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

Submitted via e-mail to: fsb@bis.org

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

Fidelity Management & Research Company[1] ("Fidelity") appreciates the opportunity to comment on the Consultative Document "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (the "Proposal"), published by the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO") on January 8, 2014.[2]

We applaud the FSB and IOSCO for recognizing many of the key attributes of investment funds and their managers. They correctly observe that the risk profile of an investment fund is distinct from that of its manager and from other funds because assets belong to the fund, not the manager.[3] They also recognize that investors own those assets and easily move them from one fund to another.[4] These and other attributes make funds and their managers fundamentally different from other entities that the FSB has designated "SIFIs," such as banks.[5]

Perhaps most importantly, in contrast to banks, investment funds are not financed primarily with debt. Most funds employ little or no leverage and are essentially 100% equity capital. Such funds cannot become insolvent and thereby disrupt the financial system by transmitting losses to their creditors. Instead, unlike banks, the substantial equity capital absorbs any declines in the value of the fund's portfolio of assets.[6]

Regulators are extremely unlikely to find an investment fund that meets the criteria necessary to be a SIFI. Further, even if a fund could present that kind of risk to the global financial system, designating that fund would not effectively mitigate that risk. Therefore, we applaud the FSB and IOSCO for asking whether a focus on activities may be superior to entity-by-entity SIFI designation. While this would be a fundamental change from the approach for assessing risk in banks and insurers, we believe the

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[1] Fidelity and its affiliates are leading providers of mutual fund management and distribution, securities brokerage, and retirement recordkeeping services, among other businesses.
[2] FSB and IOSCO, "Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies," Jan. 8, 2014 [hereinafter *Proposal*].
[3] *Id.* at 30 (explaining that "other considerations further distinguish the risk profile of a fund from that of a fund manager").
[4] *Id.*
[5] *See*, *e.g.*, *id.* at 3, 29.
[6] *Id*. at 29.

substantial differences between those businesses and asset management require a different approach. We urge the FSB and IOSCO to refocus their efforts on identifying activities that could create systemic risk and publish a new methodology for comment.

If, however, they proceed with the methodology as currently envisioned, we urge them to consider that:

- The SIFI assessment process must be designed to identify only those entities (i) that can fail and (ii) whose failure would disrupt the global financial system.
- Funds without leverage or significant fixed obligations cannot fail.
- If the FSB and IOSCO are determined to produce a factor-based framework, the framework should be designed to account for the following:
    - Analysis of investment funds is more appropriate than focusing on asset managers or groups of entities, such as funds and their managers or families of funds;
    - The $100 billion threshold for size is arbitrary and will produce both false positives and false negatives;
    - Size alone is not indicative of potential systemic risk;
    - Leverage should be a materiality threshold and separate impact factor rather than merely an indicator of interconnectedness; and
    - Existing regulatory scrutiny should be considered expressly within the framework.
- Designation of a small subset of investment funds will be ineffective in mitigating any systemic risk, given the high level of substitutability and competition in the industry.
- Focus should shift from individual entities to activities conducted by funds and other market participants; and any identified risks should be addressed by targeted regulations that apply broadly to anyone engaged in a given activity.

Fidelity continues to believe that investment funds and their managers do not present the types and the scale of risk that SIFI designation was intended to address. We further believe that the proposed methodology to identify investment funds as potential non-bank non-insurance ("NBNI") SIFIs is flawed and should be abandoned in favor of an approach focused on activities rather than entities. In Part One of this letter, we provide a narrative discussion of our positions. In Part Two, we respond directly to selected questions in the Proposal.

<u>Part One</u>

Before answering selected questions individually, we provide supporting detail on the points outlined above.

