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October 31, 2013

SUBMITTED VIA INTERNET

Ms. Elizabeth Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Re: The Report on Asset Management and Financial Stability of the Office of Financial Research

Dear Ms. Murphy:

On behalf of certain clients of our Firm, we appreciate the opportunity the Securities and Exchange Commission ("Commission" or the "SEC") has provided for public comment on the report issued by the U.S. Office of Financial Research ("OFR") entitled "Asset Management and Financial Stability" ("Report").[1] We sincerely appreciate the efforts of the SEC to invite public participation in this process, which has so many important ramifications. The leadership demonstrated by the SEC will be essential to increasing the understanding of asset management in the regulatory community and analyzing any potential regulatory policies in a rigorous, objective and transparent manner.[2]

We submit for the SEC's consideration that the Report is fundamentally flawed in many respects and analytically unreliable. In this comment letter, we focus on the flaws in the Report regarding its assessment of risks that may be applicable to U.S. registered, floating net asset value ("NAV"), open-end investment companies ("Funds") and their investment advisers.

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1 Dechert is an international law firm which acts as legal counsel to financial services firms, asset managers and investment funds worldwide, representing clients ranging from small start-up and boutique operations to some of the largest financial institutions in the world. In our practice, we represent approximately 50 mutual fund groups in the United States, amounting to hundreds of separate mutual funds.

2 We understand that some of our comments are basic and well-understood by the Commission. However, we feel compelled to make them having been invited by the SEC to comment on the OFR Report. We presume that our comments along with the SEC's own views will be passed along to the OFR, and to the FSOC, which commissioned the Report and of which the SEC and OFR are both members.

I. Executive Summary

The analysis in this comment may be summarized as follows:

1. Neither the Financial Stability Oversight Council ("FSOC") nor the OFR have laid the proper legal foundation to use the Report for its intended purpose to help the FSOC better understand asset management, any threats that may arise from it, any need for additional regulation, and whether any such regulation should involve the designation authority under Section 113 of the Dodd-Frank Act ("DFA") or an alternative response.

2. Reliance on the Report will taint the administrative record and provides a basis for companies to challenge designation and other regulatory actions that attempt to rely on the Report, including any recommendation for regulatory action such as any final FSOC proposed recommendations to the SEC regarding the regulation of money market funds ("MMFs").

3. The Report has significant and substantive factual, analytical, and methodological defects that render it completely unreliable and insufficient to form the basis of any policy determinations.

4. It paints the widely diverse asset management industry with the same brush, and draws conclusions about risks as if the industry were a monolith, failing to differentiate adequately between different investment vehicles, structures, strategies, and entities, which is essential to measuring, modeling and drawing any meaningful conclusions regarding individual vulnerabilities and systemic risks.

5. It ignores that:

    a. Investors purchase shares of a Fund with the understanding that the potential for poor investment performance, including the loss of principal, is a natural and well-understood risk;

    b. Investors do not rely on the financial strength of the investment adviser of a Fund; and

    c. Volatility and fluctuation of a Fund's NAV are normal market features, and not inappropriate risks that require extraordinary regulation and supervision.

6. The Report's concerns regarding asset management risks are based on unsupported arguments, speculation or theories that investors will conclude that Funds are engaged in undisclosed "reaching for yield" or "herding" behavior, which will trigger rapid redemptions by the shareholders who learn of such behavior.[3]

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[3] Concerns regarding Funds engaging in fire sales are dependent upon the premise that large numbers of investors will simultaneously develop concerns about undisclosed "reaching for yield" or "herding," which will cause them to redeem their interests in Funds *en masse*, causing unaffiliated Funds to engage in wide-

7. It fails to provide any substantiation or sufficient data to support its speculation that Funds are subject to significant redemption risk, or that "runs" on Funds would cause or amplify systemic risk.

8. By only acknowledging limited aspects of the SEC's comprehensive and well-tested legal and regulatory regime governing Funds, contractual limitations and basic economic realities and then proceeding with speculative discussions of risks as if none of these factors would have any impact, the Report, does not adequately take into account the myriad inherent structural safeguards that significantly mitigate the risks about which it speculates.

9. It fails to consider the stability and resiliency Funds demonstrated during the very economic crisis that led to the creation of the OFR and the FSOC, which shows that they are viewed by investors as long-term investment vehicles and strongly suggests that the risk mitigating factors described in the preceding point are effective.

10. The Report views the asset management industry unrealistically and improperly through a prudential regulatory lens that is calibrated to the proprietary risk-taking activities of banks or insurance companies, rather than the activities and purposes of the asset management industry, and ignores the fundamental difference between the role played by asset managers acting as agents for investors, as opposed to principals.

11. The Report suffers from a range of administrative defects and attempts to identify and measure risks before establishing basic definitions and metrics that the public can evaluate and use.

12. The SEC should act to ensure that its extensive understanding and regulatory perspective in regard to the asset management industry is utilized to (a) correct the fundamental defects in the Report and (b) help the FSOC better understand asset management, any threats that may arise from it, any need for additional regulation, and the appropriate form of any such regulation.

II. The Purpose of the Report

The Report's stated purpose is to respond to the request of the FSOC for the OFR to provide data and analysis that would inform the FSOC's analysis of whether and how to consider asset management firms for enhanced prudential standards and supervision under Section 113 of the DFA.

The Report does not achieve its stated purpose. In fact, it seriously misstates the risks it discusses, or simply fails to provide adequate empirical support or analysis to substantiate those which it purports to identify. Reliance on the Report by the FSOC will taint the administrative record and provide a basis for challenging any designation actions by the FSOC that rely upon it.

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scale sales of assets to satisfy redemptions in concentrated markets that are highly subject to disruption. This chain of events is both highly unlikely and highly speculative.

III. The Report Contains Substantial Inaccuracies and Analytical Defects

1. The Report Fails to Make Important Distinctions between Different Investment Vehicles and Types of Investors

The Report professes to cover the entire asset management industry in the United States, with the exception of MMFs and private funds, and seeks to explain what systemic risks of this falsely homogenized business exist. This is perhaps the single greatest flaw of the Report. It is impossible to make sound conclusions or glean meaningful guidance without a more focused effort. The asset management industry is diverse and varied in many respects that have significant implications for risk assessment and analysis. Any syllogism that is based on an erroneous predicate is defective, and that is what OFR has done with the Report.

