asset management group

September 21, 2016

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

Re: Financial Stability Board, "Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities" (22 June 2016)

Dear Sirs/Madams:

The Asset Management Group ("**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") appreciates the opportunity to comment on the consultative document, titled *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* ("**Consultative Document**") published by the Financial Stability Board ("**FSB**"), dated 22 June 2016. The AMG's members are primarily U.S.-based asset management firms, many with a global footprint. This letter focuses on the four areas of asset management activities identified by the FSB as "structural vulnerabilities" and responds to the FSB's recommendations within each area: (i) liquidity risk management; (ii) leverage; (iii) operational risks; and (iv) securities lending activities of asset managers and investment funds.

We appreciate that in seeking to fulfill its mandate of promoting global financial stability, the FSB recognizes that the asset management industry plays a very different role than banks and insurance companies in the financial markets. We are encouraged by the FSB's shift in focus to asset management products and activities and away from its past initiative of establishing methodologies for identifying individual funds or asset managers as systemically important. We believe that this revised approach better reflects the fundamental nature of the asset management business, recognizes the differences between asset management and other financial services firms, and better informs the FSB's approach to regulatory frameworks in U.S. and non-U.S. jurisdictions.

Before providing our specific comments in response to the Consultative Document and addressing various concerns raised by the recommendations therein, we begin with an executive

[1] The AMG's members represent primarily U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds, and private funds such as hedge funds and private equity funds. While our members operate outside the U.S. and most are considered to be global enterprises, the background and orientation of our organization is rooted in U.S. laws and regulations. Our letter reflects our familiarity with such laws and regulations. We wish to emphasize, however, the need for a global approach to all issues set forth in the Consultative Document and, accordingly, our comment letter references both U.S. and non-U.S. laws, regulations, proposals, and policies.

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summary as well as an introduction highlighting our general positions to-date on prudential regulatory initiatives in the asset management industry.

I. Executive Summary

We are generally supportive of the FSB's recommendations, including the implementation of robust liquidity risk management programs, access to a wide range of risk mitigation tools, a better understanding of the use of leverage and securities lending practices across jurisdictions, and effective operational risk plans and practices. In our comments, we echo our support but also highlight for the FSB how the deep and intricate regulatory framework that governs the everyday operations of asset managers and investment funds already address many of the concerns presented in the Consultative Document. Our goal is for the FSB to use these responses to further inform their approach to and views of asset management as (1) unique and not akin to the banking industry; and (2) well-equipped to continue its track record for successfully meeting shareholder redemptions through normal and stress conditions without presenting a systemic risk to global financial stability.

Liquidity

Liquidity risk management is absolutely fundamental to the daily operations of open-end funds. It is inherent in their design. The ability of investors to redeem shares freely and promptly is central to the very concept of mutual funds. Accordingly, we are not aware of any evidence to support a claim that the asset management industry has ever experienced significant problems meeting investor redemption requests. We also are not aware of any evidence to support a hypothetical connection between liquidity risk in open-end funds and systemic risk to global financial markets. Rather, the evidence demonstrates the asset management industry has consistently been able to meet shareholder redemptions through periods of market stress.

We further believe that national securities regulators should lead, and IOSCO should coordinate, any inquiries into new liquidity challenges. Therefore, we support the FSB's acknowledgement of the role of securities regulators and the Consultation's reference to IOSCO operationalizing many of the recommendations.

On the specific recommendations:

- FSB Recommendations Relating to Regulatory Information and Investor Disclosures
    - Current regulations and practices already call for extensive disclosures across jurisdictions. In addition, in the U.S., the Securities Exchange Commission ("**SEC**") has commenced rulemakings to enhance liquidity reporting requirements.
    - To the extent the recommendations initiate additional reviews of disclosure and reporting requirements, we encourage the FSB to ensure that the additional reviews are necessary, given that current regulations, market practices, and the very nature of open-end funds support a finding that they do not pose a threat to global financial stability.

- We encourage the FSB to focus on the harmonization of data requirements across jurisdictions, especially where overlapping regulations create inefficiencies in the reporting and disclosure of liquidity profile information.

- FSB Recommendations Relating to Redemptions and Risk Management Tools
  - Investment funds across jurisdictions have access to a wide range of liquidity risk management tools and practices, many of which are tailored to the structure of particular markets.
  - The FSB's call for additional liquidity tools is not commensurate with the risks posed by open-end funds. Therefore, we urge the FSB to refrain from pursuing these recommendations or, at minimum, delay consideration of these recommendations pending further action by national securities regulators.

- FSB Recommendation Relating to Stress Testing at the Level of Individual Open-End Funds
  - We believe it is premature to recommend authorities consider stress testing for mutual funds because: (a) there is a conceptual problem with the very notion of stress testing the capital adequacy of a mutual fund, where the objectives, methods, and costs and benefits are wholly undefined and therefore immeasurable; and (b) it reflects a central misunderstanding of the critical differences between the risk profiles of a bank and a mutual fund.

- FSB Recommendation Relating to System-Wide Stress Testing
  - We reiterate our position that stress testing is a flawed concept. Further to this point, based on available research and data, we add that implicating all funds in large-scale tests would be an exercise unlikely to yield helpful results.
  - We strongly urge the FSB to withdraw its system-wide stress testing recommendation.

- FSB Recommendations Relating to the Adequacy of Tools in "Exceptional Circumstances"
  - Liquidity risk management tools, whether ordinary or extraordinary, fall on a spectrum, such that an asset manager's use of any given tool is specific to the liquidity event involved, exceptional or not.
  - We oppose the confusing and unsupported recommendations that draw a distinction between "extraordinary" and ordinary tools for application to "exceptional" circumstances.

- FSB Recommendations and Exchange-Traded Funds ("**ETFs**")
    - We submit that the features that make ETFs unique – in-kind redemptions, use of redemption fees, and the function served by authorized participants ("**APs**") in the primary market – allow ETFs to manage liquidity risk effectively.
    - Instead of tailoring the proposed recommendations to fit within the ETF context, we urge the FSB to await the results of the SEC's request for comment on ETFs and similar products, which should further illuminate issues specific to ETFs and fill the gaps on the nature and uses of ETFs.

Leverage

- FSB Recommendations Relating to Leverage
    - Leverage serves many important, beneficial functions and should not be subject to undue restriction. We agree with the FSB that the use of leverage is not widespread, and therefore we believe it is not a source of systemic risk.
    - We support regulators' efforts to better understand leverage and harmonize reporting requirements, but caution against the use of simplistic metrics to measure funds' use of leverage and the imposition of additional leverage restrictions.

Operational Risk

- FSB Recommendation Relating to Operational Risk
    - There is a misconception that financial stress and market volatility are correlated and cause operational issues in the asset management industry.
    - We are not aware of any current or potential operational challenges faced by asset managers and their funds– including the transfer of assets or investment mandates and legal or regulatory requirements – that implicate global systemic risk. In fact, the record demonstrates that asset managers and their funds routinely enter and exit the market without creating systemic disruptions.
    - Regulatory considerations, client expectations, and reputational considerations compel asset managers to develop sophisticated and evolving risk management processes that are in the best interests of their clients and tailored to their business and operations. In addition, in the U.S., for example, the SEC has proposed new regulations to address business continuity and transition planning.
    - We welcome the opportunity to further discuss with the FSB how asset managers address operational issues.

Securities Lending Activities

- FSB Recommendation Relating to Securities Lending Activities
    - Securities lending in general is not a source of systemic risk. Moreover, securities lending is already subject to a range of existing and pending regulations that we believe adequately address any risks that may be associated with the practice.
    - The indemnifications that are the subject of the FSB's recommendation are well regulated and the potential liability is self-contained and limited to the difference between the replacement cost of the security and the value of the collateral pledged.
    - Securities lending is helpful to the financial markets in a number of respects and regulators should not take measures that would tend to limit securities lending activity.

II. Introduction

We have been actively engaged in providing our views to the FSB, the International Organization of Securities Commissions ("**IOSCO**"), the Financial Stability Oversight Council ("**FSOC**"), and the SEC for several years regarding asset management activities and related issues. We submitted comments to the SEC in 2013 relating to the *Asset Management and Financial Stability* study published by the Office of Financial Research ("**OFR**").[2] A few months later, we provided written comments to the FSB and the SEC in response to the OFR study and issues relating to separate accounts,[3] as well as comments on the FSB's consultative document, entitled *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* ("**NBNI G-SIFIs**").[4] In August 2014, we joined a number of other organizations in petitioning the FSOC to propose amendments to, seek public comment on, and ultimately amend, FSOC's existing rules concerning the designation of systemically important nonbank financial institutions for supervision by the Board of Governors of the Federal Reserve System.[5] Last year, we submitted comments in response to FSOC's *Notice Seeking Comment on Asset Management Products and Activities*.[6] We provided comments to the FSB on the FSB/IOSCO revised proposal, entitled *Assessment Methodologies*

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[2] *See* Letter from AMG and Investment Adviser Association ("**IAA**") to the SEC (Nov. 1, 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589945983.

[3] *See* Letter from AMG to FSB and SEC (Apr. 4, 2014) ("**April 2014 AMG Letter to FSB and SEC**"), *available at* http://www.sifma.org/issues/item.aspx?id=8589948419.

[4] *See* Letter from AMG to FSB (Apr. 4, 2014) ("**April 2014 Letter to FSB**"), *available at* http://www.sifma.org/issues/item.aspx?id=8589948402.

[5] *See* Petition from AMG, American Council of Life Insurers ("**ACLI**"), Association of Institutional Investors ("**AII**"), American Financial Services Association ("**AFSA**"), and Financial Services Roundtable ("**FSR**") to FSOC (Aug. 19, 2014), *available at* http://www.sifma.org/issues/item.aspx?id=8589950444.

[6] *See* Letter from AMG and IAA to FSOC (Mar. 25, 2015) ("**March 2015 AMG IAA Letter to FSOC**"), *available at* http://www.sifma.org/issues/item.aspx?id=8589953776.

for Identifying NBNI G-SIFIs.[7] And in July 2015, we provided comments to the FSB in response to the request for feedback on the *Peer Review on Implementation of the FSB Policy Framework for Financial Stability Risks Posed by Non-Bank Financial Institutions*.[8] As we discuss in specificity below, most recently, we have submitted comment letters to the SEC on various proposed rulemakings that relate to issues addressed in the Consultative Document.

Without reiterating the extensive information provided in these submissions, we believe a few overarching themes bear emphasis.

First, asset management firms and mutual funds[9] already are subject to comprehensive laws and regulations in both the U.S. and jurisdictions around the globe. In the U.S., the Investment Advisers Act of 1940 ("**Advisers Act**") and the Investment Company Act of 1940 ("**Investment Company Act**") provide the basic statutory framework for asset management firms and mutual funds (asset management firms also may be subject to regulations imposed by the Commodity Futures Trading Commission, the U.S. Treasury Department, the U.S. Department of Labor, and non-U.S. regulators). The Advisers Act prohibits misleading, deceptive, and fraudulent acts or practices by asset management firms, grants the SEC broad authority to issue regulations governing the activities of asset management firms, and requires asset managers to put the interests of their clients ahead of their own interests. Indeed, SEC regulations govern nearly every aspect of activities and operations of asset management firms. SEC-registered firms are subject to a variety of requirements relating to insider trading, custody, brokerage and commissions, proxy voting, books and records, privacy, best execution, advertising, and client referral arrangements. Importantly, the assets managed by asset management firms must be held at registered broker-dealers or banks. Asset management firms must adopt written codes of ethics, which set forth standards of conduct expected of advisory personnel and address conflicts of interest that could arise from personal trading by such personnel. They also must adopt and implement written policies and procedures reasonably designed to prevent violations of the Advisers Act, review those policies and procedures at least annually to determine their adequacy and effectiveness, and designate a chief compliance officer responsible for administering those policies and procedures. The Investment Company Act and rules promulgated by the SEC thereunder impose many other specific regulations governing the formation and operation of funds, including requiring strict oversight by boards that include a significant percentage of independent directors. It is unquestionable that the legal, regulatory, and compliance obligations of SEC-registered asset management firms and mutual funds are rigorous, sweeping, and resource-intensive. These wide-ranging legal and regulatory requirements are designed to protect investors, facilitate capital formation, and maintain and promote fair and orderly markets. We believe it is imperative for the

[7] *See* Letter from AMG and IAA to FSB (May 28, 2015), *available at* http://www.sifma.org/issues/item.aspx?id=8589954882.

[8] *See* Letter from AMG to FSB (July 24, 2015), *available at* http://www.sifma.org/issues/item.aspx?id=8589955644.

[9] Under U.S. laws and regulations, the term "mutual fund" encompasses both open-end funds and money market funds. An exchange-traded fund is an open-end fund, but not a mutual fund. We recognize that this nuanced terminology is unique to the U.S. asset management industry. We use the term "investment fund" to refer to all funds, including mutual funds and private funds. We also are aware that the Consultative Document narrows the focus of its liquidity recommendations to open-end funds. Accordingly, this letter does not discuss money market funds, their unique structure, and related reforms.

FSB to understand and recognize the current and pending legal, regulatory, and compliance framework when analyzing whether asset management activities present a systemic risk.

Second, we understand the desire to examine practices in jurisdictions around the globe with respect to issues raised in the Consultative Document. We acknowledge the importance of the FSB's role in monitoring and advising with regard to best practices in meeting regulatory standards as well as promoting coordination and information exchange among authorities responsible for financial stability. We also submit, however, that national securities regulators are in the best position to understand the particular nuances of the asset management activities under their authority and engage with industry participants, including through the rulemaking process. We encourage the FSB, consistent with its role relating to best regulatory practices, promoting coordination among regulators, and working to facilitate the exchange of information among policymakers, to work with all regulators to understand the highly developed asset management regulatory framework around the globe.

We stress the need for all regulators and policymakers to understand the importance of harmonizing laws and regulations around the globe. Such harmonization is essential to ensuring that businesses and the economic growth they generate are not hamstrung by conflicting or inconsistent policies and to prevent costly, unnecessary, and inefficient requirements on asset management businesses, the investors they serve, and capital markets more broadly. The FSB is in a unique position to provide leadership in attaining this important goal. The AMG is committed to working with members of the FSB and IOSCO to achieve a better understanding of the asset management industry, its activities, and the laws and regulations governing such activities. We welcome the opportunity to continue to meet with FSB officials to share information, data, and our members' working knowledge of industry practices and activities in order to inform an appropriate analysis of existing regulatory requirements across the globe as well as pending regulatory initiatives in the U.S.

Third, we appreciate the following statements made by the FSB in the Consultative Document:

> It is also important to acknowledge that asset managers and their funds pose very different structural issues from banks and insurance companies. In contrast to banks and insurance companies, which act as principals in the intermediation of funds, asset managers usually act as agents on behalf of their clients and are subject to fiduciary duties to act in the best interests of investors. Asset managers are appointed by investors to manage their money in accordance with pre-defined investment strategies. They are intermediaries between the investors (ranging from sophisticated institutional investors, SWFs, pension funds, and insurance companies to charities, endowments and individual retail investors) and the markets. It is the clients, and not the managers, who own the assets and reap the investment returns while bearing the investment risks.
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> This different structure of the asset management sector offers some important stabilizing features to the global financial system. Asset managers usually do not use their balance sheets in transactions between their clients and the broader marketplace, since an asset manager itself generally does not enter into financial market transactions as a principal. Given that an asset manager's balance sheet is generally very small relative to the size of

> assets managed, distress at the level of the asset manager should generally pose less of a risk to the financial system than distress across its funds.[10]

We have emphasized these important facts in our previous submissions to the FSB and other regulators and welcome the inclusion of these statements in the Consultative Document. Specifically, we highlight the following:

1. Asset management activities are fundamentally different from bank and insurance company activities.

2. Asset management activities have not been shown to pose any systemic risks to global financial stability. On the contrary, asset management activities are a stabilizing force in financial markets, facilitating long-term investment in financial assets, distributing risk broadly across asset holders and geographies, and promoting retirement security for millions.

3. The essential structural differences between the asset management industry and banking and insurance businesses require a contrasting framework for assessing and addressing risk.

4. Applying to asset management activities prudential standards tailored to banking and insurance regulatory structures is tantamount to forcing a square peg into a round hole. While we appreciate the FSB's explicit acknowledgement of the fundamental differences between asset management activities on the one hand and banking/insurance activities on the other, we find that many of the recommendations set forth in the Consultative Document fail to account for these critical differences.

Fourth, we continue to stress the need to base any recommendations that address global economic systemic risk on empirical data and exacting analysis. Unfortunately, while we appreciate that the Consultative Document explicitly recognizes the divergent characteristics between asset management activities and banking and insurance activities, the recommendations seem to still be largely premised on speculative or anecdotal "evidence." For example, the first section of the Consultative Document notes as follows:

> During prolonged periods in which highly accommodative monetary policies affect asset valuations, investors may reach for yield and under-price credit and liquidity risks. This could interact with a decline in secondary market liquidity, so that a shift in market expectations could produce repricing of assets, liquidity strains in certain markets, and the potential for contagion across asset classes.
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> Although historical evidence suggests that non-money-market open-ended funds have not created global financial stability concerns in recent periods of stress and heightened

[10] Consultative Document, at 7-9.

volatility, developments in the sector and the increasing holdings of fixed income assets by investment funds suggest that risks may have increased in recent years.[11]

There is no disagreement that global markets have been dealing with central banks' highly accommodative monetary policies since well before the 2008 financial crisis. But there is no evidence to support a link between the "vulnerabilities" identified in the Consultative Document and global systemic risk. In fact, throughout our response, we highlight how the recommendations on liquidity and other areas are based on hypothetical or unsubstantiated risks. The above-cited excerpt references uncertain situations where investors "may reach" for greater yield, which "could interact" with other uncertain situations, and that these developments "could produce" serious negative economic consequences. Indeed, the Consultative Document correctly states that open-end funds "have not created global financial stability concerns in recent periods of stress and heightened volatility" but then speculates that risks have increased because assets in funds also have increased. This ignores the inflation of asset values by authorities across financial sectors. For example, with respect to fixed income assets, the Federal Reserve recently revised its data to show that bond funds' share of the bond market is actually relatively small and stable and that, rather than growing rapidly, the share of corporate bonds held by bond funds has been flat since 2012.[12] We respectfully suggest that the FSB's recommendations should be re-evaluated in light of less hypothetical and unproven contingencies and more on substantiated data and information.

In a similar vein, we urge the FSB to acknowledge and factor in the basic structure and characteristics of collective investment vehicles, such as open-end funds. As noted in our comments below, the architecture and regulatory framework of these funds are designed to eliminate or mitigate the specific risks identified in the Consultative Document. Imposing additional and unnecessary requirements – particularly requirements that are applicable to the very different risks associated with banking activities – will produce counterproductive results and negative consequences.

We also wish to underscore our appreciation and recognition of the FSB's continuing focus on asset management activities, as opposed to the designation of NBNI SIFIs. As we have consistently stated, we believe that it is most productive "to assess and regulate activities in which investment funds and other capital markets participants engage than it would be to try to

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[11] Consultative Document, at 10.

[12] *See, e.g*., *Revised Fed Data Show Mutual Funds' Share of Corporate Bond Market is Small and Stable* (Aug. 26, 2016), *available at* https://www.ici.org/viewpoints/view_16_corporate_bond_share ("The Fed's latest data revision shows both that bond mutual funds are a minor player in the corporate bond market—bond mutual funds' share of the market rose from 9 percent in 2009 to 15 percent in 2015—and that their share has been basically flat since 2012" and "the Fed revised down mutual funds' holdings of corporate and foreign bonds in the Flow of Funds Accounts over the period of 1991 to 2015, with the largest revisions occurring in the past five years. For example, for year-end 2015, mutual fund holdings of corporate and foreign bonds were revised down by $855 billion, from $2.6 trillion (the figure published in March 2016) to $1.7 trillion (the figure published in June 2016). The Fed's improved approach brings the Flow of Funds figures in line with the actual market value of the bonds that investment funds hold."). *See also,* BlackRock ViewPoint, *Breaking Down the Data: A Close Look at Bond Fund AUM* (Jun. 2016) ("**BlackRock Bond Fund Paper**"), *available at* https://www.blackrock.com/corporate/en-at/literature/whitepaper/viewpoint-breaking-down-the-data-bond-fund-aum-june-2016.pdf, at 11.

identify individual entities that represent concentrated risk to such a degree that they warrant different regulation than their competitors."[13] We also wish to emphasize that the amount of assets under management attributable to a particular asset management firm or investment fund does not automatically equate to systemic risk and is not a significant factor in a firm or fund's risk profile. Client assets flow freely among different asset management firms without creating risks to the global economy. For example, a separate account client's decision to move assets from one asset management firm to another ordinarily does not trigger the redemption of the assets managed by the first asset management firm. Similarly, the assets of a pension fund that decides to hire a different asset manager will likely remain at the same custodian – the only thing that will change is the asset manager. Asset managers also are subject to a very high degree of competition both from other asset managers and due to internal priorities at various institutional clients, where assets are generally managed directly by clients.[14] We reiterate our support for a permanent move away from attempting to designate particular firms or funds as systemically important and thereby subjecting them to bank-style prudential regulation that is incompatible with their risk profile, business model, and duties to clients.[15]

Finally, we wish to stress that positions set forth in this letter derive from our commitment to serving the interests of our clients. As fiduciaries, asset managers are obligated to put the interests of their clients ahead of their own. This bedrock principle guides the activities and practices of the members of our organization. Accordingly, our responses to the Consultative Document incorporate and reflect the best interests of our clients.

With the foregoing in mind, following are our specific comments. We have organized our comments according to the four areas identified by the FSB in the Consultative Document: liquidity mismatch, leverage, operational risk, and securities lending. For convenience of reference, the FSB's recommendations are restated before each response, and, where thematically helpful, we address multiple recommendations concurrently.

III. FSB Recommendations to Address Issues Relating to Liquidity

The first nine recommendations concern various issues related to the management of alleged liquidity risks posed by open-end funds. The AMG strongly supports efforts to implement strong and effective liquidity risk management policies and procedures. Our members understand the necessity of implementing and maintaining liquidity risk management

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[13] April 2014 AMG Letter to FSB and SEC, *supra* note 3, at 2.

