



November 1, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Public Feedback on OFR Study on Asset Management Issues (SEC File No. AM-1)

Dear Ms. Murphy:

The Investment Company Institute¹ greatly appreciates that the Securities and Exchange Commission has solicited public comment on *Asset Management and Financial Stability*, a study issued one month ago by the Office of Financial Research (“OFR Study”).² We supported the Financial Stability Oversight Council’s announcement in April 2012 that OFR would study the asset management industry to inform FSOC’s consideration as to what threats to financial stability—if any—arise from asset management companies and whether such threats can be mitigated by regulation applicable to systemically important financial institutions (“SIFIs”) or are better addressed through other regulatory measures.³ We believed that FSOC’s announcement signaled its recognition—quite appropriate, in our view—that the risk profile of asset management companies differs from that of

¹ The Investment Company Institute (ICI) is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$15.7 trillion and serve over 90 million shareholders.

² OFR, *Asset Management and Financial Stability* (Sept. 2013), available at http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf. See also *Public Feedback on OFR Study on Asset Management Issues* (press release dated Sept. 30, 2013), available at <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539852635#.UksBE6xZPIw>. Given the short comment period and the importance of the issues raised in the OFR Study, we urge the SEC to keep its comment file open past November 1 to accept additional submissions by interested parties.

³ FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637 (April 11, 2012) at 21644 (emphasis added).

banks and other nonbank financial companies and FSOC's commitment to exercising its SIFI designation authority in a careful and thoughtful manner.

Unfortunately, the OFR Study does not meet the standards we would expect for such an important undertaking. Given its many shortcomings, the OFR Study should not serve as the basis for policy decisions or regulatory action of any kind and, accordingly, should be withdrawn.

I. Introduction and Summary of Comments

As both investors in the capital markets and issuers of securities, ICI members support appropriate regulation to ensure the resiliency and vibrancy of our nation's financial system. Striking the right regulatory balance, however, is a difficult task. Our financial system is complex and dynamic. Insufficient regulation can lead to abuses and excessive risk, and immoderate or uninformed regulations can have negative consequences for investors, market participants, financial markets, and the economy.

In the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), Congress envisioned that OFR research would provide expert technical support to FSOC and its member agencies to support sound, well-informed policy decisions.⁴ Regrettably, by the measure of the important purposes for which it was undertaken, the OFR Study falls far short. For the reasons detailed below, the OFR Study reflects an inaccurate understanding of the asset management industry in general and registered investment companies ("registered funds") in particular.⁵ This comment letter does not attempt to catalogue every shortcoming of the OFR Study nor respond in detail to each issue it raises. Rather, we seek to highlight the most significant deficiencies, which fall into four broad themes. Those themes correspond to the sections that follow:

Problems with methodology, data, and the presentation of information pervade the OFR Study and call into question the credibility of the analysis. (Section II and Appendix A)

At the outset, we note our serious concerns with methodology and the presentation of information in the OFR Study. As documented in Appendix A, the OFR Study is replete with sweeping conclusions unsupported by data; lacks clarity, precision, and consistency in its scope and focus; and misuses or misinterprets data. These flaws have great potential to confuse or mislead both policymakers and the public, particularly those who are less familiar with the asset management industry. They also raise doubts about the level of analytical rigor involved in conducting and documenting OFR's work. Any future study of the asset management industry should be conducted methodically—taking into account all the various segments of the industry, the differing ways in which

⁴ See Section 154(c)(1), (c)(1)(C) of the Dodd-Frank Act (requiring OFR to develop "independent analytical capabilities" to, among other things, "conduct, coordinate and sponsor research to support and improve regulation of financial entities and markets").

⁵ Given ICI's expertise, our comments below focus primarily on the implications of the OFR Study for registered funds and their advisers.

they are regulated, and relevant historical experience—and in close cooperation with the SEC, the regulator with the greatest expertise and experience in capital markets and asset management.

The core thesis of the OFR Study—that herding, redemptions, and fire sales pose systemic risks—is not supported by empirical research regarding registered funds. (Section III and Appendices B and C)

The core argument that the OFR Study puts forth is that investors and asset managers “crowd or ‘herd’ into popular asset classes or securities” and thus “magnify market volatility.” The OFR Study then argues that stock and bond funds “face the risk of large redemption requests in stressed markets” forcing fund managers to sell portfolio securities at fire sale prices and transmitting risks across the financial system. The academic research cited in the OFR Study is inconclusive about the extent to which herding exists, and does not address redemption pressures or fire sales. The OFR Study also ignores publicly available empirical evidence showing that stock and bond fund investors do not redeem heavily during periods of financial stress. As summarized in Appendix B, previous ICI research has demonstrated that during periods of market stress, from 1945 through the most severe financial crises, mutual fund investors have not reacted precipitously to financial market shocks. Hence, the OFR Study’s concern—that fire sales by stock and bond fund asset managers could lead to a collapse of securities prices and create systemic risks—is without any historical basis. The OFR Study’s examination of exchange-traded funds (“ETFs”) similarly falls short.

The OFR Study loses sight of the key distinction between banks and asset management firms—the agency nature of an asset manager’s business, which results in a vastly different risk profile. (Section IV)

The OFR Study recognizes on its very first page that asset managers act primarily as agents on behalf of clients. An asset manager itself does not take on the risks inherent in the assets it manages for registered funds or other clients, nor does it own client assets. Investment gains and losses from a client account are solely attributable to that account, and do not flow through to the manager. As a result, the agency nature of the asset management business stands in stark contrast to the principal capacity in which banks operate. Unfortunately, the OFR Study later loses sight of this defining characteristic, for example, in implying that “concentration of risks” among funds could make an asset management *firm* a source of risk. With regard to registered funds, the OFR Study does not adequately consider that each fund and each adviser is a separate legal entity, which prevents risks from flowing among funds, advisers, and the broader financial markets.

The OFR Study fails to recognize that the existing regulation of registered funds and their advisers not only protects investors but also mitigates risk to the financial system. (Section V)

The OFR’s attempt to describe in broad terms the “activities” of asset managers has the unfortunate effect of obscuring the regulatory protections to which registered funds are subject under the Investment Company Act of 1940, other federal securities laws, and related SEC regulations. This approach by OFR suggests a failure to understand, or to give due weight to, the importance of these

protections, both individually and collectively, in serving the interests of registered fund shareholders and in mitigating risk to the broader financial system.

ICI has long maintained that SIFI designation and prudential regulation are neither warranted nor appropriate for registered funds and their advisers. In Section VI, we review those arguments in light of the OFR Study and conclude that the study provides no predicate for FSOC to exercise its SIFI designation authority. For example, the OFR Study discounts or disregards recent and ongoing regulatory reform efforts, even those that are relevant to topics covered in the study. Moreover, the “remedies” that flow from SIFI designation, including the imposition of capital requirements, are neither practical nor effective for dealing with the purported “vulnerabilities” identified in the OFR Study.

II. Problems Pervade the OFR Study and Call into Question the Credibility of its Analysis

At the outset, we note our serious concerns with methodology and the presentation of information in the OFR Study. These flaws have great potential to confuse or mislead both policymakers and the public, particularly those who are less familiar with the asset management industry. They also raise doubts about the level of analytical rigor involved in conducting and documenting OFR’s work.

In Appendix A to this letter, we provide examples to illustrate our concerns that the OFR Study:

- is replete with sweeping conclusions that are presented without supporting data;
- lacks clarity, precision and consistency in both its focus and scope; and
- misuses or misinterprets data in a way that suggests a lack of care and attention to detail and, in many cases, a lack of deep understanding about the asset management industry generally and the mutual fund industry specifically.

These concerns are not mere quibbles, because they call into question the credibility of the analysis set forth in the OFR Study.

We also are concerned that the overall approach of the OFR Study appears to be “results driven.” Indeed, in the first sentence of the Introduction, the study states that it provides “an analysis of how asset management firms and the activities in which they engage *can* introduce vulnerabilities that *could* pose, amplify, or transmit threats to financial stability.”⁶ The Introduction further indicates that the OFR Study “describ[es] the factors that make the industry and individual firms vulnerable to

⁶ OFR Study at 1 (emphasis added).

financial shocks”⁷ Put differently, the OFR Study appears to conclude *a priori* that asset managers pose risks to the financial system at large and then hypothesizes circumstances to support that conclusion. Further study should take a more objective approach; for example, by providing an assessment of whether or not, and if so the extent to which, asset managers may introduce “vulnerabilities” of a systemic nature that SEC regulation cannot address.

III. The Core Thesis that Herding, Redemptions, and Fire Sales Pose Systemic Risks is Not Supported by Empirical Research Regarding Registered Funds

The core argument that the OFR Study puts forth is that investors and asset managers “crowd or ‘herd’ into popular asset classes or securities,...contribute to increases in asset prices,...and magnify market volatility.” The OFR Study then argues that stock and bond funds “face the risk of large redemption requests in stressed markets” forcing fund managers to sell portfolio securities at fire sale prices and transmitting risks across the financial system. While the OFR Study puts forth this hypothesis, the academic research in this area is quite mixed about the extent to which herding even occurs and certainly has not concluded that mutual funds and their investors create systemic risks.

First, the academic research that the OFR Study cites⁸ actually concludes that on average there is little evidence of herding among mutual funds.^{9,10} The evidence is inconclusive about whether mutual fund asset purchases and sales even cause securities prices to deviate from their fundamentals. Some research argues that fund purchases may actually enable price discovery and move securities prices closer to their fundamental value.¹¹ Other research has found no evidence that funds affect securities prices.¹² Finally, even when research has concluded that mutual funds and other institutions can affect

⁷ *Id.*

⁸ Russ Wermers, 1999, “Mutual Fund Herding and the Impact on Stock Prices,” *Journal of Finance*, April, pp. 581-622. Sias, Richard W., 2004, “Institutional Herding,” *The Review of Financial Studies*, Vol. 17, No. 1 (Spring, 2004), pp. 165-206.

⁹ For example, Wermers (1999) finds “little herding by mutual funds in the average stock.” Similarly, Sias (2004) notes that, among the various categories of institutional investors studied, mutual funds “exhibit little evidence of focusing on their most direct competitor’s trades...and exhibit the weakest tendency to herd.”

¹⁰ Additionally, several academic works not cited by the OFR Study cast doubt on whether fund herding occurs to an economically meaningful extent: Lakonishok, Josef, Andrei Shleifer, Robert Vishny, 1992, “The Impact of Institutional Trading on Stock Prices,” *Journal of Financial Economics*, Vol. 31 (1992), pp. 23-43; Grinblatt, Mark, Sheridan Titman, and Russ Wermers, 1995, “Momentum Investment Strategies, Portfolio Performance, and Herding: A Study of Mutual Fund Behavior,” *American Economic Review*, December, pp. 1088-1105; Borensztein, Eduardo and R. Gaston Gelos, 2003, “A Panic-Prone Pack? The Behavior of Emerging Market Mutual Funds,” *IMF Staff Papers*, Vol. 50, No. 1.

¹¹ Wermers (1999) finds evidence that “mutual funds’ herds speed the price-adjustment process and are not destabilizing.”

¹² Sias (2004) finds “no evidence that institutional herding drives prices from fundamental values.”

securities prices,^{13,14} it has not demonstrated that these price changes pose systemic risks by leading to a rapid unwind of positions or causing fire sales.^{15,16}

The OFR Study's speculation about the behavior of stock and bond fund investors also is inconsistent with publicly available empirical evidence. As summarized in Appendix B to this letter, previous ICI research has demonstrated that during periods of market stress dating back to 1945 and through the most severe financial crises, mutual fund investors have not reacted precipitously to financial market shocks. As Appendix B demonstrates, evidence cited by the OFR Study indicating that bond mutual funds experienced large redemptions during the 2007-2008 financial crisis is either exaggerated or simply erroneous. Finally, Appendix B shows that even when redemptions do materialize, they are unlikely to lead to much downward pressure on securities prices because mutual funds' purchases and sales of stocks and bonds are small relative to the value of overall stock and bond market trading. Contrary to the OFR Study's contention, investors do not redeem heavily from stock and bond funds during periods of market stress and fund portfolio managers are not heavy sellers of portfolio securities in down markets. Hence, the concern that fire sales on the part of stock and bond fund asset managers could lead to a collapse of securities prices and create systemic risks is without any historical basis.

The OFR Study likewise falls short with regard to its examination of ETFs, an increasingly popular investment product for institutional and retail investors. In its assessment of factors that could make the asset management industry vulnerable to financial shocks, the OFR Study states that ETFs "may transmit or amplify financial shocks originating elsewhere." The OFR Study does not provide any empirical evidence or academic research to support this hypothesis. Indeed, the OFR Study does not identify potential types or origins of these shocks nor does it explain the mechanism by which these shocks could be spread or magnified through the financial system in such a way as to create instability. The OFR Study also is silent on which financial markets could be impacted from these perceived ETF amplifications.

¹³ Dasgupta, Amil, Andrea Prat, and Michela Verardo. 2011. "Institutional Trade Persistence and Long-Term Equity Returns." *Journal of Finance* 66, no. 2: 635-653.

¹⁴ Gennaioli, Nicola, Andrei Shleifer, and Robert Vishny, 2012, "Neglected Risks, Financial Innovation, and Financial Fragility," *Journal of Financial Economics*, Vol. 104, Issue 3 (June 2012), pp. 452-468.

