UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF
THE COMMISSIONER

May 15, 2014

*via e-mail: rule-comments@sec.gov*

U.S. Securities and Exchange Commission
100 F Street, NE
Washington, D.C. 20549
Attn: Office of the Secretary

Re: Public Feedback on OFR Study on Asset Management Issues

Ladies and Gentlemen:

I submit this comment letter on my own behalf and representing my own views in connection with the Office of Financial Research ("OFR") *Asset Management and Financial Stability Report* ("OFR Report"). The report was intended to address the purported risks to the stability of our financial markets posed by the asset management industry.[1] Notwithstanding my position as a presidentially-appointed and Senate-confirmed Commissioner at the Securities and Exchange Commission ("SEC" or "Commission") – the primary regulator of the asset management industry for the past 75 years – I have no statutory standing whatsoever in the Financial Stability Oversight Council ("FSOC") and will therefore play no formal role in FSOC's misguided debate over whether to designate asset managers as systemically important financial institutions ("SIFIs") pursuant to Title I of the Dodd-Frank Act. As such, I commend SEC Chair Mary Jo White for posting for comment the fundamentally flawed OFR Report, and it is that document and subsequent regulatory activities about which I offer these comments.

I note at the outset that virtually all of the commenters on the OFR Report thus far have sharply criticized the absence of empirical data underlying the generalizations advanced by the report and the flawed methodology used to analyze systemic risk.[2] Many argued that FSOC should not rely on the report to inform its policy decisions and some even called for OFR to

[1] OFR, *Asset Management and Financial Stability*, September 2013, available at http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

[2] *See, e.g.*, comment letter of Scott C. Goebel, General Counsel, Fidelity Management and Research Co., Boston, Massachusetts (November 1, 2013) ("The OFR fails to provide sufficient data or analysis to support any of the speculation included in the Report."); comment letter of Paul Schott Stevens, President & CEO, Investment Company Institute (November 1, 2013) ("[T]the OFR Study is replete with sweeping conclusions unsupported by data; lacks clarity, precision, and consistency in its scope and focus; and misuses or misinterprets data."); comment letter of James J. Angel, Ph.D., CFA, Visiting Associate Professor, University of Pennsylvania, The Wharton School (November 5, 2013) ("The Study is incomplete… [It] provides a brief overview of the asset management industry, comparable to a chapter in an introductory textbook, along with a generic list of things that could go wrong."). All comment letters are available electronically on the SEC's website at http://www.sec.gov/comments/am-1/am-1.shtml.

withdraw the report.[3] Among other criticisms, many commenters observed that the report reflects a severe lack of understanding of the asset management industry (including by inaccurately describing it as a homogenized group of entities and activities), that it is riddled with unfair generalizations, that it completely fails to address how prudential regulation would address any of the risks it purported to identify, and that it ignores the existing oversight authority for asset managers by the SEC and other federal agencies.[4]

I also note that FSOC's SIFI designation process is being conducted in a time and manner conspicuously contemporaneous with an even broader initiative on the part of the Financial Stability Board ("FSB"), an unaccountable international body comprised of bureaucrats from many different jurisdictions to identify non-bank, non-insurer entities, including asset managers, as *global* SIFIs, including asset managers. FSOC and FSB – everyone's favorite "F words" these days, it seems – are both dominated by banking regulators and are intent on expanding the jurisdiction of the agencies led by certain constituent members by designating non-bank entities as systemically important with little to no input from the primary regulators of those entities. To be clear, like FSOC, despite its broad remit encompassing by its own terms the entire field of "financial sector policies,"[5] the FSB and its agenda are dominated by banking regulators and appear to be guided by the principle that regulations designed for banks should be applied as widely as possible. What's good for the goose is good for the gander, they believe – but the gander has had enough of this power grab, and is calling for an honest debate on these issues.

The FSOC and FSB initiatives are pure – and dangerous – folly. Applying bank regulatory principles to capital markets regulation is a fatally misguided approach, the regulatory equivalent of trying to jam a square peg into a round hole. Bank regulators should resist their apparently innate urge to regulate asset managers – and, for that matter, all other non-bank entities – like banks. Forcibly imposing bank-like regulation on these capital market participants

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[3] *See, e.g.*, comment letter of Timothy W. Cameron, Managing Director, Asset Management Group, and Matthew J. Nevins, Esq., Managing Director and Associate General Counsel, Asset Management Group, Securities Industry and Financial Markets Association; David G. Tittsworth, Executive Director, Investment Adviser Association (November 1, 2013); comment letter of Richard M. Whiting, Executive Director and General Counsel, Financial Services Roundtable, Washington, District of Columbia (November 1, 2013).

