

April 9, 2014

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

Re: Public Feedback on OFR Study on Asset Management Issues

Dear Ms. Murphy:

Attached for filing in the above-referenced comment file is a copy of a comment letter that we submitted to the Financial Stability Board on its Consultation Report on "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions." This letter will supplement our letter dated November 1, 2013, which we submitted to the Commission in response to the OFR's September 2013 report, Asset Management and Financial Stability.

Sincerely,

A handwritten signature in black ink, appearing to read "Paul Stevens". The signature is fluid and cursive, with a large initial "P" and "S".

Attachment

April 7, 2014

Secretariat of the Financial Stability Board  
c/o Bank for International Settlements  
CH-4002  
Basel, Switzerland

Re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Globally Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies

Dear Sir or Madam:

The Investment Company Institute, on behalf of its entire fund membership,<sup>1</sup> appreciates the opportunity to comment on the Financial Stability Board's proposed assessment methodologies for identifying non-bank non-insurer globally systemically important financial institutions ("NBNI G-SIFIs").<sup>2</sup> Over the last several years, ICI has actively supported US and global efforts to address the abuses and excessive risk taking highlighted by the global financial crisis and to bolster areas of insufficient regulation, such as with respect to the OTC derivatives markets. As both investors in the capital markets and issuers of securities, our members support appropriate regulation to ensure the resiliency and vibrancy of the global financial system.

Nevertheless, we have become increasingly concerned that certain proposed reforms, advanced in the name of promoting financial stability, may be far broader than necessary and sweep beyond any demonstrable risks. This seems to reflect an inclination, on the part of some, to paint the entire canvas

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<sup>1</sup> The Investment Company Institute (ICI) is the national association of US investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$16.8 trillion and serve more than 90 million shareholders. ICI's affiliate, ICI Global, is a global fund trade organization based in London; members include regulated US and non-US based funds publicly offered to investors in jurisdictions worldwide. ICI Global seeks to advance the common interests and to promote public understanding of global investment funds, their managers, and investors. Members of ICI Global manage total assets of \$1.4 trillion in non-US funds.

<sup>2</sup> *Assessment Methodologies for Identifying Non-Bank Non-Insurer Globally Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (8 January 2014) ("consultation"), available at [http://www.financialstabilityboard.org/publications/r\\_140108.pdf](http://www.financialstabilityboard.org/publications/r_140108.pdf).

of the financial system with a single broad brush and dramatically expand the authority of bank regulators, as well as the applicability of bank regulatory standards that are entirely out of keeping with the way in which other types of financial institutions are structured, operated and currently regulated.

Given these concerns, it should come as no surprise that we are deeply troubled by the process being pursued at the FSB (and by the US Financial Stability Oversight Council) pointing to the possible designation of regulated investment funds as SIFIs. The design of US law, enshrined in the Dodd-Frank Wall Street Reform and Consumer Protection Act, supports the use of SIFI designation only in *rare and compelling* cases—*i.e.*, where regulators have determined, on the basis of a thorough and reasoned analysis, that a specific company poses significant risks to the financial system that cannot otherwise be adequately addressed through enhancements to existing regulation or other regulatory authorities.<sup>3</sup>

The FSB's draft consultation on NBNI financial entities specifically encompasses investment funds, broadly defined. Quite accurately, the consultation recognizes the “very different nature of [investment] funds’ risk profiles” in contrast to those of banks, insurance companies, and other financial entities. Likewise, the consultation properly highlights numerous features and characteristics of investment funds—such as their substitutability—which rebut the notion that funds (especially regulated funds) are plausible sources of risk to global financial stability. And yet, despite the compelling logic FSB itself advances, the consultation puts regulated funds squarely in focus for possible SIFI designation: by its current terms, the proposed assessment methodology for investment funds would embrace fourteen large regulated US funds<sup>4</sup> simply by virtue of their size.

## **I. Executive Summary**

1. ICI and its members, both in the United States and globally, long have favored sound regulation to address risks to investors and the capital markets. We actively have supported US and global efforts to address abuses and excessive risk taking highlighted by the global financial crisis and to bolster areas of insufficient regulation. It is important, however, to think critically about where and how risks appear—and to choose the right tool, out of the many that regulators have at their disposal, to address risks appropriately and effectively. As the consultation recognizes, the risk profile of

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<sup>3</sup> In the European Union, the European Commission has been asked by Parliament to assess whether asset managers should be designated as systemically significant taking into account the scope of their activity and using a comprehensive set of indicators such as size, business model, geographical scope, risk profile, creditworthiness, whether they trade for their own account and whether they are subject to requirements relating to the segregation of client assets. The exact process around any work by the European Commission is unclear. *See* Resolution of the European Parliament on Recovery and Resolution Framework for Non-Bank Institutions, December 10, 2013, available at <http://www.europarl.europa.eu/sides/getDoc.do?type=TA&language=EN&reference=P7-TA-2013-0533>. We are unaware of any SIFI initiatives related to asset managers or funds by other national authorities.

<sup>4</sup> Thirteen of these regulated US funds are mutual funds, including ten stock and bond mutual funds and three money market funds. One fund is an ETF organized as a UIT.

investment funds—and certainly of regulated funds—is starkly different from that of banks or insurance companies. Designation of regulated funds as “systemically important financial institutions” (“SIFIs”), whether in the US or other jurisdictions, is neither necessary nor appropriate as a means to address concerns about stability of the global financial markets, and the consequences of doing so would be highly adverse to the designated fund, its investors, the overall fund marketplace and fund investing at large.

2. The Financial Stability Board (“FSB”) has defined non-bank, non-insurer global SIFIs (“G-SIFIs”) as entities “whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions.” Application of these concepts outside the world of banking and insurance requires a more robust and informed understanding of investment funds than is reflected in the consultation. Our detailed comments, including our empirical research, seek to help fill that gap by examining each element of the FSB consultation in the context of the structure, regulation, and historical experience of regulated funds in the US and other jurisdictions. (Our comments generally address regulated stock and bond funds, but SIFI or G-SIFI designation also would not be appropriate or effective for money market funds, which currently are subject to separate regulatory actions.)
3. We sincerely appreciate the opportunity to comment on the consultation, as we do previous opportunities to comment on the work of the FSB. That said, we continue to have serious concerns about many aspects of the assessment process, a process that is not expressly sanctioned by any provisions of US or other law and that lacks sufficient transparency. The process appears designed to permit the FSB, other international regulatory bodies, and central bank representatives to exercise maximum discretion over matters with very serious potential consequences for regulated funds and other affected entities, without specific authorization in law or requirements for “due process.” We would urge the FSB, as well as the Financial Stability Oversight Council (“FSOC”) in the US, to adopt procedures that assure greater transparency and accountability and that promote greater public and industry confidence.
4. As for the substance of the consultation and the proposed methodology for investment funds, we submit that size is not a *per se* indicator of risk. The consultation proposes a “materiality threshold”—set at US \$100 billion in assets under management—to define a “practical and manageable number” of investment funds to be analyzed under the proposed methodology. It incorrectly theorizes a linear relationship between size and risk in this context. In fact, the size of an investment fund—in contrast to a bank—by itself reveals very little about whether that fund could pose risk to the global financial system. Based on their investment objectives and policies and their portfolios, two funds of the same size can present sharply different risk profiles. We submit that *any*

initial threshold for evaluating investment funds should include balance sheet leverage—the “interconnection” that speeds the transmission and heightens the impact of risk among institutions, and the essential fuel for financial crisis.

5. The proposed *per se* materiality threshold does not serve to filter the universe of investment funds in any way that would usefully advance the stated objectives of the Group of 20 (“G20”) and the FSB. It produces an assessment pool of 14 funds—all regulated US funds—as the *only* funds worldwide that automatically would be subjected to further examination. Moreover, the proposed threshold clearly is at odds with the FSB’s stated goal of maximizing the consistency of treatment of different types of financial entities. That threshold in fact produces a pool of investment funds that are orders of magnitude smaller than global systemically important banks (“G-SIBs”). Far from promoting consistency, the consultation in fact proposes to apply a unique and more sweeping standard to investment funds, without any justification for this difference in treatment.
6. In sharp contrast to banks, these 14 funds have virtually no leverage (see Figures B.1 and B.2, Appendix B). Their balance sheet leverage ratio, calculated under the FSB’s definition, averages 1.04. At this rate, for a regulated US fund to achieve the same dollar amount of indebtedness as the *smallest* US G-SIB, the fund would have to hold *US\$ 5.4 trillion* in assets under management. As former Federal Reserve Chairman Alan Greenspan recognized in analyzing the global financial crisis, mutual funds do not serve to fuel “serial contagion”—in other words, systemic risk—precisely because of their lack of leverage. In addition, the 14 large regulated US funds pursue investment strategies that are comparable to literally hundreds of competing funds in the US market. As is typical for regulated US funds, their portfolio holdings are highly diversified. These funds are, in short, highly “substitutable.” All of them have simple capital structures, and their business and operations are straightforward and transparent. Thus, they lack the “complexity” that the FSB offers as a crucial element of its G-SIFI definition.
7. The concepts of “distress” and “disorderly failure”—stemming directly from the FSB’s concern with “too-big-to-fail” institutions—are derived from experience with banks and have little relevance to investment funds. Investment losses do not constitute “distress”: unlike bank depositors, fund investors are not promised either a gain on their investment or a return of their principal. Some investors may react to losses by selling their fund shares. The ability to redeem shares on a daily basis, however, is a defining feature of US mutual funds and underlies many of these funds’ regulatory requirements and operational practices—notably including daily valuation of fund assets and liquidity requirements.

8. The concept of public “bailouts” likewise has little relevance to investment funds. Literally hundreds of regulated US funds exit the business through liquidation and merger each year, without any government intervention or taxpayer assistance. As the consultation recognizes, “even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact” for the period from 2000 through 2012. When a mutual fund liquidates, it follows an established and orderly process to distribute its remaining assets *pro rata* to its investors and wind up its affairs, in accordance with provisions of federal and state law and under the oversight of the fund’s board of directors or trustees. Thus, such funds have no need for bank-like “resolution planning,” and regulators have no need for additional authority to cope with “disorderly failures” of these funds.
9. The FSB posits circumstances under which an investment fund “has to liquidate its assets quickly, [which] may impact asset prices and thereby significantly disrupt trading or funding in key markets.” Since the inception of regulated fund investing in the US almost seventy-five years ago, the historical evidence is consistent and compelling: stock and bond funds have never faced such a scenario, not even during the global financial crisis of 2007-2008 (Appendix F). Indeed, across a range of adverse market events and conditions, sales of stocks and bonds by regulated US funds represent a modest share of overall market activity—a fact that reflects the nature today of their largely retail investor base and the long-term financial goals of most fund investors.
10. While the FSB consultation does not specify what policy measures would apply to investment funds designated as G-SIFIs, the Dodd-Frank Wall Street Reform and Consumer Protection Act in the US prescribes a comprehensive set of requirements for non-bank SIFIs. Most troubling is the prospect of capital requirements (perhaps as high as 8 percent) for “loss absorption.” Unlike banks, regulated funds simply have neither the need nor the ability to meet capital requirements. Their “capital” comes from investors who own fund shares and who fully accept that *they* will absorb investment gains and losses on a *pro rata* basis. Mechanisms for “loss absorption” would be antithetical to funds’ basic nature and purpose, would introduce moral hazard, and would lessen market discipline.
11. Capital requirements and assorted fees assessable to nonbank SIFIs under the Dodd-Frank Act would put a designated fund at a distinct competitive disadvantage and distort the market. The 14 regulated US funds singled out by the FSB’s materiality threshold are highly efficient, relatively low-cost funds within their asset classes: they have an asset-weighted average expense ratio of just 31 basis points. Investors in regulated US funds are highly sensitive to fund costs and their impact over time on fund returns. It would not take much in added regulatory costs to condition the investors in these funds to avail themselves of one of the many competing funds not

subject to these costs. The Dodd-Frank Act also authorizes assessments of nonbank SIFIs if needed to reimburse the US Government for costs of resolving a distressed financial institution—*e.g.*, a large bank holding company—under the Act’s Orderly Liquidation Authority. The purpose of the Orderly Liquidation Authority provisions was to avoid having the costs of “bailouts” fall on US taxpayers. Designation of a regulated US fund raises the prospect that this burden would fall on individual investors, many of whom would have entrusted the fund with their retirement savings—in substance, a taxpayer bailout.

12. Prudential supervision by the US Federal Reserve also could affect the management of a designated fund’s portfolio and how the fund serves its investors. It sets up the potential—arguably, the likelihood—for a clash between the goals of prudential supervision and the fiduciary duty that the fund’s manager and board of directors owe to the fund. In the interest of mitigating risks to the financial system at large, the Federal Reserve could impel a fund’s manager to maintain financing for banks or other counterparties, to remain exposed to certain markets, to avoid exposure to certain issuers, or to maintain excess levels of cash or cash equivalents in the fund’s portfolio—regardless of whether such actions, in the judgment of the fund’s manager, serve the interests of the fund and its investors.
13. As an alternative to designation of individual regulated funds, to the extent that regulators believe specific activities or practices pose risks to the market or to the financial system, they should use their considerable rulemaking authority to address those risks through activity-based regulation. In the US and other jurisdictions, post-crisis legislation has augmented regulators’ broad authority by adding many new tools to address abuses and excessive risk-taking. Regulators already are making notable use of these authorities. The approach currently being taken with respect to money market funds is an example of an activity-based focus on risk mitigation, which is a more promising approach to asset management more generally. In the US, these efforts include, for example, regulatory reform for securities lending and repurchase agreement transactions and changes in the way swaps are traded, cleared and settled. Of particular note, the US Securities and Exchange Commission is working to strengthen its oversight of US asset managers and regulated funds—an effort we welcome. In addition, ICI’s Board of Governors has endorsed a voluntary industry initiative to shorten settlement cycles for a range of securities from trade date plus three days (T+3) to T+2. Globally, the FSB itself, along with other global bodies, is playing an active role in efforts to mitigate risk in the financial system. Together with our members, ICI is engaging across this range of initiatives to help advance efforts to make markets and market participants more resilient to future shocks, without imposing undue costs and burdens on regulated funds and their investors.

## II. G-SIFI Methodology for Investment Funds: Initial Observations

The G20 Leaders directed the FSB, in consultation with IOSCO and other standard-setting bodies, to develop assessment methodologies for NBNI G-SIFIs.<sup>5</sup> According to the consultation, the FSB has chosen to develop a sector-specific assessment methodology for the investment funds sector based on its “relatively large size in the nonbank financial space and given historical examples of financial distress or failures . . . that had an impact on the global financial system.”<sup>6</sup>

Several observations are important at the outset. First, we know of no G20 mandate that the FSB *specifically* develop an assessment methodology for investment funds, let alone for comprehensively regulated, publicly offered investment funds. This appears to be a decision of the FSB, which suggests that the FSB has discretion in this regard—discretion that should be informed by the extensive body of information we expect the consultation will generate.

Second, while the consultation loosely refers to “historical examples” that formed the basis for including investment funds, it cites no such examples.<sup>7</sup> Should this be an oblique reference to the experience of the Reserve Primary Fund, a US money market fund, in the financial crisis, we submit it would be inappropriate to view all regulated investment funds, including other money market funds, through that narrow lens. Even during the worst days of the financial crisis, regulated stock and bond funds and nearly all other money market funds did not encounter the problems experienced by the Reserve Primary Fund in September 2008. Moreover, while the consultation indicates that money market funds are within its scope,<sup>8</sup> significant reforms have been made to these funds since 2008 and additional reforms remain under active consideration in both the US and EU.<sup>9</sup> The approach currently being taken with respect to money market funds is an example of an activity-based focus on risk mitigation which, as we discuss below, is a more promising approach to asset management more generally. While we believe that SIFI (or G-SIFI) designation would not be appropriate or effective for money market funds,<sup>10</sup> our comments in the remainder of this letter generally will address regulated

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<sup>5</sup> Assessment methodologies for identifying global systemically important banks (“G-SIBs”) and global systemically important insurers (“G-SIIs”) already have been developed. Authorities have identified 29 G-SIBs and 9 G-SIIs.

<sup>6</sup> Consultation at 7 (footnote omitted).

<sup>7</sup> We surmise that it could refer, for example, to the experience of Long-Term Capital Management, a complex, unregulated and highly-leveraged hedge fund. If so, this example is similarly an altogether inappropriate lens through which to view the world of regulated funds.

<sup>8</sup> Consultation at 28.

<sup>9</sup> See Money Market Fund Reform; Amendments to Form PF, SEC Release No. IC-30551 (June 5, 2013), available at <http://www.sec.gov/rules/proposed/2013/33-9408.pdf>; Proposal for a Regulation of the European Parliament and of the Council on Money Market Funds (September 4, 2013), available at <http://eur-lex.europa.eu/legal-content/EN/ALL/?jsessionid=qkthTQBLQRqjXznkpyqp5mypyZL1z6CL7TxhS2QNHnfflDBqXTT!-334468165?uri=CELEX:52013PC0615>.

<sup>10</sup> Federal Reserve Board Governor Daniel Tarullo has expressed a similar view. See *Regulating Systemic Risk*, Remarks by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, at the 2011 Credit Markets Symposium,

stock and bond funds. For ease of discussion below, we refer to such funds, which are comprehensively regulated under the Investment Company Act of 1940, as “regulated US funds” (or “US mutual funds,” where appropriate).<sup>11</sup> We use the term “regulated non-US funds” to refer to stock and bond funds that are organized or formed outside the US and substantively regulated to make them eligible for sale to retail investors,<sup>12</sup> such as funds domiciled in the European Union and qualified under the UCITS Directive (“UCITS”).<sup>13</sup> The term “regulated funds” refers collectively to regulated US funds and regulated non-US funds.

Third, as the FSB continues to consider a sector-specific methodology for investment funds, it is indeed appropriate to keep the focus of its analysis on individual investment funds, and not on groups of investment funds and/or a fund manager.<sup>14</sup> The consultation is correct in its characterization that economic exposures are created at the investment fund level as such, and that an investment fund is a separate legal entity the assets of which are separate and distinct from—and not available to claims by creditors of—other funds or its manager.<sup>15</sup> Looking at the nature and experience of funds as such will provide a much-needed empirical basis and context for the FSB’s analysis. It also serves to clarify important reasons for our strongly held view that G-SIFI designation directed at investment funds generally, and regulated funds in particular, is ill advised. The consultation, for example, correctly notes that the investment funds sector is “highly competitive with numerous substitutes existing for most investment fund strategies (funds are substitutable).”<sup>16</sup> Further, the focus on a fund points up the illogical and adverse consequences that might arise from designation, *i.e.*, application to a fund of a regulatory model developed for the strikingly different business of banking. We discuss all these consequences below.

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Charlotte, N.C. (March 31, 2011), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf>, at 5-6. We accordingly urge that any final methodology for investment funds exclude money market funds.

<sup>11</sup> Appendix C summarizes this regulatory regime, which both protects investors and minimizes risks to financial stability.

<sup>12</sup> A regulated non-US fund is regulated as a public investment company under the laws of the country in which it is organized or formed, and it is eligible for sale to the retail public, even if the fund elects to limit its offering to institutional investors. As with regulated US funds, regulated non-US funds typically have substantive regulation in areas such as disclosure, form of organization, custody, minimum capital, valuation, and investment restrictions (*e.g.*, leverage, types of investments or “eligible assets,” concentration limits and/or diversification standards).

<sup>13</sup> UCITS, or “undertakings for collective investment in transferable securities,” are collective investment schemes established and authorized under a harmonized EU legal framework, currently EU Directive 2009/65/EC (generally the “UCITS Directive”), under which a UCITS established and authorized in one Member State can be sold cross border into other Member States without a requirement for an additional full registration. UCITS also are sold to retail investors outside the European Union.

<sup>14</sup> We provide further comments on why it would *not* be appropriate for the methodology to focus on groups of investment funds and/or a fund manager in Appendix A.

<sup>15</sup> Consultation at 30. For similar reasons, in the case of series or umbrella fund structures, the focus should be on individual series or sub-funds.

<sup>16</sup> *Id.*

Fourth, we have serious concerns about many aspects of the assessment process as outlined in the consultation.<sup>17</sup> The proposed process would provide the FSB, IOSCO, and national authorities with tremendous discretion to engage in highly subjective deliberations the outcome of which, as we discuss later in this letter, could have devastating effects. The process (including the development of an assessment methodology) is not governed or guided by any specific law or statute. Funds being considered for G-SIFI designation would face a great deal of uncertainty. They may have little or no information as to the basis upon which specific decisions are being or will be made.<sup>18</sup> They would have no assurances as to even basic fairness because there are no transparency or “due process” requirements. For example, there is no required notice that a fund is being evaluated (*i.e.*, for funds that do not meet the materiality threshold but are considered by national authorities to be “potentially globally systemic”) or that a fund will *not* be designated (for funds that do meet the materiality threshold). There is no requirement to permit funds to provide information that they believe is relevant to a designation determination. There is no requirement to consider the relative costs and benefits of a potential designation. And there is no formal (or informal) mechanism for challenging a G-SIFI determination.

Finally, we would submit that declining to use the tool of G-SIFI designation in the case of regulated funds does not imply that global regulators are “soft” on systemic risk regulation. To the contrary, as the consultation acknowledges, risks can stem from markets, products and instruments.<sup>19</sup> Since the global financial crisis, policymakers and regulators in many jurisdictions have made significant progress in a number of areas in line with G20 commitments and FSB work to strengthen the global financial system and improve international financial regulatory coordination and oversight. Such areas include increasing the resiliency of depository institutions through higher capital and other requirements, improving transparency and regulatory oversight of hedge funds (or “alternative funds”) and their managers, implementing reforms to the regulation and oversight of credit rating agencies, implementing comprehensive OTC derivatives markets reforms and enhancing regulatory cooperation and information sharing between jurisdictions.<sup>20</sup>

In the three sections that follow, we discuss the various elements of the NBNI G-SIFI definition: Section III addresses the proposed analysis of an investment fund based on factors such as

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<sup>17</sup> We have similar concerns with the process by which the US FSOC considers non-bank financial entities for possible SIFI designation.

<sup>18</sup> The consultation mentions “guidelines” to be developed by the FSB, in consultation with IOSCO and other relevant standard-setting bodies. Consultation at 10. These guidelines apparently will address the analysis to be conducted by national authorities regarding the impact of failure or material distress of an NBNI financial entity on the global financial system, and the “Narrative Assessment” national authorities are to develop discussing the assessment methodology’s systemic risk indicators and transmission mechanisms. There is no indication that such guidelines would be developed through a consultation process or released publicly at all.

<sup>19</sup> Consultation at n.5.

<sup>20</sup> See, *e.g.*, Letter from Mark Carney, Chairman, Financial Stability Board, to G20 Finance Ministers and Central Bank Governors, dated 17 February 2014, regarding progress and challenges of financial reforms.

its size, interconnectedness and complexity; Section IV addresses the possibility of “distress” or “disorderly failure” of the investment fund; and Section V addresses the transmission of the investment fund’s distress to other market participants, thereby threatening global financial stability. In each of these sections, we highlight the reasons why we believe the FSB would be hard pressed to justify the NBNI G-SIFI designation of any regulated fund, including the very largest regulated US funds.

### **III. Proposed Impact Factors for Analyzing Investment Funds: Why Even the Largest Regulated US Funds are Not G-SIFIs**

The consultation sets forth a high-level framework consisting of five “impact factors” that would be applied to any investment fund that is selected for evaluation.<sup>21</sup> In keeping with the G-SIFI definition,<sup>22</sup> these impact factors include size, interconnectedness, and complexity; the other two are substitutability and global activities (cross-jurisdictional activities). For each impact factor, the consultation proposes one or more specific “indicators” that would inform the consideration of how that impact factor should be applied to investment funds.<sup>23</sup>

The consultation proposes to establish a *per se* “materiality threshold” for investment funds based on their size. The consultation sets forth absolutely *no* empirical analysis or historical experience suggesting a linear relationship in this context between size and risk. It merely indicates that “[i]n theory, the larger the size of a fund, the greater its potential impact on counterparties (counterparty channel) and markets (market channel).”<sup>24</sup> Based on this “theory,” the consultation proposes to use fund size, measured by net assets under management (AUM), as an initial filter to define the pool of investment funds for which more detailed data will be collected and to which the assessment methodology would be applied—thus “reducing the size of the NBNI G-SIFI assessment pool to a practical and manageable number.”<sup>25</sup> The threshold proposed is US \$100 billion in AUM. The consultation asserts that this US \$100 billion in AUM measure is “broadly consistent with the G-SIB and G-SII methodologies.”<sup>26</sup> In keeping with the FSB’s evident intent, if this threshold were adopted in its current form, it indeed would significantly limit the pool of investment funds requiring further

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<sup>21</sup> The same impact factors would be applied to other types of NBNI financial entities, including finance companies and market intermediaries (broker-dealers).

<sup>22</sup> As noted above, G-SIFIs are financial entities “whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions.” See consultation at 2.

<sup>23</sup> We discuss our views regarding the proposed indicators in Appendix D.

<sup>24</sup> Consultation at 33 (emphasis added).

<sup>25</sup> *Id.* at 8.

<sup>26</sup> *Id.* at 9. National authorities could add entities to the assessment pool that do not meet the threshold but are deemed “potentially globally systemic.”

evaluation. Only 14 funds worldwide today would be implicated—*all* of which are regulated US funds.<sup>27</sup>

In the discussion below, we explain why *any* threshold based on size alone is inappropriate and therefore urge that this threshold be modified to include balance sheet leverage. In addition, we provide our general views on the proposed impact factors, as well as our perspective on how those factors would apply in the context of regulated funds.

#### Size (Materiality Threshold)

In our view, basing the materiality threshold entirely on size is fundamentally flawed because—in contrast to a bank—size alone reveals very little about whether an investment fund could pose risk to the global financial system. Based on their investment objectives and policies and the specific contents of their portfolios, two funds of equal size can have sharply different risk profiles—and a smaller fund can have a risk profile substantially greater than a much larger fund. As a result, looking at a fund's size *in isolation* is not a useful screening mechanism.

The flaw in the proposed materiality threshold is also evident from the specific assessment pool that it produces. As noted above, the effect of the proposed US \$100 billion threshold is to single out just 14 funds—all regulated US funds—as the *only* funds worldwide that automatically would be subjected to further examination. For the many reasons discussed throughout this letter, these funds are highly unlikely to pose risk to global financial stability. We submit that the proposed *per se* US \$100 billion AUM materiality threshold does not serve to filter the universe of investment funds in any way that would usefully advance the stated objectives of the G20 and the FSB.<sup>28</sup>

Moreover, the proposed threshold clearly is at odds with the FSB's stated goal of maximizing the consistency of treatment of different types of financial entities in the context of designation of G-SIFIs. For example, the average total assets of the largest regulated US funds pale in comparison to the average total assets of G-SIBs.<sup>29</sup> The proposed materiality threshold produces a pool of investment funds that are orders of magnitude smaller than the designated banks. These facts make clear that the consultation, far from being consistent across different sectors, in fact proposes to apply a unique and more sweeping standard to investment funds, without any justification for this difference in treatment.

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<sup>27</sup> These funds are listed in of Appendix B, Figure B.1.

<sup>28</sup> The stated objectives are to address the systemic and moral hazard risks associated with the failure of a financial institution that is considered “too big to fail.” See, e.g., *Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF)*, Report of the Financial Stability Board to the G-20 (2 September 2013) (“TBTF Report”) (stating that “the ‘too-big-to-fail’ (TBTF) problem arises when the threatened failure of a SIFI leaves public authorities with no option but to bail it out using public funds to avoid financial instability and economic damage. The knowledge that this can happen encourages SIFIs to take excessive risks and represents a large implicit public subsidy of private enterprise.”).

<sup>29</sup> See Appendix B, Figure B.3.

Given these concerns, we recommend that the materiality threshold include consideration of balance sheet leverage. We recognize that the consultation already contemplates considering leverage as part of the assessment of a fund's "interconnectedness," which is appropriate.<sup>30</sup> Nevertheless, we believe that also including leverage as a component of the materiality threshold would help regulators better focus their attention and efforts on entities that—in contrast to regulated funds—conceivably could raise global financial stability concerns.

Incorporating leverage as a consideration for initial screening purposes in fact would advance the FSB's stated goal of treating different types of financial entities as consistently as possible. For example, *all* banks are leveraged to one degree or another, meaning that determining the assessment pool for banks based on bank size necessarily takes into account bank debt. This happens because the size of a bank's balance sheet and the amount of its debt go hand-in-hand: the larger the bank, the more debt the bank has. This simply reflects the nature of banks, which is to take deposits (thus, by definition creating indebtedness), use those deposits to make loans, and seek to earn a spread on the difference between borrowing and lending rates. Indeed, using a size-based materiality standard for banks implicitly treats a large amount of debt as a necessary condition for posing systemic risk. But the same is *not* true for regulated funds; thus, looking at balance sheet leverage plus net AUM in identifying the pool of funds subject to further scrutiny would promote more consistent outcomes. As discussed in Appendix B, *it would be necessary for a regulated US fund with a leverage ratio of 1.04 (the average of large regulated US funds) to have assets of about US \$5.4 trillion to achieve the same dollar amount of leverage as the smallest US G-SIB.*

When size is viewed in these "apples to apples" terms, it should be quite apparent that even the largest regulated funds are not "too big to fail," a conclusion further supported by these funds' substitutability and fundamental nature as an investment product (with investors absorbing any losses) that does not experience "distress or disorderly failure" requiring government intervention, all as discussed further below.

