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

RE: Office of Financial Research: Report on Asset Management and Financial Stability

Dear Ms. Murphy:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation, representing the interests of more than three million businesses and organizations of every size, sector and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory system for the capital markets in order to promote economic growth and job creation. The CCMC sincerely appreciates the opportunity provided by the Securities and Exchange Commission ("Commission" or "SEC") to comment on the Office of Financial Research's ("OFR's") Report on Asset Management and Financial Stability ("Report"). We note that OFR has not itself requested comment, and we applaud the SEC's initiative to solicit the views of the public on this important issue for America's capital markets.

The Chamber is extremely concerned because the Report lacks information fundamental to the asset management industry, fails to take into account differing structures and strategies amongst asset management companies and makes general assertions that are not grounded in facts. This is particularly troubling since the Report is one of the first major efforts undertaken by the OFR and yet it falls short of Congress's intent in establishing the OFR. Furthermore, the Report itself contradicts precedents set by the Financial Stability Oversight Council ("FSOC" or the

"Council") on the role of asset management and systemically important financial institutions ("SIFIs").

Accordingly, the CCMC respectfully requests that the SEC, as a member agency of FSOC, request that the Report be withdrawn and that FSOC acknowledge that the Report, in its current form, does not provide an appropriate or reasonable basis for the Council to undertake an evaluation of asset management firms with regard to potential SIFI designations. If any further efforts are undertaken in this area it should be done in consultation with the SEC which is the lead regulatory agency for this industry.

Discussion

The FSOC asked the OFR to provide data and analysis to better inform the Council's analysis of whether, and how, to consider asset management firms for supervision as SIFIs that will be subject to supervision by the Board of Governors of the Federal Reserve System and thereby be subject to the application of enhanced prudential standards under the Dodd-Frank Act ("DFA"). The OFR stated that it has responded to the FSOC's request by analyzing industry activities, describing the factors that make the industry and individual firms vulnerable to financial shocks, and by considering the channels through which the industry could transmit risks across financial markets.

CCMC's Key Concerns and Requests

We request that the SEC advise the OFR and the Council that the Report, in its current form, does not provide an appropriate or reasonable basis for the Council to undertake an evaluation of asset management firms with regard to potential SIFI designations or for other regulatory purposes, due to the numerous and serious defects in the Report. These include serious flaws in its methodology, its unsupported and unwarranted assertions and its highly speculative conclusions. The key defects in the Report include the following.

1. ***Asset management is an agency activity. It does not involve investors investing in the business of the asset manager.***

Many of the fundamental problems with the Report arise from the fact that the authors of the Report are unwilling or unable to recognize the critical difference between an investor placing funds in a vehicle that is managed or advised by an asset manager and investing directly in a financial company, such as a bank holding company, that holds its own assets as a principal.

Investors who place their funds in asset management vehicles fully understand that they are investing in something that will, in turn, invest in the securities of other companies. They are not investing in the asset manager. Investors are fully aware that the value of their investments will increase or decrease based on the performance of the investments made by the vehicle in which they have invested. They do not base their investment expectations on the financial results or financial condition of the asset manager.

The Report repeatedly suggests or infers that asset managers face the same types of issues that may confront large financial companies that act in a principal capacity. This is a fundamental error. To the extent that the Report purports to support the designation of one or more asset management firms as SIFIs, this flaw alone would undercut the credibility of that action and would provide the basis for a challenge.

Asset management firms simply do not present the types of risks at which section 113 of the DFA, which authorizes SIFI designations by the FSOC, is directed.

2. ***Asset management takes many forms. The Report fails to engage in an individualized comprehensive sector-by-sector analysis of the business, operational and regulatory attributes of each particular sector in order to properly evaluate the risks that may be posed by the sector.***

The Report recognizes that asset management takes many different forms, which have widely varying business, operational and regulatory structures. Yet, it incorrectly conflates different models into a single concept of asset management, suggesting that its conclusions regarding systemic risk are, at best, contrived. This would seem to indicate a lack of in-depth analysis and understanding of the industry, which in and of itself would make any further action based on the Report unfounded.

This also calls into question OFR's ability or willingness to coordinate effectively with the SEC, which has primary jurisdiction over asset managers. A failure to understand an industry or to coordinate with its primary regulator raises serious questions on the ability of OFR to fulfill its statutory mission to assist the FSOC in carrying out the Council's responsibilities under the DFA.

