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28 May 2015

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

Re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Secretariat of the Financial Stability Board:

CFA Institute[1] appreciates the opportunity to provide comments to the Financial Stability Board (FSB) on the Second Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions promulgated by the FSB and IOSCO (Consultation or Proposal). CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Executive Summary

CFA Institute supports the monitoring of investment companies, asset management firms and other entities for their potential to create systemic risks to the financial system. Focusing on particular activities, investment vehicles, and market practices that hold potential risk is important for identifying areas before they rise to systemic risk proportions. This monitoring must be based on a meaningful understanding of a particular industry, as well as its interplay with other entities within the larger financial system.

Framework for assessment. We agree size is an important factor to consider as a first-tier analysis of entities, firms and sectors that may have systemic risk potential, as they *a priori* have the most potential for creating havoc on the global marketplace in times of distress or failure. Thus, we believe size should be an initial filter in winnowing the pool of market participants to be assessed.

[1] CFA Institute is a global, not-for-profit professional association of more than 131,000 investment analysts, advisers, portfolio managers, and other investment professionals in 147 countries, of more than 123,700 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 144 member societies in 69 countries and territories.

Nevertheless, we believe that while a consideration, size alone should not be determinative of systemic risk, but must be considered in relation to the entity's functions. For example, size may be much less significant in the realm of asset management than the banking industry, in light of the asset manager's agency status, its lack of ownership of assets and the types of investments it handles.

In light of the 2007-2008 financial crisis and its effect on the global marketplace, we support the work being undertaken by the FSB, IOSCO and other regulatory bodies to thwart future crises. In formulating methodologies for assessing systemic risk potential, we encourage all parties to take into account measures being proposed or already implemented by regulators. For example, regulators in different jurisdictions are in the process of implementing, and considering further rules for investment funds and asset managers that are aimed at reducing systemic risk potential.

Substitutability. We agree that the ability of others to take over in cases where a major market player is in distress or failure must be considered in any analysis of systemic risk potential. In all but extraordinary cases, however, we do not believe this to be a major concern when assessing the systemic risk potential for investment funds or asset managers. Instead, we believe that the assets owned by funds or managed by asset managers would be transferred to and assumed by other market participants without creating serious market disruptions that would rise to systemic proportions.

Asset Liquidation. We appreciate the FSB's concerns about possible ramifications to the greater market, including contagion, stemming from forced sales of a significantly large fund. With respect to investment funds, we believe that sufficient regulatory measures have been implemented in some jurisdictions to mitigate concerns about runs, first redeemer advantage, and contagion related to money market funds. While we support continued review of other investment fund practices that raise concerns, we believe that these new regulations address, and mitigate the risks of, what proved to be the most systemically risky of the investment funds.

Leverage. We believe that leverage by investment funds may lead to risk and encourage new requirements aimed at better monitoring and management of these risks. Although we do not believe that leverage alone, without other contributing factors, would create an environment that is systemically risky, we do encourage additional focus on the use of derivatives and certain liability-driven investments, and their effects on the markets. We do believe that the use of leverage by asset managers heightens the potential for failure by the firm.

Securities Lending. While traditional securities lending in marketable securities does not pose a significant risk for markets, there is greater risk associated with the borrowing of securities for securities lending related to funding needs of large institutions. We support continued monitoring and better information collection of these activities to enable regulators to recognize how problems may flow through the financial system.

Discussion

We appreciate the FSB's efforts to develop methodologies for assessing the systemic risk potential and implications of finance companies, market intermediaries, investment funds and asset managers with an intent to identify, monitor and reduce the risk relating to these entities (non-bank, non-insurer globally systemically important financial institutions or NBNI G-SIFIs). Taking proactive measures to assess and, if necessary, to address areas deemed to pose significant risk or that are detrimental to our domestic and global marketplace is an important endeavor, and one that CFA Institute supports.

Given the severe effect on the global marketplace from the financial crisis of 2007-2008, we believe it is only prudent to review practices that might significantly contribute to future turmoil. We believe that any conclusions about an entity's contribution to systemic risk must not be undertaken in haste, must derive from a full and meaningful understanding of that entity's business, an analysis of its role in the financial services industry, an assessment of the interplay with service providers, and consideration of the use of practices that have potential to significantly contribute to systemic risk. FSB's issuance of this second Consultation to refine the proposed framework and methodologies attests to an effort to take a measured step to weighing industry input.

