ARNOLD & PORTER LLP

John D. Hawke, Jr.
John.Hawke@aporter.com

+1 202.942.5908
+1 202.942.5999 Fax

555 Twelfth Street, NW
Washington, DC 20004-1206

November 5, 2013

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Proposed Rule on Money Market Fund Reform: Amendments to Form PF; Release No. S7-03-13.

Dear Chair White:

Enclosed for filing in the above-referenced docket is a copy of comments submitted last week on behalf of our client, Federated Investors, Inc., in the comment docket for a recent report by the Treasury Department's Office of Financial Research ("OFR") entitled "Asset Management and Financial Stability." The OFR Report, which was prepared at the request of the Financial Stability Oversight Council, provides insights into the views of those advising FSOC on the need for structural changes to money market funds ("MMFs").

The Commission has based its proposed "Alternative 1" for MMF reform upon the FSOC position that MMFs which seek to maintain a stable NAV of $1 per share are vulnerable to a so-called "first mover advantage" and destabilizing "runs" by redeeming shareholders which can only be remedied by forcing all MMFs to move to a floating NAV. The OFR Report takes the position that *variable* NAV mutual funds are *also* vulnerable to the "first mover advantage," and to destabilizing "runs" that create systemic risks. The OFR Report assertion undermines the credibility of the OFR and FSOC on asset management issues, including MMF structure and regulation, as well as the purported intellectual underpinnings for the movement of MMFs to a variable NAV as proposed by the FSOC and included in the Commission's Alternative 1.

The Report views investment funds and investment management activities through the lens of bank regulation, leading to serious analytic flaws that we have detailed in the enclosed letter. The OFR Report should give pause to those in the investment management industry and the Commission who believe that FSOC will be satisfied with changes only to MMFs.

Sincerely,

John D. Hawke, Jr.

ARNOLD & PORTER LLP

John D. Hawke, Jr.
John.Hawke@aporter.com

+1 202.942.5908
+1 202.942.5999 Fax

555 Twelfth Street, NW
Washington, DC 20004-1206

November 1, 2013

The Honorable Mary Jo White
Chair
U.S. Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Comments on OFR Report on Asset Management and Financial Stability

Dear Chair White:

We are writing on behalf of our client, Federated Investors, Inc. and its subsidiaries ("Federated"), to provide comments in response to the Securities and Exchange Commission's (the "Commission's") request for public feedback on the September 2013 report of the Treasury Department's Office of Financial Research ("OFR") entitled "Asset Management and Financial Stability" (the "Report").[1] The Report was prepared at the request of the Financial Stability Oversight Council ("FSOC").

Federated has more than 40 years of experience in the investment management business. Through its mutual funds and investment advisory and related services, Federated has served the investment needs of millions of individual and institutional investors of all sizes.

We appreciate this opportunity to provide comments on the Report.

[1] OFR, *Asset Management and Financial Stability* (Sept. 2013) ("Report"), http://www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx.

I. Introduction

The Report contains a number of analytical flaws, as discussed further below. Taken as a whole, the Report views the securities markets through the lens of a bank regulator that shows an inability or unwillingness to understand the fundamentals of how markets work and the role of an investment manager as agent and fiduciary for its clients. Investors make investment decisions to further their interests and investment objectives. Investment managers act as agents seeking to take action for their clients to further their clients' interests and investment objectives. Investment managers do not act to further the policy objectives of the Federal Reserve System or the Treasury Department by making or staying in investments to further the common good as determined by federal government officials. When there are more buyers than sellers at a price, prices go up. When there are more sellers than buyers at a price, prices go down. Not everyone makes the same decisions, or makes their decisions at the same time, or receives the same price.

The Report identifies these characteristics of markets and investment managers as flaws which create undefined "systemic risks" that need to be corrected by structural changes. The reality is these attributes are the core strengths of a market-based economy.

A. The OFR Report fails to take fundamental structural differences between asset managers and banks into account.

Investment management is an agency activity. Investment managers do not guarantee returns. The Investment Advisers Act prohibits investment advisers from guaranteeing results to their client-investors. The value of a client's investments managed by an investment manager are not tied to the financial health of the investment manager. Investment managers do not act as principals in managing the investments of their clients. If the clients' investments decrease in value, the investment manager does not lose money and is not liable to the client for the loss in value.

In contrast, banks intermediate financing primarily by accepting deposits from their customers and making loans or investments. In each case the bank acts as principal for its own account. The deposit is a debt obligation owed by the bank to the depositor. The loan or investment is a debt obligation owed to the bank by the borrower or issuer. If the loan or investment declines in value, the bank still owes the depositor 100 cents on the dollar plus interest and must repay the depositor according to the timing specified in the deposit contract.

Although the OFR Report acknowledges this key point in the introduction, it proceeds to ignore the distinction and analyze investment managers as if they were, and should be, acting as principals and guarantors of their client-investors' investment positions.

B. The failure to understand the differences between asset managers and banks led OFR to exaggerate the risks associated with asset management.

The "vulnerabilities" identified in the Report are in fact (1) ordinary investment risks that are not specific to asset management (*e.g.*, "reaching for yield"), (2) risks controlled primarily by clients of assets managers (*e.g.*, use of leverage, which is a decision that investors make, through either financing for their investments or selection of investment funds that pursue leverage strategies), (3) incentives for asset managers to limit risk taking (*e.g.*, avoiding redemptions by shareholders in order to preserve size of funds and asset-based fees) or (4) the reflection of a misunderstanding of the operations of asset managers (*e.g.*, consequences of the failure of an asset manager, which are in fact much more limited for customers and counterparties because of the agency role of the manager than consequences of the failure of a bank).

C. The failure to understand the fundamental differences between asset managers and banks led OFR to make misguided policy recommendations.

The Report inappropriately takes a bank regulatory framework—which is premised on the use of a large capital base to support principal positions and a supervisory structure designed to dictate most aspects of asset allocation and risk tolerance to protect that balance sheet and meet Federal economic policy objectives of making credit available to certain uses—and applies it to other, very different types of firms, including investment managers and mutual funds whose role is to make investments for the benefit of client-investors to meet client directions and investment objectives.

While its ultimate purposes remain vague, the Report appears designed to support a set of policy recommendations that would force asset management firms to be structured and operated like banks, hold capital against the investment positions of client-investors,[2] and make and maintain investments in times of economic uncertainty. These changes would not be made to meet client investment directions and objectives, but instead to support a Federal policymaker's objectives of attempting to regulate financial markets based upon its determination of the common good that it calls financial stability.[3] The Report notes that the Commission's program of "regulation focuses on helping ensure that managers adhere to their clients' desired risk-return profiles, but does not always address collective action problems and other broader behavioral issues that can contribute to asset price bubbles or other market cycles."[4] The Report is not addressing only investment funds, but also a "grab bag"[5] of unspecified and undefined "systemic risk" issues it sees created by management of individual client accounts. For example, the report states that "[s]ome activities highlighted in this report that could create vulnerabilities—if improperly managed or accompanied by the use of leverage … include risk-taking in separate accounts…."[6]

The public already has access to banks and deposit products. Investors use investment managers and securities investments appropriately for other needs—making investments for the account and risk of the investor. The "one size fits all" approach to

---

[2] Report at 19-20 ("The Federal Reserve's annual stress test requires the asset management divisions of large bank holding companies with money-like funds to set aside capital to cover the risk that they would have to support some of their funds during stress conditions. Figure 10 shows the book value of large dedicated asset managers compared to their assets under management—one indication of available firm resources. These resources can be used … to … provide sponsor support to funds based on market circumstances"). Never mind that this would be a clear violation of Regulation W and Section 23A of the Federal Reserve Act if a bank provided this type of support for an investment company it or an affiliate advised, and of the Volcker Rule if a bank or bank affiliate provided financial support for a private fund or commodity pool it advised.

[3] To similar effect, *see also* R. Bookstaber, *Using Agent-Based Models for Analyzing Threats to Financial Stability* 4, 9-11, 13-14, 16-19 (Office of Financial Research Working Paper #0003, Dec. 21, 2012) (suggesting that modifications to rules applicable to individual participants in financial markets can be used to alter market dynamics in a crisis) ("Bookstaber").

[4] Report at 10.

[5] *Cf*. L. Hansen, *Challenges in Identifying and Measuring Systemic Risk* (Feb. 11, 2013) at 1. ("[M]itigating systemic risk is a common defense underlying the need for macro-prudential policy initiatives. The term has become a grab bag, and its lack of specificity could undermine the assessment of alternative policies."), *avail*. http://www.nber.org/chapters/c12507.pdf.

