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November 1, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

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

Re: Comments on Report from the Office of Financial Research entitled "Asset Management and Financial Stability"

Dear Ms. Murphy:

Fidelity Management & Research Company[1] ("Fidelity") appreciates the invitation from the Securities and Exchange Commission ("SEC") to comment on the report entitled "Asset Management and Financial Stability," which the Office of Financial Research ("OFR") published on September 30, 2013 (the "Report"). As we describe in greater detail in this letter, the Report presents an incomplete, inaccurate and misleading view of the asset management industry and, thus, cannot serve as the basis for meaningful policy discussions or regulatory recommendations. In the absence of a far more accurate picture and credible analysis of this diverse industry, the Financial Stability Oversight Council ("FSOC") will be unable to conclude whether threats to financial stability actually arise from asset management, let alone whether any such threats are significant enough to warrant a regulatory response or what the appropriate response might be.

We applaud the SEC's invitation to comment, which in our view represents a healthy willingness to engage with the industry on these issues and an acknowledgement that the industry and others have expertise and perspectives that regulators should consider when they make significant policy decisions or, as with the Report, do work that is intended to inform those policy decisions. The SEC's model of engagement and transparency contrasts with the way in which the OFR produced the Report.

The FSOC directed the OFR to study the asset management industry to help it consider some fundamental questions. These include: (i) whether any threats to financial stability could arise from asset management; (ii) whether they are significant enough to warrant a regulatory response; and (iii) what form that response should take (i.e., would

[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.

designation under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") ever be appropriate or is asset management better regulated using a different regulatory regime).[2] As we explain in Section I below, the OFR's description of the asset management business is incomplete and inaccurate. It excludes significant market participants and industry segments in its attempt to broadly outline the industry. It also fails to recognize many of the salient characteristics of asset management or to appreciate the policy implications of the distinctions among asset management entities, activities, and markets in which managers invest their clients' funds. Therefore, it fails to advance the discussion of whether threats to financial stability could arise from asset management. The OFR speculates about the existence of such threats without (i) specifying the entities, activities, or markets from which they purportedly arise; (ii) substantiating them with data, measurements, or models; and (iii) considering appropriate policy alternatives to address them.[3] This speculation does not become more compelling through repetition.

The OFR fails to provide sufficient data or analysis to support any of the speculation included in the Report, which we find striking given that the OFR has described itself as "focused purely on research, data, and analysis."[4] In the Report, the OFR states that "significant data gaps impede effective macroprudential analysis and oversight of asset management firms and activities,"[5] a sentiment that is echoed throughout the Report. While it may be the case that the OFR did not have all of the data it would have liked, the OFR acknowledges that a wide spectrum of data is available, particularly with regard to registered funds.[6] It is unclear whether and how the OFR utilized any of the available data in its analysis, as none is mentioned or cited. Regardless, the alleged lack of data did not prevent the OFR from drawing conclusions and purporting to identify risks that may arise from asset management. It does so in

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[2] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637, 21644 (Apr. 11, 2012); Dodd-Frank Act § 113, Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[3] Section 153(a) of the Dodd-Frank Act charges OFR with "performing applied research and essential long-term research" and "developing tools for risk measurement and monitoring." Dodd-Frank Act § 153(a). The Report does not contain any such research or propose any such tools. In its 28 pages, the Report uses the words "could," "may" and "potential" or "potentially" over 150 times, frequently to describes threats to financial stability or transmission mechanisms about which it speculates without offering any data, measurements or models in support. (See, e.g., the chain of unsupported speculation in the following excerpt: "As an agency business, a financial services firm that suffers damage to its reputation through an extreme event in one business or fund *may* suffer redemptions or creditor pullbacks in its other funds or businesses. For example, investors in funds or accounts offered by a large asset management fund complex *may* react negatively together if the family is tainted by an operational failure, exposure of poor risk management practices, or collapse of a single fund. Although firm-specific problems are often attributed to firm idiosyncrasies and *may* not have broader market impacts, problems associated with an activity involving a large number of asset managers *could* affect market confidence and lead to redemptions."[emphasis added] Office of Financial Research, Asset Management and Financial Stability 13-14 (2013) ("OFR Asset Management Report").

[4] Office of Financial Research, 2012 Annual Report at iv ("Annual Report").

[5] OFR Asset Management Report, *supra* note 3, at 24.

[6] *Id.* at 2.

many cases without distinguishing between registered and unregistered funds, between activities and products for which data is available and those for which it is not, or between risks that it believes asset management creates and market risks that may impact all participants in a given market.

The OFR confuses its discussion of these issues by conflating entities, markets, and concepts. In some cases, the OFR acknowledges risk mitigating characteristics of industry segments and their regulation but then proceeds to draw conclusions as if these factors have no effect. As we discuss in more detail below, these are only a few of the deficiencies in the Report, but they are representative.

We believe these deficiencies are due to several factors that transcend any lack of data. We focus on two in this letter. First, the OFR employed a defective process to produce the Report. We describe this flawed process in Section II and demonstrate that it is characterized by a failure to engage appropriately with subject matter experts and a lack of rigor, transparency and accountability.

Second, as we discuss in Section III, a bank-centric perspective pervades much of the regulatory work on "systemic risk." Given the central roles that banks and similar proprietary risk takers played in the 2008 financial crisis, past financial panics and other instability arising from banking, and the importance of banks in the financial system generally, it is understandable that a bank regulatory perspective would inform this work. It should not, however, be the lens through which nonbank industries are viewed. That approach leads to distorted descriptions of nonbank industries and speculative allegations of possible threats to financial stability. The Report suffers from that approach in that it overemphasizes the few similarities to banking that exist in asset management products, activities and entities, and it under-appreciates or ignores the substantial differences, the effectiveness of existing regulation and other risk-mitigating attributes.

As we have explained to the FSOC and others, certain characteristics of the asset management business and the required regulatory consequences of designation as a systemically important nonbank financial company under Section 113 of the Dodd-Frank Act, which were intended for proprietary risk-takers, make the Section 113 designation authority fundamentally incompatible with asset management entities.[7] Any attempts to designate asset management entities to mitigate a perceived risk would not achieve the desired result; rather, they would likely be destructive and counterproductive. For example, in an industry as competitive as ours with the high degree of substitutability that mutual fund investors enjoy, FSOC designation of a fund out of concern about mass redemptions may itself trigger those redemptions and, in any event, would not prevent investors from seeking the same exposure in an undesignated fund.

[7] Letter from Scott C. Goebel, Senior Vice President and General Counsel, on behalf of Fidelity Investments, to Lance Auer, U.S. Department of Treasury 10 (Dec. 19. 2011). A copy of our December 2011 is attached as Appendix A.

If a threat to U.S. financial stability that warrants a regulatory response were to arise from asset management, a targeted industry-wide solution would be the most effective and efficient response. The SEC's regulatory regimes for registered mutual funds and their advisers are good examples of that approach. The SEC, as the primary regulator for registered mutual funds and their advisers, has used its framework successfully by focusing regulations on specified risks, on an industry-wide basis, for over 70 years. Furthermore, although these regimes were designed to protect investors, and create efficient, robust markets, in doing just that they also addressed many of the topics that preoccupy macroprudential bodies like the FSOC and bank regulators today — topics like leverage, liquidity, diversification, and transparency.[8]

While we continue to believe that asset managers and registered funds do not present threats to financial stability, if the FSOC or any of its member agencies believe the industry bears more consideration, any further steps should be carefully considered, keeping in mind the robust regulatory regime already in place. Further, the SEC is the FSOC member with the most expertise regarding asset management. As such, we believe that the SEC is best suited to advance this policy discussion and set a constructive agenda focused on:

(i) identifying and correcting the flaws in the Report;

(ii) increasing the general understanding of asset management, its regulation and its role in the financial system;

(iii) identifying any data or analysis necessary to accomplish these goals (recognizing that extensive data is already available to regulators on funds, firms and the industry);

(iv) playing a leading role in any efforts undertaken to produce that data and analysis; and

(v) continuing to engage with industry, the public, and other stakeholders in a transparent manner, as the SEC has done by requesting comments on this Report.

We are certainly willing to partner with the SEC in those efforts, just as we were willing to partner with the OFR. Although at times we have different views on particular matters, we are confident that the SEC is the FSOC member with the most knowledge of the asset management industry and should, therefore, design and lead these efforts. We are hopeful, based on the invitation to comment on the Report, that the SEC will continue to drive greater understanding of the asset management business within the OFR and the FSOC.

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[8] For a discussion of these regulations generally, please see pp. 3 and 6 of Appendix A. For a discussion of how much tighter the leverage and liquidity limits are that already apply to registered mutual funds than apply to banks and other SIFIs, please see pp. 10, 13 of this letter.

I. CRITIQUE

The OFR notes in several places in the Report that it does not have all of the data it would like in order to identify and evaluate risks. If true, then one must ask whether the only appropriate conclusion is that the OFR does not have the data it believes it needs. One also wonders how the OFR could reach conclusions regarding the existence of threats to financial stability arising from asset management without such data. In criticizing recent regulatory work on systemic risk generally, Lars Peter Hansen, who received the 2013 Nobel Prize in Economics wrote that "mitigating systemic risk" has become an all-too-common response when anyone questions the need for and wisdom of regulatory actions of the sort that the FSOC and the OFR are considering.[9] Hansen warns that the "term has become a grab bag, and its lack of specificity could undermine the assessment of alternative policies."[10]

Although the OFR does not use the terms 'systemic risk' or 'SIFI' in the Report, it does rely on buzz words that are too frequently part of discussions of systemic risk even though their meanings are ambiguous. These terms include 'vulnerable to financial shocks,' 'disruptions to financial markets,' 'fire sales,' and 'herding.' The OFR features these terms in the Report yet does so not only without proposing explicit definitions or any method to measure them or their impacts, but also without suggesting, measuring, or modeling the costs and benefits of any existing or alternative regulatory responses. In fact, the Report does not advance the discussion of, or take a position on, the question of whether regulatory action is even required in response to any of the risks the OFR names. Rather, in the absence of academic or empirical rigor, the OFR falls back on imprecise allusions to hypothetical threats. Such an approach is troubling because we are concerned that the Report could be used in the future to "rationalize regulatory discretion," whatever form it may take.[11]

Further, data on large segments of the industry is available to regulators that constitute the FSOC.[12] For example, Fidelity and/or the funds it manages file information such as financial statements, comprehensive holdings (including derivatives exposure), and custody information with the SEC on forms such as 13D, 17h, ADV, N-CSR, N-MFP, N-Q, N-SAR, and PF. One can get a sense of the scope and scale of the data already available by considering the amount of information reported on just one of these forms. Based on a recent report by SEC staff, over 2,300 advisers covering over

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[9] Lars Peter Hansen, *Challenges in Identifying and Measuring Systemic Risk*, University of Chicago and the NBER 1 (Feb. 11, 2013), *available at* http://www.nber.org/chapters/c12507.pdf.
[10] *Id.*
[11] *Id.*
[12] *See* SEC, Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports (July 25, 2013).

18,000 private funds have filed Form PF, pertaining to nearly $7.3 trillion in private fund assets.

If the OFR did not analyze this data when preparing the Report, Fidelity encourages it to do so — we cannot ascertain whether and how such data might have been analyzed based on the Report itself. In order to determine whether the OFR requires data that is not currently available to regulators, it must first catalog and analyze what is currently available. If there are, in fact, gaps, we encourage the OFR to work with industry and fellow FSOC members to consider carefully the costs and benefits of requiring its submission.[13] There will be little benefit to regulators and significant costs to the industry unless requests for more data are targeted to specific gaps with respect to particular areas of concern. Blanket requests for reams of data are likely to provide little useful information and could also be prohibitively costly to both the industry to produce and the regulators to receive and analyze.

Generally, the Report describes asset management activities and participants inaccurately and then compounds that problem by neglecting to consider asset managers within the broader context of the financial system.[14] The OFR identifies potential risks and describes them as if they arise from or apply solely to asset managers, failing to recognize or acknowledge that many other entities participate in the activities. The proper approach to performing the assessment the OFR has been tasked with is to consider the asset management industry not in isolation, but, rather, in its place within the broader financial system. For that assessment to be useful, the "models, methods, and measurements" that Hansen describes should be developed and applied to the substantial volume of data that is available, thereby facilitating the requisite discussion and criticism of the resulting analysis.[15] To date the OFR has not followed this approach and, as a result, the Report suffers from many obvious deficiencies. Below, we describe these deficiencies conceptually and then provide a number of specific examples.

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[13] We note and appreciate OFR's previous acknowledgements of the importance of avoiding duplication and collecting data efficiently through a collaborative process. *See, e.g.*, OFR Annual Report, *supra* note 4, at v ("The OFR will not collect data for collection's sake. Indeed, the Dodd-Frank Act requires that the OFR not duplicate others' data collection efforts. The OFR is working with the federal financial supervisors to inventory the data they already collect and to improve data-sharing among them—creating economies of scale, lowering costs, and reducing regulatory burden. While the opportunities are immense for improving financial data available both to supervisors and to financial companies themselves, the Office is sensitive to the potential costs.").

[14] As discussed in Section II of this letter, these flaws are evident in the first three "Figures" in the Report, which OFR says "provide an overview of the asset management industry and its firms and activities." As we explain in Section II of this letter, they do not.

[15] Hansen, *supra* note 9, at 2; U.S. Government Accountability Office, GAO-12-886, Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions 50-51 (2012) ("GAO Report") ("Successfully implementing their mandates will require FSOC members to actively work together and with external stakeholders. Appropriate accountability and transparency mechanisms also need to be established to determine whether FSOC and OFR are effective and to ensure that the public and Congress have sufficient information to hold [them] accountable for results.").

1. Lack of Evidence and Causality

The Report presents conclusions without supporting evidence and, in many cases, even without a clear causal link between an activity and an eventual outcome. The Report relies heavily on anecdotes and, even when support is seemingly cited, closer examination reveals that the support does not always stand for the propositions claimed.[16] The OFR makes many broad, unsubstantiated statements without clearly defining the issues, scope, or scale, and implies that a hypothetical occurrence may somehow be risk worthy of the FSOC's attention no matter how improbable.

2. Failure to Offer a Framework

As mentioned above, the Report was prepared in the context of the FSOC's attempts to consider the appropriate application of its designation authority under Section 113 of the Dodd-Frank Act. This will be an iterative process, just as the FSOC's monitoring of threats to financial stability will be an on-going exercise. If the asset management industry is to be considered as part of that exercise, then, in addition to an accurate picture of industry activities and participants, the FSOC will also require a credible and sustainable framework by which it can continually evaluate the industry. Such a framework should include a clear description of when and where any threats to U.S. financial stability may arise, a model explaining their potential impacts on both financial stability and the U.S. economy, and data to which the framework can be applied. Only with such details can the FSOC or its members then accurately determine whether a response is needed and what form that response should take. For that matter, a clear articulation of the risks to financial stability arising from particular asset management activities would serve to send valuable signals to industry participants insofar as many asset managers would likely opt to moderate or eliminate altogether such "riskier" behaviors.

