SIDLEY AUSTIN LLP
SIDLEY

SIDLEY AUSTIN LLP
787 SEVENTH AVENUE
NEW YORK, NY 10019
(212) 839 5300
(212) 839 5599 FAX

BEIJING
BOSTON
BRUSSELS
CHICAGO
DALLAS
FRANKFURT
GENEVA
HONG KONG
HOUSTON
LONDON
LOS ANGELES
NEW YORK
PALO ALTO
SAN FRANCISCO
SHANGHAI
SINGAPORE
SYDNEY
TOKYO
WASHINGTON, D.C.

FOUNDED 1866

November 1, 2013

VIA E-MAIL: rule-comments@sec.gov

Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090
Attn: Elizabeth M. Murphy, Secretary

Re: **"Asset Management and Financial Stability"**
Office of Financial Research of the Treasury Department (September 2013)

Ladies and Gentlemen:

Sidley Austin LLP[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission (the ***SEC***) regarding the report entitled, "Asset Management and Financial Stability" (September 2013) (the ***Report***),[2] published by the Office of Financial Research of the Treasury Department (the ***OFR***).

Introduction

The OFR prepared and published the Report at the request of the Financial Stability Oversight Council (the ***Council***), which is studying the activities of asset management firms to better inform its analysis of whether to consider such firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (***Dodd-Frank***). The Council asked the OFR, in collaboration with Council members, to provide data and analysis to inform this consideration. On September 30, 2013, the SEC requested that the public provide feedback on the Report.

[1] Sidley is a global law firm with more than 1,700 lawyers in 19 offices around the world. Sidley advises asset managers and investment funds with respect to a wide range of matters involving the Investment Company Act of 1940 (the ***Investment Company Act***), the Investment Advisers Act of 1940 (the ***Investment Advisers Act***) and the Securities Act of 1933 (the ***Securities Act***), including the applicability of the these and various other laws and related regulations to different types of fund entities, including investment companies registered under the Investment Company Act.

[2] The Report is available at: http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

We appreciate the OFR's efforts in producing the Report at the request of the Council. The question of the applicability of Section 113 to various large non-bank financial institutions is of importance both to the stability of the nation's financial markets and to the resilience and growth of the U.S. economy they serve. We know that the Council understands that designation of one or more asset managers or funds as a systemically important financial institution (***SIFI***) pursuant to Section 113 would represent a dramatic shift in the regulation of such entities and that, even if limited to a few entities, such designations could nonetheless significantly alter the asset management industry, the capital markets and the economy in ways that must be objectively, rigorously and transparently analyzed. In light of these very important considerations and the considerable work yet to be done to produce the required analysis, we are pleased to provide the following information and legal analysis, which we believe may be useful to the SEC and the Council.

Our Approach

At the outset we note that the Report was, in most respects, intended as a work of economic and market research, and that as lawyers we would not propose to address it on these terms. Rather, we have analyzed the Report in light of existing laws and regulations applicable to asset management firms as they relate to the activities and risks discussed in the Report.

In this regard, we note that one of the factors that the Council must consider when making determinations under Section 113 in respect of a company is "[t]he degree to which the company is already regulated by 1 or more primary financial regulatory agencies."[3] In addition, we note that where a SIFI candidate has a primary functional regulator, the Council must consult with that regulator before making a Section 113 determination about that candidate.[4] Perhaps equally relevant for purposes of this letter is the fact that complementing its authority to designate *entities* as SIFIs is the Council's authority to make recommendations to regulatory agencies as to *financial activities or practices* where it believes new or heightened standards and safeguards should apply.[5] It is thus critically important that the Council be informed of the

[3] Dodd-Frank Section 113(a)(2) reads: "In making a determination under paragraph (1) [regarding the designation of a U.S. non-bank financial company as a SIFI], the Council shall consider— . . . (H) the degree to which the company is already regulated by 1 or more primary financial regulatory agencies."

[4] Dodd-Frank Section 113(g) reads: "*Consultation.* — The Council shall consult with the primary financial regulatory agency, if any, for each nonbank financial company or subsidiary of a nonbank financial company that is being considered for supervision by the Board of Governors under this section before the Council makes any final determination with respect to such nonbank financial company . . . ."

[5] Under Dodd-Frank Section 120(a), the Council "may provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards . . . for a financial activity or practice conducted by . . . nonbank financial companies under their respective jurisdictions, if the Council determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems spreading among bank holding companies and nonbank financial companies, financial markets of the United States, or low-income, minority, or underserved communities." We note that in addition to its formal authority under Section 120, the Council may also make recommendations and suggestions as contemplated by Dodd-Frank Sections 112(a)(2)(E), (F) and (K). We note further in this regard that a September 2012 GAO report encouraged the Council and the OFR to "further promote collaboration among FSOC's members and with external stakeholders, which is critical to their ability to achieve their missions." GAO, Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions (September 2012), p. 54.

relationship that existing laws and regulations bear to the activities and risks addressed in the Report.

We also note that the Report disclaims any significant consideration of money market funds, hedge funds, private equity funds and other private funds.[6] As a consequence of excluding those and other[7] pools of managed assets, the Report presents an incomplete picture of the industry. Also as a consequence, we offer only limited comments regarding these important asset management areas, and most of our comments concern investment management firms in their roles as advisers to investment companies registered under the Investment Company Act.[8]

As we discuss in some detail below, we believe that the activities and risks cited in the Report, inasmuch as they relate to investment management firms advising registered investment companies, are well addressed by existing law and regulation, and that the SEC's oversight in this area is active, substantial and effective. Accordingly, we do not believe that the Report supports the proposition that investment management firms or the funds they advise require substantial additional (or substantially different) prudential regulation, which SIFI designation or any other attempt to impose on them prudential standards under Dodd-Frank would represent.

We of course recognize that consideration of the Report is far from the end of the Council's broader analysis of the asset management industry; however, we emphasize that, given the Report's express limitations as to scope (*e.g.*, excluding private funds and money market funds) and its acknowledged limitations as to available information (particularly in the realm of separate accounts), the Report does not provide a basis for informed policy discussions of industry activities or participants. Moreover, it is insufficient to support regulatory action of any sort, including a determination that one or more large funds or managers should be designated as SIFIs.

Our detailed comments are organized in the attached tables, which address, in order, the "Vulnerabilities" and "Transmission Channels" cited in the Report. As noted above, we have focused our comments on observations and analyses of the statutory and regulatory regime applicable to registered investment companies and their advisers. In this context, we offer two basic kinds of input: (i) we suggest how the risks cited in the Report are currently addressed under applicable law; and (ii) we clarify aspects of the Report that seem to confuse different kinds of regulatory treatment applicable to different kinds of entities and activities.

The tables do not address two aspects of the Report: (i) the Report's observations regarding limitations of available data ("Data Gaps" in the Report's lexicon) and (ii) relatedly, the Report's observations about separate accounts. In the following executive summary, we treat

---

[6] *See* Report, p. 2 ("The report does not focus on particular risks posed by money market funds. . . . In addition, the activities and risks posed by hedge funds, private equity, and other private funds are not addressed in detail.").

[7] In focusing on "private investable assets" (*see* Report, p. 4, Figure 1), the Report also ignores large pools of government-managed investable assets, including those managed by the Federal Reserve, the GSEs and sovereign wealth funds.

[8] We will point out, however, based on our substantial experience advising participants in the broader asset management industry, portions of the Report in which the OFR has unduly conflated risks attendant to one part of the market with those of another.

these two subjects in brief, as they lend themselves less directly to the kind of legal analysis that we are able to provide regarding the balance of the Report.

Executive Summary

As noted above, the detailed commentary presented in the attachment to this letter follows the outline of the principal two sections of the Report ("Vulnerabilities" and "Transmission Channels"). It also takes into account each section's designated subsections. Our commentary is then organized by reference to the principal OFR concerns that are discussed in the Report. We summarize that commentary in the bullet points below.

As a general matter, the Report's discussion of each of these categories relies too often on generalized conclusions and limited references that do not meaningfully buttress the principles they are intended to support. In addition, the Report frequently confuses one type of asset management business with another (*e.g.*, registered vs. unregistered funds) and pays inadequate attention to current laws and regulations and ongoing efforts by the SEC to improve the existing regulatory framework. Moreover, the failure of the Report to cite evidence of asset managers or registered investment funds having contributed in a significant manner to the market risks addressed in the Report is telling, particularly in light of the recent financial crisis. These deficiencies undermine the Report and hamper, rather than spur, a constructive discussion of the issues it seeks to address.

1. ***Vulnerabilities***

   a. *Reaching for Yield and Herding*. In this section we noted three principal risks that concern the OFR:

      i. The risk that investors who fail to appreciate the risks of their investments will engage in heavy redemptions once the risks are understood.

         - The extensive disclosure regime under the Securities Act and the Investment Company Act limits significantly the risk that investors will not understand the risks entailed by their registered investment company investments.

         - The Report does not cite any data or even any instance when this risk – investors in registered investment companies rushing to exit their fund investment upon appreciating hidden risk – actually occurred. A key statement in this section – "investors might not fully recognize or appreciate the nature of risks taken by their portfolio managers, despite required disclosures and investment mandate restrictions" – is not in fact supported by the reference cited for the proposition.[9] As noted above, this is a recurrent flaw in the Report.

         - Designation of investment management firms or their advisee funds as SIFIs would do little, if anything, to address informational issues, even if such issues were prevalent. To the extent concern remains regarding the content and efficacy of disclosure, the SEC is in the best position to address any such shortcoming.

[9] *See* discussion at pp. 16-17 below.

ii. The risk that asset managers will engage inappropriately in risky investment strategies to improve their own standing or compensation.