The Report generally treats all assets under management or administration the same, regardless of the vehicle through which investors gain access to advisory services or the types of investors who gain this access. For example, an investor who gains access to a Fund through a variable annuity product or retirement account will behave differently than a retail investor investing through a self-directed brokerage account or an institutional investor, including in times of market stress. The Report makes no attempt to consider these key factors, essentially treating all assets the same in terms of risk.

2. The Report Does Not Adequately Recognize the Separation of Funds from Their Advisers

In addition to failing to distinguish between investment products and types of investors, the Report does not sufficiently address asset managers independently from the products and entities for which they provide advisory services. Although the Report concedes that asset managers "act primarily as agents[,]" it does not effectively separate the risks that may apply to a Fund from those that may apply to its investment adviser.[4] For example, the Report provides no basis or empirical data for determining that distress experienced by a manager will spread to the Funds it manages or vice versa. It is just presumed. Further, we are aware of no instances in the more than 70 year history of the Investment Company Act of 1940 ("1940 Act") where this has occurred to any meaningful degree.

Funds are separate legal entities from their investment advisers. Investors in a Fund receive shares of the Fund, which represent pro rata interests in the assets of the Fund, and the value of which fluctuates daily based on the value of these assets. The financial condition of the adviser has no bearing on the performance of the Fund's shares.

A primary purpose of the 1940 Act is to ensure the independence of each Fund by protecting it from overreaching by investment advisers and other third parties to the detriment of the Fund and its shareholders. As such, the 1940 Act imposes significant restrictions on Fund investment advisers and other Fund service providers, among others, and has the effect of separating the business affairs of a Fund from those of its investment adviser and distributor. In light of these requirements, the success or failure of a Fund's adviser should have little or no direct impact on the assets of the Fund. That appears to be what actual market experience says to those who are listening.

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[4] Report at 1.

A Fund's investment adviser serves at the pleasure of the board and the shareholders of the Fund, and any adviser may be terminated on short notice if it is deemed appropriate to do so.[5] Thus, in the event that an investment adviser experiences financial difficulty or other issues that cause the adviser to be unable to continue to properly serve a Fund, the adviser may be terminated, and the board may hire a different adviser to manage the Fund's assets. In our experience, Fund boards are keenly focused on issues that may impact the ability of an investment adviser to effectively serve a Fund, and will take appropriate action to address any concerns.

The 1940 Act and the SEC's Rules thereunder also strictly regulate how assets of a Fund may be held, providing significant barriers preventing an investment adviser or an affiliate from seizing, abusing or commingling the assets of a Fund.[6] In effect, these provisions generally require a Fund to keep assets in the custody of a federal or state regulated bank or certain other specified entities such as a futures commission merchants or foreign sub-custodians, and impose stringent limitations intended to prevent personnel of the investment adviser from misapplying Fund assets. Moreover, the use of bank custodians insulates each Fund's assets from those of other Funds, preventing any direct spillover effects from one Fund to another in the event of distress.

Section 17 of the 1940 Act and Rule 17d-1 thereunder have the effect of limiting the connections between a Fund and its investment adviser and other affiliates in a way that is intended to insulate the Fund from the adviser and other affiliates. In this regard, Section 17(a), generally prohibits any "affiliated person" of a registered investment company (a "first-tier affiliate"), or any affiliated person of such person (a "second-tier affiliate"), acting as principal, from knowingly selling any security or other property to the registered investment company, or from knowingly purchasing any security or other property from a registered investment company.[7]

Section 17(d) and Rule 17d-1 also prohibit first- or second-tier affiliates from acting as a principal to participate or effect a transaction with a Fund that would constitute a "joint enterprise or other joint arrangement or profit-sharing plan" (a "joint transaction"), without specific relief from the SEC.[8] Joint transactions include generally any plan, contract, authorization or arrangement, or any practice or

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5 Section 15 of the 1940 Act (15 U.S.C. § 80a-15) requires either a Fund's board or the Fund's shareholders to consider whether to re-approve all advisory contracts with the Fund at least once annually, and that all advisory contracts must be terminable at any time, without penalty, by the board or the Fund's shareholders on not more than 60 days' notice. Under Section 15(c) of the 1940 Act (15 U.S.C. § 80a-15(c)), an advisory contract may provide for an initial term of two years. After the expiration of this initial term, the contract must be re-approved by the board annually for it to continue.

6 *See* Section 17(f) of the 1940 Act (15 U.S.C. § 80a-17(f)) and Rules 17f-1 through 17f-7 thereunder (17 C.F.R. §§ 270.17f–1 through 270.17f–7).

7 Section 17(a) (15 U.S.C. § 80a-17(a)) is intended primarily to proscribe "a purchase or sale transaction when a party to the transaction has both the ability and the pecuniary incentive to influence the actions of the investment company." *See* Investment Company Act Release No. 10886 (Oct. 2, 1979), citing Investment Trusts and Investment Companies: Hearings on S. 3580 Before a Subcomm. of the Senate Comm. on Banking and Currency, 76th Cong., 3d Sess., at 256-59 (1940).

8 The requirement also applies to principal underwriters of the mutual fund and their affiliated persons.

understanding concerning an enterprise or undertaking whereby a Fund and an affiliate "have a joint or a joint and several participation, or share in the profits of such enterprise or undertaking."[9]

3. The Report Improperly Assesses Risks to Which Asset Managers are Subject and Fails to Justify its Emphasis on Large Asset Managers

While the Report seeks to establish a link between the fortunes of an investment adviser and the Funds it manages without providing any support, it overstates and misunderstands the risks applicable to investment advisers themselves. Unlike banks, insurance companies, and other financial institutions that invest their own assets as principals, investment advisers, in that capacity, are in the business of managing their clients' assets. Investment advisers to Funds earn revenues in the form of investment advisory fees that normally are based on a percentage of the Fund's net assets. For these reasons, investment advisers, though not immune from failure, have been far less likely to fail than other financial companies which operate balance sheet assets. Moreover, the desirable nature of the revenue stream from managing Funds and other assets also suggests that investment advisers are unlikely to disappear even in the event of insolvency, in the absence of engaging in other businesses with different risk and liability characteristics.