Regrettably, the OFR provides no such framework in any of the areas of risk it purports to describe. Instead, the OFR seems to have adopted a 'know it when you see it' approach of the sort that Hansen describes. This approach raises serious concerns for future financial regulation because it invites "a substantial amount of regulatory discretion" and "can also lead to bad government policy."[17] As Hansen observes, the discipline that comes from rigorous models and methods could produce useful

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[16] *See* our discussion below of Chester S. Spatt, Chief Economist and Director, Office of Economic Analysis, U.S. Securities and Exchange Commission, Speech at Hedge Fund Regulation and Compliance Conference: Conflicts of Interest in Asset Management (May 12, 2005); Steffanie Brady, Ken Anadu, & Nathaniel Cooper, *The Stability of Prime Money Market Funds: Sponsor Support from 2007 to 2011* (Federal Reserve Bank of Boston, Working Paper RPA 12-3, 2012).
[17] Hansen, *supra* note 9 at 2.

measurements of systemic risk to help counter the "temptation [of regulators] to respond to political pressures."[18]

3. Lack of Deference to Existing Regulatory Restrictions and Industry Characteristics

The Report lists some of the existing industry characteristics, economic incentives, and regulatory restrictions that mitigate the potential impact of the risks it describes. The OFR fails, however, to give sufficient credence to these mitigants. In a few places in the Report, the OFR makes a passing reference to existing regulatory requirements, but then asserts, nonetheless, that risks they are designed to mitigate could threaten U.S. financial stability. Particularly in the case of mutual funds, many of the risks the OFR identifies are mitigated by existing regulation and present no credible threat to U.S. financial stability.

4. Designation is Not the Answer

To the extent that the OFR and the FSOC believe that a risk exists, the FSOC must determine that it poses a "threat to financial stability of the United States" and is not sufficiently mitigated by existing regulation.[19] If the FSOC believes that further action is required in any of the areas the OFR has identified, we believe that the FSOC should defer to the SEC and/or the CFTC as the experienced, knowledgeable capital markets regulators. Designation under Section 113 of the Dodd-Frank Act is unlikely to mitigate any risk that an asset manager, fund or related activity could pose. For example, designation of a fund would likely render it uncompetitive and prompt investors to redeem a substantial portion of its assets. Liquidation would be an ironic result if the designation of the fund were premised on the potential for its material financial distress to threaten U.S. financial stability. Instead, as we explain in Appendix A, we believe that the application of targeted regulations to identified risks on an activity- or industry-wide basis is the most appropriate response.

Herding and Reaching for Yield

The OFR's discussion of herding and reaching for yield exemplifies the deficiencies outlined above. The OFR states that asset managers can 'herd' into securities and that this "could contribute to increases in asset prices," which in turn could magnify "distress if the markets…face a sudden shock."[20] The OFR also notes that portfolio managers may 'reach for yield' or seek higher returns from investing in riskier assets because of competitive factors, low interest rates or low market volatility.[21] The

[18] *Id.*
[19] Dodd-Frank Act § 113(b)(1), Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[20] OFR Asset Management Report, *supra* note 3, at 9.
[21] *Id.*

OFR presents these conclusions without the supporting data and analysis required to illustrate how these activities could contribute to threats to financial stability.

These conclusions are also inconsistent with our experience. At Fidelity, decisions to buy, sell or hold securities are made independently by each portfolio manager, without firm-level influence. Each portfolio manager decides whether a security is best suited for his or her fund's investment objectives and within that fund's prospectus limitations. At any time, and in fact virtually all of the time, portfolio managers at Fidelity take opposing views on one security or another. For example, in the second quarter of 2013, there were more than 25,000 security trades between Fidelity mutual funds and accounts. In each case, at least one Fidelity portfolio manager placed an order to buy a security while another Fidelity portfolio manager placed an order to sell that same security. Of course, because lot sizes and trading days do not always correspond, and some funds and accounts cannot trade between each other under relevant regulatory requirements, there were even more instances in which two Fidelity funds traded in the opposite direction in the same security during the period. In the absence of any data from the OFR, we question (i) what 'herding' means, (ii) what framework could be used to distinguish it from price discovery reflected in normal market activity, and (iii) how any threat it may present to *stability of market prices* could threaten *U.S. financial stability*.

As for how any such risks might be mitigated, the Report mentions in passing that "the asset management industry has many practices and regulatory restrictions that can mitigate such risks", and further acknowledges that "regulatory restrictions are designed to align the interests of investment advisers and their clients and mitigate conflicts of interest."[22] The regulatory requirements that the OFR cites, such as concentration limits, liquidity requirements and comprehensive disclosure obligations, should lead one to conclude that herding behavior is unlikely to present risks in the case of registered mutual funds. Likewise, the obligations to conform to investment mandates and to disclose portfolio holdings, combined with the highly-competitive nature of the mutual fund industry, caution against concluding that reaching for yield is a significant issue in the case of registered mutual funds.

Yet the OFR goes on to question the efficacy of those regulatory restrictions, stating that "potential information disparities between investment advisers and their clients could undermine those mitigants in the industry."[23] The only "evidence" the OFR offers of information disparities is a 2005 speech focused on the alignment of an adviser's interest with those of investors, particularly with respect to fees and compensation. Despite its positioning by the OFR as standing for the proposition that regulatory mitigants could be undermined by information disparities, in fact the speaker simply asserts in the speech that there may be "differences in risk preferences between

[22] *Id.*
[23] *Id.*

the investor and the manager." [24] The speaker does not contend that investors do not understand or accept the risks of investment. Nonetheless, the OFR used this single 2005 speech — again, a speech in which there is a statement that there "may be" differences in investor and manager risk preferences — as a basis to make unsubstantiated leaps in logic and imply that information disparities could negate existing regulation.

At the end of this section, the OFR notes that, "It is important to recognize that asset managers can also have a stabilizing effect on the market. For example, asset managers with the financial strength and liquidity to buy assets trading significantly below their intrinsic values potentially could help to stabilize declines in prices."[25] Considered objectively, this assertion[26] should have caused the OFR to reconsider some of its conclusions.

Redemption Risk

The OFR also discusses redemptions as a key risk, yet fails to identify with any specificity the threat to U.S. financial stability that could result. Instead, the Report makes vague references to factors such as "spread[ing] stress from certain types of portfolio assets to other portfolio assets and market segments," detrimental impacts on market confidence, and increased market risks.[27] Were they to materialize, we do not believe that any of these outcomes would arise from asset management per se, or be of sufficient magnitude to meet the test in Section 113 of the Dodd-Frank Act.[28]

The Report acknowledges that "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." [29] First, Fidelity and the industry interpret the SEC's requirement to mean that mutual funds *must* have at least 85 percent of their assets in liquid securities. Inexplicably, the Report goes on to allege liquidity risk in mutual funds, citing the inability of a fund to impose redemption restrictions. The OFR seems to be conflating redemption dynamics in all funds with long-debated concerns with Rule 2a-7 money market fund redemptions (a topic that is currently being addressed by the SEC), but we fail to see, and the Report does not demonstrate, why such liquidity risk would materialize in transparent, robustly supervised, variable NAV funds with at least 85 percent liquidity. In addition, advisers to mutual funds actively monitor redemption

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[24] Spatt, *supra* note 16.
[25] OFR Asset Management Report, *supra* note 3, at 12.
[26] We use the term "assertion" here advisedly. Although it is Fidelity's experience and belief that asset managers do engage in market actions that have the effect of stabilizing prices, we acknowledge that fact gathering and analysis might be useful in this area.
[27] OFR Asset Management Report, *supra* note 3, at 12.
[28] Dodd-Frank Act § 113(b)(1), Pub. L. No. 111-203, 124 Stat. 1376 (2010).
[29] OFR Asset Management Report, *supra* note 3, at 12.

activity and liquidity in order to comply with the SEC's requirements and also to meet the portfolio's stated investment objectives.

Further, we do not believe that redemptions, which are a normal and appropriate feature of open-end mutual funds, cause negative outcomes, nor does the OFR provide clear empirical evidence that they do. That is not to say that high redemptions in the face of falling asset prices cannot be painful for investors (and investment managers); rather it is Fidelity's view that redemptions simply do not manifest risks to the financial system. Many of the citations and examples in this section of the Report are of idiosyncratic products that are a narrow subset of the overall asset management universe. For example, the OFR cites a Federal Reserve working paper on money market funds[30] (despite an assertion early on that the Report "does not focus on particular risks posed by money market funds"[31]) to argue that investors believe they can rely on sponsor support in a crisis.[32] Whether true or not (and Fidelity believes not), this point simply has no relevance at all for the great majority of asset management products offered in the United States.

The Report also offers a few anecdotes of isolated incidents, apparently neglecting to consider whether the vast majority of funds required manager support within that same environment. Using all of this implausibly to allege a broader expectation of manager support, the Report then goes on to assert that "investors who expect their investments to be protected by explicit or implicit backstops could be expected to redeem funds in larger numbers if there is any sign that protections are eroding."[33] This is yet another example of a leap in logic based on a small sample with unique characteristics. We believe it is inappropriate to draw any conclusions about redemption risk more broadly based on these citations alone.

The OFR states, "Investors in mutual funds with portfolios of securities with varying levels of liquidity may have a 'first-mover advantage' to sell early."[34] Floating NAV mutual funds, which must mark to market their securities daily in order to strike fund net asset values and maintain 85 percent liquidity, do not suffer from a first mover advantage. There is no impetus to redeem immediately because the price at which an investor redeems is an accurate reflection of the value of the fund's underlying securities. To the extent that the OFR and the FSOC believe that funds with stable NAVs present redemption risk, we believe no action is required given that reforms are being properly considered by the SEC in its pending rulemaking on money market funds.

Securities Lending

[30] Brady et al, *supra* note 16.
[31] OFR Asset Management Report, *supra* note 3, at 2.
[32] *Id.* at 14.
[33] *Id.*
[34] *Id.* at 12.

The section on securities lending suffers from many of the same deficiencies we outlined above. The OFR begins its discussion of securities lending programs with its conclusion — that inadequate risk management with respect to the reinvestment of cash collateral in "securities lending programs illustrates how redemption-like risk can create contagion and amplify financial stability shocks."[35]

The most troubling aspect of the discussion of risks posed by securities lending comes at the end. After having drawn conclusions about the risks posed, the OFR admits, "The connection between securities lending markets and cash collateral reinvestment, redemption risk, and short-term funding markets is not well understood and is difficult to measure due to a lack of comprehensive data."[36] Later, they note that collecting transaction and position data on securities lending between large institutions would "improve regulators' visibility into market activities."[37] In light of the OFR's acknowledgement that it lacks data and understanding, it seems reasonable to conclude at most that more data and analysis are needed. The OFR, instead, inexplicably offers conclusions about threats to U.S. financial stability.

In this area, as with many others, the Report could lead one to believe that a regulatory response is warranted. However, even if the data gaps are filled and it can be demonstrated that a risk exists, the FSOC must still consider whether that risk warrants a response and, if so, what form the response should take. Because the Report was prepared in the context of Section 113 of the Dodd-Frank Act, the first inclination may be to consider designation of significant players in the securities lending market. As we explain in our December 2011 comment letter to the FSOC, however, we believe that entity-specific designation would be ineffective and that the only way to mitigate risks appropriately would be through targeted regulations that apply to the entire securities lending market. In fact this is the sort of market-based reform that is currently being pursued in the securities finance markets.[38] Discussing securities lending without discussing these reform efforts presents an incomplete and misleading picture of these markets, asset management's roles in them, and the levels of risk they may present.

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[35] *Id.* at 15.
[36] *Id.* at 16.
[37] *Id.* at 25.
[38] *See, e.g.*, William C. Dudley, President of the Federal Reserve Bank of New York, Introductory Remarks at Workshop on "Fire Sales" as a Driver of Systemic Risk in Tri-Party Repo and Other Secured Funding Markets (Oct. 4, 2013), *available at* http://www.newyorkfed.org/newsevents/speeches/2013/dud131004.html (observing that "we can feel proud of the enhancements that are currently underway in the tri-party repo market," emphasizing that many are the result of collaboration across the market among industry participants and regulators, and stressing that the "diversity of participants in the tri-party repo market has made it difficult to move forward quickly with a market solution" so "[i]ndustry leadership is absolutely critical to overcoming" the remaining challenges.).

Fire Sales

The Report suggests that certain factors in asset management can "increase the likelihood and severity of fire sales."[39] The OFR defines fire sales as "rapid sales of assets that temporarily depress market prices."[40] Determining the price of a security by matching buyers with sellers, known as price discovery, is a central feature of capital markets.[41] And one person's fire sale is another person's buying opportunity; otherwise the transactions never occur. Assuming that every fire sale presents risks is, at best, only looking at half of the picture. Nevertheless, the Report fails to provide specifics that would allow one to identify a fire sale and distinguish it from price discovery.

The OFR has also given the FSOC no ability to gauge the degree of harm that could ensue. In a few sentences, the OFR asserts that fire sales could cause "market prices to decline and market confidence to fall", which in turn could "deepen a crisis."[42] If the OFR believes fire sales can threaten U.S. financial stability, it should identify both potential causes and the point at which it believes that a market decline is of sufficient magnitude that it exceeds the normal fluctuations of a healthy securities market and moves into an area where a threat to financial stability is likely. The next logical step would be to ask what regulatory mechanisms are currently available to maintain market stability and then consider whether they are effective.

Given the OFR's failure to identify and analyze the consequences of any particular fire sale that has occurred in the past, much less how to define a future fire sale, the Report does not improve the FSOC's ability to identify activities or conditions that may give rise to fire sales or to evaluate available regulatory responses. We believe that providing such a framework is a prerequisite if the FSOC or others intend to consider these issues in an informed manner let alone take regulatory action to mitigate any risks that may arise. Normal market volatility hardly raises the specter of 'threats to financial stability' that are a necessary prerequisite to any Section 113 analysis. Further, the goal of regulation under Title I of the Dodd-Frank Act should not be to dampen the inherent risk taking that is a fundamental prerequisite for well-functioning capital markets.[43]

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[39] OFR Asset Management Report, *supra* note 3, at 22.
[40] *Id.* at 21.
[41] Richard Berner, Director of the OFR, noted the importance of price discovery in a May 2013 speech, referring to it as one of the "six fundamental services the financial system provides." Financial Stability Analysis: Using the Tools, Finding the Data (May 30, 2013), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl1960.aspx.
[42] OFR Asset Management Report, *supra* note 3, at 22.
[43] *See* Janet L. Yellen, Chair, Fed. Reserve Bd., Remarks at Fourteenth Annual International Banking Conference: Pursuing Financial Stability at the Federal Reserve (Nov. 11, 2011) ("[S]electing the right policies to address specific forms of systemic risk is important for ensuring that reasonable risk-taking and innovation continue to take place in financial markets so as to foster broader productivity gains, economic growth, and job creation.").