#### Size (Impact Factor)

Separate from the question of how to determine the assessment pool of investment funds is the proposal to consider size as an impact factor when evaluating any funds that are part of that pool. Here again, it is important to bear in mind that a fund's size, by itself, is virtually meaningless to an analysis of the potential for systemic risk. Other characteristics, such as the degree of leverage, and the fund's structure, investment strategies, portfolio composition, and investor demographics, would be more important. Some of these characteristics already are anticipated to be part of the analysis in relation to other proposed impact factors, such as interconnectedness and complexity.

***Application to Regulated Funds.*** As discussed above and in Appendix B, while they are larger than other regulated funds, the very largest regulated US funds are much smaller than the banks that

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<sup>30</sup> We discuss the significance of leverage in greater detail in commenting on "interconnectedness" below.

have been designated as G-SIBs. In addition, these large funds invest in deep and liquid markets in amounts that are small relative to the size of those markets.<sup>31</sup> And, in any event, as indicated above, size alone does not provide meaningful information about systemic risk.

#### Interconnectedness (and the Role of Leverage)

According to the consultation, “[s]ystemic risk can arise through direct and indirect inter-linkages between entities within the financial system so that individual failure or distress can have repercussions throughout the financial system.”<sup>32</sup> When “interconnectedness” is defined in this way, the key issue is not only whether an entity is highly “connected” to other market participants but also whether the entity’s failure could force a disorderly unwinding of its on- and off-balance sheet positions and spark a cascade of failures among the entity’s counterparties that then spread to the counterparties of those firms.

Interconnectedness poses the greatest risk when it is coupled with leverage. The potential for systemic risk is further magnified if a leveraged entity has a large number of creditors that are themselves leveraged. In such a case, the entity’s failure could potentially lead to failure among its creditors, which in turn could have implications for still more firms—the “repercussions” the consultation mentions. By contrast, in the event of the failure of a firm whose creditors are not highly leveraged, those creditors would take a charge against their own capital, but further repercussions would be unlikely.

The consultation appropriately recognizes the importance of considering leverage when assessing interconnectedness of investment funds. It states:

The more interconnected a fund, or the greater the counterparties’ credit exposures are to that fund, the greater that fund’s potential impact in case of default on counterparties (counterparty channel) and to the broader financial system. Equally, the greater a fund’s leverage, the greater its potential impact on counterparties that have provided finance (counterparty channel) and on markets in the event of a disorderly and rapid de-leveraging (market channel).<sup>33</sup>

We agree with these observations and the emphasis on the important role of leverage. History amply demonstrates that companies that are highly leveraged pose greater potential risk to the financial system than those that are not. In a November 2010 letter to FSOC, we observed that

historically, virtually all systemic crises have arisen when a financial institution (or group of financial institutions) has taken on excessive leverage or debt-like exposure (such as through credit default swaps). Leverage provides the grease that makes modern

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<sup>31</sup> See Appendix F, Figure F.15.

<sup>32</sup> Consultation at 5.

<sup>33</sup> *Id.* at 33-34.

financial systems an efficient engine for economic growth. But in times of strain, leverage also can act as a multiplier, turning small losses into large ones, and creating risks that can shake the system overall. . . When one highly leveraged firm holds the debt of another highly leveraged firm, losses can mount exponentially and spread quickly. As a result, companies that are highly leveraged pose greater potential risk to the financial system.<sup>34</sup>

Other commentators similarly have recognized the role of leverage as the essential fuel of financial crises. For example, former Federal Reserve Chairman Alan Greenspan is one of many authorities who have emphasized the central role of leverage in the 2008 financial crisis. Chairman Greenspan recently wrote:

Subprime [mortgages] were indeed the toxic asset, but if they had been held by *mutual funds* or *in 401(k)s*, we would *not* have seen the serial contagion we did. ... It is not the toxic security that is critical, but the *degree of leverage* of the holders of the asset. ... In 2008, tangible capital on the part of many investment banks was around 3 percent of assets. That level of capital can disappear in hours, and it did. And the system imploded.<sup>35</sup>

***Application to Regulated Funds.*** Regulated funds “interact” with large numbers of investors and market participants. But as discussed in Section V below, regulated funds generally act as providers of capital and typically are the *bearers* of counterparty exposure, rather than transmitters of risk to their counterparties. In addition, such funds’ interactions with counterparties are limited in nature and subject to regulatory constraints and protections.

Moreover, regulated funds’ interconnections pose very modest risks because these funds have regulatory limits on leverage and typically have little or no leverage.<sup>36</sup> Notably, Chairman Greenspan specifically recognized that mutual funds would not have fueled “serial contagion”—in other words, systemic risk—precisely because of their lack of leverage. Consistent with the observation in the

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<sup>34</sup> See Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010 (commenting on advance notice of proposed rulemaking regarding SIFI designation of nonbank financial companies) at 7, available at <http://www.ici.org/pdf/24696.pdf>.

<sup>35</sup> Alan Greenspan, “How to Avoid Another Global Financial Crisis,” *The American*, March 6, 2014 (emphasis added), available at, <http://american.com/archive/2014/march/how-to-avoid-another-global-financial-crisis>.

<sup>36</sup> For example, UCITS may invest in derivatives instruments subject to requirements related to counterparties, underlying instruments, liquidity, exposure limits and risk monitoring. Exposure is generally limited to the total net value of a fund's assets with some Member States providing funds with the ability to distinguish between measuring exposure for a sophisticated versus a non-sophisticated fund, such as through a commitment approach or a value at risk approach. See generally UCITS Directive, Articles 50-52 (describing eligible investments, risk management, exposure, concentration and diversification requirements) and Article 83 (borrowing).

consultation,<sup>37</sup> the Investment Company Act and related guidance from the SEC and its staff strictly limit mutual funds' ability to take on leverage. The maximum ratio of debt-to-assets allowed by law is 1-to-3,<sup>38</sup> which translates into a maximum allowable leverage ratio of 1.5-to-1. And in sharp contrast to banks, the largest regulated US funds barely are leveraged at all.<sup>39</sup>

### Substitutability

The consultation asserts that “[t]he systemic importance of a single financial entity increases in cases where it is difficult for other entities in the system to provide the same or similar services in a particular business line or segment in the global market in the event of a failure.”<sup>40</sup> We agree that the lack of ready substitutes for a financial entity that provides a critical function or service on which other market participants rely can be an important factor in assessing whether that entity may pose risk to global financial stability.

With respect to investment funds, the consultation correctly notes that “the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable).”<sup>41</sup> Thus, in the context of investment funds, this factor suggests that funds do not pose risk to financial stability.

The consultation states that while most investment funds are “generally substitutable,” some funds are “highly specialised and invest in thinly traded markets.”<sup>42</sup> It proposes several indicators in order to assess the substitutability of these funds. We disagree with the premise that funds with these characteristics would lack substitutes and the implication that, on the basis of those characteristics, such funds might be more likely than other funds to pose risk to financial stability. The consultation provides absolutely no empirical support for these propositions.

***Application to Regulated Funds.*** As acknowledged by the FSB, regulated funds have a high degree of substitutability. This is one of many reasons why such funds do not pose risk to global financial stability. We further note that the materiality threshold has produced an assessment pool of funds none of which invest in specialized markets. Appendix F provides information illustrating the substitutability of the largest regulated US funds. These funds have highly diversified portfolios. They

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<sup>37</sup> The consultation correctly observes that for investment funds other than hedge funds, there are “strict leverage limitations imposed by existing regulations.” Consultation at n.43.

<sup>38</sup> See Section 18(f) of the Investment Company Act, which prohibits any mutual fund from issuing a class of senior security or selling any senior security of which it is the issuer, but permits borrowing from a bank, provided that there is asset coverage of at least 300 percent for all such borrowings.

<sup>39</sup> See Appendix B, Figures B.1 and B.2.

<sup>40</sup> Consultation at 5.

<sup>41</sup> *Id.* at 30.

<sup>42</sup> *Id.* at 34.

generally invest most of their assets in the deepest, most liquid markets in the world and their holdings amount to only small percentages of the worldwide supply of stocks and bonds. In addition, these funds must compete against a large number of other regulated funds; for example, as Figure F.19 shows, the five US regulated funds with assets greater than \$100 billion that Morningstar categorizes as Large Blend must compete in a market with more than 500 other regulated US funds with similar investment objectives.

### Complexity

The consultation indicates that “[t]he systemic impact of a financial entity’s distress or failure is expected to be positively related to its overall complexity, i.e. its business, structural and operational complexity. That is, in principle, the more complex a financial entity, the more difficult, costly and time-consuming it will be to resolve the failing institution.”<sup>43</sup>

Speaking to complexity in the context of investment funds, the consultation states that “[t]he more complex a fund’s operations and strategy, the harder it is to unwind in an orderly manner (credit and market channels).”<sup>44</sup> It further notes that “[a] fund’s complexity is particularly difficult to measure given the challenges of the availability and consistency of data, among other things.”<sup>45</sup>

As a general matter, we agree that complexity could be a relevant consideration in assessing an entity’s potential to pose systemic risk. Features such as complicated capital structures, large networks of affiliates and subsidiaries, and off-balance sheet liabilities have the potential to make it more difficult for regulators to detect risk. We also believe that lack of transparency is a related consideration.<sup>46</sup>

***Application to Regulated Funds.*** The business, structure, and operations of regulated funds typically are straightforward and transparent. This is because such funds generally are regulated and supervised to make them eligible for sale to a wide range of investors, including retail investors.<sup>47</sup> The

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<sup>43</sup> *Id.* at 5.

<sup>44</sup> *Id.* at 36.

<sup>45</sup> *Id.*

<sup>46</sup> We suggest that the FSB consider developing indicators related to these characteristics.

<sup>47</sup> For example, in Canada, mutual funds are generally regulated as securities by laws in place in each province, and specifically regulated as funds in a series of detailed national instruments and their companion policies that apply across the country. Funds are primarily regulated by National Instrument (NI) 81-102 which includes portfolio investment rules, including limits on leverage and borrowing, as well requirements on custodianship, sales, redemptions, NAV calculation, fundamental changes and sales communications, among others. Detailed disclosure rules governing form and content of prospectuses, annual information forms and Funds Facts (analogous to the U.S. summary prospectus) are set out in NI 81-101. Other substantive rules regulate areas such as sales practices (NI 81-105), continuous disclosure (NI 81-106) and independent review committees to consider conflict of interest matters (NI 81-107). Similarly, detailed requirements applicable to UCITS include those related to disclosure and custody (including newly enhanced depositary requirements) as well as investment restrictions and limitations. *See* UCITS Directive (requirements regarding simplified disclosure (key investor information document) (Article 78), annual and semi-annual reports (Article 68), appointing a depositary bank as a

Investment Company Act requires mutual funds to have a simple capital structure.<sup>48</sup> It prohibits them from issuing debt or preferred stock. In addition, there are restrictions on fund investments in securities issued by other investment companies, insurance companies, investment advisers, broker-dealers or underwriters.<sup>49</sup> Among other things, these restrictions prohibit funds from controlling other funds and from creating complicated pyramid structures. The Investment Company Act also strictly regulates a fund's interactions with affiliates.<sup>50</sup> Regulated US funds' simple capital structure also promotes balance sheet transparency. Unlike other types of financial entities, they generally have little or no leverage (as discussed above), do not engage in joint ventures with affiliates, and do not rely on off-balance sheet financing. In addition, they are subject to more extensive disclosure and public reporting requirements than any comparable financial product, including quarterly disclosure of all portfolio holdings and audited annual financial statements.

#### Global Activities (cross-jurisdictional activities)

The consultation says that “[t]he global impact from a financial entity’s distress or failure should vary in line with its share of cross-border assets and liabilities. The greater the global reach of a financial entity, the more widespread the spill-over effects from its failure.”<sup>51</sup> With respect to investment funds, it expresses the following views:

The greater the number of markets a fund invests in or has interaction with, the greater its global footprint and its importance for global financial stability. The proposed indicators . . . attempt to measure a fund’s global activities. Where managers invest significant amounts of investors’ funds in one or more foreign jurisdictions (indicator 5-1), or are authorised to market and sell shares of their funds within these (indicator 5-2), or have operations with counterparties based in different jurisdictions (indicator 5-3), the occurrence of a fund failure may create contagion that would transmit across borders via the market channel or counterparty channel.<sup>52</sup>

As discussed further in Appendix D, we urge care with interpreting the results of the proposed indicators. For example, investments in multiple foreign jurisdictions could be indicative of *reduced* potential for systemic risk based on, for example, greater diversification of the fund’s asset base and lower levels of ownership (so less chance of any significant impact) in any particular market.

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custodian and its responsibilities (Article 22-26), redemption (Article 76), diversification and issuer concentration (Articles 52 and 56), permitted assets, including limitations relating to derivatives and leverage (Articles 50-52)).

<sup>48</sup> Section 18 of the Investment Company Act.

<sup>49</sup> Section 12 of the Investment Company Act.

<sup>50</sup> Section 17 of the Investment Company Act.

<sup>51</sup> Consultation at 36.

<sup>52</sup> *Id.*

***Application to Regulated Funds.*** While many regulated US funds invest in multiple jurisdictions, most are sold primarily in the US, primarily due to tax considerations.<sup>53</sup> Of the 11 regulated US funds that meet the proposed materiality threshold, three invest only in the US and all 11 are sold primarily in the US. The “global footprint” of these funds therefore is small. In the case of UCITS, some invest in multiple jurisdictions and are also distributed outside of their European domicile, including outside the European Union, resulting in a diversification of investments and unit holders. In addition, when UCITS are distributed outside the European Union, the funds must be locally qualified for sale in that jurisdiction, meaning there is regulatory attention in addition to the oversight of the regulatory authority of the UCITS’ domicile.

#### **IV. Distress and Disorderly Failure of Regulated Funds: Why This Concern is Misplaced**

By the consultation’s own definition, G-SIFI designation is contemplated only with respect to those investment funds that could experience “distress” or disorderly failure to a degree that could threaten global financial stability. This definition is rooted in the actual experience of the global financial crisis, when the distress or disorderly failure of certain large, complex and highly leveraged financial institutions—banks, insurance companies and investment banks—required direct intervention by governments, including a number of bailouts, to repair the damage.

In its most recent progress report to the G20 Leaders on implementation of measures to strengthen financial stability, the FSB remarked on its “substantial progress toward[s] ending too big to fail.” The report explained:

Following the collapse of Lehman Brothers and the subsequent public rescue of many large banks, G20 Leaders called on the FSB to propose measures to address the problems associated with systemically important financial institutions (SIFIs). The “too-big-to-fail” problem arises when a SIFI’s threatened failure *forces public authorities to bail it out* to avoid large-scale financial instability and long-lasting economic damage. The resulting public absorption of private losses distorts incentives, leading to excessive risk-taking by SIFIs, and can be ruinous for public finances.<sup>54</sup>

As a starting point, the concept of public bailouts is inapposite to regulated funds. Investors are not promised gains on their investment, or even a return of the principal amount they invested. All

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<sup>53</sup> Regulated US funds typically distribute their income currently to meet specific US tax rules that are designed to provide fund investors with tax treatment that is “comparable” to that received by direct investors in securities. As a result, net income and long-term capital gains generally flow through to investors without the fund also incurring US taxes on the amounts distributed. The effect is that income is directly taxable to investors. As such, regulated US funds are generally referred to as “distributing funds.” This contrasts with the tax structure of many funds outside the United States, which are more typically structured as “accumulating” or “roll-up” funds.

<sup>54</sup> Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability: Report of the Financial Stability Board to G20 Leaders (5 September 2013) (emphasis added), available at [http://www.financialstabilityboard.org/publications/r\\_130905c.pdf](http://www.financialstabilityboard.org/publications/r_130905c.pdf).

investment results—gains and losses, no matter how big or small—belong to the regulated fund’s investors on a *pro rata* basis. If a fund doubles in value, it is the investors who reap this reward. And if the fund plunges in value, it is the investors who absorb the impact of those losses. This is the expectation shared by all investors in regulated funds and by the broader marketplace.<sup>55</sup> And it is one that contrasts sharply with the expectation of bank customers, who have deposited their money in anticipation of principal repayment plus interest, as well as the expectation of the broader marketplace, which anticipates government action and intervention to preserve the safety and soundness of individual banks and the banking system generally.

The concept of “distress” is similarly ill fitting in the context of regulated funds. Past investment performance, no matter how consistent, is no predictor of future investment performance. And increases and decreases in a regulated fund’s net asset value are an inherent part of fund investing. During the financial crisis and ensuing global recession, many regulated funds experienced sharp declines in value. Now that financial markets are stronger, many if not most of those funds have gained back that lost value. Equally important to recognize is the fact that investors in a regulated fund whose NAV is declining will not be of a single mind about those losses in value. Long term investors, or those following a specific asset allocation strategy, will be much more willing to stay the course and maintain their investment in the fund even if its NAV continues to fall further. Investors with a lower tolerance for investment risk or a shorter investment horizon, on the other hand, may decide to sell their fund shares in order to seek to eliminate the prospect of further losses.

US mutual funds offer their investors the ability to redeem shares on a daily basis.<sup>56</sup> Many non-US regulated funds similarly offer shares that can be redeemed on a daily basis. This is a defining feature of these funds, and it is one around which many of the regulatory requirements and operational practices for these funds are built. Of particular importance are daily mark to market valuation of all portfolio assets and maintaining much of the portfolio in liquid investments.

#### *Daily Valuation of Fund Assets*

US mutual funds must value all their portfolio holdings on a daily basis, based on market values if readily available.<sup>57</sup> If there is no current market quotation for a security or the market quotation is unreliable, the fund board of directors or trustees (a substantial majority of whom typically are

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<sup>55</sup> A regulated fund’s prospectus and other documents provide extensive discussion of the risks of an investment in the fund.

<sup>56</sup> As discussed below, US mutual funds have tools at their disposal that can be used temporarily to help manage redemptions.

<sup>57</sup> A UCITS must publish its unit price when offering purchases and redemptions, at least twice a month (*i.e.*, every 14 days), although the vast majority of UCITS offer purchases and redemptions on a daily basis. Valuation must comply with national law and fund documents. There are also important oversight responsibilities related to valuation and pricing for the fund depositary and the independent auditor. *See generally* UCITS Directive Chapter IV (Articles 22-26) (describing obligations of the depositary); Articles 76, 84 and 85 (pricing and redemption); and Article 73 (requirement for audited financial statements).

independent of the fund's manager) has a statutory duty to "fair value" the security in good faith.<sup>58</sup> The mutual fund uses the values for each portfolio holding to calculate the net asset value ("NAV") of its shares each business day, using pricing methodologies established by the fund board. The daily NAV is the price used for all transactions in fund shares. As the SEC has observed, these pricing requirements are critical to ensuring that mutual fund shares are purchased and redeemed at fair prices and that investor interests are not diluted.<sup>59</sup> They also promote market confidence, because they allow investors, counterparties and others to understand easily the actual valuations of fund portfolios.

Given the importance of the pricing process, mutual funds have extensive policies and procedures designed to ensure that fund portfolio securities are properly valued and that the fund's NAV accurately reflects the fund's net asset value per share. Valuation policies generally serve to: define the roles of various parties involved in the valuation process; describe how the fund will monitor for situations that may necessitate fair valuation of one or more securities; describe board-approved valuation methodologies for particular types of securities; and describe how the fund will review and test fair valuations to evaluate whether the valuation procedures are working as intended. These policies are a critical component of a US mutual fund's governance process and compliance program, and accordingly are a significant area of focus for the SEC during inspections and examinations.<sup>60</sup> Valuation is also a critical component of the audit process.<sup>61</sup>

### *Liquidity to Support Redemptions*

At least 85 percent of a US mutual fund's portfolio must be invested in "liquid securities," which are defined as any assets that can be disposed of within 7 days at a price approximating market value.<sup>62</sup> On an ongoing basis, mutual funds monitor the overall level of liquidity in their portfolios as

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<sup>58</sup> "Fair value" refers to the amount the fund might reasonably expect to receive for the security upon its current sale. See Accounting Series Release No. 118, SEC Release No. IC-6295, 35 Fed. Reg. 19986 (Dec. 23, 1970).

<sup>59</sup> See, e.g., Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IC-26299, 68 Fed. Reg. 74714, 74718 (Dec. 24, 2003) (adopting Rule 38a-1 under the Investment Company Act).

<sup>60</sup> For more detail, see generally ICI, Independent Directors Council and ICI Mutual Insurance Company, *An Introduction to Fair Valuation*, (Spring 2005), available at [http://www.ici.org/pdf/05\\_fair\\_valuation\\_intro.pdf](http://www.ici.org/pdf/05_fair_valuation_intro.pdf).

<sup>61</sup> A US mutual fund's financial statements must be audited annually by an independent public accountant registered with the US Public Company Accounting Oversight Board ("PCAOB"). Among other things, the independent accountant examines the fund's valuation policies and procedures to confirm that the prices used to value the fund's security holdings are consistent with generally accepted accounting principles. As required by SEC rules, the independent accountant must verify 100 percent of the security valuations applied to the fund's portfolio at the balance sheet date; the accountant also would typically review valuations for selected dates throughout the year. The auditing of security values and fair value measurements is a significant area of focus in PCAOB inspections of public accounting firms.

<sup>62</sup> See Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992); SEC Division of Investment Management, IM Guidance Update No. 2014-1 at 6 (Jan. 2014), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf> (explaining that the 1992 Guidelines are Commission guidance and remain in effect).

well as the liquidity of particular securities, as circumstances warrant. Many mutual funds adopt a specific policy with respect to investments in illiquid securities; these policies are sometimes more restrictive than the SEC guidelines.<sup>63</sup> Although an unexpected market event potentially could cause certain previously liquid securities to become illiquid, the SEC has determined that the 85 percent standard should ensure a mutual fund's ability to meet redemptions.<sup>64</sup>

There are times, of course, in which market conditions or investor redemptions may pose particular challenges for a regulated fund. The consultation appropriately recognizes that regulated fund managers may have certain liquidity management tools at their disposal that can be used on a temporary basis.<sup>65</sup> For US mutual funds, three such tools deserve mention here. First, a US mutual fund has by law up to seven days to pay proceeds to redeeming investors, although as a matter of practice, funds typically pay proceeds within one to two days of a redemption request.<sup>66</sup> By using the full seven day period for accounts held direct, a US mutual fund would have more flexibility in meeting redemptions. Second, US mutual funds may reserve the right to redeem in kind—that is, to provide a redeeming investor with portfolio securities rather than cash proceeds.<sup>67</sup> This tool is used sparingly today by mutual fund managers because it is operationally more challenging than cash redemptions and because cash redemptions are what investors typically expect. Nevertheless, depending upon the particular circumstances, redemptions in kind do help a US mutual fund manage certain redemption requests in a way that minimizes disruption to investors remaining in the fund.

Third, if a US mutual fund is faced with an emergency situation that would make it reasonably impracticable for the fund to dispose of portfolio securities or determine the fair value of its assets, the mutual fund may seek relief from the SEC to suspend redemptions temporarily or postpone the payment of redemption proceeds beyond seven days.<sup>68</sup> The SEC and its staff have used this authority,

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<sup>63</sup> Similarly, UCITS are required to manage liquidity risk in order to comply with the responsibility to meet redemption requests. UCITS must have an adequate and documented risk management policy. UCITS also may not invest more than 10% of their assets in transferable assets and money market instruments which are not listed on an exchange or dealt on another regulated market. *See generally* UCITS Directive, Recital 5 and Article 1 (objective to invest in transferable securities and other liquid assets), Article 50 (eligible assets), Article 51 (risk management) and Article 84 (obligation to redeem at unit holder request).

<sup>64</sup> SEC Release No. IC-1862, *supra* note 61 (stating that the 85 percent standard was “designed to ensure that mutual funds will be ready at all times to meet even remote contingencies”).

<sup>65</sup> Consultation at 30.

<sup>66</sup> Section 22(e) of the Investment Company Act. Similarly, in accordance with the requirements of national authorities, UCITS typically have up to 14 calendar days from the redemption dealing deadline to pay redemption proceeds to investors.

<sup>67</sup> The SEC has stated that it can be desirable for US mutual funds to have available the flexibility to redeem in kind. *See* Adoption of (1) Rule 18F-1 under the Investment Company Act of 1940 to Permit Registered Open-End Investment Companies Which have the Right to Redeem in Kind to Elect to Make Only Cash Redemptions and (2) Form N-18F-1, SEC Release No. IC-6561 (June 14, 1971). UCITS are also permitted to redeem in kind, for example UCITS domiciled in Ireland are permitted at the discretion of the UCITS to redeem in kind an investor's holding if the investor requests the redemption of more than 5% of the net assets of the UCITS on any single dealing day.

<sup>68</sup> Section 22(e) (2) of the Investment Company Act. UCITS may also temporarily suspend the redemption of units on

for example, in response to emergencies outside the US and the disruption of trading in particular markets.<sup>69</sup> Even in the face of unforeseen events, however, funds are generally expected to value their portfolio securities (using market quotations or their fair valuation methodologies) and calculate their NAVs.<sup>70</sup>

Other jurisdictions permit their regulated funds to use similar or other liquidity management tools, such as gates or limited suspensions of redemptions, “swing pricing,” and dilution levies. For example, UCITS may, in accordance with national law and fund rules, temporarily suspend redemptions or “gate” redemptions, meaning limiting the amount of total assets that can be redeemed on a pro-rata basis (*e.g.*, 10% of total fund assets). Further, the UCITS Directive permits the UCITS home Member State to allow its authorities to require the suspension of redemptions in the interest of the fund’s unit holders or the public.<sup>71</sup> Some Member States also allow UCITS to utilize “swing pricing,” a method by which a fund’s price (or NAV) is adjusted to pass on the cost of movements into and out of a fund to those investors leaving or investing in the fund rather than the long-term or remaining fund investors. The concept behind swing pricing is that trading costs dilute the value of existing unit holder’s interests in the fund.<sup>72</sup> A dilution levy also is another tool which is a fee that can be assessed as an entry or exit charge on exiting or entering investors. Like swing pricing, a dilution levy is intended to address the trading costs associated with entering and exiting investors while seeking to preserve the value of a fund’s assets for remaining investors.<sup>73</sup> In Canada, regulated funds have the ability to borrow up to 5% of the fund’s NAV to manage redemptions.

Like the concept of “distress,” that of “disorderly failure” is equally inapt to regulated funds. Here again, the FSB should avoid looking at regulated funds through the lens of its experience with banks. We do not mean to suggest that regulated funds never close. In fact, fund managers routinely close or reorganize regulated funds for a variety of reasons, including the inability to attract or maintain sufficient assets, mergers with or acquisitions of fund managers offering duplicate or similar strategies, departures of key portfolio managers, or poor investment performance. ICI data show that hundreds of

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notification to the UCITS home Member State.

<sup>69</sup> *See, e.g.*, Letter to Investment Company Institute from Gerald Osheroff, Associate Director, SEC Division of Investment Management (March 20, 1986) (permitting municipal bond funds to suspend redemptions for two days due to a temporary freeze in the municipal bond market caused by uncertainty over proposed tax reforms). Similarly, in March 1994, ICI requested and received oral no-action relief to allow certain funds to suspend redemptions for one day when the assassination of a Mexican presidential candidate caused the Mexican Stock Exchange to close.

<sup>70</sup> *See, e.g.*, Letter to Craig S. Tyle, General Counsel, ICI from Douglas Scheidt, Associate Director and Chief Counsel, Division of Investment Management, SEC (Dec. 8, 1999) at n.14 (observing that certain funds “used a variety of indicators and benchmarks to fair value price their Asian portfolio securities” in connection with “the extreme volatility that occurred in world financial markets in October 1997”).

<sup>71</sup> *See* UCITS Directive, Article 84 (obligation to redeem).

<sup>72</sup> *See* UCITS Directive, Article 85 (valuation set by national law, fund rules or instruments of incorporation).

<sup>73</sup> *Id.*

US mutual funds exit the business each year, without government intervention or taxpayer assistance. We concur with the consultation's observations about the frequency of mutual fund mergers and liquidations in the US and that, "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact" for the period 2000-2012.<sup>74</sup>

When a US mutual fund does need to liquidate, there is an established and orderly process by which the fund liquidates its assets, distributes the proceeds *pro rata* to investors and winds up its affairs, all without consequence to the financial system at large. This process, which is explained in detail in Appendix E, adheres to requirements in the Investment Company Act and state or other relevant laws based on the domicile of the fund, including consideration and approval by the mutual fund's board of directors. Furthermore, all actions by the fund manager and the fund directors are undertaken in accordance with their fiduciary obligations to the fund.

