added). Professor Goldstein also raised questions about asset managers amplifying financial system risks and creating negative externalities for the economy, but he again suggested only further study: "Now, in general, ***I think we need to understand these things better.*** I don't think that we have the answer in the literature as to . . . how much of this risk is non-systemic, how much of it can be dealt with at the level of the fund, and the extent to which to do something beyond that." Tr. 71-73 (emphasis added). When pressed by Mr. De Leon about whether fund activity was simply an investor-driven shift in asset allocation rather than a manager-amplified threat to financial stability, Professor Goldstein likewise conceded that ***"we have a lot of work to do in order to understand it better."*** Tr. 82 (emphasis added). And he gave the same answer when Mr. Mendelson pointed out that asset management has not seen runs historically: "I think what we need to keep in mind is what will happen going forward because the financial system is changing and I think more activity will potentially move into funds. So ***we just need to understand it better*** and identify the forces and see whether they are being addressed with the current structure." Tr. 82-83 (emphasis added).

Ms. Breeden raised the issue of potential "liquidity mismatch" risk that could allow fund customers to redeem their shares more easily than funds could promptly sell their holdings. Tr. 129. But she acknowledged that actual evidence of such a risk has not been developed:

"[I]t's really hard to size this risk. . . . History doesn't help us a lot. And I think ***the academics are only just getting going on this topic. So I think there's potentially something out there and I think we've got a lot more work to do better to understand it***." Tr. 133 (emphasis added).

Professor Scharfstein likewise said there "is a case for us understanding better what is happening in leveraged entities, in particular hedge funds." Tr. 142. About the kind of "counter-party risk" that was a problem when LTCM collapsed, he voiced a "need to know whether or not there are emerging issues like that" and observed that ***"we are at the beginning of understanding"*** such risk in a world where managed funds and accounts may play a greater role in supplying credit. Tr. 142-43 (emphasis added). About liquidity mismatch risk he echoed Ms. Breeden in stating: "[W]e have to ask the question . . . , is that too risky in some way? And I think ***we don't know the answer to that question***, but we need to address that question." Tr. 144 (emphasis added). Professor Scharfstein also recognized that careful consideration must be given to the proper regulatory response to risks in the asset management business: "I guess the question is, as we think about risks within the asset management industry and kind of what to do about it, I think there's a question about how much or what form the monitoring of that industry should take." Tr. 152.

Professor Metrick raised questions about various potential risks that may arise in the asset management business, but he admitted: "Those are questions. I'm not saying I have answers." Tr. 217-18; *see also* Tr. 225-26 ("I don't think we have a great understanding yet"); Tr. 243 ("I don't have a great answer"). Professor Schoenholtz similarly proposed a series of "questions that merit attention and research," including questions regarding the impact of potential operational weaknesses at the asset manager and custodian level, the possibility of "herding patterns . . . in selective classes of bond funds," and potential "solvent but illiquid funds." Tr. 161-62. However, Professor Schoenholtz did not suggest that he – or anyone else – has conducted this research. Again, these questions may be a helpful guide to a research agenda for FSOC staff's "focused analysis," but they do not provide any information as to what that research may yield.

Beyond all these pleas for greater understanding and further study of potential risks posed by asset managers and the funds they manage, the SEC's Norm Champ described a new SEC program that has just begun to look at risk across the asset management industry. According to Mr. Champ: "Among the newest initiatives that we have been pursuing is an ongoing asset manager risk monitoring and oversight program. This program includes a dedicated team of professionals with financial and quantitative backgrounds that monitor trends in the asset management industry, analyze industry data and carry out targeted examinations on policy questions." Tr. 23-24. Indeed the SEC recently announced the creation of a new office within its Division of Economic and Risk Analysis, which it created in 2009. This new office will "coordinate efforts to provide data-driven risk assessment tools and models to support a wide range of SEC activities," including the SEC's ongoing work related to FSOC.[16]

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[16] *See* the SEC press release "SEC Announces Creation of New Office Within its Division of Economic and Risk Analysis," dated September 11, 2014, available at http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370542914800#.VBLpyWfwtQt .

In short, academics and regulators are only at the beginning of their efforts to determine whether, how and to what extent asset managers or the funds they manage affect financial stability – positively or negatively – and whether any of those effects require a regulatory response. With so much work still to be done to better understand asset management, we support FSOC's determination that the appropriate next step is "a more focused analysis of industry-wide products and activities," and note that it makes little sense to move forward with any specific policy recommendations until that work is conducted in a rigorous, informed manner.

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We appreciate the opportunity to submit this summary of FSOC's productive May 19 Conference on asset management. As FSOC continues its "open dialogue" regarding risks in the asset management business, we stand ready to participate.

Thank you for your consideration. We look forward to engaging with you and your fellow FSOC members as you analyze these important issues.

Sincerely,

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

John Gidman
President
Association of Institutional INVESTORS

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

APPENDIX A

List of Speakers and Panelists at the Financial Stability Oversight Council's May 19, 2014 Conference on Asset Management

- Sarah Breeden, Head of Market Sectors and Interlinkages Division, Financial Stability, Bank of England (Panelist)
- Norm Champ, Director, Division of Investment Management, Securities and Exchange Commission (Speaker)
- Kent Daniel, Professor of Finance, Columbia Business School (Panelist)
- William De Leon, Global Head of Portfolio Risk Management, PIMCO (Panelist)
- John Gidman, Chief Information Officer, Loomis, Sayles & Company (Panelist)
- Itay Goldstein, Joel S. Ehrenkranz Family Professor, Professor of Finance, The Wharton School of the University of Pennsylvania (Panelist)
- Alan Greene, Executive Vice President, U.S. Investor Services, State Street Corporation (Panelist)
- Ken Griffin, CEO, Citadel (Panelist)
- Nellie Liang, Director, Office of Financial Stability Policy and Research, Board of Governors of the Federal Reserve System (Moderator)
- Michael Mendelson, Portfolio Manager, Risk Parity Strategies, AQR (Panelist)
- Andrew Metrick, Deputy Dean & Michael H. Jordan Professor of Finance and Management, Yale School of Management (Panelist)
- Mary Miller, Under Secretary for Domestic Finance, U.S. Department of the Treasury (Speaker)
- Barbara Novick, Vice Chairman, BlackRock (Panelist)
- Philip Prince, Treasurer, Pine River Capital (Panelist)
- John Rogers, President and CEO, CFA Institute; Member, Systemic Risk Council (Panelist)
- David Scharfstein, Edmund Cogswell Converse Professor of Finance and Banking, Harvard Business School (Panelist)
- Kim Schoenholtz, Professor of Management Practice, New York University Stern School of Business (Panelist)
- Peter Stahl, Associate General Counsel, Fidelity Investments (Panelist)
- Lawranne Stewart, Senior Counsel, Commodity Futures Trading Commission (Moderator)
- John Worth, Chief Economist, National Credit Union Administration (Moderator)