3. ***The Report makes a series of unsupported assertions regarding the asset management industry and the anticipated behavior of investors to establish its speculative theory of transmission of risks throughout the financial system.***

The narrative used in the Report to support the concept that the "asset management industry" poses a threat to systemic financial stability rings hollow at best. The syllogism for its approach is based on the predicate that *something* related to an industry could have a destabilizing impact on financial stability at large, but it fails to provide empirical evidence or economic data to support: (i) the *likelihood* of the purported triggering events occurring, (ii) the *likelihood* that such events would have a material impact on the industry if they occurred, or (iii) the *likelihood* that financial reactions within an industry would translate into a meaningful impact on systemic financial stability.[1]

This simply cannot become the standard by which financial stability analysis under Title I of the DFA is conducted by the OFR or the FSOC. The stakes for economic growth and prosperity in the U.S. are too high.

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[1] The Report constructs a three-stage process by which: (i) numerous unrelated investors in various parts of the asset management industry come to a sudden, spontaneous and simultaneous recognition that their asset managers have been engaged in "reaching for yield" or "herding"; (ii) that causes large numbers of investors to engage in rapid redemptions of their holdings among a widely dispersed set of asset managers; and (iii) then these redemptions cause sales of holdings in a wide range of investments of sufficient size and concentration so as to destabilize particular asset markets to such an extent that threatens systemic financial stability. The Report provides literally no support for this thesis.

The three-stage template used by the Report seems to be largely drawn from the arguments made by the FSOC in regard to the FSOC's view of threats that the money market fund ("MMF") industry purportedly poses to financial stability. FSOC, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012) ("FSOC MMF Recommendations"). However, the Report expressly disclaims that it addresses issues related to MMFs, stating that it "does not focus on particular risks posed by money market funds." Report at 2.

4. ***Oversight Directed at Asset Managers Will Adversely Impact the Interests of Investors.***

Enhanced prudential requirements were designed in the DFA for financial companies that are engaged in large scale activities as principals, not for asset managers that merely provide an investment management service to clients. If asset managers are mislabeled and mischaracterized, and thereby subjected to inapplicable principal-based requirements, that form of regulation will inevitably undermine the vitality and viability of the industry rather than promote systemic stability. That harm will not, however, be confined to the asset managers, since they are merely serving the needs and interests of their investor clients.

Investors have placed what the Report estimates to be $53 trillion with asset managers, because they value the services and the wide range of investment options that asset managers offer. Investor action of that scale is also indicative of their comfort with the risk profiles of the industry. Unnecessarily impairing the activities and operations of asset managers will directly and substantially harm the interests of U.S. investors by limiting the availability of asset management options, increasing costs, and reducing competition and innovation. All of this will harm the U.S. capital markets and capital formation.

The Report appears to look with concern at the reality that investment involves the potential for both gains and losses. It appears to proceed from the premise that the potential for investors to experience losses on assets placed with asset managers carries the threat that investors will respond to the prospect or realization of losses with massive redemptions of such holdings from their asset managers. It further appears that the Report is concerned that such redemptions will, in turn, destabilize the financial system.

We believe that this is a fundamentally incorrect way to analyze financial stability considerations. CCMC believes that the ability of U.S. investors to freely and fully exercise their individual investment choices at any time, including through the use of asset managers, is not a threat to financial stability, but rather is the bedrock strength of the U.S. capital markets. We believe that asset managers provide an efficient and effective means for investors to put assets to work in a manner that supports capital formation that grows U.S. businesses and jobs while offering the potential for financial benefits for investors.

In that context, it is very disturbing that under the guise of protecting the financial system from the "threats" posed by asset managers, the Report, in effect, lays the groundwork for a system of oversight that will impact the freedom and flexibility of investors to pursue their own investment preferences and strategies. Because the strength of the U.S. capital markets is critical to our economy, the OFR and FSOC should resist the temptation to tamper with this important asset.

5. ***Requests Regarding the Report.***

We believe that many of the fundamental defects that impair the Report are attributable to the failure of the OFR to seek and/or to consider seriously input from (i) knowledgeable FSOC member agencies, particularly the SEC, which has decades of expertise in this area by virtue of its primary jurisdiction over the federal regulation of the asset management industry; (ii) private sector investors with experience with asset management firms; and (iii) asset management firms themselves.

In light of the overwhelming deficiencies in the Report, the FSOC should not consider or use it for any purpose. Accordingly, we respectfully request that the SEC, as a member agency of the Council, request that the Council request that the OFR immediately withdraw the Report. We further request that the Council advise the OFR that any future version of the Report should only be released after the OFR has broadly solicited and thoroughly considered input from the regulatory agencies and the public.