Assuming *arguendo* that a regulatory response is warranted, we believe that designation of a few large asset managers or funds would do nothing to mitigate any risk that fire sales could pose. As we discuss in Section III and Appendix A, the characteristics of the asset management industry render the enhanced prudential standards both inappropriate and unlikely to mitigate any threats from fire sales.

Despite our concerns with the Report generally and the section on fire sales in particular, we recognize that illiquid markets can exacerbate the likelihood and severity of a fire sale. Likewise (as we discuss further below), the existence of leverage can, in times of distress, exacerbate the need to sell securities quickly. For example, in the case of declines in the market price of dot-com stocks in 2000-2001, losses were spread relatively widely across many types of investors, most unlevered. In contrast, in the recent financial crisis, losses were felt disproportionately at key nodes of the financial system, including banks, broker-dealers and securitization vehicles, all of which were highly leveraged and dependent on wholesale short-term financing.

While the risks associated with the business models of those entities are appropriately the subjects of numerous regulatory reforms to address flaws exposed by the last crisis, the registered mutual funds that are within the scope of the Report had no similar issues. We believe their performance during the crisis supports our position that the risks posed by illiquidity and excessive leverage in registered mutual funds generally are adequately addressed already by their existing regulatory regime. For subsets of registered funds with unique characteristics, such as money market funds, the SEC is appropriately considering whether additional reforms are required and what forms they should take. In addition, based on our experience with our own business, we can attest that the majority of our strategies classified as "Unregistered AUM" in Figure 2 are not complex, highly leveraged, or substantially exposed to illiquid securities.

Leverage

Despite the fact that the discussion of leverage suffers from the same deficiencies as other sections in the Report, Fidelity believes that the OFR has properly identified excessive leverage as a potential issue more generally. We recognize and appreciate that excessive leverage can magnify losses and lead to distress, as evidenced by the experience of Long-Term Capital Management or the frequency of bank failures. We were pleased to see that the OFR cited the restrictions on leverage that apply to registered investment companies. We believe that the 300% asset coverage requirement that the OFR identifies, which limits the amount of cash borrowings that a fund can undertake, has worked effectively for many years and has served the interests of mutual fund shareholders.[44]

[44] Investment Company Act of 1940 § 18(f)(1), 15 U.S.C. §§ 80-a1-80-a64 (2006).

In the case of derivatives, the OFR also properly identifies the restrictions that the SEC and its staff have imposed via a series of releases and no-action letters, dating back to its first noteworthy release in 1979.[45] We disagree, however, that the few anecdotes that the OFR mentions constitute proof that mutual funds regularly experience, or are likely to experience, distress from their use of derivatives. Fidelity believes that the SEC's existing requirements on the use of derivatives by mutual funds have been an effective vehicle for controlling risks and we are not aware of evidence to the contrary despite the prominent role derivatives played in the last crisis.

The OFR also identifies the ongoing work by the SEC to evaluate further the use of derivatives by registered investment companies and to consider whether any changes should be made to its requirements. We believe that the FSOC should defer to the SEC on this issue given their considerable experience in this area.

Firms as a Source of Risk

The OFR asserts that "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."[46] And, further, that the "connections that asset managers have with other financial services firms" mean that risk could be transmitted from asset managers to the rest of the market or vice versa.[47] The Report also mentions that "having common service providers…could result in common difficulties in the event of widespread service disruptions or redemptions."[48] As with other areas in the Report, the OFR offers sweeping generalities in place of substantive analysis.

The Report assumes a failure of a large asset management firm as the starting point for its discussion without addressing probability or causation — i.e., whether and how such a failure could arise. At the beginning of the Report, the OFR rightly recognizes that asset managers act primarily as agents, managing money on their clients' behalf.[49] However, the OFR seems to have forgotten this important consideration in its later, more expanded speculation regarding the potential for risk to arise from a firm. An adviser is hired to exercise investment control over client assets subject to certain restrictions, but the assets of a fund never become assets of the adviser nor are they commingled with assets of another fund. The adviser manages the fund's assets but does not become financially responsible for them. Their performance cannot threaten its solvency the way the performance of proprietary assets of a bank or other subsidiary can threaten the solvency of a bank holding company.

[45] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 27, 1979).
[46] OFR Asset Management Report, *supra* note 3, at 18.
[47] *Id.* at 21.
[48] *Id.*
[49] *Id.* at 1.

Asset management entities typically exhibit a low risk of "failure" or financial distress and are therefore unlikely to warrant designation or any other regulatory action intended to address such risk. A loss of confidence in a fund, whether due to declines in asset values or to concern with a class of assets in which the fund is invested, could lead to shareholder losses if the fund were forced to sell securities to meet redemptions on a scale that depressed the market prices of the securities. However, these sales would be little different than if the investors had invested directly in the classes of assets in which the fund was invested. Assets would be sold into the markets and losses incurred. In contrast to bank deposits, the expectation of loss is inherent in an investment in a fund. Given the legal separation between advisers and their funds, any losses to the fund would not impact the balance sheet of the adviser or *vice versa*.[50]

Funds are an aggregation point for individual investors. Their investment goals and risk tolerances drive their investment decisions, such as fund selection. Investors exercise their discretion when choosing to invest individually in a basket of securities or deciding instead to hire a manager because of the scale and expertise that an asset manager offers. Yet, assuming *arguendo* that the OFR has properly identified a particular type of risk (e.g. herding, fire sales, etc.), either an asset manager investing on behalf of an investor or that investor investing directly would create the same issue.

The FSOC cannot designate an individual investor or a portfolio manager whose expertise the investor is hiring. Neither could threaten U.S. financial stability on his or her own. Attempting to regulate the fund or portfolio manager as an aggregation point would be similarly ineffective. The portfolio manager could move to an undesignated firm or start a new one. Likewise, the individual investor could leave the designated entity or, instead, replicate the fund's investment strategy by investing directly in the securities and markets in which it had been invested.

The OFR correctly notes that asset management firms are agency businesses with small balance sheets,[51] and that the amount of proprietary investments made by asset management firms "tend to be small relative to client assets under management."[52] Unlike a bank, the amount of proprietary risk taking by an asset manager is minimal, at most. The small amount of proprietary investments explains why asset management firms are not, and should not be, required to set aside liquidity or capital reserves.

Further, asset management is an intensely competitive business with highly substitutable products and highly mobile assets and participants. The Investment Company Institute ("ICI") reports that over 700 sponsors managed mutual fund assets in the United States in 2012; and intense competition has prevented any single firm or group

[50] Please see Appendix A for a full discussion of the implications these characteristics have for regulatory policy.
[51] OFR Asset Management Report, *supra* note 3, at 19.
[52] *Id.* at 7.

of firms from dominating the market over the past twenty-five years.[53] This competition is evident in other measures as well. For example, the mutual fund industry had a Herfindahl-Hirschman Index[54] number of 465 as of December 2012.[55]

The Report mentions that "several large, complex financial institutions with asset management divisions suffered material distress during the recent crisis" and that "stress spread between these companies' other businesses and their asset management subsidiaries," citing Bear Stearns, Wachovia, and Lehman.[56] This seems to imply that the asset management division could have been the source of this distress, yet no evidence or causal link is offered in support of these contentions. If, after the financial crisis, these three bank-focused examples are all that the OFR can cite, it bears considering whether threats to financial stability actually arise from asset managers or if, instead, existing regulation is effective. Further, the Report neglects to consider that in credit risk evaluations, asset management divisions of large systemically significant banks are conventionally viewed as a credit-positive factor given the stable cash flows, low leverage and low market risk.

The Report also suggests that assessing the threats posed by privately-held asset management firms is difficult because these firms do not issue public financial statements. Again, it seems that the OFR failed to consider available data. For example, as part of the quarterly filing requirements for Fidelity's broker-dealers, we file consolidating statements of financial condition and income for Fidelity's parent company, FMR LLC, with the SEC.[57] Thus, our regulators already have more information about us and other private firms like ours than the OFR seems to realize. Regardless, we believe that, *ceteris paribus*, a privately-held company whose shareholders are engaged in managing the firm is likely to pose *less* risk than a publicly-held company.

In these private firms, the interests of company management and its shareholders are the same when the shareholders are the managers. There is no agency problem of the sort that motivates so much of modern corporate governance at public companies and that many have suggested contributed to the excessive risk-taking that precipitated the 2008 crisis. For example, many have observed the link between investment banks shifting from private partnerships to public companies and the resulting increases in their leverage

[53] Investment Company Institute, 2013 Investment Company Fact Book 24 (2013), *available at* http://www.ici.org/pdf/2013_factbook.pdf ("ICI Report").
[54] In 1982, the Antitrust Division of the U.S. Department of Justice adopted guidelines for challenging mergers based on the Herfindahl-Hirschman Index ("HHI") of market concentration. The HHI considers the number and relative market shares of firms in an industry. The HHI has since become a widely accepted standard for measuring market concentration and determining the competitiveness of markets.
[55] ICI Report, *supra* note 53, at 25. Index numbers below 1,000 indicate that an industry is unconcentrated.
[56] OFR Asset Management Report, *supra* note 3, at 19.
[57] These filings are required by Rule 17h-1T(a) under the Securities Exchange Act of 1934. 17 C.F.R. 240.17h-1T.

and overall risk profiles.[58] Furthermore, private companies have more freedom to invest over longer time horizons than companies who must explain their earnings to markets quarterly. Clearly neither model is perfect or risk-free. However, the OFR's implication that privately held companies like ours present more risk than public companies is unfounded.

These Deficiencies Must Be Addressed

These issues are too important to be discussed in the cursory fashion evident in the Report. Bad policy is likely to result from an approach that does not rely enough on rigorous analysis and relies too heavily on the unfettered discretion of regulators. The Report is particularly concerning because it was borne of an effort by the FSOC to consider exercising its Section 113 authority with respect to asset managers. In matters of U.S. financial stability, which are within the purviews of the OFR and the FSOC, regulatory actions will, by definition, impact the U.S. financial system and the U.S. economy.[59] The consequences of any misguided regulatory actions will extend far beyond companies and markets that may be directly targeted and will have a significant impact on the well-being of individual investors, businesses, the financial markets, and the U.S. economy.

II. DEFICIENT PROCESS

Sound processes are fundamental to researching and analyzing a subject, whether one is conducting academic research or evaluating regulatory policy alternatives. We do not believe the OFR's process met this standard, as it was characterized by (i) a lack of meaningful engagement with the industry experts, including an apparent failure to address concerns raised by the SEC, (ii) creation and discussion of an erroneous and incomplete picture of the asset management industry, and (iii) no apparent attempt to measure or model their hypotheses. These deficiencies in the OFR's process contributed

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[58] *See, e.g.,* Thomas M. Hoenig, Vice Chairman of the Federal Deposit Insurance Corporation, and Charles S. Morris, Vice President and Economist Federal Reserve Bank of Kansas City, *Restructuring the Banking System to Improve Safety and Soundness*, December 2012, at 12. "With the growth of bond markets and the development of MBS securities in the 1980s, investment banks moved from partnership structures to public corporate structures. The corporate structures essentially allowed the investment banks to engage in riskier activities that put the firm's capital at risk, such as proprietary trading, leveraged lending, and hedge fund sponsorship, that the partners were much less willing to do when their own money was at risk." *available at* http://www.fdic.gov/about/learn/board/Restructuring-the-Banking-System-05-24-11.pdf .

[59] *See, e.g.*, FSOC's published rationale for designating Prudential, in which FSOC cites the facts that "Prudential is a significant participant in financial markets and the U.S. economy and is significantly interconnected to insurance companies and other financial firms through its products and capital markets activities" in support of its designation. Thus, the positive or negative effects of Prudential's designation will clearly be felt by the financial markets and the U.S. economy, not just by Prudential. Financial Stability Oversight Council, Basis for the Financial Stability Council's Final Determination Regarding Prudential Financial, Inc. 2 (2013), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf.

significantly to the defects in the Report. They are also representative of a pattern of process deficiencies and a lack of transparency, which members of Congress, the Government Accountability Office, and the industry have called upon the OFR and the FSOC to correct. The flaws in the Report illustrate the perils of continuing to ignore those calls.

Lack of Meaningful Engagement with Industry Experts

Experience with OFR

The OFR appears to have attempted to study the asset management industry without engaging in any meaningful way with either the industry itself or the SEC, its primary regulator.[60] Eighteen months ago, when the FSOC asked the OFR to study the asset management industry[61], we had hoped to share our perspective and experiences. We wanted to engage with the OFR to help them produce something worthwhile that advanced the understanding of the industry in light of the FSOC's request — but we never had meaningful engagement.[62] In fact, the OFR never asked us to confirm information about our firm that they included in the Report. If they had, we would have privately corrected the basic errors they made in describing us. In the first six pages of the Report, Fidelity is named in two tables and, in both cases, the information is wrong.

These errors are noteworthy for two reasons: (i) they could have been avoided with basic diligence — either checking public records or contacting us to confirm the information; and (ii) these tables (referred to as "Figures" in the Report) and one other are supposed to "provide an overview of the asset management industry and its firms and activities."[63] We do not believe they provide a complete or accurate overview of the industry.

Inaccurate

Almost all of the information about Fidelity in Figures 2 and 3 is incorrect. In Figure 3, the Report incorrectly identifies our asset management entity and our parent company. Figure 2 overstates our assets under management ("AUM") by approximately $200 billion. The OFR attributes the additional amount to "Unregistered AUM," so the

[60] *See, e.g.*, Sarah N. Lynch, *SEC Sees Flaws in New Treasury Asset Manager Report: Sources*, Reuters, Oct. 7, 2013, *available at* http://www.reuters.com/article/2013/10/07/us-sec-assetmanager-report-idUSBRE9960XD20131007.
[61] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637, 21644 (Apr. 11, 2012).
[62] It seems our outreach and the OFR's response were not unique. We frequently discuss regulatory developments with other asset management firms and trade associations, all of which have significant resources and expertise. We know that many of them also reached out to the OFR and had similar experiences.
[63] OFR Asset Management Report, *supra* note 3, at 3-6.