¹⁵ Dasgupta, Amil, Andrea Prat, and Michela Verardo (2011) find that stocks that were persistently bought by "institutions" underperformed in the long-run (2 years later) compared to stocks persistently sold, perhaps, signaling short-term stock price overvaluations. The paper, however, focuses not on mutual funds exclusively, but on all U.S. portfolio managers, including hedge funds. Additionally, the paper does not examine the questions of redemption pressure, fire sales or systemic risk.

¹⁶ Gennaioli, Shleifer, and Vishny (2012) is a theoretical paper about highly risk averse investors wanting a riskless security and investing in financial intermediaries that invest in risky assets. The assumptions of this model do not capture the fundamental nature of fund investors or stock and bond funds themselves and is not instructive in understanding the activities of stock and bond funds and their investors on the markets.

While it is prudent to focus on possible implications of new products under stressed financial market scenarios, it is even more crucial that researchers and regulators follow-up any conjectures by conducting a thorough and careful empirical analysis. We believe that the OFR Study falls far short of this reasonable standard. For instance, the OFR Study says that “[t]he Flash Crash on May 6, 2010 demonstrated the role ETFs can play in transmitting price dislocations in a distressed market”¹⁷ and then cites the statement “many of the securities experiencing the most severe price dislocations on May 6 were equity-based ETFs” from the SEC-CFTC Joint Report on the Flash Crash. What the OFR Study fails to note is that the SEC-CFTC Joint Report explains that the primary reason why ETFs were disproportionately affected is because the liquidity shock that started in the futures market spread to individual stocks in the equity market. This liquidity shock in the underlying equity securities was then conveyed to domestic equity-based ETFs because they track the value of the underlying individual stocks.¹⁸ In the case of the Flash Crash, domestic equity-based ETFs overwhelmingly were the recipients of the liquidity shocks from the futures and equity markets and not the transmitters of the liquidity shocks.

The Study also cites two more recent incidents, both of which occurred on June 20, 2013, as examples of the need to study the role ETFs may have in amplifying market stress. A closer examination of these incidents—which we provide in Appendix C—would have revealed that the ETF sponsors and ETF authorized participants (“APs”) involved had engaged in sound risk management policies and that there were no market disruptions or spillovers from these occurrences.

Finally, assertions about possible links between ETFs and equity market volatility need to be analyzed after accounting for macro developments. Even cursory analytics show that episodes of heightened equity market volatility predate the growth of ETFs; volatility is a global phenomenon and occurs in markets where ETFs play a much smaller role than they do in the United States; and macroeconomic events, not particular market instruments, offer far more plausible explanations for episodes of volatility.¹⁹

IV. The OFR Study Gives Inadequate Consideration to Key Structural and Other Characteristics of Asset Managers and Registered Funds

A. Asset Manager’s Agency Role

The OFR Study recognizes early on—on the very first page, in fact—that asset managers act primarily as agents on behalf of clients and that this feature distinguishes asset management firms from

¹⁷ OFR Study at 11, note 17.

¹⁸ See Securities and Exchange Commission and Commodity Futures Trading Commission, *Findings Regarding the Market Events of May 6, 2010*, Report of the Staffs of the CFTC and SEC to the Joint Advisory Committee on Emerging Regulatory Issues (September 10, 2010) at 39.

¹⁹ See ICI Viewpoints, *The (Dis)Connection Between ETFs and Market Volatility* (February 23, 2012), available at http://www.ici.org/viewpoints/view_12_etf_vol.

banks, which typically act as principals. Highlighting this key distinction at the outset makes sense because the agency nature of an asset manager's business results in a vastly different risk profile from that of a bank. And it is highly relevant to the specific policy issue upon which the OFR Study is supposed to inform FSOC: the extent to which an asset management firm could pose a risk to U.S. financial stability.²⁰ Indeed, OFR Director Richard Berner recently was quoted as stating: "we recognize and [FSOC] recognizes that asset management activities . . . are different from banking activities and the banking industry And that is exactly why we were asked to do this report in the first place."²¹

Acting as agent, an asset manager manages client assets in accordance with the investment objectives, risk tolerance, and time horizon of each client. In the case of registered funds, for example, a fund's adviser manages the fund's portfolio pursuant to a written contract with the fund and in accord with the fund's investment objectives and policies as described in its registration statement. Registered fund advisory fees compensate the adviser for managing the fund as a fiduciary and agent and for providing ongoing services that the fund needs to operate. Advisers are not compensated, however, for bearing the fund's investment risks. This is because an asset manager itself does not take on the risks inherent in the securities or other assets it manages for registered funds or other clients,²² or in other activities or strategies it may pursue on behalf of clients, such as securities lending. Those are investment risks that appropriately are borne by the clients. The manager does not own client assets²³ and it may not use the assets of any client to benefit itself or any other client. Investment gains and losses from a client account are solely attributable to that account, and do not flow through to the manager. As a result, the agency nature of the asset management business stands in stark contrast to the principal capacity in which banks operate.

Banks extend loans, often with maturities of 30 years or more, to large numbers of heterogeneous borrowers. Because each loan is unique, deep and liquid markets cannot form to allow for efficient trading of these assets. Banks finance most of these activities through deposits, which are short-term and highly liquid. Regulators manage these maturity mismatch and liquidity concerns by providing access to the Federal Reserve's discount window, requiring deposit insurance, and

²⁰ As discussed in Section VI, below, it also is highly relevant to any consideration of applying enhanced prudential standards to an asset manager.

²¹ Sarah N. Lynch, *SEC Sees Flaws in New Treasury Asset Manager Report: Sources*, Reuters, Oct. 8, 2013, <http://www.reuters.com/article/2013/10/07/us-sec-assetmanager-report-idUSBRE9960XD20131007>.

²² In its 2011 annual report to Congress, FSOC observed that "[i]n separately managed accounts, investment losses fall solely on the account owner, so these accounts generally do not raise direct financial stability concerns." Financial Stability Oversight Council, 2011 Annual Report, at 65. This statement is equally true for registered funds and other types of collective investment vehicles.

²³ Under Section 113 of the Dodd-Frank Act, among the criteria that FSOC must consider in determining whether to designate a nonbank financial company for enhanced prudential standards and consolidated supervision by the Federal Reserve Board is "the extent to which assets are managed rather than owned by the company."

establishing capital requirements to act as “shock absorbers” to protect depositors against losses in the value of these illiquid assets.²⁴

In the asset management model, the manager’s obligations to investors are not comparable to those of banks to depositors. As noted above, asset managers manage assets as fiduciaries on behalf of their clients, relying on generally stable fee-based income instead of investing on behalf of the firm to obtain the potential for positive performance with high-risk assets.²⁵ Clients understand that portfolio results, positive or negative, belong to them alone and accept the risk that their investments may lose value.²⁶ Unlike with bank deposits, the risk of loss is inherent in an investment, including an investment in a registered fund. Asset managers are not engaged in a “shadow” form of banking. They provide *different* services and maintain significantly *different* organizational structures that appropriately manage risk for their clients.

Unfortunately, the OFR Study loses sight of this defining characteristic of asset managers, *i.e.*, their agency status. For example, under the heading “Firms as sources of risk,” the OFR Study postulates that “[c]oncentration of risks among funds . . . may pose a threat to financial stability,”²⁷ but it does not explain either how “concentration of risks among funds” would occur or, even if it did, how that would make an asset management *firm* a source of risk. The asset manager itself, acting as an agent, would not be exposed to the risks of its clients’ accounts.

There are other conflicting signals about the agency nature of the asset management business in the OFR Study. The study recognizes that “[a]s agency businesses, asset management companies tend to have small balance sheets, and nonbank, non-insurance asset managers are not required by U.S. regulation to set aside liquidity or capital reserves for their asset management businesses.”²⁸ But almost immediately afterwards, it introduces a chart (Figure 10) showing “the book value of large dedicated asset managers compared to their assets under management—one indication of available firm resources.”²⁹ The OFR Study indicates that “[t]hese resources can be used for operational purposes, as well as to seed new funds or potentially provide sponsor support to funds based on market

²⁴Insurance companies, like banks, put their balance sheets at risk, evidenced by their state-imposed capital requirements, which account for risk in both their assets and their liabilities (the insurance risk) in order to protect policyholders. *See, e.g.*, Douglas J. Elliott, Brookings, *Regulating Systemically Important Financial Institutions That Are Not Banks* 16, 20 (May 9, 2013), <http://www.brookings.edu/research/papers/2013/05/09-regulating-financial-institutions-elliott>.

²⁵ *See* OFR Study at 9 (recognizing that most asset managers earn fees based on the amount of assets under management).

²⁶ *See, e.g.*, Letter from Scott C. Goebel, SVP and General Counsel, Fidelity Management & Research Co., to the Financial Stability Oversight Council, dated Dec. 19, 2011, at 10.

²⁷ OFR Study at 18.

²⁸ *Id.* at 19 (footnote omitted).

²⁹ *Id.* at 19-20.

circumstances.”³⁰ The implication is that FSOC and, presumably investors, should consider a registered fund adviser’s capitalization and ability to provide financial support for its funds in assessing the “riskiness” of the fund. This would be a radical and dangerous departure from the agency model that has proved so robust and successful for so many years.³¹ It also suggests that asset management would present less risk if performed by organizations with the most “available firm resources”—*e.g.*, the largest banks, thus further concentrating risks in these very institutions.

The OFR Study also suggests that instances of discretionary sponsor support contribute to uncertainty among investors about who will bear losses when they do occur—likely making funds prone to large, unexpected outflows. For example, it states:

Direct and indirect support provided to investors in collective investment vehicles and separate accounts are not prominently disclosed, but, according to industry interviews, occurred during the crisis.³² Investors who expect their investments to be protected by explicit or implicit backstops could be expected to redeem funds in larger numbers if there is any sign that protections are eroding.³³

Implicit in these assertions is the notion that investors do not understand or are oblivious to the risks of investing in a collective investment vehicle, such as a registered fund. There is nothing in the OFR Study, however, indicating that it has surveyed fund investors, gauged their attitudes, or analyzed

³⁰ *Id.* at 20 (footnote omitted).

³¹ In the case of registered funds, Section 17 of the Investment Company Act prevents most types of sponsor support, absent prior approval by the SEC on a case-by-case basis. See *infra* Section V, Transactions with Affiliates.

³² This statement is incorrect as applied to registered funds and other funds that prepare their financial statements in accordance with Generally Accepted Accounting Principles. Under GAAP, support from the adviser or an affiliate must be prominently disclosed in a fund’s financial statements. This disclosure consists of (1) a separate line item in the income statement identifying the amount of support received, and (2) financial statement footnote disclosure describing the amounts and circumstances of the support. See Financial Accounting Standards Board (FASB) Accounting Standards Codification 946-20-05-2 and FASB ASC 946-20-45-1.

³³ OFR Study at 14. These assertions seem to be based, at least in part, on a working paper by staff of the Federal Reserve Bank of Boston that reviewed sponsor support provided to money market funds between 2007 and 2011. We note that in the context of money market funds, the SEC has defended disclosure and investors’ understanding of money market funds—even when sponsor support for money market funds was at issue. In 1996, the SEC adopted Rule 17a-9 under the Investment Company Act, an exemptive rule permitting purchases of certain money market fund portfolio securities by affiliated persons under specified conditions. In 2010, the SEC amended Rule 17a-9, making it even easier for a sponsor to offer support by buying securities out of a money market fund portfolio. At that time, the SEC stated that the amendments would not “materially change shareholders’ perceptions about money market funds or the likelihood of sponsor support during times of market turmoil.” See Money Market Fund Reform, SEC Release No. IC-29132 (February 23, 2010), 75 Fed. Reg. 10060 (March 4, 2010) at 10087. Rather, the SEC noted that affiliated sponsor support “transactions appear to be fair and reasonable and in the best interests of fund shareholders.” *Id.*

their behavior. To be sure, some advisers have on rare occasions voluntarily supported their funds.³⁴ But these advisers do so as a business decision. Given clear and prominent disclosure that registered fund investors bear the risk of loss from their investment, the likelihood or even possibility of support should be—and, we believe, is—contrary to investor expectations.

B. Other Characteristics Affecting the Relationship Between Registered Funds and Their Adviser and Between Two or More Funds

The OFR Study fails to appreciate fully the significance of an asset manager's agency status. It also ignores several other characteristics of registered funds and their advisers that relate directly to any concerns with respect to "interconnectedness" between such funds and their adviser, and among the funds themselves. Put another way, contrary to the speculations in the OFR Study,³⁵ there are several cogent reasons why risk does *not* flow from one fund to related or similar funds or to the adviser.³⁶ For example:

- Each fund is a separate legal entity.
 - The shareholders or creditors of one fund have no recourse against the shareholders or creditors of any other fund, whether or not that fund has the same or a different manager.
 - Each shareholder in a fund has an individual, pro rata ownership interest in the underlying assets of the fund, by virtue of the shareholder's ownership of fund shares. The fund's assets are recorded on the fund's balance sheet, not the balance sheet of the fund's adviser.
- Shareholder recourse for losses is limited to the fund and does not extend to the fund adviser (absent wrongdoing on the part of the adviser). Thus, even if a fund were to suffer investment losses equal to all of its assets, the reputation of the adviser would suffer and its revenues decline, but the adviser would not be financially responsible for such losses nor be required to take any direct charge against its capital.³⁷

³⁴ The OFR Study cites an instance in which an adviser made a business decision to purchase shares of a non-money market registered fund that was experiencing stress. This is a wholly insufficient basis upon which to draw any general conclusions about investor expectations with regard to sponsor support.