[4] *See, e.g.*, comment letter of Hester Peirce, Senior Research Fellow, and Robert W. Greene, Research Associate, Mercatus Center at George Mason University, Arlington, Virginia (November 1, 2013) (addressing OFR Report's lack of understanding of asset management industry and its heterogeneity); comment letter of Tim Buckley, Chief Investment Officer, and John Hollyer, Principal and Head of Risk Management Group, Vanguard (November 26, 2013) (describing significant shortcomings of OFR Report, including broad generalizations and unreliable data and analysis); comment letter of Paul H. Kupiec, Ph.D., Resident Scholar, American Enterprise Institute, Washington, District of Columbia (October 31, 2013) (observing that report fails to offer any evidence that designating asset managers as SIFIs would address risks to financial market stability); comment letter of Senator Mark Kirk, Senator Thomas Carper, Senator Patrick Toomey, Senator Claire McCaskill, and Senator Jerry Moran (January 23, 2014) (arguing that OFR Study fails to acknowledge extensive existing regulation of asset management industry already in place).

[5] *See, e.g.*, FSB Website, Overview, http://www.financialstabilityboard.org/about/overview.htm.

will negatively impact the U.S. economy and work to the detriment of the investing public while doing nothing at all to protect taxpayers or investors.

FSOC and the OFR Report

FSOC is a creation of the Dodd-Frank Act. It was originally conceived as a collegial council of regulators[6] – an expanded and formalized version of the President's Working Group on Financial Markets, which had served for over two decades as a consultative group for the harmonization of financial market regulatory policy and the facilitation of communications between U.S. financial regulators. I was in the trenches as an SEC staffer during the financial crisis and saw firsthand the tragic consequences that flowed from uncoordinated, uninformed regulatory responses to critical problems. As such, I appreciate the concept of an entity tasked with playing a coordinating and information sharing role. FSOC, however, emerged from the final legislation with unprecedented and extraordinary regulatory powers, in particular the authority to subject non-bank financial institutions to prudential regulation by the Federal Reserve if such institutions are deemed to pose a threat to the financial stability of the U.S. economy, and to make a "recommendation" that an independent agency engage in a particular rulemaking.[7]

FSOC soon showed it had no hesitation to exercise this power, as the SEC learned with respect to the regulation of money market mutual funds.[8] In November 2012, the members of FSOC voted *unanimously* to propose for public comment "Proposed Recommendations Regarding Money Market Mutual Fund Reform,"[9] a proposal that, if adopted, would allow FSOC to issue a formal "recommendation" to the SEC.

[6] *See* Benton Ives and Phil Mattingly, *Geithner Outlines Regulatory Overhaul*, CQ Weekly, Mar. 28, 2009, *available at* 2009 WLNR 6351182 (discussing Senator Dodd's call for "a council of regulators" that could "watch for systemic risks" with the help of "a professional staff that could analyze systemic risk"); *see also Industry Backs Multi-Agency Approach on Risk*, Compliance Reporter, May 22, 2009, *available at* 2009 WLNR 26668110 (noting that certain ex-SEC officials and senior industry professionals "backed a council of regulators approach for overseeing risk") (noting one idea for "a framework in which a council of agencies could act more as an oversight body than as a regulator").

[7] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 113, 124 Stat. 1376 (2010).

[8] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 120, Pub. L. 111-203, 124 Stat. 1376 (2010); Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69,455 (Nov. 13, 2012).

[9] Financial Stability Oversight Council, *Proposed Recommendations Regarding Money Market Mutual Fund Reform* (November 2012) available at
http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf.

Pursuant to the provisions of the Dodd-Frank Act, an agency that receives such a "recommendation" from FSOC must either comply with it, take alternative steps that yield a comparable result, or explain in writing why it has elected not to carry out FSOC's wishes.[10] Imposing this requirement on frontline regulators represents an unprecedented interference in the affairs of ostensibly independent agencies and heightens the risk of "regulatory sabotage" – the selective use of legislative authority, regulatory authority, or both by one set of market participants to competitively harm another set of market participants.