Report also overstates our percentage of unregistered AUM and understates our percentage of "Registered Funds AUM." Below, we show both the incorrect numbers from the Report and the correct numbers, as of December 31, 2012.[64]

	Worldwide (WW) AUM *$ in billions*	WW Registered Funds AUM *$ in billions*	Registered Funds AUM *as % of WW AUM*	WW Unregistered AUM *$ in billions*	Unregistered AUM *as % of WW AUM*
Incorrect Data in the Report	$1,888.3	$1,436.3	76.1%	$452.0	23.9%
Correct Data	$1,690.9	$1,489.4	88.1%	$201.5	11.9%

Basic errors such as these raise obvious questions about the accuracy of the rest of the data in the Report and the validity of the OFR's analysis. They also clearly illustrate the need for the OFR to be more transparent and work more collaboratively with the industry.

The other errors in the first three Figures are conceptual in nature. The OFR omits key players in its representation of the industry. For example, Figure 1 omits some large pools of "private investable assets" such as those managed by family offices. Further, by focusing on private investable assets, the OFR also omits some of the largest pools of *investable assets*, including those managed by the Federal Reserve Board ("FRB"), Fannie Mae and Freddie Mac, and sovereign wealth funds.[65] These investors can and do move markets and, as such, Fidelity believes they should be included in any analysis of the asset management industry.

Figures 2 and 3 exhibit similar conceptual errors given that their stated purpose is to "provide an overview of the asset management industry and its firms and activities."[66] Figures 2 and 3 only describe the "Top 20 Asset Managers." They do not explain how these Top 20 managers are representative of an entire industry that is highly competitive and highly fragmented and whose activities and participants are highly diverse.[67] The only observation OFR offers regarding the diversity among the 20 named managers is to note that they "vary significantly in the extent of their unregistered investment

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[64] *See* Fidelity Investments, http://www.fidelity.com/inside-fidelity/fidelity-facts/fidelity-corporate-fact-sheet .
[65] OFR Asset Management Report, *supra* note 3, at 4, Figure 1.
[66] *Id.* at 3.
[67] On page 3 of the OFR Asset Management Report, the OFR claims that the industry is simultaneously "highly competitive" and "highly concentrated." We agree that the industry is highly competitive, but fail to how see how it could be highly concentrated at the same time. Further, the OFR's claim of concentration is not consistent with the mutual fund industry's HHI of 465. *See* ICI Report, *supra* note 53, at 25.

management activities."[68] They do not discuss in any detail the substantial variation in their ownership, corporate structures, business lines, product and service offerings, customers or existing regulation. These lists hardly present a picture of the industry let alone an accurate or complete one.

Lack of SEC Involvement

The SEC has decades of expertise studying the asset management industry and regulating effectively the parts over which it has jurisdiction. Although the FSOC asked the OFR to produce the Report, we firmly believe that the SEC should have played a leading role in preparing it. If media sources are correct, the OFR failed to take the SEC's "critical feedback" into account and therefore did not correct significant flaws in the report.[69] If true, we believe the OFR missed an opportunity to improve the quality of its final product by working more closely with the SEC.

A Troubling Pattern

The flawed process that resulted in this Report is characteristic of past OFR and FSOC conduct that many have observed and called upon them to change. The Government Accountability Office issued the most sweeping and fundamental call for the OFR and the FSOC to change when it published a report entitled "New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions" (the "GAO Report").[70] The GAO Report highlights a number of deficiencies in OFR and FSOC practices that are consistent with the deficiencies we found in this Report. The GAO cited the following issues:

- *Lack of Rigor* — The GAO found that the FSOC does not "use a systematic forward-looking approach to identify" threats to financial stability and that "some threats may not be identified consistently or at all."[71] The GAO also found that information missing from FSOC reports makes it difficult to determine which threats "require immediate action, which potential emerging threats are most likely to have severe outcomes, and how best for decision makers to address differing threats."

- *Lack of Transparency and Accountability* — The GAO called on the FSOC to create "a collaborative and comprehensive framework for assessing the

[68] OFR Asset Management Report, *supra* note 3, at 3.
[69] *See, e.g.*, Lynch, *supra* note 60.
[70] See, GAO Report, *supra* note 15.
[71] *Id.* at 53.

impact" of designations on designated companies and on the U.S. economy.[72] If the FSOC or the OFR has created such a framework or a baseline for measuring the effects of the initial nonbank SIFI designations, they have not published it. And, as the GAO states, "Appropriate accountability and transparency mechanisms also need to be established to determine whether FSOC and OFR are effective and to ensure that the public and Congress have sufficient information to hold the entities accountable for results."[73]

- *Collaboration Is Essential* — Although the GAO called on the OFR and the FSOC to take a number of remedial actions, they also encouraged them to engage with others. The GAO recommended that the OFR and the FSOC "promote collaboration among FSOC's members and with external stakeholders, which is critical to their ability to achieve their missions."[74] The GAO went on to note specifically that collaboration with external parties could include using "industry experts."[75]

There have been multiple letters from members of both houses of Congress calling on the OFR and the FSOC to correct the problems identified by the GAO Report and stressing the importance of these issues more generally. For example, the Chairman and the Ranking Member of the Senate Subcommittee on Securities, Insurance and Investment sent Secretary Lew a letter expressing their views that transparency and public comment are critical to the FSOC's responsibilities and emphasizing the "distinct differences between the banking business model, on which the SIFI designation authority and regulatory scheme are based, and the business models of other financial services industries such as asset management."[76] The response from Treasury to the Senators' letter merely recited previous commitments that were the original basis for the Senators' criticisms, and did not respond directly to the Senators' concerns.[77]

When considered in isolation this correspondence is worrisome, but in the context of previous calls for the OFR and the FSOC to change their approach, the pattern of behavior becomes more alarming. With respect to the Report, the OFR appears not to have heeded calls for process improvements. Although we appreciate the fact that the OFR published the Report, we also note that, notwithstanding the calls for public engagement, neither they nor the FSOC asked for comments.

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[72] *Id.* at 55 (Such a "framework should include assessing the effects of subjecting designated [financial market utilities] and nonbank financial companies to new regulatory standards, requirements, and restrictions; establishing a baseline from which to measure the effects; and documenting the approach.").
[73] *Id.* at 50-51.
[74] *Id.* at 54.
[75] *Id.* at 55.
[76]Letter from Sen. Jon Tester & Sen. Mike Johanns to Jack Lew, Chairman, Financial Stability Oversight Council (Apr. 25, 2013).
[77] Letter from Alastair M. Fitzpayne, Assistant Secretary for Legislative Affairs, Department of the Treasurty, to Sen. Jon Tester (May 30, 2013).

III. BANK-CENTRIC PERSPECTIVE

In addition to the defective process and analytical flaws discussed above, we believe that viewing asset management from a bank-centric perspective also contributed to the poor quality of the report. Much like the pattern of problematic behavior highlighted by the GAO, the OFR and the FSOC need to change this perspective in order to credibly and effectively evaluate nonbank industries.

Banking Crises, Regulatory Responses and Current Momentum

The OFR is a non-voting member of the FSOC and serves as its research arm.[78] Bank regulators are heavily represented on the FSOC, outnumbering capital markets regulators like the SEC and CFTC. In addition, we know that staff from the Federal Reserve system was seconded to the OFR to work on the Report.

The banking sector was at the heart of the 2008 crisis and required the most direct government support under TARP of any industry. Of the $475 billion that the U.S. Treasury reports was committed through TARP's five program areas, "[a]pproximately $250 billion was committed in programs to stabilize banking institutions."[79] The banking sector also benefitted from many of the other crisis-era government support programs, including the Federal Reserve Board's Term Auction Facility and Primary Dealer Credit Facility.[80]

This is not a new phenomenon. Banking crises have required extraordinary support and motivated financial reforms many times since the late 1800s. These range from the financial panics of the late 1800s and early 1900s that motivated the establishment of the Federal Reserve System in 1913, to the savings and loan crisis of the 1980s, and to the 2008 crisis which led to the passage of Dodd-Frank Act. The bank-focused regulatory reform efforts prompted by the most recent crisis have continued domestically and internationally. They include the imposition of Basel III capital requirements, stress testing and resolution planning here in the United States and international efforts to designate and regulate global systemically important banks.[81]

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[78] Dodd-Frank Act § 153(a), Pub. L. No. 111-203, 124 Stat. 1376 (2010).

[79] U.S. Department of the Treasury, *Tarp Programs*, http://www.treasury.gov/initiatives/financial-stability/TARP-Programs/Pages/default.aspx# (last visited Oct. 29, 2013).

[80] *See, e.g.*, Board of Governors of the Federal Reserve System, Regulatory Reforms: Term Auction Facility, http://www.federalreserve.gov/newsevents/reform_taf.htm (last visited Oct. 29, 2013); Federal Deposit Insurance Corp., http://www.fdic.gov/news/news/press/2008/pr08093.html (last visited Oct. 29, 2013) ("'This temporary increase in deposit insurance coverage [then from $100,000 to $250,000] should go far to help consumers maintain confidence in the banking system and the marketplace,' said FDIC Chairman Sheila C. Bair.").

[81] *See, e.g.*, Basel Committee on Banking Supervision, *Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement* (July 2013), *available at* http://www.bis.org/publ/bcbs255.pdf.

Finding Bank-like Risks Is Required to Justify a SIFI Designation

The OFR and many members of the FSOC appear to view the nonbank industries that they consider through a bank regulatory lens, which seems to predispose them to find bank-like risks wherever they look. For example, as described above in Section I, the OFR seems to see bank-style "run risk" everywhere, including risks in redemptions and fire sales.

Run risk is familiar to the bank regulators at the FSOC. It is a primary risk for banks — one that the bank regulatory regime was created to address. The SIFI regulatory regime is by and large an enhanced version of the Federal Reserve's bank holding company regulatory regime.[82] Thus, finding bank-like risk is essential to justifying a SIFI designation. If bank-like risk does not exist, there is no justification for imposing the enhanced bank regulatory regime on a company.

One of many problems with this approach is that bank-like risks do not exist in many nonbanks or in many areas of the financial markets. For example, we always manage our customers' money so as to maximize the returns on their investments within the bounds of the relevant investment mandate. Investors may lose money, but a loss creates no solvency risk for the fund or the manager. Further, the risk of potential loss is disclosed to and accepted by investors.

Conversely, those same investors do not accept a similar risk when they deposit their money in a bank. If they lose their deposit, the bank has failed. Bank failures have significant, well understood consequences for depositors, creditors, clients, counterparties, and the financial system. Those consequences help explain the creation of the federal safety net for banks — deposit insurance and Federal Reserve credit.[83]

The consequences of bank failures stand in stark contrast to the limited implications if investors in one or more Fidelity funds lose money on their investments. If the value of an investment in a fund declines, the fund has not failed and neither has the manager. The fund has certainly performed more poorly than the investors and manager had hoped, but everyone involved accepted the possibility of asset price declines; the investor bears the loss and the manager's revenues decline proportionately

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[82] Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies, 77 Fed. Reg. 594, at 597 (Jan. 5, 2012) ("This proposal would apply the same set of enhanced prudential standards to covered companies that are bank holding companies and covered companies that are nonbank financial companies." Although the Federal Reserve states that it may "tailor" those standards for nonbanks, it does not propose or commit to make any specific modifications, and many have observed that it has limited flexibility to do so (*See, e.g.,* note 95 below)).
[83] *See, e.g.*, *supra* note 58, and Thomas M. Hoenig, *Banking Safety Net Makes Wall Street Dangerous*, American Banker – Online (Jan. 17, 2013), *available at* http://www.fdic.gov/news/letters/safetynet.html.

(often both because the asset-based fees typically charged in the industry decline as asset prices fall and because poor performance often leads some investors to redeem). Similarly, if investors redeem their investments for reasons other than performance, the fund has not failed; neither has the manager. The investors may or may not invest their remaining money with another manager or directly in the markets. For these and many other reasons, there is no federal or private "safety net" for funds or their managers.

These distinctions also help explain the differences between the bank regulatory system and the SEC's regime for registered funds. As the Report acknowledges and we discuss above in Section I, the SEC focuses on disclosure transparency and adherence to fund guidelines. Accordingly, investors in a registered fund benefit from significantly greater transparency with respect to their investment than they have into bank balance sheets as depositors. This transparency and the alignment of interests enable more effective oversight and control than exist in the relationship between a bank depositor and the bank. Potential problems arising from that lack of transparency are compounded by a divergence of interests. The bank promises to return the funds and pays the depositor a low interest rate that is justified substantially by the federal safety net. The bank then invests the money and keeps the profits or losses on the investment for itself.

The differences described above are fundamental but they are also representative. The list of differences between banking and asset management is much longer and more significant than any list of similarities. Although the Report acknowledges some of them, in many places it de-emphasizes these differences and exaggerates or imagines similarities, creating a distorted view of asset management. In isolation this would be troubling enough. It is, however, even more concerning given that (i) the Report was commissioned as the FSOC considers the appropriate scope and application of its designation authority under Section 113 and (ii) some FSOC members have recently expressed opinions that this authority has been applied inappropriately based on a lack of understanding of a nonbank industry that is further compounded by an application of "bank-like concepts" to it.

A Recent Example: Insurance

The members of the FSOC with insurance expertise who dissented from the designation of Prudential harshly criticized the FSOC's rationale for designation. In their written dissents, they assert that the FSOC's basis for designating Prudential exhibits many flaws associated with viewing a nonbank industry through a banking lens. The deficiencies they cite are strikingly similar to the flaws in the Report that we describe above. For example Roy Woodall, the independent FSOC member with insurance expertise, wrote that:

> "Key aspects of [FSOC's] analysis are not supported by the record or actual experience; and therefore are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment and the state insurance company resolution and guaranty fund systems. . . . . [FSOC's reasons for designating Prudential] are simply not reasonable or defensible, and provide no basis for me to concur."[84]

One of the primary risks cited in the FSOC's rationale for designating Prudential was run risk.[85] This was an alleged risk that the dissenters assert lacks empirical support and, in any event, would be mitigated substantially by existing regulation and economic incentives. This perspective led another FSOC member to object to Prudential's designation on the basis that the FSOC's rationale "inappropriately applies bank-like concepts to insurance products and their regulation, rendering the rationale for designation flawed, insufficient and unsupportable."[86] The criticism cited above comes from two members who were named to the FSOC *because of their insurance expertise.*

It appears that a similar dynamic at was work when the OFR prepared this Report. Specifically, neither its primary regulator nor the industry appear to have had meaningful input into the Report. It has been reported that the SEC has "been concerned that the people involved in the study lack a fundamental understanding of the fund industry itself." The SEC's concern over this lack of fundamental understanding and a draft of the Report that "exaggerated the riskiness of the business" prompted the SEC to comment on the draft Report but apparently the OFR "failed to take a number of the SEC's critical feedback into account."[87] Now that we have read the Report, we share their concerns. Regulatory actions based on a deficient process will not achieve the desired results and are far more likely to do more harm than good.