The data in the Report focuses primarily on large asset managers, implying that the more assets under management an investment adviser has, the more systemic risk it may pose. The Report provides no support for this implication. Having more assets under management does not make an investment adviser more systemically important in the same way that having more balance sheet assets might be viewed as causing a bank or an insurance company to be more systemically important. It is important to note that assets under management are not assets of the adviser. The capital of an adviser is not used to support or stabilize investment performance of assets under management. Tellingly, the Report does not attempt to state or imply that any one investment adviser or Fund is, or could be, large or important enough to be systemically significant solely by virtue of its investment activities.[10]

4. The Report Relies on Incorrect and Incomplete Data

Missing and inadequate data seriously limits the usefulness of the Report. The Report concedes that "there are limitations to the data currently available to measure, analyze, and monitor asset management firms and their diverse activities, and to evaluate their implications for financial stability."[11] It notes that these gaps limit its ability to determine the financial condition of asset managers, including Funds' investment advisers, or even understand their operations. It therefore appears to acknowledge that

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9 *See* Rule 17d-1(c) under the 1940 Act (17 C.F.R. § 270.17d–1(c)).

10 In fact, the Report ignores available data regarding the relatively small influence of large players in the industry, both currently and over time. According to a recent Investment Company Institute ("ICI") report, "of the largest 25 fund complexes in 1995, only 15 remained in this top group in 2012." ICI, *2013 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry* 24-25 (2013), *available at* http://www.icifactbook.org/pdf/2013_factbook.pdf ("Fact Book"). The Fact Book also notes that "the [Fund] industry had a Herfindahl-Hirschman Index number of 465 as of December 2012," where any number under 1,000 indicates a lack of concentration in an industry. *Id.*

11 Report at 2.

significant data and analysis is necessary in order to draw reasonable conclusions. This suggests a shoot, ready, aim approach to regulation. If OFR receives the data, will it be willing to contradict the concerns and conclusions it has prematurely identified? Why the rush to judgment without the data? In the absence of data necessary "to measure, analyze, and monitor asset management firms and their diverse activities, and to evaluate their implications for financial stability," isn't the only appropriate conclusion that you need more data?

In some cases, the data that actually is in the Report is misleading. Figures 1 and 2 of the Report are intended to "provide an overview of the asset management industry and its firms and activities."[12] These Figures form a key basis for many of the assertions and conclusions in the Report. Yet, the Report concedes that the data in Figure 1 is subject to "double counting" because of "cross investing" among asset managers. This is correct, but there are also other instances of double counting in the figures. For example, in the Fund context, an adviser often will retain a subadviser to provide day-to-day investment management services to a Fund. In such a case, the Figures presumably would count that Fund's assets twice, as being under the management of the adviser and the subadviser, without regard to the fact that only the subadviser controls the day-to-day acquisition and disposition of the Fund's holdings. Further, it appears that the data on assets under management in the Figures include assets under "administration," such as where an asset manager serves as a custodian for an employee benefit plan. Assets under administration should be excluded from the calculus because asset managers are not in the position to control these assets, much less their behavior in times of crisis. The data on assets under management also includes substantial assets in vehicles that have significant limits on redeemability, such as closed-end funds and private funds, and in separate accounts maintained by private clients that do not issue shares.

5. The Report Views Asset Management through the Inappropriate Lens of Prudential Regulation and Incorrectly Implies that Fund Investors Rely on the Strength of the Investment Adviser

The Report seems to view the asset management industry through a prudential regulatory lens that is simply not appropriate. Unlike banking regulation, securities regulation, including the Securities Act of 1933 ("1933 Act"), the 1940 Act and the Investment Advisers Act of 1940 ("Advisers Act"), fundamentally is generally not designed to ensure the safety and soundness of institutions or the protection of individuals' assets against investment losses.[13] To the contrary, securities regulation is appropriately designed primarily to protect investors from informational disadvantages and fraud through disclosure and, in the investment company context, overreaching from the adviser and its affiliates.[14] Risk of loss is inherent in investing, unlike with insured bank deposit accounts. When an investor buys

12 Report at 3.

13 *See, e.g.*, Edward V. Murphy, *Who Regulates Whom and How? An Overview of U.S. Financial Regulatory Policy for Banking and Securities Markets*, Congressional Research Service (May 28, 2013), *available at* http://fpc.state.gov/documents/organization/211399.pdf; Franklin Allen and Richard Herring, *Banking Regulation versus Securities Market Regulation,* Wharton School Center for Financial Institutions Working Paper 01-29 (July 2001), *available at* http://finance.wharton.upenn.edu/~allenf/download/Vita/0129.pdf.

14 *See id.* However, as discussed throughout Section IV below, the 1940 Act, the Rules thereunder, and related SEC guidance provide Funds with significant protection from many of the potential risks outlined in the Report, including redemption risk and leverage risk.

shares of a Fund, the investor specifically understands that their investment is subject to market volatility and loss, including the potential to lose all of its value. Investment risk and market volatility are not problems with the system that need correcting, they are key features of the system.

According to the Report, investors in Funds may believe that they can rely on the financial strength of the sponsor to support a Fund in times of crisis. The Report offers no persuasive support for this claim. Repeatedly, the Report relies on events and analysis related to MMFs, which the Report claims are not within its scope, and a very limited set of short-term cash-like Funds. Given the unique attributes of these funds, which are not shared by Funds generally, the Report fails to provide meaningful support for this claim. Floating NAV Funds are, by definition, subject to fluctuations in value, and no investor can reasonably *expect* an adviser to prevent losses in such Funds. An investor chooses a Fund based on its investment strategy and the perceived skill of the investment adviser to implement that strategy effectively, not based on the adviser's financial condition or an implicit guarantee of principal protection.