We note, however, two aspects of this Consultation that we believe warrant attention. First, we believe that while size is a relevant factor in defining a pool of entities for further consideration, regulators should avoid a presumptive causal relationship between size and risk when it comes to asset managers. In particular, we note the distinction between banks that guarantee depositors' principal, and asset managers who are agents that a) do not own assets; b) are constricted in their roles to handle client money in accordance with client directives as set out in investment policy statements and other client expressions of risk tolerance; and c) then pass on the changes in market values to their clients.

We agree that size should serve as a beginning point in defining the pool of entities for a systemic risk analysis. However, size may be a more significant factor in certain sectors and should not displace the weight of other relevant factors. For example, analysis of investment funds and asset managers should consider other pertinent factors such as asset concentrations, correlations with asset concentrations in other parts of the financial sector, mismatches in the maturities of the assets vis-à-vis the liabilities controlled or managed by these entities, and the degree of operating and financial leverage employed by the funds and the managers. We believe that an appropriate approach should also focus on the risks that may stem from the nexus of client money flows (correlated or procyclical), asset concentrations, and the ability of the market [at any time] to absorb those flows.

Second, we note that any review of potential systemic risk must consider the regulatory, legislative, and industry responses to the financial crisis that have already been undertaken, or are being studied, to address concerns. We believe that efforts to establish a system for review and/or designation must, of necessity, weigh the safeguards and restrictions that have already been implemented. Otherwise, the totality of the situation that needs to be addressed will not be fully considered.

Framework for Assessment

As an overarching principle for identifying the scope of financial entities whose distress of disorderly failure "would cause significant disruption to the global financial system and economic activity across jurisdictions," the FSB has focused on three primary characteristics--size, complexity and systemic interconnectedness. From that, the FSB has established a framework for analyzing all potentially systemically risky institutions, using a three-part approach composed of "transmission mechanisms," "impact factors" that extend to all NBNI financial firms and methodologies—general, and sector-specific.

Systemic Risk and Transmission Mechanisms

Despite the diversity of business models of non-bank entities, the FSB has proposed three "channels" for assessing whether a financial entity's distress would likely be transmitted to other parts of the market and thus pose systemic risks:

- Exposures/counterparty channel (the effect of an entity's failure on its creditors, counterparties, investors or other market participants)
- Asset liquidation/market channel (the indirect impact of an entity's failure, such as disruptions in trading in key markets, the impact on asset prices from rushed liquidations)
- Critical function or service/substitutability (entity can no longer perform critical functions and there are no available substitutes)

Impact Factors

In an attempt to provide some uniformity for assessing potentially systemic entities, the FSB has established a basic set of impact factors to apply:

- Size (importance of single entity for stability increases with scale of activity undertaken)
- Interconnectedness (direct and indirect inter-linkages can produce repercussions throughout financial system)
- Substitutability (systemic importance increases where there are no providers of the same services in a particular business line or global market segment)
- Complexity (systemic impact of failure is correlated to its overall business, structural and operational complexity), and
- Global activities (cross-jurisdictional activities) (global impact from failure should correlate with share of cross-border assets and liabilities)

We find these factors relevant, though not complete. Moreover, we are concerned about the FSB's goal of providing uniformity for the assessment of nonbanks. This concern is based on the wide variety of business and funding models used in the financial services sector, and in the asset management business, in particular. Moreover, financial services entities employ an expansive mix of liquidity models, investment portfolios and strategies, capital structures and markets they target. We believe this could exacerbate the potential for systemic failure rather than mitigate such issues. [2]

[2] CFA Institute has recently released a report on shadow banking that explores financial stability risks in the nonbank arena, reviews the scale of regulation that is already being applied to the nonbank sector, and discusses the importance of having an appropriately-calibrated regime for such entities. See http://www.cfapubs.org/doi/abs/10.2469/ccb.v2015.n2.1

Operational framework for methodologies

Recognizing the range of business models and activities of non-bank, non-insurer entities, the FSB has proposed an operational framework for making determinations about the systemic risk implications of a financial entity:

- Scope of assessment (focused on measuring impact, rather than probability, of failure)
- Materiality threshold for determining the assessment pool (focus is on size and leverage for asset management entities);
- Assessment process and outcome (establishment of processes for more detailed assessments of certain entities, assignment of review to appropriate home jurisdictions, consistency checks and overall coordination to maintain international consistency)

As noted above, we believe there are factors other than size which contribute significantly to a firm's systemic potential. Other pertinent factors include the degree to which a firm has concentrated its holdings in one or a limited number of asset classes or issuers, including correlations with asset concentrations in other parts of the financial sector. We also believe that mismatches in the maturities and/or the liquidity of the assets vis-à-vis the liabilities controlled or managed by these entities has a significantly negative effect on a firm's systemic potential, and that this factor was a key factor in the liquidity issues faced by commercial and universal banks in the 2008 financial crisis.