Similarly, UCITS have orderly liquidation procedures as prescribed in their fund rules and the laws of the UCITS home Member State.<sup>75</sup> Liquidations are subject to the fiduciary responsibilities of the UCITS' management company and/or directors, requiring the liquidation to be conducted in an orderly manner and in the best interest of investors. During a liquidation the right of an investor to receive redemption proceeds is suspended and replaced with the right to receive a pro rata share in the assets of the UCITS, as and when realized by management following the orderly disposal of investments in such manner as is determined by management for the purposes of maximizing returns to investors.<sup>76</sup>

In the vast majority of cases, a fund merger or liquidation is not compelled by unusual circumstances, so the process can unfold over a time period that the fund manager and fund board deem appropriate. If, however, a particular situation demands an expedited timetable, the fund manager and fund board have the ability to act swiftly. An example from the height of the 2008 financial crisis is instructive. On September 18, 2008, Putnam Investments announced the closing of the Putnam Prime Money Market Fund and the distribution to investors of the fund's assets. The fund had no exposure to Lehman Brothers or other troubled issuers, but had experienced significant redemption pressures from its concentrated institutional investor base. The fund manager and the

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<sup>74</sup> This data is included as part of Appendix E.

<sup>75</sup> See, e.g. UCITS Directive Article 19 (management company and complying with rules of UCITS home Member State, including rules related to liquidation and winding up).

<sup>76</sup> The liquidation procedure usually involves the appointment of an official liquidator with statutory powers and responsibilities regarding the accumulation, realization and distribution of assets. The party in control of the UCITS liquidation, whether that is the management company, liquidator or board, has the ability to apply to the courts for directions. Investors have the right to be notified of the termination of the UCITS and may have the right to appoint a liquidator. The depositary continues to be responsible for the safekeeping of assets during the liquidation of a UCITS and has oversight in relation to the payment of the proceeds from the realization of assets to investors. In addition, it is possible to merge a UCITS with another UCITS, either within the same Member State or on a cross border basis. The merger of UCITS can be done on a voluntary basis, whether on a redemption and subscription basis or by a share exchange whereby assets of the migrating UCITS are transferred to the receiving UCITS in exchange for the issue of shares in the receiving UCITS.

fund's board of directors determined to close the fund rather than sell portfolio securities into a liquidity constrained market; this action allowed the fund to treat all of its investors fairly. Just six days later, on September 24, the fund merged with Federated Prime Obligations Fund at \$1.00 per share and investors did not lose any principal.<sup>77</sup>

For all of the reasons discussed above, we believe it is clear that regulated funds generally, and US mutual funds in particular, do not experience “distress” or disorderly failure that could threaten global financial stability. There is no need for such funds to engage in resolution planning in advance, nor for regulators to have additional authority to protect against their disorderly failure.

## **V. Views on Systemic Risk Transmission**

The consultation contemplates two “transmission channels” by which the distress or failure of an investment fund could lead to losses on the part of counterparties or other market participants.<sup>78</sup> As explained in detail below, no regulated fund is likely to be a source of risk transmission to the global financial system and its participants. Instead, and as discussed more fully in Section VII below, to the extent the FSB or national authorities have demonstrable concerns about specific activities or practices in the asset management sector, they should address those concerns through activity-based regulation.

### Counterparty Channel

The counterparty channel involves situations in which a bank, broker or other counterparty has extended financing to an investment fund or has “direct trading linkages” to an investment fund. The consultation postulates that “[l]osses on investments by a fund could, if exposures are significant and have not been adequately managed, generate heavy losses to counterparties and ultimately destabilise creditors who might be systemically important in their own right.”

As a general matter, relationships between counterparties are an appropriate area of focus when considering the potential for risk transmission. We concur with the consultation's focus on “financing”—or, to put it differently, leverage—as a potential source of risk to counterparties. We further concur with the consultation's implicit recognition that adequate risk management by the investment fund and its counterparty will mitigate the possibility of losses that result in risk transmission.

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<sup>77</sup> See “Putnam Fund Shifts Investors to Federated,” *New York Times* (September 24, 2008) (citing *Bloomberg News*), available at <http://www.nytimes.com/2008/09/25/business/25fund.html>.

<sup>78</sup> The consultation proposes a third channel—referred to as the “critical function or service / substitutability channel”—by which the financial distress of an NBNI financial entity could be transmitted to other financial firms and markets, but does not view that channel as being applicable to investment funds. We agree with the consultation's approach, concurring with its conclusion that “funds are highly substitutable.” Consultation at 3, 29-30. For further discussion of substitutability, see Section III of this letter.

Regulated funds are, first and foremost, holders of long positions in debt and equity instruments through paid-in capital (equity) from investors. Regulated funds thus generally act as *providers of capital* (to financial and operating companies, various governments, and the U.S. Treasury and central banks), rather than as borrowers of capital.<sup>79</sup> In other words, it is far more common that a regulated fund—and, by extension, its investors—are the bearers of counterparty exposure (*e.g.*, by reason of the fund's purchase of debt issued by a bank), rather than transmitters of risk to those counterparties.

More specifically, for regulated US funds, financing and other transactions with counterparties are largely limited to three situations: securities lending, derivatives transactions or borrowing. The extent to which a regulated US fund may engage in such activities is strictly limited by the existing regulatory regime administered by the SEC.

- **Borrowing.** Any borrowing by a US mutual fund must be from a bank. In addition, the mutual fund must maintain asset coverage of at least 300 percent for all such borrowings.<sup>80</sup> This means that a mutual fund's leverage ratio—measured as total assets to net equity or net assets, consistent with the definition set forth in the consultation—cannot exceed 1.5. As a practical matter, the leverage ratios for US mutual funds are generally well below this level.<sup>81</sup>
- **Derivatives Transactions.** US law and related guidance from the SEC and its staff effectively limit the extent to which regulated US funds can invest in derivatives.<sup>82</sup> As a general matter, such a fund must “cover” any future indebtedness by segregating liquid assets on its books or

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<sup>79</sup> At the end of 2013, regulated US funds as a whole held 29 percent of the outstanding US corporate equity, 15 percent of US and international corporate bonds, 11 percent of US Treasury and government agency securities, 25 percent of US municipal securities, and 45 percent of commercial paper.

<sup>80</sup> Section 18 of the Investment Company Act. With respect to UCITS, Member States generally may authorize borrowing by a UCITS provided the borrowing is for (a) temporary purposes or (b) other specific enumerated purposes and represents no more than 10% of the UCITS' assets. If the borrowing is authorized under (a) or (b), the borrowing cannot exceed 15% of the UCITS' assets in total. *See* UCITS Directive, Article 83 (borrowing restrictions).

<sup>81</sup> See Appendix B, Figure B.1 for the leverage ratios of regulated U.S. funds with net assets greater than \$100 billion.

<sup>82</sup> A regulated US fund that invests in derivatives must take into consideration various provisions of the Investment Company Act and related SEC rules. These include the leverage limitations of Section 18, which governs the extent to which a fund may issue “senior securities,” as well as provisions governing diversification, concentration, investing in certain types of securities-related issuers, valuation, accounting and financial statement reporting, and applicable disclosure provisions. These provisions are described in detail in a 2011 SEC concept release. *See* Use of Derivatives by Investment Companies Under the Investment Company Act of 1940, SEC Release No. IC-29776 (Aug. 31, 2011), 76 Fed. Reg. 55237 (Sept. 7, 2011).

maintaining offsetting positions. These limitations help assure that a regulated US fund will be able to meet its obligations.<sup>83</sup>

- Securities Lending. Well established SEC guidelines apply to securities lending activities by regulated US funds.<sup>84</sup> Among other things, these guidelines restrict the types of collateral that are permissible and how that collateral may be treated, impose limitations on the amount of securities lending, ensure the ability of a fund to recall securities in a timely manner, and mitigate conflicts of interest.<sup>85</sup> A regulated US fund must receive from the borrower at least 100% of the value of the loaned securities as collateral, and the collateral must be marked to market daily to ensure that at least 100% collateral is maintained at all times.<sup>86</sup> Permissible collateral is limited to cash, US Treasury and agency securities and, subject to limitations, certain bank guarantees and irrevocable bank letters of credit. Although regulated US funds do engage in securities lending, it is generally to a very limited degree.<sup>87</sup>

Finally, we note that the potential for “inadequately managed” exposures in these areas is further minimized by other regulatory requirements applicable to regulated US funds, including daily mark-to-market valuation of all positions (including collateral and coverage amounts, as discussed above) and independent board oversight of the fund’s investment program.

#### Asset Liquidation / Market Channel

The asset liquidation / market channel contemplates situations in which an investment fund, as a significant investor (or provider of liquidity) in some asset classes, may be forced to liquidate positions. The consultation posits that, in times of stress, such liquidations “could cause temporary

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<sup>83</sup> In Canada, regulated funds also have strict limits on the use of leverage and derivatives, *e.g.*, borrowing restrictions, maximum portfolio exposure limits and counterparty concentration limits. *See e.g.*, NI 81-102 sections 2.6 -2.8. *See also* notes 36 and 84 (generally describing UCITS restrictions and derivatives).

<sup>84</sup> Likewise, the European Securities and Markets Authority (“ESMA”) and Member States have issued specific rules and guidance relating to UCITS and securities lending activities. Recent ESMA guidelines include rules for UCITS entering into OTC derivatives. *See generally* UCITS Directive, Article 51, and ESMA Guidelines on ETFs and Other UCITS Issues, 2012/474 available at <http://www.esma.europa.eu/news/esma-publishes-etf-guidelines-and-consults-repo-arrangements> and Questions and Answers, ESMA 2013/314 (March 2013). Regulated funds in Canada also have restrictions related to securities lending.

<sup>85</sup> Moreover, a regulated US fund may lend securities only if such activity is permitted by its organizing documents, disclosed to investors, and subject to approval and oversight by the fund’s board of directors.

<sup>86</sup> As a matter of market practice, securities lending arrangements typically establish somewhat higher thresholds (102% collateral for loaned domestic securities and 105% collateral for loaned foreign securities).

<sup>87</sup> SEC guidelines generally prohibit a fund from having on loan at any given time securities representing more than one-third of the fund’s total net asset value. In calculating this limit, the collateral (*i.e.*, the cash or securities required to be returned to the borrower) can be included as part of the lending fund’s total assets, meaning that a fund can lend up to 50% of its asset value before the securities loan. It is our understanding that lending by regulated US funds typically stays below that limit.

distortions in market liquidity and/or prices that cause indirect stress to other market participants.” It observes that such effects “may be amplified” by an investment fund’s use of leverage. The consultation further suggests that such effects may occasion a loss of investor confidence in a specific asset class, causing “runs” on other investment funds presenting similar features or conducting a similar strategy.<sup>88</sup>

All regulated funds routinely buy and sell securities and other instruments in managing their portfolios. Sales of portfolio assets may be prompted by a variety of events, including a change in the portfolio manager’s view about the desirability of holding a particular asset, changes in the market value of that asset, or the need to meet investor redemptions. These transactions are inherent in the business of offering investors the opportunity to invest in a professionally managed portfolio following stated investment objectives, as well as the opportunity to exit that investment. For US mutual funds, which are required to redeem their shares daily, and other regulated funds with similar redemption frequencies, maintaining a sufficiently liquid portfolio is both the key to effective portfolio management *and* a central requirement in the existing regulatory regime.<sup>89</sup> It is thus important for the FSB to distinguish “routine” sales of portfolio assets from those that are the focus of the consultation—situations in which an investment fund “has to liquidate its assets quickly, [which] may impact asset prices and thereby significantly disrupt trading or funding in key markets.”<sup>90</sup>

In theory, for such a situation to arise, three conditions must exist. First, an investment fund must be facing unusual circumstances—higher than expected redemption requests from investors, or a significant and unexpected market event. Second, the investment fund must be selling portfolio securities quickly, either in order to meet those redemptions or to protect fund assets against further capital losses. And third, the sales must represent a large enough fraction of total trading that they would substantially move prices (in order to cause the significant disruption that the consultation posits).

With regard to US mutual funds, the historical evidence is compelling: these funds have *never* faced such conditions, not even during periods of the most severe market stress, including the global financial crisis of 2007-2008. Appendix F describes this evidence in detail.

Several factors help to explain why the actual experience of US mutual funds does not reflect any such “transmission channel” at work. As described more fully in Appendix F, more than 95 percent of mutual fund shares are held by retail investors, and for many of them, saving for retirement is their primary investment goal. In addition, nearly 80 percent of those who invest in mutual funds outside of employer-based retirement accounts rely on the advice of a financial professional. This combination of retirement saving and the use of financial professionals leads investors to pursue investment strategies

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<sup>88</sup> Consultation at 29 (discussing the asset liquidation/market channel as applicable to investment funds).

<sup>89</sup> Although the UCITS Directive only requires UCITS to offer redemption at least twice a month, UCITS typically offer investors daily redemption.

<sup>90</sup> Consultation at 3 (discussing the asset liquidation/market channel generally).

with an eye toward diversification and the long term. It should come as no surprise, therefore, that the volatility of flows into and out of stock mutual funds has steadily declined since the 1980s,<sup>91</sup> coinciding with the growth of retirement assets and the use of mutual funds in retirement accounts.

This long-term focus of US mutual fund investors, in our view, has two important implications for financial stability. First, redemption requests almost never rise to unmanageable levels for a US mutual fund, even during periods of severe financial stress. As discussed in Appendix F, ICI data looking at periods of market stress dating back to 1945 demonstrates that investors in US mutual funds have not reacted precipitously, even during the most severe financial crises such as the fall of 2008. Second, even in those times of stress, investors are making new purchases of fund shares, and funds are continuously receiving dividend and interest income. A mutual fund can use new these cash inflows to support redemptions, thus minimizing the fund's need to sell portfolio securities. For example, during September and October 2008, investors *purchased* \$274 billion of equity mutual fund shares and \$141 billion in bond mutual fund shares. In addition, during those two months stock funds reinvested \$7 billion in dividend payments and bond funds reinvested nearly \$11 billion. As a result, net outflows from stock funds (including reinvested dividends) amounted to only 2 percent of fund assets during September and October of 2008 and 1.8 percent of bond fund assets.

Another significant factor is the close correlation between investor activity in US mutual fund shares and portfolio transactions by the fund manager. As shown in Appendix F, the data suggest that, in the face of unexpected market events, managers of US mutual funds generally are not selling portfolio assets into the market *unless* such sales are correlated to investor flows. This fact, taken together with the staying power of US mutual fund investors as outlined above, suggests that even a large US mutual fund is unlikely to face a situation in which it must "liquidate its assets quickly" as contemplated by the asset liquidation/market channel.

Finally, any sales of portfolio assets by US mutual funds are unlikely to impact market prices to any substantial degree. Appendix F shows that even when redemptions do materialize, they are unlikely to lead to much downward pressure on securities prices because sales of stocks and bonds by US mutual funds are small relative to the value of overall stock and bond market trading.

The factors described above and the actual historical experience of US mutual funds—consistent over time and grounded in the fundamental regulatory principles to which these funds must adhere—should substantially allay the FSB's concerns that a large US mutual fund *could potentially* face higher than expected redemptions or a significant and unexpected market event. If such a situation ever were to arise, however, the US mutual fund would have at its disposal the range of tools discussed in Section IV including, if determined necessary, the option to liquidate the fund in an orderly way, with no disorder to the broader financial system. For these reasons, and those discussed earlier in this letter,

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<sup>91</sup> This data is shown in Appendix F, Figure F.2.

we question how the FSB could justify the G-SIFI designation of *any* US mutual fund and more broadly, any regulated fund.

## **VI. Consequences of G-SIFI Designation for US Mutual Funds: Harm to Funds and Their Investors**

By design, the consultation omits discussion of any policy measures that would apply to NBNI G-SIFIs. It states that the FSB will work with IOSCO and others to develop such measures after the identification methodologies have been finalized and published.<sup>92</sup> Given that the proposed assessment methodology for investment funds, if adopted without change, would require the evaluation of at least 14 regulated US funds for possible G-SIFI designation, we believe the FSB should be mindful of the likely consequences of such designation.

While the precise details of the policy measures are uncertain, the FSB's previous statements and work on G-SIFI issues—and the FSB's stated goal of maximizing the consistency of treatment of G-SIFIs across categories—suggest that any such policy measures will be similar to those already established for G-SIBs and G-SIIs. Those policy measures consist of: (1) resolution planning requirements; (2) additional “loss absorption” capacity (*i.e.*, capital) requirements; and (3) enhanced prudential supervision requirements.<sup>93</sup> As we understand it, national authorities (*e.g.*, the US FSOC) ultimately would be responsible for the implementation of any policy measures developed by the FSB.

In the US, the Dodd-Frank Act already prescribes a comprehensive set of requirements for non-bank SIFIs.<sup>94</sup> The US FSOC will look to the Dodd-Frank Act, as the governing legal authority, to determine what will constitute prudential supervision for a US mutual fund designated as a G-SIFI. Importantly, the Dodd-Frank requirements encompass all three elements of the existing policy measures for G-SIFIs. For the reasons set forth below, applying these requirements to any US mutual funds would be highly problematic for those funds and their investors.

### SIFI Requirements under the Dodd-Frank Act

Under the Dodd-Frank Act, both bank holding companies with \$50 billion or more in total consolidated assets and nonbank financial companies designated as SIFIs become subject to certain mandatory enhanced prudential standards and consolidated (prudential) supervision by the US Federal Reserve. The Federal Reserve also has authority to impose heightened prudential standards in certain other areas.<sup>95</sup> By statute, the prudential standards must be “more stringent than the standards and

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<sup>92</sup> Consultation at 2.

<sup>93</sup> See TBTF Report, *supra* note 28, at 2.

<sup>94</sup> See, *e.g.*, Section 165 of the Dodd-Frank Act.

<sup>95</sup> Appendix G identifies each of these standards.

requirements applicable to nonbank financial companies and bank holding companies that do not present similar risks” to US financial stability.<sup>96</sup>

Exactly how these requirements will be applied to any specific nonbank SIFI is not yet known. The Federal Reserve has adopted rules to implement most of the Section 165 requirements for large bank holding companies, but those rules do not apply to nonbank SIFIs; the Federal Reserve is still considering how it will apply these standards to nonbank SIFIs.<sup>97</sup> Nevertheless, because the Dodd-Frank standards are designed to moderate bank-like risks, the prescribed “remedies” are ill-suited to a mutual fund.

**Financial Implications.** Most troubling is the prospect of capital requirements. Unlike banks which, as the consultation notes, have capital requirements to protect their depositors and other creditors against the risk of losses,<sup>98</sup> US mutual funds simply have neither the need for capital nor the ability to meet capital requirements. Their “capital” comes from investors who own fund shares—shares that represent the investors’ pro rata interests in all the underlying assets of the fund.<sup>99</sup> Investment losses or gains are not retained by the fund’s manager, but entirely passed on to the fund’s investors. Applying capital or “loss absorption” requirements to mutual funds or other regulated funds to protect against losses would be antithetical to their basic nature and purpose; as fund investors understand and expect, these are investment products that entail investment risk.<sup>100</sup> If capital were actually available or were perceived to be available to absorb fund investors’ losses, it would introduce moral hazard and lessen market discipline.

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<sup>96</sup> Section 165(a)(1)(A) of the Dodd-Frank Act.

<sup>97</sup> Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,239, 17,244–45 (Mar. 27, 2014) (recognizing “that [SIFIs] may have a range of businesses, structures, and activities, that the types of risks to financial stability posed by nonbank financial companies will likely vary, and that the enhanced prudential standards applicable to bank holding companies and foreign banking organizations may not be appropriate, in whole or in part, for all nonbank financial companies”).

<sup>98</sup> Consultation at 29.

<sup>99</sup> Commenting on the possibility of capital requirements for nonbank financial companies designated as SIFIs, Brookings Institution Fellow Douglas J. Elliott recently wrote: “If this powerful tool is applied too widely, such as to fund managers that act as pass-through entities and not true intermediaries, it could substantially change the ability of otherwise valid business models to work. Ironically, adding an unreasonable burden to, say, mutual funds could push financial assets into the hands of financial intermediaries instead that present greater systemic risks.” Douglas J. Elliott, Brookings, *Regulating Systemically Important Financial Institutions That Are Not Banks* (May 9, 2013), <http://www.brookings.edu/research/papers/2013/05/09-regulating-financial-institutions-elliott>, at 10-11.

<sup>100</sup> The European Systemic Risk Board (“ESRB”) also noted this significant issue in its consideration and rejection of capital as a recommendation for money market funds. The ESRB stated, “Capital buffers are not in line with the fundamental feature of an investment fund where investors carry the investment risk; moreover, they may potentially further blur the distinction with banks.” Recommendations of the ESRB of 20 December 2012 on Money Market Funds (ESRB/2012/1) at 30, available at [https://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB\\_2012\\_1.en.pdf?1927788d42d471badf02537198dcd a24](https://www.esrb.europa.eu/pub/pdf/recommendations/2012/ESRB_2012_1.en.pdf?1927788d42d471badf02537198dcd a24).

But an unresolved inconsistency between two provisions in the Dodd-Frank Act calls into serious question just how much flexibility the Federal Reserve would have to limit the application of capital requirements to any US mutual fund designated as a SIFI or G-SIFI. Although one provision of the Dodd-Frank Act gives the Federal Reserve discretion in applying capital standards to nonbank SIFIs,<sup>101</sup> senior Federal Reserve officials have indicated that the other provision—known as the “Collins Amendment”<sup>102</sup>—may not.<sup>103</sup> The Federal Reserve accordingly may be compelled to hold a US mutual fund SIFI to the bank minimum capital requirement of 8 percent (although it is unclear whether that precise standard would be applied).<sup>104</sup>

In addition to the various prudential standards discussed above and in Appendix G, US nonbank SIFIs also are subject to certain fees and assessments. These charges include annual fees to defray the Federal Reserve’s increased supervisory costs,<sup>105</sup> and semi-annual assessments to cover the expenses of the FSOC and the US Treasury Department’s Office of Financial Research.<sup>106</sup> The Dodd-Frank Act also authorizes assessments if needed to reimburse the US Government for costs of resolving a distressed financial institution determined to be systemically important—for example, a G-SIB or other large bank holding company—under the new Orderly Liquidation Authority established under the Dodd-Frank Act.<sup>107</sup>

These fees and assessments are designed to require systemically important financial institutions to help shoulder the costs associated with systemic risk monitoring and regulation and, if necessary, the resolution of a systemically important financial institution. But as applied to US mutual funds, these charges are tantamount to taxes on millions of fund investors. And given that the purpose of the Orderly Liquidation Authority provisions was to avoid having the costs of “bailouts” fall on taxpayers, it would be both ironic and most unfortunate if the end result were to burden US mutual fund investors—many of whom are saving for retirement—with those costs.

The costs of added fees, assessments, and capital requirements could be substantial, and while their exact level is uncertain, it would not take much to increase the fees that investors in the largest

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<sup>101</sup> See Section 165(b)(1)(A)(i) of the Dodd-Frank Act (providing the Federal Reserve authority to determine that capital standards are inappropriate for a particular SIFI and to substitute “other similarly stringent risk controls.”)

<sup>102</sup> See Section 171 of the Dodd-Frank Act, which requires the imposition of minimum leverage capital and risk-based capital standards on any SIFI.

<sup>103</sup> For example, in response to a question at a recent Congressional hearing, Federal Reserve Chair Janet Yellen said that the Collins Amendment “requires us to establish consolidated minimum risk-based leveraging capital requirements for these entities that are no lower than those that apply to depository institutions.” U.S. House of Representatives Committee on Financial Services hearing on “Monetary Policy and the State of the Economy (Feb. 11, 2014).

<sup>104</sup> See 12 C.F.R. 217.10(a)(3) (the capital adequacy rule for US bank holding companies).

<sup>105</sup> See Section 318(c) of the Dodd-Frank Act.

<sup>106</sup> See Sections 118 and 155(d) of the Dodd-Frank Act.

<sup>107</sup> See Section 210(o)(1)(A)(ii) of the Dodd-Frank Act.

regulated US funds currently pay. Those funds are highly efficient, relatively low-cost funds within their asset classes. Their expense ratios range from 76 basis point down to 3 basis points; their asset-weighted average expense ratio is 31 basis points. Increased costs would make these funds less competitive and less attractive to investors.<sup>108</sup> Indeed, application of these measures to any regulated US fund would put that fund at a distinct competitive disadvantage, leading to distortions in the fund marketplace. Given the ready substitutability of funds, capital requirements and other unique costs incurred by one fund might cause investors to leave that fund and invest in another similar fund not subject to the same regulatory costs.<sup>109</sup> Funds would have a strong incentive to avoid reaching the \$100 billion threshold so as to avoid being subjected to these measures. Thus, the measures could invite regulatory arbitrage and could have the effect of limiting investor choice.

Fund Management Implications. The designation of US mutual funds as SIFIs also may affect the management of funds' portfolio investments and how these funds serve their investors. For example, under the Dodd-Frank Act, the Federal Reserve can require SIFIs to hold specified levels of liquid assets, which presumably would mean cash or cash equivalents. A stock or bond fund, for example, might be obligated on an ongoing basis to hold substantially more cash than it contemplated in establishing its investment objectives and policies. Such a requirement would impede a designated mutual fund's ability to deliver returns its investors expect—another factor that would render it less competitive.

Over and above the consequences of imposing the specific prudential requirements enshrined in the Dodd-Frank Act, subjecting US mutual funds to the Federal Reserve's supervisory authority has other serious implications. It sets up the potential—arguably, the likelihood—for a clash between the goals of prudential supervision, on the one hand, and the fiduciary duty of a fund manager and fund board to act in the best interests of the fund, on the other. The Federal Reserve's supervisory charge under the Dodd-Frank Act is to “prevent or mitigate” the risks presented by large, interconnected financial institutions.<sup>110</sup> That charge, which is similar to the “safety and soundness” authority the Federal Reserve has over banking organizations, affords the Federal Reserve broad powers, including, for example, powers to limit a firm's acquisition activities and to require a firm to reduce its credit exposure to certain counterparties.<sup>111</sup> The Federal Reserve's authority includes an ability to insist on

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<sup>108</sup> See *Understanding Investor Preferences for Mutual Fund Information*, ICI Survey (2006), available at [http://www.ici.org/pdf/rpt\\_06\\_inv\\_prefs\\_full.pdf](http://www.ici.org/pdf/rpt_06_inv_prefs_full.pdf); see also ICI Research Perspective, *Trends in the Expenses and Fees of Mutual Funds*, Vol. 19 No. 3 (April 2013), available at <http://www.ici.org/pdf/per19-03.pdf>; see also ICI Research Perspective, *The Economics of Providing 401(k) Plans: Services, Fees, and Expenses*, 2012, Vol. 19 No. 4 (June 2013), available at <http://www.ici.org/pdf/per19-04.pdf>; see also SEC Pub. No. 164, *How Fees and Expenses Affect Your Investment Portfolio*, Office of Investor Education and Advocacy, Investor Bulletin (February 2014), available at [http://www.sec.gov/investor/alerts/ib\\_fees\\_expenses.pdf](http://www.sec.gov/investor/alerts/ib_fees_expenses.pdf).

<sup>109</sup> This is another reason why an entity-based approach does not make sense in this context.

<sup>110</sup> See Section 165(a)(1) of the Dodd-Frank Act.

specific changes to an organization's operations, governance and policies and to enforce its recommendations through a variety of penalties.<sup>112</sup>

Such measures may make sense in the context of highly leveraged banking organizations, for which such prudential supervision has long been a necessary part of the regulatory fabric and which receive the benefits of federal deposit insurance, access to the Federal Reserve's discount window and other forms of federal government support. They also may be prudent in the case of other designated SIFIs, to the extent those SIFIs share banking organization characteristics. But application of these measures to a regulated US fund could have significant adverse consequences. A particular fund may undertake to its investors, for example, to track a relevant index as closely as possible, maintain exposure to certain asset classes or securities issuers, or manage within a wide variety of other, different parameters. Undertakings of this kind are binding. They are reflected in the fund's investment objectives and policies and disclosed to investors in its prospectus—and fund managers under US law have a legal obligation to act in the best interests of the fund.

In the interest of mitigating risks to the system, however, the Federal Reserve's enhanced supervisory authority presumably could be exercised to impel a fund's manager to manage the fund's portfolio in a manner that the manager otherwise would not do, and that the manager may believe to be contrary to the best interests of the fund's investors and to its own fiduciary duties. This might involve, for example, requiring the fund to maintain financing for banks or other counterparties, remain exposed to certain markets, avoid exposure to certain issuers, or maintain excess levels of cash or cash equivalents in the fund's portfolio. Compromising the ability of the fund to achieve its investment objectives, or worse yet exposing it to avoidable losses, quickly will make the fund uncompetitive and prompt investors to move to other funds whose managers are not subject to similar constraints on their ability to fulfill their investment mandates and their duties to the fund. Conflicts of this kind could arise in *any* situation in which the Federal Reserve, acting in response to perceived prudential or macroprudential concerns, imposes obligations on a US mutual fund to promote the safety and soundness of a bank or the banking system or the financial system at large that, in substance, conflict with the exclusive loyalties owed by the fund's manager and board to the fund.

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<sup>111</sup> For example, in one notable instance, the Federal Reserve used its broad safety and soundness authority to prohibit a banking organization from engaging in acquisitions in order to promote compliance by the banking firm with other, unrelated regulatory obligations. See Citigroup: Order Approving Acquisition of a Bank (Mar. 16, 2005); see also Clint Riley, *Citigroup Is Cleared to Pursue Deals*, Wall St. J., Apr. 5, 2006, <http://online.wsj.com/news/articles/SB114415284483416422>.