³⁵ For example, the OFR Study states that "[i]nstability at a single asset manager could increase risks across the funds that it manages or across markets through its combination of activities." OFR Study at 18 (footnote omitted).

³⁶ Although our specific focus is on registered funds, most of the same concepts also apply with respect to other types of managed assets, such as separately managed accounts and collective investment trusts.

³⁷ This point is related to the agency role of an asset manager, as discussed above.

- The investment adviser cannot pledge a fund's assets to advance its own interests; by law, fund assets must be held in custody by an eligible custodian as specified under the Investment Company Act. Thus, in the highly unlikely event that a fund's investment adviser were to go bankrupt, the fund's assets would be transferred to another investment adviser, subject to fund board approval, through a procedure that is governed by the Investment Company Act and is outside the adviser's bankruptcy proceeding. This entire process would be seamless for fund shareholders. Even short of a bankruptcy, if the board had concerns about the financial viability of a fund's adviser, it could invoke its authority to terminate the fund's advisory contract and hire a new adviser.³⁸
- The adviser must manage each fund's assets as a fiduciary, meaning that the adviser has a fundamental legal obligation to act in the best interests of the fund pursuant to a duty of undivided loyalty and utmost good faith.³⁹

The OFR Study speculates that the failure of a large asset management firm “could be a source of risk,” depending on the firm’s “size,⁴⁰ complexity, and the interaction among its various investment management strategies and activities.”⁴¹ It further speculates that “[d]istress at a large asset manager could amplify or transmit risks to other parts of the financial system.”⁴² But it fails to explain what would constitute “failure” or “distress” for such a firm, or to provide any specific evidence in support of these contentions. Moreover, the OFR Study discounts the extent to which managed accounts generally could be transferred to a different manager in such a situation (and, as noted above, in the registered fund context this process would have the benefit of involvement by the fund’s independent board).

The CFTC appropriately took into account the relationship between an asset manager and its clients in an interpretive position related to the definition of the term “major swap participant” for purposes of rules implementing Title VII of the Dodd-Frank Act. The CFTC concluded that swap or

³⁸ See generally Section 15(a) of the Investment Company Act.

³⁹ See *SEC v. Capital Gains Research Bureau Inc.*, 375 U.S. 180 (1963).

⁴⁰ The above-described features provide strong support for our view that the assets of registered funds should not be attributed to the funds’ adviser when considering the extent to which the adviser may pose systemic risk. See Letter from Paul Schott Stevens, President & CEO, ICI to FSOC (Nov. 5, 2010) (commenting on FSOC Advance Notice of Proposed Rulemaking Regarding Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies), at 6–7. See also Incentive-based Compensation Arrangements, SEC Release No. 34-64140 (March 29, 2011), 76 Fed. Reg. 21170 (April 14, 2011). In proposing rules to implement Section 956 of the Dodd-Frank Act concerning executive compensation (applicable to certain types of large financial institutions, including investment advisers, but exempting those “with assets of less than \$1,000,000,000”), the SEC disregarded assets under management, stating: “For investment advisers, asset size would be determined by the adviser’s total assets shown on the balance sheet for the adviser’s most recent fiscal year end.”

⁴¹ OFR Study at 18.

⁴² *Id.*

security-based swap positions of client accounts managed by asset managers or investment advisers may be excluded when determining whether those entities are major participants.⁴³ The CFTC indicated that its interpretation was influenced in particular by statutory language addressing entities that “maintain” substantial positions or “whose” outstanding swaps and security-based swaps create substantial counterparty exposure.⁴⁴ In other words, the CFTC correctly concluded that the risks associated with investments made on behalf of client accounts do not reside with asset managers and investment advisers and, therefore, asset managers and investment advisers do not have “substantial” counterparty exposure.⁴⁵

The Basel Committee on Banking Supervision and the Board of the International Organization of Securities Commissions took a similar approach in the context of margin requirements for uncleared derivatives. The BCBS and IOSCO determined to permit the use of a threshold of €50 million for all types of counterparties under which initial margin would not have to be exchanged. With respect to investment funds, they clarified that the threshold would apply at the individual fund level as long as the funds are distinct legal entities that are not collateralized by, or otherwise guaranteed or supported by, other investment funds or the investment adviser in the event of fund insolvency or bankruptcy.⁴⁶ Therefore, the BCBS and IOSCO recognized that potential counterparty risk should be assessed at the individual fund level rather than at the level of the fund complex or adviser.⁴⁷

The OFR Study does not adequately consider the many features and characteristics of funds and their advisers discussed above that, as recognized by other regulatory bodies, prevent risk from flowing from one fund to similar or related funds or to the adviser.

V. The OFR Study Fails to Recognize That the Existing Regulation of Registered Funds Not Only Protects Investors But Also Mitigates Risk to the Broader Financial System

The OFR’s attempt to describe in broad terms the “activities” of asset managers has the unfortunate effect of obscuring the regulatory protections to which registered funds are subject under the Investment Company Act, other federal securities laws, and related SEC regulations. These protections are not wholly unknown to OFR—in fact, some of them are discussed in various places in

⁴³ CFTC and SEC, Further Definition of “Swap Dealer,” “Security-Based Swap Dealer,” “Major Swap Participant,” “Major Security-Based Swap Participant” and “Eligible Contract Participant”, 77 Fed. Reg. 30596 (May 23, 2012) at 30690.

⁴⁴ *Id.*

⁴⁵ The CFTC also was influenced in part “by the fact that it would not appear appropriate to impose certain regulations applicable to major participants (e.g., capital) upon those entities.” *Id.* (footnote omitted). As noted above and in Section VI below, we agree that capital requirements would not be appropriate for asset managers.

⁴⁶ Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 13, 2013 available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf>.

⁴⁷ It appears that BCBS and IOSCO never even contemplated assessing counterparty risk at the adviser level, presumably because the fund, not the adviser, is the counterparty.

the OFR Study, and many of them are listed in a single sentence in its Appendix. This approach by OFR therefore suggests a failure to understand, or to give due weight to, the importance of these protections, both individually and collectively, in serving the interests of registered fund shareholders and in mitigating risk to the broader financial system.⁴⁸ The OFR Study's apparent criticism, for example, of the lack of barriers to redemptions ignores the fact that daily redeemability at net asset value is a defining feature of mutual funds (the most common form of registered fund) and one around which many of the protections in the Investment Company Act are built.⁴⁹

The risk mitigating aspects of the regulatory framework for registered funds include the following:⁵⁰

Daily Valuation of Fund Assets

Registered funds must value their portfolio holdings on a daily basis, based on market values if readily available. If there is no current market quotation for a security or the market quotation is unreliable, the fund board has a statutory duty to "fair value" the security in good faith. The fund uses the values for each portfolio holding to calculate the net asset value ("NAV") of its shares each business day, using pricing methodologies established by the fund's board of directors. The daily NAV is the price used for all transactions in fund shares. As the SEC has observed, these pricing requirements are critical to ensuring fund shares are purchased and redeemed at fair prices and that shareholder interests are not diluted.⁵¹ They also promote market confidence, because they allow investors, counterparties and others to understand easily the actual valuations of fund portfolios.

⁴⁸ In 1992, the SEC's Division of Investment Management issued a lengthy and detailed study reexamining the regulation of investment companies in light of the "tremendous growth and structural change" in financial markets over the preceding 50 years. See Division of Investment Management, U.S. Securities and Exchange Commission, *Protecting Investors: A Half Century of Investment Company Regulation* (May 1992) ("Protecting Investors Report") at xvii. The report notes at the outset that "[t]he Investment Company Act establishes a comprehensive federal regulatory framework for investment companies." *Id.* at xviii. It later explains that the staff's recommendations for reform in thirteen distinct areas "leave unchanged the fundamental principles underlying the Investment Company Act. . . . Of course, no amount of regulation can prevent unsuccessful management of investment companies or losses on investments. It can, however, limit self-dealing, undue risks, and imprudent practices, as well as promote informed investor choice." *Id.* at xxii.

⁴⁹ See, e.g., Letter from Paul Schott Stevens, *supra* note 40 at 11 ("the regulation of mutual funds controls the potential risks of redemption very differently than banks do the potential risks of withdrawals").

⁵⁰ This discussion focuses on the regulation of mutual funds, which are the predominant form of registered investment company. The framework is slightly different for closed-end funds, which do not promise daily redeemability but rather list their shares for trading on a national securities exchange. For a more thorough discussion of the comprehensive regulatory framework applicable to registered funds and their managers, see, e.g., *2013 Investment Company Fact Book*, 53rd edition, Investment Company Institute, at Appendix A. The *Fact Book* is available at www.icifactbook.org.

⁵¹ See, e.g., Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IC-26299, 68 Fed. Reg. 74714, 74718 (Dec. 24, 2003) (adopting Rule 38a-1 under the Investment Company Act).

Liquidity to Support Redemptions

Mutual fund shareholders have the right under almost any circumstances to redeem shares daily, so the funds must maintain liquidity for ordinary redemptions. At least 85 percent of a mutual fund's portfolio must be held in "liquid securities," which are defined as any assets that can be disposed of within 7 days at a price approximating market value.⁵² As part of the daily process to determine the fund's NAV per share, liquidity determinations are regularly reevaluated. Many funds adopt a specific policy with respect to investments in illiquid securities; these policies are sometimes more restrictive than the SEC guidelines. Although an unexpected market event could potentially cause certain previously liquid securities to become temporarily illiquid, the SEC has determined that the maintenance of 85 percent of a portfolio in liquid securities should satisfactorily ensure a fund's ability to meet redemptions.⁵³ If that is not the case, and a registered fund finds itself unable to meet redemptions, it may liquidate and make a *pro rata* distribution to its shareholders.⁵⁴

Leverage

As the OFR Study recognizes, the Investment Company Act and related guidance from the SEC and its staff limit the extent to which funds can enter into transactions involving leverage, such as selling securities short, purchasing securities on margin, or investing in derivatives.⁵⁵ Funds generally may not engage in these types of transactions unless they "cover" their exposure. A fund can cover its exposure by meeting enumerated asset coverage tests or, in certain cases as permitted by SEC guidance, by segregating liquid assets on its books or maintaining offsetting positions. These limitations on

⁵² See Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992). Although as a technical matter the SEC has rescinded the Guidelines to Form N-1A, most of the positions taken in the Guidance, including those relating to liquidity, continue to represent the SEC staff's position. For money market funds, Rule 2a-7 under the Investment Company Act imposes more stringent liquidity requirements.

⁵³ *Id.* (stating that the 85 percent standard was "designed to ensure that mutual funds will be ready at all times to meet even remote contingencies").

⁵⁴ See generally Jack Murphy, Julien Bourgeois and Lisa Price, Dechert LLP, *How a Fund Dies*, in Review of Securities & Commodities Regulation, Vol. 43, No. 21 (Dec. 1, 2010) (describing the various steps in the liquidation process, including passage of a resolution by the fund's board of directors, liquidation of assets, payout to shareholders, and deregistration under the Investment Company Act).

⁵⁵ OFR Study at 17. The OFR Study observes that unregistered funds and accounts are not subject to these regulatory restrictions. Indeed, excessive leverage (along with lack of transparency) was a key factor in the 1998 collapse of Long-Term Capital Management, a hedge fund manager whose failure required intervention by the Federal Reserve to protect the broader financial system. As the President's Working Group on Financial Markets noted, "Assessed against the trading practices of hedge funds and other trading institutions . . . the LTCM Fund stood out with respect to its opaqueness and low degree of external monitoring, and its high degree of leverage." See *Hedge Funds, Leverage, and Lessons of Long-Term Capital Management*. Report of the President's Working Group on Financial Markets (April 1999), at 14. Quite curiously, the experience of LTCM is mentioned nowhere in the OFR Study.

funds' use of transactions involving leverage help assure that a fund will be able to meet its obligations.⁵⁶ As the Senate Banking Committee observed during the development of what eventually became the Dodd-Frank Act, "a typical mutual fund could be an example of a nonbank financial company with a low degree of leverage."⁵⁷ In contrast, companies with a high degree of leverage pose greater potential risk to the financial system. This is because leverage acts as a multiplier in times of market stress, turning small losses into large ones.

Transactions with Affiliates

The Investment Company Act contains a number of strong and detailed prohibitions on transactions between a registered fund and affiliated organizations such as the fund's adviser, a corporate parent of the fund's adviser, or an entity under common control with the fund's adviser. Among other things, Section 17 of the Investment Company Act prohibits transactions between a fund and an affiliate acting for its own account, such as the buying or selling of securities (other than those issued by the fund) or other property, or the lending of money or property. It also prohibits joint transactions involving a registered fund and an affiliate. In some cases, transactions involving an affiliate are permitted in accordance with SEC rules and exemptive orders, which impose conditions designed to protect investors and require the fund's board of directors to adopt and review procedures designed to ensure compliance with those conditions. The detailed and restrictive provisions of the Investment Company Act governing dealings with affiliates are no less stringent than those contained in Sections 23A and B of the Federal Reserve Act. These Investment Company Act provisions also prevent most types of sponsor support, absent prior approval by the SEC on a case-by-case basis.