We note, however, that existing regulation in both Europe and the United States serve to mitigate the systemic risk implications of concentrations in certain investment vehicles. For example, money market rules in both jurisdictions require that 10% of assets held by the fund mature within a day and 20% within a week. Moreover, UCITS rules require portfolio concentration limits; for equity funds, holdings in any one stock are limited to 10% of portfolio holdings, while all holdings between 5% and 10% of the portfolio cannot exceed 40% in the aggregate.

Investment Funds and Asset Managers

In addition to the general framework the FSB has developed to apply generally to the assessment of NBNI G-SIFIs, it also has created "sector-specific" methodologies for each of the four groups covered by this Consultation—finance companies, market intermediaries (securities broker-dealers), investment funds (including hedge funds) and asset managers. We understand that the FSB has already developed "near-final" specific methodologies for finance companies and market intermediaries. This Consultation presents a revised approach for determining the appropriate sector-specific methodologies that should apply to each of the other groups, including asset managers and investment funds.

As noted in the Consultation, the asset management industry is composed of (a) investment funds and (b) asset managers. While we address certain aspects of both areas separately, in keeping with the approach of this Consultation, we also focus our comments on areas that involve both asset managers and funds.

Investment Funds

For purposes of this Consultation, investment funds are defined to include open- and closed-end public funds (common mutual funds, money market funds, and exchange-traded funds) and private funds (hedge funds, private equity funds, and venture capital funds).

Of particular concern to the FSB and IOSCO are possible exposures that could result from the distress of failure of a fund resulting from leverage, both through the borrowing of money (balance sheet leverage) and the use of derivatives that are not centrally cleared. The Consultation notes that "'leverage' is considered a key driver for investment funds in posing risks to the global financial system."

Materiality thresholds for investment funds

While the Consultation on this matter issued in 2014 by the FSB and IOSCO proposed materiality thresholds based solely on size, this Consultation has decided to inject a leverage component to reflect its concerns.

Based on that, there are two options that are being considered for the materiality threshold for investment funds:

- USD 30 billion in net asset value, with a balance sheet financial leverage of 3 times that amount, with a "size-only" backstop of USD 100 billion net AUM; or
- USD 200 billion in gross AUM, unless the investment fund "is not a dominant player in its markets (e.g., substitutability ratio below 0.5% or fire sale ratio below 5%)."

The proposed threshold for materiality for private funds (including hedge funds and private equity), is USD 400 billion of Gross Notional Exposure (GNE)[3], to also reflect the emphasis on leverage.

We agree with the FSB's attempts to account for the lack of substitutability – i.e., whether another firm would have the capacity to take over and administer the failed firm's accounts, or to operate in the business that the failed entity occupied. Likewise, a firm that controls a specific market in the way that AIG did prior to 2008 creates a significant concern. The demise of AIG had significant consequences due to its contingent liabilities, the vast majority of which purported to insure other financial institutions against a deterioration in the value of their mortgage loan portfolios. This became a problem because a) the firm maintained a significant concentration and was a dominant player in a market that had grown to significant proportions, in part due to risk-based capital requirements; b) because of the significant leverage, much of it off-balance sheet, inherent in the contracts the firm was creating; c) the number and significance of other counterparties who were contracting with the firm to hedge their own exposures to the mortgage loan market; and d) the firm's inability to meet its obligations under the contracts it created with these other counterparties.

Size of any sector or firm must be carefully weighed as part of the total mix of activities, interconnectedness, and engagement in services or with products that are of a nature that would affect markets to a degree that would be systemic. This may be particularly important when

[3] The Consultation defines Gross Notional Exposure (GNE) as the absolute sum of all long and short positions, considering the notional value (delta-adjusted when applicable) for derivatives.

considering the systemic risk potential of market sectors, like asset management, where managers typically do not hold or own assets for themselves and are limited in their actions by client mandates, on investment activities.