[6] Report at 1.

financial regulation embodied in the Report is contrary to the intent of Congress in the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") to tailor regulation to different contexts.

D. The Report should be a wake-up call for anyone who did not see where the FSOC, Federal Reserve, and Treasury were headed.

If the mind-set and intent of the FSOC, Federal Reserve and Treasury were not already clear by now, the Report, and the opinions issued in the FSOC's recent designation of the first group of non-bank systemically important financial institutions ("SIFIs"),[7] should make clear the intent of these agencies is to break the long-standing structural models of non-bank financial firms and force them into bank-like capital structures.

The Dodd-Frank Act does not grant any authority to the FSOC to regulate entire industries or to require the primary regulator to change the structure or regulations applicable to an industry. Section 113 of the Dodd-Frank Act provides authority for the FSOC (by a two-thirds vote) to designate only a few of the largest and most significant non-bank financial firms as SIFIs and subject them to supervision and regulation by the Federal Reserve under Title I and liquidation by the FDIC under Title II of the Act. Section 120 of the Dodd-Frank Act authorizes the FSOC only to make *recommendations* to other financial regulators on systemic risk issues, but not to force those regulators to make changes. Moreover, the Dodd-Frank Act does not supplant the requirements of the federal securities statutes applicable to investment advisers and investment funds or the factors that the Commission must consider in adopting or amending rules intended to protect the public interest: protection of investors and promotion of efficiency, competition, and capital formation.

Nor does the Dodd-Frank Act suggest that non-bank financial firms should be analyzed as if they were banks or structured or regulated like banks. Although the FSOC and the Federal Reserve have acknowledged this in passing,[8] they have shown an unwavering tendency to analyze non-bank firms as though they were banks and seek to impose bank-like regulatory frameworks upon them.

---

[7] *Available at* http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx.

[8] Report at 1 ("[Asset management] activities differ in important ways from commercial banking and insurance activities.").

Evidence of this tendency includes:

- Asserting that insurance companies, mutual funds and entire markets are subject to bank-like "runs";[9]
- Seeking to impose bank-like capital requirements;[10]
- Analyzing agency activities as though they were principal activities;[11] and
- Overlooking or discounting the framework established by Congress and overseen by the Commission for regulation and supervision of investment management firms.[12]

The Report in particular takes the position that variable net asset value ("NAV") mutual funds, whose share prices move up and down with daily market valuations of their portfolio investments (which use forward pricing), are subject to "runs" by investors who redeem, and that these investor redemptions create "systemic risk" when the mutual fund sells portfolio investments to raise cash to meet the investor redemptions. Oddly, proponents of FSOC-dictated changes to the Commission's rules applicable to money market mutual funds ("MMFs") have maintained that MMFs are subject to investor "runs" because they seek to maintain a *stable* NAV of $1 per share, and that movement to

[9] Report at 12-16. The Report cites runs on mutual funds, the securities lending business of insurance companies, and the money markets. *See also* FSOC, Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc. (Sept. 19, 2013) (citing potential for runs on insurance companies), http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf.

[10] Report at 19-20 (stating that the available resources of an asset manager can be used to "potentially provide sponsor support to funds based on market circumstances").

[11] *See, e.g.*, Report at 21. The Report claims that asset managers could transmit risks across the financial system through rapid sales of assets. Yet asset managers sell as agents for their clients, who would make the "sell" decision themselves if there were no asset managers acting on their behalf.

[12] *See, e.g.*, Report at 10. The Report asserts that current regulation of asset managers "focuses on helping ensure that managers adhere to their clients' risk-return profiles, but does not always address collective action problems and other broader behavioral issues that can contribute to asset price bubbles or other market cycles." This suggests that asset managers should be required to shift their focus away from their clients' risk-return profiles to advance certain public policy objectives.

a variable NAV for MMFs would solve this alleged structural defect.[13] Yet here, the OFR reveals the FSOC and Treasury's true colors: variable NAV does not stop investor runs or solve for the alleged systemic impact of investors moving to safer asset classes in times of economic uncertainty. The real problems FSOC and Treasury have with *all* mutual funds, we now learn in the Report, is that they issue redeemable securities, and their investment managers do not have a large capital base to guarantee investment returns to shareholders by bailing them out of losses in a crisis.[14]

The Report should be a wake-up call for those segments of the mutual fund and broader investment management industry (as well as for the Commission, the CFTC and state insurance commissioners) who thought that the FSOC had its eyes on MMFs alone, and would not re-imagine *all* segments of the investment management industry as *de facto* banks that should be regulated like banks. Indeed, coupled with the recent designation of non-bank financial institutions as systemically important, it should be a wake-up call for participants in all aspects of the financial markets.

Before the Financial Crisis, the Treasury Department began work on its "*Blueprint For A Modernized Financial Regulatory Structure*," which was published in March 2008.[15] The *Blueprint* called for a transfer of authority to the Federal Reserve. Under the *Blueprint*, all financial services providers including mutual funds, private funds, and broker-dealers were to have a federal charter.[16] The Federal Reserve was to have authority over these firms in its role as the "Market Stability Regulator." The *Blueprint* also called for the Federal Reserve to receive broad new powers focused on these firms, state and federally-chartered banks, federally-chartered insurance companies, and the overall financial system. The *Blueprint* also called for Federal Reserve oversight of payment and settlement systems.[17]

[13] Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455, 69466 (Nov. 19, 2012).

[14] Report at 12-16, 19-20.

[15] U.S. Department of the Treasury, *Blueprint For A Modernized Financial Regulatory Structure* 1 ("Treasury began this current study of regulatory structure after convening a conference on capital markets competitiveness in March 2007."), *available at* http://www.treasury.gov/press-center/press-releases/Documents/Blueprint.pdf.

[16] *Id*. at 19.

[17] *Id*. at 9.

The stated rationale for the proposal in the Treasury *Blueprint* was preserving U.S. international competiveness and efficiency. Its only references to assuring financial stability and addressing financial crises are to the thrift crisis of the 1980s. With the Financial Crisis, the purpose supporting the power shift called for by the *Blueprint* was changed to protecting the stability of the financial system. Yet the end result remained centralization of authority in the Federal Reserve. A patient might reasonably doubt the doctor when the same remedy is offered for different maladies.

E. The Report shows that some would favor a centrally-planned economy over a market economy.

Markets go up and down, based on investor buying and selling decisions, allocating investments to areas of lowest risk relative to return, in a relatively efficient market, and away from investments with lower returns relative to risk. This function of securities markets is not based on the structure of the investment management industry or particular products. It is based on the fundamental choice of investors to optimize the risk-adjusted returns on their investments.

The Report treats this set of attributes of a market-based economy as a structural flaw in the investment management industry to be remedied through more control by Federal policymakers who are to decide how investments must be allocated and when they can be sold. If only their investors could be forced to remain invested during a crisis, mutual funds would not be forced to sell portfolio securities into the markets and thus would avoid further depressing prices through these sales.

Yet investment managers simply act as agents and fiduciaries for their clients. If there were no mutual funds and no investment advisers, investors would simply sell individual securities that they directly own through a broker-dealer, which would put the same downward price pressure on market prices. Without the assistance of professional managers, average investors would have to rely to a greater extent on broker recommendations and ratings, which would exacerbate some of the “collective action” risks identified in the OFR report.

During the Financial Crisis, the Commission, seeking to stabilize the markets, adopted emergency regulations to restrict "short selling" of shares of financial issuers.[18] The import of what the OFR Report is suggesting is even more radical—that mutual funds and investment managers cause or amplify financial instability because shareholders are permitted to redeem their shares and investment managers to individually managed accounts can sell large blocks of shares;[19] ergo the regulatory framework for investment management must be changed to prevent fund shareholders from redeeming and investment managers holding long positions from selling when contrary to federal government policy, in order to place a floor under market prices.

Government efforts to distort markets and manage prices through regulation to achieve economic stability have real costs on the economy, as well as on savers, investors and borrowers. In the end, these efforts usually fall of their own weight, but not before inflicting real damage.[20]

This FSOC approach of treating asset managers as "shadow banks" posing "systemic risks" that should be regulated like banks is clearly no longer just about money market funds. The essential message of the OFR Report—that movement of investor capital through the securities markets affects the prices of securities and thereby creates

---

[18] Emergency Order Pursuant to Section 12(k)(2) of the Securities Exchange Act of 1934 Taking Temporary Action to Respond to Market Developments, Exchange Act Release No. 34-58592 (Sept. 18, 2008).

[19] Report at 12-15.