Custody of Assets

The Investment Company Act requires all registered funds to maintain strict custody of fund assets, separate from the assets of the adviser. This requirement is intended to safeguard fund assets from theft or misappropriation. Nearly all funds use a bank custodian for domestic securities, and the custody agreement is typically far more elaborate than the arrangements used for other bank clients.⁵⁸ Notably, under the Investment Company Act regulatory structure, collateral posted by a registered fund must be placed with an eligible custodian and maintained as required under the Investment Company Act. The benefits of this approach were highlighted following the collapse of Lehman

⁵⁶ We note that the issue of economic leverage (which the OFR Study describes as increased market exposure without the incurrence of future obligations) and various other aspects of derivatives use by registered funds are currently under consideration by the SEC staff. See *Use of Derivatives by Investment Companies Under the Investment Company Act of 1940*, SEC Release No. IC-29776 (Aug. 31, 2011), 76 Fed. Reg. 55237 (Sept. 7, 2011) ("SEC Derivatives Release").

⁵⁷ See S. Rep. No. 111-176, accompanying S. 3217, the Restoring American Financial Stability Act of 2010, at 48 (discussing the "degree of leverage" factor to be considered by FSOC in exercising its SIFI designation authority).

⁵⁸ The Investment Company Act and rules thereunder permit other limited custodial arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository.

Brothers, as registered funds with such custody arrangements were able to take control of both their own collateral and the collateral posted by Lehman with far less difficulty than market participants with different custody arrangements.

Diversification Requirements

All mutual funds are required by the federal tax laws to be diversified.⁵⁹ Generally speaking, with respect to half of the fund's assets, no more than 5% may be invested in the securities of any one issuer; with respect to the other half, the limit is 25%. In other words, the minimum diversification a fund could have is 25% of its assets in each of two issuers, and 5% of its assets in each of 10 additional issuers. If a fund elects to be diversified for purposes of the Investment Company Act (and most do), the requirements are more stringent—with respect to 75% of its portfolio, no more than 5% may be invested in any one issuer.

Transparency

Under the federal securities laws and applicable SEC regulations, registered funds are subject to the most extensive disclosure requirements of any financial product. Funds provide a vast array of information about their operations, financial conditions, contractual relationships with their advisers and other matters to regulators, the investing public, media, and vendors such as Morningstar. The marketplace simply does not have access to anything even approaching this degree of transparency about banks and their holdings. In fact, some believe that the opacity of banks' balance sheets contributed to the spread and severity of the 2008 financial crisis.⁶⁰

More specifically, mutual funds are required to maintain a current prospectus, updated at least annually, which provides investors with information about the fund and its operations, investment objectives, investment strategies, risks, fees and expenses, and performance, among other things. The prospectus also must describe all principal investment strategies and risks of a fund. According to guidance from the SEC staff, any principal investment strategies disclosure related to derivatives “should be tailored specifically to how a fund expects to be managed . . . This disclosure also should describe the purpose that the derivatives are intended to serve in the portfolio . . . and the extent to which derivatives are expected to be used.”⁶¹ The prospectus must be provided to investors in connection with a purchase of fund shares.⁶²

⁵⁹ See Subchapter M of the Internal Revenue Code.

⁶⁰ *The Financial Crisis of 2008 in Fixed Income Markets*, Gerald P. Dwyer and Paula Tkac, Working Paper 2009-20, Federal Reserve Bank of Atlanta (Aug. 2009).

⁶¹ Letter from Barry Miller, Associate Director, Office of Legal and Disclosure, Division of Investment Management, SEC to Karrie McMillan, General Counsel, ICI (July 30, 2010) at 4.

⁶² Additional information must be made available to investors upon request in a Statement of Additional Information, commonly referred to as the SAI.

Fund shareholders receive annual reports containing audited financial statements within 60 days after the end of the fund's fiscal year, and semi-annual reports containing unaudited financials within 60 days after the fiscal year mid-point. These reports must contain updated financial statements, a comprehensive list of the fund's portfolio securities including derivatives contracts, management's discussion of financial performance, and other specified information. Following their first and third quarters, funds file an additional form with the SEC, Form N-Q, disclosing their complete portfolio holdings. The SEC makes Form N-Q publicly available upon receiving it. These quarterly portfolio holdings disclosures include any assets earmarked against derivatives transactions, as well as any assets posted as collateral.⁶³ They also list open derivatives positions, including terms of the contracts, their notional value and fair value. The SEC staff takes the view that for over-the-counter derivatives such as swaps, "terms" of the contracts include the identity of the counterparty.⁶⁴ This high degree of transparency allows investors and other market participants a clear understanding of a fund's investment strategy, holdings, and financial condition.

Independent Board Oversight

The OFR Study makes a passing reference in the Appendix to "governance for fund management" as one of the requirements for registered funds under the Investment Company Act. In fact, registered funds are unique among investment products in that they are required by statute to have a board of directors and, further, that the board generally must have at least a majority of members who are independent of the fund's investment adviser.⁶⁵ Fund directors are subject to duties of care and loyalty under state law, and the independent directors serve as "watchdogs" for the interests of fund shareholders.⁶⁶ In broad terms, the fund board oversees the management, operations and investment performance of the fund. Directors also have significant and specific responsibilities under the federal securities laws, including signing the fund's registration statement (and assuming strict liability for any material misstatements or omissions therein), approving the contract with the fund's investment adviser and overseeing the adviser's provision of services under that contract, and overseeing potential conflicts of interest as well as the fund's compliance program.⁶⁷

⁶³ Funds typically do not post substantial portions of their portfolios as collateral.

⁶⁴ See Letter from Barry Miller, *supra* note 61.

⁶⁵ In fact, the number of independent directors on a fund board is typically far higher than required by law. As of year-end 2012, independent directors made up three-quarters of boards in 85 percent of fund complexes. See Independent Directors Council/Investment Company Institute, *Overview of Fund Governance Practices, 1994–2012*, available at http://www.idc.org/pdf/pub_13_fund_governance.pdf.

⁶⁶ *Burks v. Lasker*, 441 U.S. 471 (1979).

⁶⁷ For a more complete discussion of the oversight role of fund boards, see, e.g., *Frequently Asked Questions About Mutual Fund Directors*, available at http://www.idc.org/pubs/faqs/faq_fund_gov_idc; *Fundamentals for Newer Directors*, available at <http://www.fundamentals.idc.org>; and American Bar Association Section of Business Law, *Fund Director's Guidebook* (3rd ed. 2006), available at <http://apps.americanbar.org/abastore/index.cfm?pid=5070526§ion=main&fm=Product.AddToCart>.

Mandatory Compliance Programs

While compliance has always been a cornerstone of the registered fund industry, the adoption of the fund compliance program rule (Rule 38a-1 under the Investment Company Act) in late 2003 introduced formalized practices and new requirements for registered funds and their boards, and presented fund boards with new tools for overseeing compliance. Under the rule, registered funds must adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws. These policies and procedures must provide for the oversight of compliance by the fund's key service providers—its investment adviser(s), principal underwriter(s), administrator(s), and transfer agent(s). Registered funds must review at least annually the adequacy of their own policies and procedures, as well as those of their service providers, and the effectiveness of their implementation.

Rule 38a-1 also requires registered funds to designate a chief compliance officer ("fund CCO") who is responsible for administering the fund's compliance policies and procedures.⁶⁸ The rule contains provisions designed to promote the independence of the fund CCO from the fund's investment adviser. At least annually, the fund CCO must provide a written report to the fund board that addresses, among other things, the operation of the fund's (and its service providers') policies and procedures and each material compliance matter that occurred since the date of the last report. Although the rule requires compliance reviews and reports to be undertaken at least annually, such reviews and reports may occur on a more frequent basis, or on an ongoing basis throughout the year.

VI. SIFI Designation and Prudential Regulation are Neither Warranted Nor Appropriate For Registered Funds and Their Advisers

The OFR staff prepared this study to inform FSOC's analysis of whether, and how, to consider asset management firms for enhanced prudential standards and supervision by the Federal Reserve Board under Section 113 of the Dodd-Frank Act.⁶⁹ Under Section 113, FSOC may designate a nonbank financial company for these purposes only upon determining that either: (1) the company's material financial distress; or (2) the nature, scope, size, scale, concentration, interconnectedness or mix of the company's activities—could pose a threat to the financial stability of the United States.⁷⁰ As discussed above, the OFR Study does not establish that any of the so-called "vulnerabilities" to which it alludes have the potential to threaten U.S. financial stability, especially insofar as registered funds and their advisers are concerned. For this reason, the study provides no predicate for FSOC to exercise its SIFI designation authority.

⁶⁸ Rule 206(4)-7 under the Investment Advisers Act of 1940 imposes similar requirements on all federally registered investment advisers (including all advisers to registered funds).

⁶⁹ OFR Study at 1.

⁷⁰ Section 113 requires FSOC to consider ten specified criteria in making a SIFI determination; FSOC also has discretion to consider any other risk-related factor it deems appropriate.

Regulators have many tools for addressing risks in the financial system. The Dodd-Frank Act provided regulators many new tools to address abuses and excessive risk taking by financial market participants. These include tools that affect financial institutions generally and those targeted either to eliminate excessive risk taking in, or to improve regulatory oversight over, specific sectors. The broad scope of these and other new authorities, combined with existing authorities, should allow FSOC to reserve SIFI designation only for those circumstances in which other regulatory actions clearly would be inadequate to address or limit the perceived risks to the financial system.

Notably, as contemplated by the Dodd-Frank Act, regulators have used and are continuing to use both new and existing authorities to address risks where they arise—with the front-line regulators taking the lead—and the effect of these actions has been to mitigate risk in the financial system or to make markets and market participants more resilient to future shocks. The OFR Study gives short shrift to, or in some cases, completely disregards, recent and ongoing regulatory efforts—even those that concern or are relevant to topics covered in the study. For example, the OFR Study does not take into account that securities lending and repo transactions are currently the subject of specific regulatory efforts, with additional efforts on the horizon.⁷¹ The significant protections afforded under Title VII of the Dodd-Frank Act likewise go unnoticed by the OFR Study. Rules under that title govern, among other things, initial and variation margin requirements for cleared and uncleared swaps and other terms central to counterparty and clearinghouse relationships. Once fully implemented, the Title VII regime will dramatically change the way swaps are traded, cleared and settled, to the benefit of both individual counterparties and the financial system generally.

With respect to registered funds, various aspects of their use of derivatives currently are under consideration by the SEC staff.⁷² In connection with the staff's review, ICI has recommended the adoption of a specific rule under the Investment Company Act addressing counterparty exposure.⁷³ We have suggested that such a rule should, similar to counterparty-specific rules in Europe and elsewhere: (1) address the appropriate way to calculate counterparty exposure; (2) set an appropriate limit on uncollateralized exposure to any one counterparty; and (3) require additional counterparty risk disclosure in certain contexts.⁷⁴

⁷¹ See, e.g., Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (Aug. 29, 2013); see also Section 984 of the Dodd-Frank Act.

⁷² See SEC Derivatives Release, *supra* note 56.

⁷³ See Letter from Karrie McMillan, General Counsel, ICI to Elizabeth M. Murphy, Secretary, SEC dated Nov. 7, 2011 (commenting on the SEC Derivatives Release), at 17, 20-21.

⁷⁴ At present, the Investment Company Act's requirements relating to diversification, concentration and investments in securities-related issuers potentially limit counterparty exposure, but it is not always clear how these tests are meant to apply. This issue is discussed at length in the SEC Derivatives Release, *supra* note 56.

Designation is a potent tool that should be used judiciously—only when other regulatory actions would be inadequate. In our view, the designation of individual companies for heightened supervision should be reserved for those circumstances, presumably quite limited, when FSOC has determined that a specific company poses significant risks to the financial system that clearly cannot otherwise be adequately addressed through enhancements to existing financial regulation and/or other regulatory authorities provided by the Dodd-Frank Act.

FSOC should have a reasonable expectation that the “remedies” that would flow from designation are necessary and will be effective to address the specific risks that SIFI designation seeks to minimize. As mentioned above, SIFI designation entails the imposition of enhanced prudential standards (such as risk-based capital requirements and leverage limits, liquidity requirements, and stress tests), and supervision by the Federal Reserve Board. These requirements are designed to moderate bank-like risks and are ill-suited or unnecessary for registered funds and their advisers, which—as we have explained above—do not present the types or scale of risks that would warrant application of such requirements.⁷⁵

Capital requirements, for example, are a tool of proven value in banking regulation. But as discussed in Section IV. A. above, requiring an asset manager to hold capital is fundamentally inconsistent with the asset management business model in which the manager provides services to clients in an agency capacity and does not take on investment risk itself. Imposing capital requirements on registered funds likewise would be inappropriate and unduly burdensome; unlike banks, these funds simply have neither the need nor the ability to meet capital requirements. Their “capital” comes from investors who own fund shares—shares that represent the shareholders’ pro rata interests in all the underlying assets of the fund.

Commenting on the possibility of capital requirements for nonbank financial companies designated as SIFIs, Brookings Institution Fellow Douglas J. Elliott recently wrote:

If this powerful tool is applied too widely, such as to fund managers that act as pass-through entities and not true intermediaries, it could substantially change the ability of otherwise valid business models to work. Ironically, adding an unreasonable burden to, say, mutual funds could push financial assets into the hands of financial intermediaries instead that present greater systemic risks.⁷⁶

Second, SIFI designation by its very nature—*i.e.*, designating *individual companies* for enhanced prudential regulation—is not a practical or effective way to address the risks hypothesized by the OFR

⁷⁵ Capital requirements also would have no bearing on some of the specific risks the OFR Study discusses, such as reaching for yield and herding. Even assuming for the sake of argument that these behaviors occur to any significant degree, and that it would be desirable to curb them in some fashion, imposing capital requirements on an asset manager that acts as an agent for clients would not be responsive to those goals, given that the manager’s capital is not at risk.