- There are significant existing legal restrictions that protect investors from being harmed by investment adviser conflicts of interest. First and foremost, investment advisers are subject to strict fiduciary duties requiring them to act in the best interest of the investment companies that they advise. Moreover, the Investment Company Act and the Advisers Act both impose detailed regulatory restrictions and requirements that reinforce these duties.

- The Report provides no basis for concluding that the imposition of Federal Reserve oversight and enhanced prudential standards would serve remaining concerns regarding conflicts of interest. One of the Report's cited references stands, in part, for the proposition that conflicts of interest are inherent in the asset management process, as they are in any agency/principal commercial arrangement.[10] The SEC has had long experience managing these inherent issues through regulation and oversight, and we believe that any need for additional regulation in this regard should follow the course of previous regulation in the area. This is particularly true because the Report does not cite any evidence of conflicts of interest actually exacerbating systemic risk (for example during the 2007-2008 timeframe).

iii. The risk that investment companies will facilitate investor herding behavior and contribute both to the formation of asset bubbles generally and to the possibility of dislocations in illiquid markets specifically.

- The Report neither defines "herding" with any rigor nor suggests any framework for identifying it. The Report suggests that herding behavior may be the result of certain assets "appear[ing] to offer the best returns relative to the risks;" however, the Report offers no insight as to the distinction between "bad" herding activity, on the one hand, and "good" risk/reward investing pursued in parallel by multiple market participants, on the other.[11]

- The Report fails to recognize that, in the context of collective investment vehicles, investors – not the funds or their investment managers – drive market effects. In fact, investment diversification by fund managers may reduce risk in the market by buffering individual investors' inclination to "herd."

---

[10] The cited studies (*see* Report, p. 9, note 11) address inherent conflicts of interest between agents and principals in the context of asset management and point out that asset managers may engage in more (or, in some cases, less) risky behavior as a result, but they do not provide evidence of related systemic risk.

[11] *See* discussion at pp. 19-20 below.

- As to the risk of crowding into illiquid markets, we note that historical SEC staff guidance has required that at least 85% of an open-end registered investment company's portfolio be invested in assets that can be sold in seven or fewer days at approximately their carrying value. This restriction renders highly unlikely the risk of the kind of shocks associated with excessive exposures to illiquid assets.

- As to the broader risks associated with asset bubbles, it is true that market participants can unduly (at least in hindsight) pressure asset prices upward through their investment activity. Asset managers, acting on behalf of their investor-principals, can act as one mechanism for this. But this is simply the nature of markets – or, put another way, of all market participants. Nothing in the Report suggests that asset managers and investment companies play any role in the formation of asset bubbles that differs from that played by individual investors or that SIFI regulation would address. In other words, the Report does not indicate how the interposition of a collective pool, on its own, introduces new or increased risk. The Report's reference to ETFs as a potential contributing factor is a case in point. Nothing in the Report explains how treating one or more investment management firms or ETFs as SIFIs would lessen the fact that investors may buy and sell ETFs or the assets held by ETFs directly in a manner that contributes to bubble formation and deflation.

- The creation of asset bubbles is a macroeconomic phenomenon, and should be addressed accordingly at the market level, if at all, rather than at the level of individual firms. In contrast, whatever the scope of eventual prudential regulation for SIFIs adopted under Section 165 of Dodd-Frank,[12] the regulation would, by its nature, focus on single institutions; it would reflect the microeconomic supervisory mechanism of the SIFI provisions. The Report offers no explanation for the mismatch between the macroeconomic risks cited and the potential microeconomic regulation at issue.

b. *Redemption Risk*. Under this heading the OFR seems to address the following risks:

   i. The risk of a mismatch between investment company investor redemption demands and investment company liquidity.

   - As noted above (in the context of risks associated with crowding into illiquid markets), registered investment companies that are subject to daily redemption requirements (open-end funds) must, because of these requirements, maintain at least 85% of their portfolio in assets that may be liquidated in one week. We also note that many registered investment companies reserve the right to settle redemption demands

[12] The Federal Reserve has proposed rules under Dodd-Frank Sections 165-166. *See* "Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies; Proposed Rule" (January 5, 2012), 77 FR 593.

"in-kind" and that, while this is a relatively rare occurrence, the Report's own references indicate that the right can be exercised effectively, particularly in cases of very large redemption requests.[13]

- To a significant degree, the Report's discussion of risks associated with redemption rights is a restatement, via reference to the redemption mechanism, of the risks described in the preceding section – those of investor herding and the creation and deflation of asset bubbles. This is not surprising since, as observed elsewhere, investment management is at its core an agency arrangement in which fund investors, not the funds themselves or their managers, drive the related market effects. No support is provided for the proposition that investor redemption behavior independently poses a risk *per se* for registered investment companies let alone for U.S. financial stability.

ii. The risk associated with investment companies that are used for short-term investments.

- The Report provides no data on this point; rather, it cites two anecdotal cases in which funds that operated under short-term investment guidelines lost significant value. But nothing in the record related to those funds suggests that they are exemplary of risks associated with daily redemption rights related to registered investment companies.[14] One of the two cases did not involve a registered fund at all but, rather, a private fund formed in accordance with Section 3(c)(7) of the Investment Company Act for the benefit of large institutional investors. The second case did involve a registered investment company, but there is no evidence in the record that this fund suffered liquidity pressures due to redemption requests. Indeed, the SEC press release announcing settlement of related enforcement proceedings noted an entirely different reason for liquidity problems (payment obligations under derivative contracts – discussed in the comments on leverage below). One might surmise from the fact that this was an enforcement action that this was an exceptional case, not a representative example of any kind of risk typically associated with funds generally.

- More generally, the Report employs an inappropriate juxtaposition of, on the one hand, the two funds cited and, on the other hand, money market funds in general. As noted above, the latter are expressly excluded from significant consideration under the Report because they are *sui generis* and are appropriately the subject of independent study and consideration by the SEC in the context of proposed enhanced regulation. This is appropriate because money market funds represent

---

[13] *See* discussion at p. 24 below.

[14] *See* discussion at pp. 24-25 below.

a different risk profile: they seek to maintain, in a way that other registered investment companies do not, a stable NAV, and they are used by some market participants as *de facto* substitutes for bank deposits. By speaking of short-term bond funds in the same breath as money market funds, the Report implies that they present similar risks. No justification is presented in the Report for this implication.

iii. The risk associated with securities lending activities.

- In its discussion of redemption risks, the Report also raises concerns about securities lending. Notably, no evidence is presented that would suggest that securities lending by registered investment companies has been associated with large redemption demands or, for that matter, any other kind of risk.

- It bears emphasis that, like other kinds of leverage, leverage associated with securities lending – the fact that a lender of securities typically receives cash collateral which it then invests, resulting in a leveraged portfolio to the extent the cash is invested in other securities – is strictly limited by existing regulation of registered investment companies. Effectively, such funds may lend no more that one-third of their assets, and they must receive cash or government securities as collateral. This alone severely limits the risk associated with securities lending activity.

- Against this background, the Report cites two instances of trouble associated with securities lending. Both are inapposite in the context. One is the case of AIG, which incurred very significant losses when it invested cash collateral in new securities that lost significant value; this example is of little relevance here since it has nothing to do with investment companies. The second case is cited for the proposition that: "Some asset managers also invested cash collateral in assets adversely affected by the financial crisis, such as structured investment vehicles and Lehman Brothers notes, and they provided financial support to those cash collateral reinvestment funds." But the case does not involve an investment company that had difficulty because of *its own* securities lending (and cash collateral investing) practices. Instead, it involves a money market fund that was the vehicle in which unidentified securities lenders invested their cash collateral.[15] The Report supplies no data supporting its discussion, no examples in which a registered investment company lost significant amounts due to securities lending activity, and no support for an implication that the existing regulatory framework is inadequate to address any concerns that do exist.

[15] *See* discussion at pp. 26-27 below.

c. *Leverage*. The OFR's concerns with investment company leverage may be grouped as follows:

i. The risk that leverage increases liquidity shortfalls.

- Although the Report makes several general and conclusory statements regarding the risks attendant to leverage, it does not cite any evidence for the proposition that registered investment companies actually create significant risk because of leverage. This is no surprise given that the Investment Company Act severely limits the amount of debt an open-end registered investment company can have – limiting debt-to-equity ratios to no greater than 1 to 2 in the case of registered investment companies. To understand how conservative this is, one can simply observe that maximum ratios that are 30 times more permissive (15 to 1) are imposed by Dodd-Frank on companies that are deemed to pose a "grave threat" to the financial stability of the United States (*i.e.*, a threat significantly greater than the baseline threat associated with designation as a SIFI under Section 113 in the first place).[16]

- The Report makes only passing reference to risks that might be associated with leverage incurred by asset managers themselves. This is because any such risk is very limited: as businesses that are based on agency services, asset managers tend to have small balance sheets (as the Report acknowledges elsewhere)[17] and, more importantly, their financial health has no direct impact on the value of the assets they manage. Those managed assets are segregated, custodied separately and protected by a robust regulatory regime that protects them from malfeasance or distress at the manager. The Report ignores these protections, which make the risk it hypothesizes too unlikely to warrant consideration without data, a model or something more than speculation to substantiate the purported risk. *See also* the discussion of "Transmission Channels" below.

ii. The risk that derivatives create excessive leverage.

- Derivatives are often used to create levered exposures, and this leverage (like all leverage) can create risks. The Report, however, glosses over the fact that registered investment companies are subject to existing limitations on derivatives use that are akin to the limitations noted above in respect of other types of leverage. Moreover, as detailed in the attachment, the SEC is in the process of carefully evaluating derivatives usages by registered investment companies.

---

[16] *See* discussion at pp. 29-30 below.

[17] *See* Report, p. 19 ("As agency businesses, asset management companies tend to have small balance sheets . . . .").