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84 Financial Stability Oversight Council, Views of the Council's Independent Member Having Insurance Expertise 1, *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.

85 Financial Stability Oversight Council, Basis for the Financial Stability Council's Final Determination Regarding Prudential Financial, Inc. 3 (2013), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf. For example, "Prudential could face pressure to rapidly liquidate a significant portion of its general account assets to meet redemption and withdrawal requests" and "separate account contract holders, particularly those with guaranteed contracts, also could choose to surrender policies, particularly if they lost confidence in Prudential's ability to meet its obligations."

86 Financial Stability Oversight Council, View of Director John Huff, the State Insurance Commissioner Representative 1, *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf.

87 Lynch, *supra* note 60.

Paradigm Shift

The OFR issued the Report at an opportune moment to consider the appropriate design, scope and impacts of the SIFI regime and other macroprudential regulatory initiatives. We believe the OFR should collaborate with experts and stakeholders to help the FSOC and its member agencies address the many unanswered questions in order to progress in their work.

When the FSOC first publicly described the assignment it had given the OFR to study asset management companies, it acknowledged that those companies and activities may not threaten U.S. financial stability. The FSOC also acknowledged that any risks they do pose may not be "well-measured by the quantitative thresholds approach" that the FSOC designed to identify candidates for designation.[88] We think that these acknowledgements should have led the FSOC to conclude that asset management companies do not present the types or scale of risk that SIFI designation is designed to address. If the thresholds do not "capture" certain companies, it is logical to conclude that they do not present those risks. As we have acknowledged, they may present risks, but not of that type or scale.[89]

We are not alone in thinking it unlikely that asset management companies would present such a threat and that, even if they did, designation would be the wrong answer. Leading thinkers on capital markets, financial regulation and macroprudential policy have expressed similar views.[90] Rather than adopting that view, the FSOC directed the OFR to study asset management. We do not argue that additional, thoughtful study is not a potentially useful exercise, but as described throughout our letter, we are convinced that the Report does not represent thoughtful study that could inform policy discussions or regulatory decision-making.

Key Questions About the SIFI Regime Remain Unanswered

The OFR published the Report at a time when key questions about the design, efficacy, and scope of the SIFI regime remain unanswered.

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[88] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637, 21643-44 (Apr. 11, 2012).

[89] *See, e.g.*, pp.10-12of Appendix A.

[90] *See, e.g.*, Letter from R. Glenn Hubbard, Co-Chair, John L. Thornton, Co-Chair, & Hal S. Scott, Director, Committee on Capital Markets Regulation, to Neal S. Wolin, Acting Chairman, Financial Stability Oversight Council 3 (Feb. 15, 2013) ("CCMR Letter") (concluding that "characteristics of the asset management business make it fundamentally incompatible with the SIFI designation authority and the regulatory regime that comes with it;" and that not only are AUM not indicative of "systemic risk" posed by managers or funds but that AUM also demonstrate "why designation would be an ineffective and therefore inappropriate regulatory approach to asset managers or funds."); *see also* Douglas J. Elliott, *Regulating Systemically Important Financial Institutions that Are Not Banks* 7-8, Initiatives on Business and Public Policy at Brookings (May 9, 2013) (opining that mutual funds, institutional investors and others are unlikely to present sufficient systemic risk to warrant SIFI designation).

Design

The specific regulations that will apply to designated companies are a work in progress. Although the FSOC has designated three nonbank SIFIs, neither the FSOC nor the FRB has determined what designation will mean for those companies.[91] Thus, even though the purpose of SIFI designation is to use FRB supervision and enhanced prudential standards to mitigate threats to financial stability, the FRB has not specified what those standards will be and neither the FSOC nor the FRB have articulated how or why they will be effective.[92] However, based on the FRB's proposed enhanced prudential standards, the FRB clearly intends to start with the bank holding company framework but has provided no specifics regarding whether, how, or when it would tailor that framework for nonbanks.

Efficacy

In Appendix A we describe the attributes of our industry that would make designation an ineffective and inappropriate regulatory response if threats to U.S. financial stability were to arise from asset management. We discuss such matters as the inappropriateness of capital requirements, resolution planning, and the Volcker Rule to the asset management model. We also address structural considerations such as the legal and operational separation between funds and their advisers, which preclude a single designation capturing an adviser and all of the funds it manages. Finally, we examine how designation of an adviser or a fund likely would result in substantial asset flight and, perhaps, liquidation.

We believe that our assessment remains applicable and relevant today. We continue to believe that designation is not an appropriate response if there were threats to U.S. financial stability arising from the asset management industry's activities or participants. Instead, if a such threat were to arise and it is determined that a regulatory response is warranted, a targeted industry-wide solution would be the most effective and efficient response. The SEC's regulatory regimes for registered mutual funds and their

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[91] FSOC has the authority under Section 115 of the Dodd-Frank Act to recommend standards to the FRB, but it did not do so publicly for any of the three nonbanks it designated. FRB's "Enhanced Prudential Standards" under Sections 165 and 166 of the Dodd-Frank Act are not final. *See supra* note 82. Prudential's recent public statement indicates that the capital standards that will be applied to it are not final. Statement from Prudential Financial, Inc. Regarding Final Designation as a Non-bank Systemically Important Financial Institution, http://news.prudential.com/article_display.cfm?article_id=6706 (last visited Oct. 29, 2013).

[92] In its published rationales for the designations, FSOC makes vague statements on this subject and simply recites the types of standards listed in Sections 165 and 166 of the Dodd-Frank Act without providing any details. See, e.g., Financial Stability Oversight Council, Basis for the Financial Stability Council's Final Determination Regarding Prudential Financial, Inc. 11-12 (2013), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf.

advisers are good examples of that approach. The SEC has used that structure successfully to regulate registered mutual funds and advisers for over 70 years.

Many leading policymakers and scholars have opined on the inappropriateness of regulating nonbanks — asset management companies in particular — as if they were banks.[93] For example, FRB Governor Daniel Tarullo has observed that "treating financial firms of all sorts as banks could be both ineffective and inefficient."[94] In the same speech, he also noted that the FRB's authority to tailor those bank standards for nonbanks is strictly limited and that "a more targeted, industry-wide response" may be preferable to address any risks that nonbanks may present.[95]

Furthermore, there are unintended consequences associated with any regulatory action. Given that SIFI designation is intended to impact the U.S. financial system, the risks associated with those unintended consequences are likely to be of a higher order of magnitude than those created by other regulatory actions. Accordingly, they warrant careful consideration before the designation authority is applied. One such risk arises from overreliance on a single, highly complex, bank regulatory scheme.[96]

This suggests that policymakers should consider carefully whether designation of nonbanks should be an option of last resort. Of all the options, designation is the most likely to exacerbate systemic risk. In addition to relying too heavily on a single regulatory model, it is also likely to increase homogeneity of large, interconnected, financial services firms and, therefore, the correlation between those institutions' risks, increasing the risk of multiple failures. As more nonbanks are subjected to the bank regulatory regime via designation they will be forced to adopt similar business models and asset portfolios and will be subject to similar risks, thereby decreasing diversity in the financial services sector. As we have seen in past crises, these similarities will likely increase dramatically during times of stress. The regulators' discretion, abilities, and incentives to deviate from that model and thereby prevent homogeneity are limited for the reasons described above and in Appendix A, among many others.

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[93] *See, e.g.*, CCMR Letter, *supra* note 90, at 3; Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, & Kenneth E. Bentsen, Jr., EVP, Public Policy and Advocacy, Securities Industry and Financial Markets Association, to Jennifer J. Johnson, Secretary, Board of Governors of the Federal Reserve System (Apr. 30, 2012).

[94] *See* Daniel K. Tarullo, Remarks at the 2011 Credit Markets Symposium 7 (Mar. 31, 2011), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf.

[95] *Id.* at 8, n.5.

[96] *See, e.g.,* Andrew G. Haldane, Speech at the Federal Reserve Bank of Kansas City's 36th Economic Policy Symposium: The Changing Policy Landscape (Aug. 31, 2012), at 1 ("For what this paper explores is why the type of complex regulation developed over recent decades might not just be costly and cumbersome but sub-optimal for crisis control. In financial regulation, less may be more.") *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf.

Unfortunately, the public has no way to know what effects the SIFI regime is having on its targets and on the economy. The Chairman of the FSOC has said that nonbank SIFI designations "will help protect the financial system and broader economy."[97] However, the OFR and the FSOC have not created a framework to measure the impacts of the SIFI regime, which itself remains undefined. Therefore, Congress and the public cannot evaluate or hold them accountable for its consequences.[98]

Scope

Just as it is an opportune moment to examine questions about the design and efficacy of the SIFI regime, it is also essential that we examine its appropriate scope. Now that the first nonbanks have been designated, including some obvious pre-crisis candidates like AIG, it is time to consider whether the scope of the SIFI regime has already extended as far as (or farther than) would be appropriate. As we discussed above and have seen in the insurance context, the further from the bank business model the regime is extended, the harder its application is to justify.

Important Questions

Some members of the FSOC may be reluctant to examine these questions. Nonetheless, we encourage the SEC, Congress and others to ask questions such as:

- Is the Dodd-Frank Act's SIFI regime working as intended for banks?
    - If so, what are the intended effects and how are those being measured and monitored?
    - What unintended consequences may also occur and how are those being measured and monitored?
- If the Dodd-Frank Act's SIFI regime is not working as intended for banks, for which it was designed, why is that the case?
    - Why would the FSOC apply it to nonbanks, for which it was not designed?
- When will the SIFI regime for nonbanks be defined?
    - How can the FSOC justify a designation without being able to specify, measure and monitor the intended effects?

[97] Press Release, U.S. Department of the Treasury, Financial Stability Oversight Council Makes First Nonbank Financial Company Designations to Address Potential Threats to Financial Stability (July 9, 2013), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl2004.aspx.
[98] GAO Report, *supra* note 15 at 50, 53-56.

- How, specifically, would designation mitigate a given threat to financial stability?
    - Can the threat be measured or modeled?
    - What evidence does the FSOC have that designation would mitigate it? Can the impact of designation be measured or modeled?
    - What unintended consequences might result from designation? How are those being measured and monitored?
- What alternatives to designation are available? Which of the regulatory alternatives do the data and analysis demonstrate will be most effective and efficient?

We think these questions are fundamental and must be answered before the SIFI designation authority under Section 113 is used. We also believe that these questions should be answered based on rigorous, transparent analysis of available data and an open critical discussion of the policy alternatives.

CONCLUSION

Shared Goals

We have a strong desire to see the OFR and the FSOC operate openly and effectively and to collaborate with them because we have a shared interest in creating a resilient, efficient financial system. Collaboration among regulators and industry stakeholders and experts is critical to achieving that goal.[99]

We share that goal because our customers need to save for the future. The importance of these issues to our customers, our firm and the U.S. economy and our belief in the potential of collaboration among industry and the regulatory community to produce the best outcomes motivated us to offer to collaborate with the OFR. We are reiterating that offer to the OFR and extend it to the SEC and others on the FSOC.

We believe that an objective, rigorous, transparent approach to issues of common concern should underlie regulatory policy discussions like this one. While we continue to believe that the asset management industry, and registered funds in particular, do not present the types of risk that the FSOC was designed to address, if the FSOC or any of its member agencies believe the industry bears more consideration, we believe any further steps should be taken carefully and thoughtfully, keeping in mind the robust regulatory regime already in place. Further, although at times we have different views on particular matters, based on their experience as the primary regulator of asset management and the capital markets, we believe the SEC is best suited to design and lead on these issues.

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[99] *Id.* at 54 (promoting "collaboration among FSOC's members and with external stakeholders...is critical to [FSOC's and OFR's] ability to achieve their missions.").

SEC Leadership and Expertise

We believe that the OFR missed an opportunity to engage constructively with experts on asset management, particularly the SEC. We always welcome the opportunity to provide comments and are encouraged that the SEC has sought input from the public on the Report. The SEC has a well-established process of seeking input from diverse interests to help inform their already substantial expertise in approaching complex issues like this in a rigorous and transparent manner. We continue to believe that the SEC should take the lead in policy discussions impacting capital markets and investors. We encourage the SEC to draw on its expertise and the comments it receives to:

(i) identify and correct the flaws in the Report;

(ii) increase the general understanding of asset management, its regulation and its place in the financial system;

(iii) identify any data or analysis necessary to accomplish these goals (recognizing that extensive data is already available to regulators on funds, firms and the industry); and

(iv) work with other policymakers and industry experts in leading any efforts undertaken to produce data and analysis.

We appreciate the opportunity to comment on the Report. Fidelity would be pleased to provide any further information regarding our comments or respond to any questions that the SEC staff may have.