[14] *See* BlackRock ViewPoint, *Who Owns the Assets? Developing A Better Understanding of the Flow of Assets and the Implications for Financial Regulation* (May 2014) ("**BlackRock Asset Owners Paper**"), *available at* http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf, at 2 (finding that more than three quarters of financial assets are managed directly by asset owners, not asset managers).

[15] SEC Commissioner Michael S. Piwowar has generally agreed, stating "If the [SEC], as the regulator responsible for overseeing mutual funds, were to conclude that the redemption requirements under Section 22(e) [of the Investment Company Act] could create broader market concerns, a far more appropriate response would be to consider what regulatory solutions can be constructed by the [SEC] to address such concerns, rather than for prudential regulators to designate funds and/or their advisers and/or their activities as systemically risky." Piwowar, Remarks at the 2015 Mutual Funds and Investment Management Conference (Mar. 16, 2015), *available at* https://www.sec.gov/news/speech/031615-spch-cmsp.html, at 7.

programs that are tailored to meet the specific characteristics and risks of their investment products. However, we do not support recommendations that securities regulators impose one-size-fits-all requirements or to mandate costly and ineffective regulations to address hypothetical risks that are unsupported by evidence.

As the FSB has observed, historical evidence suggests that investment funds have not created global financial stability concerns.[16] Consistent with that finding, we are not aware of any evidence to support a claim that the investment management industry has ever experienced significant problems meeting investor redemption requests.[17] Nor is there any evidence to support a hypothetical connection between liquidity risk in open-end funds and systemic risk to global financial markets.[18]

A collective investment product, such as an open-end fund, is designed to take into account anticipated liquidity and redemption stresses. In the U.S., for example, investors in open-end funds can redeem their shares on each business day and funds are required to meet redemption requests within seven days.[19] In practice, three-day settlement requirements take most redemptions to a T+3 settlement timeline (or less), with pending efforts by the U.S. financial services industry to move to a T+2 settlement timeline.[20] To facilitate redemption

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[16] Consultative Document, at 8.

[17] *See* Letter from Investment Company Institute ("**ICI**") to SEC (Jan. 13, 2016) ("**ICI Liquidity Letter to SEC**"), *available at* https://www.ici.org/pdf/16_ici_sec_lrm_rule_comment.pdf. *See also* Paul Hanouna, Jon Novak, Tim Riley, Christof Stahel, Staff Economists, SEC, "Liquidity and Flows of U.S. Mutual Funds," *Division of Economic and Risk Analysis* (Sept. 2015), *available at* http://www.sec.gov/dera/staff-papers/white-papers/liquidity-white-paper-09-2015.pdf.

[18] *See, e.g*., Jeremy C. Stein, Board of Governors of the Federal Reserve System, *Comments on "Market Tantrums and Monetary Policy,"* a paper by Michael Feroli, Anil K. Kashyap, Kermit Schoenholtz, and Hyun Song Shin, Remarks at the 2014 U.S. Monetary Policy Forum (Feb. 28, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/stein20140228a.pdf. Former Federal Reserve Governor Stein concluded that regulators do not "know enough about the empirical relevance of the AUM-run mechanism, to say nothing of its quantitative importance, to be making recommendations at this point." *Id*., at 6.

[19] Investment Company Act Section 22(e). *See* Chair Mary Jo White, *Statement on Open-End Fund Liquidity Risk Management Programs and Swing Pricing* (Transcript), SEC Open Meeting (Sept. 22, 2015), *available at* https://www.sec.gov/news/statement/open-end-fund-liquidity-risk-management-programs--sept-22-2015.html. As noted by White, many funds promise, and investors have come to expect, to receive their assets more quickly.

[20] Requirements of Rule 15c6-1 under the Securities Exchange Act of 1934 (imposing a maximum time period on broker dealers for the payment of funds and delivery of securities) effectively take most fund investments to a T+3 (trade date plus three days) settlement timeline. The SEC staff has instructed funds to assess the mix, including level of cash reserves, lending and credit facilities and percentage of holdings to determine whether, under normal circumstances, funds will be able to facilitate compliance with the three-day settlement standard. *See* Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, to Paul Schott Stevens, General Counsel, ICI (May 26, 1995). In addition, The Depository Trust & Clearing Corporation ("**DTCC**"), a leading post-trade financial services company providing clearing and settlement services to financial markets, in collaboration with various industry associations, including SIFMA, is working to shorten the settlement cycle to T+2 and complete market participation implementation by the third quarter of 2017. *See* Deloitte & Touche LLP, Industry Steering Committee ("**ISC**"), SIFMA, and ICI, *T+2 Industry Implementation Playbook: Including a Detailed Implementation Schedule, Interim Milestones, and Dependencies* (Dec. 2015), *available at* http://www.ust2.com/pdfs/T2-Playbook-12-21-15.pdf?n=76587. *See also* PricewaterhouseCoopers LLP, ISC, and DTCC, *Shortening the Settlement Cycle: the Move to T+2* (2015), *available at* http://www.ust2.com/pdfs/ssc.pdf

requirements, U.S. open-end funds' holdings in illiquid securities are limited to 15 percent of their net assets, where "illiquid securities" are generally defined as securities that cannot be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to the security by the fund.[21]

While the mutual fund industry has experienced significant growth in the last 20 years,[22] we do not believe that increased investment in, for example, bond funds or the development of new types of funds, including ETFs and alternative funds, creates a threat to global financial stability.[23] On the contrary, the evolution of the mutual fund industry has been accompanied by the development of regulations and market practices designed to protect investors while also safeguarding innovation, investment, and capital formation. In fact, evidence suggests that as the fund industry has grown, so, too, has its ability to accommodate greater redemption requests.[24] The SEC, for example, has rarely issued orders allowing the suspension of redemptions for periods of restricted trading or emergency situations.[25] To the contrary, following the September

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(noting that "major markets across the globe either are examining a move to T+2 (Canada and Japan), are currently moving to T+2 (Australia), or have already completed a move to T+2 (European Union, Hong Kong, and South Korea)"), at 5.

[21] *See* Revisions of Guidelines to Form N-1A, SEC Rel. No. IC-18612 (Mar. 12, 1992) ("**Guidelines Release**"), *available at* https://www.sec.gov/rules/other/1992/33-6927.pdf; SEC Division of Investment Management, IM Guidance Update No. 2014-01 at 6, n. 12 (Jan. 2014) ("**Revisions of Guidelines**"), *available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf (explaining that the 1992 Guidelines are SEC guidance and remain in effect despite the general rescission of the Guidelines in 1998). The Liquidity Proposal would codify SEC guidance on 15 percent limit on illiquid holdings. *See Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release*, SEC Rel. Nos. 33-9922, IC-31835 (Sept. 22, 2015), 80 Fed. Reg. 62274 (Oct. 15, 2015) ("**Liquidity Proposal**"), at 62317.

[22] For example, as of the end of 2015, there were 9,156 open-end funds (excluding money market funds, but including ETFs registered under the Investment Company Act), as compared to 2,960 at the end of 1992. *See* ICI, 2016 Investment Company Fact Book (2016), *available at* http://www.ici.org/pdf/2016_factbook.pdf ("**2016 ICI Fact Book**"), at 176 and 183.

[23] *See* ICI Liquidity Letter to SEC, *supra* note 17, at 4-5. As noted by the ICI, "Growth in bond fund assets should not pose concerns. Despite recent growth, bond fund assets currently make up a smaller share of long-term fund assets than they did in the mid-1980s and their flows are less variable. Much of the growth in bond funds reflects secular trends: the aging of Baby Boomers and shifts from direct holdings of securities toward indirect holdings through funds. These trends reflect households' long-term planning decisions, which are unlikely to change abruptly as a result of market corrections. Concerns about growth in the assets of specific fund types, such as high-yield funds, are overstated. High-yield fund assets today make up a smaller share of the high-yield debt market than they did 15 years ago. Also, these funds hold liquid assets, such as common stock and short-term securities, to help meet redemptions. For similar reasons, concerns about growth in emerging market funds and alternative funds are overstated." *See also* ICI Letter to FSOC (July 18, 2016), *available at* https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf (finding that "even extremely large outflows from high-yield bond funds – assumed outflows far greater than ever seen in history – are simply too small to pose systemic risks"), at 10.

[24] *See* ICI Liquidity Letter to SEC, *supra* note 17, at 12, finding that "Gross redemptions have varied over time reflecting market conditions. They have also varied over time by investment types (see Appendix Figure A1, which provides a breakdown of gross redemptions by equity, hybrid, and bond mutual funds and ETFs). But a key feature of Figure 1 is that as the fund industry has grown, funds have accommodated a vastly greater volume of redemptions."

[25] *See* Liquidity Proposal, *supra* note 21, at 32-33, fn. 82. *See also* discussion on Third Avenue Management, LLC, *infra* note 95.

11, 2001 U.S. terrorist attacks, for example, certain funds were issued relief to resume trading even when the New York Stock Exchange was closed. We believe the industry's continued ability to meet shareholder redemptions through periods of market stress demonstrates that current regulation and market practices have worked well to mitigate risks related to liquidity and redemptions in open-end funds.[26]

Liquidity risk management does not operate in a vacuum. Investors will choose to invest with asset managers that have implemented liquidity risk management policies and practices that will safeguard their assets as well as their right to redeem, especially during times of market stress. Investors' heightened and well-informed focus on liquidity is evidenced by the increase in investor queries to asset management firms regarding firms' liquidity risk management practices and processes in light of market events across U.S. and non-U.S. jurisdictions, including, for example, the 2008 financial crisis and, most recently, Brexit. Liquidity risk management is a response to market demand as well as a regulatory obligation.

In the U.S., asset managers employ liquidity risk management programs tailored to their funds' individual characteristics, investment objectives, policies, strategies, holdings, potential obligations, historical flows, and investor base. These programs are structured to allow a fund to meet shareholder redemptions within seven days and, as discussed in detail below, encompass a variety of liquidity risk management tools, including maintaining cash and cash equivalents and investing in liquid securities. Non-U.S. jurisdictions and their national regulators also have established liquidity management frameworks that encompass a breadth of liquidity management tools. While the regulatory definitions of "liquidity" and "liquid instruments" differ across jurisdictions, U.S. and non-U.S. capital markets share certain overarching liquidity principles, including the right of investors to redeem at the frequency set forth in a fund's governing documents and the requirement to establish and implement appropriate risk management and internal quality controls to properly identify, assess, monitor, and control material risks.[27] For example, the European Union imposes significant regulatory requirements on alternative investment funds ("**AIFs**") and Undertakings for Collective Investment in Transferable Securities ("**UCITS**"), such as an independent risk management function, liquidity risk management requirements, monitoring the ongoing liquidity profile of assets within a fund, stress testing at the individual fund level, and various related disclosures to regulators and investors.[28] The Hong Kong Securities and Futures Commission ("**SFC**") recently issued a

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[26] *See* Nellie Liang, Director, Program Direction Section, Office of Financial Stability Policy and Research, Board of Governors of the Federal Reserve System, *Asset Management, Financial Stability and Economic Growth* (Transcript), The Brookings Institution Conference (Jan. 9, 2015), *available at* https://www.brookings.edu/events/asset-management-financial-stability-and-economic-growth/, at 48, stating, "[M]utual funds in their current form have been around for a long time – 75 years now. And they've weathered all kinds of adverse market conditions without noticeably contributing to systemic risk. Indeed, they have provided a diversity of sources of funds for borrowers and may have had stabilizing influences on aggregate credit."

[27] *See* Board of the IOSCO, *Liquidity Management Tools in Collective Investment Schemes: Results from an IOSCO Committee 5 Survey to Members: Final Report* (Dec. 2015) ("**IOSCO Report**"), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD517.pdf, at iii.

[28] International Capital Market Association ("**ICMA**") and European Fund and Asset Management Association ("**EFAMA**"), *Managing Fund Liquidity Risk in Europe* (Apr. 2016) ("**ICMA/EFAMA Report**"), *available at* https://www.efama.org/Publications/EFAMA_AMIC_Report_Managing_Fund_Liquidity_Risk_Europe.pdf, at 1. The report explains that "the UCITS Directive is a unique investment product legislation – justified by the retail

circular to provide guidance to management companies of SFC-authorized funds on liquidity risk management.[29] The SFC developed its guidelines following its examination of funds' liquidity risk management practices and international regulatory principles and good practices. Existing liquidity risk management programs for open-end funds across jurisdictions have demonstrated the ability to weather global stress events, including the 2008 financial crisis. As investment products and technological support systems become more sophisticated, asset managers and their regulators are best positioned to consider new liquidity challenges and, if necessary, respond by developing practices, tools, and processes tailored to and consistent with the structure of their markets.[30] We reiterate our belief that national securities regulators should lead, and IOSCO should coordinate, the inquiry into new challenges.

In summary, liquidity risk management is absolutely fundamental to the day-to-day operation of open-end funds. It is inherent in their design – not a new idea to be imported and fabricated from scratch (as it has been for banks pursuant to the latest round of Basel reforms).[31] *The investment management industry understands the business imperative of seeking to meet investor demands under reasonably foreseeable market conditions. The ability of investors to redeem shares freely and promptly is central to the very concept of mutual funds.*

With these general comments in mind regarding liquidity risk management, we now turn to the FSB's specific recommendations.

A. FSB Recommendations Relating to Regulatory Information and Investor Disclosures

<u>Recommendation 1</u>: *Authorities should collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability*

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nature of the UCITS pan-European passporting. It is characterized by the offer to investors of on-demand liquidity and built around a significant and prescriptive regulatory framework." ICMA/EFAMA Report, at 10. The UCITS regime prescribes the types of instruments that a fund may hold, including liquidity considerations. Furthermore, the Alternative Investment Fund Managers Directive ("**AIFMD**"), which took effect on July 22, 2013, provides specifically for "a robust liquidity management framework" requiring funds to employ "an appropriate liquidity management system, including procedures to monitor the liquidity risk of the [alternative investment fund] and to ensure that the liquidity profile of the investments of the [alternative investment fund] complies with its underlying obligations." ICMA/EFAMA Report, at 6.

[29] Hong Kong SFC, *Circular to Management Companies of SFC-Authorized Funds on Liquidity Risk Management* (July 4, 2016), *available at* http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC29.

[30] The Australian asset management industry, in anticipation of the FSB's proposals on the structural "vulnerabilities" of asset management activities, stated that there are a number of features of the Australian regulatory regime that should serve to limit global systemic risk and resolved to continue to engage internationally and domestically to better understand and, if appropriate, address any "risks" posed by the industry. *See* Fiona Price and Carl Schwartz, *Reserve Bank Bulletin: Recent Developments in Asset management* (Jun. 2015) ("**Reserve Bank Bulletin**"), *available at* http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-8.pdf, at 76-77.

[31] *See* Basel Committee on Banking Supervision, *Basel III: Liquidity Coverage Ratio and liquidity risk monitoring tools* (Jan. 2013), *available at* http://www.bis.org/publ/bcbs238.pdf; Basel Committee on Banking Supervision, Consultative Document, Basel III: The Net Stable Funding Ratio (Jan. 2014), *available at* http://www.bis.org/publ/bcbs271.pdf. In contrast to mutual funds, liquidity risk management is not inherent in the design structure of banks, hence its addition through the Basel III framework following the 2008 financial crisis.

perspective. They should review existing reporting requirements and enhance them as appropriate to ensure that they are adequate, and that required reporting is sufficiently granular and frequent.

<u>Recommendation 2</u>*: Authorities should review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by open-ended funds to investors regarding fund liquidity profiles, proportionate to the liquidity risks funds may pose from a financial stability perspective. Authorities should enhance existing investor disclosure requirements as appropriate to ensure that the required disclosures are of sufficient quality and frequency. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.*

We agree with the proposition that asset management firms and their funds should provide appropriate information to regulatory authorities and clear and effective disclosures to investors. In fact, current regulations and practices already call for extensive disclosures.[32] For example, in Europe, the UCITS Directive and the AIFMD require extensive disclosures to regulators and investors. In the U.S., all-SEC registered asset management firms must provide information required by Form ADV, Parts 1 and 2A, which are available via the SEC's public disclosure website.[33] Every mutual fund must provide a written prospectus, including information about fees and fund expenses, as well as regular shareholder reports detailing portfolio holdings information. Private funds must submit detailed and substantial reports to the SEC, as required by Form PF. We would be pleased to assist the FSB and other regulators with a review of these existing information and disclosure requirements.[34]

In addition, last year, the SEC commenced two rulemakings to enhance reporting requirements for asset management firms and mutual funds. The first rulemaking, which has since been finalized, requires additional information to be disclosed on Form ADV, as well as new recordkeeping requirements, for all SEC-registered asset management firms.[35] Under the new rulemaking, Form ADV disclosures will include information about separately managed accounts, derivatives exposure and borrowings, social media, and custodians.[36] The second rulemaking would enhance data reporting for mutual funds and ETFs, including requiring a new monthly portfolio holdings reporting form (Form N-PORT) and a new annual reporting form for census-type information (Form N-CEN).[37] These regulatory changes will augment current

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[32] *See* ICMA/EFAMA Report, *supra* note 28, at 1.

[33] *See* www.adviserinfo.sec.gov.

[34] *See* Letter from AMG to SEC (Aug. 11, 2015), *available at* https://www.sec.gov/comments/s7-09-15/s70915-31.pdf.

[35] *Form ADV and Investment Advisers Act Rules,* Rel. No. IA-4509; File No. S7-09-15 (Aug. 26, 2016) (the "**2016 Disclosure Rules Update**").

[36] *Id*.

[37] *Investment Company Reporting Modernization*, Rel. No. 31610 (May 20, 2015), 80 Fed. Reg. 33590 (June 12, 2015) ("**Reporting Modernization Proposal**"). *See* discussion regarding the timing of the Reporting Modernization Proposal relative to the Liquidity Proposal in note 60, *infra*.

reporting and disclosure rules and provide substantial additional data to U.S. regulators and investors.

We believe the repository of information already available regarding asset management firms and their funds provides a wealth of information to regulators and investors. The FSB's recommendations to initiate yet another review of disclosure and reporting requirements and to collect even more data is not only repetitive of regulatory efforts in this area, but also counterproductive from an efficiency and operational cost perspective. For example, the AIFMD includes a robust reporting and disclosure regime.

Separately, the SEC also has proposed regulations designed to promote effective liquidity risk management and to enhance disclosures regarding fund liquidity and redemption practices.[38] The SEC's Liquidity Proposal would (i) require open-end funds to establish a liquidity risk management program tailored to a fund's specific profile and accompanying risks, (ii) permit (but not require) funds to use "swing pricing" as a liquidity risk management tool, and (iii) enhance disclosures regarding a fund's holdings and liquidity risk management practices.[39] It also highlights that open-end funds are not currently expressly required to disclose how they manage liquidity risk.[40] Therefore, in an effort to improve the ability of investors, regulators, and other market participants to better understand open-end funds' redemption practices and their management of liquidity risk, the SEC has proposed various enhancements to open-end fund disclosure documents, specifically amendments to Form N-1A, Regulation S-X, proposed Form N-PORT, and proposed Form N-CEN.[41] According to the SEC, these additional disclosure and reporting obligations are intended to increase the amount and quality of information available to investors and regulators regarding open-end funds' redemption practices, their management of liquidity risks, and how liquidity risk management can affect redemptions.[42]

We believe that an overview of the SEC's proposal is helpful to understanding the current disclosure landscape and considering whether collecting additional information is necessary. Accordingly, we summarize the primary aspects of the SEC's proposal below, along with our comments.

First, the SEC proposed various amendments to Form N-1A, the registration form for U.S. open-end management investment companies that details information about a fund's fundamental characteristics, investment risks, holdings, and other related information.[43] The proposed amendments to Form N-1A would require a fund to (i) disclose the number of days within which the fund will pay redemption proceeds to shareholders, (ii) disclose the methods that the fund uses to satisfy redemption requests (*e.g*., cash equivalents maintained by the fund, proceeds of the sale of portfolio holdings, or borrowings by the fund) and whether such methods

[38] Liquidity Proposal, *supra* note 21.

[39] *Id*.

[40] *Id*., at 62344.

[41] *Id*.

[42] *Id*.

[43] SEC, Form N-1A, *available at* https://www.sec.gov/about/forms/formn-1a.pdf.

are used on a regular basis or only during times of market stress, and (iii) file with the SEC any credit agreements to which the fund is a party.[44] In addition, if a fund adopts swing pricing as a liquidity tool, it would be required to explain the circumstances under which swing pricing would be employed, the effects of swing pricing on the fund,[45] and the effects of swing pricing in its performance disclosure and financial highlights information.[46]

Second, the SEC proposed amendments to Regulation S-X, which sets forth the form and content requirements for open-end fund financial statements.[47] The proposed amendments would require a fund that has adopted swing pricing to show the impact of swing pricing on the fund's net asset value ("**NAV**") in its financial statements.[48,49]

Third, the SEC proposal includes amendments to proposed Form N-PORT, which would require funds to report to the SEC on a monthly basis the liquidity classification of each portfolio holding or portion thereof, as of month end.[50] The Liquidity Proposal would require a fund to classify each of its assets into one of six categories, each one corresponding to the amount of time that is expected to be needed to convert the asset to cash "at a price that does not materially affect the value of that asset immediately prior to sale."[51] These asset-by-asset classifications would be made available to the public on proposed Form N-PORT for the last day of each quarter, on a 60-day delayed basis.

We strongly object to the public disclosure of liquidity classification information and have recommended to the SEC that all filings on Form N-PORT should be made on a non-public basis.[52] It is our view that proposals that recommend public disclosure of detailed liquidity information may be harmful to funds and to the liquidity of their portfolio assets, especially during times of market stress. Investors may use such liquidity disclosures to look only to the most conservative holders of securities and disregard the positive views of other holders. Funds also may be tempted to copy peer funds' classifications. In the event that a fund does experience a liquidity event, public disclosure of its classifications may expose the fund to predatory trading that results in front-running of the fund's portfolio securities. In addition, the information

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[44] Liquidity Proposal, *supra* note 21, at 62370.