<sup>112</sup> For example, recently the Federal Reserve restricted the ability of five large banking organizations to pay dividends or take other capital actions. Four of those five faced such restrictions not because they had weak quantitative capital positions but, instead, because of "qualitative" deficiencies (such as perceived weaknesses in capital planning governance and controls). See Comprehensive Capital Analysis and Review 2014: Assessment Framework and Results (Mar. 2014), available at [http://www.federalreserve.gov/newsevents/press/bcreg/ccar\\_20140326.pdf](http://www.federalreserve.gov/newsevents/press/bcreg/ccar_20140326.pdf).

### Acknowledging the Limitations of Prudential Regulation

While we are deeply concerned about the potential consequences of applying ill-suited policy measures to US mutual funds, it is encouraging that key financial regulatory officials recognize that prudential standards and regulation are not the answer for everything. Federal Reserve Board Governor Daniel Tarullo has observed that “prudential standards designed for regulation of bank-affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions.”<sup>113</sup> We agree. The nature of the policy measures that have been adopted or discussed for SIFIs and G-SIFIs to date, and the implications of those measures for US mutual funds or other regulated funds, only serve to underscore our view that designation would be inappropriate for regulated funds.

## **VII. A Better Approach to Addressing Identified Risks: Activity-Based Regulation**

For the reasons discussed earlier in this letter, regulated funds simply do not pose the concerns that give rise to a G-SIFI designation: namely, that a large, complex, and interconnected entity’s *distress or disorderly failure* would *cause significant disruption to the global financial system and economic activity across jurisdictions*—sparking a need for government intervention that would be costly for taxpayers. Moreover, forcing regulated US funds into a bank regulatory mold through the imposition of prudential standards and Federal Reserve supervision would be wholly inappropriate and have harmful consequences for these funds and their investors. Likewise, singling out individual regulated funds in other jurisdictions for heightened supervision and bank-style prudential regulation would be inappropriate and would distort the competitive landscape for such funds.

Instead, to the extent regulators believe specific activities or practices pose risks to the market or to the financial system, they should use their considerable rulemaking authority to address those risks through activity-based regulation. In the case of activities or practices involving the capital markets, capital markets regulators should drive the process for identifying issues and considering appropriate solutions. The consultation acknowledges that an approach that focuses on activities or groups of activities could be an alternative way to consider possible financial stability risks in the asset management sector.<sup>114</sup> In the US, financial regulators already had broad rulemaking powers before the

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<sup>113</sup> *Regulating Systemic Risk*, Remarks by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, at the 2011 Credit Markets Symposium, Charlotte, N.C. (March 31, 2011), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf>. SEC Chair Mary Jo White echoed this sentiment in recent remarks, stating: “We also will continue to engage with other domestic and international regulators to ensure that the systemic risks to our interconnected financial systems are identified and addressed – but addressed in a way that takes into account the differences between prudential risks and those that are not. We want to avoid a rigidly uniform regulatory approach solely defined by the safety and soundness standard that may be more appropriate for banking institutions.” *Remarks to the 2014 SEC Speaks Conference*, Mary Jo White, Chair, SEC (Feb. 21, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540822127>.

<sup>114</sup> See Consultation at 32. As a related matter, Question 6-4 inquires whether the assessment methodology for investment funds should be based on whether particular activities or groups of activities pose systemic risks and, if so, how such a methodology should be designed. We do not have any suggestions for the design of such a methodology because we do not

global financial crisis; in response to the crisis, the Dodd-Frank Act provided regulators many new tools to address abuses and excessive risk taking by financial market participants. These include tools that affect financial institutions generally and those targeted either to eliminate excessive risk taking in, or to improve regulatory oversight over, specific sectors. Similar tools have been provided in Europe, significantly through regulatory overhaul both at the pan-European level (*e.g.*, ESMA) and national level (*e.g.* in the United Kingdom).<sup>115</sup> New legislation, particularly the Alternative Investment Fund Managers Directive (“AIFMD”), allows for greater oversight of and reporting by alternative fund managers.

Notably, regulators have used and are continuing to use both new and existing authorities to address risks where they arise—with the front-line regulators taking the lead. The FSB itself, along with other global regulatory bodies and standard-setting authorities, also has played an active role in some of these efforts. The effect of these actions has been to mitigate risk in the financial system or to make markets and market participants more resilient to future shocks. For example, securities lending and repo transactions are currently the subject of specific regulatory efforts, with additional efforts on the horizon.<sup>116</sup> Under Title VII of the Dodd-Frank Act, which addresses the regulation of swaps, regulators have promulgated rules governing, among other things, initial and variation margin requirements for cleared and uncleared swaps and other terms central to counterparty and clearinghouse relationships. Once fully implemented, the Title VII regime will dramatically change the way swaps are traded, cleared and settled, to the benefit of both individual counterparties and the financial system generally.

Reforms have been and continue to be implemented by regulators and policymakers around the globe to strengthen the operation of the securities markets themselves, thereby mitigating risks in the financial system and the potential impacts of future shocks on market participants. In the EU, for example, agreement was recently reached on changes to the directive on markets in financial instruments (“MiFID”) addressing a number of market-related issues, including dark pool trading, high frequency trading, and over-the-counter derivatives (these are also further regulated by the recent European Market Infrastructure Regulation (“EMIR”). Market structure reforms are also underway in Asia. The Australian Securities and Investments Commission, in August 2013, adopted new market

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believe an entity-based approach to regulation of activities is appropriate. Applying consistent rules on an industry-wide basis across entities that engage in the same activity or activities would be more effective and would avoid the competitive distortions associated with selective application of heightened regulatory standards. This type of activity-based regulation does not require a methodology but rather is the natural result of regulators fulfilling their responsibilities, whether on their own initiative, pursuant to national legislation, or in response to standards or recommendations developed by global bodies such as the FSB.

<sup>115</sup> In the United Kingdom, responsibility for regulatory oversight (previously the responsibility of the Financial Services Authority) was reorganized and reallocated among the Financial Conduct Authority, the Prudential Regulation Authority and the Bank of England.

<sup>116</sup> See, *e.g.*, Financial Stability Board, *Strengthening Oversight and Regulation of Shadow Banking: Policy Framework for Addressing Shadow Banking Risks in Securities Lending and Repos* (Aug. 29, 2013); see also Section 984 of the Dodd-Frank Act.

integrity rules on dark liquidity and high frequency trading, as well as guidance on rules regarding the regulator's expectations of market operators and participants. Similarly, the Hong Kong Securities and Futures Commission recently issued a consultation examining the regulation of dark pools, and the Monetary Authority of Singapore and the Singapore Exchange jointly issued a consultation paper setting out proposals to strengthen the securities market in Singapore.

In addition to these regulatory developments, ICI's Board of Governors has endorsed a voluntary initiative led by the Depository Trust & Clearing Corporation to shorten settlement cycles for a range of securities from trade date plus three days (T+3) to T+2. The voluntary move to a T+2 settlement cycle would reduce systemic, liquidity, and operational risks, promote better use of capital, and create significant process efficiencies for market participants—all changes that would benefit investors. The initiative also would align U.S. practices with a global movement toward shorter settlement cycles.<sup>117</sup> Harmonization across regions could help global funds better manage cash flows, thus reducing and simplifying financing needs.

Finally, and of particular note, the SEC is working to strengthen its oversight of US asset managers and regulated funds—an effort we welcome. For example, the SEC's Division of Investment Management is working to expand its asset manager risk management oversight program, which includes developing a proposal for enhancing its collection of data on regulated US funds.<sup>118</sup> The latter initiative, which we support, is designed to provide the SEC with more timely and useful information about regulated fund operations and portfolio holdings. Together with our members, we are engaging with the SEC staff to provide industry expertise and practical information that we hope will help lead to requirements that measurably improve the SEC's ability to identify and monitor risks without imposing undue costs and burdens on regulated US funds. More broadly, we are engaging across the range of initiatives described above to help advance efforts to make markets and market participants more resilient to future shocks, without imposing undue costs and burdens on regulated funds and their investors.

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<sup>117</sup> European markets are moving to a T+2 settlement cycle in 2014, and much of Asia is already on a settlement cycle shorter than T+3.

<sup>118</sup> See, e.g., *Remarks to the 2014 Mutual Funds and Investment Management Conference*, Norm Champ, Director, SEC Division of Investment Management (Mar. 17, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370541168327#.UzWaXM6qkSo>.

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We appreciate the opportunity to comment on this consultation. If you have any questions regarding our comments or would like additional information, please contact me at (202) 326-5901 or [paul.stevens@ici.org](mailto:paul.stevens@ici.org), Dan Waters, Managing Director, ICI Global, at (011) 44- 203- 009- 3101 or [dan.waters@iciglobal.org](mailto:dan.waters@iciglobal.org), Brian Reid, ICI Chief Economist, at (202) 326-5917 or [reid@ici.org](mailto:reid@ici.org), or Frances Stadler, Senior Counsel, at (202) 326-5822 or [frances@ici.org](mailto:frances@ici.org).

Sincerely,

/s/ Paul Schott Stevens

Paul Schott Stevens  
President & CEO  
Investment Company Institute

Appendices

## List of Appendices

- A. Why Focus at the Fund Level is Appropriate
- B. Evaluation of Systemic Importance: Why it is Critical to Consider Both Size and Leverage as a First Measure
- C. Comprehensive Regulatory Regime for US Mutual Funds
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- E. Liquidations of US Mutual Funds
- F. Asset Liquidation / Market Channel is Nonexistent for US Mutual Funds
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### Why Focus at the Fund Level is Appropriate

***Q6-3. Which of the following four levels of focus is appropriate for assessing the systemic importance of asset management entities: (i) individual investment funds; (ii) family of funds; (iii) asset managers on a stand-alone entity basis; and (iv) asset managers and their funds collectively? Please also explain the reasons why you think the chosen level of focus is more appropriate than others.***

As indicated in the body of our comment letter, as the FSB continues to consider a sector-specific methodology for investment funds, it is entirely appropriate to keep the focus of its analysis on individual investment funds, and not on groups of investment funds and/or a fund manager. The consultation is correct in its characterization that (1) economic exposures are created at the investment fund level,<sup>1</sup> and (2) an investment fund is a separate legal entity the assets of which are separate and distinct from—and not available to claims by creditors of—other funds or its manager.<sup>2</sup> In addition to justifying the decision to focus at the fund level, these points are some of the key reasons why it would be *inappropriate* for the analysis of systemic importance to focus on families of funds, asset managers on a stand-alone basis, or asset managers and their funds collectively.

#### Family of Funds

We can think of no convincing policy rationale for aggregating separate funds when assessing systemic importance. In addition to being a separate legal entity, each fund has its own investment objectives, strategies, and policies; one fund's economic exposures will be different from another's and belong to it alone. Within a family of funds, there is typically a diverse array of funds designed to meet a wide spectrum of investor needs. In addition to varying in such features as size and investment risk characteristics, individual funds could have very different investor bases (*e.g.*, retail vs. institutional). The consultation mentions the possibility of aggregating groups of funds following the same or similar investment strategy, but it is our understanding that it is not common for an asset manager to offer multiple funds with the same investment strategy.

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<sup>1</sup> There is recent and relevant precedent for focusing at the fund level. In establishing margin requirements for uncleared derivatives, the Basel Committee on Banking Supervision and IOSCO established a threshold of €50 million for all types of counterparties under which initial margin would not have to be exchanged. With respect to investment funds, they clarified that the threshold would apply at the individual fund level as long as the funds are distinct legal entities that are not collateralized by, or otherwise guaranteed or supported by, other investment funds or the investment adviser in the event of fund insolvency or bankruptcy. Margin Requirements for Non-Centrally-Cleared Derivatives, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 13, 2013, available at <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf>. Therefore, the BCBS and IOSCO recognized that potential counterparty risk should be assessed at the individual fund level rather than at the level of the fund complex or fund manager.

<sup>2</sup> Consultation at 30. For similar reasons, in the case of series or umbrella fund structures, the focus should be on individual series or sub-funds.

## Asset Manager

It likewise would be inappropriate for a G-SIFI assessment methodology to focus on asset managers themselves. The consultation correctly recognizes that asset managers act as agents on behalf of the investment funds they manage.<sup>3</sup> The agency nature of an asset manager's business results in an asset manager having a vastly different risk profile from that of a bank. It also makes it unlikely that an asset management firm could pose a risk to global financial stability.

Acting as agent, an asset manager manages client assets in accordance with the investment objectives, risk tolerance, and time horizon of each client. In the case of regulated US funds, for example, a fund's manager manages the fund's portfolio pursuant to a written contract with the fund and in accord with the fund's investment objectives and policies as described in the fund's prospectus. Regulated fund management fees compensate the manager for managing the fund as a fiduciary and agent and for providing ongoing services that the fund needs to operate. Managers are *not* compensated, however, for bearing the fund's investment risks. This is because an asset manager itself does not take on the risks inherent in the securities or other assets it manages for regulated funds or other clients,<sup>4</sup> or in other activities or strategies it may pursue on behalf of clients, such as securities lending. Those are investment risks that appropriately are borne by the clients. The manager does not own client assets<sup>5</sup> and it may not use the assets of any client to benefit itself or any other client.<sup>6</sup> Investment gains and losses from a client account are solely attributable to that account, and do not flow through to the manager. As a result, the agency nature of the asset management business stands in stark contrast to the principal capacity in which banks operate.

Banks extend loans, often with maturities of 30 years or more, to large numbers of heterogeneous borrowers. Because each loan is unique, deep and liquid markets cannot form to allow for efficient trading of these assets. Banks finance most of these activities through deposits, which are short-term and highly liquid. US bank regulators manage these maturity mismatch and liquidity concerns by providing access to the US Federal Reserve's discount window, requiring deposit insurance,

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<sup>3</sup> *Id.* at 29-30.

<sup>4</sup> In its 2011 annual report to Congress, FSOC observed that "[i]n separately managed accounts, investment losses fall solely on the account owner, so these accounts generally do not raise direct financial stability concerns." Financial Stability Oversight Council, 2011 Annual Report, at 65. This statement is equally true for regulated funds and other types of collective investment vehicles.

<sup>5</sup> Under Section 113 of the Dodd-Frank Act, among the criteria that FSOC must consider in determining whether to designate a nonbank financial company for enhanced prudential standards and consolidated supervision by the Federal Reserve Board is "the extent to which assets are managed rather than owned by the company."

<sup>6</sup> As indicated in the consultation, the assets of a fund "are separated and distinct from those of the asset manager and as a result, the assets of a fund are not available to claims by general creditors of the asset manager." Consultation at 30 (footnote omitted). The consultation states that fund assets are required to be held by a third-party custodian in jurisdictions such as the US and EU. *Id.* at n.37.

and establishing capital requirements to act as “shock absorbers” to protect depositors against losses in the value of these illiquid assets.<sup>7</sup>

In the asset management model, the manager’s obligations to investors are not comparable to those of banks to depositors. As noted above, asset managers manage assets as fiduciaries on behalf of their funds and other clients, relying on generally stable fee-based income instead of investing on behalf of the firm to obtain the potential for positive performance with high-risk assets. As the consultation acknowledges, fund investors understand that portfolio results, positive or negative, belong to them alone and accept the risk that their investments may lose value.<sup>8</sup> Unlike with bank deposits, the risk of loss is inherent in an investment, including an investment in a regulated fund. Asset managers are not engaged in a “shadow” form of banking. They provide *different* services and maintain significantly *different* organizational structures that appropriately manage risk for their clients. For all of these reasons, it would not make sense for a systemic risk assessment methodology to focus at the level of the asset manager.

### Asset Managers and Their Funds Collectively

Based on our comments above regarding families of funds and asset managers, we do not see any merit to this approach.

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<sup>7</sup> Insurance companies, like banks, put their balance sheets at risk, evidenced by their state-imposed capital requirements, which account for risk in both their assets and their liabilities (the insurance risk) in order to protect policyholders. See, e.g., Douglas J. Elliott, Brookings, *Regulating Systemically Important Financial Institutions That Are Not Banks* 16, 20 (May 9, 2013), <http://www.brookings.edu/research/papers/2013/05/09-regulating-financial-institutions-elliott>.

<sup>8</sup> Consultation at 29 (stating that “[u]nlike banks, for instance, where capital is set aside to protect depositors and other creditors against the risk of losses, investment management is characterized by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund’s invested portfolio.”).

**Evaluation of Systemic Importance:  
Why it is Critical to Consider Both Size and Leverage as a First Measure**

The consultation proposes a materiality threshold of US \$100 billion of fund net assets for determining the assessment pool of investment funds to be evaluated for possible designation as NBNI G-SIFIs. This threshold would single out just 14 funds—all regulated US funds—as the *only* funds worldwide that automatically would be subjected to further examination.

This appendix provides data and analysis supporting the views in the body of our comment letter that: (1) a materiality threshold based entirely on size is inappropriate because size alone reveals very little about whether an investment fund could pose risk to the global financial system; (2) the proposed US \$100 billion threshold does not serve to filter the universe of investment funds in any way that would usefully advance the stated objectives of the G20 and the FSB; (3) including consideration of balance sheet leverage in the materiality threshold would help regulators better focus their attention and efforts on entities that—in contrast to regulated funds—conceivably could raise global financial stability concerns; and (4) incorporating leverage as a consideration for initial screening purposes would advance the FSB’s stated goal of treating different types of financial entities as consistently as possible, because leverage is implicit when considering which banks should be included in an assessment pool.

The data also support our view that any “interconnections” that regulated US funds have (*e.g.*, through interactions with counterparties) pose very modest risks because these funds have little or no leverage.

**B.1     A Materiality Threshold of US \$100 Billion Would Single Out 14 Large Regulated US Funds**

A US \$100 billion materiality threshold would capture only 14 funds across the entire world. All of these funds are regulated US funds (Figure B.1). Of these, one is an ETF that is structured as a UIT, and three are money market mutual funds. The remaining 10 are other stock and bond mutual funds (“mutual funds”). Six of the funds are index funds.

**Figure B.1**  
**Regulated US Funds with Net Assets > \$100 Billion and Their Leverage Ratios**

| <b>Fund name</b>                         | <b>Net assets, Dec 2013<sup>1</sup></b> | <b>Leverage ratio<sup>2</sup></b> |
|------------------------------------------|-----------------------------------------|-----------------------------------|
| <b>Mutual funds</b>                      |                                         |                                   |
| Vanguard Total Stock Market Index        | \$307.3                                 | 1.01                              |
| PIMCO Total Return Fund                  | \$237.3                                 | 1.18                              |
| Vanguard Institutional Index Fund        | \$162.8                                 | 1.00                              |
| Vanguard 500 Index Fund                  | \$159.8                                 | 1.00                              |
| American Funds Growth Fund of America    | \$138.9                                 | 1.00                              |
| CREF Stock Account                       | \$126.5                                 | 1.05                              |
| Vanguard Total International Stock Index | \$113.5                                 | 1.06                              |
| American Funds EuroPacific Growth Fund   | \$112.4                                 | 1.01                              |
| Fidelity Contra Fund                     | \$111.1                                 | 1.01                              |
| Vanguard Total Bond Market Index         | \$108.1                                 | 1.08                              |
| <b>ETFs</b>                              |                                         |                                   |
| SSgA SPDR S&P 500 ETF Trust              | \$174.9                                 | 1.00                              |
| <b>Money market mutual funds</b>         |                                         |                                   |
| Vanguard Prime Money Market Fund         | \$131.8                                 | 1.01                              |
| Fidelity Cash Reserves                   | \$119.2                                 | 1.01                              |
| JP Morgan Prime Money Market Fund        | \$117.8                                 | 1.01                              |

<sup>1</sup>Lipper data as of December 31, 2013.

<sup>2</sup>Data comes from each fund's most recent financial statements. Leverage ratio is measured as gross AUM of the fund/NAV of the fund.

Note: Dollars are in billions.

Sources: Fund documents; Lipper

In the remainder of this appendix, references to “the large regulated US funds” or the “regulated funds with assets greater than \$100 billion” include all of the funds listed above other than the three money market funds.

## **B.2 Large Regulated US Funds Have Virtually No Leverage**

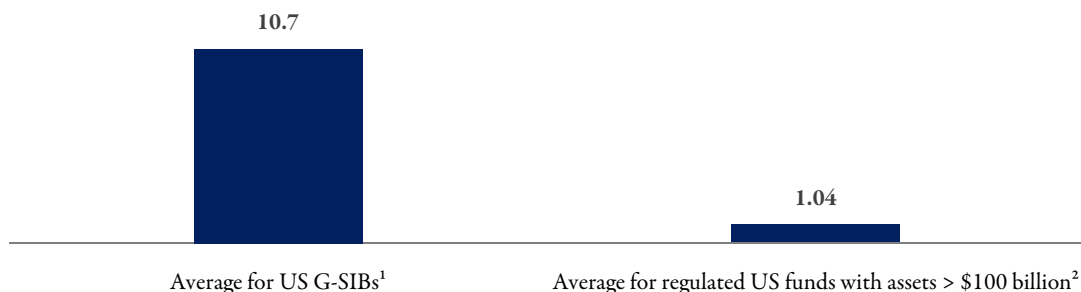
Due to regulatory limits on leverage and as a matter of normal industry practice, regulated US funds generally have little if any leverage. The consultation defines leverage for an investment fund as a fund's gross assets under management divided by its net asset value. Figure B.1 shows that the 14 regulated US funds that have assets greater than \$100 billion have virtually no leverage.

The leverage ratios for these regulated US funds stand in contrast to those for global systemically important banks. Figure B.2 compares the average leverage ratio for the large regulated US funds with

the average leverage ratio for US G-SIBs.<sup>1</sup> The average leverage ratio of US G-SIBs is 10.7, indicating for these large banks, one dollar of equity supports more than ten dollars of assets.<sup>2</sup>

**Figure B.2**

**Leverage Ratios for G-SIBs and Regulated US Funds with Assets > \$100 Billion**



<sup>1</sup>As reported by FDIC for 2013:Q2.

<sup>2</sup>Measured as a fund's total assets relative to a fund's total net assets.

Sources: *Investment Company Institute, FDIC, fund documents*

**B.3    The Largest Regulated US Funds are Small Compared to G-SIBs**

Even the largest regulated US funds are small compared to G-SIBs. Figure B.3 compares the assets of US G-SIBs with those of the regulated US funds with assets greater than \$100 billion. The largest US G-SIB has assets of \$2,439 billion compared to \$307 billion for the world's largest mutual fund. The average US G-SIB has assets of \$1,278 compared to the average of \$159 billion for the regulated US funds with assets greater than \$100 billion.

The fact that regulated US funds are generally much smaller than G-SIBs and use little, if any, leverage illustrates that the proposed materiality threshold of US \$100 billion in AUM produces an assessment pool of funds that have vastly different risk profiles from those of G-SIBs. This is important, because as the next section shows, for a G-SIB, size goes hand-in-hand with indebtedness, and it is the amount of indebtedness relative to the size of the economy that creates systemic risk.

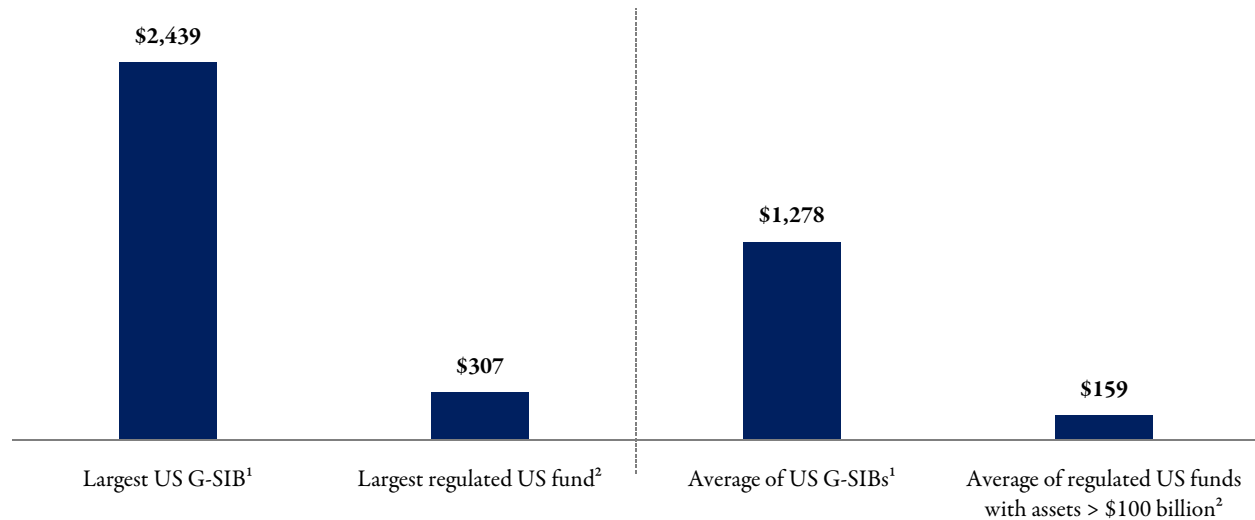
<sup>1</sup> The leverage ratio for a US G-SIB is measured here as a bank's total assets divided by the book value of the bank's equity.

<sup>2</sup> Assets for US G-SIBs are as reported by the FDIC. [See "Capitalization Ratios for Global Systemically Important Banks \(G-SIBs\)," Federal Deposit Insurance Corporation.](#)

**Figure B.3**

**Regulated US Funds With Assets Greater than \$100 Billion Are Dwarfed by Size of US G-SIBs**

*Assets, billions of US dollars<sup>1</sup>*



<sup>1</sup>Assets for US G-SIBs are those reported by FDIC for G-SIBs as of 2013:Q2.

<sup>2</sup>Assets for regulated US funds are those reported by Lipper as of December 31, 2013.

Sources: Investment Company Institute, Lipper, FDIC

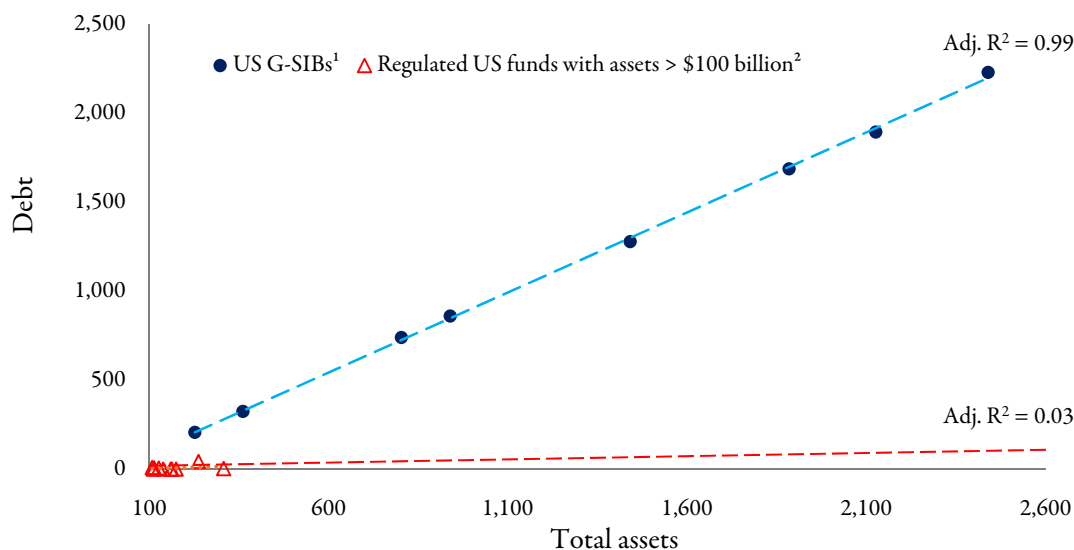
**B.4 Size Means Greater Indebtedness for G-SIBs but Not For Regulated US Funds**

The size of a bank's balance sheet and the amount of its debt go hand-in-hand: the larger the bank, the more debt the bank has. This simply reflects the nature of banks, which is to take deposits (thus, by definition creating indebtedness), use those deposits to make loans, and seek to earn a spread on the difference between borrowing and lending rates.

In contrast to banks, larger size does not imply that a regulated fund has a greater dollar amount of indebtedness. A fund could be quite large and have little, if any, outstanding debt. In fact, the world's largest regulated fund, which is a \$307 billion index mutual fund whose target index is the entire US stock market, has essentially no debt at all (a leverage ratio of 1.01).

**Figure B.4**  
**Large Size Does Not Imply that a Regulated US Fund with Assets Greater than \$100 Billion Is Systemically Important**

*Billions of dollars*



<sup>1</sup>Assets for US G-SIBs are those reported by FDIC for G-SIBs as of 2013:Q2.

<sup>2</sup>Assets for regulated US funds are those reported by Lipper as of December 31, 2013.

Sources: Investment Company Institute, Lipper, fund documents

To illustrate, Figure B.4 shows a scatter plot of assets and debt for both US G-SIBs and regulated US funds with assets greater than \$100 billion. As indicated by the “line of best fit,” there is a strong, nearly one-to-one, relationship between the assets of US G-SIBs and the dollar amount of debt they have taken on.<sup>3</sup> In contrast, there is essentially no relationship between fund assets and the amount of debt that large regulated US funds have.<sup>4</sup>

Thus, for banks, size (which includes leverage) provides a very strong indicator of the risk a G-SIB might pose to the stability of the global financial system through leverage and debt. In contrast, for a regulated US fund, size alone does not convey *any* information about the risks a fund might pose to global financial stability.