- Again, the Report contains no data or analysis to support a conclusion that asset managers or funds add to or exacerbate this market risk. The two examples cited in this section of the Report – a fund previously cited in the redemption section of the Report, together with a second fund that incurred derivative losses – do not add any real weight to an argument that registered investment funds or their advisers threaten U.S. financial stability such that they should be designated as SIFIs or subjected to other additional regulation. In the case of the first fund, the principal claim made by the SEC was one of faulty disclosure. It is unclear from the record whether the credit default swap exposure that caused the losses in question represented levered exposure – or whether, by contrast, the funds could have taken the same exposure in the cash market (*i.e.*, by on-balance sheet purchases of the underlying securities). Moreover, the second example involved a non-registered fund, and thus bears little relevance to the topic of the Report.[18]

d. *Firms as Sources of Risk*. The OFR's concern here is more singular than in the other subsections:

i. The risk that the failure of an investment management firm itself could be a source of systemic risk.

- The Report makes largely generalized assertions in this section, with several references to the kinds of risks addressed elsewhere in the Report.

  - It speaks of the risks posed by correlations among highly levered *unregistered* funds; but as noted above, consideration of this type of fund is not the subject of the Report.

  - It speaks of a firm with *extensive repo and securities lending* businesses; but it draws no connection between the potential risks of these strategies and an investment management firm itself (which is not likely to act as principal with respect to such strategies).

  - It speaks of complex financial institutions with asset management divisions, citing Bear Stearns, Wachovia and Lehman – in a manner reminiscent of its earlier citation to AIG; but it doesn't explain the relationship between, on the one hand, the problems suffered by asset management divisions of banking and investment banking firms resulting from group interconnections and, on the other hand, any risks associated with independent (*e.g.*, non-bank-affiliated) investment management firms.

  - It speaks of the stress testing required of asset management divisions of *large bank holding companies* affiliated with

[18] *See* discussion at p. 31 below.

money-market funds; but it doesn't suggest a nexus between this sort of asset management operation and that of an independent asset management company and/or the context of advising non-money market funds.

- Separately the Report suggests that, were an investment manager to fail, counterparties of its funds might be confused and not distinguish between exposures to the firm and those to the funds. No data or even historical evidence are provided. Again, the absence of data or concrete examples is compelling – especially in light of the recent financial crisis. It supports a hypothesis that the risk that the OFR alleges may not exist or may be effectively mitigated either by existing regulation and/or by market practices. In any event, as we discuss at some length below, the removal and replacement of a failing investment adviser in such a circumstance is relatively straightforward and significant confusion is therefore unlikely.

2. Transmission Channels

a. *Exposure of Creditors, Counterparties, Investors or Other Market Participants*.

i. The risk that interconnections between asset managers and other financial companies could transmit financial market risks.

- Although multiple linkages of this sort exist, there are substantial and detailed rules that apply to registered investment companies that limit connections. These rules are principally aimed at reducing the effect of conflicts of interest between asset managers and their advisee funds, but they have the corollary effect of reducing connections. For example, there are clear restrictions on borrowing transactions between affiliated registered investment funds, and prohibitions on "principal" transactions between registered investment companies and their advisers.

- Registered investment companies are also required to disclose their intentions to concentrate their investments in securities of issuers in particular industries and whether they intend to operate as diversified or non-diversified funds under the Investment Company Act.

b. *Disruptions to Financial Markets Caused by Fire Sales*.

i. The risk that fire sales are impelled by demands for liquidity and spread quickly throughout the financial markets.

- This is a concern that, in one form or another, echoes throughout the Report. Indeed, whether in the context of a discussion of herding and asset bubbles, or of redemption pressures, or of leverage, the ultimate risk can be summed up, in large part, as a risk of market contagion evidenced by fire sales and the hoarding of liquidity. The Report provides no evidence that the asset management or investment company structures exacerbate or add to these market risks. We believe that existing regulation and attendant SEC oversight adequately address the risks that are the focus of the Report. Absent data, models, historical examples or some other evidence, there is no basis to conclude otherwise.

3. Data Gaps

As noted above, we have focused our comments on legal and regulatory considerations relevant to the Report. We have not addressed the Report's observations with respect to the availability of information and data. We would note, however, that through the public filing of various forms with the SEC and other regulators with jurisdiction over asset managers, their funds, and the capital markets, a significant amount of information regarding registered investment funds and their investments is available to the investing public.[19] It is unclear to us whether the OFR has catalogued or analyzed all of the available information in preparing the Report. Furthermore, since the advent of Form PF with respect to private funds, the broader asset management universe has contributed to large new data streams available to regulators. We also know that the cost of compliance with informational requirements – whether associated with systems, legal, compliance or other operations within a firm – is significant. We would thus encourage, in the context of any suggestion that the investment management industry provide additional data, that the SEC, CFTC and other capital markets and asset management regulators (i) inform the OFR of the extent and availability of the data that is or will be collected, (ii) collaborate to identify any gaps, and (iii) collectively determine how to fill them as efficiently as possible. This should involve a detailed and thoughtful cost/benefit analysis before implementing any new requirements.

4. Separate Accounts

We have not generally commented regarding the Report's few observations about separate accounts because, in large part, those observations sounded a consistent theme – namely, that the OFR did not have the means to evaluate adequately separate accounts. In this regard, we would echo our own theme, sounded immediately above – namely that any additional disclosure obligations imposed on investment managers should be adopted only after a very careful data assessment and cost/benefit analysis are completed.

Concluding Remarks

We have many years of experience with the investment management industry, its regulation and its oversight by the SEC. While we believe there is always room for improvement of the regulatory framework, particularly as markets change, we also believe that over the course of almost 75 years, Congress and the SEC have developed an effective regime for investment company and adviser regulation. And more to the point here, we believe that the risks cited by the Report, to the extent they are relevant to the world of registered investment companies and their advisers, are well addressed under current laws and regulations. Thus, our interest in commenting on the Report was driven by a desire to put the Report's observations and analysis under the light of current regulation and to highlight some of the shortcomings and

[19] *See, e.g.,* SEC Forms N-CSR, N-Q, N-MFP and 13-F. In addition, the SEC receives additional information through the filing of SEC Form N-SAR.

flaws in the Report that prevent it from achieving its mission – to increase the Council's understanding of the asset management industry and the optimal approach to its regulation.

As we believe we have demonstrated, many of the concerns and risks discussed in the Report are unsubstantiated or are based upon anecdotal assertions or generalized suppositions. Others do not even apply to the registered investment fund industry that is the focus of the Report. The few risks that have been documented are addressed by current regulation, and existing regulators are best suited to assess the current regulatory regimes and the advisability of any potential expansion or modification of current laws and regulations. For these reasons, discussed in detail below, the Report provides no substantive answers to the Council's questions concerning whether asset management firms or the funds they manage present threats to U.S. financial stability. The Report certainly does not provide a sufficient basis for regulatory action, let alone the application of a new bank-centric regime on a small group of asset management companies, which is what SIFI designation under Section 113 of Dodd-Frank would entail.

* * * *

We appreciate the opportunity to comment on the topics discussed above and for the SEC's consideration of our views. We would be happy to provide any additional information on any of the subjects discussed in this letter and would also be happy to meet with representatives of the SEC to discuss these matters.

Should you have any questions or desire any clarification concerning the matters addressed in this letter, please do not hesitate to contact any of the individuals listed below.

Very truly yours,

Sidley Austin LLP

Sidley Austin LLP

John A. MacKinnon ([redacted])
Frank P. Bruno [redacted]
Andrew W. Stern ([redacted]
William A. Shirley ([redacted])

cc: Honorable Jacob J. Lew, Secretary of the Treasury, Chair of the Financial Stability Oversight Council, U.S. Department of the Treasury

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

Honorable Richard Cordray, Director, Consumer Financial Protection Bureau

Honorable Thomas J. Curry, Comptroller of the Currency, Office of the Comptroller of the Currency

Honorable Edward J. DeMarco, Acting Director, Federal Housing Finance Agency

Honorable Gary Gensler, Chair, Commodity Futures Trading Commission

Honorable Martin J. Gruenberg, Chair, Federal Deposit Insurance Corporation

Honorable Deborah Matz, Chair, National Credit Union Administration

Honorable Mary Jo White, Chair, Securities and Exchange Commission

Richard Berner, Director, Office of Financial Research

S. Roy Woodall, Jr., Independent Member, Financial Stability Oversight Council

John P. Ducrest, Commissioner, Louisiana Office of Financial Institutions

John M. Huff, Director, Missouri Department of Insurance, Financial Institutions, and Professional Registration