[45] Liquidity Proposal, *supra* note 21, at 62343. *See also* discussion regarding swing pricing as an optional liquidity risk management tool under the section entitled, "FSB Recommendations Relating to Redemptions and Risk Management Tools," *infra*.

[46] *Id*.

[47] 17 CFR 210.6.

[48] Liquidity Proposal, *supra* note 21, at 62343.

[49] We had a number of recommendations with respect to proposed amendments to Regulation S-X as set forth in the Reporting Modernization Proposal and relating to standardized enhanced derivatives disclosures in fund financial statements. *See* Letter from AMG to SEC (Jan. 13, 2016) ("**January 2016 AMG Letter to SEC**"), *available at* http://www.sifma.org/issues/item.aspx?id=8589958342, at 47.

[50] Liquidity Proposal, *supra* note 21, at 62379.

[51] *Id*., at 52292. The six categories are as follows: (a) 1 business day, (b) 2-3 business days, (c) 4-7 calendar days, (d) 8-15 calendar days, (e) 16-30 calendar days, and (f) more than 30 calendar days.

[52] *See* January 2016 AMG Letter to SEC, *supra* note 49, at 35.

disclosed on Form N-PORT would be as of a single past point in time and therefore stale. In sum, investors relying on this disclosure information would be using outdated, unreliable, and potentially misleading information. Any explanatory disclosure advising shareholders as to the limitations of the information on liquidity classifications may only serve to give investors a false sense of security and precision, perpetuating the dissemination of misleading information to investors.

We also have stressed that the liquidity classification system proposed by the SEC is inherently subjective,[53] a point that may not be immediately obvious to retail investors, and one that may be construed as a precise measure of risk, which, in turn, may be exploited in the courts. Liquidity is intrinsically dynamic and fluid. Public disclosure of position-level liquidity classification information would not reflect up-to-date liquidity of a fund's portfolio and may exacerbate liquidity risk.[54]

While we strongly object to the public disclosure of liquidity classification information, we generally would not object to the reporting of similar information to industry regulators for the purpose of increasing standardization, objectivity, and comparability of liquidity risk across fund groups. For example, we have proposed an alternative classification system that, in our view, would better serve the goal of adopting a uniform liquidity classification approach.[55] Our alternative classification system – "asset-type mapping with exceptions"– would require five categories of asset classification, each one defined by the liquidity characteristics of instruments in each relevant category.[56] The definitions used to describe each category would reflect a common set of variables used in determining liquidity categorization, including: market conditions (normal versus stressed), market structure (size, breadth, and depth of the market), and transaction costs (bid-ask spreads).[57] Positions that possess liquidity characteristics that the fund believes may be distinguished from those that are typical for the asset type at issue would be addressed on an exception basis and recategorized accordingly (as either more or less liquid).

We believe our alternative approach would create an objective baseline of the general liquidity classification of each asset type and provide asset managers with the flexibility to make necessary adjustments to those classifications. Reporting this information to a regulator, as opposed to disclosing the information to the general public, would allow the regulator to digest comprehensive information and better understand liquidity risk without exposing a fund to unintended consequences.

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[53] *See* discussion under the section titled "FSB Recommendations Relating to Redemptions and Risk Management Tools."

[54] *See* January 2016 AMG Letter to SEC, *supra* note 49, at 37-38.

[55] We discuss this alternative classification system in more detail in our response to the Liquidity Proposal. *See* January 2016 AMG Letter to SEC, *supra* note 49, at 4-7; Letter from AMG to SEC (Apr. 12, 2016) ("**April 2016 Letter to SEC**"), *available at* http://www.sifma.org/issues/item.aspx?id=8589959806, at 3.

[56] *Id*. We emphasize that we do not support the liquidity classification system proposed by the SEC, and, therefore, we do not support reporting of those classifications on Form N-PORT.

[57] *See* April 2016 Letter to SEC, *supra* note 55, at 3.

The SEC's proposal also includes amendments which would require disclosure of certain information regarding a fund's liquidity risk management practices.[58] A fund would be required to disclose, for example, if it has available a committed line of credit, whether it engaged in interfund lending or interfund borrowing, and whether it engaged in swing pricing.[59] We generally agree that this type of information can serve to further inform investors' understanding of their funds' exposure to liquidity risk.[60]

We strongly urge the FSB to assess the historical track record of the asset management industry in maintaining liquid assets necessary to meet investors' redemption requests. The record demonstrates that the asset management industry has not encountered harmonized redemption behaviors that can be associated with "herding" or forced sales.[61] Available evidence suggests that open-end fund investors do not act with a herd mentality[62] and they do not tend to redeem en masse. This is explained, in part, by the fact that open-end funds are the primary investment savings vehicles for retirement income, with a majority of open-end fund assets invested in long-term funds as of year-end 2015.[63] Thus, we oppose the collection of additional liquidity profile information where current regulations, market practices, and the very nature of open-end funds support a finding that they do not pose a systemic threat to financial stability.[64]

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[58] *See* Liquidity Proposal, *supra* note 21, at 62347.

[59] Liquidity Proposal, *supra* note 21, at 62347.

[60] The amendments to proposed Form N-CEN discussed in this paragraph relate only to those amendments advanced by the SEC in its Liquidity Proposal. We note that the SEC's Reporting Modernization Proposal introduces proposed Form N-CEN to replace current Form N-SAR. Proposed Form N-CEN would require the reporting of census-type information including information on whether a fund is part of a larger "family of funds," classification of a fund as open or closed, information on fund directors, information on matters submitted for a vote of security holders, and other background information about the fund. The comment period for the Reporting Modernization Proposal was re-opened to address overlapping information in the Liquidity Proposal. We note that, prior to SEC's re-opening of the comment period, the Reporting Modernization Proposal had already received over 400 industry comments. This is indicative of both the interconnectedness and complexity of the SEC's current initiatives and serves as a prime example as to why additional recommendations advanced by the FSB in this area could contribute to industry confusion. *See* Reporting Modernization Proposal, *supra* note 37, at 179-191.

[61] *See Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, Strategic Insight (Nov. 13, 2013) ("**Mutual Funds and Systemic Risk**"), at 5. In October 2008, a period of significant market volatility, stock fund portfolio managers sold on a net basis an amount equal to only 0.4% of all assets held in such funds.

[62] *Id*.

[63] *See* 2016 ICI Fact Book, *supra* note 22, at 8.

[64] In the Consultative Document, the FSB notes that a number of contingencies would need to occur for the liquidity transformation in open-end funds to have an "amplifying" effect on risks to financial stability. "There would need to be significant redemptions from funds (and greater redemptions than would be the case if investors had invested directly in the markets) accompanied with significant asset sales by those funds (particularly sales of less liquid assets). Finally, those asset sales would need to be significant enough, either relative to total assets or normal trading volume in particular market segments, to lead to material price declines or increases in price volatility in the secondary markets that would be serious enough to impair market access by borrowers. Furthermore, when myriad market participants sell assets, the amplification can become more acute when it also prompts leveraged investors (*e.g.* hedge funds, banks, broker-dealers) to unwind risk positions in markets. If this occurred, it could affect other

We urge the FSB to consider whether the benefits of its recommendations will offset the costs to investors. Inevitably, some degree of risk is necessary to encourage innovation, investment, and capital formation, and any additional requirements relating to the collection of liquidity profile information may lead to unintended consequences, such as higher fees and fewer choices for investors.[65] *Given the breadth of existing reporting and disclosure requirements, we believe the FSB's recommendations to collect, review, and enhance outstanding reporting and disclosure regulations are unnecessary and unsupported by historical data. Instead, the FSB should seek to harmonize data requirements across jurisdictions, especially where overlapping regulations create inefficiencies in the reporting and disclosure of liquidity profile information.*

B. FSB Recommendations Relating to Redemptions and Risk Management Tools

Recommendation 3: In order to reduce the likelihood of material liquidity mismatches arising from an open-ended fund's structure, authorities should have requirements or guidance stating that funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and investor behaviour during normal and stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Recommendation 4: Where appropriate, authorities should widen the availability of liquidity risk management tools to open-ended funds, and reduce barriers to the use of those tools to increase the likelihood that redemptions are met even under stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

Recommendation 5: Authorities should make liquidity risk management tools available to open-ended funds to reduce first-mover advantage, where it may exist. Such tools may include swing pricing, redemption fees and other anti-dilution methods. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

As an initial matter, with respect to the so-called "first-mover advantage," we believe it is important to debunk the concept as constituting a mere academic theory without evidentiary support, especially in view of the fact that this theory operates as an underpinning factor motivating these recommendations. The FSOC has suggested that a first-mover advantage

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financial institutions and the ability of corporations and sovereigns to raise money in the capital markets and subsequently could spill over to the real economy." Consultative Document, at 11. The fact that the FSB acknowledges the long sequence of events that would need to occur in order for open-end fund activity to create a hypothetical that would result in a negative and "amplifying" effect on markets suggests to us that the FSB would agree that, as a general matter, open-end funds do not pose a threat to financial stability.

[65] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Remarks at The New York Times DealBook Opportunities for Tomorrow Conference Held at the One World Trade Center, New York, N.Y. (Dec. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722, stating, "Our objective, however, is not to eliminate all risk. Far from it. Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors. Just as our regulatory program evolves, so too must our understanding of the balance that program strikes between reducing undue risks and preserving the principle of "reward for risk" that is at the center of our capital markets."

"may" be attributed to the mutualization of trading costs or the "waterfall theory," the sale by funds of their most liquid assets first in order to meet redemption requests.[66] While the costs of redeeming fund shares are mutualized, or borne *pro rata*, among all shareholders, empirical evidence suggests that mutualization of trading costs does not result in systematic incentives for investors to redeem shares ahead of others during periods of market stress.[67] To suggest otherwise ignores the fundamental characteristics of mutual funds, which are aimed at curbing incentives for short-term redemptions and protecting against shareholder dilution. Moreover, the waterfall theory does not accurately reflect how asset managers actually manage liquidity. Asset managers do not automatically sell a fund's most liquid assets first in order to meet redemptions.[68] There are other concerns, including an asset manager's duties to the fund to meet its investment objective and maintain exposures to certain asset classes, that also weigh on the decision to buy or sell any portfolio holding at any given time. The theory of first-mover advantage may read well on paper, but it does not translate in practice and there is no evidence to support its claims of importing systemic risk.[69]

We also strongly emphasize that open-end funds' portfolio composition and investment strategies are specifically designed to be compatible with anticipated redemptions. Liquidity risk management is embedded in a fund's structure, calibrated to its redemption terms from the moment of inception, and adjusted as necessary on an ongoing basis throughout its lifespan. Ensuring consistency between a fund's investment strategies and its redemption terms and conditions, however, is not tantamount to a requirement for redemption frequency to align exactly with liquidity in all fund holdings. In other words, it would not be feasible for a daily liquidity fund to be held to a standard whereby it should maintain a portfolio of securities that could be sold, in its entirety, on a daily basis at current market value. To the extent that the FSB is suggesting that redemption frequency translate into liquidity of a fund's entire portfolio, we request additional clarification as to the basis for such recommendation, how such a standard may be attained, if at all, and additional consideration as to whether this would in fact result in any benefit to global financial stability or operate as a detractor from investors' long-term retirement goals.

U.S. open-end funds already have a wide range of liquidity risk management tools and practices at their disposal, some of which are in response to regulatory requirements that serve as checks on illiquidity, and, as discussed above, additional liquidity risk management policies are being considered in the U.S. by the SEC.[70] For example, open-end funds offer investors the

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[66] *See* ICI Letter to FSOC (Mar. 25, 2015) ("**March 2015 ICI Letter to FSOC**"), *available at* https://www.ici.org/pdf/15_ici_fsoc_ltr.pdf, at 18-23, at 7.

[67] *Id*., at 42 (finding that "consistent patterns of investor behavior provide evidence that asset management practices and mutualization of trading costs are not causing destabilizing fund outflows by incentivizing large numbers of investors to leave funds, nor are they deterring investors from buying fund shares during periods of market stress").

[68] *Id*., at 25-34. *See also* Sean Collins and Chris Plantier, *The "Waterfall Theory" of Liquidity Management Doesn't Hold Water*, ICI Viewpoints (Mar. 9, 2016), *available at* https://www.ici.org/viewpoints/view_16_nyfed_bond_flows_03.

[69] *See* March 2015 ICI Letter to FSOC, *supra* note 66, at 42.

[70] *See* discussion regarding the SEC's Liquidity Proposal under the section titled, "FSB Recommendations Relating to Regulatory Information and Investor Disclosures," *supra*.

ability to purchase and redeem shares at NAV on a daily basis, such that funds have a general responsibility to both maintain a level of liquidity that is appropriate under the circumstances and engage in ongoing portfolio liquidity monitoring.[71] The very purpose of the requirement that limits a fund's holdings in illiquid securities to not more than 15 percent of a fund's assets is to ensure that funds have adequate investments to meet daily redemption requests.[72] This 15-percent requirement is intended to guide asset managers in the process of assessing liquidity needs and tailoring those needs to the investment strategies and characteristics of individual funds. In addition to the limit on illiquid holdings,[73] the following policies, strategies, and tools guide or may be employed by asset managers to meet shareholder redemption requests and generally manage liquidity risk:

- Mutual fund boards of directors have a duty to monitor funds' liquidity and pricing practices.

- In very limited circumstances, a fund has the ability to suspend the right of redemption or postpone the date of redemption payments more than seven days after the tender of mutual fund shares.[74]

- Asset managers structure and manage open-end fund portfolios with the objective of ensuring that the fund will have sufficient assets to satisfy redemption requests. Liquidity considerations are managed at fund inception and on an ongoing basis. For example, to enable the sale of securities when needed, asset managers may have investment guidelines with minimum liquidity thresholds (including guidelines for loan funds requiring a minimum amount of assets that have contractual settlement periods) or a maximum amount of below-investment grade bonds.[75] Asset managers also may use qualitative driven liquidity "scores," which are informed by the experience of market practitioners as well as the security type, maturity, sector, credit quality, embedded optionality, and other attributes that influence investor demand.[76]

- Asset managers may conduct performance tests and/or scenario analyses – taking into account various factors including, for example, fund cash flows, investment strategy, portfolio liquidity, use of borrowings and derivatives, cash and cash equivalents on

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[71] *See* Guidelines Release, *supra* note 21, at Section I.

[72] *See* Revisions of Guidelines, *supra* note 21.

[73] We note that Liquidity Proposal would codify guidance with respect to illiquid assets, such that a fund would not be able to acquire additional illiquid assets (*i.e.*, assets that cannot be sold within seven days at approximately the value ascribed by the fund) if, immediately after the acquisition, the fund would have invested more than 15 percent of its assets in such illiquid assets. These assets would be labeled "15% standard assets." *See* Liquidity Proposal, *supra* note 21, at 62317.

[74] Section 22(e) of the Investment Company Act. *See* discussion on T+3 settlement timeline, *supra* note 20.

[75] *See* March 2015 AMG IAA Letter to FSOC, s*upra* note 6, at Appendix A-1.

[76] *Id*.

hand, and borrowing arrangements – to assess the impact of market and global macro conditions on a fund.[77]

- Liquidity management practices may include maintaining cash or cash equivalents and investing in liquid securities.

- Lines of credit (both committed and uncommitted),other credit facilities, such as interfund lending facilities, and reverse repurchase agreements can be used to provide funds with emergency access to liquidity sources in order to meet large or unexpected redemptions.

- Derivatives can be used by asset managers to mitigate risk.

- To address redemptions, asset managers may use redemptions in-kind, staggered cash outflows, and voluntary advance notification procedures.[78] Asset managers also may choose to close the fund to new investors (if the portfolio manager believes that additional investments cannot be invested in sufficiently liquid assets).

- Frequent trading policies generally discourage frequent purchases, redemptions, and exchanges in fund shares, which have the potential to interfere with the management of a fund's portfolio, increase costs, and potentially result in dilution of shareholder interests.

- Non-U.S. jurisdictions also allow for a wide range of liquidity risk management tools, including, redemption fees and gates, redemptions in-kind, side pockets and suspensions of redemptions.[79]

We note that open-end funds have followed existing policy measures and implemented their choice of currently available liquidity tools to accommodate investor redemptions successfully, even during times of market volatility. Historical analysis of fund flows indicates that over the past three decades, during every financial crisis, net withdrawals by open-end fund investors were consistently limited in magnitude.[80] Empirical evidence demonstrates that

[77] *See e.g*., Liquidity Proposal, *supra* note 21, at 62304, fn. 257 (citing that asset managers continually review a broad series of metrics to evaluate the current adequacy of a fund's liquidity position, including historic data regarding redemption request levels, stressing the historic redemption levels, assessing levels of liquidity of categories of assets held by the fund based on industry standards, assessing current and expected market conditions of the types of asset held by the fund, and then assessing liquidity in those various market conditions).

[78] The SEC has found, based on staff outreach, that advance notification procedures – where a fund has implemented policies to encourage certain shareholders (*e.g*., large shareholders or institutional shareholders) to provide advance notification of their intent to redeem a significant number of shares of the fund – are relatively common. *Id*., at 62307.

[79] *See* IOSCO Report, *supra* note 27, at iii.

[80] *See* Mutual Funds and Systemic Risk, *supra* note 61, at 1. "Net outflows averaged under 2% of assets monthly, and atypical high redemptions were very short in duration. During October 2008, stock fund portfolio managers sold on a net basis an amount equal to only 0.4% of all assets held in such funds." *See also* March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 15.

investors continue purchasing into the mutual fund market during periods of market stress.[81] In addition, funds also purchase and redeem during normal and stressed markets and do so for a variety of reasons, including portfolio rebalancing, accommodation of fund flows or in response to the investment decisions of asset managers.[82] The buy and sell activities of investors and open-end funds add liquidity into the markets, fueling financial stability. In short, the FSB's call for additional liquidity tools is unwarranted because open-end funds' clear record of redemption and liquidity capacities demonstrates the effective use of available liquidity tools.

The Consultative Document makes reference to the use of particular tools, suggesting that regulators should consider making such tools, including liquidity constraints, redemption fees, redemption gates, and swing pricing, widely available in order "to increase the likelihood that redemptions can be met under stressed conditions" and "to remove first-mover advantage, where it may exist."[83] As outlined above, there is a wide range of tools already available to asset managers. In addition, liquidity risk management programs are yet another tool for open-end funds to manage liquidity mismatches, reduce any perceived or potential risk that open-end funds may not be able to meet redemption obligations, and mitigate dilution of shareholder interests. We also believe that private market participants are well-positioned to conceive of and assess the most effective liquidity risk management tools for their specific funds in the absence of prescriptive rules and regulations.

Specifically, with respect to swing pricing, we note that the SEC's Liquidity Proposal would permit, but not require, the use of swing pricing as a liquidity risk management tool in the U.S. We generally support the concept, availability, and use of swing pricing as an optional tool, but believe universal adoption of swing pricing without further inquiry into how swing pricing may be implemented in certain jurisdictions would be inappropriate.[84] For example, we are concerned that operational processes in the U.S. vary substantially from those in Europe, such that the use of swing pricing as a liquidity risk management tool would face various implementation hurdles in U.S. markets. In Europe, where swing pricing has been used effectively, [85] the timing of NAV calculation relative to order cut-off is such that distribution channels provide the majority of fund flow information to funds before a fund's NAV is struck

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[81] *See* March 2015 ICI Letter to FSOC, *supra* note 66, at 18-23.

[82] *Id*.

[83] Consultative Document, at 17-18.

[84] BlackRock conducted a study of its retail UCITS funds that use partial swing pricing and found that fund performance would have been impaired, in some cases considerably, without use of swing pricing. *See* BlackRock, Swing Pricing: *The Dilution Effects of Trading Activity* (Dec. 2011) ("**BlackRock Swing Pricing Paper**"), *available at* http://www2.blackrock.com/content/groups/internationalsite/documents/literature/1111157589.pdf , at Appendix B.

[85] A survey conducted by the Association of the Luxembourg Fund Industry confirms a strong directional trend towards the adoption of swing pricing as an anti-dilution tool in Luxembourg, a hub for the organization of UCITS funds in Europe. *See* Association of the Luxembourg Fund Industry ("**ALFI**"), *Swing Pricing: Survey, Reports & Guidelines* (Feb. 2011), *available at* http://www.alfi.lu/sites/alfi.lu/files/ALFI_Swing_Pricing.pdf, at 13. *See also* BlackRock Swing Pricing Paper, *supra* note 84. The results of the ALFI survey indicated that the majority of respondents were already using swing pricing and the number of asset managers using swing pricing had tripled over the previous five years.

and published for industry-wide dissemination. This gives European funds the benefit of using up-to-date fund flow information in assessing net purchases and net redemptions and determining whether or not the level of the fund's net purchases or net redemptions exceed a specified percentage of the fund's NAV (the "**swing threshold**"). In contrast, U.S. open-end funds are required to strike NAV at a time before fund flow information from most distribution channels is received by the fund.[86] U.S. asset managers need fund flow information to determine whether adjustments to a fund's NAV are necessary.[87] In other words, U.S.-based asset managers would not have complete and accurate fund flow information to make a "reasonable" determination as to whether or not to employ swing pricing. Thus, we believe the recommendations regarding swing pricing are premature and require additional evaluation prior to implementation across all jurisdictions.

With respect to the implementation of redemption fees and gates as liquidity risk management tools, we also have serious concerns about promoting their increased use in U.S. markets. Most recently, the SEC considered proposing liquidity requirements for open-end funds similar to those imposed on money market funds, which include redemption fees[88] and gates.[89] In floating this idea, the SEC found that U.S. open-end funds are generally moving away from the use of redemption fees to manage short-term trading risk.[90] Implementation of redemption fees (or purchase fees) requires coordination with a fund's service providers, which adds an element of operational complexity and therefore increases operational costs.[91] With respect to redemption gates, the SEC determined that open-end funds have not "demonstrated the same risk of significant redemptions during times of market stress that money market funds may face, and which redemption gates are meant to prevent in money market funds."[92] More importantly, the SEC concludes that "while there is some evidence of a first-mover advantage among money market funds during the financial crisis, there is currently no matching evidence of first-mover advantage among funds that are not money market funds."[93] On this point, the

[86] 17 CFR 270.22c-1.