To make this point concrete, consider the following. As of 2013, regulated US funds with assets greater than \$100 billion had an average leverage ratio of 1.04. As of the second quarter of 2013, the smallest US G-SIB had indebtedness of \$207 billion. A regulated US fund with a leverage ratio of 1.04 (the average for the 11 regulated US funds with assets greater than \$100 billion) would need to have assets

<sup>3</sup> The “line of best fit” is a linear regression of bank debt on bank assets. In that regression, the coefficient on bank assets is 0.90, which is statistically significantly different from zero, but indicates that the relationship is slightly less than a one-to-one.

<sup>4</sup> For regulated US funds with assets greater than \$100 billion, the “line of best fit” is a linear regression of fund debt on fund assets. The coefficient on fund assets is 0.07 and is statistically insignificantly different from zero.

of about \$5.4 trillion to match this level of dollar indebtedness.<sup>5</sup> Viewed another way, a US mutual fund by law is permitted have a leverage ratio of up to 1.5. If such a fund existed, it would need to have assets of \$621 billion to achieve a level of dollar indebtedness equal to that of the smallest US G-SIB. That amount is twice the size of what is currently the world's largest mutual fund.

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<sup>5</sup> This is seen by noting that \$5.4 trillion times .04 (the average percent indebtedness of the 11 US regulated funds with assets greater than \$100 billion) equals \$216 billion, very close to the \$207 billion indebtedness of the smallest G-SIB.

## **Comprehensive Regulatory Regime for US Mutual Funds**

Regulated US funds are subject to comprehensive requirements under the Investment Company Act of 1940, other federal securities laws, and related Securities and Exchange Commission regulations. These protections, both individually and collectively, serve to protect the interests of fund investors and to mitigate risk to the broader financial system.

This discussion focuses on the regulation of mutual funds, which are the predominant form of regulated fund in the US. Daily redeemability of fund shares at net asset value is a defining feature of mutual funds and one around which many of the requirements applicable to them are built. The regulatory framework is slightly different—but no less stringent—for closed-end funds, which do not promise daily redeemability but rather list their shares for trading on a national securities exchange; for UITs, which are redeemable but are required by law to have a largely fixed portfolio that is not actively managed or traded; and for ETFs, which are organized as mutual funds or UITs but whose shares trade intraday on stock exchanges like closed-end funds.

For a more thorough discussion of the comprehensive regulatory framework applicable to regulated US funds and their managers, see Appendix A to ICI’s 2013 Investment Company Fact Book, available at [www.icifactbook.org](http://www.icifactbook.org).

### *Daily Valuation of Fund Assets*

US mutual funds must value all their portfolio holdings on a daily basis, based on market values if readily available. If there is no current market quotation for a security or the market quotation is unreliable, the fund’s board of directors or trustees (a substantial majority of whom typically are independent of the fund’s manager)<sup>1</sup> has a statutory duty to “fair value” the security in good faith.<sup>2</sup> The mutual fund uses the values for each portfolio holding to calculate the net asset value (“NAV”) of its shares each business day, using pricing methodologies established by the fund board. The daily NAV is the price used for all transactions in fund shares. As the SEC has observed, these pricing requirements are critical to ensuring that mutual fund shares are purchased and redeemed at fair prices and that shareholder interests are not diluted.<sup>3</sup> They also promote market confidence, because they allow investors, counterparties and others to understand easily the actual valuations of fund portfolios.

Given the importance of the pricing process, mutual funds have extensive policies and procedures designed to ensure that fund portfolio securities are properly valued and that the fund’s

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<sup>1</sup> For further discussion of the fund board’s role and responsibilities, see *Independent Board Oversight* below.

<sup>2</sup> “Fair value” refers to the amount the fund might reasonably expect to receive for the security upon its current sale. See Accounting Series Release No. 118, SEC Release No. IC-6295, 35 Fed. Reg. 19986 (Dec. 23, 1970).

<sup>3</sup> See, e.g., Compliance Programs of Investment Companies and Investment Advisers, SEC Release No. IC-26299, 68 Fed. Reg. 74714, 74718 (Dec. 24, 2003) (adopting Rule 38a-1 under the Investment Company Act).

NAV accurately reflects the fund's net asset value per share. Valuation policies generally serve to: define the roles of various parties involved in the valuation process; describe how the fund will monitor for situations that may necessitate fair valuation of one or more securities; describe board-approved valuation methodologies for particular types of securities; and describe how the fund will review and test fair valuations to evaluate whether the valuation procedures are working as intended. These policies are a critical component of a mutual fund's governance process and compliance program, and accordingly are a significant area of focus for the SEC during inspections and examinations.<sup>4</sup> Valuation is also a critical component of the audit process.<sup>5</sup>

### *Liquidity to Support Redemptions*

At least 85 percent of a mutual fund's portfolio must be invested in "liquid securities," which are defined as any assets that can be disposed of within 7 days at a price approximating market value.<sup>6</sup> On an ongoing basis, mutual funds monitor the overall level of liquidity in their portfolios as well as the liquidity of particular securities, as circumstances warrant. Many mutual funds adopt a specific policy with respect to investments in illiquid securities; these policies are sometimes more restrictive than the SEC guidelines. Although an unexpected market event potentially could cause certain previously liquid securities to become illiquid, the SEC has determined that the 85 percent standard should ensure a mutual fund's ability to meet redemptions.<sup>7</sup>

### *Leverage*

The Investment Company Act and related guidance from the SEC and its staff strictly limit mutual funds' ability to take on leverage. These limitations stem from Section 18(f) of the Investment Company Act, which prohibits a mutual fund from issuing a class of senior security or selling any senior security of which it is the issuer, but permits borrowing from a bank, provided that there is asset coverage of at least 300 percent for all such borrowings. As a result, the maximum ratio of debt-to-assets allowed by law is 1-to-3, which translates into a maximum allowable leverage ratio of 1.5-to-1.

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<sup>4</sup> For more detail, *see generally* ICI, Independent Directors Council and ICI Mutual Insurance Company, *An Introduction to Fair Valuation*, (Spring 2005), available at [http://www.ici.org/pdf/05\\_fair\\_valuation\\_intro.pdf](http://www.ici.org/pdf/05_fair_valuation_intro.pdf).

<sup>5</sup> A mutual fund's financial statements must be audited annually by an independent public accountant registered with the US Public Company Accounting Oversight Board ("PCAOB"). Among other things, the independent accountant examines the fund's valuation policies and procedures to confirm that the prices used to value the fund's security holdings are consistent with generally accepted accounting principles. As required by SEC rules, the independent accountant must verify 100 percent of the security valuations applied to the fund's portfolio at the balance sheet date; the accountant also would typically review valuations for selected dates throughout the year. We note that the auditing of security values and fair value measurements is a significant area of focus in PCAOB inspections of public accounting firms.

<sup>6</sup> *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992); SEC Division of Investment Management, IM Guidance Update No. 2014-1 at 6 (Jan. 2014), available at <http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf> (explaining that the 1992 Guidelines are Commission guidance and remain in effect).

<sup>7</sup> SEC Release No. IC-18612, *supra* note 6 (stating that the 85 percent standard was "designed to ensure that mutual funds will be ready at all times to meet even remote contingencies").

### *Transactions with Affiliates*

The Investment Company Act contains a number of strong and detailed prohibitions on transactions between a mutual fund and affiliated organizations such as the fund's manager, a corporate parent of the fund's manager, or an entity under common control with the fund's manager. Among other things, Section 17 of the Investment Company Act prohibits transactions between a fund and an affiliate acting for its own account, such as the buying or selling of securities (other than those issued by the fund) or other property, or the lending of money or property. It also prohibits joint transactions involving a mutual fund and an affiliate. In some cases, transactions involving an affiliate are permitted in accordance with SEC rules and exemptive orders, which impose conditions designed to protect investors and require the fund's board of directors, including the independent directors, to adopt and review procedures designed to ensure compliance with those conditions. The detailed and restrictive provisions of the Investment Company Act governing dealings with affiliates are no less stringent than those contained in Sections 23A and B of the US Federal Reserve Act. These Investment Company Act provisions also prevent most types of sponsor support, absent prior approval by the SEC on a case-by-case basis.

### *Custody of Assets*

The Investment Company Act requires mutual funds to maintain strict custody of fund assets, separate from the assets of the fund manager. This requirement is intended to safeguard fund assets from theft or misappropriation. Nearly all mutual funds use a bank custodian for domestic securities, and the custody agreement is typically far more elaborate than the arrangements used for other bank clients.<sup>8</sup> Notably, under the Investment Company Act regulatory structure, collateral posted by a mutual fund must be placed with an eligible custodian and maintained as required under the Investment Company Act. The benefits of this approach were highlighted following the collapse of Lehman Brothers, as mutual funds with such custody arrangements were able to take control of both their own collateral and the collateral posted by Lehman with far less difficulty than market participants with different custody arrangements.

### *Diversification Requirements*

All US mutual funds are required by federal tax laws to be, among other things, diversified.<sup>9</sup> Generally speaking, with respect to half of the fund's assets, no more than 5% may be invested in the securities of any one issuer; with respect to the other half, the limit is 25%. In other words, the minimum diversification a fund could have is 25% of its assets in each of two issuers, and 5% of its assets in each of 10 additional issuers. If a fund elects to be diversified for purposes of the Investment

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<sup>8</sup> The Investment Company Act and rules thereunder permit other limited custodial arrangements: Rule 17f-1 (broker-dealer custody); Rule 17f-2 (self custody); Rule 17f-4 (securities depositories); Rule 17f-5 (foreign banks); Rule 17f-6 (futures commission merchants); and Rule 17f-7 (foreign securities depositories). Foreign securities are required to be held in the custody of a foreign bank or securities depository.

<sup>9</sup> See Subchapter M of the Internal Revenue Code.

Company Act (and most do), the requirements are more stringent—with respect to 75% of its portfolio, no more than 5% may be invested in any one issuer.

### *Transparency*

Under the federal securities laws and applicable SEC regulations, mutual funds are subject to the most extensive disclosure requirements of any financial product. Funds provide a vast array of information about their operations, financial conditions, contractual relationships with their managers and other matters to regulators, the investing public, media, and vendors such as Morningstar. The marketplace simply does not have access to anything even approaching this degree of transparency about banks and their holdings. In fact, some believe that the opacity of banks' balance sheets contributed to the spread and severity of the 2008 financial crisis.<sup>10</sup>

More specifically, mutual funds are required to maintain a current prospectus, updated at least annually, which provides investors with information about the fund and its operations, investment objectives, investment strategies, risks, fees and expenses, and performance, among other things. The prospectus also must describe all principal investment strategies and risks of a fund. The prospectus must be provided to investors in connection with a purchase of fund shares.<sup>11</sup>

Mutual fund investors receive annual reports containing audited financial statements within 60 days after the end of the fund's fiscal year, and semi-annual reports containing unaudited financials within 60 days after the fiscal year mid-point. These reports must contain updated financial statements, a comprehensive list of the fund's portfolio securities including derivatives contracts, management's discussion of financial performance, and other specified information. Following their first and third quarters, funds file an additional form with the SEC, Form N-Q, disclosing their complete portfolio holdings. The SEC makes Form N-Q publicly available upon receiving it. These quarterly portfolio holdings disclosures include any assets earmarked against derivatives transactions, as well as any assets posted as collateral.<sup>12</sup> They also list open derivatives positions, including terms of the contracts, their notional value and fair value. The SEC staff takes the view that for over-the-counter derivatives such as swaps, "terms" of the contracts include the identity of the counterparty.<sup>13</sup> This high degree of transparency allows investors and other market participants a clear understanding of a fund's investment strategy, holdings, and financial condition.

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<sup>10</sup> *The Financial Crisis of 2008 in Fixed Income Markets*, Gerald P. Dwyer and Paula Tkac, Working Paper 2009-20, Federal Reserve Bank of Atlanta (Aug. 2009).

<sup>11</sup> Additional information must be made available to investors upon request in a Statement of Additional Information, commonly referred to as the SAI.

<sup>12</sup> Funds typically do not post substantial portions of their portfolios as collateral.

<sup>13</sup> See Letter from Barry Miller, Associate Director, Office of Legal and Disclosure, Division of Investment Management, SEC to Karrie McMillan, General Counsel, ICI (July 30, 2010).

### *Independent Board Oversight*

Mutual funds are required by statute to have a board of directors (or trustees), which generally must have at least a majority of members who are independent of the fund's investment manager.<sup>14</sup> Fund directors are subject to duties of care and loyalty under state law, and the US Supreme Court has said that the independent directors serve as “watchdogs” for the interests of fund investors.<sup>15</sup> In broad terms, the fund board oversees the management, operations and investment performance of the fund. Directors also have significant and specific responsibilities under the federal securities laws, including signing the fund's registration statement (and assuming strict liability for any material misstatements or omissions therein), approving the contract with the fund's investment manager and overseeing the manager's provision of services under that contract, and overseeing potential conflicts of interest as well as the fund's compliance program.<sup>16</sup>

### *Mandatory Compliance Programs*

While compliance has always been a cornerstone for mutual funds, the adoption of the fund compliance program rule (Rule 38a-1 under the Investment Company Act) in late 2003 introduced formalized practices and new requirements for funds and their boards, and presented fund boards with new tools for overseeing compliance. Under the rule, mutual funds must adopt and implement written policies and procedures reasonably designed to prevent violations of the federal securities laws. These policies and procedures must provide for the oversight of compliance by the fund's key service providers—its investment manager(s), principal underwriter(s), administrator(s), and transfer agent(s). Funds must review at least annually the adequacy of their own policies and procedures, as well as those of their service providers, and the effectiveness of their implementation.

Rule 38a-1 also requires mutual funds to designate a chief compliance officer (“fund CCO”) who is responsible for administering the fund's compliance policies and procedures.<sup>17</sup> The rule contains provisions designed to promote the independence of the fund CCO from the fund's investment manager. Specifically, the fund board, including a majority of the independent directors, must approve the appointment and compensation (and, if necessary, the removal) of the fund CCO. At least

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<sup>14</sup> In fact, the number of independent directors on a fund board is typically far higher than required by law. As of year-end 2012, independent directors made up three-quarters of boards in 85 percent of fund complexes. See Independent Directors Council/Investment Company Institute, *Overview of Fund Governance Practices, 1994–2012*, available at [http://www.idc.org/pdf/pub\\_13\\_fund\\_governance.pdf](http://www.idc.org/pdf/pub_13_fund_governance.pdf).

<sup>15</sup> *Burks v. Lasker*, 441 U.S. 471 (1979).

<sup>16</sup> For a more complete discussion of the oversight role of fund boards, see, e.g., *Frequently Asked Questions About Mutual Fund Directors*, available at [http://www.idc.org/pubs/faqs/faq\\_fund\\_gov\\_idc](http://www.idc.org/pubs/faqs/faq_fund_gov_idc); *Fundamentals for Newer Directors*, available at <http://www.fundamentals.idc.org>; and American Bar Association Section of Business Law, *Fund Director's Guidebook* (3<sup>rd</sup> ed. 2006), available at <http://apps.americanbar.org/abastore/index.cfm?pid=5070526&section=main&fm=Product.AddToCart>.

<sup>17</sup> Rule 206(4)-7 under the Investment Advisers Act of 1940 imposes similar requirements on all federally registered investment managers (including managers of mutual funds).

annually, the fund CCO must provide a written report to the fund board that addresses, among other things, the operation of the fund's (and its service providers') policies and procedures and each material compliance matter that occurred since the date of the last report. Although the rule requires compliance reviews and reports to be undertaken at least annually, such reviews and reports may occur on a more frequent basis, or on an ongoing basis throughout the year.

### *SEC Oversight*

The SEC is tasked with monitoring and enforcing mutual funds' compliance with the Investment Company Act as well as all other applicable federal securities laws and regulations. The SEC staff promotes compliance with the federal securities laws through outreach, publications, and inspections of mutual funds and their managers conducted by SEC examiners, accountants, and lawyers. These inspections include a detailed review of the funds' advertisements, books and records, capital structure, fee structure, investment management contracts, corporate governance, best execution and sales practices. In addition, as part of its robust disclosure review, the SEC reviews all mutual fund registration statements. This disclosure document includes, among other things, the funds' investment objectives and goals, capital structure, risk disclosures, fee table, financial highlights information and financial intermediary compensation.

## **Comments on the Proposed Indicators**

***Q6-5. Are the proposed indicators appropriate for assessing the relevant impact factors? If not, please provide alternative indicators and the reasons why such measures are more appropriate.***

As discussed in the body of our comment letter, we do not believe regulated funds should be considered for G-SIFI designation based on any reading of the five impact factors outlined in the consultation—size, interconnectedness, substitutability, complexity and global activities. In the event the FSB decides to adopt an assessment methodology that includes various indicators for use in analyzing how these five impact factors should be applied to investment funds, we provide our thoughts on the proposed indicators below.

### **Factor 1: Size**

#### **Indicator 1-1: Net assets under management (AUM or NAV) for the fund**

The consultation states that “[i]n theory, the larger the size of a fund, the greater its potential impact on counterparties (counterparty channel) and markets (market channel). This is a key indicator for determining systemic importance and thus, it is proposed that this indicator is used to determine the assessment pool of investment funds subject to the methodology.”<sup>1</sup>

See our comments at pp. 11-12 of the comment letter explaining that size alone reveals very little about an investment fund’s potential to pose systemic risk and emphasizing the importance of considering other characteristics such as the degree of leverage, and the fund’s structure, investment strategies, portfolio composition, and investor demographics.

### **Factor 2: Interconnectedness**

#### **Indicator 2-1: Leverage ratio**

Consistent with our views on the relationship between leverage and interconnectedness (see comment letter at pp. 13 -14), the consultation proposes using a fund’s leverage ratio as an indicator of a fund’s interconnectedness. Leverage ratio would be measured by “Gross AUM of the fund/NAV of the fund.”

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<sup>1</sup> Consultation at 33. See our comments at pp. 11-12 of the comment letter cautioning against the use of a materiality threshold based solely on size and recommending the addition of a leverage component. Our recommendation to add a leverage component appears to be consistent with the indicator role that the FSB envisions for net assets under management; namely, that “the larger the size of a fund, the greater its potential impact on counterparties.” A fund, regardless of its size, can only pose potential risk to its counterparties to the extent that the fund’s positions with those counterparties involve leverage.

Given the role of leverage in multiplying losses and spreading risks among interconnected firms in times of strain, we strongly agree that leverage ratio is a relevant measure to review in connection with assessing the risks posed by an investment fund's "interconnectedness." In addition, we believe that the consultation correctly defines leverage ratio as Gross AUM of the fund/NAV of the fund.

#### Indicator 2-2: Counterparty exposure ratio

This indicator is defined as "total net counterparty exposure at the fund/Net AUM (NAV) at the fund." Total net counterparty exposure at the fund is defined as "the total sum of all residual uncovered exposures that the fund positions represent for its counterparties, after considering valid netting agreements and collateral/margin posted by the fund to its counterparties." The consultation explains that "[t]he more interconnected a fund, or the greater the counterparties' credit exposures are to that fund, the greater that fund's potential impact in case of default on counterparties (counterparty channel) and to the broader financial system."<sup>2</sup>

We agree in concept that "uncovered" counterparty exposures may be relevant to an analysis of "interconnectedness." It is difficult, however, to evaluate the utility of this proposed indicator without further guidance as to how it would be calculated. For example, for uncleared derivatives, the amount of "uncovered" counterparty exposures will change significantly once jurisdictions in the near term adopt margin requirements for uncleared derivatives.<sup>3</sup> Moreover, as indicated in Section V of our comment letter, US law and related guidance from the SEC and its staff require US funds to "cover" any future indebtedness by segregating liquid assets on its books or maintaining offsetting positions. These requirements help assure that a regulated US fund will be able to meet its obligations. The FSB should clarify that these coverage practices, like the posting of margin, are a form of coverage for purposes of Indicator 2-2.

#### Indicator 2-3: Intra-financial system liabilities

This indicator is "total net counterparty exposure at the fund in value, primarily with G-SIBs and G-SIIs." The consultation says that "[t]he larger the exposure of the fund to counterparties, especially with more systemically important financial entities, the greater the impact of its failure."<sup>4</sup>

This indicator would be subject to the same issues as discussed above regarding Indicator 2-2, since Indicator 2-3 is also based on "net counterparty exposure."

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<sup>2</sup> *Id.* at 34.

<sup>3</sup> *Margin Requirements for Non-Centrally-Cleared Derivatives*, Basel Committee on Banking Supervision and Board of the International Organization of Securities Commissions, September 2013, *available at* <http://www.iosco.org/library/pubdocs/pdf/IOSCOPD423.pdf>. National regulators are expected to adopt margin rules that are consistent with the international final margin policy framework for uncleared derivatives.

<sup>4</sup> Consultation at 34.

### **Factor 3: Substitutability**

As noted on pages xx-xx of our comment letter, the consultation correctly acknowledges that investment funds are highly substitutable. The consultation later states that while most investment funds are “generally substitutable,” some funds are “highly specialised and invest in thinly traded markets.” It proposes several indicators in order to assess the substitutability of these funds. Although none of the 14 regulated US funds that meet the proposed materiality threshold fits this description, we share our thoughts on the proposed indicators for “highly specialised” funds below.

#### **Indicator 3-1: Turnover of the fund related to a specific asset/daily volume traded regarding the same asset**

According to the consultation, this proposed indicator “attempts to measure a fund’s substitutability by its turnover related to a specific asset, as measured by the fund’s percentage of daily trading volume with respect to that asset.”<sup>5</sup> We agree that this kind of approach is relevant to a fund’s substitutability but we have a concern with the focus on “specific assets.” For example, it would be quite difficult, if not impossible, to measure the turnover of a fund’s holdings of stock issued by a given bank relative to the total market trading of the bank’s stock. Also, it is unclear how meaningful such an analysis would be for global systemic purposes if it were undertaken for each and every security (or issuer) held by a fund, regardless of the importance of that issuer to the global economy. Thus, we recommend considering broader measures, such as the total value of a fund’s stock trades relative to the relevant stock market or the total value of fund’s fixed income trades relative to the size of the relevant bond market.

#### **Indicator 3-2: Total fund turnover vs. total turnover of funds in the same category/classification**

The consultation contends that the higher this measure, “the higher the potential systemic risk of the fund.” We disagree. In our view, this proposed indicator would not provide meaningful information for evaluating substitutability, let alone potential systemic risk, because it does not take into account that there are multiple ways to invest in the markets. A fund’s turnover relative to that of other similar funds is irrelevant to whether there are available substitutes for that investment strategy. Another notable problem with this proposed indicator is that it would be quite sensitive to how “same category/classification” is defined. In the US, different data providers sometimes use similar sounding category names, such as “alternative fund,” but follow different criteria to decide which funds fall into such categories. Thus, “category/classification” would not lend itself to consistent application. For these reasons, we believe proposed Indicator 3-1, modified as we suggest above, is a far more useful measure.

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<sup>5</sup> *Id.*

### Indicator 3-3: Investment strategies (or asset classes) with less than 10 market players globally

The consultation notes that “[a]lthough funds generally are highly substitutable products . . . there may be particular niche markets where a large fund invests heavily, either cornering or occupying a significant portion of the market, and where like substitutes may not be available.”<sup>6</sup> We are not aware any such circumstances and believe they are highly unlikely to arise for a number of reasons. First, most funds, including large funds, hold highly diversified portfolios, making a very large position in a particular market less likely. Second, as noted earlier, regulated US funds, including the very largest funds, generally account for a small volume of overall stock and bond market trading, making it highly unlikely that a fund’s trading will influence the overall market. Third, even to the extent that a fund’s trading *might* move the prices of a “particular niche market,” the question arises whether that “niche” is systemically important. But even assuming such a situation existed, the proposed indicator would not help regulators find it. This is because the key issue, as suggested in the quoted statement, is a fund’s share of the underlying market—more specifically, what share of the overall trading volume the fund accounts for, not how many players there are. In addition, the proposed indicator poses practical difficulties because it is unclear how “market players” would be identified; some of them might not be funds. In any event, the number of market players would be a moving target as new entrants continually come into the market in response to investor demand for a particular strategy.

### **Factor 4: Complexity**

#### Indicator 4-1: OTC derivatives trade volumes at the fund/Total trade volumes at the fund

The consultation states that “[f]unds that engage in a significant volume of OTC derivatives in comparison to their total trading activity potentially could be exposed to higher counterparty risk.”<sup>7</sup> We question whether this proposed indicator would provide useful information as to either a fund’s “complexity” or its potential to pose systemic risk. For example, a bond fund’s use of swaps to manage interest rate duration or risk is not a complex investment strategy. We further note that if the concern is exposure to counterparty risk, it might make more sense to consider some measure of counterparty concentration rather than total volumes.

#### Indicator 4-2: Ratio (%) of collateral posted by counterparties that has been rehypothecated by the fund

The consultation contends that a high percentage “increases exposure risks for counterparties” because they “may not see their collateral returned if the fund does not honour its commitments.” We understand that “rehypothecation” is intended to refer to re-use of that collateral for the fund’s own separate purposes, such as where collateral received with respect to one transaction was posed as collateral in a second transaction. It is important to clarify this. Regulated US funds do not rehypothecate collateral in this sense. When regulated US funds engage in transactions such as

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<sup>6</sup> *Id.* at 35.

<sup>7</sup> *Id.*

securities lending, regulatory guidelines impose strict requirements on collateral practices that minimize the risks to counterparties. For example, the value of collateral received from a borrower must be equal to at least 100 percent of the value of the loaned securities and must be in the form of cash, U.S. government and agency securities, and, subject to limitations, certain bank guarantees and irrevocable bank letters of credit. As a matter of established market practice, regulated US funds almost always receive cash collateral, which is held in a segregated account and may be reinvested only in very high quality, highly liquid investments. The collateral must be marked to market daily, and additional collateral posted as needed to maintain at least 100 percent coverage.

Indicator 4-3: Ratio (%) of NAV managed using high frequency trading strategies

The consultation states that “[h]igh frequency trading strategies can introduce market risk” and that “the interaction between automated execution programs and algorithmic trading strategies can quickly erode liquidity and result in disorderly markets.”<sup>8</sup> In our estimation, this proposed indicator has little to do with the “complexity” of an investment fund and should be eliminated. To the extent the use of high frequency trading strategies raises regulatory concerns, activity-based regulation would be a more appropriate and effective way to address those concerns.

Indicator 4-4: Weighted average portfolio liquidity (in days)/Weighted average investor liquidity (in days)

According to the consultation, the lower this ratio (of “the number of days it takes to liquidate a portfolio of investments” to “the number of days it takes for an investor to realise their investment”), the lower the potential risk of the fund. With a lower ratio, “the fund is less exposed to liquidity risk and mismatch with investors’ liquidity demands.”<sup>9</sup> The consultation notes that the ratio varies depending on whether the historical data used are based on normal market conditions (which “will understate risk”) or on stressed market conditions.

This indicator appears to be designed to provide insight into a fund’s ability to meet redemptions and whether there is a mismatch between the portfolio liquidity and investor redemption rights. As currently formulated, however, it does not factor in some of the key information that would be important to such an analysis. This information includes net flows to a fund from investors and from other sources such as dividends and interest payments (rather than just focusing on outflows) and the liquidity management techniques funds have at their disposal (including those identified on page 30 of the consultation and, for US mutual funds with accounts held direct, the seven-day window in which to pay proceeds to a redeeming shareholder). We suggest modifying the proposed indicator to ensure that such information also is considered.

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<sup>8</sup> *Id.*

<sup>9</sup> *Id.*

#### Indicator 4-5: Ratio of unencumbered cash to gross notional exposure (or gross AUM)

The consultation states that the lower this ratio, “the higher the potential systemic risk of the fund as adverse market moves can cause the fund to run out of assets to satisfy margin calls or to post collateral.”<sup>10</sup> As the consultation recognizes, gross notional exposure is less relevant to investment funds other than hedge funds. The ratio of unencumbered cash to gross AUM is not a relevant measure of risk for regulated funds.

#### **Factor 5: Global Activities (cross-jurisdictional activities)**

##### Indicator 5-1: Number of jurisdictions in which a fund invests

According to the consultation, “[f]unds that invest globally may have a larger global impact than funds that invest in the securities of only a few jurisdictions.”<sup>11</sup> We question this assumption, which is not supported by any data. Investments in multiple jurisdictions could just as easily be indicative of reduced systemic risk based on, for example, greater diversification of the fund’s portfolio holdings across different markets and a wider base of fund investors, both of which would serve to mitigate risk.

##### Indicator 5-2: Number of jurisdictions in which the fund is sold/listed

The consultation states that funds sold or listed in many jurisdictions “may have a larger global impact with respect to their operations” than those sold in one or a few jurisdictions.<sup>12</sup> Similar to our comment on the previous indicator, when looking at this indicator, regulators should bear in mind that a more diversified, less correlated investor base may in fact reduce systemic risk.

##### Indicator 5-3: Counterparties established in different jurisdictions

The consultation notes that contract and bankruptcy laws can vary across jurisdictions. It states that “[t]he higher the number of jurisdictions faced by a fund through its trading counterparties, the potentially more complex the situation if the fund had to be liquidated.”<sup>13</sup> We question the assumption that a counterparty’s domicile will affect the liquidation of a fund. We are not aware of instances in which cross-border counterparty relationships have impeded the liquidation of a regulated fund.