IV. The Report Overstates the Vulnerability of Funds to Shocks and Understates the Legal Provisions and Structural Characteristics that Protect Funds from Shocks

1. The Report Ignores the Structural Characteristics of Funds that Protect Them from Risks

Continuing with its theme of painting a diverse industry with the same, broad brush, the Report makes no effort to consider the structural and operational characteristics that provide Funds significant protection from the types of "shocks" discussed in the Report. Unlike most of the conclusions of the Report, these protections are not theoretical. In our more than 35 years as a firm representing Funds, we have never observed a floating NAV Fund of any significance failing to meet redemptions in accordance with applicable law.

Funds have transparent, uncomplicated legal structures. They are organized as corporations or business trusts, or as "series" thereof that have segregated assets and liabilities. They do not engage in multiple lines of business and are subject to asset diversification requirements under securities and/or tax law. In addition, as noted above, specific statutory restrictions prohibit Funds from engaging in most types of transactions with their investment advisers.

Funds have straightforward, highly scalable business models and have one product to sell – Fund shares. Funds do not engage in complicated business activities. As open-end vehicles, Funds are not permitted to issue preferred shares. Funds typically outsource virtually all services necessary for their operation, including asset management, administration, maintenance of share ownership records, sales, and custody of Fund investments.[15] As a result, Funds typically do not have employees in the normal sense; rather, they have a board of directors or trustees and a small number of officers responsible for taking certain actions on behalf of the Funds, which officers typically are employees of the adviser. In a striking difference from other sorts of financial companies, the purchasers of the "product" offered by a Fund – Fund investors – elect the board of directors and thus control the Fund's governance structure.

[15] These functions usually are performed by an investment adviser or subadviser, administrator, transfer agent, distributor and custodian, respectively.

Fund boards of directors or trustees are subject to state law fiduciary duties and are responsible for the oversight and supervision of a Fund's operations. Moreover, a core principle of the 1940 Act that underlies a significant portion of the regulations promulgated by the SEC, is that a Fund board must have sufficient independence from the Fund's investment adviser and other affiliated persons[16] to ensure that the Fund is operated for the benefit of investors, as opposed to others. In this regard, Section 10(a) of the 1940 Act requires that at least 40 percent of a Fund's board not be "interested persons," as that term is defined in Section 2(a)(19) of the 1940 Act, of the Fund or its investment adviser or distributor ("Independent Directors"),[17] and most Funds currently are obligated under SEC Rules to have a majority of Independent Directors.[18] Recent data indicates that for 96.5 percent of mutual fund boards, at least 67 percent of the board seats are held by Independent Directors.[19]

The members of a Fund's board have a federally imposed fiduciary duty to the Fund and its shareholders under Section 36 of the 1940 Act in addition to their state law duties. The board serves as an independent and important check on the influence of the Fund's investment adviser and other affiliated persons.[20]

Funds have transparent balance sheets, consisting of the investments held, which are subject to daily mark-to-market valuation. They have modest liabilities. In addition, Funds generally invest in relatively

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16 Section 2(a)(3) of the 1940 Act (15 U.S.C. § 80a-2(a)(3)) defines an "affiliated person" of another person to include, among others, any person directly or indirectly owning, controlling, or holding with power to vote, 5% or more of the voting securities of the other person; any person 5% or more of whose voting securities are directly or indirectly owned, controlled, or held with power to vote, by the other person; any person directly or indirectly controlling, controlled by, or under common control with, the other person; and, if the person is an investment company, any investment adviser or any member of an advisory board of the investment company.

17 Section 2(a)(19) of the 1940 Act (15 U.S.C. § 80a-2(a)(19)) defines "interested person," with respect to a registered investment company, to include any affiliated person of the company and that person's immediate family, and any interested person of the investment adviser or principal underwriter of the company.

18 *See* Role of Independent Directors of Investment Companies, Investment Company Act Release No. 24,816 (Jan. 2, 2001).

19 ICI./Indep. Dirs. Council, 2013 Directors Practices Study: Practices and Compensation 3.44 (2013).

20 Indeed, the Supreme Court has held that the very framework of the 1940 Act reflects Congress's expectation that Fund boards will exercise the authority granted to them under state law to protect the interests of a Fund and its shareholders. *See Kamen v. Kemper Fin. Svcs.*, 500 U.S. 90, 107 (1991); *Burks v. Lasker*, 441 U.S. 471, 485 (1979). Moreover, Rule 38a-1 under the 1940 Act (17 C.F.R. § 270.38a–1) requires a Fund's board to designate a chief compliance officer to report directly to the board regarding the operation of the Fund's required written compliance program. In the adopting release for Rule 38a-1 under the 1940 Act (17 C.F.R. § 270.38a–1), the SEC recognized that the Rule "provides fund boards with direct access to a single person with overall compliance responsibility for the fund who answers directly to the board. The rule provides the board with a powerful tool to exercise its oversight responsibilities over fund compliance matters." *See* Compliance Programs for Investment Companies and Investment Advisers, Investment Company Act Release No. 26,299 (Dec. 17, 2003).

easy-to-value investments in light of an SEC position that requires the vast majority of Fund investments to be in highly liquid assets that can be easily priced.[21]

2. The Report Drastically Overstates the Vulnerability of Funds to Shocks

In addition to the claim that investment advisers are sources of risk, which we address above, the Report describes three factors that it concludes make the asset management industry vulnerable to shocks: (1) reaching for yield and herding behaviors; (2) redemption risk; and (3) leverage. The Report fails to support its conclusions with respect to any of these three factors, particularly as they relate to Funds and their investment advisers.

a. "Reaching for Yield"

The Report concludes that portfolio managers may "reach for yield" to gain a competitive advantage against their peers, including portfolio managers to Funds. The Report does not clearly define or explain this phenomenon, or how it differs from normal market behavior reflecting price discovery. Moreover, the Report fails to provide the data or analysis necessary first to conclude that this behavior is significant in the Fund industry, or secondly, that Funds or managers may pose increased systemic risk if they engage in it to any meaningful degree.