The example of money market mutual funds, the subject of FSOC's proposed "recommendation" to the SEC, provides a useful illustration. These funds were created in the early 1970s as a response to the prohibition on paying interest on demand deposit accounts at U.S. banks and have been regulated by the SEC ever since. Over time, these funds grew to the point where they represented a significant alternative to banking products – and a constant thorn in the side of the bank regulators unable to extend their jurisdiction to include this so-called "shadow banking" alternative.

Having proven its ability and willingness to take steps to impose its "recommendations" upon purportedly independent agencies, last year FSOC commenced a review of the activities of asset management firms to determine whether such firms should be designated as SIFIs and therefore subject to enhanced prudential standards and supervision. In connection with this review, FSOC asked the Treasury-based OFR to perform an analysis of the asset management industry, including its vulnerability to financial shocks and the potential risks it poses to the financial markets.

In September 2013, OFR released its findings in the OFR Report, a document riddled with fundamentally flawed conclusions that were the inevitable result of the deeply unsound process followed by OFR in its performing its analysis. Not only does the OFR Report inaccurately define and describe the activities and participants in the asset management business, it makes matters worse by analyzing the purported risks posed by asset managers in a vacuum instead of in the context of the broader financial markets. It offers up speculative conclusions of systemic risk without any reference to the data used to support them – unsurprising, given that clearly, little if any data was actually considered – and without any reasoned policy arguments about how to address them. The end product was a botched analysis that grossly overstates – indeed, in many cases simply invents without supporting data – the potential risks to the stability of our financial markets posed by asset management firms.

Exponentially compounding the mistakes of fact and poor substantive analysis contained in the OFR Report was OFR's brazen refusal to consider the comments and input of experts from the SEC, the very agency charged by Congress with regulating asset managers. The Commission has had regulatory authority for over seventy years to oversee the asset management industry, yet the comments of SEC staff – many of which were meant to correct or clarify plainly inaccurate

[10] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 120(c)(2), 124 Stat. at 1409 (2010).

statements and non-sequiturs – fell on deaf ears. As members of Congress aptly noted in a recent letter to Treasury Secretary Lew, thanks to the cavalier attitude of the OFR Report's authors, the SEC staff "left little more than fingerprints, while their attempts to substantively improve the final product were summarily rejected."[11]

In a letter sent to Congress on May 14, 2014, the Treasury Department argued that OFR had, indeed, consulted extensively with the SEC on its report, and cited numerous emails and staff meetings to support the claim. Being an outsider to all things FSOC, and certainly never having received any of the cited emails or participated in any of the referenced meetings, I will not wade into this suddenly lively factual dispute. I am compelled, however, to point out one fact that I found astonishing. Apparently, even the Treasury Department, the Secretary of which is the Chairman of FSOC, does not understand the membership structure of FSOC. The letter repeatedly cites to "member agencies," of which there are none. Anyone who has paid any attention to the flawed construct of FSOC knows that its membership consists only of the chairpersons, directors, and secretaries of selected federal entities. With respect to the independent agencies, the "agencies" are not members, and therefore non-chairperson presidential appointees to those entities such as myself and my fellow Commissioners at the SEC do not belong to the club. This is not just semantics—as FSOC painfully learned in the context of money market funds, an "agency" isn't really involved in a matter unless all of the presidential appointees are. A chairperson and selected staffers do not an agency make.

Having been warned that my comments would not be considered, as well as having experienced FSOC's blatant and complete disregard for any input whatsoever from the primary regulator during the money market mutual funds debate, I declined to grasp at straws in the unrealistic hope of leaving even my "fingerprints" on the OFR Report. That the presidentially-appointed Commissioners of the agency responsible for regulating the asset management industry were not afforded a meaningful opportunity to comment on the report is strong evidence that, as the same members of Congress observed in their letter to Secretary Lew, "OFR produced the report as simply a pretext for further action to designate asset managers as systemically important, and not as an unbiased and objective review of the industry."[12]

In short, the OFR Report completely failed to provide a legitimate rationale for systemic risk designation. I am sure that its myriad inaccuracies and unsupported conclusions would make excellent fodder for the litigation that would be sure to follow any decision to designate asset managers as SIFIs. Nevertheless, it appears that FSOC is intent on marching forward with

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[11] Letter from Darrell Issa, Chairman, H. Comm. On Oversight and Gov't Reform, and Jim Jordan, Chairman, Subcomm. On Economic Growth, Job Creation, and Regulatory Affairs of the H. Comm. On Oversight and Gov't Reform, to The Honorable Jacob J. Lew, Secretary, Dep't of the Treasury (April 7, 2014).