I. *The Report Fails to Engage in a Proper Individualized Segment-by-Segment Analysis of the Asset Management Industry and Instead Effectively Treats the Entire Industry as an Undifferentiated Mass*

The Report describes the asset management industry as holding approximately $53 trillion in financial assets.[2] It acknowledges that asset management firms "have a

[2] *Id.* at 1.

diverse mix of businesses and business models, offer a broad variety of funds, and engage in many activities."[3]

The Report attempts to present the diversity of the asset management industry in a chart on page 4.[4] The chart identifies six combinations of categories of asset managers and types of asset management vehicles that it has apparently homogenized for purposes of the discussion of "asset management" in the Report. The chart also refers to three types of asset management vehicles under the heading "Private Fund Firms Regulatory AUM:" hedge funds, private equity funds and other private funds. They amount to approximately $10 trillion in assets under management, but are apparently outside the scope of the Report.[5]

The Report simply fails to address the statutory, regulatory, operational and business environments in which the six categories of asset management activities operate.[6] Among the basic questions that any purported survey of the potential risks posed by asset management firms would discuss are:

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[3] *Id.* at 3.

[4] Although the Report refers to approximately $53 trillion of assets in the asset management industry, the left hand side of the chart on page 4, which is titled, "Private Investable Assets – assets under management in billions," totals approximately $84 trillion of assets under management. The Report acknowledges, among other things, that amounts reflected in that column "include double-counting due to cross-investing among managers and multi-sourcing of data in construction of [the] table." *Id.*, Figure 1 at n. 1. The OFR apparently believes that note 1 is adequate to explain a **$31 trillion discrepancy**.

The right hand side of the chart which is titled "Asset Managers – assets under management in billions" includes data for registered investment advisers, insurance companies, bank holding companies and banks, and private fund firms regulatory assets under management that total approximately $53 trillion in assets, but this amount is subject to the same caveat indicating that these amounts "include double-counting due to cross-investing among managers and multi-sourcing of data in construction of [the] table." For three of the four categories the Report lists as sources "P&I/OFR, Morningstar," "P&I/OFR, NAIC," and "P&I/OFR, Call Reports." The references to P&I are to the publication known as Pensions and Investments. This raises the question of what is intended by the repeated references to "P&I/OFR". Did the OFR enter into a joint venture with P&I in preparing parts of the Report? Why are P&I and OFR referred to repeatedly as some type of combined source, when other sources are clearly treated separately? Is the P&I/OFR source material available to the public? The numerous questions raised and left unanswered by the chart on page 4 go directly to the quality and credibility of the Report.

[5] *Id.* at 2.

[6] These are: (i) registered investment adviser separate accounts, (ii) registered investment adviser mutual funds, (iii) insurance company off-balance sheet separate accounts, (iv) insurance company insurance separate accounts, (v) bank

1. What are the regulatory restrictions that apply to asset managers in each of these categories?

2. What type of disclosures do they have to make to their clients?

3. What constraints apply to their actions with respect to the asset management vehicle that they advise?

4. To what extent are assets under management/administration subject to self-direction by the owner of the assets?

The Report does not address these points in anything other than a haphazard fashion. Any credible and responsible effort that intended to consider seriously risks in the asset management industry would have separately and comprehensively analyzed each of the six asset management categories that appear to be within the scope of the Report. Instead, the Report largely relies on undifferentiated references to "asset managers" rather than a careful, meaningful, specific analysis of individual categories of asset management activity.

Taking the Report at face value, a reader would conclude that the OFR had just stumbled on an essentially unexamined and unregulated canyon in which $53 trillion of assets lurk. The Report inexplicably does not address basic critical questions such as what are the implications on particular asset management categories of:

1. The Investment Advisers Act of 1940 ("Advisers Act") and the SEC's regulations thereunder;

2. The Investment Company Act of 1940 ("1940 Act") and the SEC's regulations thereunder;

3. The Securities Act of 1933 and the SEC's regulations thereunder;

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holding company and bank separate accounts, and (vi) bank holding company and bank common and collective trust funds.

4. The Commodity Exchange Act and the Commodity Futures Trading Commission's regulations thereunder;

5. The Office of the Comptroller of the Currency's Part 9 rules regarding Fiduciary Activities of National Banks;

6. The Employee Retirement Income Security Act and the Department of Labor's regulations thereunder;

7. The Internal Revenue Code and Internal Revenue Service regulations thereunder;

8. State insurance laws and insurance regulations;

9. State banking laws and banking regulations; and

10 State laws governing the conduct of investment advisers.

The impact of these critical laws and regulations on each of the six categories of asset management are left unexplored and unaddressed by the Report. This is a fundamental defect that undermines the credibility of the Report.