Funds must invest according to their principal investment strategies, and advisers to Funds have strong incentives to invest according to these strategies to meet the expectations of shareholders.[22] Because Funds continuously offer their shares, they are required under the 1933 Act to maintain a "current" prospectus, which must be updated at least annually.[23] As the SEC well knows, it requires each Fund's prospectus to describe the Fund's principal investment strategies.[24] This disclosure must be complete and not materially misleading.[25] Investing in a manner that deviates from the prospectus disclosure could subject the Fund, its investment adviser and its board to private suits and enforcement actions by the SEC

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21 Non-MMFs are subject to an SEC requirement to limit investments in securities and other instruments deemed illiquid (generally defined as investments that could not be sold at approximately the price at which the fund has valued them within seven calendar days) to 15 percent of assets, measured at the time of purchase. The SEC imposed this requirement to "assure that mutual funds will be able to make timely payment for redeemed shares." *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992). The SEC requires mutual funds to take remedial action as promptly as possible in the event that more than fifteen percent of a Fund's assets become illiquid.

22 Report at 9.

23 *See* Section 5 and Section 10(a)(3) of the 1933 Act (15 U.S.C. §§ 77e and j(a)(3)).

24 Item 4(a) of Form N-1A, *available at* http://www.sec.gov/about/forms/formn-1a.pdf.

25 Section 11 of the 1933 Act (15 U.S.C. § 77k) has been read to impose strict liability on all the signers of any registration statement containing an untrue statement of material fact or omitting a material fact required to be stated or necessary to make the statement not misleading. In addition, Section 34(b) of the 1940 Act (15 U.S.C. § 80a-33(b)) makes it unlawful for any person to make an untrue statement of material fact in a Fund's prospectus.

and state regulators.[26] Because of these requirements, Funds' chief compliance officers routinely monitor compliance by investment advisers with prospectus disclosure regarding principal investment strategies, under the oversight of the board.

The Report is unclear as to whether it views "reaching for yield" to be a risk that only would be applicable in cases where a Fund invests in a manner that would violate its prospectus disclosure, or whether reaching for yield could be problematic when a Fund invests in accordance with its prospectus disclosure. If the Report is referring to the latter scenario, it does not explain why it would be inappropriate for a Fund to invest in accordance with its disclosure, nor does it provide any potential solutions to this alleged problem.

In any event, the Report speculates that a significant group of investors in a Fund suddenly could realize that the portfolio manager is reaching for yield and quickly redeem their shares. The Report does not explain how investors would discover this activity or under what conditions groups of investors may be willing to redeem precipitously, and does not cite any examples of this type of event ever occurring in the past with respect to a Fund.[27]

The Report also indicates that "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."[28] However, the Report fails to recognize that this structure is prohibited for Funds.[29]

Consistent with its treatment of many other areas, the Report speaks of reaching for yield in a general sense, without applying it to particular vehicles, sectors, or markets. Reaching for yield is a relative concept – a manager would reach for yield within its investment strategy only relative to other managers in similar strategies. However, even assuming that this phenomenon is significant, it only potentially could be an issue for certain sectors or types or sizes of Funds. A portfolio manager reaching for yield in a large capitalization equity Fund would present different, and lesser, risks than a portfolio manager reaching for yield in a shallow market that is prone to liquidity problems, for example. Painting all

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26 The SEC has taken numerous enforcement actions against Funds and investment advisers in the past for violations of prospectus disclosure. *See, e.g.,* In the Matter of: Top Fund Management, Inc., Investment Company Act Release Nos. 30315 (Dec. 21, 2012); In the Matter of: Pax World Management Corp., Investment Company Act Release Nos. 28344 (July 30, 2008); In the Matter of: Piper Capital Management, Inc., Investment Company Act Release Nos. 26167 (Aug. 26, 2003).

27 A systematic flaw in the Report that is demonstrated here is its propensity to offer a theoretical risk or financial catastrophe that has never occurred and build a set of assumptions and conclusions upon it. We will refrain from criticizing that kind of logic each time it occurs, but hope that the SEC will be able to impose some discipline on OFR to evaluate and analyze realistic financial risks.

28 Report at 9.

29 Section 205(b) of the Advisers Act (15 U.S.C. § 80b-5(b)) prohibits an investment adviser from charging a performance fee to a Fund unless the adviser's compensation increases or decreases proportionately based on the Fund's performance relative to an appropriate index or other measure of performance. This type of arrangement commonly is known as a "fulcrum fee."

investment products, including Funds, with the same brush renders the Report's conclusions basically useless.

Even viewing Funds in their entirety and assuming for the sake of argument that reaching for yield is a real and significant phenomenon, the Report does not consider the possible existence of a countervailing effect from portfolio managers that are outperforming peers taking a more conservative approach to "lock-in" relative performance. Just as it is unclear what the effects of reaching for yield are to Funds or the markets in which they operate, it also is unclear whether and to what extent this countervailing practice erases these effects.

b. "Herding"

The Report states that competitive pressures may cause "asset managers to crowd into similar, or even the same, assets at the same time."[30] The Report concludes that this behavior could lead to adverse market impacts. But it fails to substantiate this as a real problem, particularly for Funds. Moreover, the Report seems to suggest that herding behavior can occur both among asset managers and investors, but does not clearly explain these phenomena or quantify their separate risks, nor does it provide a method or model to determine how to discern herding from normal market behavior.

The Report contains no empirical data as to the sectors or subsectors of the Fund industry in which it believes that herding actually occurs or has occurred in the past. Moreover, it does not provide data or analysis to support a conclusion that herding among Funds could have a noticeable impact on systemic stability, as opposed to potentially increasing market volatility. There is simply no explanation or description of how investors might detect herding behavior by a Fund's portfolio manager or under what circumstances this would be likely to lead to mass redemptions.