[20] One of the Federal Reserve's stock rhetorical points regarding MMFs is that they resulted from "regulatory arbitrage" during the 1970s and early 1980s when the Federal Reserve dictated under Regulation Q the interest rates that banks could pay depositors. Another way to view the same fact pattern is that the Federal Reserve's Regulation Q was an effort to force savers (and borrowers) to subsidize bank profitability, and investors, issuers and markets found a way to stop being forced to pay that subsidy. *See, e.g.*, U.S. Department of the Treasury, *Modernizing the Financial System: Recommendations for Safer, More Competitive Banks* (1991) at XVIII-9 through XVIII-11 ("1991 Treasury Report"). The 1970s saw market pressures lead to the end of many federal regulatory efforts to fix prices, including the collapse of the Bretton Woods Accord, the end of fixed commissions on securities transactions, the end of federal restrictions on the ownership of gold, and the quick rise and fall of the Ford Administration's inadvertently comical "Whip Inflation Now" campaign. Gerald Ford, "Whip Inflation Now" Speech (Oct. 8, 1974), *available at* http://millercenter.org/president/speeches/detail/3283; M. Crutsinger, Ford's WIN Buttons Remembered, Wash. Post (Dec. 28, 2006), *available at* http://www.washingtonpost.com/wp-dyn/content/article/2006/12/28/AR2006122801002.html.

"systemic risk" that should be curtailed by regulatory restrictions on the movement of investor capital—echoes sentiments now openly expressed by the leadership[21] and staff[22] of the Federal Reserve System calling for federal regulatory intervention in financial markets to set or manage investment decision-making and ultimately prices. The intentions stated by senior Federal Reserve officials for this approach are apparently benign—to intervene through regulatory and supervisory action to address the market dislocations (and potential reaching for yield and asset bubbles) caused by the large amount of liquidity injected by the Federal Reserve into the economy.[23] Yet each step taken by the federal government to address through aggressive regulatory action the unintended effects of easy money has, in turn, its own unintended consequences on markets, investors and the economy that must be addressed by further regulatory action. Although this road may be paved with (apparently) good intentions, the destination is unclear, and certainly this path is not taking us towards more open and efficient markets.

There is nothing in the Dodd-Frank Act supporting this approach to financial regulation, and eighty years of precedent in the Federal securities laws is diametrically opposed to it. The Commission should not remain silent while the Treasury Department and Federal bank regulators seek to gut the primary functions of the securities markets, which are to protect investors, require full and fair disclosures and access to information, and efficiently establish securities prices through competitive bidding, leading to an allocation of capital and funding of issuers that have competitive business models.

---

[21] Charles L. Evans, President and CEO, Federal Reserve Bank of Chicago, Financial Stability and Monetary Policy: Multiple Goals, Multiple Tools, delivered at Financial Management Association Annual Meeting Luncheon, Chicago Illinois (Oct. 18, 2013) (discussing policy of the Federal Reserve to provide extensive liquidity to the financial system in order to maintain historically low interest rates and stimulate economy, while using prudential systemic risk controls to prevent banks and non-bank financial institutions—specifically mentioning insurance companies and pension plans—from "reach[ing] for yield by investing in excessively risky assets"), *available at* http://www.chicagofed.org/webpages/publications/speeches/2013/10_18_13_financial_stability_monetary_policy_fma_chicago.cfm ("Evans").

[22] *See* July 2012 Federal Reserve Bank of New York staff blog post and 2006 Federal Reserve Bank of Atlanta staff "macroblog" post praising WIN program, *available at* http://libertystreeteconomics.newyorkfed.org/2012/07/historical-echoes-whip-inflation-now-and-then.html; http://macroblog.typepad.com/macroblog/2006/12/was_win_a_loser.html.

[23] *See* Evans, *supra*.

If the Federal Reserve is concerned that its policy of quantitative easing is leading to cheap funding of risky securities investments, then it should tighten up on margin requirements and bank lending standards for securities loans. Managing investment decision-making by investment managers, mutual funds and investors, and limiting the redeemability of mutual fund shares, are not appropriate roles for the FSOC or the Federal Reserve.

F. The purpose of the Dodd-Frank Act was to end "too big to fail," not make it worse.

Congress was very clear in the Dodd-Frank Act that the intent of Titles I and II, which created the FSOC, was to end "too big to fail."[24] The FSOC's actions to date are designed instead to entrench it. The OFR's suggestions on capitalization of investment managers, forced funding in times of crisis[25] and limits on investment redeemability will lead to greater concentration of investment management in the banking industry, which will in turn increase systemic interconnectedness and "too big to fail" problems, in conflict with the intent of the Dodd-Frank Act.

G. The Report lacks real analysis or understanding.

There is little in the way of meaningful analysis in the Report. It simply rolls through a list of differences between market-based investment strategies where investment managers act as fiduciaries for customers, helping allocate assets and invest for the client's account and risk, and the balance sheet-based banking business where banks borrow from depositors and lend to borrowers. The Report determines that the market-based agency strategy involves market risk to investors not faced by bank depositors, and therefore poses risk to the economy. This risk to the financial system is caused by the chance that investors can lose money on their investments and they (or their investment advisers) might choose, in an effort to avoid losing money, to sell riskier investments and shift the proceeds to less risky investments in times of economic uncertainty. These sales can cause market prices to decline.

---

[24] The preamble to the Dodd-Frank Act specifies that it is intended "to end 'too big to fail' [and] to protect the American taxpayer by ending bailouts…."

[25] Report at 19-20.

Sections 113(a)(2)(G) and 120 of the Dodd-Frank Act require that the existing framework for regulation and supervision of firms be taken into account. Although FSOC may make recommendations to the Commission as primary regulator of investment advisers, the Dodd-Frank Act provides no authority whatsoever for the OFR or FSOC to impose standards or regulatory requirements upon the investment management industry.[26] Notably, even in the absence of a primary regulator, FSOC is not empowered to act, but must instead request legislation from Congress to address financial areas with no primary regulator.[27]

Congress and the Commission have put in place a regulatory system under the Investment Advisers Act and Investment Company Act for investment advisers and investment funds that is designed to protect clients from counterparty risk exposure to the investment adviser. Key features of this system include:

- Client assets must be held in custody at a custodian bank or broker-dealer;[28]

- Transactions between the client on the one hand, and the investment adviser (or the adviser's affiliates) on the other, are generally prohibited, subject only to very narrow and limited exceptions;[29]

- Material risks and conflicts of interest must be disclosed in writing to the client;[30]

- Advisers are not allowed to guarantee clients' investment performance;[31]

---

[26] *See* Dodd-Frank Act §§ 119(d), 120(c), 120(e).

[27] Dodd-Frank Act § 120(d)(3).

[28] Investment Company Act § 17(f); 17 C.F.R. §§ 270.17f-1 *et seq.*, 275.206(4)-2.

[29] Investment Company Act § 17; Investment Advisers Act § 206(3); 17 C.F.R. §§ 270.17a-1 *et seq.*, 275.206(3)-1 *et seq.*

[30] 17 C.F.R. § 275.204-3; Form N-1A, N-7.

[31] *See* SEC Staff Letter to Robert Reinhart (avail. Sep. 21, 1971); Contingent Advisory Compensation Arrangements, SEC Rel. IA-721 (May 16, 1980).

- Clients must receive periodic statements of account,[32] or audited financial statements in the case of an investment fund;[33]

- Standards of current, independent valuation are applied to the statements to clients on the value of assets in their accounts;[34]

- Client accounts are subject to annual independent audit;[35]

- Advisory fees are limited by fiduciary and anti-fraud standards and must be clearly disclosed in writing to the client;[36] and

- Clients must, under the terms of advisory contracts, be permitted to terminate the advisory relationship with or without cause, on short notice, and without financial penalty.[37]

The net result of this regulatory framework is that clients of investment managers are exposed to the risks of a decline in value or illiquidity of their investments—which is precisely the risk that clients knowingly undertake when they choose to invest in

[32] 17 C.F.R. § 275.206(4)-2(a)(3).

[33] 17 C.F.R. § 275.206(4)-2(b)(4) & (5).

[34] Investment Company Act § 2(a)(41); 17 C.F.R. §§ 270.2a-4, 275.206(4)-8(a)(1); SEC Accounting Series Rel. No. 118 (Dec. 23, 1970); SEC Accounting Series Rel. No. 113 (Oct. 21, 1969); Investment Company Act Rel. No. 26299 (Dec. 17, 2003) (compliance program requirement includes valuation program compliance).

[35] 17 C.F.R. § 275.206(4)-2(a)(4).