Asset liquidation

This Consultation expresses concerns about the effect on market channels that may be caused by the distress of forced sales of a significantly large fund, including runs on redemption in open-end funds, the possibility of contagion, and depressed market prices.

We recognize that portfolio composition and the ability to meet redemptions in times of market stress may be tightly linked. Regulators in certain markets have already taken steps to address concern about sectors such as money market funds that in times of stress, fund investors may rush to redemption, leading to runs and correlated effects on related sectors.

For example, the U.S. Securities and Exchange Commission has implemented a number of regulatory measures that address concerns about runs on the market in times of market stress. Investment fund managers must manage and mitigate redemption risk through well-established liquidity management mechanisms. To this end, at least 85% of mutual fund assets must be in liquid instruments that can be sold within seven days. There is general recognition that such expectations may be challenged during times of market stress for many types of funds. To that end, funds also have mechanisms in place to retard contagion due to heavy demand by delaying redemptions for seven days during times of stress, by borrowing against fund assets to meet those redemption requests, or by making "in-kind" redemptions.

These gating features can add to liquidity problems down the line for other market participants, nevertheless. For example, when private equity firms issued capital calls during the 2008 financial crisis, some investors sought to meet those calls by placing redemption orders from their index fund holdings. The assumption was that these holdings were invested in some of the most liquid securities in the most liquid securities markets in the world. Some of those redemption orders were gated, however, leaving the investors unable to access their capital and meet the capital calls.

Money market funds contributed contagion during 2007 and 2008, largely due to their role as a funding source for commercial banks and the mismatch in maturities of their assets and liabilities. In response, the U.S SEC implemented regulations aimed at reducing the potential for "runs," including new rules requiring floating net asset values (NAVs) for the pricing of institutional prime money market fund shares. Stable NAVs are permitted only for funds invested solely in government securities and for funds available for retail investors. Non-government money market funds must use liquidity fees and redemption gates to deter runs on the market from excessive redemptions demands. While these new rules remain untested, we believe they ultimately will reduce the incentive for large institutional investors, in particular, to seek first redemption advantages.

CFA Institute has also supported consideration of other measures[4] to manage the resolution of mass redemptions in times of high market stress. These mechanisms include advance-notice

[4] See: http://www.cfainstitute.org/Comment%20Letters/20110428.pdf, CFA Institute comments to SEC regarding the President's Working Group Report on Money Market Fund Reform, dated 28 April 2011.

periods for redemptions, the use of in-kind distributions, temporary suspensions of redemptions, or pro-rata redemptions for redeeming investors. We believe that such mechanisms should be used only in periods of high market stress, and that market regulators would have to carefully and tightly restrict such declarations to those circumstances related to market-wide stresses. We believe such mechanisms will, in most cases, mitigate and lessen the negative effects of the failure of a private fund and prevent the contagion of failure to other firms within the financial system.

We note that the Consultation dismisses comments it has received relating to whether asset sales resulting from redemptions would materially impact market prices, given the ability to use fees, gates or redemption limits to reduce the effect. Noting that these exist, but "are infrequently used, their availability to mitigate potential systemic risk warrants further investigation, particularly in light of the continued increase in AUM of investment funds."

We believe that money market funds, which posed the greatest risk in the last crisis, now have regulatory safeguards that mitigate their future risk. As noted, fees, gates, and redemptions limits are now required by some regulatory schemes as direct mitigating tools. We've been advised by members that such mechanisms were effective in stemming investor runs during 2008, and we believe that mechanisms implemented specifically in response to identified risks must be valued and allowed to work. That they have so far been infrequently used to date may simply stem from a lack of need, in part because of their existence, and not reflect their value.

We support this body's efforts to thoroughly analyze all aspects of this industry that could reasonably lead to future systemic risk. We also believe that a number of concerns in the asset management area can be mitigated through regulatory and industry initiatives. For example, in the United States, the U.S. Securities and Exchange Commission is considering stress-testing requirements for large investment advisers and funds as an additional means of identifying and managing risk. It also has identified a number of areas in which it intends to address risk.