II. *Asset Management Firms are Engaged in Agency Activity and Are Not Principals To Which SIFI Designation Standards are Intended to Apply: The Report Contradicts FSOC Precedent*

The issue under consideration by the FSOC and the question that the OFR stated that it was responding to in issuing the Report is "whether—and how—to consider [asset management] firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Act."[7] As discussed above, the Report is fundamentally flawed in that it improperly and insupportably tries to treat asset managers and the asset management industry as being subject to the same

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[7] *Id.* at 1. In that regard, it is notable that neither the FSOC nor the OFR purport to be addressing the possibility of designating any individual asset management vehicle, as compared to an asset management firm, as a SIFI.

considerations and risks as may apply to the consideration of whether a financial firm that engages in principal activities should be designated as a SIFI.

Asset management is an agency activity. Investors who place their funds in asset management vehicles are not investing in the asset manager. Instead, they are selecting an asset management vehicle which may be advised, managed, or administered by an asset manager. Investors may retain control over how their assets are invested, or may place them in a fund or other vehicle that operates in accordance with written investment strategies, or in accordance with the terms of an investment advisory agreement. These are all choices made by investors. But they are not decisions by investors to become investors in asset management firms.

The Report shows no basic understanding of how the asset management industry operates. Asset managers are subject to having their contractual investment management and advisory relationships terminated by clients. This, for example, is an essential element of the statutory and regulatory requirements for independence between the mutual funds registered under the 1940 Act and the investment advisers that they engage on a contractual basis.[8] Outside the context of the 1940 Act, the Advisers Act and the SEC regulations thereunder prescribe certain requirements to protect clients from improper conduct by investment advisers.[9] In this regard, investment advisers have a fiduciary duty to act in the best interests of their clients.[10] These requirements are carefully and appropriately structured to address the relationship between an investment adviser and its clients.

The Report's fundamental misunderstanding about the nature of asset management and the role played by asset managers is even more difficult to fathom when considered in the light of the FSOC's recent clear understanding of the distinction between risks posed by principal activity of a company as compared to agency asset management activity.

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[8] *See* 1940 Act, section 15(a)(3).

[9] *See* Regulation of Investment Advisers by the U.S. Securities and Exchange Commission, Staff of the Investment Adviser Regulation Office, Division of Investment Management, U.S. Securities and Exchange Commission, March 2013, *available at* http://www.sec.gov/about/offices/oia/oia_investman/rplaze-042012.pdf.

[10] *See*, *e.g.*, *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

On July 8, 2013, the FSOC issued a statement describing the basis for its determination to designate American International Group, Inc. ("AIG") as a SIFI. The statement makes it clear that the FSOC fully understands the non-principal nature of asset management activities and the high level of transferability of asset management businesses to unaffiliated third party asset managers in the event that a firm that was partially engaged in asset management activities were to experience financial distress. In the context of a discussion of a range of factors related to its consideration of AIG, the Council made the following observations:

> The Council also considered ***the extent to which assets are managed rather than owned by AIG, and the extent to which ownership of assets under management is diffuse***. [Emphasis in original] The relevance of this factor to AIG is limited. ***If AIG were to experience material financial distress, its asset management business likely could be transferred to other asset managers, and therefore it is unlikely that AIG provides a critical function as a third-party asset manager***. [Emphasis added][11]

Simply put, unlike a situation involving a firm's own assets and liabilities that reside on its balance sheet, transfer of an asset management business by a firm, even one facing material financial distress is, in the view of the FSOC, readily achievable. And that is the point. Asset managers do not present the same financial stability concerns that may arise with firms that are engaged in principal activities.

III. ***The Report's Contentions Regarding "Reaching for Yield" and "Herding" are Confusing, Unsupported and Unconvincing***

As explained above, the OFR apparently believes it can identify a potential spark or sparks that will trigger the rapid redemption runs which will result in asset "fire sales" that will transmit disruption in the asset management industry into

[11] Basis of the Financial Stability Oversight Council's Final Determination Regarding American International Group, Inc. at 12, *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Basis%20of%20Final%20Determination%20Regarding%20American%20International%20Group,%20Inc.pdf.

destabilizing events in asset markets which will, in turn, threaten the financial stability of the U.S. The Report attempts to pin the "spark" role on speculation about investor responses to two purported phenomena—"reaching for yield" and "herding."