⁷⁶ Elliott, *supra* note 24, at 10-11.

study. For example, in the case of “reaching for yield,” “herding,” and redemption risk, it would be virtually impossible to attribute these “vulnerabilities” to any particular fund or asset manager in advance.⁷⁷

We are not alone in cautioning that SIFI designation is not a panacea. For example, in remarks concerning the regulation of systemic risk in 2011, Federal Reserve Board Governor Daniel Tarullo addressed the implementation of Section 113 of the Dodd-Frank Act. He stated that “the tool of designating firms is a limited one,” adding that the structure created by Congress suggests that “the standard for designation should be quite high.”⁷⁸ Governor Tarullo also specifically recognized that “prudential standards designed for regulation of bank-affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions.”⁷⁹

The OFR Study does not purport to make the case that any registered funds or their advisers pose risks meeting the statutory standards for SIFI designation. Nor does it indicate that such risks would be appropriately addressed by designating any such funds or their advisers as SIFIs. Unfortunately, however, the study’s many shortcomings obscure the reality that registered funds and their advisers have not been and are highly unlikely to be a source of systemic risk—as a result of their structure, operations, and regulation, and as demonstrated by empirical evidence, including experience during the worst financial crisis since the Great Depression.⁸⁰

VII. Conclusion

Given its many shortcomings, the OFR Study should not serve as the basis for policy decisions or regulatory action of any kind and, accordingly, should be withdrawn. Any future study of the asset management industry should be conducted methodically—taking into account all the various segments of the industry, the differing ways in which they are regulated, and relevant historical experience—and in close cooperation with the SEC, the regulator with the greatest expertise and experience in capital markets and asset management.

⁷⁷ It would be inconsistent with Congressional intent and FSOC’s previous statements to designate any asset management firm or fund based solely on its size. *See generally* Section 113 of the Dodd-Frank Act; FSOC, Authority to Require Supervision, *supra* note 3.

⁷⁸ *Regulating Systemic Risk*, Remarks by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, at the 2011 Credit Markets Symposium, Charlotte, N.C. (March 31, 2011), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf>, at 5.

⁷⁹ *Id.* at 6.

⁸⁰ In this regard, it is telling that the Dodd-Frank Act did not alter the existing strong and effective regulatory framework governing registered funds.

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Thank you for the opportunity to submit these views. If you have any questions regarding our comments or would like additional information, please feel free to contact me at [REDACTED] or [REDACTED] Karrie McMillan, ICI General Counsel, at ([REDACTED]) or [REDACTED] or Brian Reid, ICI Chief Economist, at ([REDACTED]) or [REDACTED]

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens
President & CEO
Investment Company Institute

Appendices (3)

cc: The Honorable Mary Jo White, Chair
The Honorable Luis Aguilar, Commissioner
The Honorable Dan Gallagher, Commissioner
The Honorable Kara Stein, Commissioner
The Honorable Mike Piwowar, Commissioner

Mr. Norm Champ
Director, Division of Investment Management

Mr. Craig Lewis
Director and Chief Economist, Division of Economic and Risk Analysis
U.S. Securities and Exchange Commission

The Honorable Jacob Lew, Secretary
Ms. Mary Miller, Acting Deputy Secretary and Under Secretary for Domestic Finance
Mr. Richard Berner, Director, Office of Financial Research
U.S. Department of the Treasury

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The Honorable Ben S. Bernanke
Chairman, Board of Governors of the Federal Reserve System

The Honorable Gary Gensler
Chairman, Commodity Futures Trading Commission

The Honorable Martin Gruenberg
Chairman, Federal Deposit Insurance Corporation

Mr. Edward DeMarco
Acting Director, Federal Housing Finance Agency

The Honorable Thomas J. Curry
Comptroller of the Currency

The Honorable S. Roy Woodall, Jr.
Financial Stability Oversight Council

The Honorable Debbie Matz
Chairman, National Credit Union Administration

The Honorable Richard Cordray
Director, Consumer Financial Protection Bureau

Appendix A

Methodology and Accuracy of the OFR Study

In Section II of our letter, we note our serious concerns with methodology and the presentation of information in the OFR Study. The examples below, while not exhaustive, support our view that the OFR Study should not form the basis for policy decisions or regulatory action of any kind.

Unsupported Generalizations

The OFR Study is replete with sweeping assertions that are difficult to parse and lack supporting data. Consider, for example, a sentence stating that “similar concerns”¹ “could arise if a firm with extensive repo and securities lending businesses, and that managed strategies with an array of interconnections through derivatives and other exposures, had difficulty unwinding or transferring clients’ investments to another asset manager during a period of market weakness.”² These multiple layers of conjecture do not meaningfully inform FSOC or any other reader about the asset management industry. The OFR Study provides no analysis or data even attempting to show a plausible connection between any of the various activities mentioned and risk to U.S. financial stability, but leaves a reader with the impression that such a connection assuredly exists.

In another example, the OFR Study states that “[d]istress at a large asset manager could amplify or transmit risk to other parts of the financial system,”³ but again, this broad assertion is presented starkly—with no explanation or supporting information.⁴

Lack of Clarity, Precision, and Consistency Regarding Focus and Scope

While the title of the document indicates that the focus of the OFR Study is “asset management,” the body of the document touches on a wide range of firms and activities and seems to paint all with the same brush. In many instances, the OFR Study includes statements about asset managers that read as though the statements have general applicability, when in actuality that is not the case. For example, the OFR Study posits that “[t]he extensive connections asset managers have with other financial services firms, and the concentration of some of these services, increase the potential that risks originating in other market sectors could be transmitted or amplified through asset managers into broader financial markets, or conversely, that risks originating in asset managers could be

¹ It is unclear which “concerns” this refers to; presumably, the potential that an asset management firm may pose a threat to financial stability.

² OFR Study at 19.

³ *Id.* at 18.

⁴ The OFR Study later indicates that “several large, complex financial institutions with asset management divisions suffered material distress during the recent crisis” and that stress spread between these companies’ other businesses and their asset management subsidiaries. *Id.* at 19. But, despite possibly leading readers to conclude otherwise, there is no indication that the asset management subsidiaries either were a source of risk to financial stability or that, to the extent they experienced “distress,” they “amplif[ied] or transmit[ed] risk to other parts of the financial system.”

transmitted to other market sectors.”⁵ Whether this statement is valid as to any individual asset manager—and if so, whether it has any bearing on U.S. financial stability—is highly questionable. But certainly it does not accurately depict “asset managers” as a whole.

The OFR Study, at times, specifically refers to registered funds, to unregistered funds, or to some subset of one of these categories (*e.g.*, money market funds or hedge funds). In other instances, however, the OFR Study blurs or fails to make these important distinctions. Precision in this regard is very important; compared to unregistered funds, registered funds have substantially different regulatory regimes, client bases, and risk tolerances, and utilize different investment strategies to achieve their clients’ goals, all of which have significant implications for understanding what point OFR is seeking to make and whether it is, or could be, valid.

For example, the section of the report on “reaching for yield” and “herding” behaviors includes a statement that “[i]n some cases, managers’ incentives (for example, some performance fees) may be structured so that managers share investors’ gains on the upside but do not share investors’ losses on the downside, a situation that creates incentives to invest in riskier assets.”⁶ Nowhere does the OFR Study clarify that this statement does not apply to registered funds. In the case of registered funds, SEC rules prohibit performance fees unless they have symmetrical bonus or penalty features.⁷

The OFR Study states in the introduction that it “does not focus on particular risks posed by money market funds,” given that such funds already are the subject of separate regulatory efforts.⁸ And yet, at times it appears to project OFR’s perception of the experience of money market funds during the financial crisis⁹ on all funds—particularly in the discussion of redemption risk—without specifically mentioning money market funds. For example, the OFR Study claims that “[i]n some circumstances, investors may believe that they can rely on sponsor support of the fund or product in a crisis, even in the absence of a legal or stated guarantee. They may hold this belief because of the way a product was marketed or because such support has been granted in the past.”¹⁰ There is no reference to money

⁵ *Id.* at 21.

⁶ *Id.* at 9.

⁷ See Section 205(a)(1) and 205(b)(2) of the Investment Advisers Act of 1940 and Rules 205-1 and 205-2 thereunder.

⁸ OFR Study at 2.

⁹ In our analysis of the events of 2007-2008, we found that many factors (including repeated shocks from failures by banks and other financial institutions and the lack of coherent, consistent government response to those failures) spurred the experience of money market funds. See Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Members of the Financial Stability Oversight Council (January 24, 2013), available at http://www.ici.org/pdf/13_fsoc_mmf_recgs.pdf, at 30-37. Our findings also are consistent with the SEC staff’s characterization of events during 2008, which found that there are many possible explanations for the redemption activity during the financial crisis, including factors such as investors preferring the safety, liquidity, and transparency of government securities. See SEC Division of Risk, Strategy and Financial Innovation, *Response to Questions Posed by Commissioners Aguilar, Paredes, and Gallagher* (November 30, 2012), available at <http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf>, at 7-9.

¹⁰ OFR Study at 14 (citation omitted).

market funds, but there is a bare bones citation to a paper—“Brady, Anadu, and Cooper (2012).”¹¹ Only upon matching this up with the list of references included at the back of the document does a reader discover that it is a Federal Reserve Bank of Boston staff working paper entitled “The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007-2011.” At the very least, as a matter of basic accuracy, it is incumbent upon the OFR not to blur or ignore relevant distinctions among different types of funds.

Data Issues

In several instances, the OFR Study misuses or erroneously interprets data. In other cases, it is difficult to ascertain whether OFR Study figures are correct because the study provides too little detail on sources and definitions of data used. These data problems suggest insufficient care in the study and, in many cases, a misapprehension of the institutional details of asset management in general and the mutual fund industry specifically. These types of errors could lead to incorrect conclusions and misdirected policy recommendations. Below we provide a few illustrative examples.

1. The OFR Study overstates the size of the U.S. asset management industry.

The OFR Study states that “The U.S. asset management industry oversees the allocation of approximately \$53 trillion in financial assets.”¹² This lets the reader infer that dollar assets managed by asset managers operating within U.S. borders on behalf of U.S. residents total \$53 trillion. The \$53 trillion figure, however, is based on the total *worldwide* assets under management of asset managers, as reported by Pensions & Investments (P&I), irrespective of whether those assets are domiciled outside of the U.S. and irrespective of the currency in which those assets are denominated. Thus, for instance, it would appear to include euro-denominated assets domiciled in Europe on behalf of German or French citizens.¹³ A more plausible estimate for the concept that should be of most interest to FSOC might be the P&I total for assets under management for U.S. clients, which is \$28 trillion. Although this is still a large figure, it is about *half* the figure cited by the OFR Study. The OFR Study also overstates the size of the U.S. asset management industry through double counting.¹⁴ For example, it arrives at the \$53 trillion total by adding the \$45.4 trillion dollars in worldwide assets managed by “Registered Investment Advisers” to the \$8.7 trillion managed by “Insurance Companies.” Firms included in the P&I data under the category “Insurance Companies” appear to have been included already under the category “Registered Investment Advisers.”

¹¹ See *id.*, n. 25.

¹² OFR Study at 1. The statement references Figure 1.

¹³ An example of this is Amundi, which contributes almost \$1 trillion to the total worldwide assets under management figure from P&I. P&I also reports that only 0.1% of the nearly \$1 trillion in worldwide assets managed by Amundi are assets managed for U.S. clients.

¹⁴ Footnote 1 to Figure 1 acknowledges that “[f]igures include double-counting due to cross-investing among managers and multi-sourcing of data in construction of table.” OFR Study at 4. The footnote does not make up for the fact that this type of approach does not produce reliable research data.

2. The OFR Study overstates assets in defined benefit pension (DB) plans.

The OFR Study (see Figure 1 in the OFR Study) indicates that assets in DB pension plans (labeled in that figure as “Defined Benefit Plan Sponsors”) totaled \$11.4 trillion as of December 31, 2012, of which \$6.6 trillion was in private DB plans, \$3.2 trillion was in state and local DB plans and \$1.6 trillion in federal government DB plans. The figures for private and federal DB plans are incorrect. As of December 31, 2012, assets in private DB plans totaled \$2.5 trillion; assets in private sector *defined contribution* (DC) plans, totaled another \$4.1 trillion for a total of \$6.6 trillion that the OFR Study states as being assets in DB plans.¹⁵ The OFR Study similarly errs in reporting assets in federal government DB plans as \$1.6 trillion as of December 31, 2012. This figure is incorrect on two accounts. First, it includes assets in the federal government Thrift Savings Plan (TSP), which is a DC plan.¹⁶ As of December 31, 2012, assets in TSP totaled \$335 billion. A second, more general concern is that the OFR Study lists the assets in federal government DB plans under the heading “Private Investable Assets.” This is incorrect: the “assets” supporting federal government defined benefit pension liabilities generally are non-marketable government securities, which are neither private securities nor can they be sold in private markets.