David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division

Michael T. McRaith, Director, Federal Insurance Office

Honorable Luis A. Aguilar, SEC Commissioner

Honorable Kara M. Stein, SEC Commissioner

Honorable Daniel M. Gallagher, SEC Commissioner

Honorable Michael S. Piwowar, SEC Commissioner

Norm Champ, Director, SEC Division of Investment Management

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
Vulnerability Cited[20]		
Reaching for Yield and Herding "An extended low interest rate investment climate, low market volatility, or competitive factors may lead some portfolio managers to 'reach for yield,' that is, seek higher returns by purchasing relatively riskier assets than they would otherwise for a particular investment strategy." (9) "Some asset managers may also crowd or 'herd' into popular asset classes or securities regardless of the size or liquidity of those asset classes or securities." (9)	**Investors may not appreciate the risks associated with their investments.** "[I]***nvestors might not fully recognize or appreciate the nature of risks taken by their portfolio managers***, despite required disclosures and investment mandate restrictions." (9) "[R]esearch on mutual funds has shown that managers who are lagging their peers toward year-end often take more risks than managers who are outperforming. Depending on the flexibility of investment mandates, managers may take risks that investors do not fully appreciate. ***If these risks***	The OFR's concern here is twofold: That investors may be surprised by risks of which they were unaware, and that once the risks are realized investors may seek to redeem shares in a manner that exacerbates market declines. Related to this concern is a worry that investment advisers may incur more risk than related disclosure might anticipate. The Securities Act of 1933 (the ***Securities Act***) and the Investment Company Act of 1940 (the ***Investment Company Act***) mandate an extensive and detailed disclosure regime for publicly offered registered investment companies. As a consequence, investors should not be surprised by risks associated with their related holdings. Indeed any reaching for yield or herding behavior will likely find its impetus not in investment advisers or their faulty disclosure, but in investors themselves: as has been noted extensively elsewhere, the investment management sector of the financial markets operates on an agency basis. While investment advisers may influence specific holdings at the margin, the vast majority of investment decision making is driven by individual investors. In this context, disclosure is critical, as it is critical that investors understand their investments. When it comes to reducing the particular systemic risks associated with market participants reaching for yield and engaging in herding behavior, we believe existing law and regulation, together with related enforcement practices, achieve all that can be achieved in the context of regulating investment advisers and their funds. The Report suggests nothing that direct Federal Reserve oversight and additional prudential regulation of investment advisers or registered investment companies would accomplish that is not already being accomplished by the existing SEC regulatory framework. To address these kinds of risks in a principal/agent context – beyond ensuring that investment decision-making by principals is well informed – regulation must target the principals directly. Regulation of advisers and funds (agents) should not become a proxy for regulation of investors (principals), who could take the same actions directly. As to ensuring coherent and complete disclosure, Form N-1A (relating to open-end funds) and Form N-2 (relating to closed-end funds), the registration forms used by registered investment companies under the Securities Act and

[20] Parenthetical page references following quotations are to the Report. Emphases are added.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
"These behaviors could contribute to increases in asset prices, as well as magnify market volatility and distress if the markets, or particular market segments, face a sudden shock." (9)	***suddenly become apparent,*** they could spur redemptions and a flight to quality, which could in turn trigger adverse market contagion as managers sell assets to meet those redemptions." (9-10) "Another way that these risks could surface is by investors herding into certain new products, particularly if the products are relatively illiquid and ***investors fail to fully appreciate their risks under different market conditions.*****"** (11) "In recent years, asset managers have developed registered funds that allow retail investors to gain exposure to certain alternative investment strategies more typically pursued by hedge funds. . . . . During a market shock, when the risks become more apparent, ***investors who failed to appreciate the risks of these investments*** could engage in heavy redemptions of these products, exacerbating the shock." (11-12)	the Investment Company Act, require extensive disclosures, including, among other things, disclosures relating to: • the fund's investment objective(s) • the fund's principal investment strategies • the fee table • the principal risks of investing in the fund • a statement that a description of the fund's policies and procedures with respect to the disclosure of the fund's portfolio securities is available (i) in the fund's statement of additional information; and (ii) on the fund's website, if applicable (open-end funds only) • portfolio turnover disclosure for the most recent fiscal year • the fund's investment restrictions • whether the fund is classified as non-diversified or diversified • any policy to concentrate in securities of issuers in a particular industry or group of industries • the structure of, and the method used to determine, the compensation of each portfolio manager required to be identified in the registration statement Disclosure in the summary prospectus for open-end funds, including a description of the principal risks of investing in the fund, is required to be presented in plain English. Prior to any registration statement becoming effective, it undergoes a review by the staff of the SEC. In addition, at any time an amendment to the registration statement is filed pursuant to Rule 485(a) under the Securities Act (for example, if there has been a material change to the fund), the amendment to the registration statement will be reviewed by the staff of the SEC prior to effectiveness. Interestingly the Report, to its credit, acknowledges these valuable disclosure requirements: > Registered funds are required to disclose information to investors about their risks, portfolio holdings, concentrations, and investment strategies. Registered investment advisers are required to disclose to their clients in their annual brochures their significant investment strategies and related risks. In addition, regulatory restrictions are designed to align the interests of investment advisers and their clients and mitigate conflicts of interest. Managers have strong incentives to provide clients investment strategies matching their risk-return profiles. Given that most asset managers earn fees based on the amount of assets under management and that clients may freely move their accounts to another adviser or fund, advisers have strong incentives to meet client expectations. (9) However, the Report then immediately states:

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
		However, potential information disparities between investment advisers and their clients could undermine those mitigants in the industry. Specifically, investors might not fully recognize or appreciate the nature of risks taken by their portfolio managers, despite required disclosures and investment mandate restrictions. (9) The first sentence, like certain other assertions in the Report, seems to be little more than a truism. This is underscored upon examination of the second statement, which is supported not by a citation to a study that addresses disclosure in the context of registered investment companies and their advisers, but by a speech given in the context of a conference dedicated to hedge funds related to potential conflicts of interest in the asset management industry generally.[21] In any event, if there are improvements to be made in the realm of disclosure, the SEC and the existing regulatory regime have demonstrated that they are in the best position to design and implement such changes, and the Report provides no basis for concluding that additional or different regulation is warranted, let alone that Federal Reserve oversight or prudential regulation of agents would improve current disclosure. Thus we believe that to the extent there is yield-reaching or herding behavior, it is not generally a function of investment management decisions, but investor desires. This is consistent with a primary feature of the investment management industry: it operates in an agency environment. The decision-makers are fund investors, who make their investment decisions based on their goals and risk tolerance, aided by detailed disclosure. Thus, while we would not (even were it within our particular competence as lawyers to do so) deny the risks that may be associated with reaching for yield or herding into particular market sectors, we believe that subjecting investment management firms (or their registered investment funds) to oversight and prudential regulation following a designation under Section 113 would have no effect on this risk. Before moving on, a last word regarding disclosure requirements: they are valuable only to the extent they are satisfied and, where not satisfied, they are enforced. This is no different from requirements associated with prudential regulation. We note in this regard that the SEC is vigilant with respect to registered fund disclosure practices. The SEC has enforcement tools to address circumstances in which registered funds fail in their disclosure obligations. Evidence of this is found in the Report itself: in the Report's discussions of redemption risk and leverage (addressed separately in related comments below), the Report cites the case of an SEC enforcement proceeding addressing alleged disclosure failures. There the SEC found that the funds in question made misleading statements in certain offering documentation and other communications, and more than $35

[21] The authority cited for the second sentence is a speech given in 2005 by the SEC's then-Chief Economist (Keynote Address at the "Hedge Fund Regulation and Compliance Conference" held on May 12, 2005 in New York, NY).

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
		million was paid in fines to settle the SEC's charges. Existing regulation requires robust disclosure and the existing, effective oversight, by the SEC, reinforces current regulation. That oversight is currently effected not only via means of before-the-fact vigilance described above, but via concerted enforcement activity when issues surface nonetheless. There is no reason to believe that better enforcement would result through some other form of regulation, especially if, like SIFI designation, it could not be applied to the entire industry.
	Asset managers may take risks in the hope of improving their own standing or compensation. "[R]esearch on mutual funds has shown that ***managers who are lagging their peers toward year-end often take more risks than managers who are outperforming***. Depending on the flexibility of investment mandates, managers may take risks that investors do not fully appreciate. . . . Regulation of asset managers often focuses on limiting conflicts of interest between asset managers and their clients, which can help mitigate these risks." (9-10)	Again the Report highlights a risk, nods in the direction of existing regulation, and then only speculates about the possibility that the existing regulatory framework might not be adequate to address the risk. We would suggest, to the contrary, that the Investment Advisers Act of 1940 (the ***Investment Advisers Act***) provides strong protections against the risk of investment managers selecting investments in self-interest and that the place to start is the nature of an investment adviser's fiduciary duty. All investment advisers (registered or unregistered) are subject to Section 206 of the Investment Advisers Act, which prohibits fraudulent, deceptive or manipulative conduct. In addition to the specific prohibitions set forth in Section 206, the U.S. Supreme Court has held that Section 206 imposes a fiduciary duty on investment advisers by operation of law.[22] The purpose of this duty is to eliminate conflicts of interest and to prevent an adviser from overreaching or taking unfair advantage of a client's trust. As a fiduciary, an investment adviser has, with respect to each client, an affirmative duty of utmost good faith to act solely in the best interests of the client, to use all reasonable care to avoid misleading the client, and to make full and fair disclosure of all material facts.[23] In addition to the demands placed on all fiduciaries, investment managers included, there are specific requirements under the Investment Company Act that protect investors against the self-interest of investment advisers. For instance, Section 17(a) prohibits principal transactions with the adviser or its affiliates; Section 17(d) prohibits joint transactions with the adviser or its affiliates; and Section 10(f) prohibits underwriter affiliates of the adviser from dumping securities in the fund. In addition, Rule 17j-1 under the Investment Company Act requires registered investment companies and their advisers to adopt codes of ethics designed to prevent, among other things, an affiliated person of a fund or its investment adviser from engaging in any practice or course of business that operates or would operate as a fraud or deceit on the fund, or to engage in any manipulative practice with respect to the fund.[24] Moreover, the sort of risk highlighted by the Report (an investment manager's taking greater risks to improve its

[22] *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

[23] *See, e.g.*, *id*.