***Q6-6. For “cross-jurisdictional” activities, should “the fund’s use of services providers in other jurisdictions (e.g., custody arrangements with service providers in jurisdictions other than where its primary regulator is based)” be used?***

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<sup>10</sup> *Id.*

<sup>11</sup> *Id.*

<sup>12</sup> *Id.*

<sup>13</sup> *Id.*

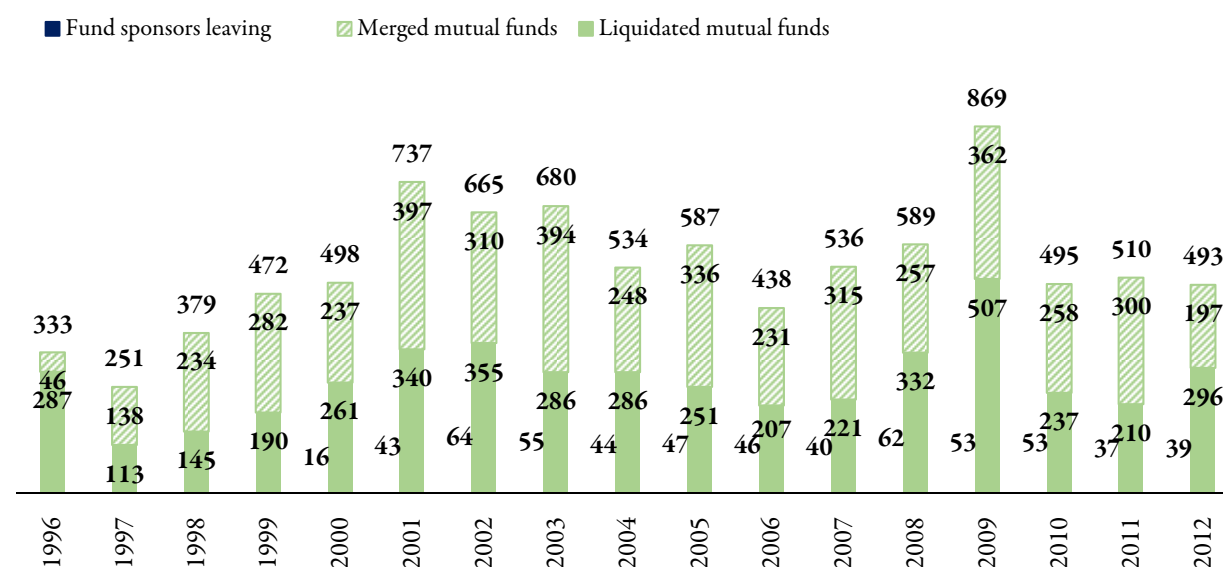
We note that use of a local custodian is required for a regulated US fund to invest internationally. As a result, the indicator suggested in Q6-6 is essentially identical to Indicator 5-1. For regulated US funds and UCITS, custody of fund assets is tightly prescribed by home jurisdiction fund regulations, and custody relationships are entered into with highly regulated banks, often designated G-SIBs, that offer global custody services through a network of local sub-custodians. Use of such custodians is a risk-mitigant for funds and investors, not an indicator of systemic risk.

### Liquidations of US Mutual Funds

In the US, mutual funds routinely close and mutual fund sponsors exit the business, without creating stress for investors or financial markets. Figure E.1 shows the number of US mutual funds that have been merged or liquidated in each year since 1996, as well as the number of mutual fund sponsors exiting the business in those same years. The numbers are significant. In 2012 alone, for example, 493 mutual funds were merged or liquidated, and 39 mutual fund sponsors left the business. Outside of press coverage by the media specific to the regulated US fund industry, these 2012 events passed with little notice and certainly did not create distress in the financial markets.

**Figure E.1**

**US Mutual Funds and Mutual Fund Sponsors Routinely Exit the US Mutual Fund Market\***



\*Data for number of mutual funds that are merged or liquidated include US mutual funds that are funds-of-funds and those that are not. Excludes ETFs and closed-end funds.

Source: Investment Company Institute

When a US mutual fund does need to liquidate, there is an established and orderly process by which the fund liquidates its assets, distributes the proceeds pro rata to investors and winds up its affairs. This process, which is spelled out on a step by step basis below, adheres to requirements in the Investment Company Act of 1940 and state or other relevant law based on the domicile of the fund. It includes consideration and approval by the mutual fund's board of directors, including the independent directors. All actions by the fund manager and the fund directors are undertaken in accordance with their fiduciary obligations to the fund.

### Process for Liquidating and Dissolving a US Mutual Fund\*

1. Consideration of whether to liquidate the fund, by fund manager and fund board
2. Determine whether approval by fund investors is needed, based upon state law and the fund's charter documents
3. Prepare a plan of liquidation and dissolution
4. Fund board to consider and approve the plan of liquidation and dissolution
  - a. Fund directors to consider the details of the proposed plan and the rationale for liquidating the fund
    - i. Is liquidation and dissolution in the best interests of the fund?
    - ii. Are there other viable options?
  - b. Directors will make a determination based on their duties to the fund
5. Announce the plan of liquidation and related details
  - a. Date on which fund will be closed to new investors
  - b. Date on which liquidation proceeds will be paid to investors ("Closing Date")
    - i. The Closing Date will depend upon factors such as portfolio liquidity, the degree of ease in converting portfolio securities to cash or cash equivalents, recommendations of the fund's portfolio manager, and the fund's investment strategy and objectives
  - c. Description of how purchases, redemptions and exchanges will be conducted during the period prior to the Closing Date
6. Fund to begin the liquidation process
  - a. Set aside reserves for liquidation-related expenses (typically limited)
  - b. Pay any debts or other obligations (often limited to previously accrued fees to service providers)
  - c. Begin to convert portfolio securities to cash or cash equivalents
7. Pay liquidation proceeds to investors on the Closing Date
8. File last financial reports with the SEC
9. File an application with the SEC for deregistration of the fund (on Form N-8F)
10. File with the state to dissolve the fund (typically a perfunctory filing)

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\* For further detail, see Jack Murphy, Julien Bourgeois and Lisa Price, *How a Fund Dies*, Review of Securities & Commodities Regulation, Vol. 43 No. 21 (Dec. 1, 2010).

## **The Asset Liquidation / Market Channel Hypothesis and the Experience of US Mutual Funds**

The asset liquidation / market channel hypothesis contemplates situations in which an investment fund, as a significant investor (or provider of liquidity) in some asset classes, may be forced to liquidate positions. The consultation posits that, in times of stress, such liquidations “could cause temporary distortions in market liquidity and/or prices that cause indirect stress to other market participants.” It asserts that such effects “may be amplified” by an investment fund’s use of leverage. The consultation further speculates that such effects may occasion a loss of investor confidence in a specific asset class, causing “runs” on other investment funds presenting similar features or conducting a similar strategy.<sup>1</sup>

This appendix provides evidence supporting the views in the body of our comment letter that the kinds of risks the consultation posits as arising through investment funds simply do not materialize with respect to regulated US funds.

### **1 Hypothesis That US Mutual Funds Could Be Destabilizing Has Been Voiced Repeatedly Since the Great Depression**

The suggestion that mutual funds could destabilize markets is not a new one. Indeed, such claims have been expressed in the US as far back as 1929.<sup>2</sup> Each time this hypothesis has been put forward, however, it has been questioned for lack of evidence and the dire outcomes predicted simply have *not* materialized.

In 1940, SEC officials testified in Congress that “if you were to have a run on ... [a mutual fund]—and it is no different from a run on a bank ... you will get a program of liquidation [of portfolio securities] which may result in ... an undesirable effect upon the stock market in general.” In the same hearings, however, others testified that mutual funds were not bank deposits and there was no evidence of “runs” on mutual funds in the late 1920s and early 1930s and, further, that the very conditions (*i.e.*, falling stock prices) that might cause some investors to redeem could be seen by other investors as a buying opportunity, leading them to increase their investments in mutual funds.<sup>3</sup>

Claims that mutual funds could be destabilizing were repeated in 1959 when a cover story in *Time* magazine reported the charge that “in a falling market, millions of panicky, inexperienced shareholders would redeem their shares, forcing the funds to liquidate huge blocks of stock and collapse the

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<sup>1</sup> Consultation at 29.

<sup>2</sup> See the discussion in Matthew P. Fink, *The Rise of Mutual Fund: An Insider’s View*, Oxford University Press, 2008, especially pages 38-39 and references therein.

<sup>3</sup> See *Investment Trusts and Investment Companies*, Hearings, Senate Banking Subcommittee, 76<sup>th</sup> Congress, 3d session, 1940.

market.”<sup>4</sup> Despite nine significant bear stock markets over the next 25 years, we have seen no evidence of investor panic or even heavy redemption of mutual fund assets during any of these market downturns.<sup>5</sup>

Such concerns were renewed yet again in 1994 by Henry Kaufman who argued “The technology is in place for a cascade of selling by investors in mutual funds [and that] excesses originating in the mutual funds area may be the source of an economic shock should an asset price bubble be suddenly burst.”<sup>6</sup> At that time, Donald Morgan, a Federal Reserve economist, countered that such risks appear remote because households invest in stock and bond mutual funds primarily to save for retirement.<sup>7</sup> Moreover, even Kaufman acknowledged that “we do not know how the ordinary investor in mutual funds will react when equity prices and bond prices continue to display spasms of volatility.”<sup>8</sup>

These same kinds of concerns were posited in the late 1990s with respect to mutual fund investments in emerging markets. As with mutual funds in general, the evidence indicates that such claims simply were not borne out by the data.<sup>9</sup>

## **2 Empirical Data Rebut the Asset Liquidation / Market Channel Hypothesis**

The consultation is concerned with situations in which an investment fund “has to liquidate its assets quickly, [which] may impact asset prices and thereby significantly disrupt trading or funding in key markets.”<sup>10</sup> In theory, for such a situation to arise, three conditions must prevail: First, an investment fund must be facing unusual circumstances—higher than expected redemption requests from investors, or a significant and unexpected market event. Second, the investment fund must be selling portfolio securities quickly, either in order to meet those redemptions or to protect fund assets against further capital losses. And third, the sales must represent a large enough fraction of total trading that they would substantially move prices (in order to cause the significant disruption that the consultation posits).

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<sup>4</sup> “Wall Street: The Prudent Man,” *Time*, June 1, 1959.

<sup>5</sup> See John Rea and Richard Marcis, “[Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944-95](#)” *Perspective, Investment Company Institute*, volume 2, number 2, March, 1996.

<sup>6</sup> Henry Kaufman, “Structural Changes in the Financial Markets: Economic and Policy Significance,” *Economic Review*, Federal Reserve Bank of Kansas City, second quarter, 1994.

<sup>7</sup> Donald Morgan, “Will the Shift to Stocks and Bonds By Households Be Destabilizing?,” *Economic Review*, Federal Reserve Bank of Kansas City, second quarter, 1994.

<sup>8</sup> Kaufman, *supra* note 6.

<sup>9</sup> See John Rea, “U.S. Emerging Market Funds: Hot Money or Stable Source of Investment Capital?” *Perspective, Investment Company Institute*, volume 2, number 6, December 1996; Mitchell A. Post and Kimberlee Millar, “[U.S. Emerging Market Equity Funds and the 1997 Crisis in Asian Financial Markets](#),” *Perspective*, volume 4, number 2, June 1998.

<sup>10</sup> Consultation at 3 (discussing the asset liquidation/market channel generally).

There is no evidence of these conditions ever arising for US mutual funds, which are by far the most common type of regulated US fund. Indeed, there is compelling evidence that they would not.

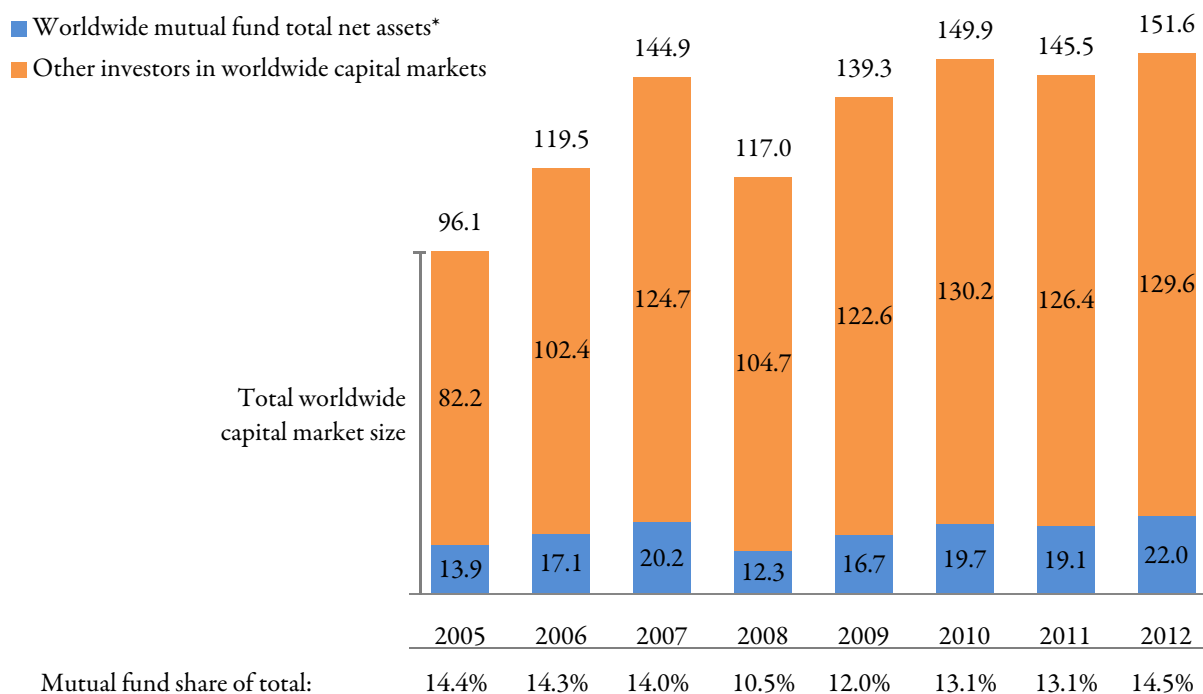
As shown below, there is strong evidence that investors in US mutual funds do not redeem heavily even during the most severe financial crises.

There is also strong evidence that, in the aggregate, mutual fund portfolio managers on net buy or sell portfolio securities almost entirely in response to investor flows. Because investor redemptions are modest even during periods of financial stress, funds' sales of portfolio securities also will be limited during such periods. Moreover, during periods of financial stress, portfolio sales tend to be more limited than investor redemptions because mutual funds maintain cash assets to help meet redemptions.

Finally, even if significant redemptions were to materialize, leading to significant sales of portfolio securities (as a percent of funds' assets), it is highly questionable whether such sales would significantly move market prices. Figure F.1 shows that regulated US funds and their counterparts in other jurisdictions (such as UCITS) hold only about 15 percent of the value of worldwide stock and bond markets. As this appendix shows later, the assets of US mutual funds are also small in comparison to overall US stock market capitalization.

**Figure F.1**  
**Mutual Fund Share of Worldwide Stock and Bond Markets**

*Trillions of US dollars, year-end, 2005–2012*



\*Data exclude ETFs and money market funds.

Sources: *International Investment Funds Association and International Monetary Fund*

### 3 Investors Do Not Redeem Heavily from US Mutual Funds During Periods of Financial Stress<sup>11</sup>

ICI has examined on numerous occasions the question of how US mutual fund investors react to volatility in stock and bond markets. Using data almost from the inception of the Investment Company Act in 1940—including the stock market crash of 1987, the bond market decline in 1994, the bursting of the dot.com bubble in the early 2000s, the financial market crisis of 2007-2009 and, most recently, the reaction of bond mutual fund investors in 2013 to a sharp rise in long-term interest rates as a result of monetary policy—the evidence clearly indicates that investors’ net redemptions from US mutual funds remain modest during even the worst financial crises.

#### *US Equity Mutual Fund Flows*

One overriding feature of the data on US mutual fund net flows is the modest level of net outflows from equity mutual funds, even during severe market downturns.<sup>12</sup> Assets in equity mutual funds have increased dramatically in the past 50 years (Figure F.2) and the number and percentage of households investing in mutual funds have increased significantly.<sup>13</sup> Variability in monthly net flows to equity mutual funds, however, has not increased, but has remained between approximately -4 to 4 percent of fund assets (Figure F.3). In fact, month-to-month percentage changes in net flows to equity funds have been much more moderate in the past 25 years than they were in the early- to mid-1980s. Net outflows from equity funds did not increase sharply even during periods of severe market downturns. Four periods are particularly illustrative.

#### 1945–1986

From 1945 to 1986, there were twelve major stock market cycles (as identified by peaks and troughs in the S&P 500 index) of varying magnitudes and lengths. In a number of these cases, investors on a net basis continued to *purchase* equity fund shares (*i.e.*, equity funds experienced net inflows) throughout stock market contractions.<sup>14</sup> The largest stock market downturn during this period occurred from January 1973 to December 1974, when the S&P 500 declined 42 percent. Net outflows from equity

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<sup>11</sup> The analysis in the remainder of this appendix excludes ETFs and money market funds.

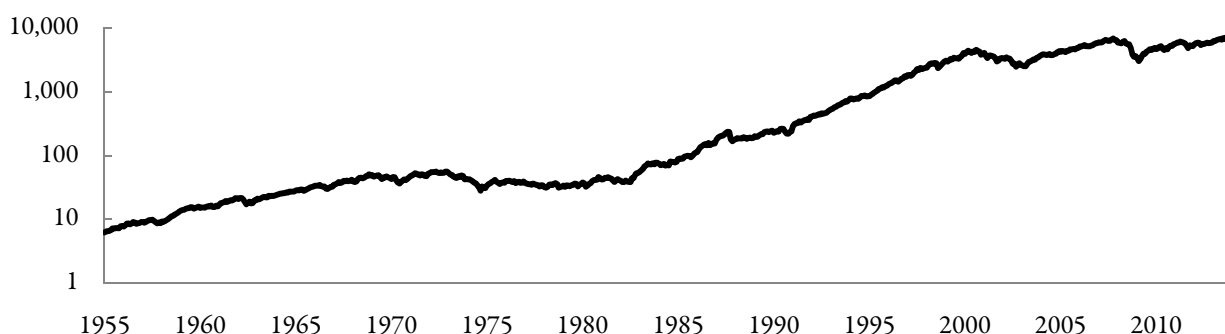
<sup>12</sup> The concept of “net flows” relates to the amount of money coming into or out of a mutual fund on a net basis. ICI defines net new cash flow as the dollar value of new sales of fund shares minus redemptions, plus net exchanges. A positive number for net new cash flow (or “net inflow”) indicates that new sales plus exchanges into funds exceeded redemptions plus exchanges out of funds. A negative number (“net outflow”) indicates redemptions plus exchanges out of funds exceeded new sales plus exchanges into funds. Net outflows, not redemptions, is the appropriate concept for measuring pressure that investors’ redemptions place on a fund because, in any given month, a fund typically experiences redemptions from certain investors but these are to a great extent offset (or even more than offset) by new purchases of fund shares by other investors.

<sup>13</sup> See *Investment Company Institute, 2013 Investment Company Fact Book*, 53<sup>rd</sup> edition, Figure 6.1.

<sup>14</sup> John Rea and Richard Marcis, “Mutual Fund Shareholder Activity During U.S. Stock Market Cycles, 1944-95” *Perspective*, Investment Company Institute, volume 2, number 2, March, 1996. Available at <http://www.ici.org/pdf/per02-02.pdf>.

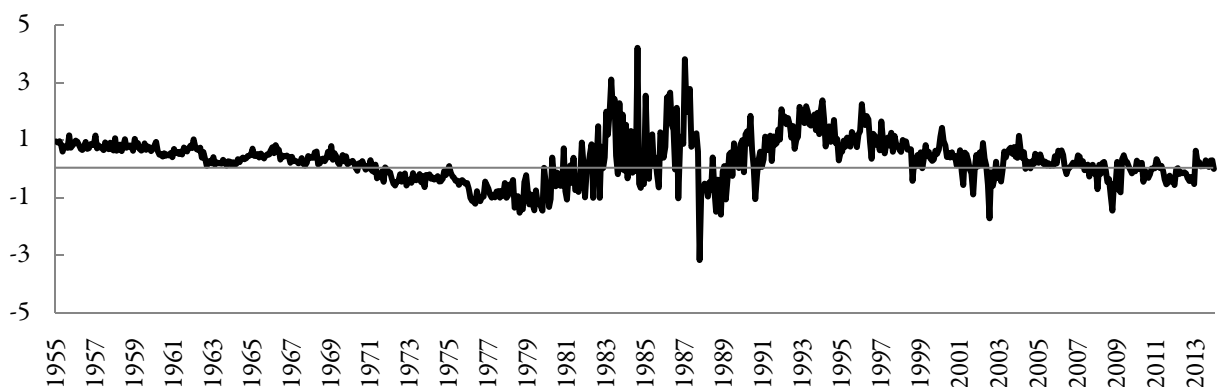
mutual funds over this period were modest, cumulating to \$3.2 billion, or 5.8 percent of equity fund assets. During this period, the maximum one-month net outflow from equity funds was 0.6 percent of equity fund assets. Thus, despite the fact that the stock market fell almost by half, mutual fund investors did not redeem precipitously; rather, they remained calm in the face of a vast stock market downturn.

**Figure F.2**  
**Total Net Assets of US Equity Mutual Funds**  
*Billions of dollars, monthly, 1955–2013*



*Source: Investment Company Institute*

**Figure F.3**  
**Flows to US Equity Mutual Funds as a Percent of US Fund Assets**  
*Percent, monthly, 1955–2013*



*Source: Investment Company Institute*

### Stock Market Crash: October–December 1987

Over the period October to December 1987, the stock market declined by 23 percent. Over these three months, net outflows from equity funds totaled only 4.2 percent of their assets. The largest one-month net outflow from equity funds during this period was 3.2 percent, which occurred in October 1987, when in a single month the S&P 500 declined by 22 percent.

### Bursting of Dot.Com Bubble: March 2000–September 2001

From December 31, 1987 to March 31, 2000 assets in equity mutual funds grew from \$175 billion to \$4.4 trillion, a nearly 25-fold increase. Nevertheless, over this period investors still redeemed only modestly during financial market stresses, such as during the bursting of the dot.com bubble.

From December 31, 1987 to March 31, 2000, the S&P 500 index rose 507 percent (from a level of 247 to 1499) and the NASDAQ index, which was then more reflective of small-cap stock prices, rose 1,286 percent (from a level of 330 to 4573). The dot.com bubble began to burst in mid-March 2000. From February 29, 2000 to September 28, 2001, the NASDAQ and S&P 500 indexes declined by 68 percent and 24 percent, respectively. Over this same period, however, equity funds received net *inflows* totaling \$227 billion. Equity funds did experience net outflows in five separate months during this period, but in only two cases (March 2001 and September 2001) did these net outflows total more than 0.5 percent of fund assets. Even in these two months, net outflows were hardly precipitous, totaling just 0.6 percent of equity fund assets in March 2001 and a bit more, 0.9 percent, in September 2001.<sup>15</sup>

### Financial Crisis: 2007–2009

During the recent financial market crisis, the stock market declined at historic rates, with the S&P 500 index falling 53 percent from October 31, 2007 to February 27, 2009. The market's decline in calendar year 2008 was the second worst annual decline in the United States since 1825. Given the magnitude of the decline, investors did, on net, redeem shares in equity funds. In the 17-month period November 2007 to March 2009, equity funds experienced net outflows cumulating to \$281 billion. These net outflows, however, equaled only 4.1 percent of the assets of equity funds at the beginning of this period (*i.e.*, as of October 2007). The bulk of these net outflows occurred during the worst of the financial crisis, July to December 2008. And yet, over these six months, the net outflows (\$205 billion) amounted to just 3.6 percent of equity fund assets.

These net outflows were modest from another perspective: they amounted to very little relative to the overall size of the US stock market. For example, in no month during the period from November 2007 to March 2009 did net outflows from equity funds total more than 0.5 percent of the market value of stocks listed on the New York Stock Exchange and NASDAQ (Figure F.4). The largest one-month net outflow from equity mutual funds was in October 2008, when equity mutual funds experienced

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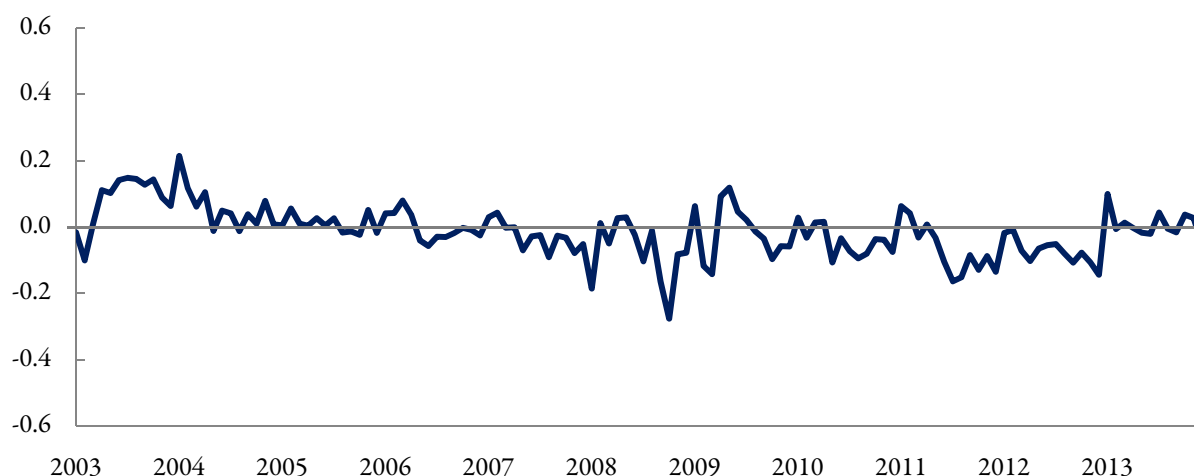
<sup>15</sup> Recall, however, that September 2001 was the month of the 9/11 attacks. During September 2001, the stock market (measured by the S&P 500 index) declined 8 percent and trading in the stock market was suspended for four days.

outflows of \$71 billion, equal to 0.44 percent of the \$15.9 trillion capitalization of the US stock market as of September 2008.

**Figure F.4**

**Net Flows to US Domestic Equity Mutual Funds as a Percent of Domestic Stock Market Capitalization\***

*Percent, monthly*



\*Includes market capitalization for the NYSE and NASDAQ stock exchanges.

*Source: Investment Company Institute and World Federation of Exchanges*

Market Crises Have Not Spurred Large Scale Net Outflows from Individual Equity Mutual Funds

The consultation expresses concern about whether net outflows from a single fund could potentially create distress, either through forced liquidation of securities or by the “distress of one particular fund leading to ‘runs’ on other funds.”

Evidence from net flows to individual funds provides evidence that such concerns are misplaced. Figure F.5 considers monthly flows (as a percent of fund assets) to individual US equity mutual funds over the period 1985 to 2013, as well as during three periods of market stress: October 1987, September 2001, and September to October 2008.

The blue bars represent flows to funds during “average market conditions.” On average over this period, monthly flows cluster tightly around zero. For example, on average between 1985 and 2013, 21 percent of the monthly fund flows are between -0.5 percent and 0.5 percent. Half of the monthly flows are between -1.0 percent and 1.0 percent. On average, most funds experience only very small inflows or outflows on a monthly basis. During periods of market stress, if certain individual funds or groups of funds experience large net outflows, the distribution of flows should shift significantly to the left.

This does not happen. For example, in October 1987, there was a small increase in the number of stock funds with outflows larger than “normal,” but, even then, most of this occurred with funds that had outflows of less than 6 percent of their assets. A few funds had outflows of 25 percent or more, but that was little different than the average month over the entire 29-year period.

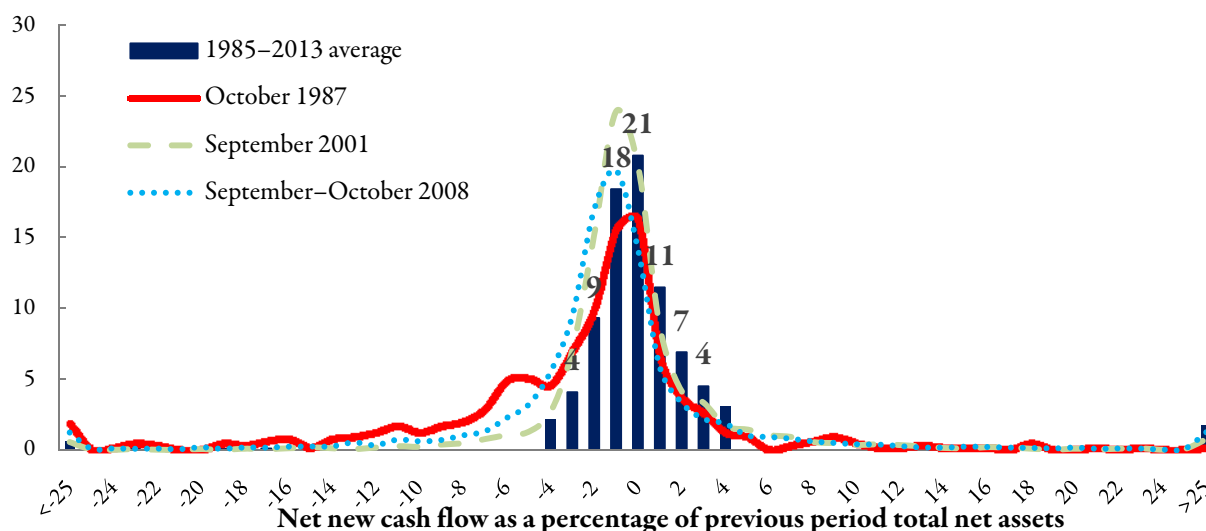
In September 2001, the distribution of monthly fund flows was nearly identical to the average for the 29-year period. In September and October of 2008, there was only a very small increase in the number of funds with outflows, and most had outflows that were in the low single digits.

