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4 December 2013

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

Re: OFR Report on Asset Management and Financial Stability

Dear Ms. Murphy:

CFA Institute[1] appreciates the opportunity to provide comments to the Securities and Exchange Commission on the report issued by the Office of Financial Research (OFR) — "Asset Management and Financial Stability" (the Report). We fully support the mission of OFR to objectively conduct research on issues related to financial stability in service to the Financial Services Oversight Council (FSOC). While we appreciate the intent of OFR to analyze the potential for systemic risk posed by the asset management industry in this context, CFA Institute has concerns about many of the underlying assumptions presented in the Report.

CFA Institute represents the views of investment professionals before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Discussion

We appreciate the OFR's efforts in creating this Report to help inform the FSOC's consideration of whether asset management firms pose systemic risks that should be subject to enhanced prudential standards and supervision. We note the Report's admission that certain areas involve data not readily available to the public and thus present limited visibility into certain market practices. To enhance the Report's credibility, we believe that OFR should request additional data as to the systemic risk potential of the asset management industry from the relevant regulator, in this case the Securities and Exchange Commission (the "Commission"). We also note that many asset managers are already subject to significant disclosure regimes as investment advisers, are subject to the

[1] CFA Institute is a global, not-for-profit professional association of more than 117,400 investment analysts, advisers, portfolio managers, and other investment professionals in 146 countries, of whom nearly 110,300 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 138 member societies in 60 countries and territories.

Investment Advisers Act of 1940, and for those organized as public companies, by the disclosure requirements of the Commission.

We support efforts to identify and mitigate systemic risk in the financial markets.[2] We strongly believe, however, that measures taken to address such risk must be grounded in solid empirical data and analysis and reflect a thorough understanding of the industry under review.

We question whether this Report, without more in-depth analysis, can form the basis for conclusions about the systemic risk implications of the asset management industry. While the Report recognizes that the asset management industry covers a diverse range of activities, it often suggests correlations between activities and potential risk that appear overly broad. For these and other reasons discussed below, we strongly encourage further data gathering and a continued analysis of the issues before reaching conclusions about whether prudential regulatory measures are needed for this industry.

Section 1—Industry Activities

We agree with the Report's recognition that the asset management industry consists of a diverse range of businesses, models, funds and activities and that "asset management activities should be the analytical building blocks for understanding the industry." It is curious then, that the very next paragraph notes that the data that is available and used for analysis in this Report "relate to firms or funds, not to activities." While the Report purports to reconcile this gap, we believe challenges remain.

For example, the Report notes that the information provided with respect to categories of investment vehicles involves "inherent double-counting" (Figure 1). Rather than extrapolating on the basis of problematic data, we believe that reconciliation of the data issues would be advisable prior to forming conclusions.

Moreover, while Figure 2 lists the top 20 asset managers according to assets under management, it fails to note the number and effect of index funds and regulated portfolios such as mutual funds, accounts that likely comprise a substantial amount of these firms' AUM. Based on the nature of these accounts, asset managers may be highly restricted in their ability to liquidate clients' holdings or engaging in other activities on a discretionary basis, information that should be considered when attempting to assess magnitude of effect. We therefore suggest further analysis on the amount of assets held by these top 20 asset managers that are restricted by the nature of the account or clients' investment policies when evaluating the potential impact of asset manager actions.

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[2] CFA Institute co-sponsors the Systemic Risk Council with the Pew Charitable Trusts for the purpose of addressing regulatory and structural issues related to systemic risk in the US. See www.systemicriskcouncil.com

Moreover, despite noting the diversity and range of asset managers and types of assets being managed, the Report groups together different types of firms and assets and proceeds to draw conclusions apparently assuming that actions will be in concert. For example, the Report notes "risk-taking in separate accounts" but does not account for the fact that the client—not the asset manager—directs the investment objectives of separate accounts subject to the clients' return and risk objectives. Thus, such risk-taking that is attributed to asset manager actions for purposes of this Report actually may not be at the manager's direction or discretion.

Section 2—Vulnerabilities

This section of the Report notes four factors that make the asset management industry vulnerable to financial shocks: "reaching for yield" and herding behaviors; redemption risk in collective investment vehicles; leverage, which can amplify asset price movements and increase the potential for fire sales; and firms as sources of risk.

Reaching for yield and herding. One of the vulnerabilities noted in the Report focuses on portfolio managers "reaching for yield" -- seeking higher returns -- "by purchasing relatively riskier assets than they would otherwise consider for a particular investment strategy." "Herding" behaviors would occur when investors, including asset managers, invest *en masse* in certain asset classes or securities regardless of their size or liquidity. The OFR's concern focuses on what would happen to asset prices and market volatility should the markets experience sudden shocks.

While this section notes that registered funds and advisers are highly regulated and must provide various disclosures, it also argues that "potential information disparities between investment advisers and their clients could undermine those mitigants in the industry" and that investors may not fully appreciate the risks taken by their managers. While the Report does not attempt to quantify the degree to which these information disparities exist, we recognize that potential information disparities could affect investor behavior and have a longstanding position of advocating for providing investors with all the information needed to make meaningful investment decisions. But we question whether the "potential information disparities," particularly with respect to regulated funds and advisers who provide a range of pertinent disclosures under the existing regulatory regime, should be viewed as a substantial contributor to systemic risk.