[36] Investment Company Act §§ 15, 36. For non-investment company advisory fees, similar principle applied under anti-fraud provisions of Advisers Act. *See Equitable Communications Co.*, SEC Staff No-Action Letter (Feb. 26, 1975); *Consultant Publications, Inc*., SEC Staff No-Action Letter (Jan. 29, 1975); *Financial Counseling Corporation*, SEC Staff No-Action Letter (Dec. 7, 1974); *John G. Kinnard & Co.*, Inc., SEC Staff No-Action Letter (Nov. 30, 1973).

[37] Investment Company Act § 15(a)(3). The same principle for non-investment company advisory clients is stated in *National Deferred Compensation*, SEC Staff No-Action Letter (Aug. 31, 1987) ("an adviser may not fulfill its fiduciary obligations if it imposes a fee structure penalizing a client for deciding to terminate the adviser's service or if it imposes an additional fee on a client for choosing to change his investment"); *National Regulatory Services*, SEC Staff No-Action Letter (Dec. 2, 1992).

securities as the price for potential profit from an increase in value of the investments. Clients of investment managers are not exposed to the risk of loss of value due to the insolvency of the investment manager.

The investment management activities of bank trust departments and trust companies, which are regulated and supervised by state and federal banking agencies, follow a similar approach based upon fiduciary principles where the bank or trust company acts as fiduciary for the client, not as a counterparty to the client.[38]

Yet the focus of the OFR Report is to call for greatly increased capital in investment managers so that the investment managers can use their own balance sheet assets to intervene to make clients whole in the event that investments made for the benefit of the clients decline in value.[39] This OFR approach so profoundly misunderstands the role of investment managers, the services that clients are seeking when they hire investment managers, 947 years of jurisprudence on the roles and relationships of fiduciaries and their clients, and terms that Congress and the Commission have specified for this adviser/client relationship, that it is difficult to give credence to any aspect of the Report.

H. The faulty premise that more bank-like regulation and Federal Reserve-style intervention will reduce risk underlies the analysis, but is flatly contradicted by the facts of the 2007-2009 Financial Crisis and the Financial Crisis Inquiry Commission report

There is an underlying presumption that more and more elaborate federal involvement in setting the structure and risk allocation of financial firms will reduce their risk of failure. Yet in the 2007-2009 Financial Crisis, it was the most heavily-regulated firms that were at the center of the problem—failed government-sponsored enterprises, failed banks, poorly-structured bank off-balance sheet contracts and bank securitization vehicles, and failed large broker-dealers in particular.[40] Moreover, the various federal

[38] *See* 12 C.F.R. Part 9; 12 U.S.C. § 92a; 12 U.S.C. § 371c-1(b)(1). *See also* Employee Retirement Income Security Act of 1974, as amended; Restatement of the Law, Third, Trusts.

[39] Report at 20 (stating that resources of asset management firms can be used to "potentially provide sponsor support to funds based on market circumstances").

[40] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011); U.S.

Footnote continued on next page

responses during the Financial Crisis to insolvencies at different firms sent inconsistent messages which confused the markets. These included the bail out of Bear Stearns, Freddie Mac and Fannie Mae, allowing Lehman Brothers to fail, and the rescue of AIG.

Regulatory incentives to allocate credit and risk to achieve certain public policy objectives (particularly full employment and affordable housing) led to an accumulation and masking of risk in the regulated part of the financial system and a massive credit bubble, which eventually popped. Nothing in the Financial Crisis can be read to suggest that the federal banking agencies did a good job in regulating banks in the years leading up to the Financial Crisis, or that imposing bank-like regulation on investment managers and moving away from a market-based, investor-driven system of asset management would reduce systemic risk. Indeed, the failure of roughly 300 FDIC-insured depository institutions during the Financial Crisis suggests that the bank regulatory model and structure should not be spread more broadly into other types of financial services firms.

II. Nature of Asset Management

A. Asset managers are agents, not principals.

Agents act as fiduciaries for clients. They do not guarantee results or act as counterparties to clients. Principals act as counterparties to customers—borrowing money from them or lending money to them, selling assets to or buying assets from them, and exposing the customers to the risk of failure by the principal.

Clients, rather than asset managers, determine their risk tolerances. Asset managers must disclose all material risks of their investment strategy (including the use of any leverage). If a strategy is attracting assets, it is because clients are willing to take those risks. A manager who takes greater risks than its clients are willing to tolerate will eventually lose assets and damage its reputation.

In its list of factors to consider in determining whether an individual financial company is systemically important (most of which clearly target lending and other activities conducted as principal), Section 113(a)(2) of the Dodd-Frank Act specifically

Footnote continued from previous page
Senate Permanent Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (Apr. 13, 2011).

distinguishes management of assets belonging to others from principal activities, confirming the obvious fact that agency activities do not create the types of counterparty exposure and risk between the investment manager and its clients, or between the investment manager and the broader financial system, that exist in lending, derivatives and other activities conducted as principal. Although Section 120 does not specify a list of factors, it is informed by the list in Section 113.

Rather than inventing new criteria intended to bring investment managers within the definition of "systemically important" with new concepts of "systemic risk," it would be more useful for OFR to focus on the criteria actually contained in the text of the Dodd-Frank Act and stated purposes of the Act to inform its analysis. The actual criteria in Section 113 for systemic significance point towards large, highly leveraged entities that engage in activities as principal, and point away from the investment management industry. In particular the criteria of the: (i) leverage of the company; (ii) off balance sheet exposures of the company; (iii) extent and nature of transactions and relationships of the company with other significant bank and nonbank financial institutions; (iv) importance of the company as a source of credit; (v) the amount and nature of the financial assets of the company; and (vi) the amount and nature of the liabilities of the company, together with the words "of the company" contained in each of these criteria make clear this section speaks to counterparty risks to third parties from activities conducted by the company as principal, rather than agency activities.

This is reinforced by the "prudential" supervision requirements described in Section 165 of the Dodd-Frank Act and FDIC resolution authority in Title II of the Act which appear to contemplate that a SIFI is a leveraged institution with a large balance sheet and substantial counterparty credit exposure, rather than an entity with a relatively small balance sheet, limited leverage or off balance sheet and counterparty exposures as principal, and that may not even have custody of any customer assets. Moreover, the preamble of the Dodd-Frank Act, by indicating a statutory objective of ending taxpayer bail-outs and "too big to fail" suggests that coverage under federal guarantees and federal insurance programs are factors suggesting systemic risks may be present --which federal programs support government-sponsored enterprises and related federally-guaranteed loan programs, banks (FDIC insurance), broker-dealers (SIPC coverage) and pension plans (PBGC coverage), but generally not something covering the obligations of investment management firms.

B. Clients bear investment risks.

Consistent with an agency relationship, clients of investment managers receive all of the returns net of fees and expenses from their investments, positive or negative. An arrangement in which clients keep all of their profits while their asset manager absorbs even some of their losses is clearly unsustainable.

Arrangements in which asset managers receive a share of the profits are already regulated by the SEC under the Investment Advisers Act, and are generally limited to sophisticated investors.[41] With respect to registered investment companies, any sharing arrangement must require the investment adviser to bear a share of any losses in order to receive a share of any profits.

C. SEC rules require segregation of client assets.

The SEC prohibits asset managers from having custody of client assets and from transacting as a principal with clients. Consequently, clients retain ownership of all assets acquired by their asset manager on their behalf. Clients do not need to liquidate investments when they terminate an asset manager; they only need to terminate the manager's trading authority.

Because an asset manager does not have custody over its clients' assets and does not protect clients from investment losses, an asset manager's capitalization is generally not material to its clients. In addition, any leverage used in an investment strategy is incurred by the client, not the asset manager. Requiring asset managers to maintain capital will therefore not affect the degree of risks or amount of leverage taken on behalf of their clients.

The Commission's long-standing agency approach to the regulation of asset managers is not inconsistent with federal banking laws. For example, agency investment activities conducted for clients are excluded from the Volcker Rule prohibition on a bank affiliate's trading in securities and derivatives on the theory that the bank affiliate, as manager, is an agent that is not exposed to the risk of the client investments.[42] The

[41] 17 C.F.R. §§ 275.205-1 *et seq*.

[42] 12 U.S.C. § 1851(d)(1)(B), (D) &(G). *See also* 12 U.S.C. §§ 24(Seventh), 92a (prohibiting most equity investments for national banks but permitting them when held by the bank as fiduciary for clients); 12

Footnote continued on next page

Volcker Rule was enacted as part of the Dodd-Frank Act and the clear Congressional distinction between agency and principal activities informs the analysis that must be conducted under Title I. The OFR approach analyzes investment management activities as if investment managers were *de facto* guarantors of client portfolios and suggests they be capitalized as such. The OFR Report's approach of treating investment managers as principals cannot be reconciled with the Volcker Rule approach.