Funds do not present the necessary indicators of systemic importance

The FSB defines a "SIFI" as an individual company that has a certain combination of characteristics, such as size, market importance (measured by substitutability), and interconnectedness, such that its failure would disrupt the global financial system and adversely impact the global economy.[7] For purposes of the SIFI designation analysis and this letter, 'failure' equals financial losses that lead (or could lead) to insolvency. A company is insolvent when its liabilities exceed its assets or it is unable to meet its obligations when due. Policy measures endorsed by the FSB and the G-20 leaders, such as the "FSB SIFI Framework"[8] that underlies all SIFI assessment methodologies, are based upon this concept of failure. The stated objective of the FSB SIFI Framework is to "address the systemic risks and the associated moral hazard problem for institutions that are seen by markets as TBTF," i.e., too big to fail.[9]

Thus, in order for a company to be a SIFI, two conditions must be present: (i) it must be able to fail *and* (ii) its failure must significantly disrupt the global financial system and global economic activity. (Henceforth, the phrase "Systemically Important" means that both conditions are present.)

The Proposal accurately describes many of the key functions and attributes of investment funds and their managers, but it fails to acknowledge that most funds have little or no leverage. Without excessive leverage or fixed obligations that represent a substantial portion of its assets (as in the case of a pension fund, for example), an investment fund simply cannot fail and thus cannot be a SIFI. Unleveraged funds are 100% equity capital, which means that the capital absorbs any declines in the value of the fund's portfolio of assets.

Even if a particular fund could fail, such fund would be unlikely to disrupt the global financial system. As the Proposal recognizes, investment funds are highly substitutable and, thus, if a fund were to fail, it would not disrupt financial markets by depriving clients of essential or irreplaceable services. In fact, the Proposal recognizes that funds open and close regularly with "negligible or no market impact."[10] Further, in the absence of excessive leverage, one fund's distress will have minimal impact on others in the financial system. The largest individual investment funds use little or no leverage and are too small to be relevant to the global financial system. In fact, they are a small fraction of the size of G-SIFI banks ("G-SIBs"). At year-end 2013, the largest U.S. mutual fund had $307 billion in assets and the tenth largest had $114 billion.[11] By comparison, as of September 30, 2013, the largest G-SIB had $3.1 *trillion* and the tenth largest had almost $2.3 *trillion*.[12]

SIFI designation would be ineffective

Even if a fund were to pose a risk to the global financial system, SIFI designation would not be an effective regulatory response. Although the Proposal does not specify the regulations that would apply if a fund were designated, by its nature SIFI designation would result in different treatment of individual investment funds. It would subject those designated funds to added costs, restrictions, uncertainty and

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[7] *Id.* at 2
[8] FSB, "Reducing the Moral Hazard Posed by Systemically Important Financial Institutions: FSB Recommendations and Time Lines," Oct. 20, 2010, *available at* http://www.financialstabilityboard.org/publications/r_101111a.pdf.
[9] FSB, "Progress and Next Steps Toward Ending 'Too-Big-To-Fail': Report of the Financial Stability Board to the G-20," Sept. 2, 2013, at 7, *available at* https://www.financialstabilityboard.org/publications/r_130902.pdf (discussing the objectives of the FSB SIFI Framework).
[10] *Proposal*, *supra* note 2, at 30.
[11] Strategic Insight Simfund/MF Desktop.
[12] Maria Tor and Saad Sarfraz, "Largest 100 Banks in the World," SNL (Dec. 23, 2013), http://www.snl.com/InteractiveX/article.aspx?cdid=A-26316576-11566&TabStates=0.

other regulatory burdens that most or all of their competitors would not face, which in turn would lead capital to shift away from the designated funds to less regulated entities.

Fund investors are highly sensitive to fees and performance. If a fund were designated a SIFI, its ability to pursue its investment strategy effectively and at competitive fee levels would be diminished. As a result, investors in a designated fund could (and likely would) simply move their assets to another undesignated fund employing a similar management strategy without the uncertainty and costs of designation, thereby shifting elsewhere the risks that led to the initial designation decision.

