

# BLACKROCK

December 3, 2013

**Elizabeth M. Murphy**  
**Secretary**  
**U.S. Securities and Exchange Commission**  
**100 F Street, NE**  
**Washington, DC 20549-1090**

Submitted via internet: <http://www.sec.gov/divisions/investment/comments-ofr-asset-management-study.shtml>

**RE: Feedback on OFR Study on Asset Management and Financial Stability**

Dear Ms. Murphy:

We are submitting this letter as a supplement to our November 1, 2013 letter. Over the past few weeks, we have had discussions with a number of policy makers who are learning about asset management. Several of them have raised questions regarding various aspects of the business of asset management, its products and its practices. The questions and answers below reflect questions that were asked in multiple meetings. We welcome the opportunity to continue the dialogue and answer questions to increase the understanding of asset management. We also continue to encourage convening a public roundtable composed of a diverse set of asset management firms (large, small, diversified, alternative), policymakers and other market participants where a broad range of questions can be asked and addressed.

We again thank the Securities and Exchange Commission for providing the public, including BlackRock, the opportunity to comment on the Office of Financial Research Study. We are prepared to assist the Federal Stability Oversight Council and its member agencies in any way we can, and we welcome a continued dialogue on these important issues.

Sincerely,

Barbara Novick  
Vice Chairman

**Q. Isn't Bear Stearns an example of how "fund managers" could go out of business and impact the financial system?**

A. Bear Stearns was the fifth largest investment bank in the U.S. prior to its acquisition by JPMorgan Chase. It engaged primarily in capital market activities, including underwriting, trading and dealing in equities, bonds and derivatives; wealth management; and providing global clearing services. Its balance sheet leverage at year-end 2007 was approximately 36 to 1 (\$395 billion in assets/\$11.1 billion in equity), one of the highest leverage ratios among the U.S. investment banks.<sup>1</sup> As with most investment banks at the time, Bear Stearns was highly dependent upon short-term funding (commercial paper and repo) to finance its operations.

Through a subsidiary, Bear Stearns was the sponsor of two "structured credit" funds that were almost entirely invested in thinly traded complex derivatives backed by subprime mortgages. Both funds were highly leveraged. When the subprime mortgage market faltered, these funds suffered large losses and were unable to meet investor redemptions or margin calls against falling collateral values. In July 2007, both funds lost nearly all their value and were placed into bankruptcy.<sup>2</sup> Bear Stearns had no legal obligation to bail out either fund, and it did not do so. In June 2007 Bear Stearns made a collateralized loan to one fund and in April 2007 a \$25 million investment to the other fund.<sup>3</sup> When these funds went bankrupt, the vast majority of the losses were taken by investors in the funds and the funds' lenders and not by Bear Stearns itself.

The primary issues in the collapse of Bear Stearns were its balance sheet exposure to subprime mortgages and the firm's reliance on short-term funding. As the market values of mortgage backed securities continued to deteriorate, pressures increased on Bear Stearns because it had large holdings of such securities *on its balance sheet*. Additionally, customers and counterparties of the firm were taking their business elsewhere, as Bear Stearns was seen as less stable than some of its competitors. This crisis of confidence drained its cash reserves and cut off its ability to finance itself in the short and medium term debt markets. Fearing its total collapse, in mid-March 2008 the U.S. Government arranged support for JPMorgan Chase to acquire Bear Stearns, with JPMorgan Chase ultimately paying \$10 per share. Note that this acquisition was eight months after the structured credit funds were put into liquidation.

The Financial Crisis Inquiry Commission found that Bear Stearns' need for a government-assisted rescue was "caused by its exposure to risky mortgage assets, its reliance on short-term funding, and its high leverage."<sup>4</sup> The collapse of the structured credit funds managed by a subsidiary did not cause the collapse of Bear Stearns, but rather the deterioration in the value of securities that Bear Stearns held directly on its balance sheet combined with its vulnerability to short-term funding ultimately weakened the firm to the point of unviability.