[87] We note that the Liquidity Proposal will permit only partial swing pricing, *i.e.*, adjustment of NAV only when the swing threshold has been exceeded. This is in contrast with full swing pricing, *i.e.*, adjustment of NAV any time the fund experiences net purchases or net redemptions. *See* Liquidity Proposal, *supra* note 21, at 62330.

[88] Mutual funds are currently permitted by Rule 22c-2 under the Investment Company Act to impose redemption fees under certain circumstances.

[89] We suggested that the SEC explore structuring a proposed redemption gate, accompanied by a redemption fee, in connection with money market reform proposals in the U.S. The gate, when triggered, would prohibit shareholders from redeeming their shares and provide a period of time for a fund to restore its liquidity, thereby serving as a backstop to runs on money market funds. *See* AMG Letter to FSOC (Jan. 14, 2013), *available at* http://www.sifma.org/issues/item.aspx?id=8589941464, at 14.

[90] Liquidity Proposal, *supra* note 21, at 62364.

[91] *Id*., at 62333, fn 467, and 62363-62364.

[92] *Id*., at 62364.

[93] *Id*. *See also* Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014), 79 Fed. Reg. 47736 (Aug. 14, 2014) ("**Money Market Fund Reform Release**"). We also have made the point that there is considerable evidence that investors do not redeem en masse from variable NAV investment funds. *See, e.g*., Sean Collins, *Why Long-Term Fund Flows Aren't a Systemic Risk: Multi-Sector Review Shows the Same Result*, ICI Viewpoints (Mar. 4, 2015), *available at*

SEC considered that swing pricing may help deter redemptions if they were motivated by first-mover advantage, explaining that if "remaining shareholders understood that redeeming shareholders would bear the estimated costs of their redemption activity, it would reduce their incentive to redeem quickly because there would be less risk that they would bear the costs of other shareholders' redemption activity."[94] Taking all of this into account, the SEC opted against recommending the use of redemption fees and redemption gates and, instead, chose to propose swing pricing as a tool to address the potential dilution of shareholder interests.

In summary, we strongly believe the record clearly demonstrates that the open-end fund industry is well-equipped, through regulatory requirements, market practice, and a variety of liquidity risk management tools, to satisfy shareholder redemption requests in normal and stressed markets. Open-end funds offer unique characteristics that make them less susceptible to first-mover advantage, contagion, and runs on the market.[95] *The FSB's recommendations for additional regulatory changes in this area are not commensurate with the risks posed by these funds. We urge the FSB to refrain from pursuing these recommendations given the lack of empirical data supporting such measures. At a minimum, we respectfully submit that the FSB should delay any consideration of these recommendations pending further action by the SEC on its Liquidity Proposal.*

C. FSB Recommendation Relating to Stress Testing at the Level of Individual Open-End Funds

Recommendation 6: *Authorities should require and/or provide guidance on stress testing at the level of individual open-ended funds to support liquidity risk management to mitigate financial stability risk. The requirements and/or guidance should address the need for stress testing and how it could be done. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.*

The FSB recommends that securities regulators should require stress testing of individual open-end funds as another way to support liquidity risk management. We question how these tests would be structured and what the objectives of the tests would be. Importantly, the Consultative Document fails to make reference to any research or data signaling that stress testing methodologies would in fact support liquidity risk management practices and thereby mitigate global financial risk. Stress testing is typically used in the context of banks, whose

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http://www.ici.org/viewpoints/view_15_fund_flow_04 (noting that outflows from funds tend to be muted, even during periods of financial market turmoil; and that even during periods of stress when funds in aggregate are seeing outflows, some funds typically are seeing inflows).

[94] Liquidity Proposal, *supra* note 21, at 62329.

[95] Third Avenue's Focused Credit Fund ("**FCF**"), as discussed in note 176, *infra*, faced heavy redemptions against a backdrop of underperformance. On December 16, 2015, the SEC issued a temporary order granting FCF's request to temporarily suspend redemptions until FCF's orderly liquidation. As noted by the FSOC, FCF's actions "came at a time of heightened volatility in the high-yield credit market, and other high-yield mutual funds also saw significant outflows" and yet, the FSOC acknowledged that "no other high-yield funds were forced to suspend redemptions." *See* FSOC, *2016 Annual Report*, *available at* https://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2016-Annual-Report.aspx, at 86. This serves as an example of how the winding down of one mutual fund does not result in contagion to other funds or runs on the market.

balance sheets are assessed to determine whether or not they have sufficient capital to withstand various economic stress scenarios. *We submit that there is a conceptual problem with the very notion of stress testing the capital adequacy of a mutual fund, which operates with little or no leverage and is insensitive to many of the macroeconomic factors that impact a bank's financial health*.

We believe that it is premature to recommend stress testing for mutual funds when the objectives, methods, and costs and benefits are wholly undefined and therefore immeasurable. We believe that the recommendation to stress test open-end funds reflects a central misunderstanding of the critical differences between the risk profiles of a bank and a mutual fund. When a bank fails, depositors lose the value of their deposits that exceed insured amounts and remaining assets and borrowers lose access to a source of capital. This, in turn, causes the amount of money and credit available in the markets to decline, creating the potential for systemic shock and pressuring government safety nets that support banks. Stress testing a bank consists of assessing its total balance sheet risk – its capital relative to its assets and exposures to creditors, borrowers, and counterparties. In contrast, when a mutual fund closes (or fails, which is a rare occurrence) or an asset manager ceases to provide investment advisory services to a fund, an investor's assets may be transitioned to a new fund or a new asset manager without creating a negative ripple effect on the financial markets. A mutual fund investor, not the fund, or the asset manager or the relevant government, knowingly and willingly, bears the market risk of his or her investment.

Attempting to aggregate the impact of investment losses at the manager level is misguided. In essence, an asset manager with a large amount of assets under management operates as a collection of smaller accounts, each with its own characteristics, objectives, and risk profiles. The assets of one account cannot be used to pay redemptions of another account (unlike bank deposits). An asset manager's consolidated balance sheet does not include these managed assets and therefore fails to reflect the fact that each fund is unique in some or all of its key attributes, including investor demographics, regulation, operation, structure, and management. Put differently, credit institutions generally will have the same exposure to a credit event, whereas any given mutual fund's exposure to a particular credit event will depend on the composition of its portfolio, investment strategy, and investor base. As such, it is difficult to understand how a stress test that aggregates exposures of individual funds would be reflective of realistic scenarios. Not surprisingly, it is widely acknowledged by industry groups and SEC staff that there is a false parallel to the process for stress testing a bank.[96]

We also are concerned that prescriptive rules in this area would result in stress tests that use a set of scenarios as inputs that would generate unrealistic results. Results that do not accurately reflect how any given fund would respond to changes in asset liquidity and redemptions during stressed markets would create a false foundation upon which to build stress testing policy. Accordingly, we believe that additional work needs to be done to assess how a

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[96] *See, e.g*., Melanie Waddell, *Big RIAs May Face Stress Tests*, THINKADVISOR (July 5, 2016), *available at* http://www.thinkadvisor.com/2016/07/05/big-rias-may-face-stress-tests?slreturn=1469316329 (noting that the SEC's chief economist, Mark Flannery, was quoted as saying, 'There's a problem that's really got us stuck, which is what does it mean to stress test a mutual fund…The parallel to bank stress tests is really extremely misleading.').

particular stress testing methodology would support liquidity management practices and whether there is a link between those results and practices that would, in turn, have any bearing on global financial stability.

We strongly urge the FSB to withdraw its stress testing recommendation until the requisite basic research is completed in this uncharted area.

D. FSB Recommendation Relating to System-Wide Stress Testing

Recommendation 9: Where relevant, authorities should give consideration to system-wide stress testing that could potentially capture effects of collective selling by funds and other institutional investors on the resilience of financial markets and the financial system more generally.

The FSB also recommends that authorities consider incorporating open-end funds into system-wide stress testing exercises to better understand how financial markets and the global financial system respond to collective selling by investors. As with the recommendation to stress test individual funds, the Consultative Document makes no specific recommendations on approach to system-wide stress tests and does not even consider, as an initial matter, whether this idea is feasible or necessary for these funds. Echoing the above discussion, we reiterate our position that there is a conceptual problem with the very notion of stress testing a mutual fund. Implicating all funds in large-scale tests assumed to predict whether the asset management industry is capable of sustaining economic shock is inconsistent with what we do know: the asset management industry is highly resilient and has successfully weathered adverse market conditions for many decades.

There is no available research or data to substantiate the FSB's call for system-wide stress testing in the mutual fund context. Quite the contrary, available research and data suggest that system-wide stress testing would not yield a comprehensive set of data from which to glean results that speak to the asset management industry's capacity for maintaining (or detracting from) financial stability. To illustrate, it is imperative to understand the sharp distinction between an asset owner and an asset manager. Asset owners, which include pension plans, insurance companies, official institutions, banks, foundations, endowments, family offices, and individual investors, have a choice of managing their assets directly, outsourcing day-to-day management activities to asset managers, or opting for a combination of both.[97] Many large institutional asset owners invest some or a portion of their assets directly, which serves to explain why approximately three quarters of financial assets are managed directly by asset owners, not asset managers.[98] Given this information, it is worthwhile to pause and consider whether inclusion of asset managers and their funds in system-wide stress tests would allow regulators to draw helpful conclusions that inform regulatory actions and liquidity risk management practices. We are of the view that regulators would be using incomplete data, based only on one quarter's worth of total assets in the asset management industry, thereby undermining any inferences drawn from system-wide stress test results.

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[97] *See* BlackRock Asset Owners Paper, *supra* note 14, at 2.

[98] *Id*.

The conceptual problem inherent in the FSB's macro stress testing proposal is further highlighted when considering how such testing would work in practice. For example, with respect to bond funds, there is an underlying concern that a market event could incite redemptions across the bond sector, which might in turn force all bond funds to sell their holdings at once, resulting in fire sales.[99] This hypothesized (and unsubstantiated) chain of events has caused some industry participants to suggest that a stress test across all bond funds may be used to determine the aggregate risks posed by the larger bond market to global financial stability. Available case studies suggest, however, that bond funds do not operate as a homogeneous group, rather, bond funds employ different investment objectives (*e.g*., municipals, high-yield, governments), invest in different types of bonds (*e.g*., short-term, intermediate, long-duration), and cater to the investment goals of a diverse investor body (*e.g*., retail, institutional, retirement).[100] Given the diversity characteristic of bond funds and their investors, it is unlikely that attempts to quantify aggregate risks across open-end bond funds would produce reliable data on how end investors will respond to any given market event. What is more, as of year-end 2015, fixed income assets held by U.S. open-end funds and ETFs represented less than 14% of the $40 trillion of debt owned by various entities included in Federal Reserve data.[101] In short, even if a stress test could be designed to account for the different types of bonds held by different bond funds as well as their diverse investor base, the results would not be representative of the entire bond market.

It is important to consider how the conceptually flawed concept of system-wide stress testing would materialize into increased shareholder costs. In this regard, the asset management industry is keenly aware that mutual funds are the investment vehicle of choice for the retirement savings of millions of investors. As such, policy makers must consider that recommendations for more data, more regulation, and more tests translate into increased costs and thereby affect those who rely on the asset management industry to support their financial futures. A mutual fund is already the subject of extensive regulation and regulatory initiatives such that system-wide stress testing would only result in compound costs to investors and diminished retirement savings without any meaningful added benefit to the health of global markets.

We strongly urge the FSB to withdraw its system-wide stress testing recommendation.

E. FSB Recommendations Relating to the Adequacy of Tools in "Exceptional Circumstances"

<u>Recommendation 7</u>: *Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds' use of extraordinary liquidity risk management tools, and the processes should be made transparent to investors and the relevant authorities. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.*

[99] *See* BlackRock Bond Fund Paper, *supra* note 12, at 11.

[100] *Id*., at 1.

[101] *Id*., at 3.

<u>Recommendation 8</u>: Authorities should provide guidance and, where appropriate and necessary, provide direction regarding open-ended funds' use of extraordinary liquidity risk management tools. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

The FSB recommends that securities regulators promote transparent decision-making processes for open-end funds' use of extraordinary liquidity risk management tools under exceptional circumstances. Without clearly defining what constitutes an "extraordinary tool" for an "exceptional circumstance," the FSB suggests that regulators should consider issuing both guidance and direction as to the types of events that may trigger implementation of such tools. In general, we find no support in the Consultative Document to justify a distinction or enable commenters to understand how the FSB differentiates between "ordinary" liquidity risk management tools and "extraordinary" liquidity risk management tools.

We reiterate that open-end funds have a robust arsenal of liquidity risk management tools at their disposal, which may be used to respond to both ordinary and extraordinary market events (if such a distinction can be even drawn by an asset manager with sufficient time to implement an ordinary versus extraordinary tool). We have previously discussed, for example, liquidity tools and requirements in Europe and the U.S. that provide an extensive arsenal to both regulators and asset managers in managing liquidity risk. The FSB provides that open-end funds may consider suspensions of redemptions, redemption gates, in-kind redemptions, and side pockets as the kinds of tools that may be considered under the "extraordinary" umbrella. But open-end funds already use a variety of liquidity risk tools, such as cash and cash equivalents, credit facilities, and even in-kind redemptions, to address exposure to liquidity risk. Liquidity risk management tools fall on a spectrum, such that asset managers' use of a particular tool is specific to the liquidity event involved. Liquidity risk management is not an afterthought; asset managers structure their fund management programs with these liquidity tools in mind, such that appropriate processes are established before market conditions become stressed. Asset managers continue to develop and introduce additional tools and risk management practices and processes as their operations and investment products expand and become more sophisticated.

As noted by the FSB, use of the tools described above, whether they are characterized as ordinary or extraordinary, should be carefully balanced against potential spill-over effects. We believe that adding an "extraordinary" label to the use of certain tools would give rise to negative speculation of fund performance among investors and result in unintended consequences. Prescriptive rules dictating the circumstances under which certain tools may or may not be employed would stifle the discretion allotted to asset managers to tailor their investment programs for their specific funds and, in turn, introduce a risk of concentration and correlation that does not currently exist (*e.g*., more asset managers relying on the same tools to respond to the same market events). Accordingly, we oppose the confusing and unsupported recommendations relating to "exceptional" circumstances and "extraordinary" tools.

F. Liquidity Recommendations and ETFs

The Consultative Document also requests comment on whether the FSB's liquidity recommendations should be tailored in any way for ETFs. We agree that there are differences

between ETFs and open-end funds that may merit different approaches.[102] In the discussion below, we highlight how the basis for many of the proposed recommendations is generally incompatible with the ETF framework. We also note that current SEC regulatory initiatives attempt to address liquidity issues as they relate to ETFs, and we discuss how the SEC's Liquidity Proposal in particular falls short of addressing the structural differences (and benefits, from a liquidity management point of view) of ETFs. We again urge the FSB to consider pending ETF liquidity risk management regulatory policies in the U.S. before advancing blanket proposals.

As an initial matter, it is important to understand the structural differences between a traditional mutual fund and an ETF. ETFs are pooled investment vehicles whose shares trade like a stock throughout the day. Like a mutual fund, an ETF offers investors a proportionate share in a pool of stocks, bonds, and other assets, and the price at which an ETF trades is a close approximation to the market value of underlying securities in its portfolio. ETF shares are created in the primary market, when APs, typically large financial institutions, submit an order to the ETF for one or more large blocks of shares called "creation units." Only APs are permitted to redeem from ETFs and, importantly, the majority of ETFs redeem their shares in-kind. Whereas a mutual fund investor buys new shares and sells existing shares directly with the fund at a specified time each day at a price determined by the fund, ETF investors buy and sell ETF shares on the secondary market at a market-determined price agreed to between investors on the exchange. This means that liquidity mismatch issues are largely irrelevant for ETFs; an ETF does not need to sell underlying portfolio securities to satisfy redemption requests.[103] Any imbalance in the supply and demand for ETF shares may affect the exchange price, but it does not result in purchases or sales of the ETF's underlying holdings. Furthermore, APs capture differences between the market price of the ETF and its NAV through the creation and redemption of creation units – a practice known as "arbitrage." In engaging in arbitrage opportunities, APs operate as a built-in tool to help maintain the market-determined price of an ETF's shares close to their underlying value. With these distinctions in mind, we turn to a discussion of the FSB's recommendations.

The first set of FSB recommendations relate to reporting obligations and investor disclosures. While we echo our support for providing appropriate information to regulatory authorities and clear disclosures to investors, we reiterate our view that current regulations and practices already serve to provide regulators and investors with extensive information and disclosures about open-end funds, including ETFs. In the U.S., for example, ETFs are required to disclose investment strategy and risk information on Form N-1A (*e.g.*, via a written prospectus). All investors that purchase creation units receive an ETF's prospectus. Investors in the secondary market may receive a prospectus from their financial intermediary or, if not, an

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[102] We note that ETFs are investment companies that may be legally classified as either open-end investment companies or unit investment trusts (UITs). The Consultative Document's liquidity recommendations focus on open-end funds specifically. However, we note that ETF analysts and investors do not view the differences between open-end ETFs and UIT ETFs as material.

[103] The SEC has provided ETFs with exemptive relief from Section 22(e) of the Investment Company Act, allowing an ETF that includes non-U.S. securities in its redemption basket to postpone delivery of such securities for a period of up to 15 days in order to address non-U.S. market holidays.

ETF is required to provide a "product description," which summarizes important information about the ETF, including information about how to obtain a prospectus. ETFs also provide transparency through daily disclosures of their underlying portfolio holdings, allowing market participants to easily spot deviations of the ETFs' exchange price from the value of its underlying holdings and to correct those deviations through arbitrage trades. This level of transparency is often cited as a special feature of ETFs, one that that has contributed to their growing popularity.[104]

In its Liquidity Proposal, the SEC has recommended certain enhancements to ETFs' reporting and disclosure obligations. As introduced above, the Liquidity Proposal would require an ETF to classify each of its underlying portfolio holdings into one of six categories, with each such category corresponding to the amount of time that is expected to be needed to convert the asset to cash in order to meet shareholder redemption requests. Our organization and other market participants have expressed concerns about the application of the classification system to ETFs.[105] The classification system is designed to address liquidity issues that are characteristic of a traditional open-end fund, specifically, whether the fund is capable of meeting cash redemptions. Because ETFs are generally not designed to meet shareholder redemptions in cash, the liquidity classification system is inconsistent with an ETF's structure and therefore irrelevant to ETFs' liquidity management needs.[106] The proposed disclosure of an ETF's position-level liquidity classification information would have no benefit or relevance to shareholders' assessment of an ETF's ability to meet redemptions in-kind.

The Liquidity Proposal also provides that proposed Form N-CEN would require ETFs to report, for the first time, the name of each of its APs, whether the AP posted collateral to the ETF or another service provider in connection with the purchase or redemption of ETF shares, and the dollar value of the ETF's shares that the AP purchased or redeemed from the ETF during the reporting period.[107] In considering these proposed disclosure requirements, we believe it is necessary to weigh the benefits of disclosure against the costs to ETF investors and, more broadly, the ETF market. The SEC suggests that this information would allow SEC staff to monitor ETF purchase and redemption activity and how such activity is distributed across APs, as well as the extent to which a particular ETF may rely on any one AP.[108] We expect that APs

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[104] *See* ICI Research Perspective, *Understanding Exchange-Traded Funds: How ETFs Work* (Sept. 2014), *available at* https://www.ici.org/pdf/per20-05.pdf.

[105] *See* January 2016 AMG Letter to SEC, *supra* note 49, at 33-34. *See also* Letter from BlackRock to SEC (Jan. 13, 2016) ("**January 2016 BlackRock Letter to SEC**"), *available at* https://www.sec.gov/comments/s7-16-15/s71615-36.pdf, at 29-31.

[106] We recognize that a small percentage of ETFs redeem in cash under certain circumstances. For example, certain ETFs sell and redeem shares solely for cash because they invest in jurisdictions that require in-cash redemptions or because they invest in bank loans, which cannot be transferred in-kind. We note that in-cash purchases and redemptions are the exception and not the norm in the ETF world. We also note that ETFs purchasing or redeeming in-cash have the ability to externalize transaction costs through redemption fees to APs, meaning that ETFs have the ability to easily manage transaction costs, thereby limiting any material dilution of ETF shareholder interests. *See id.*, at 34-35.

[107] *See* Liquidity Proposal, *supra* note 21, at 62348.

[108] *Id.*

would view detailed information about their trading activity with an ETF as proprietary and thus these proposed disclosures may prompt some APs to discontinue trading in ETFs directly and instead route their trades through large banks that serve as APs. This shift in AP participation could result in increased costs to investors and may serve to propagate concerns of overreliance on a handful of APs for ETF transactions in the primary market. We have recommended that the SEC omit this new ETF reporting requirement from proposed Form N-CEN.

We encourage the FSB to consider the reporting and disclosure recommendations in the SEC's Liquidity Proposal, as well as the industry response to those recommendations, as they apply to ETFs, before considering recommendations relating to separate and additional reporting and disclosure obligations. We believe that the FSB can play an instrumental role in studying pending regulatory initiatives in the U.S., comparing them to existing reporting and disclosure obligations in non-U.S. jurisdictions, and spotting redundancies and other inefficiencies in reporting and disclosure requirements for ETFs across jurisdictions.

The second set of FSB recommendations relate to providing open-end funds with the tools necessary to align a fund's portfolio and investment strategies with the terms and conditions of its redemption practices. The stated goal is to reduce any existing first-mover advantage. For ETFs that conduct in-kind redemptions with APs, the ETF does not bear the market impact costs and trading costs that traditional mutual funds incur when purchases or sales are effected to meet shareholder redemptions.[109] For ETFs that conduct in-cash redemptions, the ETF will typically impose a redemption fee on the AP, which is calibrated to cover expected transaction costs.[110] In this way, both in-kind and in-cash ETFs have built-in mechanisms to manage liquidity risk.