Interconnectedness

In keeping with this materiality assessment, proposed indicators for assessing potential systemic risk are the size of the fund and the interconnectedness with counterparties. While the size indicator incorporates a leverage consideration, the interconnectedness spells out various aspects of leverage that should be weighed, including the balance sheet financial leverage of the fund, its leverage ratio, the GNE to the net asset value for the fund, the ratio of posted collateral to the net asset value, counterparty risk exposure, and intra-financial system liabilities to global SIFIs.

We agree with the focus on the extent to which leverage by funds may contribute to risk. While mutual funds in the United States are limited by regulation in their use of leverage, which must be disclosed to investors, more may be required.

A primary source of leverage is through the use of derivatives, which are often used to manage risk, but can also become a source of leverage inherent in the structure of such instruments. In this area, new requirements aimed at better managing of these risks, including whether to require "broad risk management programs" as well as whether to limit the amount of a fund's leverage from the use of derivatives, are worth considering.

Certain types of investment funds, including hedge funds, private equity funds and leveraged ETPs, use leverage to boost returns and, in the process, can increase the potential for systemic problems in certain conditions.[5] CFA Institute supported monitoring of hedge fund activities in the United Kingdom prior to the 2007-2008 market turmoil[6] as a means of tracking potential systemic risks to U.K. financial markets and, in particular, the interaction between hedge funds and prime brokers. At the same time, we note that strategies that concentrate investments in specific issuers, sectors or types of credit, or that lack liquidity can lead to significant risks, regardless of how much leverage is used.

We are aware that certain structures exist in certain markets globally that could trigger wider contagion risk. In particular, some leverage bond LDI (liability-driven investment) funds may have difficulty recapitalizing in distressed markets. These funds, whose purpose is to reduce risk, could themselves become risky in chaotic bond markets because of their leverage and the potential for fire sales to meet recapitalization requirements. Given the scale and widespread use of these funds, particularly in the United Kingdom, such conditions could have consequences which are difficult to foresee.

Asset Managers

As noted in the Consultation, the asset managers' core function is to manage assets "as an agent on behalf of others in accordance with a specified investment mandate, or the investment strategy defined in the prospectus for the investment fund it manages." It also notes that with few exceptions, "the asset manager's discretion to invest assets is also subject to a number of regulatory, legal and contractual limits." We agree that this recognition is an important part of analyzing this sector's systemic risk implications.

Materiality thresholds for asset managers

In attempting to filter the pool of asset managers that would be subject to review for possible NBNI G-SIFI designation, the FSB and IOSCO are considering two types of materiality standards:

- Under a standard based on balance sheet total assets of USD 100 billion, the focus would be on how a large balance sheet could indicate the manager is involved in "significant non-asset management activities."
- The second standard being considered would be based on USD 1 trillion of assets under management, on the reasoning that this threshold may indicate a greater risk of affecting global markets. This standard presumes that "certain risks generated at the asset managers' level might also be transmitted through the investment funds that it manages"—making AUM relevant.

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[5] See section 6 of the CFA Report on shadow banking (note 2, supra) discussing survey responses wherein 13% of global respondents noted synthetic ETPs with leverage or inverted return features as the greatest systemic risk.

[6] See: http://www.cfainstitute.org/Comment%20Letters/20051103.pdf, CFA Institute Centre for Financial Market Integrity response to the U.K. Financial Services Authority's consultation, "Funds: A Discussion of Risk and Regulatory Engagement," dated 3 November 2005).

In general, we concur with the view implied in the second standard, that an asset manager of such magnitude may create risks that warrant monitoring. However, we are not convinced the first standard is appropriate. Banks that are larger than this threshold are not seen as systemic concerns despite having highly leveraged balance sheets funding illiquid, long-term assets. As noted above, asset managers typically neither own nor direct the investment of the funds they manage, and therefore pose significantly less risk for a certain AUM level than a bank with a balance sheet of similar magnitude. We concur that leverage, regardless of the type of firm, heightens the potential for failure. However, again, asset managers typically do not maintain leverage on the same magnitude as depository institutions, in part because they are not seen, in most cases, as benefiting from a sovereign safety net. While we agree it is wise for regulators charged with systemic risk oversight responsibilities to monitor the activities of such managers, we believe that naming a firm of such size as systemically important would require significant justification and highly unusual circumstances.