The allegations against these two alleged culprits are vague and ill-defined. The Report's discussion of what "reaching for yield" means is remarkably subjective. For example, it refers to asset managers that "seek higher returns by purchasing relatively riskier assets than they would otherwise for a particular investment strategy."[12] This claim appears to involve peering into the mind of an asset manager – it does not appear to involve any suggestion that the asset manager is failing to comply with the stated asset management strategy. How would the OFR undertake to identify such "thinking" by an asset manager? Moreover, how would an investor identify this "thinking" by the asset manager, so that the investor could respond to it, purportedly by redeeming assets held with the asset manager?

Another example of remarkable subjectivity arises in the OFR's discussion of investor perspectives. In essence, the OFR speculates that an investor that receives disclosures that properly set forth an asset manager's investment strategies will not understand what these disclosures actually mean and presumably at some time in the future, will reach this understanding and be surprised and disturbed and decide to redeem assets held with the asset manager.[13] This scenario seems far-fetched and certainly of no material pervasiveness.

The Report also asserts that in some cases, asset "managers' incentives . . . may be structured so that managers share investors' gains on the upside but do not share investors' losses on the downside, a situation that creates incentives to invest in riskier assets."[14] The Report does not indicate in which asset management sectors this alleged structure exists, nor does it actually tie these purported incentives to any actual

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[12] Report at 9 (note omitted).

[13] *Id.* (note omitted).

[14] *Id.* (note omitted).

violation of a written investment strategy under which an investment adviser is operating.[15]

Concerns expressed in the Report about the threat posed by "herding" are similarly confusing and contrived. The Report indicts investors for "herding," arguing that risks "could surface . . . by investors herding into certain new products, particularly if the products are relatively illiquid and investors fail to fully appreciate their risks under different market conditions."[16] Thus, it would appear that investors, through their direct personal investment decisions, would be fully capable of "herding" behavior without any involvement by asset managers at all.

The Report suggests that asset managers also engage in "herding" behavior, which it describes as "the tendency of asset managers to crowd into similar, or even the same, assets at the same time."[17] In an analysis that is directed at nearly $43 trillion dollars of assets under management, it is virtually impossible to understand what this statement is intended to mean.

- How many asset managers would have to engage in this behavior at the same time in order for it to constitute "herding"?
- What volume of assets would have to be involved?
- What degree of concentration would have to be involved in a particular asset category or market?

15 In fact, section 205 of the Advisers Act and the rules thereunder limit the circumstances in which this type of performance fee is permissible. Generally, this type of fee only is available in connection with advisory services provided to wealthy and sophisticated investors, and generally is prohibited in the registered investment company context. The only performance fee an adviser is permitted to charge a registered investment company (other than where all the shareholders of the investment company meet certain requirements) is a "fulcrum fee," wherein the adviser's compensation increases or decreases proportionately based on the investment company's performance relative to an appropriate index or other measure of performance.

16 *Id.* at 11 (note omitted).

17 *Id.* at 10.

- How would the relative degree of liquidity in an asset category be determined?

The Report apparently considers some types of "herding" to be acceptable and other types to be potentially problematic.[18] Yet, it does not provide specific examples of each category. Is herding into government securities "good herding" and herding into private sector securities "bad herding"?[19]

As with "reaching for yield," the key element in the Report's hypothesis is the extraordinarily unlikely possibility that in an enormous market of daily transactions in global financial instruments, a series of individual investors will simultaneously reach the conclusion that their personal asset managers have been engaging in "bad herding" or "reaching for yield" and will immediately react by redeeming their assets held by the asset manager.

In the context of "reaching for yield," without any empirical support, the Report postulates that if the risks associated with this conduct "suddenly become apparent, they could spur redemptions and a flight to quality, which could in turn trigger adverse market contagion as managers sell assets to meet those redemptions."[20] In order for "reaching for yield" or "herding" as triggers for financial destabilization to be credible, the Report would have to demonstrate some type of persuasive support that: (i) investors actually come to recognize in time that these two types of behavior are occurring in regard to the asset managers; (ii) large numbers of investor would recognize this behavior at the same time; (iii) this recognition would actually result in substantial levels of redemptions at numerous asset managers; (iv) these redemptions would happen at such levels that they overwhelm normal liquidity capacity at numerous asset managers; (v) these asset managers in response would have to engage in asset sales in a particular asset category or categories at a level sufficient to have a destabilizing impact on such category or categories that would have a

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[18] *See id.* at 10.