With respect to liquidity risk management tools, we submit that the features that make ETFs unique – in-kind redemptions, use of redemption fees, and the function served by APs in the primary market – allow ETFs to manage liquidity risk effectively. The SEC has recognized this in the context of swing pricing, finding that, unlike mutual funds, which typically internalize costs associated with purchases and redemptions of shares, ETFs externalize these costs by charging a fee to APs, which offsets transaction costs that may be incurred by an ETF.[111] The SEC also noted that swing pricing "could impede the effective functioning of an ETF's arbitrage mechanism…[which] is necessary in order for an ETF's shares to trade at a price that is at or close to the ETF's NAV."[112] In other words, if swing pricing were to be used by an ETF, an AP would not know whether the ETF's NAV would be adjusted and thus would be unable to

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[109] *Id*., at 62280, n. 44.

[110] *Id*.

[111] *Id*., at 62332.

[112] *Id*.

determine whether an opportunity for arbitrage exists.[113] In the end, the SEC determined that swing pricing is not an appropriate tool for ETFs that redeem in-kind.[114]

We recommend that the FSB first consider pending efforts by the SEC related to ETFs. For example, last year, the SEC requested comment on exchange-traded products ("**ETPs**"), which include ETFs, in order to better understand the nature and uses of ETPs, especially by retail investors.[115] The SEC is using this information to analyze the role that financial institutions play in keeping the price of ETF shares in line with their underlying portfolio securities and to weigh the possibility of new rules aimed at containing trading and pricing disruptions in ETF shares.[116] We strongly believe that competing efforts by the FSB in this area would be premature.

We also note that the SEC's current work-in-progress and related industry responses have already addressed some of the issues raised in the Consultative Document. For example, the FSB takes issue with an ETF's reliance on APs, highlighting the fact that APs are not obligated to create or redeem shares and how this could result in negative effects on the ability to trade without accepting significant discounts on the values of underlying assets.[117] Similarly, the Consultative Document presents a "hypothetical situation with no historical occurrence" where in an extremely stressed market no AP is left in play, thereby forcing an ETF to take on the characteristics of closed-end funds and creating a significant discount or premium on ETF shares.[118] These scenarios ignore the fact that ETFs offer an alternative layer of liquidity. An investor can access the market in bonds, for example, by buying directly in the security, accessing a bond ETF in the secondary market, or creating or redeeming shares in bond ETFs through an AP in the primary market. A recent study indicates that the majority of trading activity in bond ETFs, which are generally viewed as less liquid, occurs in the secondary market, meaning that bond ETF shares are traded without any intervention from an AP.[119] Even in the primary market, at some point, supply and demand market forces will prompt an AP to create and redeem ETF shares. We would add that ETFs holding relatively less liquid securities have demonstrated the ability to trade much like traditional ETFs holding more liquid asset classes.[120]

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[113] *Id.*

[114] Swing pricing may be an appropriate tool for ETFs that redeem in-cash because it would allow such ETFs to externalize transaction costs. *See* January 2016 BlackRock Letter to SEC, *supra* note 105, at 35. However, as noted above, even ETFs that create and redeem in cash have the ability to externalize transaction costs.

[115] *Request for Comment on Exchange-Traded Products*, SEC Rel. No. 34-75165, File No. S7-11-15 (June 17, 2015), at 34739.

[116] *See* Dave Michaels, *ETFs Prone to Pricing Disruptions Could Prompt New Rules, SEC's White Says*, WALL STREET JOURNAL (May 20, 2016), *available at* http://www.wsj.com/articles/etfs-prone-to-pricing-disruptions-could-prompt-new-rules-secs-white-says-1463745601.

[117] Consultative Document, at Annex 3.

[118] *Id.*

[119] *See* Shelly Antoniewicz, *Plenty of Players Provide Liquidity for ETFs*, ICI Viewpoints (Dec. 2, 2014), *available at* https://www.ici.org/viewpoints/view_14_ft_etf_liquidity.

[120] *See* Letter from BlackRock to SEC (Aug. 11, 2015), *available at* https://www.sec.gov/comments/s7-11-15/s71115-10.pdf, at 8, n. 25.

With respect to the third and fourth sets of recommendations, which deal with stress testing and the adequacy of "extraordinary" liquidity risk management tools, we maintain that our serious concerns about those recommendations apply equally in the ETF context.

Instead of tailoring the proposed recommendations to fit within the ETF context, we urge the FSB to await the results of the SEC's request for comment on ETPs, which should further illuminate issues specific to ETFs and fill the gaps on the nature and uses of ETFs.

IV. FSB Recommendations Relating to Leverage

Recommendation 10: IOSCO should develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions. This would enhance authorities' understanding of risks that leverage in funds may create, facilitate more meaningful monitoring of leverage, and help enable direct comparisons across funds and at a global level. IOSCO should also consider developing more risk-based measure(s) to complement the initial measure(s) and enhance the monitoring of leverage across funds at a global level.

Recommendation 11: Authorities should collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which pose significant leverage-related risks to the financial system, and take action when appropriate.

Recommendation 12: IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions based on the simple and consistent measures(s) it develops.

The FSB's leverage recommendations relate to the development of uniform metrics that financial authorities can use to monitor the use of leverage and the collection of data related to the use of leverage by funds effectively.[121] Included in these recommendations, which are primarily oriented around the acquisition of information by regulators, is the suggestion that authorities "take action when appropriate," suggesting that the imposition of additional restrictions or other direct regulatory action related to leverage may be necessary.

We do not believe that the use of leverage by funds (whether UCITS funds, U.S. registered mutual funds or similar registered funds sold at retail, or private funds) warrants regulatory measures beyond those already in place or under development in the U.S. and other jurisdictions. For the reasons detailed below, we do not believe that funds' use of leverage constitutes a source of systemic risk. Moreover, leverage plays a valid and constructive role in the modern financial system, and should not be subject to excessive regulation. We believe significant legal restrictions already exist or are under development, which obviate the need for further measures. In response to the FSB's suggestion that IOSCO develop "simple and consistent" leverage measures, we argue that leverage is inherently difficult to measure, and that simplistic measures are likely to be misleading.

[121] IOSCO also has released a statement citing a need for additional data on asset managers' use of leverage and derivatives. *See Statement on IOSCO's Priorities Regarding Data Gaps in the Asset Management Industry* (June 2016), *available at* https://www.iosco.org/library/pubdocs/pdf/IOSCOPD533.pdf. Our comments here are applicable to IOSCO's suggestions as well.

Given the extent of regulatory attention in this area, and the amount of leverage data and information already available, we believe that regulators should only consider additional data disclosure requirements if they can clearly identify any true and relevant gap in currently available data. We acknowledge that the leverage recommendations included in the Consultative Document are aimed primarily at enhancing regulators' understanding of funds' use of leverage. In principle, we support regulators' efforts to learn more about leverage, which in recent years has played an increasingly important and complex role in financial markets. However, we note that a significant amount of leverage related data and information is already collected by regulators. Further reporting and disclosure requirements in this area should therefore be imposed sparingly.

Rather than encouraging the implementation of additional, fund-specific rules on the use of leverage, we believe that the FSB could play a very constructive role simply by encouraging different jurisdictions to harmonize the leverage-related rules that are currently undergoing implementation. We reiterate our support for the harmonization of rules and regulatory practices across jurisdictions. We again emphasize the need for financial regulators to maintain consistent practices across jurisdictions in analyzing the use of leverage by funds and collecting related data.

A. Absence of a Systemic Threat

The Consultative Document asserts that funds' use of leverage can cause systemic problems through three channels: (i) by triggering counterparty losses, (ii) by passing losses on to investors, and (iii) by leading to forced sales and distressed selling.[122] As we have already stated, we are not aware of any evidence that actions of non-money market funds (whether registered mutual funds or private funds) have given rise to global financial stability issues generally.[123] We do not believe that financial leverage is somehow riskier when used by funds than when used by other types of financial institutions or, for that matter, operating companies. As detailed below, a number of specific factors weigh against the FSB's assertions that funds' use of leverage is likely to cause systemic distress through the three mechanisms referenced in the Consultative Document.

The Consultative Document's concerns regarding counterparty losses may be mitigated in many cases by steps that fund counterparties take to limit the likelihood of, and potential harm from, credit losses. Many of the lenders to funds are large banks or other sophisticated financial institutions that conduct extensive due diligence before extending credit.[124] Many fund counterparties also have highly diversified asset portfolios and therefore are well-positioned to remain healthy in the event of default by one or more borrowers. Perhaps most important, there is great diversity among investment strategies used by investment funds. Funds diversify their holdings through investments in a wide array of asset classes compared to other financial institutions, such as banks and insurance companies, whose assets are comparatively

[122] Consultative Document, at 22.

[123] *See, e.g.*, *supra* page 8.

[124] As the Consultative Document notes, banks themselves are subject to leverage restrictions, which play a role in insulating banks from harm resulting from the failure of a counterparty. *See* Consultative Document, at 23.

homogeneous. For example, the savings and loan crisis in the U.S. during the late 1980s and early 1990s occurred when a large number of savings and loan institutions held mortgages and other similar debt assets that could no longer generate income sufficient to cover those institutions' capital costs. This crisis was significant enough to necessitate a regulatory response in part because of the large number of institutions with similar assets and liabilities. The same set of conditions caused more than a thousand savings and loans entities to encounter distress in a relatively narrow window of time. This type of disruption would be unlikely to occur in the asset management industry because funds diversify their holdings among various instrument types by issuers in different industries and regions. Compared to other financial industry participants, investment funds are less likely to encounter distress in parallel with one another and, accordingly, their counterparties are less likely to encounter distress on a systemic level.

Although we acknowledge that a fund's use of leverage can accelerate a decline in the value of the fund's assets under adverse conditions, loss in asset value is not a systemic threat in the institutional investment industry in the way that it is in the banking industry or elsewhere in the financial sector. As we have repeatedly noted, an investor's interest in a fund or separate account is different from a bank deposit.[125] Whereas a bank deposit is a fixed obligation for which the depositor is understood to accept no risk of loss, shares or other interests in an investment fund move up and down in value based on changes in the value of the fund's underlying net assets, and fund investors knowingly accept risk of loss. Fund investors, unlike bank depositors, consider and use their investments as at-risk capital. Fund investors are therefore comparatively likely to maintain diverse asset portfolios and to manage proactively the risk of loss in value of individual fund investments. The risks associated with losses passed through to fund investors are substantially less than the systemic risks associated with, for example, a bank failure. Accordingly, leverage limitations similar to those applicable to banks are simply inappropriate for the asset management industry.[126]

We do not agree with the Consultative Document's premise that investment funds experience forced sales in a way that could cause systemic disruption, triggered by leverage or otherwise. There is no historical evidence or fact-based data to support this concern. Various features of investment funds, including statutory requirements and risk management techniques, make the likelihood of forced selling remote.[127] Certain features of the asset management industry and the financial markets also reduce the likelihood of forced selling. New participants come into sectors of the market when others leave because they have reached a risk limit or subjective risk tolerance or otherwise see better opportunities elsewhere. Under stressed market conditions, asset management firms take a range of different steps to mitigate losses.[128] We

[125] *See, e.g.*, *supra* pages 8, 27.

[126] Moreover, the leverage restrictions applicable to most registered open-end funds are already significantly more stringent than those that apply to banks. *See infra* page 43.

[127] *See generally* March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 33-34.

[128] We note that even waves of unexpected fund redemptions do not necessarily trigger forced sales. FCF, for example, unwound in a relatively orderly manner in consultation with the SEC, despite encountering a high volume of withdrawals. *See* Gregory Zuckerman, *Third Avenue Reaches Deal with SEC over Troubled Fund*, WALL STREET JOURNAL (Dec. 16, 2015), *available at* http://www.wsj.com/articles/third-avenue-reaches-deal-with-sec-over-troubled-fund-1450304539.

therefore do not agree with the FSB's assertion that forced sales are a negative consequence of funds' use of leverage to an extent that would warrant a global regulatory response.

We acknowledge that the use of leverage by investment funds may increase volatility in fund net asset value. We likewise note that in rare circumstances, the risks associated with leverage may give rise to concerns over financial stability, as evidenced by the 1998 failure of Long Term Capital Management ("**LTCM**"). However, a collapse similar to LTCM's is unlikely to recur, in part because LTCM was exceptionally highly leveraged (even by the standards of alternative asset managers) and because certain LTCM counterparties did not apply their own customary risk controls to their transactions with LTCM.[129] Prior to becoming distressed, LTCM had a debt to equity ratio of over 25 to 1. In contrast, U.S. mutual funds are limited to leverage ratios of 0.3 (open-end funds) or 0.5 (closed-end funds), while other types of funds (although not subject to explicit leverage limits) typically do not have leverage ratios greater than 2.0.[130] Despite the high-profile nature of its failure, LTCM was unwound in an orderly manner and did not ultimately result in systemic disruption. We remain confident in our position that use of leverage by asset managers does not give rise to systemic risks as compared to other financial institutions, such as banks. Accordingly, we submit that additional restrictions are simply unnecessary given the asset management industry's core characteristics, market practices, and historical record. We approve of regulators' efforts to better understand leverage, but reiterate that additional reporting requirements are not supported by the evidence.

B. The Benefits of Financial Leverage and Derivatives

In light of the constructive, multi-faceted role that derivatives play in the asset management industry, we believe that regulations limiting the ability of asset managers to use leverage may in fact have negative consequences to investors without improving the soundness of the financial system. In light of the use of leveraged positions to hedge, efficiently achieve investment exposures, and tailor the risk-return profiles of investment products, regulators would do a disservice to investors by establishing restrictions that unduly limit asset managers' ability to use both traditional and synthetic leverage.

Derivatives instruments can be used to establish hedge positions to mitigate investment risk. Derivatives can expose investors to risk of loss without a corresponding investment of capital, and therefore can be understood as a type of leverage (referred to in the Consultative Document as "synthetic" leverage). While derivative instruments may function as a form of leverage, they perform a key risk management function in the asset management industry. Asset managers rely on a range of derivative instruments to manage risks ranging from interest rate risk to currency risk to operational and liquidity risk. Derivatives are employed to reduce volatility and stabilize investor returns. Moreover, we believe that the use of various, sometimes countervailing leverage strategies by multiple market participants, provides safeguards against systemic risk, in addition to risk at the individual fund level. Unless carefully designed, leverage restrictions could deprive asset managers of tools that are essential to mitigating risk to

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[129] *See* March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 30.

[130] *See infra* page 43.

individual funds and at the systemic level. In this way, inappropriate restrictions on the use of leverage could in fact *create* systemic risks arising from the asset management industry.[131]

A specific example of a pending rule that may create risk is the SEC's recent proposal that derivatives positions be backstopped by "qualifying coverage assets" consisting of either cash or the specific asset required to be delivered under a derivative contract.[132] If adopted, this rule could significantly limit the ability of registered U.S. mutual funds to hedge currency risks.[133] Currently, a fund that invests in securities denominated in non-U.S. currency may substantially limit the risks associated with movements in non-U.S. currency exchange rates by entering into futures contracts. Such contracts entail agreements by funds to exchange non-U.S. currency for U.S. dollars at future dates at current exchange prices. Such arrangements permit funds to "lock in" current exchange rates and reduce or eliminate exposure to rate fluctuations. Currency hedging is popular among mutual fund managers, who often wish to invest in non-U.S. companies without simultaneously taking a speculative position in non-U.S. currency, which is effectively what happens when a fund invests in a non-U.S. denominated security without hedging. The SEC's proposed rule, if adopted, would reduce or eliminate the risk-mitigation value of currency hedging. The SEC's rule would require asset managers to backstop futures positions with cash holdings, an impractical measure that would require funds to hold large amounts of assets that have little potential to increase in value. The SEC's proposal, while intended to limit risks associated with derivatives use, would therefore have the unintended consequence of preventing mutual funds from using a risk mitigation tool that many have found useful. This example demonstrates that well-intentioned regulations can have undesirable effects.

In addition to their risk-mitigation function, derivatives also allow investors to obtain exposure to assets and markets that might otherwise be difficult to access in an efficient manner.[134] For example, some funds may more efficiently obtain exposure to investments in non-U.S. markets such as India, China, Taiwan, and South Korea though derivatives than through logistically complex local market transactions. The ability of regulated funds to provide exposure to such regions through derivatives has been essential to the ability of funds to offer complete emerging markets portfolios. To achieve comparable exposure through the cash markets in emerging markets would be more expensive without any corresponding additional benefits to investors. The same result can be observed through many derivatives or leveraged instruments that are used to achieve an investment strategy. In the absence of this tool, asset managers' ability to diversify investments would be hampered. In addition, exposure to different asset classes through funds that use derivatives, such as funds providing exposure to commodities, may allow investors to better diversify their portfolios. Investment diversification

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[131] *See generally* March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 26-27.

[132] *Use of Derivatives by Registered Investment Companies and Business Development Companies*, SEC Rel. No. IC-31933 (Dec. 11, 2015) ("**Use of Derivatives Release**"), at 178-188. The "qualifying coverage assets" concept is one of many related proposals that the SEC detailed in this release.

[133] *See generally* Letter from BlackRock to SEC (Mar. 28, 2016), *available at* http://www.blackrock.com/corporate/en-pl/literature/publication/sec-use-of-derivatives-proposal-032816.pdf.

[134] *See generally* Letter from AMG to SEC (Mar. 28, 2016) ("**March 2016 AMG Letter to SEC**"), *available at* https://www.sec.gov/comments/s7-24-15/s72415-159.pdf, at 11-12.

generally promotes financial stability. Accordingly, regulators should avoid derivatives regulation that may limit investors' ability to appropriately diversify portfolio holdings.

Asset managers may use leverage to tailor the risk-return profiles of their investment products. For example, U.S.-registered closed-end funds are permitted to issue senior securities (including debt and senior equity securities) in amounts up to 50% of total assets.[135] Certain funds use derivative instruments to enhance expected returns. For example, a closed-end fund could issue notes and preferred stock with a blended average effective annual interest rate of 4%, and could invest the proceeds in securities with an average yield to maturity of 7%. The shareholders of the fund would then be in a position to receive an incremental annual return of approximately 3% of the amount borrowed (the 7% expected return on the assets purchased less the 4% in financing costs), without making any incremental equity investment. The enhanced returns associated with this strategy would of course entail increased risk. When securities prices fall, leveraged funds may experience significantly greater declines in net asset value than funds with no leverage. However, funds offering enhanced expected returns together with increased risk are appropriate for certain long-term investors. Use of leverage to enhance expected returns is a valid investment technique that should not be subject to undue regulatory restrictions.

Finally, we note that funds' use of leverage may tend to enhance liquidity and pricing efficiency across the securities markets. By borrowing to finance investments, funds expand their purchasing capacity and inject capital into the securities markets. Increased liquidity in securities markets has far reaching beneficial effects, reducing businesses' cost of capital, facilitating businesses' access to the capital markets and (by increasing transaction volume) moving securities prices towards efficient levels. We believe that restrictions on funds' use of leverage limit securities market liquidity and, over time, tend to have negative economic effects that go beyond the financial markets.

C. Leverage Measures Must Reflect the Complexity of Financial Leverage Arrangements

We note that that the FSB's specific recommendations related to leverage focus primarily on information gathering, including the development by IOSCO of "simple and consistent" metrics for analysis of fund leverage.[136] We find it difficult to overstate the impracticality of developing useful leverage metrics that are "simple." Financial leverage can arise from an array of diverse financial instruments that are used for a wide range of purposes and that may be deployed in many different types of portfolios. Certain types of derivatives, moreover, may appear to give rise to leverage risks when in fact they have the opposite effect. For example, as discussed previously, foreign exchange futures may constitute a form of notional leverage, insofar as they may expose funds to risk of loss when considered in isolation. However, currency futures are frequently used in conjunction with foreign securities investments in order to *reduce* (not increase) portfolio risk. Foreign exchange futures may involve large dollar amounts, so a simplistic metric, such as a ratio based on gross notional exposure, would be a

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[135] *See infra* page 42.

[136] Consultative Document, at 25.

highly inaccurate indicator of the leverage risks faced by funds employing such contracts. Any newly adopted leverage measures should reflect the fact that the appropriate approach to measuring leverage may vary depending on the type of instrument involved and the purpose for which it is employed.[137]

Metrics that measure leverage in a way that accurately reflects the associated risks are inherently complicated. As the FSOC acknowledged in a recent release,[138] the most easily calculated leverage ratios all have significant drawbacks. In particular, ratios based on gross notional exposure may overstate leverage because, among other reasons, they do not take into account whether funds actually owe amounts under derivative contracts. Ratios based on market values of derivative instruments, such as gross asset value divided by net asset value, have the drawback that they do not take into account the volatility in derivative contract values. For example, a fund might not owe or be owed anything under a futures contract on a given day, but would nevertheless be exposed to risk of future liability under the contract. Other leverage measures, such as value-at-risk analysis, may not have these shortcomings, but are viewed as complex, requiring an understanding of each position in a fund's portfolio, and involve certain assumptions and estimates.

To the extent that financial regulators adopt new leverage metrics, it is essential that these metrics reflect an understanding of the complex effect that derivative instruments may have on a fund's portfolio. Our critique of the SEC's proposed derivatives rule suggests revisions to certain of the SEC's proposed leverage tests that are based in part on this principle.[139] We therefore appreciate the FSB's inclusion in its recommendations of the suggestion that IOSCO develop leverage measures "with due consideration of appropriate netting and hedging assumptions."[140] We caution, however, that leverage measures reflecting appropriate netting and hedging assumptions will inevitably be complex, and may be challenging to implement in a consistent manner across different funds and jurisdictions. We also strongly encourage that any metrics considered in response to the FSB's recommendation be studied with reference to the significant amount of analysis and attention that U.S. regulators are currently devoting to derivatives rules.[141] As discussed above, the most readily accessible leverage ratios can be crude and misleading. As we have elsewhere argued, risks associated with leverage also can be mitigated by asset segregation, rather than quantitative limits on the amount of leverage incurred.[142] Asset segregation is generally a more flexible approach to leverage management than hard limits and may therefore be preferable.