Sincerely,

cc: *Securities and Exchange Commission:*
The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
Norm Champ, Director, Division of Investment Management

Financial Stability Oversight Council:
Chairman Jacob J. Lew, Secretary of the Treasury
Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Thomas J. Curry, Comptroller of the Currency
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
S. Roy Woodall, Jr., Independent Insurance Expert

Richard Berner, Director of the Office of Financial Research
John Ducrest, Commissioner of the Louisiana Office of Financial Institutions
John 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 McRaith, Director, Federal Insurance Office, Department of the Treasury

Appendix A

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December 19, 2011

Financial Stability Oversight Council
Attn: Lance Auer
c/o United States Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Via Internet: www.regulations.gov

Re: Docket Number: FSOC-2011-0001-0045
Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies

Dear Financial Stability Oversight Council:

Fidelity Management & Research Company[1] ("Fidelity") appreciates the opportunity to comment on the Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the "NPR"), which was published by the Financial Stability Oversight Council (the "FSOC") on October 18, 2011.[2] Fidelity believes that the NPR represents a step forward in the FSOC's efforts to establish a process for exercising this authority effectively and efficiently. We are particularly encouraged by the recognition that the Dodd-Frank Wall Street Reform and Consumer Protection Act (the "DFA") has granted the FSOC multiple tools to mitigate systemic risk in addition to the authority to designate companies under Section 113.[3] [4]

Fidelity continues to believe, however, that the FSOC should provide additional clarity regarding its process for deciding to exercise this supervisory and regulatory authority. Specifically, and as discussed in greater detail in our prior comment letter,[5] we

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[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.
[2] Notice of Proposed Rulemaking Regarding Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 76 Fed. Reg. 64,264 (proposed Oct. 18, 2011) (to be codified at 12 C.F.R. pt. 1310) [hereinafter NPR].
[3] NPR, *supra* note 2, at 64,267 (explicitly recognizing that the DFA has given the FSOC "numerous authorities and tools to carry out its statutory duty to monitor the financial stability of the United States," including "the authority to make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for a financial activity or practice."). Fidelity believes that these recommendations can be made both informally, as contemplated by Subsections 112(a)(2)(E), (F) and (K) of the DFA, or pursuant to the formal process established by Section 120 of the DFA. *See* DFA, §§ 112(a)(2)(E), 112(a)(2)(F), 112(a)(2)(K), and 120 (2010).
[4] All section references refer to sections of the DFA unless otherwise noted.
[5] *See* Letter from Scott C. Goebel, Senior Vice President and General Counsel, FMR Co., dated November 5, 2010, which is available at http://www.regulations.gov/#!documentDetail;D=FSOC-2010-0001-0071.

believe that any designation determination should include careful assessments of the identified risk, the firms, activities, or industries that may present it, and the tools available to mitigate it. Fidelity recommends that the FSOC formalize those elements of the process by revising the proposed guidance to provide specifically that it will: (i) conduct those assessments, (ii) conclude that designation is the most appropriate tool to mitigate the risk presented by a company and (iii) provide the rationale for that conclusion when making any designation determination.[6]

In order to illustrate the importance of those assessments, in this letter we consider: (1) characteristics of the asset management industry that should inform any regulatory response to risks it may present, (2) the combination of industry characteristics and the nature of the regulatory regime applied to designated companies that renders designation an inappropriate tool to mitigate risk in asset management, and (3) the availability and superiority of targeted activity- or industry-wide regulation as alternatives to designation to mitigate any risks that a fund, adviser or group of such entities (collectively, "asset management entities") may present.

We begin our letter with a discussion of the characteristics of the asset management industry and of registered investment companies ("mutual funds") in particular. Specifically, we discuss the structures of mutual funds and their advisers and the robust competition in the industry, which are reflected in the design of the existing mutual fund legal framework and regulatory regime. We note that many of the attributes of the mutual fund industry that we highlight are also found throughout the broader asset management industry. These and other attributes lead us to observe that designating a single fund or adviser is likely to lead to prompt redemptions by investors, frustrating the goal of designation. In fact, designating a fund, for example, may increase risk rather than mitigating it if the risky activity had been concentrated in one fund and shifted to an unregulated fund domestically or offshore or if it were to spread to a number of funds. This likely outcome also supports our conclusion that the mutual fund regulatory regime, which already addresses multiple risks on a targeted and industry-wide basis, should serve as a model for effective and efficient regulation if any systemic risks are identified in the asset management industry.

The next section of our letter describes certain characteristics of the asset management business and consequences of Section 113 designation, and explains our view that the Section 113 designation authority is fundamentally incompatible with asset management entities. This is so because the inapplicability and costs of the bank holding company regime, which would be imposed selectively on any designated asset entity, would likely render the designated entity uncompetitive and trigger the rapid movement of the managed assets to other entities. Finally, our letter analyzes targeted activity- or industry-wide regulation as an alternative to firm designation under Section 113, and

[6] This rationale would be provided in the explanation of the basis of the proposed determination and the explanation of the basis for the FSOC's final decision that will be delivered to a nonbank financial company. *See* NPR, *supra* note 2, at 64,283.

concludes that using this broad-based approach to mitigate any risk that may be associated with asset management will lead to a superior regulatory outcome.

Section 1: Characteristics of the Asset Management Industry

Our focus below is on mutual funds, but it is important to note that (i) elements of the mutual fund structure, such as the separate legal identities of funds and their advisers, (ii) the robust competition for investors, and (iii) certain aspects of the mutual fund regulatory regime, are also relevant to an analysis of other segments of the asset management industry.

A. Mutual Fund Structure

A mutual fund is a legal entity separate from its adviser and sponsor, with its own contractual relationships, shareholders, board of directors, and assets and liabilities. A mutual fund adviser's relationships with the fund (or funds) it manages are constrained by (i) statutory law, including the Investment Advisers Act of 1940 (the "Advisers Act") and corporate law, which impose separate fiduciary duties to each fund's shareholders, (ii) advisory contracts, (iii) each fund's investment guidelines and (iv) the legal restrictions applicable to each fund set forth in the Investment Company Act of 1940 (the "Investment Company Act").[7] Ultimately, legal and operational requirements dictate that the adviser provide investment management services to each fund on an agency basis. An adviser is hired to exercise investment control over those assets subject to the restrictions described above, but the assets of a fund never become assets of the adviser nor are they commingled with assets of another fund. The adviser manages the fund's assets but does not become financially responsible for them and their performance cannot threaten its solvency the way the performance of proprietary assets of a bank or other subsidiary can threaten the solvency of a bank holding company.[8]

Similarly, because the assets of funds are not commingled and a mutual fund can have only very limited business relationships with affiliated funds, the performance of one fund's assets cannot directly threaten another fund. If one fund in a group "fails," the

[7] For example, the Investment Company Act contains a number of provisions designed to prevent specific conflicts of interest between an adviser and a fund or its shareholders. Section 17(a) of the Investment Company Act generally prohibits transactions between a registered fund and one of its affiliates, including its investment adviser, or an affiliate of an affiliate of the fund (collectively, "Affiliates"). *See* 15 U.S.C. § 80a-17(a) (2006). Section 17(d) and Rule 17d-1 restrict joint transactions between a mutual fund and its Affiliates. *See id.* § 80a-17(d). Section 17(e) restricts the compensation that an Affiliate of a mutual fund may receive when acting as an agent of or broker for a mutual fund. *See id.* § 80a-17(e). Finally, Section 10(f) restricts a mutual fund's acquisition of securities from an underwriting syndicate in which an Affiliate is participating. *See id.* § 80a-10(f). Therefore, although the adviser may manage a variety of funds, it is bound by a strict fiduciary duty and numerous other obligations to each of them.

[8] That is not to suggest that an adviser or other fund service provider may not face liability for failing to perform its duties under the relevant contract; rather, the adviser has no obligation to make investors whole for declines in the values of their investments and investors have no such expectation.

other funds are prohibited from bailing it out.[9] For these and other similar, structural reasons discussed in Section 2 below, it is not feasible to designate or regulate a group of asset management entities on a consolidated basis, and therefore any risks that they may present require a different regulatory response than designation under Section 113.

B. Substitutability and Mobility of Managed Assets, Funds and Managers

Asset management is an intensely competitive business with highly substitutable products and highly mobile assets and participants. If a fund were deemed to present systemic risks because of activities that it conducted, designating that single fund (or even multiple funds) would very likely trigger massive outflows, as investors would shift their assets to other entities that could engage in the same activities without the uncertainty and costs of designation. The same can be said of advisers because, as discussed below, portfolio managers are highly mobile enabling them to move to undesignated advisers and, perhaps, outside the FSOC's jurisdiction altogether.

The Investment Company Institute ("ICI") reports that over 600 sponsors managed mutual fund assets in the United States in 2010; and intense competition has prevented any single firm or group of firms from dominating the market over the past twenty-five years.[10] This competition is evident in other measures as well. For example, the mutual fund industry had a Herfindahl-Hirschman Index[11] number of 465 as of December 2010.[12]

Competition to attract funds from investors has also affected the number and types of funds offered by fund sponsors. Fund sponsors create new funds to meet investor demand, and they merge or liquidate funds that do not attract sufficient investor interest. There is no shortage of choices and, if one sponsor launches a successful fund, there are typically low barriers to other sponsors that wish to launch similar funds. The ICI reports that in 2010 there were over 16,000 investment companies in the United

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[9] As discussed in Section 2 "*Resolution Plans*" below, managed funds generally may lose assets through market losses and redemptions and may ultimately liquidate, but they do not typically "fail" in the same way banks and bank holding companies do unless they employ considerable amounts of leverage. Money market funds may face liquidity pressure similar to that faced by banks but, like other funds, they do not become insolvent.

[10] Of the largest 25 fund complexes in 1985, only 13 remained in this top group in 2010. *See* INVESTMENT COMPANY INSTITUTE, 2011 INVESTMENT COMPANY FACT BOOK 22 (2011), *available at* http://www.icifactbook.org.

[11] In 1982, the Antitrust Division of the U.S. Department of Justice adopted guidelines for challenging mergers based on the Herfindahl-Hirschman Index ("HHI") of market concentration. The HHI considers the number and relative market shares of firms in an industry. The HHI has since become a widely accepted standard for measuring market concentration and determining the competitiveness of markets.

[12] Index numbers below 1,000 indicate that an industry is unconcentrated. *See* INVESTMENT COMPANY INSTITUTE, *supra* note 10, at 22-23.

States alone.[13] Of course, mutual funds are just one product within the broader asset management sector and the United States is just one market for investors. For example, U.S. mutual funds must compete with other products as well, including over 9,000 hedge funds globally at year-end 2010.[14]

Managed assets are extremely portable and flow in and out of these funds regularly. For example, the ICI reported that the U.S. mutual fund industry had net cash outflows of $297 billion in 2010.[15] This compares to an estimated $55.5 billion of net inflows into global hedge funds in 2010 and overall sector sizes of approximately $1.9 trillion in global hedge fund assets under management,[16] $11.8 trillion in U.S. mutual fund assets under management, and $24.7 trillion in global mutual fund assets under management at year-end 2010.[17] Ultimately, investors control these flows because they own and control these assets in a way that the fund and manager do not.

Investors buy and redeem mutual fund shares for many reasons, ranging from a fund's performance and fees to changes in an investor's personal circumstances and investment strategies. They also choose the vehicles and jurisdictions that best suit them. Their options include a variety of registered mutual funds, such as actively managed funds, passive funds, and ETFs, as well as unregistered products on- or off-shore.[18]

The funds themselves and the advisers, including the individual portfolio managers,[19] are similarly mobile. For example, the ICI reports that, from 2007 through 2010, 2,407 mutual funds opened and 2,433 mutual funds merged or were liquidated.[20] The overall number of funds remained steady at approximately 16,000, despite changes

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[13] The ICI reported 16,090 investment companies, including traditional open-end mutual funds (as well as mutual funds that invest primarily in other mutual funds), closed-end mutual funds, ETFs, and UITs based on investment companies that report statistical information to the ICI. *See id.* at 16.
[14] HFR estimated that there were 9,237 hedge funds and fund of funds. *See* HEDGE FUND RESEARCH, INC., HFR GLOBAL HEDGE FUND INDUSTRY REPORT – YEAR END 2010 22 (2010) [hereinafter HFR REPORT].
[15] *See* INVESTMENT COMPANY INSTITUTE, *supra* note 10, at 24 ("Overall, the [U.S. mutual fund] industry had a net cash outflow of $297 billion. Investors pulled $525 billion from money market funds, particularly institutional funds. Investors, however, added $228 billion, on net, to long-term funds. The $297 billion total net outflow in 2010 was the largest on record in dollar terms. As a percentage of the average market value of assets, it amounted to 2.7 percent. On this basis, the outflow was about the same as the $23 billion outflow in 1988, which measured 2.8 percent of average assets.").
[16] *See* HFR REPORT, *supra* note 14, at 11.
[17] *See* INVESTMENT COMPANY INSTITUTE, *supra* note 10, at 22.
[18] The risk that assets will shift from more regulated jurisdictions, companies and products to those that are less regulated, including those outside the United States, is widely acknowledged. The October 2010 President's Working Group on Financial Markets published a report regarding Money Market Fund Reform Options highlights this risk in discussing the unintended consequences and limited effectiveness of partial reforms. *See, e.g.*, PRESIDENT'S WORKING GROUP ON FINANCIAL MARKETS, MONEY MARKET FUND REFORM OPTIONS 4, 6, 8, 21, and 33 n.29 (2010).
[19] *See, e.g.*, Jeffrey Gundlach, *Jeffrey Gundlach on Starting DoubleLine*, BUSINESSWEEK, Sept. 29, 2011, *available at* http://www.businessweek.com/magazine/jeffrey-gundlach-on-starting-doubleline-09292011.html; *and* http://www.doubleline.com/firm.php.
[20] *See* INVESTMENT COMPANY INSTITUTE, *supra* note 10, at 15 fig.1.9.

in the types and identities of the individual funds.[21] During that time, the number of mutual fund sponsors declined modestly from 705 to 669, but 203 sponsors exited the business and 167 entered it.

C. Mutual Fund Regulatory Regime

The mutual fund regulatory regime[22] effectively and efficiently addresses substitutability and regulates risks in the mutual fund industry because it applies targeted regulations to identified risks on an industry-wide basis. Together, the regulations applied to mutual funds constitute a comprehensive layer of substantive regulation and limitations on activities that address a multitude of risks. The regulations include requirements regarding: leverage,[23] liquidity, daily mark-to-market valuation,[24] redemption,[25] disclosure,[26] governance,[27] conflicts of interest, and transactions with affiliates, among many others.[28] Mutual funds that elect to operate as money market funds are also subject to the Securities and Exchange Commission's (the "SEC") Rule 2a-7, which imposes even more significant restrictions, including new standards imposed in the wake of the financial crisis.

The laws and regulations applied to mutual fund advisers impose fiduciary duties on the adviser and require it to manage a fund's assets in accordance with the fund's investment objectives and restrictions and for the benefit of fund shareholders.

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[21] *See id.* at 16 fig.1.10.

[22] Depending on the circumstances, activities and products of investment advisers may be subject to a host of laws and regulations in addition to the Advisers Act and the Investment Company Act, including (among others) the Securities Act of 1933, the Securities Exchange Act of 1934, the Internal Revenue Code and the Employee Retirement Income Security Act of 1974.

[23] Mutual funds are limited by Section 18 of the Investment Company Act to very low levels of leverage. For example, open-end mutual funds are limited to a maximum debt-to-equity ratio of 1 to 2. *See* 15 U.S.C. § 80a-18. By contrast, traditional financial institutions historically could have a 9 to 1 or greater debt-to-equity ratio and still qualify as "well-capitalized" for regulatory purposes. In practice, most mutual funds operate with little leverage, if any, which the Senate Banking Committee recognized in its report on S. 3217 by noting that "a typical mutual fund could be an example of a nonbank financial company with a low degree of leverage." *See* S. REP. No. 111-176, at 48 n.14 (2010).

[24] *See* 17 C.F.R. § 270.22c-1.

[25] Except in extraordinary circumstances, most mutual fund shareholders may redeem their investments on a daily basis.