3. The OFR Study overstates redemption pressure on bond funds during 2008:Q4.

The OFR Study states that “Mutual funds faced significant redemption requests during the [financial] crisis [when] redemptions from strategic income [bond] funds totaled \$75 billion in the fourth quarter of 2008, nearly twice the volume during the quarter a year earlier, and redemptions by investors in government bond funds were \$31 billion, 130 percent higher than during the fourth quarter of 2007.” According to ICI figures, Strategic Income bond funds experienced net outflows totaling \$33 billion, which amounted to just 5.0 percent of these funds’ assets as of September 2008. Contrary to the figures cited in the OFR Study, according to ICI data, Government bond funds received net *inflows* totaling \$7.4 billion. We believe that the OFR Study overstates redemptions from bond funds during this period because it inappropriately sized net outflows from bond funds on the basis of *gross redemptions*, instead of using the appropriate concept of gross redemptions less new share purchases.

4. The OFR Study understates assets in mutual funds

The OFR Study (Figure 1) states that assets in mutual funds (including assets in ETFs) totaled \$13.2 trillion as of December 31, 2012. According to ICI data, the correct figure is \$14.4 trillion (including assets in ETFs). The difference likely arises from the study’s reliance on Morningstar data to

¹⁵ See Federal Reserve Statistical Release, *Financial Accounts of the United States*, First Quarter, 2013, table L.117 (“Flow of Funds Accounts”).

¹⁶ See Federal Reserve Statistical Release, *Financial Accounts of the United States*, First Quarter, 2013, table L.118. For an explicit break down of DB and DC plan assets in federal government employee retirement plans, see Federal Reserve Statistical Release, *Financial Accounts of the United States*, Second Quarter, 2013, table L.119, which lists assets in federal DC plans as \$323.6 billion (line 15) and assets in federal DB plans as \$1.3 trillion (line 12).

size the mutual fund market, rather than using ICI data, which has somewhat broader overall coverage of the universe of mutual funds.

Appendix B

Mutual Fund Investors' Reactions During Market Corrections

The OFR Study purports to identify “redemption risk in collective investment vehicles” that makes asset managers “vulnerable to financial shocks” and posits that such outflows could force fund portfolio managers to sell assets at fire sale prices to meet redemptions. This hypothesis is not new. In 1994, Henry Kaufman (1994) argued that “The technology is in place for a cascade of selling by investors in mutual funds [and that] excesses originating in the mutual funds area may be the source of an economic shock should an asset price bubble be suddenly burst.”¹ In an accompanying piece, Morgan (1994) argued that such risks appear remote because households invest in stock and bond mutual funds primarily to save for retirement.² Moreover, at the time, even Kaufman (1994) acknowledged that “we do not know how the ordinary investor in mutual funds will react when equity prices and bond prices continue to display spasms of volatility.”

Since the publication of these studies, ICI has examined on numerous occasions the question of how mutual fund investors react to volatility in stock and bond markets. Using data almost from the inception of the Investment Company Act in 1940—including the stock market crash of 1987, the bond market decline in 1994, the bursting of the dot.com bubble in the early 2000s, the financial market crisis of 2007-2009 and, most recently, the reaction of bond mutual fund investors in 2013 to a sharp rise in long-term interest rates as a result of monetary policy—the evidence clearly indicates that investors’ net redemptions from stock and bond mutual funds remain modest during even the worst financial crises.³

There are several reasons why investors tend not to redeem fund shares during periods of financial stress. One factor is that most stock and bond fund assets are held by individual investors,⁴ and as Morgan (1994) noted, most of these individuals are investing for long-term goals, such as retirement. Virtually all individual mutual fund investors indicate that saving for retirement is one of their goals,

¹ Henry Kaufman, “Structural Changes in the Financial Markets: Economic and Policy Significance,” *Economic Review*, Federal Reserve Bank of Kansas City, second quarter, 1994.

² Donald Morgan, “Will the Shift to Stocks and Bonds By Households Be Destabilizing?,” *Economic Review*, Federal Reserve Bank of Kansas City, second quarter, 1994.

³ For succinctness, in this comment letter, the terms “net redemptions,” “redeem on net,” and “net outflow” are all taken to mean a negative value of net new cash flow from mutual funds, as defined by ICI. Similarly, the terms “net inflow” or “net share purchases” are taken to mean positive net new cash inflow to mutual funds as measured by ICI. ICI defines net new cash flow as the dollar value of new sales of fund shares minus redemptions, plus net exchanges. A positive number for net new cash flow indicates new sales plus exchanges into funds exceeded redemptions plus exchanges out of funds. A negative number indicates redemptions plus exchanges out of funds exceeded new sales plus exchanges into funds. Negative net new cash flow (“net outflow”) is the more appropriate concept for measuring pressure that investors’ redemptions place on a fund because, in any month, a fund typically experiences redemptions from certain investors but these are to a great extent offset by new purchases of fund shares by other investors.

⁴ 2013 *Investment Company Fact Book*, 53rd edition, Investment Company Institute, Chapter 6.

and about three-quarters of fund owners indicate that retirement savings is their primary goal.⁵ Account-level recordkept data also demonstrate that few investors sell shares or reallocate assets during periods of financial stress.⁶

Another reason that investors generally do not sell fund shares when markets are stressed is that most individuals who invest in mutual funds outside an employer-based retirement plan rely on the advice and assistance of financial professionals.⁷ Financial advice and assistance helps investors remain focused on an asset allocation mix to help them achieve their investment goals rather than seeking to time the markets.

Even though fund investors in aggregate redeem only modestly on net during periods of financial stress, some individual funds do experience net outflows (measured as a percentage of funds' assets) that significantly exceed industry averages. Funds accommodate these net outflows on a regular basis and during periods of financial stress without market disruption. Individual funds' sales of assets have not been disruptive to the markets because mutual funds must hold 85 percent of their portfolios in liquid securities, and because individual funds' sales of portfolio securities are small relative to the overall securities markets. Even in the aggregate, funds' sales of portfolio securities are unlikely to cause significant downward pressure on securities prices because mutual funds' total gross purchases and sales of stocks and bonds are small relative to the value of overall stock and bond market trading. These same features allow funds to liquidate or merge with other funds without market disruption. For example, in 2009, nearly 870 mutual funds either liquidated or merged without any market impact, and on average nearly 600 funds a year liquidated or merged on an annual basis since 2007.

The remainder of the appendix examines mutual fund investor flows through various stock and bond market cycles during the past several decades.

Equity Mutual Fund Flows

One overriding feature of the data on mutual fund net flows is the modest level of net outflows from equity mutual funds, even during severe market downturns. Assets in equity mutual funds have increased dramatically in the past 50 years (Figure 1) and the number and percentage of households investing in mutual funds have increased significantly.⁸ Variability in monthly net flows to equity

⁵ Dan Schrass, Michael Bogdan, and Sarah Holden, "Characteristics of Mutual Fund Investors, 2012," *ICI Research Perspective*, Vol. 18, no. 7 (November 2012). Available at <http://www.ici.org/pdf/per18-07.pdf>.

⁶ Sarah Holden and Daniel Schrass, *Defined Contribution Plan Participants' Activities, 2012*, Investment Company Institute Research Report, April 2013. Available at http://www.ici.org/pdf/ppr_13_rec_survey_q4.pdf. Sarah Holden, Jack VanDerhei, Luis Alonso, and Steven Bass, "401(k) Participants in the Wake of the Financial Crisis: Changes in Account Balances, 2007–2011." *ICI Research Perspective* 19, no. 7 (October 2013). Sarah Holden and Stephen Bass, "The IRA Investor Profile: Traditional IRA Investors' Activity, 2007–2011." *ICI Research Report* (October 2013). Available at www.ici.org/pdf/rpt_13_ira_investors.pdf.

⁷ Dan Schrass, Michael Bogdan, and Sarah Holden, "Characteristics of Mutual Fund Investors, 2012," *ICI Research Perspective*, Vol. 18, no. 7 (November 2012). Available at <http://www.ici.org/pdf/per18-07.pdf>.

⁸ See 2013 *Investment Company Fact Book*, supra n. 4, Figure 6.1.

mutual funds, however, has not increased, but has remained between approximately -4 to 4 percent of fund assets (Figure 2). In fact, month-to-month changes in net flows to equity funds have been much more moderate in the past 25 years than they were in the early- to mid-1980s. Net outflows from equity funds did not increase sharply even during periods of severe market downturns. Four periods are particularly illustrative.

1945–1986

From 1945 to 1986, there were twelve major stock market cycles (as identified by peaks and troughs in the S&P 500 index) of varying magnitudes and lengths. In a number of these cases, investors on a net basis continued to *purchase* equity fund shares (i.e., equity funds experienced net inflows) throughout stock market contractions.⁹ The largest stock market downturn during this period occurred from January 1973 to December 1974, when the S&P 500 declined 42 percent. Outflows from equity mutual funds over this period were modest, cumulating to \$3.2 billion, or 5.8 percent of fund assets. During this period, the maximum one-month net outflow from equity funds was -0.6 percent of equity fund assets. Thus, despite the fact that the stock market fell almost by half, mutual fund investors did not redeem precipitously; rather, they remained calm in the face of a vast stock market downturn.

Stock Market Crash: October–December 1987

Over the period October to December 1987, the stock market declined by 23 percent. Over these three months, net outflows from equity funds totaled only 4.2 percent of their assets. The largest one-month net outflow from equity funds during this period was 3.2 percent, which occurred in October 1987, when in a single month the S&P 500 declined by 22 percent.

Bursting of Dot.Com Bubble: March 2000 –September 2001

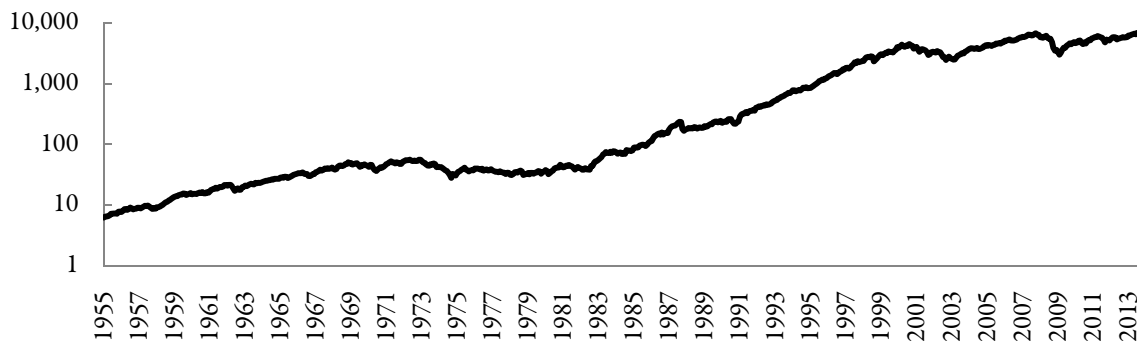
From December 31, 1987 to March 31, 2000 assets in equity mutual funds grew from \$175 billion to \$4.4 trillion, a nearly 25-fold increase. Nevertheless, over this period investors still redeemed only modestly during financial market stresses, such as during the bursting of the dot.com bubble. From December 31, 1987 to March 31, 2000, the S&P 500 index rose 507 percent (from a level of 247 to 1499) and the NASDAQ index, which was then more reflective of small-cap stock prices, rose 1,286 percent (from a level of 330 to 4573). The dot.com bubble began to burst in mid-March 2000. From February 29, 2000 to September 28, 2001, the NASDAQ and S&P 500 indexes declined by 68 percent and 24 percent, respectively. Over this same period, however, equity funds received net *inflows* totaling \$227 billion. Equity funds did experience outflows in five separate months during this period, but in only two cases (March 2001 and September 2001) did these net outflows total more than ½ percent of fund assets. Even in these two months, however, net outflows were hardly precipitous, totaling just -0.6 percent of equity fund assets in March 2001 and a bit more, -0.9 percent, in September 2001.¹⁰

⁹ John Rea and Richard Marcis, “Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944-95” *Perspective*, Investment Company Institute, volume 2, number 2, March, 1996. Available at <http://www.ici.org/pdf/per02-02.pdf>.

¹⁰ Recall, however, that September 2001 was the month of the 9/11 attacks. During September 2001, the stock market (measured by the S&P 500 index) declined 8 percent and trading in the stock market was suspended for four days.