Illiquid securities are at the most risk in the face of herding behavior, according to the Report, but it fails to take into account the SEC's limitations on investments by Funds in such securities. Funds are required to maintain the vast majority of their investments in securities and other holdings that are liquid.[31]

Furthermore, there is no justification for a conclusion that larger Funds are at a greater risk to engage in herding behavior, and therefore should be subject to enhanced restrictions that would not apply to smaller entities or the market generally. By definition, herding would be a behavior in which a large portion of a market would engage.

c. Redemption Risk

The Report states that "[a]ny collective investment vehicle offering unrestricted redemption rights could face the risk of large redemption requests in a stressed market if investors believe that they will gain an

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30 Report at 10.

31 As noted above, the SEC requires that non-MMFs maintain no more than 15 percent of their portfolios in illiquid securities, measured at the time of purchase. Moreover, the SEC requires mutual funds to take remedial action as promptly as possible in the event that more than fifteen percent of a Fund's assets become illiquid.

economic advantage by being the first to redeem."[32] This statement drastically overstates the potential redemption risks faced by Funds for several reasons. In fact, as noted above, we are aware of no instance in the more than 70 year history of the 1940 Act where a floating NAV Fund of any significance was unable to meet redemptions in accordance with applicable law.[33] This is in stark contrast to other large, complex financial institutions that offer demand accounts or have a complicated set of funding relationships, which potentially make them subject to overwhelming liquidity demands when there is a general loss of confidence by consumers.

Funds have a diverse base of predominantly individual customers who invest for retirement or other long-term goals. These investors frequently hold their Fund shares in tax-advantaged accounts such as individual retirement accounts ("IRAs"), or 529 plans that have penalties for early withdrawals.[34] As of 2012, 92 percent of households that owned Funds held at least some shares inside workplace retirement plans, IRAs, and other tax-deferred accounts.[35] Institutional investors account for a distinct minority of Fund ownership. As of 2012, data indicate that holdings of non-MMFs by institutional accounts comprised only approximately four percent of Funds' total net assets.[36]

Investors also typically invest in Funds for the long term. With respect to mutual fund accounts held outside of defined contribution retirement plans, the ICI reported that as of 2010, the average account had been open for five years.[37] Significantly, even in September, October and November of 2008, the worst period of the financial crisis, Funds experienced net redemptions of approximately $60 billion, $128

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32 Report at 12.

33 We are aware of a limited number of relatively small Funds that have failed to meet redemptions in compliance with the Section 22(e) (15 U.S.C. § 80a-22(e)) requirements, but these failures generally were caused by mismanagement or improper actions by personnel of the investment adviser or other service providers. We are aware of no such cases involving a Fund family of relative significance in the industry, or any case that involved a spillover effect to the financial system at large.

34 For example, according to data compiled by the ICI, in 2012, seventy-three percent of households owning mutual funds (*i.e.*, floating NAV Funds) indicated that their primary financial goal for their fund investments was saving for retirement, and ninety-three percent of such households indicated that they were using mutual funds to save for retirement. ICI, *Characteristics of Mutual Fund Investors*, 2012 6 (2012), *available at* http://www.ici.org/pdf/per18-07.pdf ("Characteristics").

35 Fact Book at 94. Moreover, defined contribution retirement plans and IRA assets held in equity, bond and hybrid mutual Funds totaled $5.0 trillion and accounted for 48 percent of total investments in these types of Funds. *Id.*

36 *Id.* at 105.

37 ICI, *2011 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry* 88 (2011).

billion and $41 billion, respectively,[38] on a net asset base of almost $5.8 trillion.[39] The Fund industry returned to more historic trends in terms of flows of funds quickly; in January of 2009, Funds experienced net purchases of shares totaling $25 billion.[40] Based on these experiences during the most severe and widespread crisis in living memory, it is difficult to reasonably speculate that the two types of potential triggering events described in the Report could ever have any material impact on Fund redemptions.

The Report's contention that redemption risk is significant for floating NAV Funds is in direct contrast to the FSOC's position that a floating NAV would be a solution to the FSOC's concern regarding the purported rapid redemption risk for stable NAV MMFs. The FSOC indicated in its proposed MMF reforms in November 2012 that a floating NAV, "would reduce . . . the first-mover advantage . . . because all redemptions would be priced at a fund's per share mark-to-market value."[41] Funds are required by law to value purchase and redemption orders for their shares at their NAV next-determined after receipt of an order.[42] Funds generally publish their NAVs daily at a set time, and shareholders are entitled to have their purchase or redemption orders filled using the first NAV that is set after they submit their order. This precludes the potential for mass redemptions of Fund shares based on the concern that redemptions will be dilutive of the interests of shareholders. The Report makes no mention of these important and recognized features of Funds.

In addition to the structural impact of a floating NAV, Funds are equipped to handle significant redemptions in a short period of time. Funds generally are required to satisfy investors' share redemption requests within seven days of tender.[43] Funds can and do satisfy substantial redemptions as a matter of course under all market conditions. Funds maintain a portion of their portfolios in cash or highly liquid cash equivalents in order to pay expected redemptions. Portfolio managers may increase or decrease this portion to respond to market events and anticipated redemptions. In addition, as noted above, all Funds are required to maintain the vast majority of their investments in securities and other holdings that are liquid, meaning that Funds are in a position to raise cash to pay redemptions as long as the markets are operating.

Funds could possibly experience redemptions at a level that would be difficult to manage during market disruptions of a more fundamental nature than those of 2008. However, the 1940 Act provides two separate mechanisms that would allow Funds to remain operational in periods of extreme stress. First,

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38 ICI, *Long-Term Mutual Fund Flows Historical Data* (2013), http://www.ici.org/info/flows_data_2013.xls ("Flows Data").

39 Fact Book at 144.

40 Flows Data.

41 *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, 77 Fed. Reg. 69455, 69467 (Nov. 19, 2012).

42 Sections 22(c) and 2(a)(41) of, and Rules 22c-1 and 2a-4 under, the 1940 Act (15 U.S.C. §§ 80a-22(c), 2(a)(41) and 17 C.F.R. §§ 270.22c–1, 270.2a–4).