In contrast to Bear Stearns and other broker-dealers, asset managers generally do not invest for their own account, and therefore do not assume high levels of balance sheet risk. The balance sheet of an asset manager generally comprises working capital, office space, corporate technology and goodwill, thereby requiring a modest amount of capital. An asset manager's balance sheet is very small compared with that of a bank or broker-dealer and its balance sheet generally is not leveraged significantly. Because the business of asset management is not capital intensive, asset managers do not routinely use short-term debt instruments to fund their operations and thus, unlike banks and broker-dealers, asset managers are not dependent on continued liquidity from short-term markets. Therefore, *the events that led to the collapse of Bears Stearns would not have a similar impact on a standalone asset manager.*

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<sup>1</sup> Ryback, William. *Case Study on Bear Stearns*. Toronto: Toronto Leadership Center, n.d., available at <http://siteresources.worldbank.org/FINANCIALSECTOR/Resources/02BearStearnsCaseStudy.pdf>.

<sup>2</sup> Grand Court of Cayman Islands, July 31, 2007 order appointing Simon Lovell Clayton Whicker and Kristen Beighton, joint provisional liquidators of Bear Stearns High-Grade Structured Credit Strategies Master Fund, Ltd. and Bear Stearns High-Grade Structured Credit Strategies Enhanced Leverage Master Fund, Ltd.

<sup>3</sup> *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States*. Rep. N.p.: Financial Crisis Inquiry Commission, 2011 at 240-41.

<sup>4</sup> Op. Cit. at 291.

**Q. When a large broker-dealer fails, what impact does this have on an asset manager and its clients?**

A. Asset managers have relatively small and uncomplicated balance sheets, and do not generally invest for their own account, and as such, the failure of a large broker-dealer will have little impact, if any, on the asset manager itself. Further, the asset manager acts as agent for its clients—exposures that the end-investor may have are *not* exposures of the asset manager.

Investors (whether they are clients of asset managers or investing directly) may be exposed to the broker-dealer in a variety of ways, depending on the investment strategy. Investors in a broker-dealer may include: shareholders (common equity and/or preferred); secured or unsecured creditors through investing in debt issued or backed by the broker-dealer or its holding company; a lender of securities or a borrower of securities (securities lending, repo, reverse repo); a debtor of the broker-dealer where the broker-dealer is secured (prime brokerage), or a counterparty in an uncleared derivatives transaction (where collateral is likely posted). The investor may also be a customer of the broker-dealer (as defined by federal securities and commodities laws) with its accounts held by the broker-dealer, including in the case of cleared derivatives, margin and other collateral posted to accounts within the broker-dealer's control (but under U.S. law required to be segregated).

The failure of Lehman Brothers Holdings ("LBH") in September 2008 illustrates how these various broker-dealer exposures were resolved; in some instances changes to laws and regulations have addressed issues that arose for end-investors so the impact would be different today.

Investors that held the LBH debt or equity securities saw the value of those holdings fall dramatically, although that decline, particularly the equity, occurred over time and was not just at the time of the bankruptcy filing.

Customers of LBH's U.S. broker-dealer, Lehman Brothers, Inc. ("LBI") (which was also a CFTC-registered futures commission merchant ("FCM")) were generally made whole on their customer monies; LBI had sufficient capital under SEC and CFTC rules so that it was not immediately affected by its parent and affiliates bankruptcy filings on September 15. LBI filed five days later and customers were able to move monies and positions to other broker-dealers and FCMs.<sup>5</sup>

Investors who had borrowed from LBI on a secured basis (both individual investors with margin accounts and institutional investors that used LBI as their sole prime broker) found that their collateral was frozen for a period of time, but in general ultimately recovered an amount close to the net credit value of their accounts. One reason for the delayed return was the practice of LBI to on-lend or rehypothecate collateral to its non-U.S. affiliate, Lehman Brothers International Europe ("LBIE"), which was subject to U.K. insolvency laws. Under these laws at the time, the entire LBIE estate was frozen until claims could be sorted out.<sup>6</sup>

Counterparties to LBI and LBH affiliates in derivative transactions also had collateral frozen; if the collateral was excess, it was returned to the counterparty. In some circumstances, counterparties owed money to the Lehman estate, which they were ultimately required to pay over to the bankruptcy trustee.

Importantly, all of these were *client exposures and not exposures of asset managers*, and therefore asset managers did not suffer losses in the Lehman bankruptcy. It is worth noting that one of the LBH subsidiaries was Neuberger Berman Asset Management, which did not enter bankruptcy and was sold to its management (with the Lehman bankruptcy estate retaining an equity interest) in a bankruptcy auction in

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<sup>5</sup> Ronald Filler, "Are Customer Segregated/Secured Amount Funds Protected After Lehman?" 28 Futures & Derivatives L. Rep. 1 (Nov. 2008); also see generally Report of Anton R. Valukas, Examiner, In re Lehman Bros. Holdings Inc., No. 08-13555 (JMP) (Bankr. S.D.N.Y. Mar. 11, 2010), available at <http://lehmanreport.jenner.com>.