[26] Mutual funds are required to describe their investment strategies in detail in prospectuses, statements of additional information, and semi-annual and annual shareholder reports. Furthermore, funds must disclose their entire portfolios four times per year. (*See, e.g.*, Section 30(e) and Rule 30b1-5 under the Investment Company Act.) This disclosure typically describes each security held, including the issuer/issue, shares/principal amount, and fair value. If a fund holds derivatives contracts, the reference assets/indices notional values, fair values, number of contracts, counterparties and expiration dates are described.

[27] *See, e.g.*, 15 U.S.C. § 80a-10.

[28] In addition to the SEC's oversight of mutual funds' compliance with regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act and the Advisers Act, the Internal Revenue Code sets requirements regarding a mutual fund's portfolio diversification and distributions of earnings and the Financial Industry Regulatory Authority oversees most mutual fund advertisements and sales materials.

Therefore, an adviser cannot pledge a fund's assets or otherwise use them for its own benefit; rather, the adviser must act in the best interest of the fund and its shareholders at all times. An adviser is also subject to disclosure and anti-fraud regulations in addition to the regulations imposed on the funds it manages with which it must comply.

The targeted, industry-wide regulation of the entities that constitute the mutual fund industry serves many purposes, including investor protection and market integrity, but it also regulates risks. As with other functionally regulated industries, if risks to the U.S. financial system are detected in the mutual fund industry and not already mitigated by the existing regime, the regime can be enhanced to address those risks. To the extent such risks are found in other segments of asset management, this structure should serve as a model for their effective and efficient regulation.

Section 2: Designation Would Be an Inappropriate Tool to Use on the Asset Management Industry

The characteristics of the asset management business make it fundamentally incompatible with the Section 113 authority and the regulatory regime that comes with it; and any attempt to apply this regime to asset management entities would be ineffective and inefficient at best. The structure and substitutability of funds and advisers, the inapplicability of bank regulatory standards to asset management entities, the selective manner in which they would be applied and the costs of applying them would likely render the designated entity uncompetitive and trigger the rapid movement of the assets it managed (or holds) to other entities.

A. Consolidated Supervision vs. Separate Structures of Funds and Advisers

As discussed above, funds are legally and operationally separate from each other and from their advisers. Section 113 does not empower the FSOC to disregard this legal and operational separateness during the designation process; nor does Section 165 enable the Federal Reserve Board (the "FRB") to disregard or overcome these facts when regulating a designated entity. Although the FSOC is empowered to designate a "firm" by designating the holding company of a conglomerate and thereby subjecting it and its subsidiaries to consolidated supervision,[29] it *is not* empowered to aggregate independent legal entities such as funds[30] to make a single designation determination for multiple, legally separate asset management entities.[31] Furthermore, even if Section 113 permitted

[29] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act, § 165(a)(2)(A) (2010) (in prescribing more stringent prudential standards, the FRB may consider companies' "financial activities (including the financial activities of their subsidiaries).").
[30] *See* NPR, *supra* note 2, at 64,281 n.12.
[31] *See* NPR, *supra* note 2, at 64,265 ("The Council intends to interpret the term "company" broadly with respect to nonbank financial companies and other companies in connection with Section 113 of the [DFA], to include any . . . association (incorporated or unincorporated), or similar organization."). Section 113 provides no basis for interpreting "company" to include unincorporated "associations" or groups and Section 102(a)(4)(B)(i) limits the definition of "U.S. Nonbank Financial Company" to a company that is

the FSOC to designate a group of funds, the legal, regulatory and operational separations among funds and their advisers could render unworkable any effort by the FRB to treat the designated entities as a group when applying the consolidated supervisory regime and enhanced prudential standards that are required for designated entities.

Designating a group would require a separate determination that each entity in the group meets one of the Standards.[32] Even if that could be done, the result of designation is FRB supervision of the financial activities of an individual designated entity and its subsidiaries, which the DFA carefully circumscribes.[33] This regime was designed for bank holding companies and would be applied by the bank holding company regulator, the FRB. The greater the differences between designated entities and bank holding companies, the more difficult it would be to apply the regime effectively and efficiently.

The DFA does not authorize, and, as many have observed, existing legal, regulatory and business structures employed by asset management entities could not accommodate,[34] the application of this regime to a group of funds or funds and their advisers. This result is dictated by the forms and relationships of the entities in question even if the risks presented were arguably the same as those presented by a bank-affiliated firm.[35] The relationships that make consolidated supervision of a bank holding company parent, its subsidiaries and affiliates possible and appropriate in the bank supervisory context do not exist in asset management structures, including mutual fund groups.

B. Bank Regulatory Standards Are Inappropriate for Asset Management Entities

Designation under Section 113 is applied selectively to individual companies and not to industries or groups. Therefore, these companies would have added costs and other constraints that most or all of their competitors would not face. The costs are significant by design[36] and the regime is designed for bank-affiliated entities.

"incorporated or organized under the laws of the United States or any State." *See* §§ 113 and 102(a)(4)(B)(i).

[32] The process proposed in the NPR correctly focuses on the two statutory standards for designation determinations: whether the material financial distress ("First Standard") or activities ("Second Standard") of a company could threaten U.S. financial stability (collectively, the "Standards").

[33] *See* § 167, in which Congress limits the FRB's supervisory authority even within designated nonbanks by seeking, for example, to "ensure that supervision by the [FRB] does not extend to the commercial activities" of a designated nonbank in subsection (b)(1)(B)(ii).

[34] *See, e.g.*, Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Feb. 25, 2011, available at http://www.ici.org/pdf/24994.pdf.

[35] *See* Daniel K. Tarullo, Governor, Fed. Reserve Bd., Remarks at the 2011 Credit Markets Symposium: Regulating Systemic Risk at 6 (Mar. 31, 2011) (transcript available at www.federalreserve.gov) [hereinafter Tarullo Remarks] ("[P]rudential standards designed for regulation of bank-affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions. Continuing with the money market fund example, the options for reform identified by the President's Working Group on Financial Markets show that these standards may not be the optimal form of regulation.").

[36] Section 165 requires the Federal Reserve to impose enhanced prudential requirements on designated nonbanks that "are more stringent than the standards and requirements applicable" to nonbanks that do not

The regulatory requirements contemplated by Sections 115 and 165 can appropriately be described as "enhanced" when applied to banks because, with a few notable exceptions like resolution plans, the changes made to the bank regulatory regime are changes of degree, not kind. For example, banks are already subject to consolidated capital, liquidity and similar financial requirements. Sections 115 and 165 essentially require that those existing standards be strengthened. If applied to asset management entities, however, these standards would be entirely new and cannot be tailored sufficiently to make them appropriate.[37] Although bank holding companies and nonbanks with similar business models may be able to support these standards, funds and their advisers could not. Many factors lead to this conclusion, including those specified below.

1. <u>Selective Application</u>

The structure Congress created dictates that the designation authority be exercised selectively. Thus, the prudential requirements it triggers will necessarily impact some industry participants and not others. As discussed above, designation is an entity-specific authority that is required to be applied to a "company." Furthermore, Section 113 does not simply apply a single measure, like the size threshold applied to bank holding companies, to determine whether a nonbank should be designated. Rather, in Section 113 Congress directs the FSOC to consider a lengthy list of factors and determine that the nonbank "could pose a threat to the financial stability of the United States." It is highly unlikely that individual asset management entities would pose such a threat; but, assuming that some did, the costs associated this designation would be imposed on them alone and not on their undesignated competitors.

2. <u>Regime for Bank Holding Companies and Similar Businesses</u>

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present similar risks to U.S. financial stability. *See* § 165. This requirement ostensibly serves multiple purposes including reducing the probability and expected impact of an institution's failure, as well as reducing any funding or other advantages from being perceived to be too-big-too-fail and potentially dissuading firms from becoming too-big-to-fail or increasing their systemic footprints beyond certain thresholds. (*See, e.g.*, Daniel K. Tarullo, Governor, Fed. Reserve Bd., Remarks to the Clearing House Business Meeting and Conference: The Evolution of Capital Regulation 8-10 (Nov. 9, 2011) (transcript available at www.federalreserve.gov) [hereinafter Tarullo Clearing House Remarks]).

[37] As many have observed, the DFA provides the FRB with some discretion to apply other, "similarly stringent" requirements where bank capital standards are not "appropriate" but this discretion is only granted with respect to capital standards, not for the other enhanced prudential standards required by Section 165. *See, e.g.*, Tarullo Remarks, *supra* note 35, at 7-8 and 14 n.5 ("While this discretion may be needed in particular cases, broad application of that approach would in effect require the [FRB] to develop new capital regimes for different segments of the financial system. . . . Again, if there are latent systemic risk in one or more [nonbank-affiliated] segments [of the financial system], a more targeted, industry-wide response would be preferable."). It appears, however, that even the discretion afforded by Section 165 is severely limited by the capital floor required to be imposed by Section 171. *See* § 171.

Designation under Section 113 automatically subjects a designated *non*bank to banking regulation and limitations that are designed primarily for bank-affiliated entities and other companies that take proprietary risks. These regulations will be applied in some form regardless of whether their application to a particular company would be appropriate.

As a practical matter, this supervisory regime is onerous and inflexible and cannot be altered sufficiently to make it workable for asset management entities. It is intended to mitigate threats as they typically present themselves in companies that act as financial intermediaries by incurring liabilities to finance investments in assets, such as the banking businesses for which the regime was designed. Enhanced capital, leverage, liquidity and other regulatory tools that are appropriate for banks and nonbanks with similar asset and liability structures are significantly less useful if applied to nonbank agency businesses that do not require capital to absorb losses.

Capital Requirements

For many nonbanks, including mutual funds and their advisers in particular, the regime would impose requirements that would be entirely new and irreconcilable with their structures and business models. For example, funds and advisers today are not required to hold capital as a buffer against losses; in fact, funds do not incur "losses" in the sense that banking institutions do.

Fund investors absorb both the declines and increases in asset values. They are not absorbed by the fund itself, a special class of creditors like depositors, or the Federal safety net. Thus, unlike the banking business model, which requires that capital be set aside not to protect the bank's shareholders but to protect depositors, other creditors, and the Federal safety net against the risk of losses in the bank's asset portfolio, there is no comparable class in need of protection in the asset management model.[38] Funds' investors expect their assets to be invested, the risk of loss is fully disclosed, and investors accept that risk in return for the possibility of gains. Furthermore, unlike depositors in a bank, who know that their money (i) provides leverage, (ii) is backstopped by the Federal safety net, and (iii) will be vulnerable to losses only to the extent that their deposits exceed FDIC insurance levels and losses in the bank's asset portfolio exceed its capital, fund investors expect that their investments are not materially leveraged or protected by the safety net and accept the risk that they may lose the entire value of it. Similarly, funds' advisers are not required to hold capital against their managed assets because they do not guarantee the value of those assets as banks do for their deposits and other liabilities.

[38] Leveraged funds are a potential exception but, as discussed above, the ability of registered funds to employ leverage is limited by regulation, further illustrating that any risks presented by leveraged funds and other funds in less regulated segments of the asset management industry would be best addressed through targeted, industry-wide regulation.

Ultimately, asset management entities do not present the types or scales of risks that bank-style capital requirements are intended to mitigate. Businesses that act primarily as their customers' agents do not have the same risk profile as banks because they hold assets on behalf of their customers as opposed to borrowing from customers and taking proprietary positions with those funds. Their fee and capital structures reflect this distinction. For example, a financial firm such as a mutual fund adviser that manages assets for third-party customers may charge as little as 7 basis points (0.07%) to manage an equity index fund benchmarked against the S&P 500 index.[39] Therefore, although neither the adviser nor the fund require capital as a "shock absorber" against losses in the values of those assets, if one were required of a particular fund or adviser as a result of designation, the fee structure of the product could not support it in the competitive marketplace.

Collins Amendment and Volcker Rule

In addition to prudential standards like capital requirements, other provisions in the DFA that were designed specifically with banks, similar businesses, and the Federal safety net in mind apply automatically to any designated nonbank. These include Section 619, the so-called Volcker Rule, and Section 171, the so-called Collins Amendment. Conceptually, it is entirely unclear how the Volcker Rule, even if limited to additional capital requirements and quantitative limits, would apply to asset management entities. In addition, the bank capital structure required by the Collins Amendment would be inappropriate for asset management entities. As applied to a fund manager, no risk-based or leverage-capital requirement would apply with respect to the managed assets. As applied to a fund, which typically consists almost entirely of the investors' capital, its "capital" would presumably far exceed the requirements of the Collins Amendment. Indeed, any regulatory approach to asset management entities based on capital would need to be designed anew based on the structure and any risks presented by those entities.

There does not appear to be any conceptually or statutorily sound interpretation of the Volcker Rule, Collins amendment or many of the enhanced prudential standards that would resolve the fundamental conflict among their terms and policy justifications and the very nature of the asset management business. That said, there is potentially one superficially appealing resolution, which should be eschewed. The FSOC should not attempt to resolve this conflict by interpreting the requirements of Volcker, Collins and other enhanced prudential standards "creatively" so as to minimize or avoid their application to entities they do not fit. To do so would suggest strongly that the designation authority is being extended beyond the scope Congress intended and beyond the bounds of its utility.

Resolution Plans

[39] As of December 19, 2011, the Fidelity Spartan 500 Index fund had a net expense ratio of 10 basis points on investments of at least $10,000 and 7 basis points on investments of at least $100,000.

Another fundamental element of the regime applied to designated companies is the requirement that they prepare living wills in order to demonstrate the extent of their resolvability if they were to experience financial distress.[40] Asset management entities typically exhibit a low risk of "failure" or financial distress and are therefore unlikely to warrant designation under the First Standard or to require a living will. A loss of confidence in a fund, whether due to declines in asset values or to concern with a class of assets in which the fund is invested, could lead to shareholder losses if the fund were forced to sell securities to meet redemptions on a scale that depressed the market prices of the securities. However, these sales would be little different than if the investors had invested directly in the classes of assets in which the fund was invested. Assets would be sold into the markets and losses incurred. In contrast to bank deposits, the expectation of loss is inherent in an investment in a fund.[41]

Even if an individual asset management entity could "fail," the mere act of designation by the FSOC would itself likely precipitate the "failure." Designating a fund, for example, would likely render it uncompetitive and prompt investors to redeem a substantial portion of its assets.[42] Liquidation would be an ironic result if the designation of the fund were premised on the potential for its material financial distress to threaten U.S. financial stability. Of course, even a slow rate of redemption that did not trigger liquidation would soon result in the designated fund becoming too small to threaten the stability of the U.S. financial system.