[19] A fundamental issue with the Report is its lack of definitions, risk metrics or transparent measuring devices so that outsiders can fairly analyze the Report and react to it.

[20] *Id.* at 9-10 (note omitted).

significant impact on systemic financial stability, and that these events have actually occurred in certain circumstances which may fairly be anticipated to reoccur.[21] None of that is in the Report. Nor would we expect that the OFR could come up with any credible real-world scenarios in which the foregoing chain of events could even remotely be expected to transpire.

An interesting behavioral element in this hypothesis is the underlying implied concept that investors "who learn the truth" will somehow communicate this realization to others who will join them. The Report suggests that certain investors who do not initially appreciate their asset manager's investment strategy, but then at some point in the future come to appreciate the strategy thereby causing them to redeem their holdings with their investment manager.[22] The Report implies that this hypothetical activity by such investors will, in turn, spur widescale rapid redemptions by other investors that could trigger "adverse market contagion."[23] The Report does not provide any explanation of how such individual decisions by this hypothetical category of investors and the reasons for their actions would be communicated to other investors.

Every day millions of U.S. investors make personal investment decisions based on a wide range of individualized factors. The freedom of investors to pursue effectively their own individual investment strategies is critical to the U.S. capital markets.

There simply is no reason to believe that personal views of an individual investor regarding "reaching for yield" or "herding" by the investor's asset manager and the investor's subsequent decision to respond by redeeming assets held with that asset manager would ever become known to any meaningful number of other investors. There is also no reason to believe that these other investors would reach

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[21] To its credit, the Report does note that sharp declines in particular asset markets can open opportunities for participants with other perspectives to take advantage of opportunities that may be created, noting that "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." *Id.* at 12.

[22] *Id.* at 9-10.

[23] *Id.* at 10.

the same conclusion as the original investor in regard to their asset managers or cause them to engage in redemptions.

The Report fails to provide any credible basis to believe that the foregoing scenario has any prospect of coming to pass.

IV. *The Report's Assertions Regarding "Reaching for Yield" and "Herding" Fail to Create Any Rational Prospect of Redemption Risk*

The second stage of the Report's systemic threat hypothesis – rapid, destabilizing redemptions of assets held with asset managers – only comes to pass if the "reaching for yield" and "herding" propositions set forth in the Report actually trigger meaningful redemption activity by large numbers of investors in a simultaneous wave. As noted above, the Report provides no basis to believe this phenomenon has any prospect of transpiring. As a result, there really is no reason to continue to explore and critique the Report's hypothesis.

Nevertheless, given the potential impact of the Report, the statements contained in the redemption risk section of the Report should not be left unexamined.

The redemption risk section opens by expressing concerns that floating net asset value ("NAV") mutual funds ("Mutual Funds") are subject to a meaningful risk of rapid redemptions because of the "first mover advantage."[24] This is, at a minimum, curious since the FSOC is on record recommending that the SEC consider, among other things, requiring all MMFs to operate with a floating NAV because this would reduce financial instability and the risk of runs among MMFs.[25] Moreover, the FSOC affirmatively touted the anti-run benefits of a floating NAV model for MMFs.

The unfortunate results-oriented approach taken in the Report is laid bare when one considers that the very same floating NAV that the OFR views as a significant threat is described in highly positive terms by the FSOC in its MMF reform recommendations:

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24 *Id.* at 12.

25 FSOC MMF Recommendations, 77 Fed. Reg. at 69466.

> Modified investor expectations. A floating NAV would make gains and losses on MMF investments a regular occurrence. It would accustom investors to changes in the value of their MMF shares and reduce the perception that shareholders do not bear any risk of loss when they invest in an MMF. Such beliefs can make MMFs prone to runs if shareholders suddenly become concerned that they may bear losses. Breaking the buck should no longer be a significant event *because MMFs would simply fluctuate in value in the same manner as other mutual funds. Losses – which are inevitable in an investment product* – would no longer be obscured by valuation and rounding conventions, *but would be borne by shareholders and reflected in a fund's share price just like all other mutual funds.*[26]

The redemption section of the Report goes on to postulate that Mutual Funds exist under a great continuing threat of overwhelming fund-threatening rapid redemption requests. Yet, we now have more than six decades of experience with SEC regulation of Mutual Funds, and no history of significant disruptions to such funds through this period.

The Report gives passing references to certain elements of the SEC's regulatory structure intended to protect the interests of Mutual Fund shareholders, but does not consider the effectiveness of these protections.[27] Nor does the Report consider the

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[26] *Id.* (emphasis added).