43 Section 22(e) of the 1940 Act (15 U.S.C. § 80a-22(e)).

Section 22(e)(1) permits Funds to postpone the payment date during any period during which the New York Stock Exchange is closed other than customary week-end and holiday closings.[44] Presumably, the New York Stock Exchange would be likely to close during the sorts of episodes of extreme market distress that might cause mass redemptions in Funds. Such a suspension of redemption rights would immobilize Fund assets without any further action necessary on the part of the SEC, until the Exchange opened again.

In addition, a Fund may suspend redemptions in emergency situations where it would not be reasonably practicable for the Fund to dispose of its securities or to determine its NAV.[45] The SEC is directed to determine the conditions under which such an emergency exists, and could promptly make such a determination, providing Funds the ability to suspend redemptions in certain circumstances in reliance on this provision.[46]

Finally, the SEC is authorized to order suspensions of redemptions to protect a Fund's shareholders.[47] The SEC has granted such relief in the past in a variety of situations, typically in circumstances in which a Fund's investments are, for one reason or another, difficult to value correctly.[48]

If the SEC believed that a Fund in need of such relief would never be in a position to recommence operations, it also could seek to appoint a receiver to conduct the orderly liquidation of the Fund once it has ordered the suspension of redemptions.[49]

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44 Section 22(e)(1) (15 U.S.C. § 80a-22(e)) also permits Funds to postpone redemptions when trading on the New York Stock Exchange is restricted. The SEC is required to determine the conditions under which trading is deemed to be restricted.

45 *See* Section 22(e)(2) of the 1940 Act (15 U.S.C. § 80a-22(e)(2)).

46 *See, e.g.,* MSB Fund, Inc. (pub. avail. Feb. 10, 1995) (stating that the SEC staff would not recommend enforcement against a fund for not mailing redemption checks while the entity that served as its investment adviser, administrator, transfer agent, and custodian had its assets frozen and prior to the assets being released by the entity's regulator); Investment Co. Institute (pub. avail. Mar. 20, 1986) (stating that the SEC staff would not recommend enforcement against municipal bond funds that had suspended the right of redemption and had not calculated its net asset value under Section 22(e)(2) (15 U.S.C. § 80a-22(e)(2)) when an emergency condition existed in the municipal bond market making it not reasonably practicable for the funds to value their net assets).

47 *See* Section 22(e)(3) of the 1940 Act (15 U.S.C. § 80a-22(e)(3)).

48 *See, e.g.,* In the Matter of: Centurion Growth Fund, Inc., Investment Company Act Release Nos. 20204 (Apr. 7, 1994) and 20210 (Apr. 11, 1994); The OTC-100 Fund, Inc., Investment Company Act Release Nos. 16846 (Mar. 3, 1989) and 16866 (Mar. 15, 1989); In the Matter of Suspension of Redemption of Open-End Investment Company Shares Because of the Current Weather Emergency, Investment Company Act Release No. 10113 (Feb. 7, 1978).

49 *See, e.g.,* SEC v. Alpine Mutual Fund Trust, Civil Action No. 91-2027, SEC Litigation Release No. 13101 (Nov. 21, 1991) (seeking to have a receiver appointed for failure by a fund to timely redeem its shares under Section 22(e), among other issues); Sec. & Exch. Comm'n v. Charles W. Steadman, SEC Litigation Release No. 12167 (July 17, 1989) (seeking to have a receiver appointed where, in violation of Section

Even beyond these protections, Funds are permitted to redeem "in-kind" under certain circumstances (by delivering securities and other investments as opposed to cash), and many make in-kind redemptions to institutional investors as a matter of course. This allows Funds to satisfy redemption requests without having to sell portfolio holdings, which could be particularly helpful in addressing situations where institutional investors in the Funds wish to redeem their holdings and market liquidity for the Fund's assets has been impaired. Moreover, it is typical for Funds to enter into credit agreements with banks that provide committed lines of credit to the Funds for use in emergency situations such as to meet unforeseen redemption activity, which the Report itself notes in several places.[50] In practice, it is extremely rare for Funds to have to draw on these lines of credit.[51]

3. The Report Overstates the Impact of Funds' Use of Leverage

The Report contends that leverage is a source of risk and can contribute to shocks. However, the risks of leverage are drastically overstated when it comes to Funds, and the Report provides no analysis or support for the contention that leverage undertaken by any Fund in particular or Funds in general materially contributes to systemic risk.

Funds are subject to Section 18 of the 1940 Act and related SEC Staff guidance, which require Funds to limit leverage by requiring that they maintain 300 percent asset coverage for bank borrowings and to earmark sufficient liquid assets on a mark-to-market basis to "cover" 100% of a Fund's obligations created by derivatives and other transactions that create leverage. These requirements effectively prevent Funds from taking on excessive leverage.

The Report cites two examples of Funds that ran into trouble during the crisis partially as a result of their investments in derivatives that had the effect of increasing leverage. However, the first example resulted in an SEC enforcement action for inadequate disclosure and the other resulted in a significant out of court settlement for a stable NAV fund. The fact that the first example resulted in enforcement action shows the rarity of the problem and that it represented a situation where there was alleged wrongdoing. The second example related to a stable NAV fund, which was unregistered, having no bearing on an analysis relating to floating NAV, registered Funds and out of the scope of the Report.

22(e), a fund was improperly computing its net asset value and selling and redeeming its shares, among other problems); SEC v. Falcon Fund, Inc., SEC Litigation Release No. 6417 (July 2, 1974) (seeking to have a receiver appointed with respect to a fund in violation of Section 22(3) for suspending the right of redemption, as well as other issues); SEC v. Financial Fund, Inc., SEC Litigation Release No. 6359 (May 8, 1974) (seeking to have a receiver appointed when, among other items, a fund had suspended the right of redemption and violated Section 22(e)).

50 *See* Report at 7, 12 and 21.

51 Footnote 5 of the Report contends that these lines of credit may have the effect of allowing fund managers to decrease the amount of cash on hand, creating potential liquidity risks. However, in our experience, lines of credit are rarely used by Funds and generally do not factor into the manner in which Funds are invested.