Notably, the European Parliament's Committee on Economic and Monetary Affairs recently issued a report on systemic risk issues associated with various types of non-bank financial firms, including asset management firms.[43] The Report called upon the European Commission to take into account whether the firms "trade on their own account and are subject to requirements regarding the segregation of the assets of their clients," noted that asset management firms' "client assets are segregated and held with custodians, and that therefore, the ability for these assets to be transferred to another asset manager is a substantial safeguard" and stated the committee's belief that "an effective securities law regime may mitigate many of the issues involved in the case of a large crossborder asset manager."[44] The European Parliament committee report further stated that "[t]he size and business model of the asset management sector does not typically present systemic risk."[45]

Footnote continued from previous page
U.S.C. § 1843(c)(4) (exempting fiduciary holdings by a bank holding company and its subsidiaries from restrictions on ownership of securities by a bank holding company as principal).

[43] Report on Recovery and Resolution Framework for Non-bank Institutions (2013/2047(INI)) (Oct. 22, 2013).

[44] *Id*. at 10.

[45] *Id*. at 15.

III. Vulnerabilities

A. OFR identifies reaching for yield and herding as vulnerabilities.

Investment managers allocate investments to meet stated investment objectives of clients. Seeking yield is based on investment objectives and stated parameters of clients, not on some defect in markets or investment managers. Investors can overbuy or oversell certain assets or asset classes. This is not a function of the structure of the investment management industry but in the nature of investor behavior. The same thing happens in the brokerage industry (where investors pick their own investments) and in the banking industry's lending patterns.

Regulations that reduce the availability of professional management services will only increase the risk of investors reaching for yield or following a popular investment trend. As fiduciaries, asset managers must comply with a higher standard of risk disclosure than banks (which have no fiduciary duties to their depositors).

Restricting investor choice and managing market prices through "prudential" supervision of the investment management industry, as suggested by senior Federal Reserve officials,[46] is not the proper way to address the potential for "reaching for yield," herding, and asset bubbles caused by quantitative easing.[47] If there is to be a response (other than tapering the quantitative easing) it should be through further limiting the use of leverage in buying securities under the existing regulatory authority of the Federal Reserve.

Unless the OFR is proposing to remove investor choice and have the government decide how client-investors should invest their money, yield seeking will not change. The federal government is more effective as a Monday-morning quarterback, finger-pointer and blame assessor than as a decision-maker in the ordinary course of investment management. Given the very poor track record of the government as an investment and

---

[46] Evans, *supra*.

[47] The "reaching for yield" effect is also associated with the "moral hazard" created where investors are shielded from losses and tend to seek the highest returns, regardless of risk. *See* 1991 Treasury Report, *supra*, at I-12.

credit allocator (see SBA, housing industry, etc.), taking investment authority away from investors and their managers would lead to worse outcomes and more systemic risk and instability.

B. OFR identifies redemption risk & first mover advantage as vulnerabilities.

1. Redemption mitigates risk-taking by asset managers.

As previously noted, asset-based fees create incentives for asset managers to avoid strategies that might produce volatility in the amount of their assets under management. Redemptions can be a source of such volatility and thus provide a disincentive for managers to take risks that may produce substantial or sustained redemptions. Rather than a vulnerability, redemptions are means by which the market disciplines the risk-taking behavior of an asset manager. A central tenet around which Congress structured the Investment Company Act is the redeemability of mutual fund shares.[48] This is why Federated has supported redemption restrictions for MMFs only in very limited circumstances to protect shareholders in a crisis when liquidity becomes unavailable, for a limited time (ten days) and only then based on the best interest of the clients.

2. The Report fails to establish a basis for the so-called first mover advantage.

In the Report, the OFR uses the term "first mover advantage" without any attribution or analysis.[49] "First mover advantage" is a concept from game theory. The OFR's hypothesis is that, not knowing what the other investors will do or what risks may be in a portfolio, an investor has an incentive to redeem quickly ahead of other investors to get a higher redemption price than those shareholders who are the last ones to redeem from an over-priced or illiquid mutual fund.

---

[48] *See* Investment Company Act §§ 2(a)(32), 5(a), 8(b)(1)(A), 13(a)(1), 22.

[49] Report at 12 ("In a stressed market environment, this scenario could leave slower-to-redeem investors holding shares of an increasingly less liquid portfolio whose net asset value (NAV) may fall at an accelerating rate as market liquidity premiums rise.").

The classic game theory paper analyzing bank runs notes that lack of portfolio liquidity and transparency are two underlying conditions in banks that make them susceptible to runs, and that added liquidity and suspension of deposit withdrawals are effective mechanisms to help address runs.[50] Mutual funds in contrast have significantly more portfolio liquidity and transparency than do banks, and, unlike banks, are funded almost entirely by common equity capital rather than by short-term debt. Variable NAV mutual funds consist of at least 85% liquid assets—generally securities that trade on secondary markets. These mutual funds have portfolio securities that are marked-to-market (or for many bond funds, marked-to-model) on a daily basis, and use forward pricing to establish share prices.[51] There is not a first mover advantage in the game theory sense for an investor redeeming the shares. The economic effect of a shareholder redeeming from a mutual fund is substantially the same as if the shareholder had owned directly a diverse portfolio of individual securities similar to those in the mutual fund, and then sold those individual securities in the secondary market. It is, however, much less expensive and more convenient for the investor to purchase and redeem mutual fund shares than to buy and sell a cross-section of the market.

The OFR also makes no intellectual connection between the price discovery benefit of investment analysis followed by buying or selling, and what makes markets efficient. The OFR also ignores the large segment of assets managed in individual client accounts, where there are no other "players" in the theoretical game, other than the entire market for the securities owned for the client's account.

The Report alleges that redeeming investors seek to gain an advantage over other investors by using up fund liquidity. Analysis suggests that the OFR has been unduly influenced by the federal banking agencies' own failed efforts at regulating open-end funds, as evidenced by bank collective fund debacles during the 2007-2009 Financial Crisis[52] and the 1988-1992 real estate crisis,[53] and that the OFR has no deep

[50] Diamond & Dybvig, *Bank Runs, Deposit Insurance, and Liquidity*, reprinted in Federal Reserve Bank of Minneapolis Quarterly Review (Winter 2000), originally published in the Journal of Political Economy Vol. 91, No. 3 (1983).

[51] 17 C.F.R. §§ 270.2a-4, 270.22c-1. In addition, boards of variable NAV mutual funds must consider and determine whether or not to impose redemption fees and restrictions on share purchases and redemptions. 17 CFR §§ 270.22c-2, 270.38a-1; 68 Fed. Reg. 74,729 (Dec. 24, 2003).

[52] In the Matter of John B. Flannery and James D. Hopkins, SEC Admin Proceeding No. 3-14081; In the Matter of State Street Bank and Trust Company, SEC Admin. Proceeding No. 3-13776.

understanding of how the SEC and non-bank investment managers have addressed liquidity issues and fund pricing in a far more robust fashion.

3. The OFR Report concedes variable NAV does not help stabilize MMFs.

The OFR Report analyzes variable NAV mutual funds as being subject to first mover advantage. Not only does this ignore forward pricing used to price mutual fund shares, it fundamentally undercuts the premise of FSOC's suggestion in the MMF context that runs are caused by stable NAV share prices and can be addressed by forcing MMFs to move to a variable NAV.

4. Consider the liquidity of the assets and degree of leverage when evaluating the structural risk of issuing redeemable securities.

Statutory shareholder redemption rights established by the Investment Company Act require mutual funds to have liquidity requirements and leverage restrictions. MMFs have even more stringent liquidity requirements and do not use leverage, while closed-end funds, individual accounts, and private funds have tailored requirements matching portfolio liquidity to investor needs. Bank regulators are late to this intellectual insight—they could have used liquidity requirements and leverage restrictions to prevent collective investment debacles and bank runs.[54] Investment managers and the SEC have been focused on these tools for decades.

Footnote continued from previous page
[53] *See* OCC Enforcement Action No. 95-1 (Jan. 25, 1995); *Board of Trustees of the Illinois Municipal Retirement Fund v. First National Bank of Chicago*, 263 Ill. App.3d 108 (1994).

[54] *See* Federal Reserve press release dated October 24, 2013 (announcing proposed rule that "would for the first time create a standardized minimum liquidity requirement for large and internationally active banking organizations….").