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[137] *See generally* March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 40-41.

[138] *Financial Stability Oversight Council – Update on Review of Asset Management Products and Activities*, FSOC (Apr. 18, 2016), *available at* https://www.treasury.gov/press-center/press-releases/Pages/jl0431.aspx, at 16.

[139] March 2016 AMG Letter to SEC, *supra* note 134.

[140] Consultative Document, at 25.

[141] *See* "Extensive Leverage Information is Already Available," *infra* page 45.

[142] March 2016 AMG Letter to SEC, *supra* note 134, at 4, 9, stating that "we believe the SEC's policy objectives would be best addressed through the Proposed Rule's Asset Segregation Requirements, as well as prospectus disclosure and effective risk management rather than through imposition of Portfolio Limits" and that "asset segregation, including segregation based on mark-to-market amounts, has worked for over thirty years to protect

Finally, we reiterate our strong support for the harmonization of leverage measures across jurisdictions.[143] Many asset managers are subject to multiple international regimes that employ different leverage metrics. For example, the European Union's AIFMD and its UCITS guidelines set forth two distinct methodologies for calculating leverage, while the Basel III concept of gross "notional" exposure results in yet another methodology. These different metrics present challenges for asset managers' operations and make it very difficult for regulators to use data from other regulators in a meaningful fashion. We encourage IOSCO to promote compatibility of leverage-related regulations across jurisdictions.

We also recommend that regulators take steps to facilitate data sharing across jurisdictions. We believe the FSB is well-positioned to take the lead in encouraging regulatory authorities to share more data among both regulators and market participants.

D. Existing and Pending Regulation and Other Safeguards

As acknowledged in the Consultative Document[144] and as discussed in prior correspondence with the FSB,[145] most investment funds are already subject to regulatory and other restrictions on their use of leverage. Importantly, as detailed below, existing fund leverage restrictions are significantly more restrictive than the Basel III banking leverage restrictions, even though fund investors are capable of assuming (and should be permitted to assume) more risk than bank depositors. We feel these considerations weigh strongly against recommendations for additional or more onerous restrictions on funds' use of leverage.

Chief among the U.S. statutory limitations is section 18 of the Investment Company Act (and the associated SEC guidance thereunder), which limits a registered investment company's ability to issue or sell "senior securities" which often take the form of indebtedness. Section 18(f)(1) prohibits an open-end fund from incurring indebtedness other than certain types of borrowings, and then only if the fund maintains at least 300% asset coverage. Section 18(a)(1) also prohibits a closed-end fund from incurring indebtedness unless the fund maintains at least 200% asset coverage. An investment company's use of derivatives is subject to a separate set of restrictions. If a registered fund invests in a derivative, it must cover its exposure to the instrument by holding liquid assets equal to the leveraged exposure or hold an offsetting position equal to the leveraged exposure.

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investors in Regulated Funds from losses due to the inability of Regulated Funds to meet their financial obligations under derivatives and financial commitment transactions…."

[143] *See* March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 41.

[144] Consultative Document, at 22-23, noting that "[T]he majority of investment funds are subject to regulatory limitations on traditional balance sheet leverage" and that "[a] number of regulatory measures are…in place to address risks associated with leverage. For example, the regulation of open-ended funds often provides for balance sheet leverage limits…."

[145] *See* March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 28, noting that "many pooled investment vehicles significantly limit their use of leverage to comply with statutory as well as self-imposed investment restrictions," detailing certain applicable regulations, and commenting on relevant data related to hedge funds.

Asset managers in Europe are likewise subject to leverage restrictions. UCITS are permitted to borrow up to 10% of net asset value to fund redemptions, but cannot borrow at all for speculative investment purposes.[146] UCITS may assume leverage in the form of derivatives, but their use of derivatives is subject to restrictions based on "global exposure" limitations, which are keyed off of modified gross exposure measures, value-at-risk or other appropriate, advanced leverage measures adopted by European Union member states.[147] Under AIFMD, meanwhile, alternative asset managers are required to set leverage limits for their funds and to calculate leverage, and may be subject to further restrictions at the discretion of member states.[148]

We note that the leverage restrictions that apply to open-end funds in the U.S. and in the European Union are significantly more stringent than the banking leverage restrictions under Basel III. Under Basel III, banks must maintain a Tier 1 leverage ratio of 3%.[149] Under the methodology applied to U.S. open-end funds under the 1940 Act, this would roughly equate to 103% asset coverage, well below the 300% requirement that actually applies to U.S. funds.

Self-imposed restrictions also limit leverage risk for some investment funds. Some funds have adopted written investment policies that impose more conservative leverage limits than those mandated by applicable law. For example, some funds require that indebtedness leverage (*i.e.*, borrowing) be used solely for liquidity management purposes (*e.g.*, to satisfy anticipated investor redemptions or backstop trade failures). *In general, most mutual funds operate and are financed with equity capital and do not rely on borrowed money*.[150] Asset managers also may be subject to certain restrictions through contracts with third-party service providers. Third-party service providers often enter into "service level agreements" with funds and/or asset managers

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[146] *UCITS Guide for Investment Managers*, Carne Group, *available at* http://www.carnegroup.com/wp-content/uploads/2014/08/UCITS-Guide-for-Investment-Managers-August-2014.pdf, at 9. *See Commission Directive 2010/43/EU of 1 July 2010*, OFFICIAL JOURNAL OF THE EUROPEAN UNION (Oct. 7, 2010), at Article 41, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:EN:PDF2010:176:0042:0061.

[147] *Id*., at 11-12.

[148] *Directive 2011/61/EU of the European Parliament and of the Council of 8 June 2011*, OFFICIAL JOURNAL OF THE EUROPEAN UNION, at Article 25, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2011:174:0001:0073:EN:PDF; *Commission Delegated Regulation (EU) No 231/2013 of 19 December 2012*, OFFICIAL JOURNAL OF THE EUROPEAN UNION, at Articles 6 to 11, Annex I, *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:083:0001:0095:en:PDF.

[149] *See Basel III Leverage Ratio Framework and Disclosure Requirements*, Basel Committee on Banking Supervision (Jan. 2014), *available at* http://www.bis.org/publ/bcbs270.pdf.

[150] The limitations set forth in Section 18 of the Investment Company Act (requiring 200% asset coverage for closed-end funds and 300% asset coverage for open-end funds) ensure that U.S.-registered mutual funds are capitalized primarily with equity. SEC guidance has also had the effect of extending the Section 18 limits to leverage arising from non-traditional instruments. *See*, *e.g*., *Securities Trading Practices of Registered Investment Companies*, SEC Rel. No. IC-10666 (Apr. 18, 1979), 44 FR 25128 (Apr. 27, 1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf ("Directors of investment companies should consider the Congressional purpose behind Section 18…in considering whether the securities trading practices of the investment company involved, including reverse repurchase agreements, [firm commitment agreements and standby commitment agreements,] constitute the issuance of senior securities by the investment company.").

that may include provisions requiring certain risk-management measures, including measures to ensure that funds remain financially capable of fulfilling their contractual obligations. These provisions may limit the ability of funds to use leverage at such high levels as to threaten their ability to continue to operate.

Hedge funds historically have employed more leverage than mutual funds and other types of private funds, but many private funds do not use leverage at all. Funds that use leverage typically maintain average gross leverage ratios of 2.0 or less. A 2011 Columbia University Business School working paper found that the average gross leverage ratio for the hedge fund industry was 1.5 as of October 2009 and 2.1 for the period December 2004 through October 2009.[151] By contrast, the gross leverage ratio was 14.2 for investment banks during the same period and 9.4 for the broader financial sector.[152]

Again, we underscore the need for regulators to recognize and consider the current significant restrictions on leverage, including both balance sheet and synthetic leverage, in choosing whether or not to suggest additional restrictions. Of equal importance, we emphasize that the regulatory structure applicable to the derivatives markets has undergone, and is continuing to undergo, significant changes. For example, pending SEC rulemaking seeks to impose new limits on the amount of leverage that U.S. registered open-end funds may assume through the use of derivatives.[153] Title VII of the Dodd Frank-Act ("**Title VII**") also mandated significant new rules related to swaps, including requirements that certain swaps be centrally cleared, that major swaps market participants register with applicable regulators, and that regulators impose certain new capital and margin requirements for major market participants.[154] While not exclusively applicable to funds, Title VII is intended to have the effect of limiting any potential systemic risk arising from synthetic leverage generally. In particular, central clearing mandates are designed to increase transparency and liquidity in the swaps marketplace while limiting counterparty risk by effectively mandating the involvement of a well-capitalized counterparty in certain transactions. Similarly, capital and margin requirements, which would apply to all major market participants, are designed to limit the risk of failure of marketplace participants.[155] Implementation of the Title VII requirements, which is being carried out primarily by the SEC, the CFTC, and banking regulators, is a complex process with various moving pieces still in play.[156]

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[151] Andrew Ang, Sergiy Gorovy & Gregory B. van Inwegen, *Hedge Fund Leverage* (Jan. 25, 2011), *available at* https://www0.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf, at 17.

[152] *Id.*, at 25.

[153] *See* Use of Derivatives, *supra* note 132.

[154] *See generally* Dodd-Frank Act, Pub. L. No. 111-203, sections 701-774, 124 Stat. 1423 (2010) (codified at 12 U.S.C. 5365), *available at* https://www.sec.gov/about/laws/wallstreetreform-cpa.pdf. Section 723 mandates clearing of swaps and section 763 mandates clearing of security-based swaps.

[155] *See generally Regulation of Over-the-Counter Derivatives under the Dodd-Frank Wall Street Reform and Consumer Protection Act*, Skadden, Arps, Slate, Meagher & Flom Whitepaper (2010), *available at* https://www.skadden.com/newsletters/FSR_A_Regulation_of_Over-the-Counter_Derivatives.pdf.

[156] *See generally U.S. Uncleared Swap Margin, Capital and Segregation Rules*, Davis Polk & Wardwell LLP presentation (Jan. 22, 2016), *available at*

We note that pending U.S. financial reforms parallel those under development around the world. Many non-U.S. regulators are in the process of implementing rules on clearing, margin, and capital requirements similar to those in the U.S.[157] In particular, G20 financial regulators have agreed to implement a package of relevant reforms, including new OTC derivatives regulations, by 2019.[158]

Regulations that target funds specifically, as opposed to all other market participants, are unnecessary. We strongly encourage the FSB to carefully assess and evaluate the current and evolving regulatory regime, including the SEC's pending rule proposal on derivatives and other pending U.S. regulatory initiatives, before suggesting the collection of additional data or imposition of additional restrictions on the use of leverage. We believe that the FSB's most useful role in promoting regulation of leverage may be to encourage regulators to share data and information, to take advantage of one another's institutional knowledge, and to implement compatible rules in their respective jurisdictions.

E. Extensive Leverage Information is Already Available

While we support regulators' efforts to learn more about financial leverage generally, we question the value of recommending any incremental leverage-related reporting requirements. Extensive information relating to leverage already is being collected. The FSB should thoroughly review the universe of available leverage related information before recommending additional data gathering requirements.

U.S. open-end funds are required to release financial statements publicly twice per year and detailed schedules of investments (including derivative positions) four times per year. Customarily, financial statements are accompanied by footnotes that include descriptions of leverage facilities where applicable. Form N-1A includes broad requirements that funds disclose their investments, strategies, related risks, and information on fund management. Accordingly, funds generally include discussion of anticipated use of leverage in their offering documents.[159] Funds also must disclose portfolio turnover, calculate net asset value daily, and typically release

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https://www.davispolk.com/sites/default/files/2015_11_12_US_BankRegulators_Uncleared_Swap_Margin_Capital_Segregation_Rules.pdf.

[157] *See, e.g*., *Margin Requirements for Non-Centrally Cleared Derivatives*, Basel Committee on Banking Supervision and IOSCO (Mar. 2015), *available at* http://www.bis.org/bcbs/publ/d317.pdf; *see Final Report: Draft Technical Standards on the Clearing Obligation – Credit Derivatives*, European Securities and Markets Authority (Nov. 2015), *available at* https://www.esma.europa.eu/sites/default/files/library/2015/11/2015-1481_final_report_clearing_obligation_index_cds.pdf (addressing central clearing); *see Commission Delegated Regulation (EU) No 152/201*, OFFICIAL JOURNAL OF THE EUROPEAN UNION (Feb. 23, 2013), *available at* http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:L:2013:052:0037:0040:EN:PDF, at 37, (addressing capital requirements). The derivatives rules proposed by European regulators are similar but not identical to the analogous U.S. rules. The European regulations are understood to be somewhat behind the U.S. regulation in the implementation process. *See* Ackerman, Andrew, *Europe Delays Key Swaps Rules*, WALL STREET JOURNAL (June 9, 2016), *available at* http://www.wsj.com/articles/europe-delays-key-swaps-rules-1465505745.

[158] *Implementation and Effects of the G20 Financial Regulatory Reforms*, FSB (Nov. 9, 2015), *available at* http://www.fsb.org/wp-content/uploads/Report-on-implementation-and-effects-of-reforms-final.pdf.

[159] Form N-1A, *supra* note 43. In particular, note Items 9, 16 and 17.

information about their holdings more frequently than is required by regulations (often monthly).[160] The new Title VII rules also subject certain swaps market participants to significant additional compliance and reporting rules, including requirements that all swaps trades be reported to central data repositories.[161] Under recently-finalized rules, U.S. advisers also must now disclose certain information related to the use of leverage by separate accounts.[162]

As the Consultative Document notes, certain leverage ratios are easily determined by reviewing fund balance sheets.[163] Vendors such as Bloomberg and FactSet compile publicly reported data in a format that is easily searchable. Academic literature includes data on the use of leverage by private money managers.[164] And the results of our own 2014 survey included data points on, among other things, the limited use of leverage by separate accounts.[165]

We believe that any additional data reporting requirements should, at a minimum, be tailored carefully to avoid imposing unnecessary burdens on investors or asset managers, particularly considering the amount and depth of information already available. We also believe that consistency in the data required is extremely important – both to avoid unnecessary, costly, and burdensome requirements but also to allow for true apples-to-apples comparisons that would enable regulators and policymakers to evaluate and analyze meaningful data. Collecting more data for data's sake will not achieve the goal of giving regulators consequential, useful, and relevant information to enable them to make reasonable and appropriate assessments of global systemic risks.

F. Conclusion: Need for Continued Review and Regulatory Harmonization

The Consultative Document's recommendations related to leverage anticipate additional data collection, development by IOSCO of new leverage measures, and, potentially, implementation of additional leverage restrictions. We respectfully suggest that further restrictive regulation in this area is unlikely to be beneficial. To summarize, our position is based primarily on the grounds that: (i) there is no evidence that funds' use of leverage constitutes material threat to global financial stability beyond that arising from other leveraged participants in the financial markets (in fact, any risk from funds is likely much lower given strict regulatory and contractual limitations), (ii) leverage is a useful financial tool and excessive leverage restrictions could have perverse effects, and (iii) regulators already impose significant restrictions on the use of leverage by funds and some are currently in the process of

[160] We note that mutual fund disclosure requirements, in addition to allowing regulators to access information about leverage, play a more general risk mitigation function by promoting transparency in the industry. Investors and counterparties have sufficient information to carefully assess funds' financial positions and can manage their own risk exposures accordingly.

[161] Dodd-Frank Act, sections 727-729, 766.

[162] 2016 Disclosure Rules Update, *supra* note 35.

[163] Consultative Document, at 24 ("[O]n-balance sheet leverage….can be calculated using basic balance sheet data readily available from fund financial statements.").

[164] *See*, *e.g*., Ang, Gorovy & van Inwegen, *supra* note 151.

[165] *See* April 2014 Letter to FSB, *supra* note 4.

implementing additional restrictions. While we acknowledge that certain derivatives products associated with financial leverage may tend to exacerbate financial disruptions, we do not believe that investment funds' use of these instruments necessitates new fund-specific regulations. In the end, capital markets are about risk, and investors in funds that employ leverage strategies and use synthetic instruments as risk management tools are privy to disclosures on derivatives risk.

We believe it is reasonable for regulators to continue to research the role of leverage in today's financial markets. However, we caution that fund leverage is inherently difficult to measure and that simple metrics of the type referenced on the Consultative Document are likely to be unhelpful at best and misleading at worst. We also suggest that any further data gathering efforts by regulators be made only after thorough consideration of the extensive amount of leverage related information that is currently available.

Consistent and uniform rules across regulatory regimes will create operational efficiencies for asset managers and keep fund operating costs lower for investors as well as enhance the ability of regulators to assess potential risks by allowing for more accurate comparisons. Accordingly, we support the FSB's recommendations related to leverage insofar as they promote consistency in leverage measures across jurisdictions. We believe the FSB could play a constructive role in assisting regulators in harmonizing existing and pending regulations.

V. FSB Recommendation Relating to Operational Risk

Recommendation 13: *Authorities should have requirements or guidance for asset managers that are large, complex, and/or provide critical services to have comprehensive and robust risk management frameworks and practices, especially with regards to business continuity plans and transition plans, to enable orderly transfer of their clients' accounts and investment mandates in stressed conditions*.

We strongly support robust operational policies and procedures by all asset managers designed to manage risks associated with business continuity planning, including the orderly transfer of client assets and client accounts. Various jurisdictions require investment funds to consider and implement operational risk policies and procedures. For example, in the U.K, operational risk is one of the risks that funds must consider as part of their risk management practices and include in their risk management policies and procedures. [166] Similarly, U.S.-based asset managers implement policies and procedures that address business continuity issues

[166] *See* Directive 2009/65/EC relating to Undertakings for Collective Investment in Transferable Securities, Article 38; Directive 2011/61/EU on the Alternative Investment Fund Managers, Recital 34 and Article 13 of Level 2 Regulations.

relevant to the asset manager.[167] In addition, the SEC recently proposed regulations to address various operational risk issues, including those raised in the Consultative Document.[168]

Beyond regulatory considerations, business matters – including client expectations and reputational considerations – compel asset managers to develop sophisticated and evolving risk management processes commensurate with their operations. Asset management firms simply cannot afford to be viewed as complacent or deficient in identifying and mitigating operational risks. As a result, operational risk management is a well-developed and well-managed aspect of asset management firms, and we are not aware of any current or potential operational challenges that implicate global systemic risk.

We agree with the FSB that the development and maintenance of operational risk management activities by asset managers is essential to protecting client interests and assets. At the same time, the asset management business, while important and providing a valuable investment service, is not a critical financial service. We reemphasize that approximately three quarters of financial assets are managed directly by asset owners, not asset managers,[169] which means that questions as to effective operational risk management go beyond the limits of the already-heavily regulated asset management industry. What is more, there is no clear nexus between operational risk at a fund, group of funds, or asset manager and global financial stability, and the Consultative Document presents no evidence of such a link.

We also caution against the imposition of rigid, command-and-control requirements, as well as an overemphasis on specific operational risk areas, such as those singled out by the FSB in the Consultative Document. We believe that effective business continuity planning must evolve alongside risk. Dynamic and flexible business continuity guidance will better support an asset manager's ability to adapt to new market challenges and serve to protect investors. The fact of the matter is that asset managers' business continuity plans are tested regularly and have evolved to address a variety of different and emerging risks.

Finally, we wish to reiterate the fundamental differences between asset managers and banks. The Consultative Document's recommendation, including its focus on "large" and "complex" entities, appears to manifest a bias favoring bank-type risk identification (where, for example, size and risk are directly correlated) and prudential regulation in the area of operational risk management. As we discuss in greater detail below, this type of risk-identification and regulation is inapposite to the asset management industry and unsupported by historical data. Unlike banks, there is no record that asset management firms or investment funds have failed due to operational deficiencies, are reasonably likely to fail due to such

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[167] *See Compliance Programs of Investment Companies and Investment Advisers*, Advisers Act Release 2204 (Dec. 17, 2003), *available at* https://www.sec.gov/rules/final/ia-2204.htm (citing an adviser's obligations to mitigate the operational risks resulting from a natural disaster, death of key personnel, or the adviser ceasing operations).

[168] *See Adviser Business Continuity and Transition Plans*, SEC Rel. No. IA-4439, File No. S7-13-16 ("**SEC Business Continuity and Transition Proposal**") (June 28, 2016), *available at* https://www.sec.gov/rules/proposed/2016/ia-4439.pdf.

[169] *See* discussion in the section titled "FSB Recommendation Relating to System-Wide Stress-Testing" regarding the differences between asset owners and asset managers.

deficiencies, or that such deficiencies are relevant to global financial stability. Accordingly, there is no need for special resolution authority, living wills, or similar bank-type requirements for asset managers or their funds.

A. The Structure of the U.S. Asset Management Industry Mitigates Operational Risks

Although both the FSB and SEC have recognized that operational challenges during stressed conditions have not been a source of systemic risk, regulators continue to advance the misconception that financial stress and market volatility are correlated to or cause operational stress. Back-office support functions at asset management firms, however, are largely insulated from market movements because they do not rely on credit or other market financing to operate. Accordingly, our organization and our members are unaware of any circumstance where operational risk threatened an asset manager's or an investment fund's solvency or any evidence that systemic risk has been implicated by inadequate business continuity plans

In addition to an asset manager's obligation to serve its clients' interests, the basic features of the U.S. asset management industry help to mitigate potential systemic risks that could threaten the global financial system. First, a qualified third-party custodian – not the asset manager – holds client assets. Consequently, a client's decision to terminate one manager and hire another manager does not automatically require an exchange of assets; rather the assets remain with a custodian (typically, a bank or broker-dealer) through the transition process.

Second, the asset management industry is highly competitive and the reallocation of client assets and accounts is merely part of the business.[170] Clients are able to hire different asset managers to invest their assets. In addition, the movement of client accounts among asset managers (a routine occurrence) or back to self-management by clients does not create any systemic risks to the global economy.