In conclusion, not only does the whole equity fund industry not experience heavy outflows during periods of financial market stress, the vast majority of individual equity funds also do not.

### *US Bond Mutual Fund Net Flows*

There is considerable evidence that US bond mutual fund investors, like equity mutual fund investors, redeem on net only modestly during even the worst financial crises. US bond returns have varied considerably since 1990 (Figure F.6). In a number of instances, bond returns have been negative, to a great extent reflecting periods when the Federal Reserve has tightened monetary policy (as reflected by the federal funds rate). Bond mutual fund assets grew considerably from 1990 to 2013 (Figure F.7). Nevertheless, during periods of depressed bond returns, investors in bond mutual funds have not redeemed precipitously. Three episodes since 1990 are instructive.

**Figure F.5**  
**Market Crises Have Not Spurred Large-Scale Flight from US Equity Mutual Funds\***  
*Distribution of monthly flows as a percentage of total number of funds*

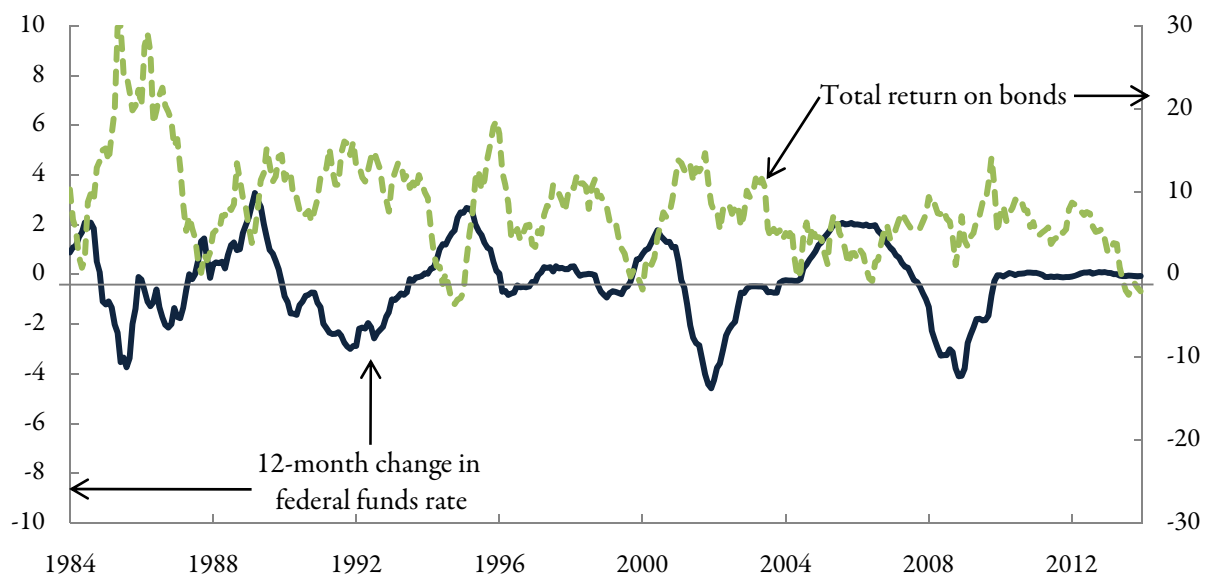


\*Net percentage flow is calculated as US mutual fund net new cash flow as a percentage of previous period US total net assets.

Note: Data exclude funds with less than \$10 million in average assets.

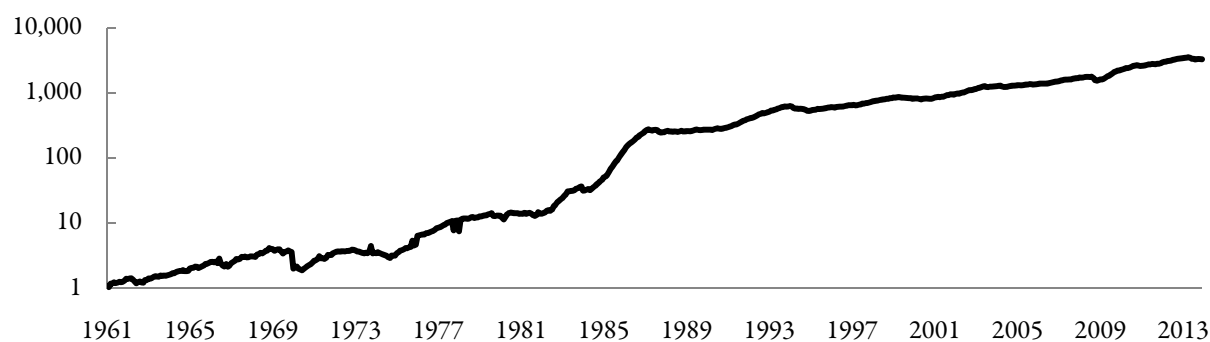
Source: Investment Company Institute

**Figure F.6**  
**US Monetary Policy and Bond Returns**  
*Monthly, percent*



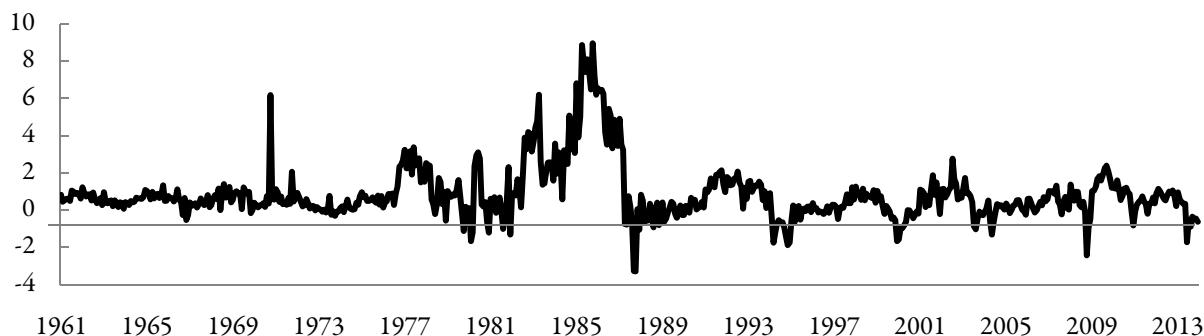
<sup>1</sup>The total return on bonds is measured as the year-over-year change in the Citigroup Broad Investment Grade Bond Index.  
*Sources: Federal Reserve Board and Bloomberg*

**Figure F.7**  
**Assets in US Bond Mutual Funds**  
*Monthly, billions of dollars, log scale*



*Source: Investment Company Institute*

**Figure F.8**  
**Net Flows to US Bond Mutual Funds as a Percentage of US Fund Assets**  
*Monthly, percent*



*Source: Investment Company Institute*

### 1994–1995

The first episode is 1994–1995, a period when the Federal Reserve sharply tightened monetary policy. This period was preceded by a long bull market in bonds when returns on bonds generally remained in high single to double digits for about 10 years. From February 4, 1994 to February 1, 1995, however, the Federal Reserve boosted its target for the federal funds rate from 3 percent to 6 percent, causing yields on long-term bonds to rise significantly—for example the yield on the 10-year Treasury note rose 1.85 percentage points—in turn leading returns on bonds to decline sharply and into negative territory for a number of months. During this time, bond mutual funds experienced net outflows totaling \$71 billion, which amounted to 11.3 percent of their January 1994 assets. These net outflows, though, occurred smoothly rather than precipitously. In no month during the twelve month period February 1994 to January 1995 did net outflows exceed 2 percent of bond funds’ assets (Figure F.8).

### 2008: The Financial Crisis

A second instructive episode is the recent financial crisis. From August to December of 2008, spreads between yields on lower-rated (Baa) bonds and Treasury securities widened by nearly 300 basis points, reflecting the weakening economy and immense stresses on the financial markets and the banking system. This, in turn, significantly depressed returns on corporate bonds. Reflecting both the falling returns on corporate bonds and, importantly, a shift by some investors to the safety and liquidity of the Treasury market, bond mutual funds experienced net outflow totaling \$65 billion from September to December 2008.<sup>16</sup> This amounted to only 3.6 percent of bond mutual funds’ assets as of August 2008.

<sup>16</sup> From September to December 2008, investment grade bond funds experienced net outflows of \$38.3 billion. Over the same period, net outflows from high yield bond funds totaled just \$1.1 billion.

Moreover, in none of these individual months did net outflows exceed more than 2.5 percent of bond fund assets (outflows were \$41 billion in October 2008, which was 2.4 percent of bond mutual fund assets as of September 2008).

In short, during the worst part of the worst financial crisis since the Great Depression, bond mutual fund investors remained calm and did not redeem precipitously.

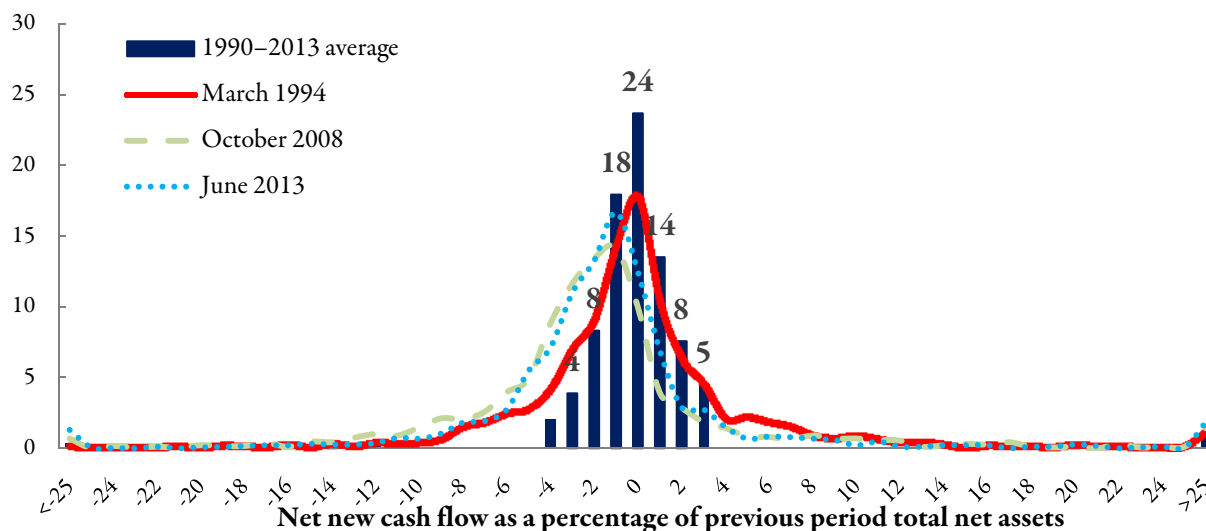
### 2013: Expectations of the End of Quantitative Easing

Returns on bonds rebounded in early 2009 and generally remained in high single digits until May 2013. Over this period, bond mutual funds received inflows totaling \$1.1 trillion, reflecting not only the attractive yields available on bonds but also to a very significant degree trends that had been in place before 2009, including demographics (the aging of baby boomers toward retirement and the greater preference of retirees and near-retirees for bonds), the increased use of target date funds (which invest in a mix of underlying bond and stock mutual funds), and the increased use by investors (in conjunction with their financial advisers) of asset allocation programs to diversify among a mix of funds.

Long-term Treasury yields began to rise in early May, following comments from numerous Federal Reserve officials indicating that the Fed's massive bond-buying program would begin to slow if the economy continued to improve. From May 1 to early July 2013, yields on long-term bonds (as measured by the yield on the 10-year Treasury note) jumped more than 100 basis points. Consequently, from April 30, 2013 to August 30, 2013, the total return on bonds (as measured by the Citigroup Broad Investment Grade Bond Index) fell 3.6 percent, the largest four-month decline since the bond market rout in 1994. Bond mutual funds did experience net outflows from June to August 2013, but they were hardly precipitous and for the most part occurred after bond yields had already increased. By the end of May 2013, assets in bond mutual funds totaled \$3.5 trillion. Over the next three months, net outflows from bond mutual funds amounted to \$106 billion, only 3 percent of their May 2013 assets.

Thus, as with equity mutual funds, evidence indicates that bond mutual fund investors do not on net redeem precipitously in the face of financial market shocks.

**Figure F.9**  
**US Bond Mutual Funds Also Have Not Shown Large-Scale Flight in Market Crises\***  
*Monthly, percent*



\*Net percentage flow is calculated as US mutual fund net new cash flow as a percentage of previous period US total net assets.

Note: Data exclude funds with less than \$10 million in average assets.

Source: Investment Company Institute

### Market Crises Have Not Spurred Large Scale Net Outflows from Individual Bond Mutual Funds

As with equity funds, there is strong evidence that individual bond mutual funds do not experience large scale net outflows during periods of market stress (Figure F.9). As before, blue bars show the percent of monthly fund flows as a percent of fund assets over a long-period, in this case 1990 to 2013. Bond fund flows are normally clustered close to zero, with 81 percent of observations lying between -3.5 percent and 3.5 percent.

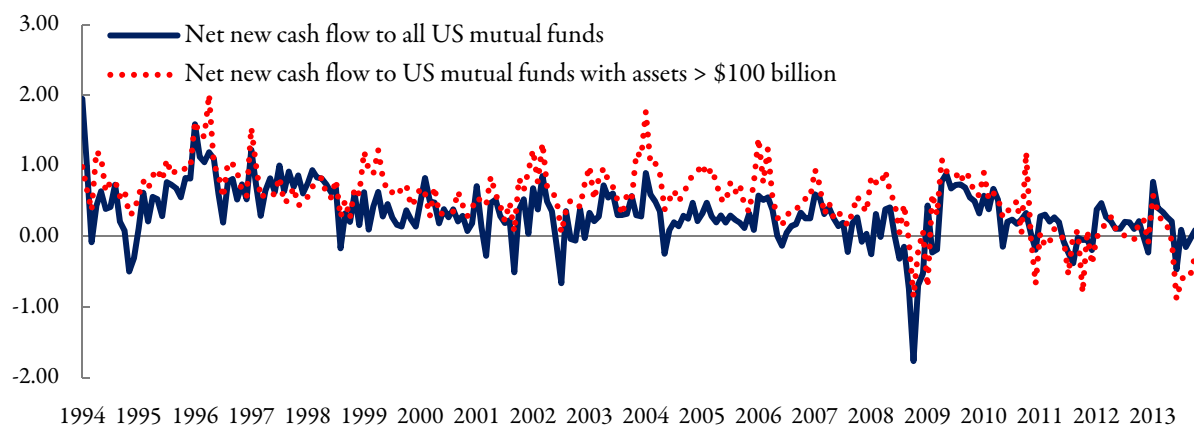
The figure considers three periods of stress in bond markets: March 1994, October, 2008, and June 2013. As with equity funds, there is no obvious, dramatic left-ward shift of the distribution as would be expected if investors in individual funds were flighty. For example, in March 1994, there was a small increase in the number of funds experiencing outflows. In October 2008, there was a somewhat larger increase in the number of funds experiencing outflows, but very few funds had outflows greater than 5 percent of their assets. The pattern in June 2013 was similar to that of October 2008.

Thus, in sum, for equity and bond mutual funds, the vast majority of individual funds do not experience heavy outflows during periods of market distress.

**Figure F.10**

**Net New Cash Flow to US Mutual Funds**

*Net new cash flow as a percent of previous month total net assets, monthly, 1994–2013*



*Source: Investment Company Institute*

#### **4 Investors Likewise Do Not Redeem Heavily from the Largest US Mutual Funds**

Section 3 above provides compelling evidence that investors in all US mutual funds do not redeem heavily during even the worst kinds of financial crises.

The same is true for US mutual funds with assets greater than \$100 billion. Figure F.10 compares net flows to all US mutual funds as a percent of fund assets (solid line) with those of US mutual funds with assets greater than \$100 billion (dashed line). As might be expected from viewing Figures F.3 and F.8, the combined flows to all US mutual funds are moderate, even during periods of financial stress such as late 2008 to early 2009. For example, over the twenty year period 1994 to 2013, the maximum monthly outflow from all US mutual funds was 1.77 percent of those funds' assets in October 2008.

Flows to US mutual funds with assets greater than \$100 billion have arguably been even more modest. For example, net outflows from these funds (as a percent of their assets) totaled just 0.86 percent in October 2008. Net inflows and outflows from these large mutual funds were slightly more variable than those of all mutual funds in selected months in 2011 to 2013.<sup>17</sup> Even so, monthly outflows in these large mutual funds never exceeded 1 percent of their assets over the 20 years 1994 to 2013.

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<sup>17</sup> The standard deviation of outflows from US mutual funds with assets greater than \$100 billion over the 20 years 1994 to 2013 was 0.30 percent per month, virtually identical to the same measure for all US mutual funds over this period (0.31 percent per month).

## **5 Aggregate Net Purchases and Sales of Portfolio Securities Are Influenced Primarily by Investor Redemptions**

Sections 3 and 4 provide evidence that investors in US mutual funds do not redeem heavily during even the worst financial crises. This, however, does not preclude mutual fund portfolio managers from selling funds' portfolio securities in the face of declining markets, which the consultation seems to contemplate.

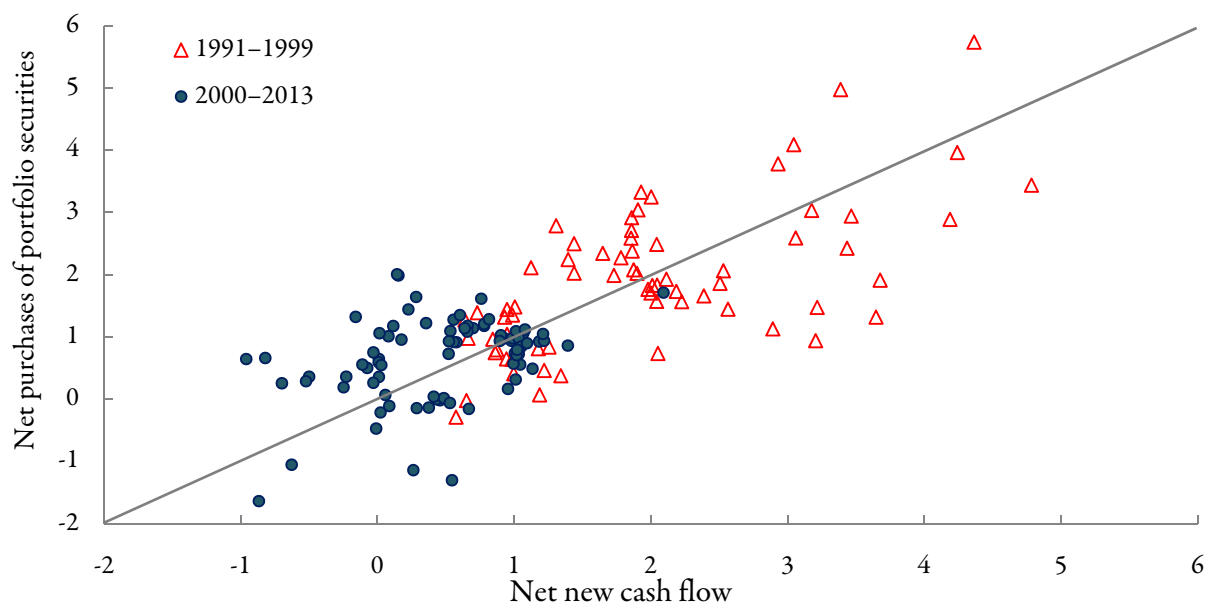
There is strong evidence that the portfolio managers of large US mutual funds buy or sell securities primarily in response to investor flows. As shown in Figure F.11, monthly net purchases of portfolio securities (y-axis) by the ten US mutual funds with assets greater than \$100 billion closely match net flows to the same funds (x-axis). Each point represents the aggregate net securities purchases of these ten funds in a given month and the aggregate net cash flows to the same ten funds in that same month. Red triangles represents months during the period January 1991 to December 1999. Blue dots represent observations for months during the period January 2000 to December 2013. The solid line in the chart is the "45 degree line." Points on the 45 degree line indicate that in a given month the net purchases of securities by these ten funds exactly matched the net cash inflows they received.

The figure shows that for these large mutual funds, their net purchases of portfolio securities were strongly related to the net cash flows that they received from investors. As seen, both the red triangles and the blue dots are scattered along the 45 degree line, indicating a close relationship between the net inflows that funds receive and the securities purchases that fund portfolio managers then undertake. This indicates that, in aggregate, funds' purchases and sales of portfolio securities are driven primarily by the investors' net purchases and sales of fund shares. Furthermore, after 1999, net flows and asset purchases are a smaller percentage of assets, and the relationship between fund net flows and portfolio transactions has become tighter.

**Figure F.11**

**US Mutual Funds with Assets > \$100 Billion Net Purchases and Sales of Portfolio Securities are Related to Funds' Net New Cash Flow**

*Percentage of assets, monthly, 1991–2013*



*Source: Investment Company Institute*

## **6 Net Flows from US Mutual Funds Are Unlikely to Put Significant Pressure on Stock or Bond Prices**

As discussed, US mutual funds do *not* experience significant net outflows during periods of exceptional financial stress. Even if large sales of funds' portfolio securities were to materialize, however, they would be unlikely to have a significant impact on market prices. This is because, as this section shows, the sales of portfolio securities by US mutual funds are a small portion of overall market trading volume.

### Stock Prices

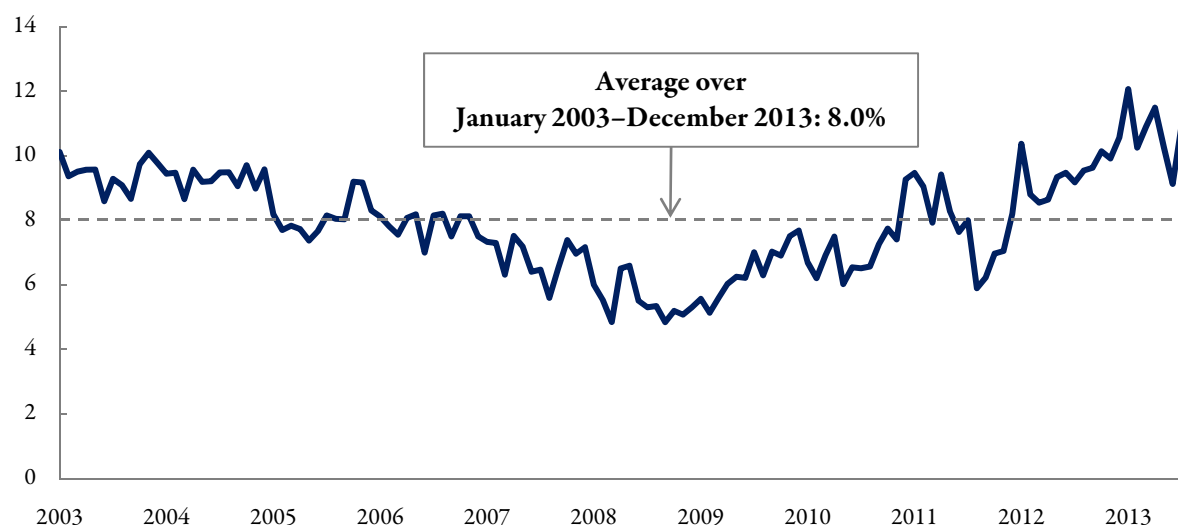
Figure F.12 shows the value of gross sales of stocks by all US domestic equity mutual funds relative to the dollar value of domestic stock trades on the NYSE and NASDAQ exchanges (*i.e.*, the volume of shares traded multiplied by the dollar value at which those shares were traded). As the figure shows, mutual funds' sales of portfolio stocks in the past decade have on average accounted for less than 10 percent of the total value of US stock trading on these exchanges even though US mutual funds held about one-quarter of the outstanding US corporate equity during this period. In other words, investors *other than* US mutual funds have accounted for at least 90 percent of the value of all trading in US stock markets over this period. Moreover, there is no evidence that mutual fund selling increased as a share of overall market trading during the financial crisis.

In sum, there is no evidence to suggest that funds' sales of equities are likely to exert the kinds of pressure on market prices that some have posited could arise in a period of financial market stress.

**Figure F.12**

**Gross Sales of Stocks by US Domestic Equity Mutual Funds as a Share of US Stock Market Trading Volume\***

*Percent, monthly, 2003–2013*



\*Includes value of shares traded on NYSE and NASDAQ stock exchanges.

*Sources: Investment Company Institute, Morningstar, and World Federation of Exchanges*

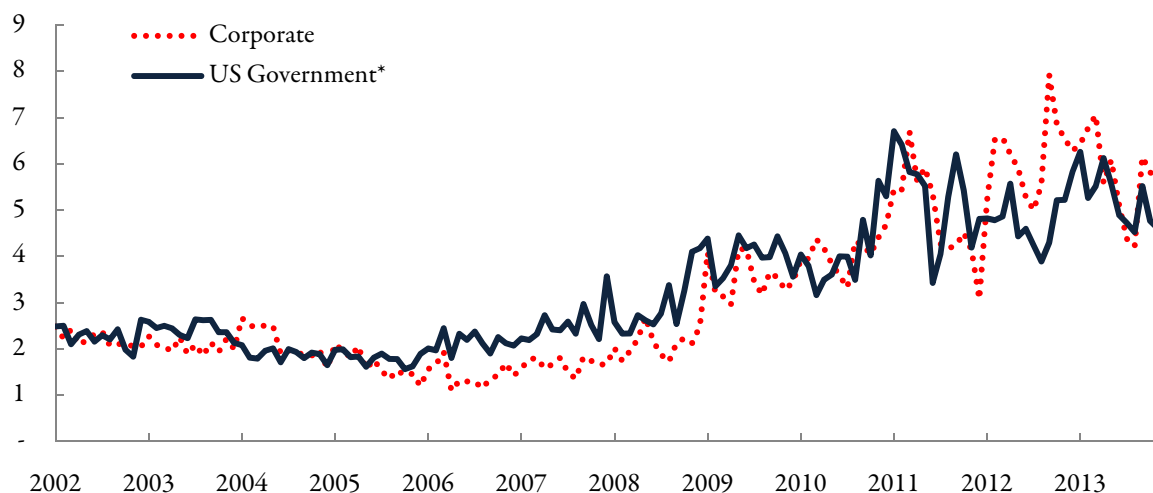
**Bond Prices**

Assets in US bond mutual funds are substantial. Consequently, such funds provide an important source of financing to US businesses and government. Nevertheless, bond funds' purchases and sales of fixed income securities amount to only a fraction of the dollar volume of trading in the US bond market. For example, as Figure F.13 indicates, bond funds' gross purchases plus sales of corporate bonds are only a small fraction of the dollar value of trading in US fixed income securities. From 2002 to December 2013, US mutual funds' trades of corporate and US government fixed income securities averaged only 3.1 percent of the dollar value of trades of market participants with primary dealers. Further, during that same period, US mutual funds' percent of trading of these securities never rose above 8 percent of overall trading with primary dealers.

**Figure F.13**

**Monthly US Mutual Fund Purchases and Sales of Fixed Income Securities as a Share of Primary Dealer Transactions Outside the Inter-Dealer Market**

*Percent, monthly, 2002–2013*



\*US Government primary dealer transactions consist of US government, federal agency, and mortgage-backed securities transactions.

*Source: Investment Company Institute and the Federal Reserve Bank of New York*

## 7 Reasons US Mutual Fund Flows Remain Stable

As we discuss in the remainder of this appendix, there are a number of factors that help explain why new outflows from US mutual funds have not been and are unlikely to be destabilizing during periods of market stress.

### Shares of US Mutual Funds Are Held Primarily by Retail Investors

US mutual funds primarily are held by individual investors, not institutional investors. In general, assets held by retail investors tend to be more stable than those held by institutions investing for their own accounts, such as hedge funds, sovereign wealth funds, defined benefit pension plans, and insurance companies.

Figure F.14 shows the assets in all US mutual funds, broken into percentages held by households and institutional investors. Of the \$12.3 trillion in such funds as of December 2013, institutional investors held just 4.9 percent (\$600 billion).

Figure F.15 shows that for US mutual funds with assets greater than \$100 billion, a very small amount of their assets are held by institutional investors, less than \$100 billion out of \$1.6 trillion in assets.