It is not clear from the Consultation whether the proposed thresholds are aimed at all business conducted by asset managers, their "core" investment management activities, or "activities they might have besides asset management and potentially for their own proprietary purposes (and not for the account of the funds or SMAs that they manage)."

If the FSB and IOSCO decide to move forward with choosing a materiality option, we urge care not to establish a presumption of systemic risk potential, but instead clarify that it is to be used only as only a way to filter the large pool of asset managers to determine whether or not they merit further review.

Interconnectedness

In attempting to assess the interconnectedness of an asset manager with other market participants, the Consultation focuses on leverage ratio, noting that the higher the leverage, the greater the potential impact distress or failure could have on the financial system. The focus here is on where asset managers themselves are interconnected with other market participants beyond asset management and perhaps for their own proprietary practices.

We concur that the use of leverage, an inability to delay redemptions, and significant asset concentrations could transmit problems throughout the financial system. At the same time, we reiterate the point of our discussion of leverage above. Specifically, we note that certain regulatory schemes restrict asset managers with the largest assets under management from using leverage. Those that can (hedge funds and exchange-traded products) have built-in protections, such as redemption gates for hedge funds and market-based pricing. At the same time, we do see a potential situation where these gates may not mitigate, and may even exacerbate, contagion. This is particularly the case where collateral is reused in a chain of transactions. Forced selling in such cases is more likely to create problems related to interconnectedness.

Substitutability and Complexity

In terms of assessing substitutability and complexity as an indicator of potential systemic risk, we understand that the failure of a large and interconnected entity may raises concerns about whether it could contribute to systemic risk. However, in the case of asset managers, we believe that this risk is substantially reduced by the marketability of the assets they manage and the pool of managers that would be able to implement the strategies outlined in offering documents or from client directives.

As asset managers do not own, but instead manage, client assets, failure of a large institution may create ripples in the markets as assets get transferred to other managers. While the transference may take time and create inconvenience for investors, we do not believe it would produce substantial market disruptions of systemic proportions. Instead, we believe that these assets, in most cases, will be absorbed by other managers with similar operations. Moreover, the sophistication of the large asset management firms that would be considered material enable them to handle investors communications and the transference of client records in a manner that would significantly quell concern among investors and other market participants.

As a factor to consider when evaluating potential systemic risk of asset managers, this Consultation states that "the extent of cross-jurisdictional activities is an essential factor in determining the global impact of the distress of failure of a particular institution." Indeed, we recognize that the failure of Lehman Brothers in 2008 caused significant difficulties for investors and institutions located in jurisdictions far from the United States. This instance, like no other, showed the negative implications of cross-jurisdictional activities.

At the same time, we think the Consultation overstates the risk where large asset managers may have activities in many jurisdictions, particularly where those routine business activities are highly substitutable. While the failure of such a business in certain circumstances may cause wider and potential systemic problems, in most cases problems are likely to be limited. Therefore, we do not believe it should be presumed that these activities automatically rise to systemic risk proportions.

Nevertheless, we believe it is wise for regulators to monitor the asset management sector for activities and structures that could create systemic disorder. To that end and in order to fully assess the risks in practices that may require more transparency, regulators should consider additional information and controls relating to the asset manager industry, such as these items that the U.S Securities and Exchange Commission is considering:

1) data reporting about risks, including the use of derivatives, securities lending, and data related to separately managed accounts;
2) controls to manage portfolio composition and to evaluate liquidity needs and the use of derivatives; and
3) the tracking of risks associated with industry transitions such as the dissolution of an adviser or other potentially major disruptions.

Exposures

In exploring activities that asset managers may undertake in addition to the management of investment funds, the Consultation asks about whether securities lending could be an activity that transmits or amplifies risk in the case of distress or failure. We assume that this concern focuses on the potential that lenders who have reinvested cash collateral from securities borrowers may face liquidity issues should the securities loans be terminated, thus requiring repayment of the cash collateral. Moreover, a decline in asset values may result in securities lending positions where the collateral declines in value, as would occur if bonds used as collateral are downgraded.

Such a circumstance could trigger sales to meet margin calls and to maintain the value of the collateral.

We recognize that there are two types of securities lending. The first involves traditional securities lending, typically by institutional investors to investors seeking to short a liquid security with the expectation of a price decline in that security. The other involves the short-term lending of securities to large financial institutions for funding purposes.