[27] *See* Report at 12. Mutual Funds are separate legal entities from their investment advisers and have separate boards of directors or trustees charged with protecting the interests of the Mutual Funds and their shareholders. The 1940 Act and the SEC's rules thereunder contain numerous provisions to protect Mutual Funds from overreaching by their investment advisers and other third parties. Among these protections are strict restrictions on how and where the assets of a Mutual Fund may be kept, which insulate these assets from seizure or abuse by the investment adviser or other third party (*see* Section 17(f) of the 1940 Act and Rules 17f-1 through 17f-7 thereunder), limitations on dealings between Mutual Funds and their investment advisers or other affiliates (*see* Section 17 and Rule 17d-1 under the 1940 Act), and numerous tools to prevent damage from rapid redemptions, including the ability to delay payment of redemptions for up to seven days and to suspend redemptions entirely during periods when the New York Stock Exchange is closed or upon the determination of the SEC that an emergency exists (*see* Section 22(e) of the 1940 Act). Moreover, many Mutual Funds reserve the right to redeem shares "in-kind" rather than in cash, which would allow a Mutual Fund to meet redemptions without selling any portfolio securities.

nature and orientation of Mutual Fund shareholders in general. Mutual Fund shareholders are largely long-term investors, with substantial portions of their investments targeted as retirement savings.[28] Thus, it is not surprising, but is significant in the context of the concerns expressed by the Report, that even during the 2008 financial crisis, Mutual Funds experienced only modest net outflows of funds.[29]

Another example of the unfortunate results-oriented approach of the Report is the unfounded and unsupported assertion that "[i]n some circumstances, investors may believe that they can rely on sponsor support of the fund or product in a crisis, even in the absence of a legal or stated guarantee."[30] Who are these investors? Has the OFR interviewed them? How did their belief square with their experience?[31] Can anyone who has any knowledge of the operations of the U.S. Mutual Fund industry assert that any meaningful portion of Mutual Fund investors expect that the investment advisers of their Mutual Funds will make up losses incurred on investments made by a Mutual Fund?

The FSOC itself does not seem to share the OFR's confusion on this point. It plainly understands that in a Mutual Fund it is the investors who benefit from the increase in the value of investments held by a Mutual Fund and who bear the risk of a decrease in the value of such investments. As the FSOC noted in its MMF reform recommendations:

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[28] Data compiled by the Investment Company Institute ("ICI") indicates that, in 2011, 73 percent of households owning Mutual Funds indicated that their primary financial goal for their fund investments was saving for retirement, and 93 percent of such households indicated that they were using mutual funds to save for retirement. ICI, *Characteristics of Mutual Fund Investors*, 2012 6 (2012), *available at* http://www.ici.org/pdf/per18-07.pdf.

[29] In September, October and November of 2008, at the height of the financial crisis, Mutual Funds experienced net redemptions of approximately $60 billion, $128 billion and $41 billion, respectively, on a net asset base of almost $5.8 trillion. ICI, *Long-Term Mutual Fund Flows Historical Data* (2013), http://www.ici.org/info/flows_data_2013.xls (regarding redemption activity); ICI, *2013 Investment Company Fact Book: A Review of Trends and Activity in the Investment Company Industry* 144 (2013), *available at* http://www.icifactbook.org/pdf/2013_factbook.pdf (regarding total assets).

[30] Report at 14.

[31] To the extent that the OFR has conducted surveys on this or other points made in the Report it would be beneficial for these materials to be made available to the public.

> *Losses*—which are inevitable in an investment product . . . *would be borne by shareholders* and reflected in a fund's share price just like all other mutual funds.[32]

That is how it works. The FSOC did not caveat its statement by saying "except that the mutual fund's investment adviser will make up for the loss," because, of course, such a statement would not be true.

It is disturbing that important elements of the Report appear to be based on the concept that important aspects of financial market behavior are driven by ill-informed investors who are capable of acting in concert to destabilize the asset management industry and the entire U.S. financial sector. We do not believe that this is an accurate or appropriate characterization of meaningful numbers of U.S. investors. Moreover, it cannot possibly form the foundation of reasoned economic and policy analysis of the asset management industry.

V. *The Report's Inappropriate Assertions Regarding Asset Management Firms As Sources of Risk*

The Report asserts that the failure of a large asset management firm could be a source of risk, depending on a range of factors.[33] A review of this section of the Report indicates that this concern appears to be largely based on the principal functions of a large firm that has an asset management component, rather than on the ground that asset management as a standalone business poses financial stability risks. As noted above, the FSOC considered just such a situation in the case of AIG, and found that even if the activities that AIG conducted as a principal caused it to experience material financial distress, its asset management business could be transferred to other asset managers.