[24] We note that, pursuant to Section 15(a)(3) of the Investment Company Act, the board of directors of a registered investment company has the right to terminate the fund's advisory contract at any time without penalty upon no more than 60 days' notice.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
		own standing) has little or no relevance in large sectors of the investment management industry. For example, in the index fund sector, there is no room – by definition – for investment adviser self-interest via reaching for higher returns and greater risks. The Report fails to differentiate among these different investment advisory products and sectors. The Report's initial "Industry Activities" section observes the very significant size of the overall industry, but the Report then immediately proceeds to discuss risks associated with reaching for yield and herding without providing any evidence regarding that portion of the registered investment company industry that, even as influenced by investor decision-making, could be susceptible. The Report acknowledges as much when it prefaces one of its concerns about risk of self-interested investment advisers with the phrase, "Depending on the flexibility of investment mandates." Put another way: OFR does not provide information in the Report regarding the relative significance of complex trading strategies in the larger asset management world. It slides from observations about great size (for the industry as a whole) to case-specific risks (for some, likely small, portion of that world) without analysis. We believe that in order for the Council to determine how any of these circumstances could threaten U.S. financial stability, the Council must have further information. In the end, this section of the OFR Report, in both the manner in which it overlooks existing regulation and oversight, and the way it suggests risks without important context, is more speculative than analytic.
	Herding: Collective action problems may lead to asset bubbles or market dislocations in respect of illiquid assets. "[R]egulation [addressing conflicts of interest] focuses on helping ensure that managers adhere to their clients' desired risk-return profiles, but does not always address ***collective action problems and other broader***	The Report neither defines "herding" with any rigor nor suggests any framework for identifying it. In this regard, the Report simply equates it to "the tendency of asset managers to crowd into similar, or even the same, assets at the same time" (10). The Report then suggests that herding behavior may be the result of certain assets "appear[ing] to offer the best returns relative to the risks" (10). But the Report offers no insight as to the distinction between "bad" herding activity, on the one hand, and "good" risk/reward investing pursued in parallel by multiple market participants, on the other. The Report further fails to recognize that, in the context of collective investment vehicles, investors – not the funds – drive market effects. In fact, investment diversification by fund managers may reduce risk in the market by buffering individual investors' inclination to "herd." This is especially likely when the long-term nature of ERISA retirement funds, pension funds, etc., is taken into account. The Report seems to be addressing two related risks at issue here: a generalized risk related to asset bubbles and a more specific risk associated with over-crowding in illiquid markets. As to the latter, we note that SEC guidelines provide that registered open-end investment companies may make only limited investments in illiquid investments.[26] Specifically, the guidelines require that at least 85% of a registered open-end investment

[25] Investment Company Act Release No. 18612 (March 12, 1992). Although the guidelines were rescinded, they continue to reflect the SEC's view on this point. *See, e.g.*, Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management, available at http://www.sec.gov/divisions/investment/icvaluation.htm.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	behavioral issues that can contribute to asset price bubbles or other market cycles." (10) "Competitive pressures can also be manifest in '***herding'—the tendency of asset managers to crowd into similar, or even the same, assets at the same time***. Such herding investment behavior in liquid assets may be unlikely to amplify financial stability shocks. Yet, ***herding into more illiquid investments may have a greater potential to create adverse market impacts*** if financial shocks trigger a reversal of the herding behavior. This behavior may occur because those assets appear to offer the best returns relative to the risks, but in other cases may result from competitive incentives or product types." (10) "These potential risks could materialize in several different asset management activities. ***Pooled investment vehicles can potentially create market volatility and more rapid***	company's portfolio be invested in assets that could be sold in seven or fewer days at approximately carrying value. Thus, as to registered open-end investment companies (the primary subject of the Report as noted above), we believe there is limited risk of the kind of shocks associated with overly-enthusiastic interest in illiquid assets. As to broader "collective action problems and asset bubbles," we would first note that they may be best addressed by macroprudential regulation – such as stress testing across firms and markets, and limitations applicable to all market participants, such as position limits and margin requirements. This sort of regulation may be contrasted with microprudential regulation – regulation and oversight of individual firms. The latter would be the primary change fostered by one or more SIFI designations in the asset management sphere. The former, by contrast, does not require SIFI action under Section 113. Thus, while no one would argue that asset bubbles and similar market phenomena are not worthy of study and, perhaps, regulation, they are largely irrelevant in the context of a consultation intended to inform decisions about the possibility of additional prudential supervision of individual firms. It is unlikely that such designations would contribute much to the goal of identifying and avoiding asset bubbles. Put another way, the Report fails to explain how designating an asset manager or fund as a SIFI would contribute to reducing the risk of either reaching for yield or herding nor does it suggest or evaluate any other regulatory approach. A further observation regarding this portion of the Report: We agree that ETFs may transmit or amplify shocks originating elsewhere in the financial markets, but the observation seems simply to concern the functioning of the financial markets generally, *i.e*., the operation of stock exchanges and other trading venues and mechanisms. The fact that fixed-income ETFs have grown from $57 billion to $252 billion between 2008 and 2012 is a reflection of investor interest in fixed income securities and their seeking exposure via ETFs. ETFs, like other market mechanisms, are channels by which the investing public efficiently may invest in different asset classes. But it is hard to see how treating individual asset managers or funds as SIFIs would address risks associated with this investor behavior. This is particularly true given that many ETFs represent passive trading strategies. In other words, it is ETF investors, rather than ETF managers, who effectively determine, via their acquisition or disposition of ETF shares, whether particular financial assets are bought or sold in a given market environment – and thus whether there is herding into a particular corner of the market. These two risks are, in essence, risks associated with asset bubbles. To the degree that regulatory supervision is warranted, it is supervision at a macroeconomic (market) rather than microeconomic (firm) level. Designating a given asset management entity as a Section 113 SIFI would be a very blunt tool for achieving this goal, as it is primarily a means of microeconomic supervision (*e.g*., relying on bank-style regulatory capital requirements and other safeguards to protect a given entity).

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	price impacts due to herding behaviors regarding investments in less liquid assets or increased redemptions due to shifting investments as risk tolerances or perceptions change. . . . ***For example, exchange traded funds (ETFs) may transmit or amplify financial shocks originating elsewhere***." (10-11) "***If a number of funds were invested in similar assets or correlated assets***, market events affecting that strategy or set of assets may affect and cause heavier redemptions in a number of funds, and sales of assets from any of those funds could create contagion effects on the related funds, spreading and amplifying the shock and its market impacts." (14-15)[25]	

[26] We note that this paragraph of the Report was included not in the yield-chasing and herding section, but in the redemption section. Although the mechanism by which the cited risk operates – significant redemptions – is perhaps relevant to the redemption section, the risk cited in fact is simply the risk of an asset bubble being popped. Thus we address it here.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
Vulnerability Cited		
Redemption Risk "Any 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 economic advantage by being the first to redeem." (12)	**There may be a mismatch between redemption demands and available liquidity.** "For example, a significant amount of assets has flowed into fixed income and hybrid mutual funds in the past five years . . . . As of 2012, 32 percent of mutual funds were bond and hybrid funds. Bond funds could be exposed to a risk of sudden price declines if interest rates were to suddenly rise. ***In times of sharp changes in interest rates or related bond-market volatility, managers of these funds may be exposed to sudden heavier redemptions if they have not adequately managed the fund's liquidity***, given market risks and the thinly traded nature	As explained above, registered open-end investment companies are required to keep at least 85% of their portfolios in assets that could be liquidated at approximately carrying value in a seven-day period. In addition, many registered open-end investment companies have the ability to satisfy redemption requests "in-kind."[27] Although redemptions in-kind rarely occur, the availability of the option bolsters the conclusion that registered open-end investment companies are unlikely to find themselves in an unmanageable liquidity position. These two requirements, combined with a cornerstone tenet regarding redemptions – namely that investors are redeemed at net asset value – ensure that investors are able to redeem their investments in accordance with well-established expectations. We note that the Report recognizes much of this: > Fund managers use well-established liquidity management tools to manage and mitigate redemption risk. As a precaution against high demand for redemptions, funds often hold cash buffers and maintain liquidity lines of credit. To meet redemption requests, under SEC guidelines, registered mutual funds should hold at least 85 percent of their investments in assets that the fund manager believes could be sold at or near carrying value within seven days. (12) Although the Report notes this important aspect of existing investment company regulation, it fails to provide any evidence or analytical basis for concluding that these regulatory restrictions may be inadequate or need further analysis. Instead, the Report simply cites generalized risks – truisms, really – and supposed counter-examples that turn out to be only tangentially related – in this case, discussion of money market funds and certain short-term bond funds (discussed further below). There is no support for a conclusion that, in the context of registered investment companies (money market funds aside, which are not the subject of the Report and about which we express no view), there is significant risk that a registered open-end investment company, assuming it is operating in accordance with applicable laws and regulations, would encounter redemption problems even in an environment of "*sharp changes in interest rates or*

[27] The Investment Company Act defines "redeemable security" to mean "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof." Rule 18f-1 provides that an open-end fund which has the right to redeem securities in-kind may file an election with the SEC to commit itself to pay in cash all redemptions by certain shareholders, subject to limitations. Such an election must be described in the fund's prospectus or statement of additional information.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	of some fixed-income markets." (15)	*related bond-market volatility*." (15) We acknowledge that such a circumstance could lead to sales of assets that could exacerbate market declines. But this risk, as discussed at length above, is a risk of "collective action" that is in no way unique to or exacerbated by the existence or operation of asset managers and their funds. If investors decide, *en masse*, that it is time to sell bonds, then bonds will be sold in volume and bond prices will fall, all of which may accelerate adverse market conditions. This, of course, is not different in any respect from the ability of an individual bond investor to sell bond holdings and in no way supports a conclusion that asset managers or their funds exacerbate this risk and therefore warrant additional regulation – let alone SIFI designation. In essence, the concern expressed in this part of the Report (aside from the separate subjects noted below) is simply the argument about reaching for yield and herding viewed from a different angle.[28] Designation of asset managers or their funds as SIFIs will not improve upon the already conservative mutual fund liquidity requirement discussed above (at least 85% of assets subject to one-week liquidity). It also seems to us that the base risk here – the desire of investors to exit a particular asset class – is not likely to be significantly influenced by prudential regulation applied to a subset of individual asset managers or more broadly through some other mechanism: those firms will largely remain, as the Report acknowledges, agents for the investment decisions of others. Put another way: there is no evidence that the experience in the last five years would have been different if one or more large asset managers had been SIFI designees subject to the Fed's enhanced bank holding company regime during the period.