Third, fund clients have access to information on the financial outlook of asset managers, which allows them to make informed decisions about the entities managing their assets. For example, Form ADV, Part 2A requires an asset manager to disclose any financial condition reasonably likely to impair its ability to meet contractual commitments to its clients where the asset manager has discretionary authority over client assets, has custody of client funds or securities, or requires or solicits prepayment of more than $1,200 in fees per client.[171] Many clients also are able to terminate asset management agreements with no more than 30 days advance written notice (60 days for registered investment funds). Access to such information drives investment choices and in the event that such information is misaligned with clients' long-term investment goals and risk profile, clients have the means to terminate their contractual

[170] *See* John Gidman stating, "The process of being hired and fired happens thousands of times a day." Letter from AMG and the AII to Jacob J. Lew, Secretary of the U.S. Department of the Treasury ("**AMG and AII Letter to Treasury**"), *available at* http://www.sifma.org/comment-letters/2014/sifma-and-investors-group-submit-letter-to-us-treasury-summarizing-the-fsoc-s-conference-on-asset-management/, at 13; 2016 ICI Fact Book, *supra* note 22, at 16 (finding that in 2015, "873 fund sponsors from around the world competed in the U.S. market to provide investment management services to fund investors.").

[171] Form ADV, Part 2A, *available at* https://www.sec.gov/about/forms/formadv-part2.pdf, at 9.

relationship with an asset manager. Investors are not passive bystanders lacking in information and financial motivation to formulate rational opinions regarding the management of their assets.

Fourth, it is not extraordinary for an asset manager or an investment fund to enter or exit the market.[172] Far from being a "vulnerability," the structure of the asset management industry facilitates such events and transitions without creating global systemic risks. In fact, it is the substitutability of asset managers and investment funds that operates as a unique characteristic of asset management firms, one that differentiates our industry from that of the banking and insurance industries. This is largely attributable to the agency relationship of asset managers managing the assets on behalf of their clients and, as discussed above, the regulatory framework supporting this relationship. As a result, asset managers and investment funds routinely enter and exit the market without creating systemic disruptions. To illustrate, as of year-end 2015, 43 U.S. fund sponsors entered the business and 37 U.S. fund sponsors left the business.[173] Also as of year-end 2015, 594 U.S. mutual funds opened and 462 merged or liquidated.[174] In addition, the SEC acknowledges that it is "aware of instances of non-routine disruptions at large advisory businesses that have resulted in transitions to new advisers or new ownership without appearing to have a significant adverse impact on clients, fund investors, or the financial markets."[175]

Accordingly, while we agree with the need for strong operational risk management policies by asset managers, we are puzzled by the FSB's focus on the "orderly transfer of…clients' accounts and investment mandates in stressed conditions." As clearly demonstrated above, we are not aware of any facts or circumstances to suggest that the transfer of assets or investment mandates is a source of operational risk for asset managers, that there are any legal or regulatory requirements that may obstruct the orderly transfer of client assets or accounts, or that there have been situations involving the transfer of client accounts that have presented any systemic impact.[176] On the contrary, the experience of our members indicates that the orderly

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[172] ICI, *Yes, Funds Come and Go – Without Government Help* ("**ICI: Funds Come and Go**") (Mar. 11, 2016), *available at* https://www.ici.org/viewpoints/view_16_resolution.

[173] 2016 ICI Fact Book, *supra* note 22, at 16.

[174] *Id*., at 19.

[175] *See* SEC Business Continuity and Transition Proposal, *supra* note 168, at 21.

[176] There are rare instances of fund failures, all of which were propelled by unique circumstances and none of which are born from operational risk issues. For example, in the case of LTCM, the issues that drove the hedge fund to failure almost 20 years ago were its highly leveraged portfolio and the lack of transparency in underwriting processes. LTCM's leverage ratio of 30 stands out as a distinct anomaly in today's asset management industry and transparency in underwriting processes has since improved. Importantly, LTCM's resolution was managed in an orderly way and did not result in systemic issues. *See* discussion on LTCM under section III.A. With respect to the 2008 situation involving the Reserve Primary Fund, the losses experienced by the fund were directly related to the unique characteristics of money market funds, including a fixed net asset value and investor demographics. As previously discussed, however, we believe that these issues have been addressed by money market reforms in the U.S. *See* April 2014 AMG Letter to FSB and SEC, *supra* note 3, at 4, 25. Furthermore, in the case of Third Avenue Management, LLC, FCF held a growing percentage of hard-to-trade, relatively illiquid assets, which eventually led management to suspend redemptions and wind-down the fund. Of note, FCF's purchase of more illiquid assets was consistent with its investment objective, strategy, and risk disclosure, such that investors in FCF were aware that the Fund's holdings were relatively less liquid upon purchase. As such, FCF's failure was unrelated to the existence, or lack thereof, of operational risk policies and procedures.

transfer of client accounts and investment mandates, even during stressed conditions, functions extremely well.[177]

B. Operational Risk Management is a Business Imperative

We also stress that asset management firms approach operational risk issues as a business imperative. Our members understand that clients will not do business with firms that fail to recognize and deal with relevant operational issues. If an asset management firm does not protect client data, if it does not put in place robust business continuity plans, or if it is unable to easily transfer client assets without difficulty, the firm's business will be punished by market forces. To put it simply, advisory clients demand that asset management firms will remain operative and that their assets will be safeguarded and easily transferable, even during stressful events.

The asset management industry's focus on operational risk processes is consistent with current regulations and guidance.[178] Many asset management firms have sophisticated investment risk and operational risk departments, as well as policies and procedures to address business continuity planning.[179] Some asset managers have developed enterprise risk management practices that use evaluation and monitoring tools to identify and address potential risks.[180] Asset managers also have access to transition management services, including transition

[177] In 2015, investors placed an estimated $949 billion total net flows in global open-end funds and exchange-traded products, with an estimated $263 billion of such flows received by U.S. funds. *See* Morningstar, 2015 Global Asset Flows Report, *available at* https://corporate1.morningstar.com/ResearchArticle.aspx?documentId=746378, at 2-3. With so many assets flowing through funds on a global scale (and considering that these totals are not gross figures, which are presumably higher), it would be peculiar to suggest that client assets and investment mandates are not easily transferable.

[178] *See, e.g*., Rule 206(4)-7 under the Advisers Act; *see also* Inv. Adv. Act Rel. No. 2204 (outlining requirements relating to investment advisers); Rule 38a-1 under the Investment Company Act; Inv. Co. Act Rel. No. 26299 (requirements relating to registered investment companies); *Comptroller's Handbook on Asset Management Operations and Controls* (Jan. 2011), at 14 (describing outsourcing and vendor oversight, business continuity and contingency planning, and information security requirements for bank-sponsored asset management operations); FINRA Rule 4370 (describing business continuity requirements for FINRA member firms); National Futures Association ("**NFA**") Rule 2-38 (describing similar requirements for NFA member firms).

[179] Rule 206(4)-7 under the Advisers Act requires each investment adviser to adopt and implement written policies and procedures reasonably designed to prevent the adviser from violating the Advisers Act. These policies and procedures should include business continuity plans because an adviser's obligation to its clients includes taking steps to protect the clients' interests from risks resulting from the adviser's inability to provide advisory services after, for example, a natural disaster. *See* the Advisers Act, discussing the need for advisers to establish a reasonable process for responding to emergencies, contingencies, and disasters, and that an adviser's contingency planning process should be appropriately scaled, and reasonable in light of the facts and circumstances surrounding the adviser's business operations and the commitments it has made to its clients. S*ee also SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year*, National Exam Program Risk Alert, Vol. II, Issue 3 (Aug. 27, 2013), *available at* https://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf.; SEC Business Continuity and Transition Proposal, *supra* note 168, at 7, stating "We understand that many investment advisers, like other financial services firms, already have taken critical steps to address and mitigate the risks of business disruptions, regardless of the source, as a prudent business measure."

[180] *See* Committee of Sponsoring Organizations of the Treadway Commission, *Enterprise Risk Management – Integrated Framework, Executive Summary* (Sept. 2004), *available at*

managers that help minimize transaction costs. Custody arrangements facilitate the transfer of accounts and funds between asset managers, providing investors with substantial protection from operational issues. In fact, European regulators acknowledge that the segregation of client assets from adviser assets in custodial accounts in the U.S. offers a substantial safeguard against operational risks inherent in the transfer of assets, and they have taken this into consideration in designing their own recovery and resolution frameworks for non-bank financial institutions following the 2008 financial crisis.[181] Because client assets are custodied and segregated in this way, they are not part of an asset manager's balance sheet and are therefore not subject to liquidation, a potential bankruptcy process, or the asset manager's creditors.

The bottom line is that asset managers have developed and implemented internal tools to manage operational risks not only because it is an aspect of their fiduciary culture, but also as a business imperative. Operational weaknesses translate into real business costs. How a particular asset manager approaches operational risks specific to the transition of client accounts is tailored to that manager's operations, including taking into consideration its size, investment products, and business model.

Notably, even during times of market stress, the asset management industry has leveraged existing operational risk practices to effect the transfers of investment mandates and client accounts without imposing significant burdens on investors or threatening global financial stability.[182] During the peak of the 2008 financial crisis, investors could and did transfer investment mandates and assets. Asset managers also have withstood various weather-related and political events, including the U.S. Northeast blackout of 2003, Hurricane Katrina and Hurricane Sandy, which struck the U.S. in 2005 and 2012, respectively, and, most recently, Brexit.

C. Management of Operational Difficulties Identified in the Consultative Document

The Consultative Document places substantial weight on the operational difficulties presented by the transfer of client accounts in stressed conditions through the following: (i) termination of over-the-counter ("**OTC**") derivatives contracts, (ii) replacement of ancillary services, and (iii) legal and regulatory issues. Although we agree that robust operational risk management policies and procedures help to address operational issues and may curb risk exposure, we are of the view that the Consultative Document's emphasis on these three scenarios is misplaced. As discussed above, there is no evidence to suggest that operational risks in the

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http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf ("[e]nterprise risk management is a process, effected by an entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives" (internal emphasis omitted)).

[181] *See* Kay Swinburne, European Parliament Committee on Economic and Monetary Affairs, *Report on Recovery and Resolution Framework for Non-Bank Institutions* (Oct. 22, 2013), *available at* http://www.europarl.europa.eu/document/activities/cont/201310/20131023ATT73307/20131023ATT73307EN.pdf, at 10.

[182] *See* AMG and AII Letter to Treasury, *supra* note 170, at 13.

asset management industry have negatively impacted financial markets, let alone global financial stability.[183] While the transfer of derivatives contracts from one manager to another may require special instructions or consideration as to the types of derivatives that make up a client's portfolio, this is not a "gap" in operational risk management practices. Similarly, issues relating to the replacement of ancillary services, such as pricing and valuation services or custodial arrangements, or relevant legal and regulatory requirements, do not create an impediment to operations under normal or stressed conditions. On the contrary, each operational "difficulty" identified in the Consultative Document is one that asset managers have considered and planned for in the process of developing their operational risk management practices.

For starters, the Consultative Document states that it is difficult to transition OTC derivatives contracts without a novation. As discussed below, financial markets have developed internal processes to address operational risks in this context. Moreover, regulatory initiatives seek to streamline the clearing process for derivatives transactions, which serve to mitigate risks associated with the transfer of derivatives accounts.

In making a determination as to the difficulties presented by any given client account holding derivatives contracts, asset managers take into consideration the types of derivative instruments held in the account as well as the terms of the derivatives contract. For example, credit default swaps are considered relatively fungible. It is also important to note that the parties to a derivative contract typically include the fund and its counterparty, but not the asset manager. In such cases, the request to transfer a derivatives contract does not require the winding down of derivatives positions – the contract is simply passed on to the new asset manager. In addition, the terms of a derivatives contract as well as other regulatory restrictions may dictate the ability of an asset manager to transfer the contract efficiently and quickly.[184] For example, an asset manager's insolvency or disengagement may trigger immediate termination of the contract. Nonetheless, we acknowledge that the transfer of client assets from one manager to another often involves a novation of derivatives arrangements because it is a common market practice to do so. During times of market stress, however, asset managers would instead choose to consummate a transfer of client assets without the complexities involved in a termination and re-establishment of OTC derivatives positions. The upshot is that the Consultative Document's focus on the transfer of OTC derivatives is overstated because a novation is often the product of convenience and market practice, not a regulatory compliance measure.

Furthermore, global market reforms have established a new regulatory framework for the OTC derivatives market, which requires, among other things, clearing of eligible OTC

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[183] The SEC states, "The 2008 financial crisis demonstrated that providers of financial services are at risk of having to exit the market unexpectedly and having to do so quickly," citing to systemic issues involving various financial services firms, including Countrywide, Bear Stearns, Merrill Lynch, AIG, and Wachovia." We note, however, that this statement is specific to financial services firms that are not asset management firms. *See* SEC Business Continuity and Transition Proposal*, supra* note 168, at 19.

[184] *Id*., at 44-45. Additional complications include regulatory approval for certain acts, the need for cross-border cooperation if the asset manager operates in multiple jurisdictions or situations where the asset manager's clients are domiciled in different jurisdictions.

transactions through central clearing platforms ("**CCPs**").[185] CCPs set standards for initial margin, acceptable collateral, and variation margin.[186] The objective of these extensive reforms is to create a standardized and more transparent derivatives market and respond to what the G20 characterized as a key element of financial system reform in the aftermath of the 2008 financial crisis.[187] For our purposes, and as recognized in the Consultative Document, the central clearing of standardized OTC derivatives should serve to mitigate operational risks involving derivatives contracts.[188]

The Consultative Document further suggests that regulators should have access to aggregated data and information on OTC derivatives positions to better understand the potential impact to the global financial system.[189] As introduced above, the OTC derivatives market is an international work in progress. It has been the subject of extensive regulatory reforms in the U.S. and Europe, which include the establishment of CCPs, guidance as to which OTC derivatives fall within the regulated "swap" umbrella, and reporting of executed swap transactions to swap data repositories ("**SDRs**").[190] SDRs offer real-time public dissemination of swap transaction information as well as confidential use of that information by regulators for purposes of assessing the risks posed to financial markets.[191] As a global regulator responsible for promoting coordination and information exchange among authorities responsible for financial stability, the FSB is in the best position to consider currently available swap transaction information and how or if such information provides additional insight into the relationship between OTC derivatives positions and operational risk as well as any resulting impact on global financial stability.

The Consultative Document also takes issue with operational challenges in replacing ancillary services, such as pricing and valuation services and custodial services. Typically, most

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[185] *See* Dodd-Frank Act, Title VII. *See also Bank of England, Over-the-counter (OTC) derivatives, central clearing and financial stability* (Q3 2015) ("**Bank of England: OTC Derivatives**"), *available at* http://www.bankofengland.co.uk/publications/Documents/quarterlybulletin/2015/q306.pdf.

[186] In the U.S., the Dodd-Frank Act has charged two regulatory agencies, the Commodity Futures Trading Commission and the SEC, with implementation of central clearing reforms, with each agency handling clearing for different types of derivative instruments. The CFTC has implemented its central clearing reforms, and the SEC is in the process of implementing these reforms. *See* BlackRock ViewPoints, *Start the Countdown – Implementation of Swaps Clearing in the US* ("**BlackRock: Implementation of Swaps Clearing**") (Sept. 2012), *available at* http://www.blackrock.com/corporate/en-cn/literature/whitepaper/implementation-of-swaps-clearing-in-the-us.pdf.

[187] Dietrich Domanski, Leonardo Gambacorta, and Cristina Picillo, "Central clearing: trends and current issues," *Bank for International Settlements* (Dec. 6, 2015), *available at* http://www.bis.org/publ/qtrpdf/r_qt1512g.htm.

[188] Consultative Document, at 29. Ironically, while the purpose of these platforms is to increase transparency and better manage counterparty risk, the concentration of risk within CCPs poses a new risk to global financial stability. High barriers to entry have resulted in the concentration of clearing activity among a small number of CCPs, making these CCPs systemically important. Global regulators, including the FSB, are aware of these issues and are working closely with national regulators to address these new challenges. *See* Bank of England: OTC Derivatives, *supra* note 185.

[189] Consultative Document, at 32.

[190] *See* BlackRock: Implementation of Swaps Clearing, *supra* note 186.

[191] *See* CFTC, *Q&A – Final Rulemaking: Part 43 (Real-Time Public Reporting)*, *available at* http://www.cftc.gov/idc/groups/public/@newsroom/documents/file/rtpr_qa_final.pdf.

of the transfer work related to the movement of client assets and client accounts is effected by a custodian. While the movement of client accounts requires careful planning and preparation, Excel spreadsheets are often all that may be necessary to share asset lists and project plans among asset managers, clients, and custodians. These transfers, though not always easy, are part of daily operations. Similarly, situations involving the transfer of ancillary services are simply a part of day-to-day operations, albeit an important aspect of any asset management firm's operational challenges. We caution that increased regulatory initiatives and requirements in this area may result in unintended consequences, such as concentration of such services among fewer financial institutions and third-party service providers.

In addition, it is abundantly clear that the asset management industry is not overly reliant on any one "large" or "complex" asset management firm.[192] On the contrary, as discussed above, investment funds and asset managers routinely exit the business without any impact on global financial stability. In fact, 25 percent of the 20 largest mutual funds in 2004 were no longer among the 20 largest mutual funds 10 years later.[193]

Noticeably, the focus on ancillary services fails to reflect the practical reality that an asset manager does not always choose the service provider that performs essential services for client accounts. For example, it is not unusual for clients to select their own custodian, meaning that the client has conducted its own due diligence of the service provider and separately negotiated the terms of its custodial arrangement with that service provider. In this case, an asset manager is not in a position to direct how a custodian will prepare for and respond to the need to quickly transition large scale services. In its Consultative Document, the FSB fails to account for this dynamic or consider whether to direct its attention to those entities that provide essential services (as opposed to the users of those services).

The Consultative Document also provides that there are legal and regulatory difficulties associated with transferring client accounts, which may include registration, account openings at non-U.S.-based depositories, reporting to investors, authorization by the relevant authority, reconciling valuations, and capturing outstanding receivables. With respect to registered investment funds, the board and shareholders of the investment fund must approve any advisory contract with any new asset manager and any assignment of such contract would require shareholder consent, which would presumably be denied if the new asset manager were unqualified or unable to provide services. With regard to risks posed by client accounts or assets domiciled in non-U.S. jurisdictions, we note that most large custodians have global operations, which help manage such transfers. Inevitably, interactions with certain non-U.S. entities or service providers will cause delays as records and instructions are verified and additional operational requirements are met. Nevertheless, the challenges presented by legal and regulatory

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[192] *See* ICI: *Funds Come and Go*, *supra* note 172.

[193] Letter from Fidelity Management & Research Company to FSB (May 27, 2015), *available at* http://www.fsb.org/wp-content/uploads/Fidelity-Management-and-Research-Company.pdf, at Exhibit 5. *See also* Taylor Tepper, *Mutual Funds Gone Down the Drain,* Money Magazine (Mar. 7, 2014), *available at* http://time.com/money/2795219/mutual-funds-gone-down-the-drain/ (citing to a Morningstar study that found that four in ten U.S. mutual funds operating ten years ago closed before 2014).

hurdles do not raise significant issues; they are part of everyday operations and interactions among asset managers, fund clients, and service providers.

Furthermore, with respect to the supposed operational challenges presented in replacing ancillary services as well as the discussion on legal and regulatory difficulties involved in the transfer of client accounts, we believe there is a misapprehension as to who is making the ultimate decision as to the care and custody of client assets. It warrants repetition to say that asset managers operate as agents for their clients, with clients choosing the asset manager for their particular investments.[194] The Consultative Document therefore begs the question: why would a client choose to invest with an unqualified asset manager, enter into a transaction where qualified managers and service providers have yet to be identified, or invest in a jurisdiction where the new manager is not familiar with local requirements? We consider the scenarios outlined in the Consultative Document to be unrealistic and uncharacteristic of the practical realities of the asset management business.

D. Reframing the Operational Risk Recommendation

We also wish to emphasize that the FSB's recommendation uses undefined terms that may cause unnecessary confusion. The recommendation targets asset managers that are "large, complex, and/or provide critical services" but also requests comment on whether the potential scope of application is appropriate.[195] The Consultative Document provides that local authorities should define what it means to be "large" and "complex," suggesting that assets under management and aggregate OTC derivate transactions relative to global totals are appropriate and relevant points of reference.[196] We believe these terms are vague, unsupported by any material evidence, and a vestige of terms that are more appropriate in the banking context. While a large amount of assets under management may be indicative of many underlying client accounts, each account has its own characteristics, objectives, and risk profiles, and it would be imprudent to assume that a firm with smaller assets under management is not susceptible to operational risks to the same or equal extent as a firm with significantly more assets under management. To illustrate, aggregate OTC derivatives transactions for a "larger" firm may be comparable to those of a "smaller" firm, meaning that the size of the firm based on assets under management is not the best indicator of a particular firm's notional or mark-to-market exposure created by the derivatives in its portfolios. The focus on aggregate OTC derivatives transactions is also a red herring because it does not take into account any offsetting transactions that a firm has engaged in to balance its derivatives risk exposure. Each asset management firm should consider its operations within the context of the risks and challenges posed by those operations and then use that assessment to design or enhance business continuity practices and policies commensurate with its findings. Assets under management constitute only one of many other characteristics – such as the nature and complexity of the asset manager's business model, its clients, investment products, and key personnel – that may serve to inform an asset manager's operational risk program.

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[194] *See* BlackRock Asset Owners Paper, *supra* note 14, at 2 (clarifying the role of asset owners and asset managers in financial markets).

[195] Consultative Document, at 31-32.

[196] *Id.*, at 31.