[12] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 120(c)(2), 124 Stat. at 1409 (2010).

its analysis.[13] While I appreciate the efforts of FSOC to provide at least a veneer of willingness to consider outside input by holding a public conference on May 19th, it is nonetheless clear to me that the bank regulators riding herd over FSOC have decided that neither the professional staff nor any non-Chair Commissioners of the SEC will be invited to the party. We can only pray that other voices of reason will step up and demand to be heard. In the meantime, I hereby register a vote of "NO" in the court of public opinion on the issue of whether to designate asset managers as SIFIs.

FSB

To make matters worse for investors and the U.S. economy as a whole, FSOC isn't the only player with its thumb on the scale in the world of SIFI designations. FSOC carries out its self-appointed missions in the shadow of the FSB, an international body created in 2009 in the wake of the financial crisis ostensibly to make recommendations about the global financial system. Dominated by European central bankers, the FSB includes representatives from all of the G-20 countries (including, notably given recent geopolitical events, Russia), the European Commission, and a number of international banking and standard setting organizations. Not surprisingly for an institution dominated by bank and non-U.S. regulators, the SEC, while nominally a member of the FSB, does not have a seat at the "grown-ups' table," and our voice is consistently ignored unless we are telling them what they want to hear.

In 2010, the G-20 directed the FSB to embark on a process to identify "globally systemically important financial institutions" ("G-SIFIs"). The FSB's initial work focused on banking organizations, but its leadership announced early on that it planned to extend its analysis to a wider array of entities, including "financial market infrastructure, insurance companies and other non-bank financial institutions that are not part of a banking group structure."[14] After naming 29 banks as G-SIFIs in 2011,[15] the FSB quickly turned its attention to insurance companies, designating nine insurers, including three in the U.S. – MetLife, Prudential, and AIG.[16]

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[13] *Fund Firms' Subsidiaries Helped Trigger Regulatory Review*, WALL. ST. J. (Apr. 25, 2014) (reporting that Blackrock and Fidelity have advanced to the second stage of a three-stage review for potential SIFI designation because their assets held by their subsidiaries exceed FSOC's minimum thresholds).

[14] Financial Stability Board, *Reducing the moral hazard posed by systemically important financial institutions: FSB Recommendations and Time Lines*, (October 20, 2010) available at http://www.financialstabilityboard.org/publications/r_101111a.pdf.

[15] Financial Stability Board, *2013 update of group of global systemically important banks* (G-SIBs), Annex I (Nov. 11, 2013) (list of G-SIBs), available at http://www.financialstabilityboard.org/publications/r_121031ac.pdf.

[16] *G-20 Financial Stability Board Names Nine Insurers Systemically Important*, WALL. ST. J. (July 18, 2013).

True to form, the FSB announced plans early this year to expand its focus to non-bank, non-insurer entities ("NBNIs") – in other words, asset managers. In a report issued in January 2014, the FSB released its proposed methodology for extending the SIFI framework from banks and insurance companies to "all other financial institutions."[17] Foreshadowing what are sure to be the FSB's ultimate conclusions, the report described potential systemic risk transmission mechanisms of asset managers and listed a number of "indicators" for assessing systemic importance, including concepts such as leverage ratio, counterparty risk, and intra-financial system liabilities. Neither surprisingly nor coincidentally, these are some of the same red herrings that form the basis for the findings of the flawed OFR Report.

The work of the FSB clearly is meant to legitimize FSOC's efforts to import prudential regulation to the U.S. capital markets through the designation of non-banking entities as SIFIs. Shielded by the purported supra-national, political mandate of its G-20 members, the FSB is preparing to force its agenda in arenas where it has no experience and simply does not belong.

Asset Managers Should Not Be Designated As SIFIs

As a preliminary point, it is my belief that the impulse to designate asset managers as SIFIs is driven by the realization on the part of bank regulators that the resolution procedures contained in Title II of the Dodd-Frank Act are, to put it bluntly, fools' gold. It is the worst-kept secret in Washington that the FDIC, which would be the central player in any potential Title II liquidation, is the driving force behind the effort to designate asset managers as SIFIs. Absent this unstated lack of faith in the viability of Title II and a nuanced understanding of the limited resolution issues posed by asset managers, the very concept of designating asset managers as SIFIs simply does not make sense.