[28] Having said this, and although money market funds are not the subject of the Report, we acknowledge that a different analysis attends there. We note that because of the important differences between these funds and other registered investment companies, such funds are subject to an existing and substantially more limiting regulatory regime, centered on Investment Company Act Rule 2a-7. They are also subject to extensive supervisory (in addition to enforcement) oversight by the SEC.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	There are particular redemption risks associated with short-term cash funds. "[R]isks are heightened for funds focused on preserving investor principal stability—such ***as money market funds or short-term investment funds*** (STIFs)—that offer daily liquidity to their investors. ***Runs on such short-term funds can be self-reinforcing, as investor redemptions further drive down prices, returns, and liquid assets in the fund—spurring more redemptions***. If perceived to have broader market implications, runs on these funds or groups of funds could contribute to risks of widespread fire sales." (13) "In one example in November 2007, Bank of America supported investors in the $40 billion Strategic	The Report does not provide evidence of significant problems at registered investment companies due to daily redemption mechanisms during the 2007-08 financial crisis. Instead, in the section related to redemption risk, the Report cites two examples – one involving a bank-sponsored private fund for institutional investors, and another involving two mutual funds advised by a non-bank sponsor. (14) These examples serve primarily to introduce confusion into the Report. First, the Report inappropriately conflates issues that may arise in the context of money market funds with issues that arose in the context of the referenced private fund and mutual funds. Second, the funds referenced, and investors in those funds, apparently did not incur any losses as a result of redemption pressures. Finally, the Report highlights the risks of derivative usage by funds without suggesting an analytic framework – in the context of a Section 113 designation or otherwise – for considering the risk. The Report lumps together two concepts here: "[R]isks are heightened for funds focused on preserving investor principal stability – *such as money market funds or short-term investment funds.*" (13) This is unfortunate for at least two reasons: first, money market funds are subject to a very different regulatory regime from the private fund and the mutual funds referenced; second, the kinds of problems associated with the former – *e.g.*, "breaking of the buck" by money market funds – apparently had little to do with the problems of the latter. As noted above, money market funds are subject to additional regulatory restrictions in light of their purpose of providing investments whose principal balance does not fluctuate and that are payable, in essence, on demand. Also as noted, the Report states that money market funds are *not* its subject. It is therefore at the very least confusing to have the Report group these kinds of funds with non-money market funds with short-term fixed income investment strategies that are not subject to the additional money market fund regulation. The Report seems to do this because its authors wished to make a point about two non-money market funds that experienced difficulty during the financial crisis. The difficulties associated with those funds, however, bore no apparent relation to redemption pressures – or bank run-like behavior on the part of its investors – that have been the focus of concerns about money market funds.[29] We note first that the Strategic Cash Portfolio fund cited by the Report was not a registered investment company at all, but was a private fund, limited to qualified purchasers pursuant to Section 3(c)(7) of the Investment Company Act. Moreover, in the course of its liquidation, its large institutional investors were redeemed "in-kind."[30] Thus, there was little if any additional associated stress created in the markets resulting from sales by the fund to meet redemption requests.

[29] To the contrary, the difficulties had much to do with risk positions taken via derivative transactions, and this subject is addressed below.

[30] *See* "CNBC Wrong Again: Columbia Strategic Cash Not a 'Money Fund.'" *Crane Data*, December 10, 2007, available at: http://cranedata.com/archives/all-articles/1213. *See also* Grynbaum, Michael M. "Mortgage Crisis Forces the Closing of a Fund." *The New York Times*, December 11, 2007 (noting that the fund "required institutional investors to have at least $25 million in assets," who generally received "their share of the securities 'in kind'"). In fact, this second article

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	Cash Portfolio, then the largest enhanced cash fund in the country, and closed the fund after ***losses on mortgage-backed securities prompted the fund's largest investor to withdraw $20 billion***. In another example in November 2008, OppenheimerFunds contributed $150 million to a mutual fund to cover ***liquidity shortfalls due to derivatives exposures***." (14)	In the case of the referenced mutual funds, there was no failure of regulation related to redemptions; there were, however, alleged violations of disclosure obligations by the funds' investment advisers. In the press release announcing the settlement of the charges, an SEC representative noted that the "funds had to sell bonds at the worst possible time to raise cash for TRS [total return swap] contract payments."[31] There is no mention of liquidity pressure due to redemptions. Indeed, the SEC's Order notes that because of the alleged disclosure violations, "the [f]unds were able to retain existing shareholders and to attract new ones."[32] The liquidity issues were of an entirely different sort, related as they were to derivative positions (discussed further below). The point is that the problem was not related to redemptions – or anything like the liquidity concerns associated with certain money market funds during the financial crisis. Unlike the risk that depositors demand repayment of bank deposits from banking institutions, investment company investors may (in the case of open-end funds only) demand daily redemption of their investments, but that redemption is at net asset value. Nothing in the Report supports the suggestion that a "first mover advantage" has been observed in a non-money market context, where investment company shares are reported at net asset value and where significant protections exist to ensure, even in this context, that the large majority of investment company assets are liquid.

was the Report's source for information about the fund, which raises a question about why – in light of the of in-kind redemptions described by the article – this circumstance was cited in the first place in a discussion about liquidity risks associated with redemption requests.

[31] Securities and Exchange Commission. "OppenheimerFunds to Pay $35 Million to Settle SEC Charges for Misleading Statements during Financial Crisis." Press Release 2012-110, June 6, 2012.

[32] *See* paragraph 26 of the Order (available at: https://www.sec.gov/litigation/admin/2012/33-9329.pdf). Although the Order notes (paragraph 18) that "the fund's cash position was inadequate to cover [certain] projected [TRS contract] payments, much less any redemptions the fund might face," it does not appear that redemption activity was itself an issue. It is worth noting that, according to the Order (paragraph 6 and 7), one of the two funds was marketed "as a fund that invested primarily in high-yield, lower grade fixed income securities also known as 'junk bonds'" and the other "as an intermediate-term, investment grade bond fund."

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	Securities lending activities may present particular risks. "***Inadequate risk management relating to reinvestment of cash collateral for asset management securities lending programs illustrates how redemption-like risk can create contagion and amplify financial stability shocks***. Lending available securities on an over-collateralized basis was considered a low-risk method to earn incremental income for a fund or separate account before the financial crisis." (15) "Through a subsidiary, AIG Securities Lending Corporation, AIG ran a large securities lending business on behalf of its life insurance subsidiaries. ***AIG Securities Lending Corporation's cash***	The Report's section on redemption risk is used by the OFR as an opportunity to comment not only on money market funds as discussed above, but also on securities lending. Again the Report takes up a discrete market activity, not the risks attendant to a particular kind of business or entity, whether an investment manager or one or more of its funds. And again, the discussion is off topic. Although there are legitimate regulatory considerations at issue when market participants engage in securities lending, the Report makes no significant connection between its observations regarding securities lending activity and the principal task at hand: determining whether the asset management business itself creates or amplifies risks that would justify, and be ameliorated by, designation of investment advisers or funds as SIFIs. The Report's first consideration of this activity is unrelated to investment management entirely: the Report cites the losses incurred by AIG as a result of its securities lending activities. This *non sequitur* stands for nothing beyond the uncontroversial proposition that where an entity lends securities and invests the cash collateral in other securities that lose value, that entity will suffer losses. The Report's second specific reference to securities lending activity is of only limited relevance to registered investment companies. Mount Vernon Securities Lending Prime Portfolio was a money market fund that operated under Rule 2a-7. The fund did not itself engage in securities lending activities. Rather, unidentified securities lenders invested cash in the fund that they had received as cash collateral in the course of their own securities lending activities. The Mount Vernon money market fund, like the Reserve Primary Fund, had difficulties because of its investments in Lehman notes and the Reserve Primary Fund itself. Thus while the *source* of the invested cash was securities lending activities, the fundamental problem involved losses incurred by a particular money market fund during a severe economic crisis. Put another way: unlike the case of AIG, where cash collateral was invested in securities that ended up losing significant value, here the cash collateral was invested relatively safely – in a money market fund. Although suffering difficulties, the money market fund appears to have repaid its investors, the securities lenders.[33] This is not to suggest that securities lending is without risk. To the contrary, like any kind of leverage, securities lending can be risky (as in the case of AIG) or not (as in the case of the securities lenders who invested in the Mount Vernon fund and appear to have received back their investments). But the Report fails to tie this risk to the asset management business model, and therefore does not support the apparent conclusion that investment managers or the registered investment funds that they advise threaten U.S. financial stability because of their securities lending activities. Although consideration of the issues presented by Rule 2a-7 money market funds –

[33] The no-action letters cited by the Report suggest that the sponsor of the Mount Vernon fund intervened to support investors in the fund. *See*, *e.g.*, Mount Vernon Securities Lending Trust – Mount Vernon Securities Lending Prime Portfolio, SEC Staff No-Action Letter (August 3, 2009) (indicating that fund in question benefited from a "capital support agreement" provided by a bank holding company).