5. Everything is not about "run risk."

The FSOC cited large-scale redemptions and a run on MMFs to support its Proposed Recommendations Regarding Money Market Mutual Fund Reform.[55] Subsequently, the SEC also cited heavy redemptions as the central premise for further MMF reform.[56] In explaining the basis for designating Prudential Financial, Inc. for supervision by the Federal Reserve Board under section 113 of the Dodd-Frank Act, the FSOC cited the possibility that Prudential Financial could face heavy redemption of the life insurance policies it issued, even though the FSOC recognized that the company had the right to defer payouts on a significant portion of policies with immediately payable cash surrender values.[57]

Now in the Report, the OFR cites the risk of heavy redemption requests in a stressed market as a reason why large asset managers could pose "systemic risk."[58] All this shows that the FSOC views "systemic risk" through the lens of a bank supervisor. But the risk of a bank run is different from redemptions in other segments of the financial system. A bank is legally obligated to pay demand deposits on demand. If a bank fails to do so, it defaults. When the depositors of a bank rush to withdraw funds from the bank, the bank is under the stress of the demands of numerous creditors and the default risk is concentrated in the bank.

In contrast, investments in mutual funds are the investor's equity, not the fund manager's liability. When investors in a fund make redemption requests, they cannot put the fund manager in default. Mutual fund shares are issued and sold under a "forward pricing" convention.[59] An investor placing a purchase or redemption order does not get

---

[55] Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455, 69466 (Nov. 19, 2012).

[56] Money Market Fund Reform; Amendments to Form PF, 78 Fed. Reg. 36834, 36850 (proposed June 19, 2013).

[57] FSOC, Basis for the Financial Stability Oversight Council's Final Determination Regarding Prudential Financial, Inc. (Sept. 19, 2013), http://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf.

[58] Report at 12-16.

[59] 17 C.F.R. §§ 275.2a-4, 275.22c-1.

the share price from the previous market close, nor a share price based on portfolio values as of the time that the order was placed. Instead, the shareholder gets the share price determined *after* the order is placed using current market values as of the time the price is next calculated. Because most mutual fund share prices are calculated once each business day as of the close of trading in New York (4 pm Eastern Time), this means the price impact of selling pressure on the individual securities in the mutual fund's portfolio is factored into the redemption price that the investor receives. The forward pricing convention does a good job of addressing any first mover advantage related to pricing that is caused by the open-end fund structure.

The OFR Report also suggests that shareholders may have a "first mover" advantage in redeeming shares from a mutual fund by accessing the limited supply of liquidity within the fund ahead of other shareholders.[60] The Report acknowledges[61] but ignores the significance of the requirement that variable NAV mutual funds maintain at least 85% of their portfolios in liquid assets, *i.e.*, publicly traded securities and other assets that can be quickly sold, and the fact that the Investment Company Act (along with the Internal Revenue Code) further requires a mutual fund to hold a diversified portfolio of securities.[62] The pool of liquidity available to the fund is the entire trading market in the diversified portfolio of securities comprising these 85% liquid assets. Although it is theoretically possible that shareholders representing 85% of the shares of a mutual fund could quickly put in redemption requests and exhaust the fund's liquidity ahead of the slower-moving 15%, that is not something that has been a problem in the past and to our knowledge has not been indicated as a cause of any financial crisis. Thus, the conjuring of a remote contingency serves to justify, in the OFR's view, destruction of the statutory redeemability of mutual fund shares.

Investment companies and private investment funds that hold illiquid assets generally do not issue daily redeemable shares and generally do not face liquidity

---

[60] Report at 12 ("Investors in mutual funds with portfolios of securities with varying levels of liquidity may have a 'first-mover advantage' to sell early, if they believe cash on hand and maturing assets are insufficient to cover redemption requests and that more liquid assets may need to be sold to meet redemptions.").

[61] Report at 12 ("To meet redemption requests, under SEC guidelines, registered mutual funds should hold at least 85 percent of their investments in assets that the fund manager believes could be sold at or near carrying value within seven days.")

[62] Investment Company Act § 5(b)(1); 26 U.S.C. § 851.

pressures. Some address the liquidity issue by having long lead times to a limited number of redemption dates, with the investment manager empowered to defer some or all of the redemptions. Others are not redeemable and trade in secondary market transactions. Exchange-traded funds (ETFs) are described by the OFR Report as creating a risk of downward price pressure in the markets for the underlying assets because investors can essentially buy shares in the market and redeem them for the underlying assets and sell those assets.[63] This downward price pressure, however, would be the same if the investors purchased the ETF's underlying portfolio securities in the first instance and later sold them.

6. The OFR's analysis, taken to its logical conclusion, results in rejection of the market economy.

If the idea is that securities decline in value when investors sell, and those who sell earlier get out ahead, and the OFR's conclusion is to stop this from happening by forcing all investors to stay invested until the FSOC gives the all-clear light, this is not a call for "systemic risk" reduction, but instead a call for abandoning a market-based economic system in favor of price setting and government allocation of capital and credit.[64]

C. Leverage identified by OFR as a vulnerability.

1. Federal Reserve and FINRA margin rules exist and apply to the assets themselves.

We agree that excessive leverage can pose risks not only to lenders and investors, but also to markets and financial stability. Excessive leverage creates asset bubbles that eventually may pop, creating a crisis. This is true whether the assets involved are stocks and bonds or single family housing. This is true even if leverage is encouraged as a matter of federal policy with all good intentions—for example to get families into homes and to create jobs in the home construction and related industries.

---

[63] Report at 11 ("ETFs . . . could also potentially accelerate or amplify price movements in markets during market turbulence").

[64] *See also* Evans, Bookstaber, *supra*.

The OFR treats this as new news—an epiphany which they must share by recommending a restructuring of the asset management industry. In view of the posture of the Treasury Department and Federal Reserve in the years leading up to the 2007-2009 Financial Crisis,[65] this is apparently an amazingly novel economic insight—to *them*. But to the Commission, Congress, and the asset management industry, this is a lesson learned and addressed in the context of investments in securities, during the Great Depression.

Sections 7 and 8 of the Securities Exchange Act of 1934 (15 U.S.C. § 78, the "1934 Act") impose restrictions on lending to purchase and carry margin stock and lending by securities broker-dealers, and further authorizes the Federal Reserve to adopt rules implementing these "margin" requirements. Federal Reserve Regulations T, U and X limit leverage for the purchase of securities. These rules prohibit lenders from lending more than 50 percent of the current market value of the collateral when extending credit to finance the buying or carrying of margin stock, including mutual fund shares.[66] Lending by broker-dealers is further restricted by FINRA Rules adopted pursuant to Sections 6 and 19 of the 1934 Act,[67] and Regulation T restricts broker-dealer from lending on assets other than margin securities.[68]

The concern voiced by senior Federal Reserve officials in support of more bank-like regulation of non-bank firms such as the investment management industry is to address the potential that low-interest credit being pumped into the economy by the Federal Reserve to stimulate the economy will result in asset managers "reaching for yield" and investing in overly risky assets to take advantage of cheap financing of their positions.[69]

If FSOC determines that the margin rules are too lax or do not cover enough categories of assets, then FSOC should recommend to the Federal Reserve and FINRA

---

[65] Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011); U.S. Senate Permanent Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (Apr. 13, 2011).

[66] 12 C.F.R. Parts 220, 221, 224.

[67] FINRA Rules 4200 *et seq*.

[68] 12 C.F.R. Part 220.

[69] Evans, *supra*.

that they be tightened. But it should not use the well-known risks posed to investors, lenders, markets and the economy as a whole by excessive leverage as a pretext for criticizing the structure and regulation of investment managers.

2. Bank regulators can regulate the lending risks of banks.

To the extent the OFR's concern is that lending to investment managers and their clients poses credit or other counterparty risk to banks and their affiliates, the Federal Reserve, Office of the Comptroller of the Currency and FDIC can (and already do) regulate and supervise bank and bank holding company lending and risk management. If the margin rules and loan-to-one borrower limits are not sufficient to protect banks, the bank regulators can impose additional requirements on bank lending based on safety-and-soundness considerations.

Bank regulators may also regulate off balance sheet lending by banks[70] and liquidity coverage ratios of banks[71] as a means to address some of the risks associated with excessive leverage in the banking system.

3. Mutual funds have tighter leverage restrictions than do banks and broker-dealers.

The Investment Company Act of 1940 further restricts the use of leverage by registered investment companies.[72] An open-end mutual fund is prohibited from using most forms of leverage, except that it may borrow to a limited degree from banks. The bank debt that an open-end mutual fund may take on must be less than one-third of its net assets, and is subject to various other restrictions and limits.[73] These lending restrictions are in addition to the margin rules mentioned above which restrict borrowing by and lending to investment companies. Moreover, because mutual funds are always "in

[70] FDIC, Risk Management Manual of Examination Policies, Section 3.8 "Off Balance Sheet Activities," available http://www.fdic.gov/regulations/safety/manual/section3-8.html#introduction.