This section of the Report also contains a discussion of the capital levels of certain asset management firms. As discussed above, there is no reasonable basis for investors in Mutual Funds to expect that a Mutual Fund's asset manager will support

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[32] FSOC MMF Recommendations, 77 Fed. Reg. at 69466 (emphasis added).

[33] Report at 18.

the value of the assets of the Mutual Fund. Thus, there is no reason for a Mutual Fund investor to be looking to the absolute or relative capital levels of the Mutual Fund's asset manager. This is another example of the Report's failure to distinguish appropriately between the operations of a major financial services company acting largely in a principal capacity as compared to an asset management firm operating in an agency capacity. In fact, it demonstrates a fundamental lack of understanding of the industry by OFR. This, of course, also raises a different set of issues regarding the ability of the OFR to appropriately inform the FSOC of important issues, particularly without collaborating with the lead regulatory agency of the industry.

VI. *The Report's Statements Regarding Disruptions to Financial Markets Caused by Fire Sales*

The third stage of the Report's systemic threat hypothesis—disruptions to financial markets caused by fire sales of certain assets—only comes to pass if the "reaching for yield" and "herding" propositions set forth in the Report actually trigger meaningful redemption activity by large numbers of investors in a simultaneous wave, and this, in turn, causes numerous asset managers to be unable to meet redemptions with their normal liquidity preparations. The Report provides no support for the suggestion that such a situation would actually come to pass.

Furthermore, the Report does not explain how rapid redemptions across a wide range of unaffiliated asset managers presumably following a full range of investment strategies could result in asset sales by such asset managers in one or more particular asset markets that would be of sufficient size, concentration and timing as to result in a systemically destabilizing impact on the financial system.

Instead, the Report merely provides a laundry list of factors that it associates with the asset management industry that it asserts could increase the likelihood and severity of fire sales, which appear completely unrelated to the overall three-stage hypothesis offered by the Report.[34]

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[34] *Id.* at 22-23.

Finally, the Report states that Mutual Funds experienced significant redemption requests during the financial crisis.[35] The Report does not, however, allege that Mutual Funds were unable to deal with the level of redemptions that were presented.

Conclusion

Any consideration by the FSOC of potential regulatory action with respect to the asset management industry or particular asset management firms must be based on careful, comprehensive understanding and analysis of the individual components of the asset management industry. There must be clear definitions of terms, precise delineations of the different aspects of the industry that can raise different risks, and transparent risk metrics that everyone agrees on and uses. For the many reasons described above, the Report does not provide such an analysis or meet the criteria needed for the FSOC to move forward. Indeed, it would appear that any regulatory action based upon a flawed report would in and of itself be flawed, potentially causing serious harm to both the financial system and the economy.

Accordingly, the CCMC believes that the SEC, as a member agency of FSOC, should request that the Report be withdrawn and that FSOC acknowledge that the Report, in its current form, does not provide an appropriate or reasonable basis for the Council to undertake an evaluation of asset management firms with regard to potential SIFI designations. If a decision is made that future work would be done in this area, we would hope that the OFR collaborates with the SEC to produce an objective and accurate report that reflects the realities and diversity of the industry and can assess its true value to the overall economy.

We stand ready to discuss these concerns with you in more detail.

Sincerely,

David Hirschmann

David Hirschmann

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35 *Id.* at 23.

cc: The Honorable Mary Jo White, Securities and Exchange Commission
The Honorable Luis Aguilar, Securities and Exchange Commission
The Honorable Dan Gallagher, Securities and Exchange Commission
The Honorable Kara Stein, Securities and Exchange Commission
The Honorable Mike Piwowar, Securities and Exchange Commission
The Honorable Jacob Lew, Secretary of the Treasury
The Honorable Ben Bernanke, Board of Governors of the Federal Reserve System
The Honorable Martin Gruenberg, Federal Deposit Insurance Corporation
Mr. Ed DeMarco, Federal Housing Finance Agency
The Honorable Thomas Curry, Office of the Comptroller of the Currency
The Honorable Roy Woodall, Financial Stability Oversight Counsel
The Honorable Debbie Matz, National Credit Union Administration
The Honorable Richard Cordray, Consumer Financial Protection Bureau
Mr. Richard Berner, Office of Financial Research