Figure 1: Assets in Equity Mutual Funds

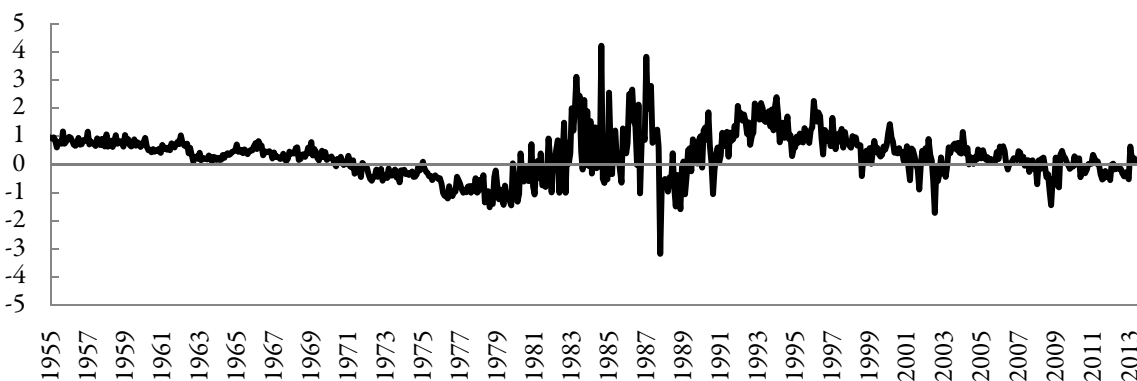
Monthly, billions of dollars, log scale



Source: Investment Company Institute

Figure 2: Net Flows to Equity Mutual Funds as a Percent of Equity Fund Assets

Monthly, percent



Source: Investment Company Institute

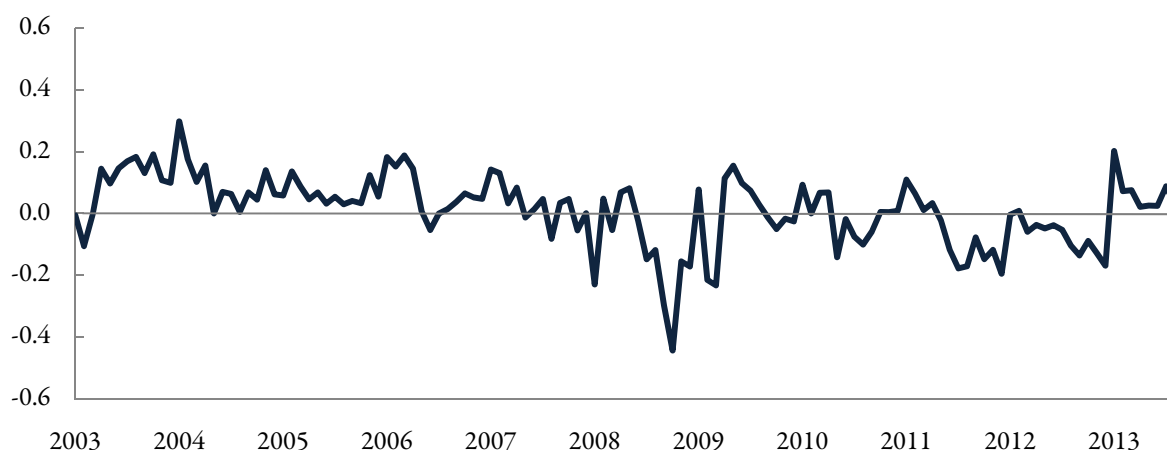
Financial Crisis: 2007–2009

During the recent financial market crisis, the stock market declined at historic rates, with the S&P 500 index falling 53 percent from October 31, 2007 to February 27, 2009. The market's decline in calendar year 2008 was the second worst annual decline in the United States since 1825. Perhaps not surprisingly given the magnitude of the decline, investors did, on net, redeem shares in equity funds. In the 17-month period November 2007 to March 2009, equity funds experienced net cash outflows cumulating to \$281 billion. These net outflows, however, equaled only 4.1 percent of the assets of equity funds at the beginning of this period (*i.e.*, as of October 2007). The bulk of these net outflows occurred during the worst of the financial crisis, July to December 2008. And yet, over these six months, the net outflows (\$205 billion) amounted to just 3.6 percent of equity fund assets.

These net outflows were modest from another perspective: they amounted to very little relative to the overall size of the stock market. For example, in no month during the period from November 2007 to March 2009 did net outflows from equity funds total more than ½ percent of the market value of stocks listed on the New York Stock Exchange and NASDAQ (Figure 3).¹¹ The largest one-month net outflow from equity mutual funds was in October 2008, when equity mutual funds experienced outflows of \$71 billion, equal to 0.44 percent of the \$15.9 trillion U.S. stock market capitalization as of September 2008.

Figure 3: Net Flows to Equity Mutual Funds as a Percent of Stock Market Capitalization*

Monthly, percent



*Includes market capitalization for the NYSE and NASDAQ stock exchanges.

Sources: Investment Company Institute and World Federation of Exchanges

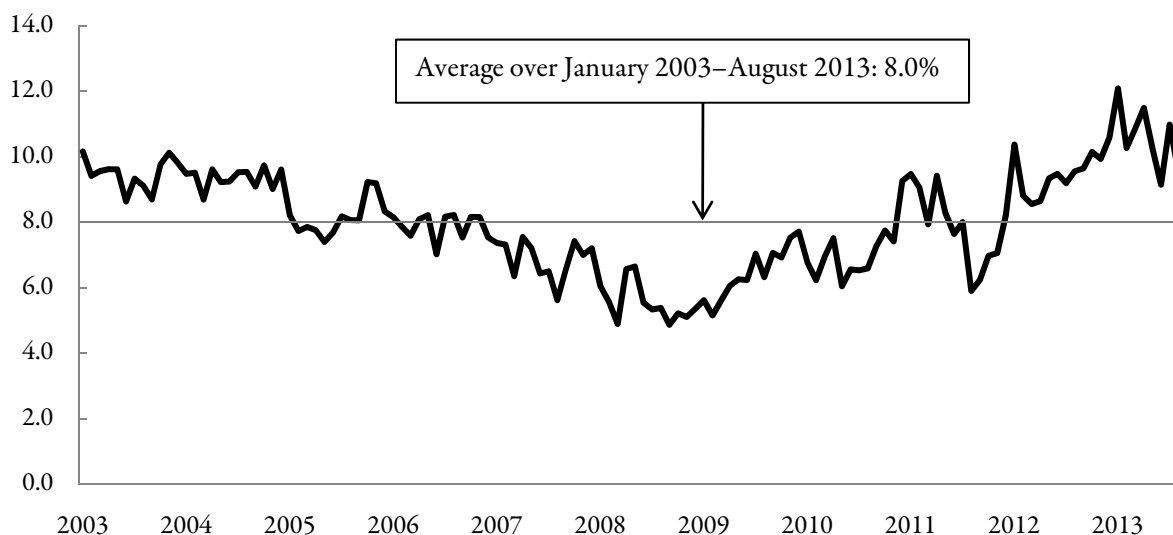
Net Outflows Unlikely to Put Significant Pressure on Stock Prices

Net outflows from equity funds are unlikely to have significantly depressed stock prices for another reason: equity mutual fund trading is small relative to the value of trading on the major stock exchanges. Figure 4 shows the value of *gross* sales of stocks by domestic equity mutual funds relative to the dollar value of domestic stock trades on the NYSE and NASDAQ exchanges (*i.e.*, the volume of shares traded multiplied by the dollar value at which those shares were traded). As the figure shows, mutual funds' sell trades have in the past decade accounted for less than 10 percent of the total value of U.S. stock trading on these exchanges. This proportion could be considered an upper bound because it does not include stock trading on other venues such as dark pools. In other words, other investors have accounted for at least 90 percent of the value of all trading in U.S. stock markets. Moreover, there is no evidence that mutual fund selling increased as a share of overall market trading during the financial crisis.

¹¹ Scaling by market value of stocks listed on the NYSE and NASDAQ exchanges *overstates* the size of mutual fund flows relative to stock market capitalization because some of the stocks held by mutual funds, such as those held by international or emerging markets funds, are listed on foreign stock exchanges.

Figure 4: Gross Sales of Stocks by Domestic Equity Mutual Funds as a Percent of NYSE and NASDAQ Stock Market Trading*

Monthly, percent

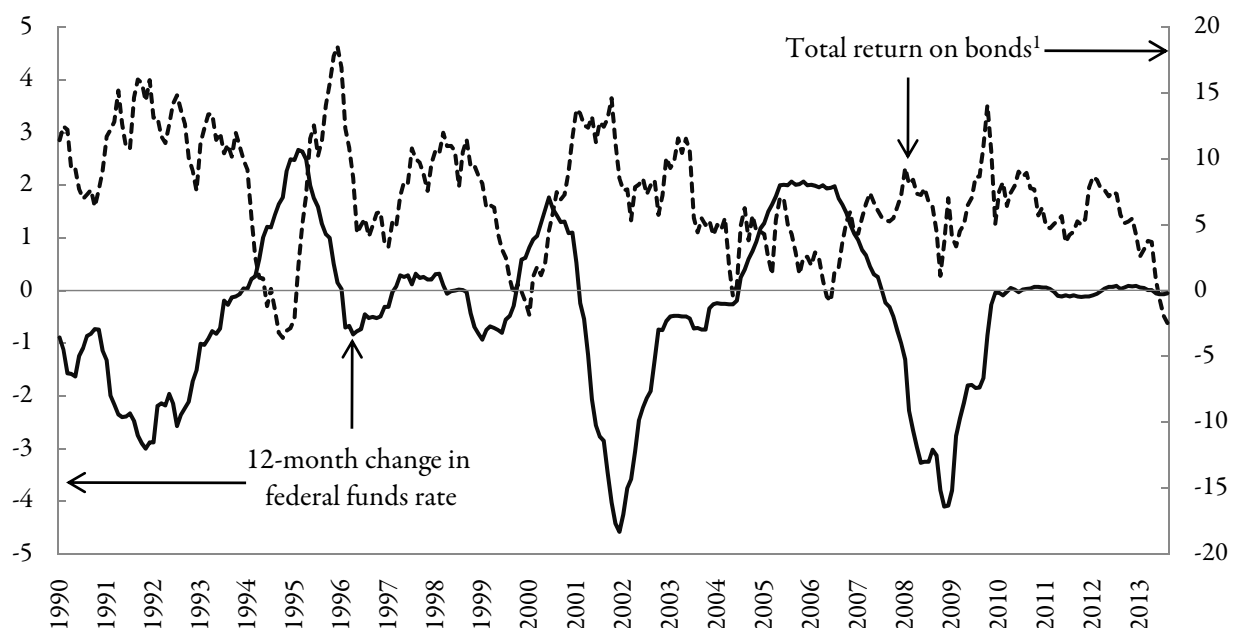


*Total value of domestic electronic order book stock trades on NYSE and NASDAQ stock exchanges, as reported by the World Federation of Exchanges; does not include trades from negotiated deals because these data are available only from January 2008 forward.

Sources: Investment Company Institute and World Federation of Exchanges

Figure 5: The Federal Funds Rate and Bond Returns

Monthly, percent

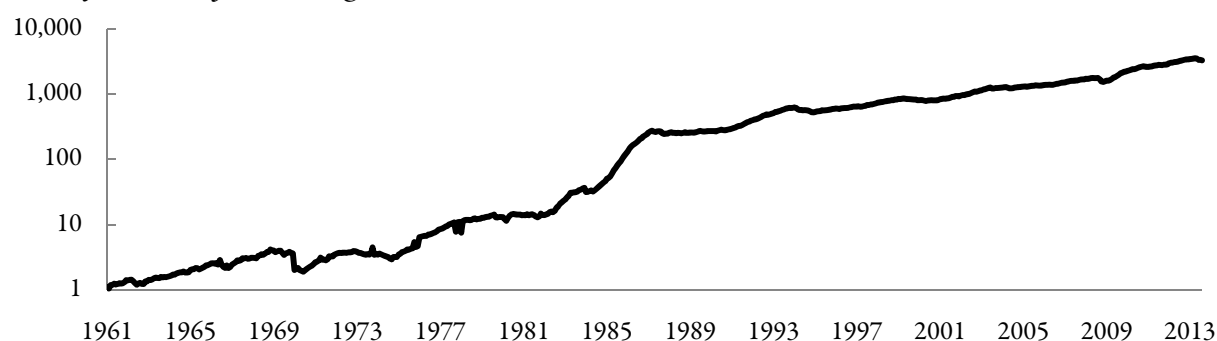


¹The total return on bonds is measured as the year-over-year change in the Citigroup Broad Investment Grade Bond Index.

Sources: Federal Reserve Board and Bloomberg

Figure 6: Assets in Bond Mutual Funds

Monthly, billions of dollars, log scale



Source: Investment Company Institute

Bond Mutual Fund Net Flows¹²

There is considerable evidence that bond mutual fund investors, like equity fund investors, redeem on net only modestly during even the worst financial crises. Bond returns have varied considerably since 1990 (Figure 5)—in a number of instances turning negative—largely reflecting periods when the Federal Reserve has tightened monetary policy (as reflected by the federal funds rate). Over this period, assets in bond mutual funds grew considerably (Figure 6). Nevertheless, during these periods of depressed bond returns, investors in bond funds, like investors in equity funds, have not redeemed precipitously. Three episodes since 1990 are instructive.

1994–1995

The first episode is 1994–1995, a period when the Federal Reserve sharply tightened monetary policy. This period was preceded by a long bull market in bonds when returns on bonds generally remained in high single to double digits for about 10 years. From February 4, 1994 to February 1, 1995, however, the Federal Reserve boosted its target for the federal funds rate from 3 percent to 6 percent, causing yields on long-term bonds to rise significantly—for example the yield on the 10-year Treasury note rose 1.85 percent—in turn leading returns on bonds to decline sharply and into negative territory for a number of months. During this time, bond mutual funds experienced net outflows totaling \$71 billion, which amounted to 11.3 percent of their January 1994 assets. These net outflows, though, occurred smoothly rather than precipitously. In no month during the twelve month period February 1994 to January 1995 did net outflows exceed 2 percent of bond funds' assets (Figure 7).

2008: The Financial Crisis

A second instructive episode is the recent financial crisis. From August to December of 2008, spreads between yields on lower-rated (Baa) bonds and Treasury securities widened by nearly 300 basis points, reflecting the weakening economy and immense stresses on the financial markets and the banking system. This, in turn, significantly depressed returns on corporate bonds. Reflecting both the falling

¹² ICI's definition of bond mutual funds excludes money market funds.