<sup>6</sup> *Lehman Brothers' Administration - Frequently Asked Questions*. Pricewaterhouse Coopers, n.d. Web. 2 Dec. 2013. <<http://www.pwc.co.uk/business-recovery/administrations/lehman/lehman-faq.jhtml>>

December 2008.<sup>7</sup> Neuberger Berman purchased the Lehman equity interests in 2012, and operates as a standalone asset manager today.<sup>8</sup>

**Q. Aren't SIVs ("structured investment vehicles") an example of how asset management firms contributed to the financial crisis?**

A. The structured investment vehicles ("SIVs") that experienced distress during the financial crisis were explicitly *not* commingled investment funds. Prior to the crisis, some large banks and other financial institutions used a type of SIV to move assets off-balance sheet and to employ leverage in a way that the parent company would be unable to do under regulatory capital requirements. These conduits effectively allowed their parent financial institutions to originate and securitize mortgages and then arbitrage existing capital rules to avoid taking capital charges. These SIVs were not funds managed by asset managers for the benefit of investing clients, but rather complicated vehicles that were created by banks for the benefit of banks.

These SIVs attempted to profit from credit spreads between short-term debt and long-term structured finance products, and often used significant amounts of leverage to generate returns. They fit the profile of "shadow banks" where the objective is for a financial institution to take risk to make returns through maturity transformation using an off-balance sheet vehicle. Funding for these SIVs came from the issuance of commercial paper that was continuously renewed or rolled over; the proceeds were then invested in longer maturity assets that had less liquidity but paid higher yields. The SIV earned profits on the spread between incoming cash flows (principal and interest payments on securities) and the outflowing cash flow of the commercial paper that it issued. When the values of the subprime mortgage assets fell during the crisis, the SIVs were unable to continue to roll over their short-term funding and many failed, causing losses to their sponsors and investors.

**Q. If an asset manager were to become distressed, end-investors, especially large institutional investors, will want to replace the distressed manager with one in which they have greater confidence. But doesn't it take a long time to replace one manager with another by moving control of the assets?**

A. A number of asset managers and global custodial banks offer transition management services, with the most active being State Street Bank, Russell Investments and BlackRock.<sup>9</sup> "Transition management" refers to the business of transitioning a portfolio of securities from its legacy (initial) portfolio to a target (future) portfolio specified by a new investment mandate.<sup>10</sup> At the beginning of a transition, investment control is given to the transition manager, while custody of the assets remains with the end-investors' custodian. Institutional investors retain transition managers in order to benefit from the transition managers' greater trading experience, its lower costs of execution, and its risk management expertise.

Institutional investors terminate investment management relationships for a variety of reasons, including underperformance, service issues, or re-allocation of their overall portfolio investments. These common-place terminations are often preceded by RFPs, negotiations over contractual terms and other activities before investment control of the assets is delivered to the replacement manager.

However, experience shows that when a manager is distressed, as a result of unexpected reputational events, end-investors *can and do move quickly*. A change in an investment manager is especially easy for separately managed accounts, as the institutional investor generally uses one master custodian for all of its

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<sup>7</sup> *Lehman's Neuberger Sale Is Approved*. The New York Times, 23 Dec. 2008. Web. 1 Dec. 2013. <[http://dealbook.nytimes.com/2008/12/23/lehmans-neuberger-sale-is-approved/?\\_r=0](http://dealbook.nytimes.com/2008/12/23/lehmans-neuberger-sale-is-approved/?_r=0)>.

<sup>8</sup> *Neuberger Berman Outperforms Over 10 Year Period and Wins New Business; Moves Toward 100% Employee Ownership*. Neuberger Berman, 5 June 2012. Web. 1 Dec. 2013. <[https://www.nb.com/press\\_center/](https://www.nb.com/press_center/)>.

<sup>9</sup> *2013 Transition Management Survey*. AiCIO, 21 June 2013. Web. 1 Dec. 2013. <<http://ai-cio.com/newdatasurvey.aspx?id=2147485318&page=2>>.