4. The Report Fails to Substantiate Impacts of Funds' Counterparty and Credit Risks

The Report asserts that counterparty and credit risk are significant for the asset management industry and for Funds. However, it fails to explain with any specificity what systemic financial stability concerns it has with regard to the possibility that Funds will transmit or amplify risk in other market sectors or to the broader financial markets. Moreover, the Report does not specify the characteristics or factors that might make certain counterparties more risky than others, nor does it explain what types of counterparty risks exist or how these relate to the Fund industry.

"Funds are not specifically required to conduct ongoing credit analysis of their derivatives counterparties,"[52] according to the Report. While there is no explicit regulation or Rule under the 1940 Act that addresses this issue, investment advisers, on behalf of Funds, routinely engage in substantial counterparty credit analysis as part of investing Fund assets. Moreover, in our experience, most major investment advisers and Fund families have investment risk management programs that are designed in large part to consider and assess counterparty risk, particularly after the 2008 crisis.

5. The Report Overstates Funds' Role in Market Disruptions from Fire Sales

The Report contends that fire sales lead to higher demand for liquidity, which can magnify or spread quickly across asset classes and financial institutions. However, it again provides no empirical data to support the belief that fire sales could cause systemic impacts, or the role a Fund or Funds in general would be likely to play in such a situation. Moreover, there is no explanation offered to identify the circumstances in which a Fund would be forced to engage in a fire sale, despite all the structural and regulatory protections discussed above. These protections provide Funds with great flexibility to deal with redemption requests, including portfolio liquidity requirements and the ability to redeem shares in-kind, which would avoid the need to sell assets to meet redemptions.

Furthermore, there is no data provided to support its belief that fire sales in a particular sector would be likely to impact systemic financial stability or to measure any hypothetical impacts. The Report fails to recognize that Funds have incentives to avoid fire sales. Harm to a market in which a Fund participates could also constitute harm to the Fund, including its NAV.

Consistent with flaws in other aspects of the Report, the report fails to distinguish among markets, sectors, and investment vehicles to a degree that would be necessary to draw any useful conclusions. Fire sales are only likely to be a potential issue in markets that are prone to liquidity problems. Any analysis of the risks and potential harms of fire sales from Funds must be limited to those Funds that operate in those markets and represent large enough participants to make an impact. Furthermore, the causal link to Funds must be clearly modeled and measured – as should its potential impact on the financial system and the economy and the intended effects of alternative regulatory responses. The Report simply fails to make these basic distinctions.

52 Report at 21.

Moreover, it does not provide any answers to the fire sale problem. It fails to provide any justification for the notion that asset managers or Funds should be uniquely restricted in their ability in times of market stress to dispose of securities.

V. The Report Represents Significant Legal and Administrative Defects

The Report is a classic administrative attempt to put the cart before the horse and short-cut a sound and fair development of an administrative record upon which determinations may be made. To that extent, it suggests to us that perhaps its purpose may be goal-oriented rather than analytically driven. Furthermore, it is impossible to comment effectively about risks and market characteristics when no definitions, metrics or standard formats have been established.

In that regard, the Report's legal and procedural defects, among others, fall into several categories.

1. The Report is arbitrary and capricious given its numerous defects, including among others set forth herein:

    a. Its failure to separately consider and analyze different segments of the asset management industry;

    b. Its significant and admitted data gaps;

    c. Insufficient empirical data to support critical assertions;

    d. Its highly speculative claims; and

    e. The absence of identified authors whose credentials, experience, and potential biases may be evaluated.

2. The Report jumps the gun, is improper and prevents meaningful public analysis and comment to the extent that neither FSOC nor OFR have complied with Sections 153 and 154 of the DFA by first adopting rules, regulations or orders which, among other things:

    a. Standardize the types and formats of data reported and collected;

    b. Develop tools for risk measurement and monitoring;

    c. Provide for coordination with FSOC member agencies in regard to standardizing the types and formats of data reported and collected; and

    d. Address the confidentiality, information security, and sharing of data.

VI. Requests for SEC Action

Much of the activity discussed in the Report falls under the primary jurisdiction of the SEC under the federal securities laws. The SEC has nearly eight decades of experience in the areas purportedly addressed by the Report. We believe that the numerous flaws in the Report indicate that the writers of the Report may not have fully taken advantage of the SEC's comprehensive understanding and knowledge of the asset management industry.[53]

We believe it is essential that any consideration by the FSOC of the asset management industry be based upon a fair, objective, and knowledgeable description and analysis of the multiple segments of the industry. Any such analysis must inevitably have the full benefit of the SEC's input.

Accordingly, we request that the SEC consider the public comments it receives in regard to the Report. We request that based on the SEC's expertise regarding the asset management industry and the comments it receives on the Report, that it advise the OFR and the FSOC that the Report is fundamentally flawed and cannot be relied on. We further request that the SEC request that the FSOC request that the OFR withdraw the Report.

In the alternative, we request that the SEC request that the OFR to invite comments from the public directly to it regarding the Report and take these comments fully and appropriately into account when and if it produces any new reports regarding the risks applicable to the asset management industry. In such circumstances, we request that the OFR consult in a full and open manner with the SEC staff and accept and consider comments and suggestions from the SEC regarding all relevant aspects of the asset management industry in connection with any future publications the OFR may issues or other actions it may take.

VII. Conclusion

For all the reasons set forth above, the Report is unreliable and should not serve as the basis for policy action of any type. Any attempt to do so lays the groundwork for significant administrative challenges to the work of OFR and the FSOC.

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53 *See* Sarah N. Lynch, SEC Sees Flaws in New Treasury Asset Manager Report: Sources, Reuters (Oct. 7, 2013), *available at* http://www.reuters.com/article/2013/10/07/us-sec-assetmanager-report-idUSBRE9960XD20131007. Indeed, a United States Government Accountability Office ("GAO") report concluded that promoting coordination among FSOC members (including the SEC) is "critical" to the ability of the OFR and the FSOC to "achieve their missions." GAO, *Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions* (GAO-12-886; Sept. 2012) at 54.

We appreciate your consideration of our comments.

Sincerely,

Thomas P. Vartanian