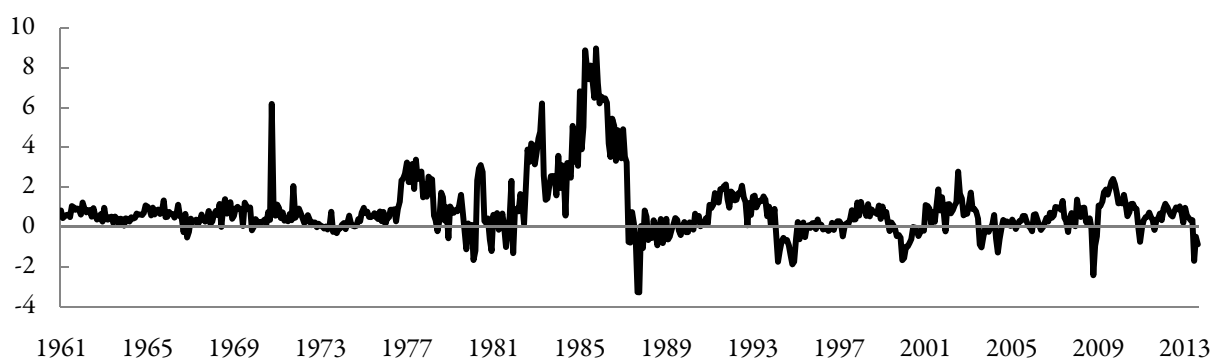
returns on corporate bonds and, importantly, a shift by all investors to the safety and liquidity of the Treasury market, bond mutual funds experienced net outflow totaling \$65 billion from September to December 2008. This amounted to only 3.6 percent of bond funds assets as of August 2008. Moreover, in none of these individual months did outflows exceed more than 2.5 percent of bond fund assets (outflows were \$41 billion in October 2008, which was 2.4 percent of bond mutual fund assets as of September 2008).

The OFR Study states that “Mutual funds faced significant redemption requests during the crisis [and that] redemptions from strategic income funds totaled \$75 billion in the fourth quarter of 2008, nearly twice the volume during the quarter a year earlier, and redemptions by investors in government bond funds were \$31 billion, 130 percent higher than during the fourth quarter of 2007.” Experiences during this period varied across types of bond funds. Bond funds investing more heavily in corporate bonds were more likely to experience net outflows, while those focusing on Treasury securities were more likely to see net inflows as investors shifted toward the Treasury market. The redemption figures listed in the OFR Study, however, are either misleading or erroneous. According to ICI figures, in the fourth quarter of 2008, Strategic Income bond funds experienced net outflows totaling only \$33 billion, which amounted to just 5.0 percent of their assets as of September 2008. Contrary to the figures cited in the OFR Study, and according to ICI data, Government bond funds received *inflows* totaling \$7.4 billion in the fourth quarter of 2008.¹³ Bond ETFs also saw net share issuance totaling \$5.5 billion in 2008:Q4. In short, during the worst part of the worst financial crisis since the Great Depression, bond fund investors remained calm and did not redeem precipitously.

¹³ We believe the discrepancy lies in either a misuse or misinterpretation by the OFR Study of ICI data. The OFR Study indicates that its figures on redemptions from strategic income funds and government bond funds come from Morningstar, but Morningstar has no category it calls “strategic income.” Thus, we believe that the OFR Study used data from ICI; ICI does have a category of bond funds entitled “Strategic Income.” We also believe that the figures the OFR Study cites for redemptions from strategic income and bond funds in 2008:Q4 are *gross* redemptions, which is a highly misleading measure of the redemption pressure that funds undergo. In any month, gross redemptions (i.e., investors redeeming out of funds) are to a great extent offset by new share purchases of the fund by other investors. It is the net difference between gross redemptions and new share purchases that is the appropriate concept for gauging overall redemption pressure on funds, which is captured by ICI’s net new cash flow figures (which this comment letter refers to as “net outflows”). ICI data indicate that gross redemptions from Strategic Income funds in 2008:Q4 totaled \$87 billion while redemption exchanges (redemptions from a given fund in a complex into another fund in the same complex) totaled \$12.5 billion. The difference (\$87 billion less \$12.5 billion) is \$74.5 billion, virtually identical to the figure cited in the OFR Study as reflecting 2008:Q4 redemptions from strategic income funds. ICI data also indicate that total gross redemptions (including sales redemptions) from government bond funds totaled \$29 billion in 2008:Q4, very close to the figure cited by the OFR Study; this, however, is a highly misleading measure of the redemption pressure on government bond funds because government bond funds actually experienced net inflows of \$7.4 billion during 2008:Q4.

Figure 7: Net Flows to Bond Mutual Funds as a Percent of Bond Fund Assets

Monthly, percent



Source: Investment Company Institute

2013: Expectations of the End of Quantitative Easing

Returns on bonds rebounded in early 2009 and generally remained in high single digits until May 2013. Over this period, bond mutual funds received inflows totaling \$1.1 trillion, reflecting not only the attractive yields available on bonds but also, to a very significant degree, demographics (the aging of baby boomers toward retirement and the greater preference of retirees and near-retirees for bonds), the increased use of target date funds (which invest in a mix of underlying bond and stock mutual funds), and the increased use by investors (in conjunction with their financial advisers) of asset allocation programs to diversify among a mix of bond and stock mutual funds as well as ETFs.

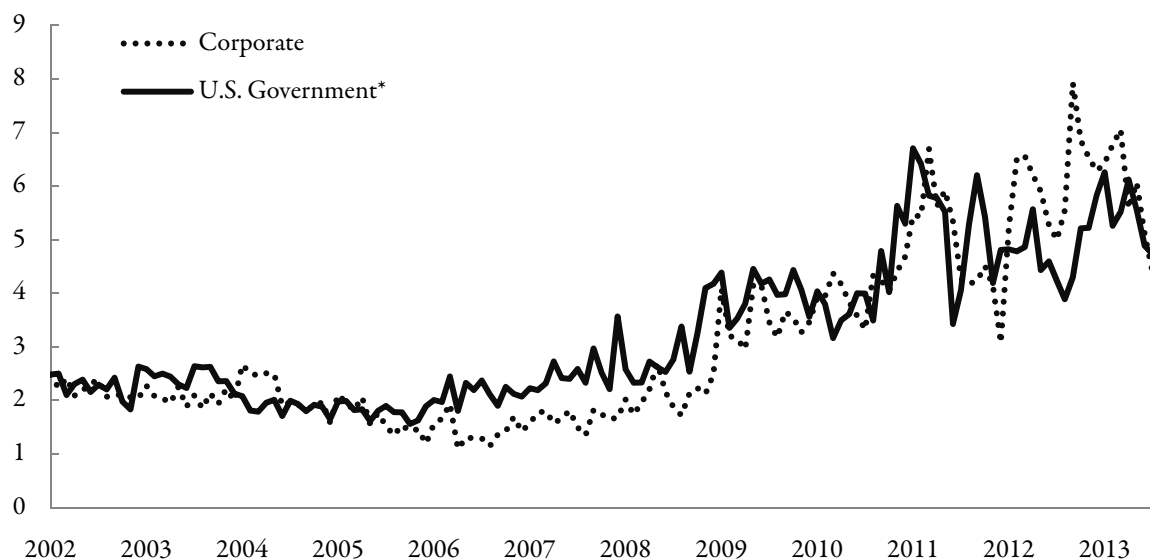
From May 1 to early July 2013, yields on long-term bonds (as measured by the yield on the 10-year Treasury note) jumped more than 100 basis points, reflecting comments by Federal Reserve Chairman Ben Bernanke that market participants interpreted as indicating that the Federal Reserve would soon begin to taper off its QE3 program of bond purchases. Consequently, from April 30, 2013 to August 30, 2013, returns on bonds (as measured by the Citigroup Broad Investment Grade Bond Index) fell 3.6 percent, the largest four-month decline since the bond market rout in 1994. Bond mutual funds did experience net outflows from June to August 2013, but they were hardly precipitous and for the most part occurred after bond yields had already increased. By the end of May 2013, assets in bond mutual funds totaled \$3.5 trillion. Over the next three months, net outflows from bond funds amounted to \$106 billion, only 3 percent of bond funds' May 2013 assets.

Thus, as with equity mutual funds, evidence indicates that bond mutual fund investors do not on net redeem precipitously in the face of financial market shocks. Moreover, as is true of equity funds, there is little reason to believe that the modest net outflows that bond funds do experience are likely to create “fire sale” pressures in the bond market. Assets in bond funds are substantial and, consequently, bond funds provide an important source of financing to businesses and government. Nevertheless, bond funds' purchases and sales of fixed income securities amount to only a small fraction of the dollar volume of trading in the bond market. For example, as Figure 8 indicates, from 2002 to August 2013, bond funds' gross purchases plus sales of corporate bonds averaged only 3.1 percent of the dollar value

of trading in such securities of market participants with primary dealers, and bond funds' percent of trading of these securities never rose above 8 percent of overall trading with primary dealers.

Figure 8: Monthly Mutual Fund Purchases and Sales of Fixed Income Securities as a Share of Primary Dealer Transactions Outside the Inter-Dealer Market

Monthly, percent



*U.S. Government primary dealer transactions consist of U.S. Government, federal agency, and mortgage-backed securities transactions.

Sources: Investment Company Institute and the Federal Reserve Bank of New York

Appendix C

Additional Information Regarding Exchange Traded Funds

As noted in the letter, the OFR Study cites two recent incidents, both of which occurred on June 20, 2013, as examples of the need to study the role exchange traded funds (“ETFs”) may have in transmitting market stress. A closer examination of these incidents would have revealed that the ETF sponsors and ETF authorized participants (“APs”) involved had engaged in sound risk management policies and that there were no market disruptions or spillovers from these occurrences.

1. An AP withdrew from accepting primary market redemptions in various ETFs because it hit an internal risk control limit.¹

Although an AP has an agreement with an ETF distributor that provides terms for ETF transactions, an AP is not legally obligated to create or redeem the ETF’s shares. Rather, APs create and redeem ETF shares only when it is in their interest to do so. As a result, in highly volatile markets, it is possible that one or more APs may stop transacting with ETFs for internal reasons, such as hitting self-imposed risk limits. This is what happened last June when an AP temporarily ceased transmitting redemption orders to various ETFs because the AP had reached an internal net capital ceiling imposed by its corporate banking parent. According to press reports, the AP had reached its ceiling and could no longer post collateral in connection with the AP’s ETF creation and redemption activity.² Although the OFR Study cites this occurrence as a possible vulnerability to ETFs and the market, there was no impact on either from the withdrawal of this AP.³ A single ETF will have multiple APs with which it transacts (some ETFs have more than 50 APs). Generally, other APs will step in to accept customer

¹ ETF shares are created when an AP, typically either the trading desk of a large bank or a broker-dealer, deposits the daily “creation basket”—a specific list of names and quantities of securities and/or other assets designed to track the performance of the portfolio as a whole—and/or cash with the ETF, generally at the end of the trading day. In return for the creation basket and/or cash, the ETF issues to the AP a “creation unit” that consists of a specified number of ETF shares. A creation unit is redeemed when an AP returns the specified number of shares in the creation unit to the ETF, typically at the end of the trading day. In return, the AP receives the daily “redemption basket,” a set of specific securities and/or other assets contained within the ETF’s portfolio. The composition of the redemption basket typically mirrors that of the creation basket, and the total value of the basket is equivalent to the value of the creation unit based on the ETF’s net asset value.

² IndexUniverse, “Bond Market Volatility Tests ETFs,” July 04, 2013.

By way of background, for large deals in the primary market, APs often post collateral against their balance sheets to address settlement timing differences relating to the underlying securities, the ETF shares, and the AP’s clients for whom they are trading. To protect against the possibility of an attempted redemption of more ETF shares than are outstanding, for example, an ETF will not release underlying securities to an AP until the AP has delivered the entire amount of ETF shares or posted sufficient collateral for any missing amount. (This policy protects ETF shareholders from losses associated with failures to deliver securities or the failure of an AP.) Good risk management policies would dictate that an AP set a limit on the amount of net collateral it can have outstanding.

³ This was not a unique occurrence—we understand that certain APs have stopped taking orders before (*e.g.*, systems failures during Hurricane Sandy and following trading losses at Knight Capital Group, Inc.) without perceptible impacts on the markets.

orders when another AP is unavailable.⁴ In addition, investors could have turned to the secondary market, which was functioning normally and not showing any signs of stress, to sell their ETF shares.

2. Another ETF opted to redeem shares only in-kind.

As noted above, a creation unit is redeemed when an AP returns the specified number of shares in the creation unit to the ETF in exchange for a set of specific securities and/or other assets contained within the ETF's portfolio. Indeed, for the ETF cited in the OFR Study, the standard protocol is redemptions in-kind. Because of the size of its asset management business, however, this ETF sponsor often can buy and sell the underlying securities of the ETF more efficiently and cheaper than a smaller firm. As an accommodation to its APs, therefore, it typically provides the option for cash redemption in exchange for a fee to cover the ETF's trading costs. The fee is set and posted in advance on its website and is not adjusted intraday; however, all cash redemptions are subject to the approval of the ETF portfolio manager. If the market for the underlying securities is volatile, the portfolio manager may believe that the cost of selling the underlying securities for the AP is likely to exceed the fee collected from the AP and, hence, will not approve cash redemptions. In these situations, APs will receive the underlying securities as is the standard procedure. In this particular instance, although the ETF portfolio manager did not make a cash redemption option available, APs' access to redemptions was never restricted—all APs requesting redemptions received the underlying basket of securities. The disapproval of cash redemptions did not appear to have an impact on the market for the underlying securities or on the secondary market for the ETF itself.

⁴ If all APs stepped away, the affected ETF shares would trade like closed-end funds temporarily.