<sup>10</sup> A transition manager may also provide interim management services when the institutional investors terminates a legacy manager but has not yet hired a new manager.

assets and can re-direct investment control extremely quickly. Most institutional clients employ more than one external manager, and in these situations the client generally asks one of their other managers for immediate assistance. In these situations, it is common for trading control of a portfolio to be moved to a new manager in less than 24 hours. The new manager generally will monitor and assess the portfolio, and will not enter into transactions for at least 72 hours to ensure that any open trades have been settled so that securities that are to be sold in effecting the transition are not inadvertently sold twice. Redemptions-in-kind from pooled vehicles may also be accomplished relatively quickly, with investment control of the portfolio in the hands of the replacement manager accomplished within the settlement cycle. Two different examples of rapid transitions between managers are set out below.

Example 1: Personnel Turnover

Wednesday March 14, 2012—Nuveen Investments announces departure of the CIO of its subsidiary, Tradewinds Global Investors.

Tuesday, March 20, 2012—large public plan client executes work order with two asset managers to transition \$900 million of AUM from Tradewinds.

Wednesday, March 21, 2012—certified asset list received from public plan client's custodian and new asset managers assume responsibility for legacy portfolio.

From announcement date to end of March, Tradewinds Global Investors sees transfers and terminations of 12-13% of its \$38 billion AUM.<sup>11</sup>

Example 2: Reputational Event

Tuesday, October 28, 2003—Putnam Investments charged by SEC with securities fraud related to market timing.

Wednesday, November 19, 2003—large public plan client terminates Putnam Investments.

Tuesday, November 25, 2003—a successor manager takes responsibility for the client's \$400 million portfolio.

From October 28, 2003 to end November 2003, Putnam experiences transfers and terminations in the amount of \$13 billion.<sup>12</sup>

**Q. Whereas fund information is often publicly available, less is known about “separate accounts.” Who owns these assets? Are these portfolios on the balance sheet of the asset manager? Does the custodian net trades across separate account portfolios managed by an asset management firm? What percentage of separate accounts employs leverage in the investment strategy? What percentage of separate accounts utilizes performance fees?**

A. Institutional investors, especially large institutions, often use “separate accounts,” which are assets managed by an external manager that are held in the name of the end-investor pursuant to a custodial agreement directly between the end-investor and a custody bank. *These assets belong to the client* and are not part of the asset manager's balance sheet. The management of these portfolios is governed by an investment management agreement between the client and the investment manager. This agreement includes investment guidelines dictating the investment objectives and constraints of the portfolio and a fee schedule which sets forth the method for calculating the fees due to the manager. While the guidelines and fees for a separate account may be tailored for a specific client, the portfolios are usually managed side-by-side with other portfolios that have similar investment guidelines, including commingled vehicles and other separate accounts. Since these assets are owned by individual clients, not the asset manager, neither the custodian nor counterparties net exposures across client portfolios managed by the same asset manager.

Given the interest in learning more about separate accounts, we have done a review of equity, fixed income, multi-asset class and alternative strategy separate accounts managed by BlackRock. We find that most clients prefer a “flat” fee based on AUM, with only a small minority of clients choosing a performance

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<sup>11</sup> Information in this example comes from BlackRock as transition manager and from public sources. See, e.g., “Ill Winds for Nuveen Subsidiary” available at <http://www.pionline.com/article/20120402/PRINT/304029974/ill-winds-for-nuveen-subsidiary-tradewinds#>.

<sup>12</sup> Information in this example comes from BlackRock as transition manager and from public sources. See, e.g., <http://articles.chicagotribune.com/keyword/putnam-investments>.

fee schedule. Based on our review, we estimate that less than 10% of the separate accounts we manage utilize leverage,<sup>13</sup> and less than 10% of clients choose performance fees.

Based on the questions we have been asked, it is apparent that there is a need to develop a better understanding of the term “separate accounts.”<sup>14</sup> Some basic information is available from public sources. For example, eVestment is a commercial database which has information on the size of a firm’s total AUM and its separate account AUM as well as detailed information on each firm’s investment strategies and the managers’ performance track record.<sup>15</sup> While the data may not be complete, eVestment is a good starting point to get a sense for separate account AUM. The below chart outlines the separate account AUM that is reported to eVestment by each manager listed in the OFR Study’s Figure 2 “Top 20 Asset Managers by Assets Under Management.”