In addition to the general folly of attempting to force bank regulatory principles upon the capital markets, there are a number of specific reasons why it defies reason to designate asset managers in particular as SIFIs and subject them to prudential regulation. First, and most importantly, the resolution process for asset managers is vastly simpler than those for most other types of financial institutions. Asset management is an agency activity, meaning that asset managers do not invest for their own accounts as principals and their exposure is limited by the legal structure of funds and separate accounts. Assets are held by custodians on behalf of clients, not by the asset managers themselves.

As such, unlike banks, asset managers do not have balance sheet obligations that complicate the unwinding process. When an asset manager goes out of business, the customer accounts and the assets within them simply relocate to a new custodian and all that remains is to liquidate the remaining, bare-bones operating assets of the management company. There are no

[17] Financial Stability Board, Consultative Document, *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (Jan. 8, 2014) (addressing high-level framework and methodologies for assessing NBNIs for potential SIFI designation).

investor assets in danger of being consumed by an imploding balance sheet. There is – to put it as simply as possible – no need for a backstop or bailout.

It is also crucial to understand that asset managers do not participate directly in the capital markets. Unlike banks (and some insurance companies), asset managers do not lend money or act as counterparties. Therefore, they have lean balance sheets that do not carry the potential systemic risk of other capital-heavy financial institutions.

In the banking sector, which features leveraged institutions operating in a principal capacity, capital requirements are designed with the goal of enhancing safety and soundness, both for individual banks and for the banking system as a whole. They reduce risk and protect against failure, and they reduce the potential that taxpayers will be required to backstop the bank in a time of stress. Capital requirements for other participants in the capital markets, however, serve a different purpose. They are designed to *manage* risk – and the corresponding potential for failure – by providing enough of a cushion to ensure that a failed asset manager can liquidate in an orderly manner, allowing for the transfer of customer assets to another asset manager.

People deposit money in banks to *avoid* risk, in the form of a federally insured guarantee on their deposits. People invest with asset managers in the capital markets because they *seek* risk and the corresponding potential for a higher return on their investment. These two fundamentally different objectives simply cannot both be achieved under the same regulatory paradigm.

In addition, the activities of asset managers already are highly regulated and subject to extensive public disclosure requirements. The Investment Advisers and Investment Company Acts provide an effective, overarching regulatory framework that protects investors from the risk. The existing regulatory regime recognizes that asset managers are participants in the capital markets and is appropriately tailored to address the risks inherent in that role.

## Conclusion

FSOC is charged in the Dodd-Frank Act with the responsibility to identify risks to the financial stability of the United States, to promote market discipline, and to respond to emerging threats to the stability of the United States financial system.[18] Unfortunately, like its alter ego the FSB, FSOC has pushed the outer limits and overstepped its bounds in defining the scope of its mandate.

It is time to acknowledge that "systemically important" is bank regulator speak for "too big to fail" – or, alternatively, "bailout eligible." FSOC and the FSB are, in essence, determining which financial entities must stay solvent under any conditions and applying a one size fits all regulatory paradigm in an attempt to make failure of those entities impossible. This is irrational

[18] *See* Dodd-Frank Wall Street Reform and Consumer Protection Act § 112, 124 Stat. 1394 (2010).

and shortsighted, especially given the vastly different resolvability considerations attendant to the wind-down of agency actors such as asset managers as compared to banks and other financial institutions.

Instead of spending its time and attention attempting to extend its regulatory purview to include the asset management industry, which by its very nature poses no systemic risk, FSOC should be focusing on the clear and present dangers that threaten our financial markets today - for example, the inevitable impact of years of loose monetary policy, the damage to capital markets liquidity that will inevitably stem from the highly flawed Volcker Rule and the disastrous return to looser lending standards in the housing markets that will result from Federal Housing Finance Agency policy and the CFPB's adoption of a laughably low standard for "qualified mortgage," which other regulators, including the SEC, seem determined to copy for their definition of "qualified residential mortgage."

The decisions made by FSOC, a body that will almost always be comprised exclusively or almost exclusively of members of the same party led by a member of the President's cabinet, take place behind closed doors with no checks or balances in place to safeguard against overreaching, no appeals process, and no disinterested fact finder. These factors ensure that there is no mechanism in place to stop the blatant regulatory creep that is taking place before our eyes. It is high time we all acknowledge that the FSOC process itself is far more dangerous to our financial markets than the purported risk factors it was purportedly created to address.

Once again, although I have no vote in FSOC, in the court of public opinion, I vote NO.

Sincerely,

Daniel M. Gallagher
Commissioner