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	collateral reinvestment practices, coupled with AIG's financial distress, caused it to sell assets that had become illiquid at a loss in order to return the cash collateral. This substantially contributed to AIG's losses. This risk was not limited to AIG. Some asset managers also invested cash collateral in assets adversely affected by the financial crisis, such as structured investment vehicles and Lehman Brothers notes, and they provided financial support to those cash collateral reinvestment funds. ***The losses on cash collateral reinvestment amplified fire sales and runs during the crisis. They also contributed to the seizing of the money markets, in which cash collateral was typically invested***. Daily marks and return of	as an investment alternative in and of itself, whatever the source of the invested cash – may be worthy of study, that is not, by the Report's own terms, a matter sought to be addressed presently by the OFR. It is important to emphasize that existing regulation restricts securities lending activities by registered investment companies. Indeed, such securities lending has been subject to significant restriction for over 30 years. Pursuant to SEC guidance,[34] these kinds of transactions have been subjected to the same kinds of limitations that apply to leverage generally (discussed in the next section below). In effect, leverage associated with securities lending transactions cannot exceed one third of a registered investment company's asset base. Moreover, a registered investment company, pursuant to the SEC guidance, generally must receive cash or government securities as collateral equal to the value (marked-to-market daily) of the lent securities. Although the Investment Company Act and regulations promulgated thereunder do not dictate how the cash collateral is invested, it must be invested otherwise in accordance with the investment company's investment objective(s), policies, guidelines and restrictions. These regulations have been effective over a long period through many different market environments and have made it unlikely that a registered investment company's reinvestment of cash collateral could result in significant losses, such as those incurred by AIG.

[34] The guidance is primarily set forth in a series of SEC staff no-action letters. *See, e.g.*, State Street Bank and Trust Company (Jan. 29, 1972); State Street Bank and Trust Company (Sep. 29, 1972); Salomon Brothers (Sep. 29, 1972); Norman F. Swanton Associates (Oct. 13, 1973); Standard Shares, Inc. (Aug. 28, 1974); Adams Express Company (Oct. 9, 1974); Salomon Brothers (May 4, 1975); Merrill Lynch Capital Fund, Inc. (March 9, 1978); Adams Express Company (Oct. 20, 1979); SIFE Trust Fund (Feb. 17, 1982); Twentieth Century Investors, Inc. (Nov. 26, 1982); Norwest Bank Minnesota, N.A. (May 25, 1995); Morgan Guaranty Trust Company of New York (April 17, 1996); The Brinson Funds (Nov. 25, 1997); The Chase Manhattan Bank (July 24, 2001); and Investment Company Institute (December 14, 2005).

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	collateral due to the declining stock market further stressed the liquidity of collateral reinvestment funds." (16)	

<table>
<tr><th>OFR
PRINCIPAL
CONCERN</th><th>OFR
SPECIFIC
OBSERVATION</th><th rowspan="2">SIDLEY
COMMENTARY</th></tr>
<tr><th colspan="2">Vulnerability Cited</th></tr>
<tr><td>Leverage

“The recent crisis illustrated that leverage, particularly short-term leverage, can subject borrowers to margin calls and liquidity constraints that increase the risk of fire sales.” (17)

“Asset managers can use leverage at the firm level (borrowing by the firm itself), or the fund level (fund borrowing, or closed-end funds offering both common and preferred shares), or the portfolio level (acquiring leveraged, structured products or trading in derivatives).”</td><td>Leverage can increase risk of liquidity problems.

No specific observations are provided.</td><td>The Report makes several general statements regarding use of leverage, but none of them are tied to risks specifically and directly associated with registered investment companies. This is not surprising since open-end registered investment companies are highly restricted when it comes to the amount of leverage that they may take on. They can only borrow from banks and, in effect, they must effectively maintain a ratio of indebtedness to equity of no greater than 1 to 2.[35] Closed-end funds can issue debt and preferred equity, but immediately after issuance must have a ratio of indebtedness to equity of no greater than 1 to 2, and indebtedness and preferred equity to common equity of no greater than 1 to 1.[36] The Report itself acknowledges this:

<blockquote>The Investment Company Act . . . limits leverage levels for investment companies registered under that act. For example, mutual funds generally are required to hold assets equal to at least 300 percent of their bank debt, restricting leverage from bank debt to 33 percent of assets. Closed-end funds may also create leverage by issuing preferred shares. (17)</blockquote>Unfortunately the Report then shifts, without analytic bridge, and rather against its own ground rules, to address private funds:

<blockquote>However, unregistered funds and accounts are not subject to these regulatory restrictions. Some complex trading strategies of such funds—such as “carry” trades in different currencies—often rely on leverage to boost returns. (17)</blockquote>It is hard to see how this observation adds to the analysis at hand. More to the point, we believe, is a comparison of the leverage levels permitted for open-end registered investment companies, on the one hand, and some of the tightest leverage restrictions found in Dodd-Frank, on the other. By contrast to the very conservative maximum ratio of 1 to 2 applicable to open-end registered investment companies, a maximum debt-to-equity ratio of 15 to 1 is built into one of Dodd-Frank’s most restrictive provisions. The 15-to-1 ratio – a ratio that would permit 30 times as</td></tr>
</table>

[35] Investment Company Act Section 18(f)(1).

[36] Investment Company Act Section 18(a)(1) and (2).

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
(17)		much debt as a 1 to 2 ratio – is triggered if the Council determines that a particular company "poses a *grave threat* to the financial stability of the United States" (emphasis added).[37] This is a provision intended to function only in case of exceptional – *i.e.*, grave – circumstances. By contrast, the Section 113 standard, for SIFI designation in the first instance, is a company that "*could* pose a threat to the financial stability of the United States" (emphasis added). The clear implication is that SIFIs – unless they are found to pose a *grave* threat – are permitted debt to equity ratios in excess of 15 to 1. By contrast, open-end registered investment companies are restricted to 1 to 2. One is left to wonder, if leverage is said to be a concern, how application of the SIFI regime to a manager or fund would reduce risk at all. The Report makes passing reference to the fact that asset management firms "can use leverage at the firm level (borrowing by the firm itself)," but then does not address this risk at all. That there is no follow-up discussion or analysis in this regard is not surprising since asset managers provide their services as agent and do not use their balance sheets in a way similar to a bank or other large financial institution that takes direct investment from market participants. Thus, while it is abundantly clear from recent financial history that leverage can be a contributing factor in destabilizing financial markets, the subject is largely irrelevant to the question of whether an investment manager or one or more of its funds should be designated SIFIs.
	Derivatives are a potential source of leverage. "In addition to borrowing, ***asset managers obtain leverage for their funds and accounts through derivatives*** (futures, options, and swaps), securities lending, and repurchase	The Report notes that registered investment companies may lever themselves by using derivatives and that the use of such derivatives is subject to current regulation: > Registered funds are permitted to invest in derivatives, but are generally required to cover these positions with liquid assets equal to the indebtedness exposure created by the transaction; this cover requirement would either be the full obligation due at the end of the contract or, with respect to certain cash-settled derivatives, the daily mark-to-market liability, if any, of the fund under the derivative. Alternatively, a fund may be permitted to cover by holding an offsetting position that effectively eliminates the fund's exposure on the transaction. Cover is not required for instruments that create economic leverage but no indebtedness leverage. (17)[38]

[37] Dodd-Frank Section 165(j)(1).

[38] The requirement that registered funds segregate liquid assets to cover indebtedness exposure created by certain transactions stems from a series of SEC staff statements of policy and no-action letters starting with "Securities Trading Practices of Registered Investment Companies", SEC Release No. IC-10666 (Apr. 18, 1979).

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	agreements." (17) "***Registered funds also may incur additional leverage through the use of derivatives***." (17) "During the financial crisis, ***the use of derivatives to boost leverage resulted in significant losses for some registered funds***. For example, the Oppenheimer Champion Income Fund and Oppenheimer Core Bond Fund—two fixed-income retail mutual funds—lost roughly 80 percent and 36 percent of their NAV in 2008, respectively. The losses were primarily due to their exposure to total return swaps—a type of derivative in which investors exchange the total gains or losses from a reference asset without owning it—on	Although the Report then cites statistics regarding increases in the usage of CDS (credit default swaps) by registered investment companies, in lieu of providing a statistical or other analytical discussion of problems that might have been associated with the activity, the Report provides two isolated examples. The first is a repeat from the section of the Report addressing redemption risk: the losses incurred by two mutual funds described above as a result of derivatives exposure.[39] The second example cited involves a non-registered fund that had become levered through the use of derivatives. This has no apparent connection to the registered fund universe that is the subject of the Report.[40] Thus, while there certainly can be concern associated with derivative use by registered investment companies, there is no way to know from the Report how much concern – much less how much systemic concern – there should be. What the Report does make clear, however, is that the SEC is working on determining an answer to the question whether additional regulation is in order. As noted in the Report, the SEC initiated a review of the regulations and policies associated with derivative use and, in September 2011, published a concept release entitled, "Use of Derivatives by Investment Companies Under the Investment Company Act of 1940 (the ***Release***).[41] The SEC noted in the Release (at page 55238): > [F]unds employ derivatives for a variety of purposes, including to increase leverage to boost returns, gain access to certain markets, achieve greater transaction efficiency, and hedge interest rate, credit, and other risks. At the same time, derivatives can raise risk management issues for a fund relating, for example, to leverage, illiquidity (particularly with respect to complex OTC derivatives), and counterparty risk, among others. The important point, then, is that the limited evidence adduced by the Report in the context of its discussion of derivatives does not warrant a new regulatory regime, where the incumbent regulator, the SEC, is actively examining the question of updating and improving, if necessary, its regulation of the area.

[39] *See* discussion at p. 25 above.

[40] Our ability to comment on the second case is hampered by the lack of any meaningful background information. The footnote in the Report associated with the short discussion of these State Street funds says simply (and without further reference): "State Street was cited by the State of Massachusetts for noncompliance with state disclosure requirements." We do note that disclosure, not leverage, was the cited concern.