<b>\$ billions</b>	
<b>Firm Name</b>	<b>Separate / Segregated Account AUM (9/30/13)</b>
BlackRock, Inc.	1,611.0
Vanguard Group Inc.	17.2
State Street Global Advisors	1,202.5
Fidelity Investments <sup>1</sup>	164.0
Pacific Investment Management Company LLC	800.8
J.P. Morgan Asset Management	608.0
BNY Mellon Asset Management <sup>2</sup>	886.0
Deutsche Asset & Wealth Management	388.9
Prudential Financial, Inc. <sup>3</sup>	335.6
Capital Research & Management Company	N/A
Amundi	644.7
The Goldman Sachs Group Inc.	341.1
Franklin Templeton Investments	158.7
Northern Trust Global Investments	344.9
Wellington Management Company LLP	707.5
AXA Investment Managers	510.5
Metlife Inc.	N/A
Invesco	195.7
Legg Mason Inc. <sup>4</sup>	7.6
UBS Global Asset Management	289.8

Source: eVestment

<sup>1</sup> Includes Fidelity Worldwide Investment Pyramis Global Advisors, and FMR Corp.

<sup>2</sup> Includes Alcentra NY LLC, CenterSquare Investment Management, EACM Advisors LLC, Insight Investment Management Limited, Mellon Capital Management Corporation, Meriten Investment Management GmbH, Newton, Standish Mellon Asset Management Company LLC, Walter Scott and Partners Limited. Please see “At a Glance – 3Q2013” (<http://www.bnymellon.com/news/factsheet.pdf>) for detail on subsidiary ownership.

<sup>3</sup> Includes Prudential Financial, Prudential Fixed Income, Prudential Investments LLC, Prudential Private Placement Investors, L.P., Prudential Real Estate Fixed Income Investors, and Prudential Real Estate Investors.

<sup>4</sup> Includes Legg Mason Investment Counsel.

<sup>13</sup> For purposes of our review, we considered an account to be utilizing leverage where the investment strategy of the account relied on borrowing, short selling or the leverage inherent in uncovered derivatives to generate returns (as opposed to, for example, the use of derivatives for hedging or benchmark replication purposes).

<sup>14</sup> The term “separate account” is also used by insurance companies but should not be confused with separate accounts managed by asset managers. As defined by the National Association of Insurance Commissioners, a “separate account” is a fund held by a life insurance company that is maintained separately from the insurer’s general assets. Insurance company separate accounts were originally designed for investment-linked variable annuities, but now include “hybrid” products—products that overlay traditional insurance company guarantees (e.g., mortality, morbidity, etc.) being allocated to the separate account investment portfolio. While there is a separate allocation of assets for an insurance company separate account (often used to track portfolio performance in the case of a variable annuity or as the first line of collateral for a stable value contract), a separate account is reflected on the balance sheet of the company, to the extent there is a call on the general account assets of the insurance company.

<sup>15</sup> eVestment Analytics, [www.evestment.com](http://www.evestment.com).

In addition to sourcing publicly available data, we recommend using a Request for Information directed at a broad and diverse group of asset management firms to provide additional data and educational information on this topic.

**Q. All large banks are required under the Dodd-Frank Act to have “living wills” – a plan for their resolution and winding-up that can be implemented should this become necessary. The policy reason is to reduce the impact a disorderly resolution could have on financial markets. How “resolvable” are asset managers?**

A. Asset managers, and funds, go out of business quite routinely, without any systemic impact whatsoever. Experience shows that asset managers are quite easily resolved, because, unlike banks, asset managers are not balance sheet lenders. This resolution occurs principally in three ways: the sale of the asset management company, along with its existing investment management contracts, to a new owner; the transfer of the investment management agreements and related personnel to another asset management company followed by the liquidation of the asset management company; or the winding down and subsequent liquidation of funds managed by an asset manager followed by the liquidation of the asset management company.

Please refer to Attachment F to our November 1, 2013 letter for examples. Information on merger and acquisition activity can be found in Attachment E to our November 1, 2013 letter. In addition, set out below is data from 2005 to 2012 regarding hedge fund launches and closures. As illustrated by this data, fund closures are a routine occurrence.

<b>Year</b>	<b>Est. Number of Funds Launched</b>	<b>Est. Number of Funds Liquidated</b>
2005	2,073	848
2006	1,518	717
2007	1,197	563
2008	659	1,471
2009	784	1,023
2010	935	743
2011	1,113	775
2012	1,108	873

Source: “HFR Global Hedge Fund Industry Report – Third Quarter 2013”, HFR, [www.hedgefundresearch.com](http://www.hedgefundresearch.com)