We note that the reference to "transition plan" is reminiscent of the living will requirement imposed on banking entities. While the focus of the Consultative Document is on the *transfer* of client assets and client mandates, use of the phrase "transition plan" in the context of "business continuity" suggests that the FSB is alluding to a wind-down plan for asset managers. Again, we reiterate that the asset management industry is fundamentally different from the banking industry. Asset managers do not "fail" in a manner that requires regulatory intervention because, unlike banks, asset managers have an agency relationship with their clients, meaning that they do not take proprietary positions or absorb investor losses. Further to this point, asset managers and their clients do not benefit from deposit guarantees and do not have access to central bank liquidity, such that the mutual fund framework mitigates risk to the financial markets. Suggesting living wills or similar requirements for asset management firms is simply inappropriate and unsupported by any available data.[197]

E. Stress Testing as an Operational Risk Management Tool

We wish to reiterate our strong concerns about stress testing at both the individual fund level and system-wide (to the extent that the FSB considers it to be a potential operational risk management tool). As noted elsewhere in this letter,[198] we believe that stress testing of asset managers or their funds is generally inappropriate, unnecessary, and unsupported by any compelling evidence of the need for or benefits of the practice. Stress testing is an established tool for banks, where an assessment of capital adequacy is made under various scenarios. But the basic characteristics of the asset management industry are not comparable to banks. Depositors of a bank are different than investors of an asset management firm or fund. Stress testing a mutual fund or asset management firm would be an expensive and unsuitable exercise that is unjustified by any historical study or data. Also, as discussed above, the concept of system-wide stress testing is conceptually flawed and we have serious concerns about the feasibility of designing a stress testing framework that would produce useful results from which to make any reliable determinations as to global financial stability.

F. The SEC's Business Continuity and Transition Proposal

Finally, we wish to remind the FSB of the SEC's pending regulatory proposal that would require every SEC-registered asset manager to adopt and implement written "business continuity and transition plans" that expressly address detailed elements related to material service disruptions and business transitions.[199] We encourage the FSB to examine the SEC's proposal, as well as industry comments submitted in response to the proposal, and consult with other regulators to gather relevant information on operational risk management practices.

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[197] See Letter from AMG to SEC (Sept. 2, 2016) ("**AMG Business Continuity Letter to SEC**"), *available at* https://www.sec.gov/comments/s7-13-16/s71316-11.pdf, at 6 (making similar arguments against living wills in the context of the SEC's Business Continuity and Transition Proposal, which, as is the case in the Consultative Document, refers to "transition plan" without clarifying that it is not proposing living will requirements akin to those imposed on banking entities).

[198] *See* discussion of Recommendations 6 and 9.

[199] *See* SEC Business Continuity and Transition Proposal*, supra* note 168, at 41. *See also* discussion under the subsection titled "Reframing the Operational Risk Recommendation" with respect to "transition plans" and our opposition to such plans where they impose requirements similar to the living will requirements imposed on banks.

While the FSB's operational risk recommendation is narrowly focused on challenges that arise from the transfer of investment mandates and client accounts, the scope of the SEC's Business Continuity and Transition Proposal is much broader, addressing a wide range of operational risks, from technology failures to natural disasters to cybersecurity attacks. The proposal would require policies and procedures reasonably designed to minimize material service disruptions after a significant business disruption and in the event that the asset manager's business is wound-down or transitioned.[200] While we agree with the FSB and SEC that an asset manager's robust operational risk management practices can serve to identify and address operational risks, we also are of the view that the SEC's Business Continuity and Transition Proposal and the FSB's operational risk recommendation both fail to recognize that the success of a business continuity plan lies not in detailed, step-by-step instructions about how to respond to unknown future market events, but rather, in a flexible and principles-based approach to operational risk management. Inelastic requirements run the risk of quickly becoming stale or obsolete whereas a dynamic business continuity program designed to provide an evolving roadmap for relevant considerations during times of market stress will allow asset managers to make decisions that will be in the best interests of their clients, their business, and their employees.

We reiterate our support for strong and effective operational risk management policies and procedures for asset management firms. We welcome the opportunity to further discuss with the FSB how asset managers address operational issues, including those highlighted in the Consultative Document's recommendation. We look forward to continuing a dialogue with the FSB and regulators around the globe to ensure that operational risk management remains a key focus for asset management firms as they seek to address the expanding and emerging risks confronting the industry.

VI. FSB Recommendation Relating to Securities Lending Activities

Recommendation 14: *Authorities should monitor indemnifications provided by agent lenders/asset managers to clients in relation to their securities lending activities. Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.*

The final recommendation included in the Consultative Document calls for regulatory authorities to take steps to monitor the risks associated with indemnifications provided by asset managers to their clients in connection with securities lending activities. This recommendation is intended to address a perceived gap in existing and proposed regulations applicable to securities based financing activities.[201]

[200] *See* SEC Business Continuity and Transition Proposal, *supra* note 168, at 26.

[201] Consultative Document, at 34.

While we generally approve of reasonable disclosure requirements,[202] *and we encourage regulators to analyze and understand the securities lending market generally, we believe that further regulatory action of the type suggested in this recommendation is unlikely to be useful. Only a small handful of asset managers provide indemnifications under securities lending arrangements. Securities lending transactions are generally overcollateralized, greatly reducing the likelihood of lending agents facing significant (or any) losses as a result of indemnification obligations. Securities lending market participants take numerous precautions to limit the risk of default and available evidence suggests that securities lending has not given rise to meaningful financial disruption historically. Moreover, securities lending is already subject to significant regulations and, as the FSB acknowledges, numerous additional regulations are already in the process of being implemented.*[203] *Losses associated with asset managers' indemnification obligations are also limited to asset manager entities themselves, which generally do not have other financial entanglements (unlike banks or other financial institutions) that would be likely to lead to systemic disruption. In short, we believe that securities lending indemnifications by asset managers do not constitute a source of systemic risk. We encourage the FSB to review currently available information carefully to better assess the materiality of the risks associated with securities lending indemnifications prior to advocating recurring reporting requirements or any other new regulations in this area.*

A. No Evidence of Risk

We reiterate that regulatory actions should be based on evidence. The FSB's recommendation is not grounded on evidence that securities lending, or associated lending agent indemnifications, constitute a material risk. Available evidence suggests that securities lending is generally carried out responsibly and does not contribute to financial instability. In recent years, only a limited number of securities borrowers have encountered difficulties fulfilling their obligations under securities loans. [204] We are aware of no default under a securities lending arrangement that has contributed to anything approaching a systemic disruption. Academic surveys of securities lending practices in stressed circumstances have identified no appreciable effect on returns, volatility, skewness, or bid-ask spreads.[205] AMG also recently conducted a survey of asset managers that showed, among other things, that (i) substantially all funds that engage in securities lending give lending agents instructions imposing restrictions on how collateral may be invested, (ii) most funds permit collateral to be invested only in money market funds, and (iii) most funds set guidelines for collateral investment related to maturity or similar

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[202] *See* Letter from AMG to FINRA (Mar. 8, 2010) (the "**March 2010 AMG Letter to FINRA**"), *available at* http://www.finra.org/industry/notices/10-03/sifma ("SIFMA firms support further disclosure of potential risks to investors….").

[203] Consultative Document, at 33.

[204] *See Securities Lending: Balancing Risks and Rewards*, BlackRock (May 2012) ("**BlackRock Securities Lending**"), *available at* http://www.blackrock.com/corporate/en-br/literature/whitepaper/balancing-risks-and-rewards-may-2012.pdf.

[205] March 2015 AMG IAA Letter to FSOC, *supra* note 6. *See, e.g*., Steven Kaplan, Tobias Moskowitz, and Berk Sensoy, *The Effects of Stock Lending on Security Prices: An Experiment* (Aug. 2012), *available at* http://www.nber.org/papers/w16335.pdf.

terms.[206] The OFR also recently released the results of a survey that suggested, among other things, that investors engage in securities lending to only a moderate degree. For example, only 10% of equity securities that are eligible for lending are actually lent out.[207] All of these findings support the conclusion that securities lending, in general, is unlikely to give rise to systemic risk and does not necessitate significant additional regulatory monitoring.

There is also no evidence to suggest that the FSB's specific recommendation on securities lending indemnifications is warranted. The FSB acknowledges that only a small handful of asset managers provide agency services related to securities lending.[208] We are aware of no evidence that asset management entities take undue risk with their own balance sheets. Accordingly, regulators should not presume that banking-style securities lending regulations, such regulatory monitoring of indemnifications by agents, are necessary.

B. Securities Lending Indemnifications and Systemic Risk

We acknowledge and appreciate that the recommendation on securities lending is relatively narrow in scope. The FSB is suggesting that regulators "monitor indemnifications provided by agent lenders/asset managers" in securities lending transactions and "verify and confirm" that asset managers are able to cover their obligations. Nonetheless, we respectfully submit that indemnifications of this type do not represent systemic risks given the limited nature of the potential liability. Accordingly, we believe the FSB should forego recommending any measures that would impose further reporting or other burdens on asset managers in relation to securities lending indemnifications absent new evidence that such indemnifications do in fact constitute a material source of systemic risk.

We also note that the securities lending recommendation appears to be based on an inappropriate conflation of banking and asset management considerations. Under Basel III, banks that provide indemnification under securities lending agency arrangements are subject to capital and reserve requirements with respect to indemnification obligations.[209] However, as we have stressed repeatedly in this letter, critical differences exist between the asset management and banking industries. Regulatory capital requirements have been established for banks for a number of reasons, none of which applies to asset managers. Banks hold assets for depositors of many different types, who rely on preservation of their bank deposits' value and are understood to accept only minimal risk of loss. In the U.S., banks borrow at the discount window and bank deposits are also FDIC insured, meaning bank failures have implications for taxpayer welfare and government financial stability. Asset managers, meanwhile, do not hold assets for anyone, but rather provide investment management services, in exchange for fees, to funds and accounts that are themselves owned by investors seeking exposure to certain assets. There is no evidence that asset management entities themselves are subject to instability as a result of their own assets

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[206] March 2015 AMG IAA Letter to FSOC, *supra* note 6, at Appendix B.

[207] *A Pilot Survey of Agent Lending Securities Activity*, Office of Financial Research (Aug. 23, 2016), at 8, *available at* https://financialresearch.gov/working-papers/files/OFRwp-2016-08_Pilot-Survey-of-Securities-Lending.pdf.

[208] Consultative Document, at 33.

[209] Consultative Document, at 34.

and liabilities. There is no reason to believe that securities lending indemnifications constitute a special threat to asset managers, which are (rightly) not subject to any other special restriction related to capitalization. We do not accept the argument that regulators should scrutinize the terms of asset managers' securities lending arrangements simply on the ground that such arrangements are considered a source of risk in the banking industry.

We further note that clients of securities lending agents perform due diligence on the lending agent's risk management practices (regardless of the lending agent's affiliation with banks or asset managers) before choosing to engage the lending agent. When borrower default indemnification is required by the client, clients have the opportunity to assess the ability of the lending agent to meet its indemnification obligations. If the lending agent does not satisfy a client's inquiry that it has sufficient financial resources to cover potential indemnification liabilities, it is unlikely that the client will engage the lending agent. Lastly, to our knowledge asset managers that act as lending agents only act as lending agents for assets where they are the asset manager, which calls into question the regulatory arbitrage theory raised in the Consultative Document.

There are a number of additional factors that weigh against the treatment of securities lending indemnifications as sources of risk, either for individual asset managers or for the asset management industry generally. Only a small handful of asset managers act as securities lending agents. Securities lending agents do not always provide indemnification to lenders, and, when they do, indemnification does not necessarily extend to every position in a portfolio. Perhaps more importantly, securities loans are almost always collateralized. Customarily (and in some cases pursuant to regulatory requirements),[210] securities loans are supported by collateral whose value equals or exceeds that of the associated loan. Under most arrangements, collateral values are tested daily and must be a minimum of 102% to 105% of the value of the securities loaned.[211] Cash provided as collateral is usually invested in money market or similar low-risk, liquid securities.[212] Since the 2008 financial crisis, securities lending agents have been inclined to invest collateral more conservatively, focusing increasingly on government money market securities. The presence of collateral significantly limits the extent of the harm that can be caused by the failure of a borrower. An indemnitor under a securities lending arrangement faces loss only when (i) a borrower of securities defaults and (ii) the collateral underlying the loan is worth less than the loaned securities. The likelihood of these conditions occurring simultaneously is low. Even when an indemnity obligation is triggered, an indemnitor's loss is limited to the difference between the value of the loan and the collateral.[213]

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[210] *See, e.g.*, *State Street Bank and Trust Company*, SEC No-Action Letter (Jan. 29, 1972); *see, e.g.*, *Nuveen Investment Funds*, SEC No-Action Letter (Feb. 14, 2014). *See generally "Securities Lending by U.S. Open-End and Closed-End Investment Companies"* (last modified Feb. 27, 2014), *available at* https://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm.

[211] March 2015 AMG IAA Letter to FSOC, *supra* note 6, at 21.

[212] *Id*.

[213] *Id*., at 22.

We note, further, that in a securities lending arrangement, the value of a loaned security is most likely to exceed that of the collateral (potentially resulting in loss in the event of a default by a borrower) when the loaned security has increased in value. This circumstance is most likely to occur when financial markets perform well. Therefore, asset managers' indemnification obligations most likely could be triggered in circumstances where asset managers are relatively well-situated to absorb losses on individual transactions. For this reason, along with those previously described, we believe securities lending indemnifications by asset managers that act as agent lenders on behalf of accounts they manage do not represent systemic risks warranting action by the FSB.

C. Securities Lending and Risk-Mitigating Market Practices

Certain features of the securities lending market that are not directly related to indemnification tend to decrease the risks of securities loans. For example, the parties involved in securities loans, including the lender, the borrower, and the agent, tend to be large institutions with sophisticated risk controls.[214] Moreover, lenders customarily obtain certifications from agents and borrowers providing assurance of those parties' financial stability and compliance with applicable legal rules.[215] Securities lending arrangements also tend to include various contractual safeguards. Lenders and agents frequently agree in advance on how collateral may be invested or on which parties may be permitted to borrow. By default, most securities accounts do not permit rehypothecation, meaning securities lending does not usually occur outside of negotiated lender-agent relationships. Regardless of the presence or absence of indemnification, such measures reduce the risk of loss arising from securities lending arrangements.

Funds are diversified investment vehicles that invest in a wide array of securities issued by wide array of companies. This diversification tends to avert systemic risk. If one fund encounters distress as a result of its securities lending activities, this does not necessarily mean that other funds will have the same issue. By extension, the risks that individual asset managers take through their indemnification obligations are not necessarily correlated with one another, and should not give rise to systemic instability.

D. Benefits of Securities Lending

We encourage the FSB to consider the many beneficial effects of securities lending prior to advocating any measures that might lead to further restrictions on the practice. Securities lending provides income to lenders while increasing liquidity and price efficiency elsewhere in the marketplace. As cited in a number of academic studies, broker-dealers borrow securities to facilitate timely trade settlement.[216] This feature of securities lending is particularly beneficial, as settlement failures in stressed market conditions could contribute to systemic market disruptions.

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[214] *Id*.

[215] *Id*.

[216] *See* Pedro A. C. Saffi and Kari Sigurdsson, *Price Efficiency and Short Selling* (Aug. 30, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=949027. For related discussion, see the March 2010 AMG Letter to FINRA, *supra* note 202, at 2.

Securities lending is believed to have mitigated certain market stresses at the start of the financial crisis in 2007.[217] Securities lending also has financial benefits for active investment managers. A fund may generate extra income by lending out securities that it expects to have in its portfolio for a long period of time. The availability of securities lending markets may make long-term investment strategies more attractive and practical for some fund managers. Securities lending markets also permit borrowers to take speculative positions with respect to securities they believe will decline in value. Though believed by some to increase market volatility, we believe short-selling in fact tends to have the opposite effect.[218] Short-sale positions tend to have countercyclical performance and can insulate funds from market downturns. Short-selling also tends to move securities prices in the direction of their intrinsic value, enhancing the pricing efficiency. As the Consultative Document itself acknowledges,[219] securities lending has the effect of facilitating price discovery and enhancing market liquidity. We believe that securities lending is a useful and fundamentally desirable financial tool. Regulators should therefore exercise caution in imposing regulations (including any obstacles to the provision of indemnification to securities lenders) that would tend to make securities lending more difficult or impractical.

E. Existing and Pending Regulations

We believe it would be premature for financial regulators to consider developing new rules related to securities lending indemnification, or to otherwise impose new regulations in this area, in light of the already rapidly changing international regulatory landscape for securities lending. As discussed in the Consultative Document,[220] the FSB itself has made headway in effecting the implementation of securities lending reforms in a number of jurisdictions. Specifically, the FSB has developed a monitoring framework designed to identify systemic risks arising from certain banking-like functions, including securities lending, performed by nonbank financial institutions.[221] The FSB also has developed a framework of regulations for securities based financing, including rules for haircuts, that FSB members are implementing.[222] The European Union has already addressed certain of the FSB's regulatory priorities through newly implemented rules requiring increased disclosure and data reporting related to securities-based

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[217] *See* BlackRock Securities Lending, *supra* note 202.

[218] Olesya Lobanova, Arun J. Prakash and Shahid Hamit, *The Impact of Short-Sale Restrictions on Volatility, Liquidity, and Market Efficiency: The Evidence from the Short-Sale Ban in the U.S*., SSRN Electronic Journal (Mar. 2010), *available at* https://www.researchgate.net/publication/228258877_The_Impact_of_Short-Sale_Restrictions_on_Volatility_Liquidity_and_Market_Efficiency_The_Evidence_from_the_Short-Sale_Ban_in_the_US.

[219] Consultative Document, at 33.

[220] *Id*., at 33-34.

[221] *Transforming Shadow Banking into Resilient Market-based Finance: An Overview of Progress*, Financial Stability Board (Nov. 12, 2015), at 3-5, *available at* http://www.fsb.org/2015/11/transforming-shadow-banking-into-resilient-market-based-finance-an-overview-of-progress/.

[222] *Id*., at 9-10.

financing transactions.[223] Post-financial crisis regulations affecting banks' and broker-dealers' ability to take risk, including, for example, increased capital requirements for swaps market participants, should likewise have an effect on the securities lending market, as banks and broker-dealers are major borrowers of securities. The FSB itself acknowledges that "regulatory tools and risk management practices seem to be in place for funds that engage in securities lending as beneficial owners and for asset managers acting as agent lenders."[224] This consideration, coupled with the extensive regulatory measures that are in place or under development, strongly weighs against the need for further regulatory actions related to securities lending. We believe that the FSB should wait until pending regulations have been fully implemented and assessed prior to issuing any recommendations on securities lending.

Securities lending markets are already subject to extensive regulation aimed limiting the risk associated with lending activities, further reducing the likelihood that securities lending indemnifications would trigger losses that could lead to systemic instability. SEC-registered funds are subject to stringent securities lending rules that have evolved over a number of years.[225] Under these requirements, mutual funds must receive cash collateral for securities they have loaned, must test the collateral against the loan on a daily basis, and must retain rights to receive dividends and exercise voting powers with respect to loaned securities. The vehicles that securities lending agents use to manage collateral have also come under increasingly stringent regulations. Following the 2008 financial crisis, significant reforms were implemented for the purpose of limiting risks associated cash management vehicles. In particular, the SEC adopted amendments to Rule 2a-7 under the Investment Company Act that are intended to mitigate risks associated with redemptions from money market funds under stressed conditions.[226] The U.S. Office of the Comptroller of the Currency also has adopted rules designed to, among other things, enhance the diversification and quality of certain non-money market short-term investment funds typically used for cash management.[227] While not directly applicable to securities lending, these cash vehicle reforms may have the effect of limiting the risks associated with securities lending generally, since collateral provided for loaned securities is typically invested in cash equivalents.

F. Securities Lending Conclusion

The FSB's securities lending recommendation relates to a practice—the provision of indemnification by asset manager lending agents—that is triggered in a narrow, specific set of circumstances where a borrower defaults *and* the borrowed security exceeds the value of the

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[223] *Regulation (EU) 2015/2365 of the European Parliament and of the Council of 25 November 2015*, OFFICIAL JOURNAL OF THE EUROPEAN UNION, available at http://eur-lex.europa.eu/legal-content/EN/TXT/HTML/?uri=CELEX:32015R2365&from=en.

[224] Consultative Document, at 33.

[225] *Supra* note 201.

[226] *See* Money Market Fund Reform Release, *supra* note 93.

[227] OCC Bulletin 2012-31, Subject: *Short-Term Investment Funds* (Oct. 10, 2012), *available at* http://www.occ.treas.gov/news-issuances/bulletins/2012/bulletin-2012-31.html (rule release establishing various rules intended to enhance portfolio quality of short-term investment funds).

collateral posted in relation to that loan. Historically, there have been an extremely limited number of borrower defaults and none of these defaults have resulted in material financial distress of agent lenders offering securities lending indemnification, given overcollateralization and other risk management practices associated with securities lending. Additionally, numerous existing and proposed regulatory measures as well as risk management practices mitigate risks associated with securities lending. At any rate, given the limited nature of potential risks associated with borrower default indemnification, this issue does not rise to the level of systemic risk. In light of these considerations, we recommend that the FSB forego issuing specific recommendations until such time as more information demonstrates a clear need for action at the global level to safeguard financial stability. We stand ready to provide information to the FSB and other policymakers in an effort to analyze and understand securities lending activities.

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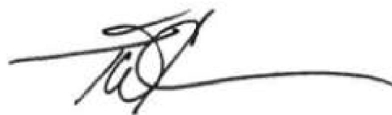
In closing, we wish to express our sincere appreciation to the FSB for inviting us to participate in the recent roundtable in London relating to asset management issues. AMG staff, as well as a number of AMG member firms, were able to attend the roundtable. We believe the discussion was very productive. We would be pleased to participate in similar events in the future as they allow for an exchange of views and ideas, promote a more fulsome understanding and appreciation of the perspectives of regulators and the asset management industry, and help to form the basis for future action.

The AMG sincerely appreciates the opportunity to comment and your consideration of these views. We stand ready to provide any additional information or assistance that the FSB might find useful. Please do not hesitate to contact either Timothy Cameron at 202-962-7447 or tcameron@sifma.org or Lindsey Keljo at 202-962-7312 or lkeljo@sifma.org with any questions.

Sincerely,



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