To support its statement that competitive forces may increase incentives for managers to take on more risk, the Report cites research that managers who are lagging their peer groups at year-end take on more risks than managers who are outperforming. Yet, many managers are constrained by the investment policy statements entered into with clients or by their fund prospectuses. Within this constrained environment, we believe there is little opportunity for managers to change their investment strategies in a pro-cyclical manner in an attempt to reverse lagging performance.

Similarly, the Report notes that competitive pressures may also result in "herding" by asset managers, and that herding into illiquid investments "*may* have a greater *potential*" for adverse market impacts "*if* financial shocks trigger a reversal of the behavior" (emphasis added). While we agree that all viable concerns should be explored when considering systemic risk, we question the degree to which "herding" occurs in today's markets and would invite a fuller examination of concrete examples of how such behavior would amplify risks that rise to a systemic level. For example, while a number of managers may be operating under similar mandates (e.g., investing in large cap domestic growth equity securities), security selection within this group will vary, resulting in market volatility in this sector on a day-to-day basis. The diversification of portfolios also serves to absorb "shocks" to a particular security or sector. Thus, while certain asset managers may invest in similar assets at the same time, the varying investment objectives for specific clients and the strategies employed by managers to balance/reweight their portfolios would generally mitigate these concerns.

We also believe it useful to discuss the fact that fund managers often lack latitude to make unilateral investment decisions that would result in some types of herding behaviors. Fund prospectuses establish the types of investments allowable for different types of funds (i.e., a large cap fund must invest in large cap equities). Similarly, with respect to separate accounts, investment policy statements clarify investors' objectives and thus would limit those asset managers' activities to those reasonably seeking to meet those objectives.

The Report's consideration of whether herding behaviors occur in less liquid securities is also inconclusive. Noting that the majority of ETF assets are invested in the "very liquid" equity market and that "the effects on market liquidity of trading in ETFs are ambiguous," it nonetheless conjectures that ETFs "could also potentially" affect price movements during times of market turbulence and reduce market liquidity.

Finally, the Report raises concerns about herding behaviors by *investors* herding into new products, the risks of which they do not fully understand, and then engaging in heavy redemptions when the risks become more apparent during market stress. We often advocate for investor education whereby investors can more fully educate themselves as to the risks of their investments. And we support initiatives whereby asset managers must provide investors with the understandable information that highlights, among other things, the risks of particular investments. But we question whether it is appropriate to focus on *investor* activity in a report focused on raising serious questions about whether activities of agents on behalf of investors contribute to systemic risk.

Redemption risk. We believe the Report correctly notes that fund managers must manage and mitigate redemption risk through well-established liquidity management mechanisms, including the fact that mutual funds must hold at least 85% of investments in highly liquid assets—those that could be sold within seven days. Yet, the Report raises concerns about the inability of managers to impose restrictions on redemptions during times of market stress. We believe the magnitude of this concern may be misplaced.

We agree that money market funds (expressly not a topic of this Report) face challenges in times of market stress with respect to redemption requests and potential "runs" that can produce a contagion effect felt throughout the markets. But we believe regulations pertaining to non-money market mutual funds mitigate some of the concerns being raised. The fact that 85% of a fund's assets are liquid would allow that fund to sell most such assets during times of heavy redemption demand. Moreover, non-money market funds have the ability to hold back redemptions for seven days during times of stress, can borrow against fund assets to meet redemption requests, and may adopt policies that allow them to make "in-kind" redemptions. While certain market repercussions might occur during extreme times of market stress, we question the probability to which they likely would *create* systemic risks.

In trying to illustrate "how redemption-like risk" contagion might also stem from inadequate risk management pertaining to the reinvestment of cash collateral, the Report notes AIG Securities Lending Corporation's cash collateral reinvestment practices as an example. While the Report does note that the connections between cash collateral reinvestment, securities lending, redemption risk and short-term funding markets are "not well understood and is difficult to measure," it nonetheless draws connections between cash collateral reinvestment practices and fire sales in the context of systemic risk. While we appreciate that securities lending practices are opaque, we nonetheless believe that amplifications of risk from this practice are likely to be modest and would not rise to a magnitude qualifying as systemic. Given our belief that there is little, if any, leveraging of cash collateral pools, the risk implications are further reduced.

Leverage. The Report's concerns here focus on events that can lead to fire sales when borrowers become subject to margin calls and liquidity is constrained. It also notes that asset managers may engage in leveraging for their accounts through derivatives and repurchase agreements.

The Report notes the sectors of the industry that regulate levels of leverage (e.g., mutual funds must hold assets equal to at least 300% of bank debt), sectors that are not formally regulated but are usually restricted by investment mandates, and that there is insufficient data available with respect to leverage in separate accounts. Concerns particularly stem from the use of leverage (especially through the use of derivatives) leading up to the 2007 financial crisis and that resulted in substantial losses.