[71] *See* Federal Reserve press release dated October 24, 2013 (proposed federal banking agency Basle III rules on liquidity coverage ratios).

[72] Investment Company Act §§ 12(a), 13(a)(2), 18.

[73] 15 U.S.C. § 80a-18.

distribution," lending by broker-dealers to finance the purchase of shares of mutual funds is further restricted by Section 11(d) of the 1934 Act.

As a practical matter, most mutual funds do not use leverage but instead rely entirely on common equity to finance their investment portfolios.

Section 23A of the Federal Reserve Act and Regulation W restrict lending by banks to purchase shares of investment companies and other investment funds advised by the bank or its affiliates, or loans to those investment companies or funds, or that are secured by shares of those investment companies or funds,[74] and the Volcker Rule prohibits *any* lending by a bank or its affiliates to a private investment fund advised by the bank or its affiliates, or secured by interests in those private funds or to an investor to purchase interests from the private fund.[75]

4. MMFs have the tightest leverage restrictions of all.

MMFs aim to maintain a stable NAV. To achieve this goal, they focus on managing the assets side of the balance sheet. Under SEC regulations, their assets must have low credit risk, short maturities, high liquidity, and sufficient diversification.[76] Using leverage to enhance return is not an investment strategy for MMFs. In fact, MMFs utilize no leverage.[77]

5. Compare this to banks with 24-1 leverage to equity ratios, blind-pool asset portfolios, no mark-to-market, and government guarantee of deposits.

In contrast, a bank is required to maintain a minimum leverage ratio of only 4%, which means that the ratio of debt to equity capital funding its assets could be as high as 24 to 1. Furthermore, bank deposits are guaranteed by the FDIC, which attracts savings to banks and helps them increase leverage. Yet such leverage supports bank assets that

---

[74] 12 U.S.C. § 371c; 12 C.F.R. § 223.2(a)(5)&(6).

[75] 12 U.S.C. § 1851(f).

[76] *See* 17 C.F.R. § 270.2a-7.

[77] Investment Company Institute, *Money Market Funds in 2012: Money Market Funds Are Not Banks* (Feb. 14, 2012), http://www.ici.org/pdf/12_mmf_mmfs_are_not_banks.pdf.

have a considerably less transparent risk profile than those managed by the mutual fund industry. Regulatory requirements as to the mix, maturity, or liquidity of assets are less rigid or stringent for banks than those for mutual funds. Banks are allowed much greater discretion than mutual funds as to the level of credit risk in their assets. Assets on the books of banks are generally not marked to market and are not transparent.

D. OFR identifies asset management firms as sources of systemic risk.

Clients of investment managers are not subject to risk of loss if the investment manager fails. Investment managers do not borrow money from or owe money to clients, do not have custody of client assets, and do not guarantee client portfolios or investment results.

Moving assets from one manager to another does not require the liquidation of the client's portfolio. It does not even require moving assets to another custodian. Clients can change managers simply by terminating the contract with their current manager and hiring a new manager. The Investment Company Act requires that all advisory contracts be terminable without penalty on not more than 60 days' notice.

Because investment managers generally have relatively small balance sheets and do not engage extensively in borrowing, lending, derivatives or other activities as principal, the direct risks from the insolvency of an investment manager to the third parties with which it deals as principal are limited in size, and are not dissimilar to the credit risks posed by other firms of similar balance sheet size. They are not systemically important by any reasonable measure of counterparty risk.

IV. Transmission channels.

A. Price discovery is a strength of free-markets, therefore exposure to other market participants should be welcome.

The first "transmission channel" identified in the Report (i.e., "systemic risk" that an asset manager could pose as a counterparty) provides an excellent example of how the OFR has exaggerated ordinary market risks that exist independently of investment management.[78] The securities transfer system developed in the U.S. requires investors to

[78] Report at 21.

hold their securities through intermediaries. As discussed above, investment adviser client accounts are held in custody at a bank or broker-dealer and investment company portfolios are held in custody at banks. Legal requirements and regulatory incentives have led to banks being the primary custodians of securities, and to concentration of custodial services among only a handful of banks. Asset managers do nothing to aggravate this risk. Federated manages assets held at all of the major custodian banks, which are selected by its clients.

If there is a "systemic risk" in the concentration of custody into a handful of banks and securities firms, the appropriate response is not increased regulation of investment managers, but instead it is to consider whether enhancements are needed to the regulation of large custodial banks and broker-dealers. Most of these already have the Federal Reserve as a prudential regulator by virtue of being banks or subsidiaries of banks or bank holding companies.

As regards credit rating agencies, pricing services and other financial service providers, asset managers actively encourage competition among these providers in a manner that reduces overall systemic risks. For example, asset managers maintain relationships with many more brokers than most individual investors do. As fiduciaries, asset managers have an obligation to seek best price and execution for their clients' trades. This includes an assessment of the quality of the execution (e.g., the chance that the broker will make an error or fail to settle the trade). The resulting competition among brokers for orders from asset managers should reduce overall transactional risk in the market.

B. The Report mischaracterizes fire sales and fails to recognize market-based means to address the fire sale issue.

The OFR Report defines "fire sales" as "rapid sales of assets that temporarily depress market prices, typically reflecting market participants' responses to market distress, including an escalating premium on liquidity and demand for it."[79] But "fire sales" really are sales where the seller is forced to sell in a hurry at any price because of a bad event. Examples in the financial markets might include sales of collateral securities upon foreclosure of a loan (or to meet a margin call), or sales of real estate into a

---

[79] *Id*.

recession and tight credit market by an open-end fund that invests in commercial real property but has a contractual or regulatory requirement that redemption requests be met within a year.[80] Sudden sales of assets into a relatively liquid market by a seller who makes a rational decision to sell, and is not forced by circumstances to do so at any price, is not a fire sale, even if the result is prices decline.

When unleveraged equity investors sell stocks they own (or redeem equity mutual funds) to move to government securities (*e.g.* for defensive purposes), it is not a fire sale, it is a choice. Prohibiting investors from selling their holdings (or prohibiting their investment managers from doing so on their behalf as agent, when judged to be in their best interests) is not preventing a fire sale; it is an effort to prop up prices in order to deceive the broader markets about what a market-clearing price in the asset is under current conditions.

Limiting the leverage employed in a portfolio is an important consideration in preventing fire sales. But this is more in the nature of regulating lenders and the terms on which they are allowed to lend than regulating investment managers. This is why we have margin rules.

Similarly, forced sales needed to raise cash have been addressed by fund managers and the SEC by limits on redemption (closed end funds, private funds and insurance company separate accounts) and by maintaining significant portfolio liquidity and diversity (open-end funds). They are further addressed for individually-managed client accounts through asset allocation and suitability decisions designed to match client portfolios with the client's need for liquidity. Portfolio managers have been dealing with these issues for generations and generally get it right in meeting client needs. This is not a "systemic risk" issue, but a fiduciary and investor protection issue. Theoretical perfection should not be the enemy of the good.

---

[80] For example, the Office of the Comptroller of Currency issued a consent order requiring The First National Bank of Chicago, Chicago, Illinois, which served as the trustee of an open-end real estate collective investment fund, to meet redemption requests in light of on-going litigation regarding a provision in the trust agreement that required the trustee to satisfy any redemption request within one year. *See* OCC Enforcement Action No. 95-1 (Jan. 25, 1995); *Board of Trustees of the Illinois Municipal Retirement Fund v. First National Bank of Chicago*, 263 Ill. App.3d 108 (1994).

The OFR Report fails to mention historical or behavioral drivers of significant market events. These include the 1987 market crash (associated with portfolio insurance),[81] the failure of Long Term Capital Management in 1998,[82] and the general tendency of many investors to follow trends (buying when markets rise, selling when markets fall), which is a primary driver of market swings. A proper treatment would show that mutual funds, and investment managers, have not been a source of price or market instability.

C. Independence of asset managers from banks is relevant in assessing systemic risk.

When investment managers are affiliated with banks, they are already subject to supervision and regulation by the Federal Reserve and/or other banking regulators to a significant degree. When investment managers are not affiliated with banks, any lending to the client portfolios is done by a lender (generally not by the investment manager) subject to comprehensive margin lending rules of the Federal Reserve and FINRA. It therefore is hard to discern how a transmission channel exists to transform a failure by the investment manager into a systemic problem.