[41] Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, SEC Release No. 29776, 76 FR 55237 (Sept. 7, 2011), available at: http://www.sec.gov/rules/concept/2011/ic-29776.pdf.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
	AAA-rated tranched commercial mortgage-backed securities. (18)	

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
Vulnerability Cited		
Firms as Source of Risk "The failure of a large asset management firm could be a source of risk, depending on its size, complexity, and the interaction among its various investment management strategies and activities. Distress at a large asset manager could amplify or transmit risks to other parts of the financial system." (18)	**The failure of an investment management firm could be a source of systemic risk.** See bullet points at right.	While this section of the Report purports to consider whether asset management firms themselves could be sources of risk, it provides no reliable evidence to support this proposition in the context of registered funds. In fact, this section never even directly addresses the question in this context. • The Report speaks of the potential that "a firm could manage a number of large, highly leveraged *unregistered funds* which have strategies that turn out to be correlated in ways firm risk managers did not anticipate either because correlations shifted in times of stress or because the manager failed to consider certain factors that led to correlations among portfolio assets." (19) The Report does not tie this statement, even by means of an equally speculative hypothetical, to managers of registered funds. • The Report cites the risk, discussed elsewhere in the document as well, that "[s]imilar concerns could arise [in respect of] a firm *with extensive repo and securities lending businesses*, and that managed strategies with an array of interconnections through derivatives and other exposures." (19) But it is not at all clear what bearing the failure of an investment manager would have on these kinds of exposures. As discussed below, were the investment manager of a registered investment fund to fail, it would likely be, thanks both to standard contractual arrangements and related regulatory flexibility, a reasonably straight forward matter of engaging a substituted manager. • The Report speaks of "complex financial institutions with asset management divisions [that] suffered material distress during the recent crisis" (19), but the Report does not suggest that the distress emanated from or was exacerbated by their asset management divisions. Indeed, the cited companies (Bear Stearns, Wachovia and Lehman) were banks and investment banks that had substantial balance sheets that came under duress, and the Report noted that "[d]uring the crisis, stress spread between these companies' other businesses and their asset management subsidiaries." (19) These are exactly the kinds of financial institutions that have properly been the focus when regulators consider systemic risk. In fact, they were among the most notable intended targets of the SIFI designation regime.[42] To suggest a linkage between

[42] As noted by Federal Reserve Governor Daniel Tarullo during a speech at a 2011 Credit Markets Symposium: "All this suggests to me that the initial list of firms designated under section 113 of the Dodd-Frank Act should not be a lengthy one. In part this is because some of the most obvious pre-crisis candidates – the large, formerly free-standing investment banks--have either become bank holding companies, been absorbed by bank holding companies, or gone out of existence." *See* http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.htm.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
		the asset management divisions of companies with large troubled balance sheets, on the one hand, and independent investment managers that advise registered investment companies, on the other, is misguided – particularly in a context where the investment managers themselves, not related entities with large levered balance sheets – are the focus. The Report notes that "[a]s agency businesses, asset management companies tend to have small balance sheets" (19), but it then fails to draw the reasonable (if not obvious) conclusions regarding the correspondingly low probability that they will fail and even lower probability that they will transmit risk of the type and scale that would threaten U.S. financial stability. • Similarly misguided is the Report's reference to "the Federal Reserve's annual stress test requir[ing] *the asset management divisions of large bank holding companies* with *money-like funds* to set aside capital to cover the risk that they would have to support some of their funds during stress conditions." (19) It is not clear how this analytical *non sequitur* is connected to the stated scope and purpose of the Report. The Report also posits that "[u]nder stress, counterparties also might not distinguish among exposures to the firm and its funds, and therefore could take risk-mitigating actions that could aggravate risks across the firm's funds and accounts." (19) Tellingly, the Report offers no evidence that this hypothetical risk has borne out outside of circumstances where, as in the case of Lehman and Bear Stearns, a large balance sheet was under significant distress. It bears emphasis that the structure of investment advisory relationships provides significant protection: a failing fund manager can and should be jettisoned by its fund advisees without too much difficulty. We note that both standard contractual arrangements between registered investment advisers and their investment managers, and applicable regulation, work to limit the friction of removing a failing manager. In this context the following factors would play important roles: • Registered investment companies are required to have boards of directors, which, through the application of various exemptive rules, are generally comprised of at least a majority of independent directors. In the event of the failure of a fund's investment manager, the board would have the fiduciary obligation to remove the manager and engage a new one. That is likely to occur either before or promptly following any actual failure. • Investment advisory agreements with registered investment companies must provide, in substance, that they may be terminated at any time, without the payment of any penalty, by the board of directors of such registered company or by the vote of a majority of the outstanding voting securities of such company on not more than 60 days' written notice to the investment adviser. Although new advisory agreements with registered investment companies must generally be approved by the vote of a majority of the outstanding voting securities of the registered company, a temporary investment advisory agreement may be entered into, without shareholder approval, after an existing advisory agreement has been terminated, subject to certain conditions, including board approval. The temporary investment advisory agreement can have a duration of no greater than 150 days following the date on which the previous advisory agreement

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
		terminated.[43] • Most registered investment companies custody their assets with a bank, pursuant to Section 17(f) of the Investment Company Act.

[43] Investment Company Act Rule 15a-4.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
Transmission Channel Cited		
Exposure to Creditors, Counterparties, Investors, or Other Market Participants "The connections asset managers have with an array of financial companies, both within a holding company structure and with outside entities, could transmit risks among asset managers, other financial companies, and broader markets." (21) "The 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	"Having ***common service providers***, such as custodians, pricing providers, or securities lending brokers, or having ***common, large clients as investors***, ***could result in common difficulties*** in the event of widespread service disruptions or redemptions." (21) "During interviews, asset managers suggested that counterparty risk management varies widely, with some firms establishing separate counterparty teams and others taking a fund-level approach subject to the discretion of portfolio managers. Funds are not specifically required to conduct ongoing credit analysis of their derivatives counterparties." (21)	We agree that many institutional investors, including asset management firms, principally through their funds, have multiple linkages with other market participants. But affiliations between funds regulated under the Investment Company Act and their investment managers, and investment manager affiliates, are strictly limited, and thus such channels of transmission of market risk should be limited. Extensive rules limiting conflicts of interest – and, therefore, connections – apply to registered investment company groups under the Investment Company Act: • Section 17(a) generally prohibits "principal" transactions between a registered investment company and its investment adviser or affiliates. • Section 17(d) and Rule 17d-1 restrict joint transactions between an investment company and its investment adviser or affiliates. • Section 17(e) and Rule 17e-1 limit the compensation that an affiliate of an investment company may receive as agent or broker for the investment company. • Section 10(f) and Rule 10f-3 restrict an investment company's ability to acquire securities underwritten by an underwriting syndicate in which its adviser's affiliate participates. In addition, pursuant to Sections 17(a) and 17(d) of the Investment Company Act noted above, mutual funds may not borrow from or lend money to an affiliated mutual fund in the absence of an SEC exemptive order (which will typically impose restrictions intended to protect both funds). Registered investment companies may invest in other investment companies only in compliance with the provisions of Section 12(d)(1) of the Investment Company Act and the rules thereunder. Section 12(d)(1)(A) provides that a registered investment company cannot acquire a security of another investment company if, immediately after such acquisition, it would own: • more than 3% of the total outstanding voting stock of the acquired company; • securities issued by the acquired company having an aggregate value in excess of 5% of the value of the total assets of the acquiring company; or • securities issued by the acquired company and all other investment companies having an aggregate value in excess of 10% of the value of the total assets of the acquiring company.

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
asset managers could be transmitted to other market sectors.” (21)		Section 12(d)(1)(G) permits open-end registered investment companies to purchase shares of other open-end funds in excess of the limits of Section 12(d)(1)(A) provided that the funds are part of the same group of investment companies. However, these affiliated funds of funds can invest only in funds in the same fund family, U.S. Government securities, short-term paper and other investments permitted by Rule 12d1-2. Also, the acquired company must have a policy that limits its acquisition of any securities of registered investment companies.
Disruptions to Financial Markets Caused by Fire Sales “Higher demand for liquidity associated with fire sales can magnify and spread quickly across both asset classes and financial institutions, causing market prices to decline and market confidence to fall across market sectors.” (21-22)	“Mutual funds faced significant redemption requests during the crisis. . . . Although redemption risks that increase outflows from funds during periods of market stress do not necessarily pose threats themselves, they complicate liquidity management and can contribute to fire-sale risk.” (23)	The Report repeatedly underscores the potential in the financial markets for fire sales. A listing of the subheadings to the bulleted points on page 22 of the Report reinforces this observation as it echoes the organization of the Report as a whole: • *Large market positions and concentrations* • *Illiquid markets* • *Reputation risk* • *Crowded trades* • *Leverage* • *Transactions with liquidity “puts”* • *Funding mismatches* As noted in response to most of these topics above, the Report fails to draw any objective, measurable or model-able connection between these market risks and the asset management business. In any event, the broad subject of the risk of fire sales in this context relates directly to two earlier subjects: redemption risk and leverage. Any need for liquidity and resulting fire sales would be a function of one or the other. As noted above, funds that are registered under the Investment Company Act are strictly regulated in both regards: open-end funds must maintain most of their assets in compliance with liquidity requirements because they offer daily redemption rights; and all registered funds are subject to limitations on leverage (including via securities lending and derivatives). The outflows from certain mutual funds cited in the Report[44] seemed to reflect selling pressures in the market as a whole – via the agency of investment funds and their investment managers. This investment behavior is altogether

[44] The Report (at p. 23) notes that, “[a]ccording to Morningstar, 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.” “According to some research, mutual funds in 2008 appeared to have been affected by fire-sale dynamics. Sharp declines in the value of their holdings of financial stocks may have compelled asset managers to sell off nonfinancial stocks in their portfolios as well. As evidence, researchers found in a 2012 paper that 10.5 percent of the 52 percent decline in the U.S. stock market related to the crisis could be attributed to distressed selling by mutual funds.”

OFR PRINCIPAL CONCERN	OFR SPECIFIC OBSERVATION	SIDLEY COMMENTARY
		independent of the presence of asset managers as agents for the investor-principals. No evidence is presented even to suggest a conclusion that designation of an investment manager or one or more of its registered investment companies as a SIFI would influence investors' behavior.