Because the assets in mutual funds primarily are held by retail investors, their ownership is diffuse. As Figure F.16 shows, US mutual funds had 238 million investor accounts as of December 31, 2014. US mutual funds with assets greater than \$100 billion also had a very large number of accounts, nearly 20 million. The dispersion of fund assets across a very large number of individual decision makers means that it is highly unlikely that a fund will face net outflows of a substantial portion of its shares over a very short period. Moreover, these millions of retail investors undoubtedly have widely divergent views about fund strategies and how, if at all, to respond to changing market conditions. For example, in a market downturn, some investors might wish to redeem shares but other investors might view the market downturn as an opportunity to buy more fund shares.

### Investors Use US Mutual Funds to Help Meet Long-Term Goals, Such as Retirement

Another important characteristic of US mutual funds that enhances the stability of their assets is, as Federal Reserve economist Donald Morgan noted in 1994,<sup>18</sup> that many investors use mutual funds to help them achieve long-term goals, such as amassing savings for retirement. Surveys indicate that virtually all individual mutual fund investors cite saving for retirement as one of their goals, and about three-quarters of fund owners indicate that retirement saving is their primary goal.<sup>19</sup> Evidence indicates that few such investors sell shares or reallocate assets during periods of financial stress.<sup>20</sup>

Figure F.17 shows the percent of assets held in US mutual funds through retirement accounts. An estimated 50 percent of mutual fund assets are retirement-related accounts, either through US defined contribution plans or via individual retirement accounts (“IRAs”) which are “like 401(k) accounts.” The percentage is even higher when looking only at US mutual funds with assets greater than \$100 billion. Sixty-two percent of the assets of those funds are attributable either to defined contribution plans or IRAs.

A related characteristic promoting the stability of assets in US mutual funds during periods of stressed markets is that most individuals who invest in mutual funds outside an employer-based retirement plan rely on the advice and assistance of financial professionals.<sup>21</sup> Financial advice and assistance helps investors remain focused on an asset allocation mix to help them achieve their investment goals rather than seeking to time the markets.

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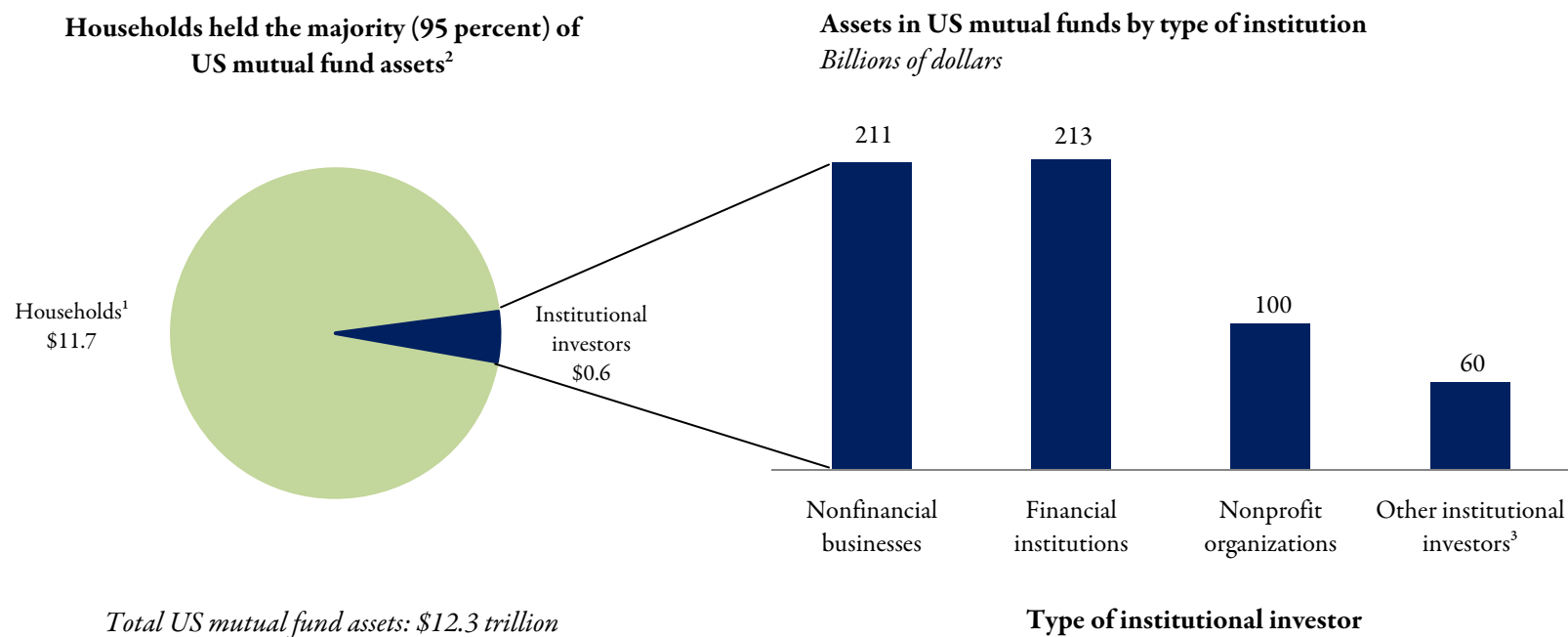
<sup>18</sup> Morgan, *supra* note 7.

<sup>19</sup> Dan Schrass, Michael Bogdan, and Sarah Holden, “Characteristics of Mutual Fund Investors, 2012,” *ICI Research Perspective*, Vol. 18, no. 7 (November 2012). Available at <http://www.ici.org/pdf/per18-07.pdf>.

<sup>20</sup> Sarah Holden and Daniel Schrass, *Defined Contribution Plan Participants’ Activities, 2012*, *Investment Company Institute Research Report*, April 2013. Available at [http://www.ici.org/pdf/ppr\\_13\\_rec\\_survey\\_q4.pdf](http://www.ici.org/pdf/ppr_13_rec_survey_q4.pdf). Sarah Holden, Jack VanDerhei, Luis Alonso, and Steven Bass, “401(k) Participants in the Wake of the Financial Crisis: Changes in Account Balances, 2007–2011,” *ICI Research Perspective* 19, no. 7 (October 2013). Sarah Holden and Stephen Bass, *The IRA Investor Profile: Activity, 2007–2011*, *ICI Research Report* (October 2013). Available at [www.ici.org/pdf/rpt\\_13\\_ira\\_investors.pdf](http://www.ici.org/pdf/rpt_13_ira_investors.pdf).

<sup>21</sup> Dan Schrass, Michael Bogdan, and Sarah Holden, “Characteristics of Mutual Fund Investors, 2012,” *ICI Research Perspective*, Vol. 18, no. 7 (November 2012). Available at <http://www.ici.org/pdf/per18-07.pdf>.

**Figure F.14**  
**Institutional and Household Ownership of US Mutual Funds**  
*Trillions of US dollars, year-end 2013*



<sup>1</sup>US mutual funds held as investments in variable annuities and 529 plans are counted as household holdings of US mutual funds.

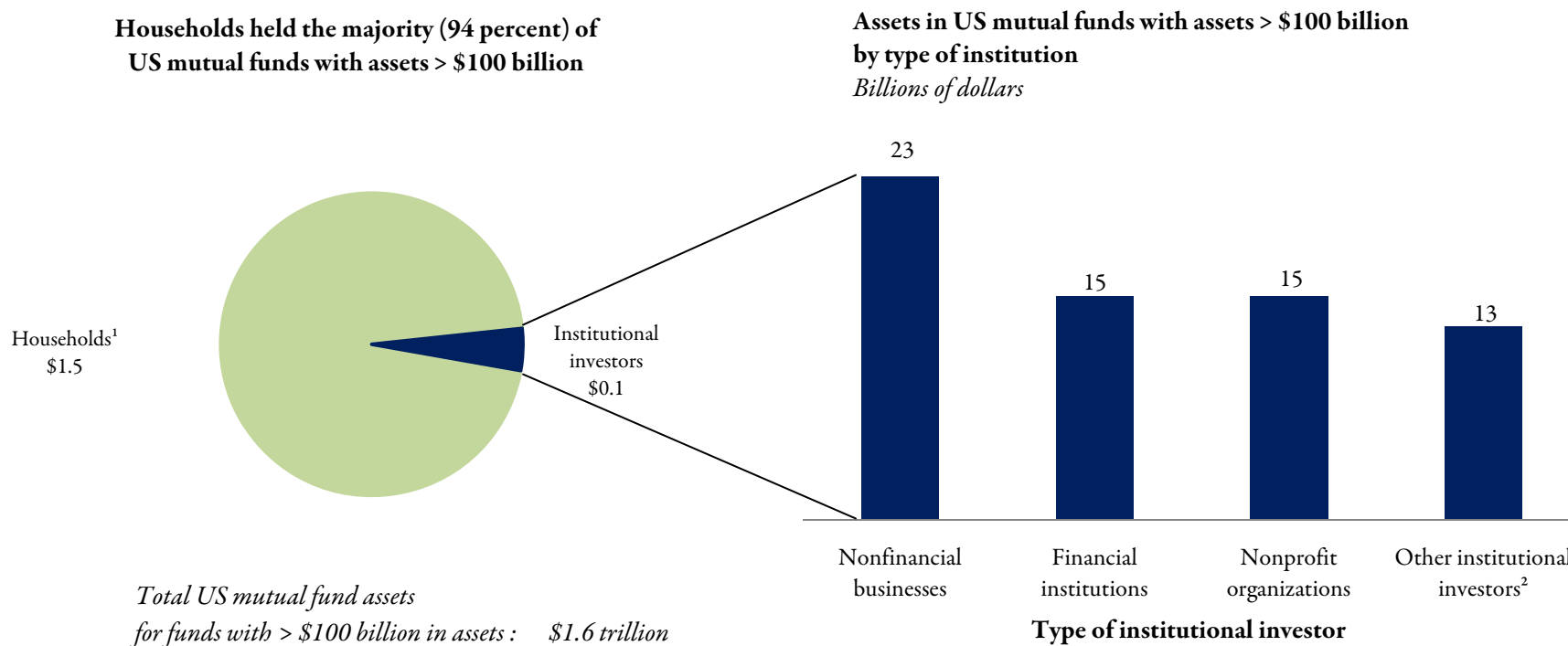
<sup>2</sup>US mutual funds include stock, hybrid, and bond mutual funds.

<sup>3</sup>This category includes state and local governments and other institutional accounts not classified.

Note: Components may not add to the total because of rounding.

Source: Investment Company

**Figure F.15**  
**Institutional and Household Ownership of US Mutual Funds with Assets > \$100 Billion**  
*Trillions of US dollars, year-end 2013*



<sup>1</sup>US mutual funds held as investments in variable annuities and 529 plans are counted as household holdings of mutual funds.

<sup>2</sup>This category includes state and local governments and other institutional accounts not classified.

Note: Components may not add to the total because of rounding.

Source: Investment Company Institute

**Figure F.16**

**US Mutual Funds: Number of Shareholder Accounts**

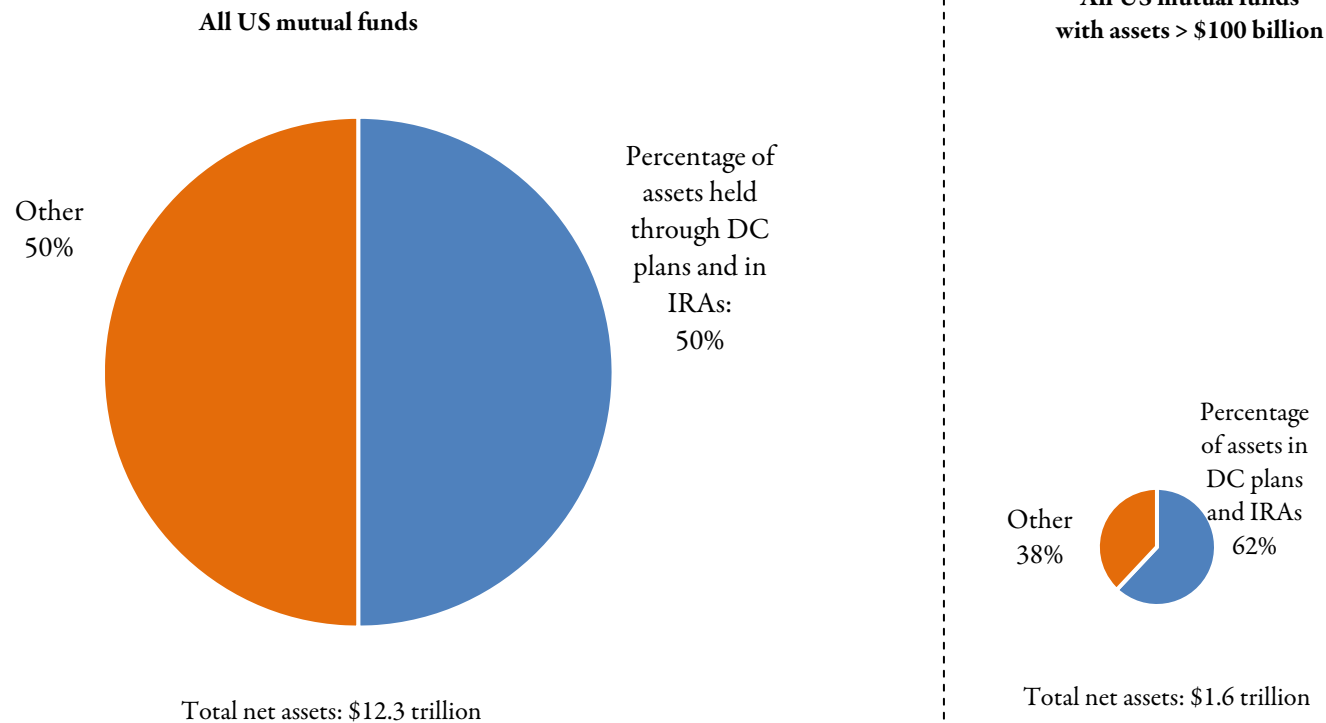
*December 31, 2013*

| <i>All US mutual funds</i> |  | <i>US mutual funds with<br/>assets &gt; \$100 billion</i> |  |
|----------------------------|--|-----------------------------------------------------------|--|
| <b>Number of accounts</b>  |  | <b>Number of accounts</b>                                 |  |
| 238,249,273                |  | 19,841,770                                                |  |

Note: Figure includes US mutual funds available as investment choices in variable annuities but excludes US mutual funds that invest primarily in other US mutual funds and exchange-traded funds.

*Source: Investment Company Institute*

**Figure F.17**  
**Percentage of Total Net Assets in Defined Contribution (DC) Plans and IRAs**  
*Percentage of total net assets, December 31, 2013*



Note: Figure includes US mutual funds available as investment choices in variable annuities and US mutual funds that invest primarily in other US mutual funds.  
Source: Investment Company Institute

## The Largest Regulated US Funds Hold Small Percentages of the Worldwide Supply of Stocks and Bonds

Of the eleven regulated US funds, nine are funds that invest solely or primarily in equities. These nine funds had assets totaling \$1.4 trillion as of December 2013. The value of the stocks these funds held, however, was only a small portion of the market capitalization of the US stock market. As of December 2013, the combined market capitalization of the NYSE and NASDAQ stock exchanges was \$24 trillion. Regulated US funds with assets greater than \$100 billion held just 4.4 percent of this and the maximum held by any of these nine funds individually is 1.2 percent (Figure F.18).

These funds hold even smaller portions of the market capitalization of stock markets outside the US. According to the World Federation of Exchanges, stock market capitalization outside the US in December 2013 was \$37 trillion. In total, regulated US funds with assets greater than \$100 billion held just 0.8 percent of that and the maximum held by any such fund was 0.3 percent. Thus, it is difficult to argue that securities purchases or sales of these funds could have large effects outside the US.

Views have sometimes also been expressed that mutual funds could pose a concern for emerging markets and such concerns have again recently been repeated.<sup>22</sup> As discussed earlier, suggestions of this kind, while not new, have not been supported by the data. It seems highly unlikely that purchases and sales of portfolio securities by mutual funds with assets greater than \$100 billion could have significant effects in emerging markets. For example, the World Federation of Exchanges indicates that the total stock market capitalization in emerging markets was \$12.7 trillion as of December 2013. Regulated US funds with assets greater than \$100 billion held just 0.32 percent of this, and the maximum percent by any one fund was 0.13 percent.

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<sup>22</sup> See, for example, Andrew G. Haldane, “The Age of Asset Management,” Bank of England, speech at the London Business School, April 4, 2014.

**Figure F.18****Holdings of Domestic and Foreign Equities for Regulated US Funds with Assets > \$100 Billion***December 31, 2013*

| <b>Fund name</b>                         | <b>Share of domestic equity market cap*</b> |                | <b>Share of foreign (non-US) equity market cap*</b> |                | <b>Share of the emerging market equity market cap*</b> |                |
|------------------------------------------|---------------------------------------------|----------------|-----------------------------------------------------|----------------|--------------------------------------------------------|----------------|
|                                          | <b>Billions of dollars</b>                  | <b>Percent</b> | <b>Billions of dollars</b>                          | <b>Percent</b> | <b>Billions of dollars</b>                             | <b>Percent</b> |
| Vanguard Total Stock Market Index        | 284.9                                       | 1.19           | 5.5                                                 | 0.01           | 0.0                                                    | 0.00           |
| PIMCO Total Return Fund                  | 0.0                                         | 0.00           | 0.0                                                 | 0.00           | 0.0                                                    | 0.00           |
| Vanguard Institutional Index Fund        | 152.9                                       | 0.64           | 2.9                                                 | 0.01           | 0.0                                                    | 0.00           |
| Vanguard 500 Index Fund                  | 149.3                                       | 0.62           | 2.9                                                 | 0.01           | 0.0                                                    | 0.00           |
| American Funds Growth Fund of America    | 105.7                                       | 0.44           | 19.3                                                | 0.05           | 1.8                                                    | 0.01           |
| CREF Stock Account                       | 87.0                                        | 0.36           | 38.8                                                | 0.10           | 5.7                                                    | 0.04           |
| Vanguard Total International Stock Index | 0.1                                         | <0.01          | 107.4                                               | 0.29           | 16.6                                                   | 0.13           |
| American Funds EuroPacific Growth Fund   | 0.9                                         | <0.01          | 104.2                                               | 0.28           | 16.7                                                   | 0.13           |
| Fidelity Contra Fund                     | 97.8                                        | 0.41           | 9.9                                                 | 0.03           | 0.2                                                    | <0.01          |
| Vanguard Total Bond Market Index         | 0.0                                         | 0.00           | 0.0                                                 | 0.00           | 0.0                                                    | 0.00           |
| SSgA SPDR S&P 500 ETF Trust              | 174.9                                       | 0.73           | 0.0                                                 | 0.00           | 0.0                                                    | 0.00           |
| <b>Total</b>                             | 1053.4                                      | 4.38           | 290.9                                               | 0.79           | 41.0                                                   | 0.32           |

\*The domestic market cap for equities is 24.035 trillion, the foreign market cap for equities is 37.027 trillion, and the emerging market equity market cap is 12.7 trillion.

*Sources: Investment Company Institute, Morningstar, and World Federation of Exchanges*

## The Largest Regulated US Funds Have a High Degree of Substitutability

The concept of “substitutability” is intended to capture the extent to which a particular investment fund occupies a specific position in its market that may not be easily and rapidly replaced by other investment funds. The consultation correctly notes that “the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable).”

It then observes that, while most investment funds are “generally substitutable,” some funds are “highly specialised and invest in thinly traded markets.”<sup>23</sup> We disagree with the premise that funds with these characteristics would lack substitutes and the implication that on the basis of those characteristics such funds might be more likely than other funds to pose risk to financial stability.

It is difficult to see how concerns about “highly specialised” funds could apply to regulated US mutual funds, which typically hold highly diversified portfolios of securities. Of the eleven regulated US funds with assets greater than \$100 billion, six are index funds, which means they generally have hundreds to thousands of individual holdings, in turn implying that no single holding represents a large portion of the fund’s portfolio (these funds’ largest holdings are typically less than 3 percent of the funds’ assets). One of the index funds is an index bond fund that invests substantially in US Treasury and agency securities—presumably, this raises no systemic concerns. The remaining five funds also have highly diversified portfolios.

**Figure F.19**

**Regulated US Funds with Assets > \$100 Billion, by Morningstar Category**

*December 2013*

| <b>Morningstar category</b> | <b>Number of funds<sup>1</sup></b> | <b>Total number of funds in category<sup>2</sup></b> |
|-----------------------------|------------------------------------|------------------------------------------------------|
| Foreign Large Blend         | 2                                  | 213                                                  |
| Intermediate-Term Bond      | 2                                  | 287                                                  |
| Large Blend                 | 5                                  | 519                                                  |
| Large Growth                | 2                                  | 475                                                  |

<sup>1</sup>Includes US ETF with assets > \$100 billion.

<sup>2</sup>Includes US ETFs.

*Source: Investment Company Institute, Morningstar, and Lipper*

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<sup>23</sup> Consultation at 34.

Moreover, the regulated US funds generally invest most of their assets in the deepest, most liquid markets in the world. For example, Figure F.19 categorizes the eleven funds according to their Morningstar categories. Nine of the mutual funds are categorized as having mandates to invest primarily in large-cap equities, where trading volumes are generally high and liquidity is plentiful. Thus, fund trades are unlikely to have any significant impact on prices in these markets. The remaining two funds are bond funds that invest heavily in the US Treasury and agency market, the world's deepest, most liquid fixed income market.

In addition, for all eleven funds, there are a large number of other regulated US funds against which they must potentially compete. For example, as Figure F.19 shows, the five regulated US funds with assets greater than \$100 billion that Morningstar categorizes as Large Blend must compete in a market with more than 500 other regulated US funds with similar investment objectives.

**Statutory Authority to Impose Prudential Standards on Nonbank Financial Companies  
Designated as Systemically Important Financial Institutions (Nonbank SIFIs)\***

**Capital requirements**

- Risk-based capital requirements: required by Sec. 165(b)(1)(A)(i), unless the Federal Reserve Board of Governors (“Federal Reserve”), in consultation with the US Financial Stability Oversight Council (“FSOC”), determines that such requirements are not appropriate because of a company’s activities; in that case, the Federal Reserve must apply “other standards that result in similarly stringent risk controls”
- Minimum risk-based capital standards: required by Sec. 171(b)(2)
- Minimum leverage capital standards: required by Sec. 171(b)(1)
- Capital requirements “to address activities that pose risks to the financial system”: appear to be required by Sec. 171(b)(7) in conjunction with FSOC recommendations for heightened regulation of a financial activity or practice under Sec. 120. Intent of the capital requirement is to “address the risks that the activities . . . pose, not only to the institution engaging in the activity, but to other public and private stakeholders in the event of adverse performance, disruption or failure of the institution or the activity.” It is not entirely clear from the interplay of these two sections whether any capital requirements adopted under Sec. 171(b)(7) must be developed in response to specific recommendations from the FSOC or could be imposed by the Federal Reserve on its own initiative in the areas outlined in Sec. 171(b)(7)(B).

**Leverage limits**

- Required by Sec. 165(b)(1)(A)(i), unless the Federal Reserve, in consultation with FSOC, determines that such requirements are not appropriate because of a company’s activities; in that case, the Federal Reserve must apply “other standards that result in similarly stringent risk controls”

**Liquidity requirements**

- Required by Sec. 165(b)(1)(A)(ii)

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\* This appendix summarizes authority provided under Sections 165 and 171 of the Dodd-Frank Wall Street Reform and Consumer Protection Act. The provisions in Section 165, as described in this appendix, apply to (1) bank holding companies, and foreign banks or companies treated as bank holding companies under the International Banking Act, with \$50 billion or greater in total consolidated assets and (2) Nonbank SIFIs. Similarly, the capital standards in Section 171 of the Dodd-Frank Act apply to (1) certain banking organizations subject to the U.S. regulatory capital requirements and (2) Nonbank SIFIs.

## **Overall risk management requirements**

- Required by Sec. 165(b)(1)(A)(iii) and (h)
- Sec. 165(h) calls upon the Federal Reserve to require each Nonbank SIFI that is a publicly traded company to establish a risk committee responsible for oversight of the enterprise-wide risk management practices of the company. The risk committee shall include (1) such number of independent directors as the Federal Reserve may determine appropriate based on certain criteria and (2) at least one risk management expert having experience in identifying, assessing and managing risk exposures of large, complex firms.

## **Resolution plan requirements**

- Required by Sec. 165(b)(1)(A)(iv) and (d)
- Sec. 165(d)(1) calls for the Federal Reserve to require any Nonbank SIFI to report periodically its plan “for rapid and orderly resolution in the event of material financial distress or failure.” The plan must include “(A) information regarding the manner and extent to which any insured depository institution affiliated with the company is adequately protected from risks arising from the activities of any nonbank subsidiaries of the company; (B) full descriptions of the ownership structure, assets, liabilities, and contractual obligations of the company; (C) identification of the cross-guarantees tied to different securities, identification of the major counterparties, and a process for determining to whom the collateral of the company is pledged; and (D) any other information that the Federal Reserve and the Federal Deposit Insurance Corporation jointly require by rule or order.”
- If the Federal Reserve and the Federal Deposit Insurance Corporation (“FDIC”) jointly determine that the plan is “not credible or would not facilitate an orderly resolution of the company” under the Bankruptcy Code, the regulators will require the company to submit a revised plan, “including any proposed changes in business operations and corporate structure to facilitate implementation of the plan.”
- If the Nonbank SIFI fails to resubmit a “credible plan,” the Federal Reserve and FDIC “may jointly impose more stringent capital, leverage or liquidity requirements, or restrictions on the growth, activities or operations of the company” until such time as the company “resubmits a plan that remedies the deficiencies.”

## **Credit exposure report requirements**

- Required by Sec. 165(b)(1)(A)(iv) and (d)
- Sec. 165(d)(2) calls on the Federal Reserve to require each Nonbank SIFI to report periodically to the Federal Reserve, FSOC and FDIC on “the nature and extent to which the company has credit exposure to other significant nonbank financial companies and significant bank holding

companies” as well as the “nature and extent to which other significant nonbank financial companies and significant bank holding companies have credit exposure to that company.”

### **Concentration limits**

- Required by Sec. 165(b)(1)(A)(v) and (e)
- Sec. 165(e) dictates that Federal Reserve rules must limit a Nonbank SIFI’s “credit exposure” to an unaffiliated company to 25% or less of the company’s capital stock and surplus (or lower level if necessary to mitigate risks to US financial stability). “Credit exposure” is defined broadly and includes all purchases of, or investment in, securities issued by the company. The Federal Reserve has authority to exempt transactions from the definition of “credit exposure” if the exemption would be in the public interest and consistent with the purpose of Sec. 165(e).

### **Stress tests**

- Required by Sec. 165(i)
- Sec. 165(i)(1)(A) requires the Federal Reserve, in coordination with the appropriate primary financial regulatory agencies, to conduct annual analyses to evaluate whether Nonbank SIFIs “have the capital, on a total consolidated basis, necessary to absorb losses as a result of adverse economic conditions.” Nonbank SIFIs will be required to update their resolution plans “as the Federal Reserve determines appropriate” based on the results of these analyses, a summary of which will be published by the Federal Reserve. Sec. 165(i)(2) requires each Nonbank SIFI to conduct semi-annual stress tests using methodologies established by rule and to submit reports to the Federal Reserve and its primary financial regulatory agency.

### **Contingent capital requirement**

- Authorized by Sec. 165(b)(1)(B)(i) and (c)
- Sec. 165(c) authorizes the Federal Reserve, subsequent to a study by FSOC of the feasibility, benefits, costs and structure of a contingent capital requirement for large bank holding companies and Nonbank SIFIs,” to require each Nonbank SIFI to maintain a minimum amount of contingent capital that is convertible to equity in times of financial stress.

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“Issued in July 2012 pursuant to Sec. 115(c) of the Dodd-Frank Act, this study concludes that “contingent capital instruments remain an area for continued private sector innovation” and encourages “the Federal Reserve and other financial regulators to continue to study the advantages and disadvantages of including contingent capital and bail-in instruments in their regulatory capital frameworks.” See FSOC, *Report to Congress on Study of a Contingent Capital Requirement for Certain Nonbank Financial Companies and Bank Holding Companies* (July 2012), available at <http://www.treasury.gov/initiatives/fsoc/studies-reports/Documents/Co%20co%20study%5B2%5D.pdf>.

### **Enhanced public disclosures**

- Authorized by Sec. 165(b)(1)(B)(ii) and (f)
- The Federal Reserve may require periodic public disclosures “in order to support market evaluation of the risk profile, capital adequacy, and risk management capabilities” of the Nonbank SIFI.

### **Short-term debt limits**

- Authorized by Sec. 165(b)(1)(B)(iii) and (g)
- Sec. 165(g) authorizes the Federal Reserve by rule to define the term “short-term debt” and to limit the amount of such debt (including off-balance sheet exposures) that may be accumulated by any Nonbank SIFI “in order to mitigate the risks that an over-accumulation of short-term debt could pose to financial companies and to the stability of the United States financial system.” With respect to a Nonbank SIFI that does not control an insured depository institution, the Federal Reserve may issue an exemption from, or an adjustment to, this limit if it determines that “such action is necessary to ensure appropriate heightened prudential supervision” of that company.

### **Other prudential standards**

Sec. 165(b)(1)(B)(iv) authorizes the imposition of such other prudential standards as the Federal Reserve, on its own or pursuant to a recommendation by FSOC in accordance with Sec. 120, determines are appropriate.