If the investment manager itself becomes insolvent, its clients simply hire a new manager to manage their portfolios (which, as discussed above, are held by a third-party bank or broker for the account of the client) and the values of their holdings are not affected. If a bank is a lender to the investment management firm itself, the same prudent lending, loan-to-one borrower and global risk management requirements that apply to all of the bank's exposures apply to that loan as well. The lending issue is a bank regulatory issue, which, if the bank regulators have set the limits appropriately, should eliminate any risk of transmission from the investment manager to the financial system.

---

[81] *See* Mark Carlson, *A Brief History of the 1987 Stock Market Crash* (2006), http://www.federalreserve.gov/pubs/feds/2007/200713/200713pap.pdf.

[82] *See* Joseph G. Haubrich, *Some Lessons in the Rescue of Long-Term Capital Management* (2007), http://www.clevelandfed.org/research/policydis/pdp19.pdf.

D. Markets are supposed to move -- it is one of their strengths.

Market prices move. Market prices go up and down based on buyer and seller interest. This is not a weakness, but a strength of markets that gives them a purpose and value to the economy in providing information on what things are worth, and where additional capital and credit should be allocated. Viewing investment managers that invest client assets in markets, and buy and sell these positions to meet client objectives, as a form of "systemic risk" or method of transmission of "systemic risk" is a significant analytical mistake. Price discovery is a process, a strength and a critical ingredient of a free market. Markets that are managed by a government to remove price fluctuations also mute the price discovery mechanisms of informed buyers and sellers and the feedback loop of risk and return from the investment decision-making process, creating the illusion of permanent stability and setting the stage for the next financial crisis.[83]

E. Report commentary on short-term financing transactions ignores work of the Commission and other primary regulators in addressing SFT risks.

In a recent speech before the International Monetary Conference on June 2nd, 2013, Vice-Chairman Janet Yellen repeated the Federal Reserve's objective in further regulating MMFs and added:

> But even when we accomplish these reforms, more work will remain to reduce systemic risk in the short-term wholesale funding markets that shadow banking relies on. A major source of unaddressed risk emanates from the large volume of short-term securities financing transactions (SFTs)--repos, reverse repos, securities borrowing and lending transactions, and margin loans--engaged in by broker-dealers, money market funds, hedge funds, and other shadow banks.

Similarly, in a September 20th, 2013 speech at the Yale Law School Conference on Challenges in Global Financial Services, Federal Reserve Governor Robert Tarullo noted that:

---

[83] See, Samuelson, "The Greenspan paradox" Wash. Post (Oct. 27, 2013) available at http://www.washingtonpost.com/opinions/robert-samuelson-the-greenspan-paradox/2013/10/27/f435e776-3da0-11e3-a94f-b58017bfee6c_print.html.

> Although the amounts of short-term wholesale funding have come down from their pre-crisis peaks, this structural vulnerability remains, particularly in funding channels that can be grouped under the heading of securities financing transactions (SFTs). The use of such funding surely has the potential to increase again during periods of rapid asset appreciation and ready access to leverage. While SFTs are an important and useful part of securities markets, without effective regulation they can create a large run risk, and thus can increase systemic problems that may develop in various asset and lending markets."

These comments make it clear that the FSOC and the Federal Reserve intend to regulate any feature of the securities market that might entail the need or apparent inducement to rapidly unwind long positions due to financing or other considerations. This is a common denominator in the Report's consideration of such topics as leverage, first mover risk in fluctuating NAV funds, and derivatives. The Report depicts these as newly discovered risks, when in fact these structures and the risks they present have been carefully studied by regulators and the industry for inherent risks, and are among the most heavily regulated by the SEC, the CFTC, FINRA, and the Department of Labor (as well as the Federal Reserve under its margin rules) in order to address those risks.

Section 113(a)(2)(H) of the Dodd-Frank Act requires FSOC to take into consideration, when assessing systemic risk, the existing regulatory framework for financial services firms. Yet the OFR Report addresses these topics from an intellectual vacuum, thoroughly unburdened by any inkling of the existing regulatory framework or the careful and lengthy public processes involved in the consideration, development and design of the regulatory controls and requirements that address these market risks.

V. Alleged Data Gaps

The OFR Report indicates that lack of data on investment manager portfolio holdings limits the ability of macro-prudential regulators (read the Federal Reserve) to judge and regulate risk-taking behavior.[84] Yet the investment management industry is already subject to extensive reporting to regulators and the public on portfolio transactions and holdings. These include real time, daily reporting by broker-dealers and securities exchanges regarding substantially all transactions in publicly-traded

[84] Report at 24-26.

securities,[85] reporting to the Commission and investors by registered investment companies on their portfolio investments,[86] reporting by managers of private investment funds on Form PF, and reporting by all large discretionary investment managers and large traders on their holdings.[87] In addition, investment advisers and investment companies are required to create and maintain very complete books and records on their investments and transactions for clients, which are available to SEC examiners and provide a complete audit trail for forensic purposes.

Notwithstanding the wealth of data available to it, the OFR seriously mischaracterizes asset numbers for the investment management industry -- holding out global aggregate figures for assets under management as though they were U.S. domestic totals, double-counting asset numbers and otherwise overstating aggregate asset amounts, and overstating aggregate mutual fund redemptions during the Financial Crisis.[88] One wonders how more data would help an agency that cannot accurately portray the information that currently is available.

The OFR Report also assumes that with sufficient information and focus, the bank regulators could or would do something beneficial in reducing risk and the transmission of that risk through the financial markets. Yet in the six months prior to the collapse of Lehman Brothers, the Federal Reserve and the SEC had a bevy of resident examiners on site at Lehman Brothers, were fully aware of its precarious financial condition, allowed it to continue to issue large volumes of commercial paper into the markets, had complete and full access to information on who was buying that commercial paper, and rather than act upon that extensive information, chose instead to issue a press release in July 2008 implying that there were no financial problems at Lehman Brothers and that pressures on financial stocks were caused by short sellers.[89]

---

85 Regulation NMS, 17 C.F.R. § 242.600 *et seq.*

86 17 C.F.R. § 270.30e-1; Form N-CSR.

87 17 C.F.R. § 240.13d-1 *et seq.*; Forms 13D, 13F, 13H.

88 *See* OFR Report at 1-8.

89 *Compare* SEC, Securities Regulators to Examine Industry Controls Against Manipulation of Securities Prices Through Intentionally Spreading False Information (July 13, 2008), http://www.sec.gov/news/press/2008/2008-140.htm, *with* Anton R. Valukas, *Lehman Brothers Holdings Inc. Chapter 11 Proceedings Examiner Report*, 1482 (Mar. 12, 2010), http://jenner.com/lehman/.

With more diffuse information on a large number of issuers and investment managers and portfolios, it is hard to imagine the Federal Reserve would be more effective in identifying risk. In any event, all of those portfolios are held in custody at a very small handful of banks and broker-dealers. If the FSOC thinks the regulators need to know who is holding what, have them look there.

VI. The Commission's mandate from Congress is protection of investors, capital formation and competition.

Congress specifically addressed in the federal securities laws the issues that the SEC must consider in regulating the securities markets and investment management industry: protection of investors; capital formation; competition; and efficiency of markets.

Using FSOC policy objectives to push the regulation of the investment management industry towards stifling these touchstones of securities regulation is not only poor economic policy, it is contrary to the Congressional mandates laid down in the securities laws.

Conclusion.

The OFR Report is lacking in both substance and depth of analysis. It appears designed to justify an FSOC and Federal Reserve role in fundamentally changing the structure and operation not only of investment managers, but also investors and markets. It is badly reasoned and poorly thought through.

We appreciate and understand the concern of the Federal Reserve that federal financing policies and programs designed to stimulate economic activity may have unintended consequences in the markets.[90] After all, that is a large part of what caused the 2007-2009 Financial Crisis.[91] The appropriate response, however, is not to make securities markets less efficient, limit investor choice or seek to slow down capital

---

[90] Evans, *supra*.

[91] *See* Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011); U.S. Senate Permanent Subcommittee on Investigations, *Wall Street and the Financial Crisis: Anatomy of a Financial Collapse* (Apr. 13, 2011).

mobility through regulations imposed on the investment management industry. A simpler and less intrusive fix is tightening the regulation of loans to finance risky investments.

One hopes that the other regulators represented on the FSOC—the Commission, CFTC and insurance regulators—will begin to recognize a pattern to the lack of understanding at the bank regulators of non-bank financial services and their structure and regulation, a lack of concern for price discovery and efficiency in capital markets, and a movement towards regulating all nonbank firms and markets like banks. If the FSOC continues down this path, it will damage our economic system, capital markets, investors, and the public, with no offsetting benefits.

We appreciate the opportunity to provide comments on the OFR Report.

Sincerely,

John D. Hawke, Jr.

John D. Hawke, Jr.