Furthermore, asset management entities typically "resolve" themselves through investors' redemptions, which prompt funds to liquidate or merge and advisers to leave the business. In segments of the industry that have experienced a significant level of fund liquidations or mergers, these events did not present systemic risks. In fact, they are part of the normal business cycle. For example, many hedge funds have safely "failed" in recent years, including during the 2008 crisis, without the need for a special resolution regime.[43] Similarly, from 2007 through 2010, 2,433 mutual funds merged or liquidated.[44]

[40] The FSOC also provides in the NPR that in Stage 3 of the designation determination process it will analyze the "resolvability" of the company being considered. *See* NPR, *supra* note 2, at 64,282.

[41] Although some commentators have suggested that the government's short-lived Treasury Temporary Guarantee Program for Money Market Funds may have created a false expectation among some money market fund shareholders that the government will support money market funds in the future, Fidelity has surveyed our customers and they overwhelmingly understand that these funds are investment products and that shareholders may incur losses, albeit rarely. *See, e.g.*, Philipp Schnabl and Marcin Kacperczyk, *Money Market Funds Missing from the Senate Bill*, REGULATING WALL STREET: MONEY MARKET FUNDS, May 2010 Monthly Archives, *available at* http://w4.stern.nyu.edu/blogs/regulatingwallstreet/shadow-banking/money-market-funds/.

[42] In contrast, bank funding, based on core deposits, is relatively sticky. Increased costs to banks due to enhanced prudential standards are also incremental. It is therefore unlikely that a bank could face a rapid downsizing as customers seek other financial intermediaries.

[43] It is estimated that, between 2000 and 2009, over 5000 hedge funds closed or went into liquidation globally, with a significant proportion doing so during the latter years of that period. HFR estimates that, at

These experiences stand in stark contrast to the unwieldy resolution of complex bank holding companies and similar organizations.

B. No Offsetting Benefits to Asset Management Entities

If an asset management entity were designated, it would bear many of the regulatory burdens as bank holding companies and other firms that are in the banking business without enjoying any of the benefits. Asset management entities do not enjoy the same funding subsidy and liquidity support from the United States government that banks receive by virtue of their access to the Federal Reserve discount window and FDIC-insured customer deposits. This support, like the lower cost funding that the largest banking firms enjoy generally,[45] would not be available to asset management entities on which enhanced prudential standards were imposed.

C. Designations Would Likely Result in Liquidations

1. Advisers

An adviser would likely be unable to support the costs and other burdens associated with designation. The asset management business is highly competitive. Performance and fees are measured in basis points (0.01%). A designated adviser would bear costs not borne by its competitors and, as a result of the competitiveness and fee structures in the industry, it would be unable to pass these on to its investors. In fact, competitive dynamics already prompt advisers to leave the business regularly. For example, the ICI reports that from year-end 2000 to year-end 2010, 502 fund sponsors left the U.S. mutual fund business.[46] Since a designated adviser would face a distinct competitive disadvantage, we anticipate that over time its professional talent would migrate to undesignated advisers.

2. Funds

Funds would likely liquidate if designated, or operate on a dramatically smaller scale after shareholders redeemed. The overall cost of designation would almost certainly reduce the competitiveness of the fund and, therefore, its appeal to investors. Prudential standards such as capital, which the Collins amendment would require, would also be inconsistent with investor expectations and irreconcilable with their structures and

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the height of the financial crisis in 2008, 1,471 hedge funds closed, and that an additional 1,023 hedge funds closed in 2009. *See* HFR REPORT, *supra* note 14. These numbers compare to 176 closures in 2003.

[44] *See* INVESTMENT COMPANY INSTITUTE, *supra* note 10, at 15 fig.1.9.

[45] *See, e.g.*, Tarullo Clearing House Remarks, *supra* note 36, at 8-9 ("An ancillary rationale [for imposing more stringent capital requirements, the surcharge on globally systemic banks in particular] is that additional capital requirements could help offset any funding advantage derived from the perceived status of such institutions as too-big-to-fail.").

[46] *See* INVESTMENT COMPANY INSTITUTE, *supra* note 10, at 14.

business models. In such a competitive market, where multiple funds with quite similar investment strategies compete for investors, a designated fund's investors would simply leave and invest in a competing fund.

After all, the designated fund would not "own" the assets. The investors in that fund would. This is true to an even greater degree of the fund's adviser. Therefore, designating a fund would not give the FSOC, FRB or any other regulator control over those assets. In fact, the assets likely would begin leaving the fund as soon as investors are notified of the designation proceeding.[47]

Section 3: If an asset management entity were to present systemic risk how would that risk best be mitigated?

A. Targeted, Activity- or Industry-wide Approach

The most appropriate regulatory structure to mitigate risks in asset management existed before the passage of the DFA and still exists. It is the application of targeted regulations to identified risks on an activity- or industry-wide basis. For example, this structure is used to regulate mutual funds and investment advisers to mutual funds and other investment vehicles. The DFA did not replace or reduce the importance of this regime or other functional regulatory regimes.

On the contrary, in recognition of their utility, the DFA created institutions and processes to extend their coverage and employ them, to the extent necessary, in the identification and regulation of systemic risk. Therefore, if the FSOC identifies a systemic risk in any segment of the asset management industry at a level that requires a regulatory response, it would be both logical and consistent with legislative intent to look first to the structure created and currently used to regulate a major segment of the asset management industry. For reasons discussed at length in this letter, Fidelity believes that the existing mutual fund regulatory model could and should be the presumptive choice to mitigate any risks found in asset management rather than selectively designating a handful of nonbank asset management entities pursuant to Section 113 and subjecting them alone to bank-like regulation. In fact, as discussed in greater detail below, the mutual fund regulatory regime has already been used once in the wake of the financial crisis to address perceived risks in money market funds, when the SEC adopted reforms to rule 2a-7 in February 2010 to tighten the rule's risk-limiting provisions.[48]

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[47] Reporting obligations applicable to a fund or a publicly traded adviser may require it to disclose the designation proceeding when the FSOC delivers the "Notice of Consideration" and thereby notifies the entity in question that it is in the "Stage 3 Pool" and "under Consideration for a Proposed Determination." (*See* NPR, *supra* note 2, at 64,282.) Following that disclosure, the managed assets would likely be substantially diminished before a designation determination was final, and well before the fund or adviser was required to register with the FRB and begin complying with the enhanced prudential standards.
[48] *See* "Money Market Fund Reform" SEC Release No. IC-29132 (February 23, 2010) available at http://www.sec.gov/rules/final/2010/ic-29132.pdf, which discusses in detail the amendments to Rules 2a-7,

B. The DFA and Existing Regulatory Regimes

Although already robust, the asset management regulatory regime, like other functional regulatory regimes, also has been supplemented by the DFA. For example, it has been reinforced by (i) the creation of entities with responsibility for the financial system as a whole, such as the FSOC and the Office of Financial Research ("OFR"), (ii) regulations applicable to all federally regulated financial entities of certain sizes, such as the stress testing regulations under Section 165 and the risk-mitigating compensation regulations under Section 956, (iii) regulations targeted at specific segments of the financial markets, such as Title VII of the DFA, which addresses the derivatives markets, and (iv) regulation of specific market participants, such as financial market utilities under Title VIII of the DFA. Furthermore, certain of its requirements have also been extended to previously unregulated segments of the industry. For example, the DFA amended the Advisers Act to require private fund advisers to register with the SEC and to comply with extensive reporting requirements, including non-public reporting of portfolio holdings to determine these funds' risk exposures.[49]

These enhancements strengthen existing regulatory regimes and fill gaps that previously existed between functional regulators, thereby enabling both new supervisory bodies and existing functional regulators to detect and mitigate many risks, including threats to U.S. financial stability. For example, the DFA allows regulators to use the full complement of regulatory tools described above to address the downward spirals in asset prices that typically mark a significant financial crisis. Functional, activity-focused regulation, supplemented as necessary by the OFR and FSOC, allows primary regulators and the FSOC to monitor activities and markets to detect and limit both the creation of those assets and the effects that their creation and related activities can have on other institutions and U.S. financial stability. In addition, the DFA deals with linkages between financial institutions that could transmit losses rapidly among those financial institutions in the provisions of Title VIII on payment, clearing and settlement.

Thus, as the FSOC appropriately recognizes in the NPR, the DFA provides for the possibility that some activities may present risks regardless of the size of the institutions engaged in them and may therefore be better addressed through other means than designation under Section 113. In most cases these activities can be addressed by existing regulatory authorities. Where activities span multiple regulators, Sections 112 and 120 authorize the FSOC to recommend heightened standards across primary financial

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17a-9 and 30b1-6T, as well as new Rules 22e-3 and 30b1-7 and new Form N-MFP under the Investment Company Act.

[49] *See, e.g.*, Dodd-Frank Wall Street Reform and Consumer Protection Act tit. IV, §§ 402, 403, and 404; Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. IA-3221, 76 Fed. Reg. 42,950 (July 19, 2011); Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. IA-3308, 76 Fed. Reg. 71,128 (Oct. 31, 2011).

regulatory agencies, if necessary. Therefore, although the DFA creates new bodies such as the FSOC and provides them with many options to fulfil their mandates, their creation should not be interpreted to mean that the new authorities or structures should supplant the existing functional regimes. In fact when mitigating risk in an industry such as asset management, which already has a robust, successful, regulatory model, we think the reverse is true – that the existing model should be preferred.

Example: Money Market Funds

Regulatory reforms that have already been adopted in response to the stress experienced by some money market mutual funds after the failure of Lehman Brothers in September 2008 have appropriately followed the approach of mitigating risks by enhancing an existing functional regime. Specifically, the changes to Rule 2a-7 targeted liquidity, maturity, risk, transparency, and the ability to suspend redemptions. The amendments to Rule 2a-7, in combination with other significant changes to the regulatory structure of our capital markets, have increased the ability of money market funds to absorb large, unexpected redemptions. In fact, the October 2010 President's Working Group on Financial Markets published a report regarding Money Market Fund Reform Options, in which it observed that the 2010 changes to Rule 2a-7 had directly addressed liquidity risks associated with maturity transformation and elements of money market fund portfolios' exposures to credit and interest rate risks.

Nevertheless, questions about money market funds remain and some financial regulators believe that additional reforms to money market funds are needed. For example, several of the agencies that constitute the FSOC currently are evaluating options to strengthen further the resiliency of money market mutual funds. Those proposals would not apply to only a subset of money market funds or their advisers because patchwork application would be incomplete at best and would not adequately deal with the regulators' concerns.[50] Instead, the proposals would be implemented by the SEC as the primary regulator at an industry-wide level.

The money market fund example illustrates the advantages of utilizing existing regulatory regimes. These regimes evolve to respond to new risks on an activity- or industry-wide basis. As markets change and new risks are identified by regulators or Congress, amendments to the applicable statutes or to underlying rules are made.

[50] *See, e.g.*, Tarullo Remarks, *supra* note 35, at 5 (describing the limited utility of the Section 113 designation authority and illustrating its limitations by stating that "[T]he rationale for regulation provided by the potential for contagion effects is really an argument for sound regulation of the type of financial firm or instrument under consideration. If a small money market fund's travails can provoke a run on the entire industry, then all such funds should be subject to requirements that reduce the fragility of their business model.").

Conclusion

Fidelity understands that the FSOC is continuing to evaluate the authorities the DFA grants it to detect and regulate systemic risk and that the authority to designate nonbanks that threaten U.S. financial stability is one piece of that mosaic. We applaud the FSOC for providing additional guidance in the NPR to that effect and for seeking to provide transparency to the market, thereby reducing the likelihood that uncertainty about the determination process could negatively affect the financial markets.[51] In particular, Fidelity supports the comments in the NPR regarding asset management that recognize that (i) asset management entities are different in kind than many other financial firms; (ii) the FSOC and other agencies will be collecting additional information that should enhance their understanding of the asset management industry; and (iii) if any threats to U.S. financial stability arise from asset management, they may be better addressed through regulatory measures other than designation.

We encourage the FSOC to expand upon that last statement and incorporate that assessment into the designation process. Specifically, Fidelity respectfully requests that the FSOC provide in the final guidance that when assessing an identified risk, including the firms, activities, or industries that may present it, the FSOC also will evaluate the tools available to mitigate it; and, before making any designation determination, the FSOC will conclude that designation is the most appropriate tool[52] to mitigate the risk presented by the company in question. The rationale for that conclusion should be provided to any nonbank for which a designation determination is proposed.

In the first three sections of this letter, we have illustrated the importance of this multi-step analysis by describing the characteristics of the asset management industry and the nature of the regulatory regime applied to designated companies that make designation an inappropriate tool to mitigate risk in asset management, and the availability and superiority of targeted activity- or industry-wide regulation as an alternative. Fidelity believes that this letter sets forth the rationale for excluding asset managers and funds from consideration for designation determinations except in truly extraordinary circumstances. This is not to say that the asset management industry should not be analyzed and, if systemic risks are found, that they should not be addressed. Rather, Fidelity believes that analysis should be conducted primarily outside the context of designation because designation will almost certainly not be the appropriate response to any risks that are identified. If any systemic risks are detected at a level that warrants mitigation, the FSOC should look first to the functional regulatory model that has been

[51] *See* NPR, *supra* note 2, at 64,269.
[52] *See* Janet L. Yellen, Vice Chair, Fed. Reserve Bd., Remarks at Fourteenth Annual International Banking Conference: Pursuing Financial Stability at the Federal Reserve (Nov. 11, 2011) ("[S]electing the right policies to address specific forms of systemic risk is important for ensuring that reasonable risk-taking and innovation continue to take place in financial markets so as to foster broader productivity gains, economic growth, and job creation.").

used successfully to regulate registered mutual funds and advisers on a targeted and industry-wide basis for over 70 years.

This conclusion suggests that a similar analysis is warranted for other industries as well. Fidelity believes that before deciding to designate a company involved in industries or practices that have been effectively regulated through activity- or industry-wide regulation in the past, the FSOC first should affirmatively determine that consolidated prudential supervision would mitigate the systemic risk in question more effectively and efficiently and, therefore, that a paradigm shift in regulation is warranted for that company specifically. Where, as with asset management entities, this test is unlikely ever to be met, the FSOC should also provide guidance to that effect.

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We appreciate the opportunity to comment on the NPR. Fidelity would be pleased to provide any further information or respond to any questions that FSOC may have.

Sincerely,

Scott C. Goebel

cc: Chairman Timothy F. Geithner, Secretary of the Treasury
Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin J. Gruenberg, Acting Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
Mary L. Schapiro, Chairman of the U.S. Securities and Exchange Commission
John Walsh, Acting Comptroller of the Currency
S. Roy Woodall, Jr., Independent Insurance Expert
William Haraf, Commissioner, California Department of Financial Institutions
John 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 McRaith, Director, Federal Insurance Office, Department of the Treasury