While we appreciate the concern about leverage practices (especially when leverage is imbedded as in some derivatives products) and their potential for contributing to systemic risk, we believe the example provided in the Report fails to make this argument. In the Oppenheimer Funds case cited, although investors initially suffered significant losses and one fund's adviser provided liquidity to make payments related to margin calls, there is no evidence that the leveraging practices and results amplified risks beyond the funds. Nor are there suggestions that this situation contributed to contagion, runs on other funds, or otherwise to systemic risk. Moreover, being regulated under the Investment Company Act of 1940, the Oppenheimer Funds were already subject to leverage restrictions and well-defined reporting requirements.

In its discussion of leveraging risks by asset managers, the Report also fails to discuss the restrictions on managers to liquidate holdings or engage in certain practices that may conflict with their clients' investment policy statements. There also needs to be mention of the fact that mutual funds are not allowed to be levered without providing disclosure in the Prospectus and Statement of Additional Information. Finally, it would be helpful for the analysis if the Report were to suggest what *magnitude* of "taking on leverage" would be considered systemically risky, especially in the context of limits on leverage currently proscribed by prevailing regulation.

Firms as sources of risk. In raising systemic risk implications relating to the firms themselves, the Report focuses on how the failure of a large and complex asset management firm could transmit risk to other parts of the financial system, as well as how "concentration of risks" within the firm could pose a threat to financial stability.

We believe that some of the discussion in this section conveys a level of concern that may not be warranted. Unlike firms who trade as principals, asset managers generally do not own the assets under their control, and client assets are segregated from firm assets in custodial accounts. Rather, they primarily act as agents for, and at the direction of, their clients. Thus, concerns about risk due to high "concentrations" of assets in larger firms need to be tempered by the fluidity of asset movements due to client directives relating to customer accounts and, with respect to mutual funds, restrictions that are spelled out in fund prospectuses and statements of additional information. Based on these restrictions and the types of account in question (separate, non-discretionary, etc.), asset managers may have limited ability to direct assets into certain investment vehicles.

The Report accurately notes that separate accounts typically are easy to move between managers due to the separation of custody and management, but raises questions about a firm's ability to unwind or transfer client assets to other managers during times of firm stress. We believe concerns about the ability of the asset management industry to absorb new accounts from managers who may be in distress or otherwise need to transfer them are exaggerated. Given the breath and capabilities of the top asset management firms featured in Figure 2, which are at the center of the Report's list of potential systemic risk concerns, we find it unlikely that a replacement manager would be lacking.

We also question the suggested risk implications about how some financial institutions "with asset management divisions suffered material distress during the recent crisis," with resulting stress spread between those companies' business and their asset management subsidiaries. As agents for their clients, the assets overseen by asset management subsidiaries are segregated from the parent's corporate assets. Investment policy statements also commonly address limitations on investments in securities related to the asset managers.

Section 3—Transmission Channels

The Report notes its concerns about two primary channels through which asset managers could transmit risks: exposure of creditors, counterparties, investors or other market participants to the manager or asset management activity; and disruptions to the financial markets that would be caused by fire sales.

Without more information, we are not convinced that these "transmission channels" would operate to amplify risk to levels that would raise systemic risk concerns. For example, the Report cites Morningstar data that redemptions from strategic income funds in the fourth quarter of 2008 nearly doubled the volume during the same quarter of 2007, without providing a context within which to weigh the importance of this information. For example, what was the quarterly average daily flow of all corporate bonds during the fourth quarter of 2008 when compared to the same period in 2007, and what percentage of the daily flow did this account for?

Similarly, another example notes that "10.5 percent of the 52 percent decline in the U.S. stock market related to the crisis could be attributed to distressed selling by mutual funds." Rather than an indicator of risk, we suggest that this was instead primarily in response to investor decisions, not fueled by independent decisions by asset managers seeking to leave the US equity market. Even if viewed as amplified risk, we wonder if a 20% decline, given the timing of market events, would indicate potential systemic risk for the future.

Section 4—Data Gaps

This Report recognizes that the lack of information in certain areas of the asset management business limit the ability of regulators and supervisors to fully analyze the extent to which the business may contribute to financial stability risks across financial markets. In particular, the Report notes data gaps that exist in separate accounts, in the securities lending and repo markets, and at the firm level. We appreciate the desire for more information across different sectors of the asset management industry as a way to further analyze potential risk. While OFR suggests that additional information on separate accounts is needed, it also notes that as a non-collective investment vehicle, there is "no shared risk or vulnerability to other shareholders' redemptions" in separate accounts.

Conclusion

CFA Institute shares concerns about market activities and sectors that could contribute to systemic risk in our financial marketplace. However, we believe that any conclusions about what they are must be carefully analyzed and based on facts, empirical data and a thorough understanding of the industry. We recommend additional research and analysis prior to developing any conclusions as to the potential for activities of asset managers to contribute to systemic risk. Should you have any questions about our positions, please do not hesitate to contact James Allen, CFA at james.allen@cfainstitute.org or 434.951.5558; or Linda L. Rittenhouse at linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

/s/ James C. Allen

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/s/ Linda L. Rittenhouse

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Director, Capital Markets Policy
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