In general, we do not believe traditional securities lending in marketable securities poses a significant risk for markets. On the contrary, such activities help to highlight and diffuse pricing bubbles. That is not to say, however, that these activities are without risk, and specifically without risk to third-parties. For example, securities lenders receiving cash collateral and reinvesting in noncash instruments create a liquidity or maturity mismatch that can have follow-on consequences for other market participants.

Entities most at risk in securities lending markets, however, are those borrowing the securities for their short selling strategies. “Shorts” are at a disadvantage because a) they must borrow shares for their strategies, b) the vast majority of investors are long investors, and c) they face the potential for being ”squeezed” by long investors. The risk of getting squeezed is a function of different factors, such as new information that supports an increase in share prices. Squeezes also may come when long investors recognize the need for the shorts to repurchase securities at some point in the future, and thus bid up the price for the securities and undermining the shorts’ position. In such circumstances, therefore, the shorts lose by having to repurchase the securities at a higher price while long investors benefit from the increase in price. The securities lenders also may squeeze the shorts by requiring the securities be repaid prior to when it would be convenient for the shorts. Again, the borrowers must repurchase the securities and potentially bid up the price in the process. As noted above, the parties put at a disadvantage in these kinds of transactions are the short investors which traditionally account for a small percentage of total investors and investment trading volume.

Nor do we see a potential systemic event arising as a consequence of shorts terminating their borrowings and demanding repayment from securities lenders. We recognize the potential for disruptions for specific firms arising in this manner, but we are less certain of system-wide disruptions. For this type of situation to rise to a systemic level would require en-masse termination of short positions, and simultaneous demands for return of collateral. For this to occur, a general expectation of increasing securities values would be needed. We believe it is unlikely for such a situation to occur without significant regulatory intervention as occurred in October 2008 when regulators restricted the ability of investors to short bank stocks. Even then, the resulting rise in the value of the underlying securities as shorts moved aggressively to repurchase shares to unwind their short positions reduced the potential harm to the lenders.

More potentially problematic is securities lending for the funding needs of large institutions. Overnight repurchase agreements, in particular, are a means of lending short-term, often less-liquid, instruments overnight in return for cash to providing needed funding. However, a large portion — nearly half — of the short-term repurchase market is largely centrally cleared in the so-called tri-party repo market (TRP) against “general collateral,” which reduces the risk in this area. At the same time, the Federal Reserve Bank of New York[7] estimates that collateral used in the slightly larger bilateral repo market is typically of higher quality, in part because of the demand for better specific types of securities, whereas the TRP market is more flexible on collateral types. In this case, nevertheless, we see the benefits of continued monitoring of these activities to enable prudential regulators to recognize how problems may flow through the financial system. In expressing concern about ways in which asset managers may not appear to prevent or mitigate risks to an investment vehicle and overall financial system, the Consultation mentions that investor preferences about the vehicle's investment strategy and portfolio allocation, or pressure to outperform benchmarks may encourage a vehicle to continue investments in certain asset classes that limit its cash or liquid holdings.

It is worth noting again that asset managers do not own assets but instead act at the direction of their clients and their investment objectives in directing investments in particular assets; in accordance with well-established rules, the managers of the majority of asset under management must operate within the parameters of client objectives, fund regulations, and objectives and strategies promised in fund prospectuses. Thus, while a fund may indeed seek to outperform a certain benchmark (and thus increase investor returns), they may act only within this diverse set of often overlapping parameters. These limitations won't completely immunize a fund from loss, but they are intended to reduce the severity of loss. To suggest that asset managers should not be seeking appropriate means of increasing investor returns (in keeping with the best interests of the client) raises questions about the fundamental underpinnings of the asset management industry, standards of care, and the use of client investment profiles.

Conclusion

We appreciate efforts by the FSB and IOSCO to assess the potential systemic risk posed by the investment funds and the asset management industry. We support the monitoring of these and other sectors in order to identify areas that raise significant concerns and to stay ahead of potential systemic developments. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Linda Rittenhouse at Linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht	*/s/ Linda Rittenhouse*
Kurt N. Schacht, CFA Managing Director, Standards and Financial Market Integrity CFA Institute	Linda L. Rittenhouse Director, Capital Markets Policy CFA Institute

[7] http://libertystreeteconomics.newyorkfed.org/2014/07/lifting-the-veil-on-the-us-bilateral-repo-market.html#.VWYhzk10yUk