An annual process to evaluate and designate individual investment funds will inevitably put regulators in a position of chasing, and failing to catch, individuals and assets as they move among funds and markets. Not only would this process fail to achieve its desired objectives, designation would likely be destructive and distort markets.

Focus on market activities, not entities

The proposed methodology would analyze a few large funds to determine whether they are Systemically Important. This analysis would present an incomplete picture of the industry, and would likely fail to identify any systemic risk in asset management and the capital markets. For example, it would not identify any risk that may be created by, and shift among, a large number of smaller funds and other market participants.

We believe, therefore, that analysis and regulation focused on activities will be the only effective means for the FSB and IOSCO to identify and mitigate any systemic risk associated with asset management. Such an approach has been employed to mitigate other market risk issues. In the derivatives markets, for example, regulators did not simply apply restrictions to a few large market participants; rather, they imposed broadly applicable structural reforms, such as central clearing and minimum margin requirements, on all participants trading derivatives.[13]

Targeting regulations to identified risks arising from activities on an industry- or market-wide basis has been used effectively by regulators for many years. For example, this structure is used in the U.S. to regulate mutual funds, their managers and other investment vehicles.[14] Similar structures are in place in other jurisdictions, such as the regulations governing Canadian mutual funds and UCITS in the European Union.[15] Although we continue to believe that investment funds and their managers do not threaten global financial stability, if the FSB and IOSCO or any of their members believe there are risks

[13] *See generally* Wall Street Transparency and Accountability Act of 2010, Pub. Law 111-203, 124 Stat. 1376, 1641-1802; Regulation 648/2012, of the European Parliament and of the Council of 4 July 2012 on OTC Derivatives, Central Counterparties and Trade Repositories, 2012 O.J. (L201) (commonly referred to as the European Markets Infrastructure Regulation or "EMIR").
[14] *See generally* Investment Company Act of 1940, 15 U.S.C §§ 80a-1-80a-64; Investment Advisors Act of 1940, 15 U.S.C. §§ 80b-1-80b-21.
[15] In Canada, mutual funds are subject to securities laws of the various provinces, as well as to national rules. *See*, National Instrument 81-102. In the European Union, several directives and regulations apply to UCITS. *See, e.g.*, Directive 2009/65/EC of the European Parliament and of the Council of 13 July 2009 on the Coordination of Laws, Regulations and Administrative Provisions Relating to Undertakings for Collective Investment in Transferable Securities (UCITS), 2009 O.J. (L302), 32; Directive 2009/111/EC of the European parliament and of the Council of 16 September 2009 amending Directives 2006/48/EC, 2006/49/EC and 2007/64/EC as regards Banks Affiliated to Central Institutions, Certain Own Funds Items, large Exposures, Supervisory Arrangements, and Crisis Management, 2009 O.J. (L302), 97; and Regulation No 1060/2009 of the European Parliament and of the Council of 16 September 2009 on Credit Rating Agencies, 2009 O.J. (L302), 1.

that must be addressed, any further steps should be carefully considered and applied broadly through the robust regulatory regimes already in place.

Objective, Rigorous, Consistent and Transparent

Regardless of whether the FSB and IOSCO refocus their efforts on activities or decide to proceed with an entity-specific methodology, we request that they revise the methodology to reflect standards that are objective, rigorous, consistent and transparent, and publish those revisions for additional consultation.

1. Regulatory discretion

The current Proposal relies too heavily on regulatory discretion and provides too little information about the designation criteria. As a result, in its current form, the methodology will not deliver one of the fundamental benefits that it should: the reduction of risk in the market without SIFI designation.

Sufficient clarity regarding how regulators will determine whether an investment fund is a SIFI and the consequences of that designation would allow investors and asset managers to evaluate the costs and benefits of engaging in higher-risk activities. A clear, transparent methodology would serve as a deterrent and prompt many to reduce their risk profiles, thereby reducing risk in the system more effectively than individual SIFI designations could.

The Proposal, however, provides too little information to market participants and to regulators. Rather than providing objective criteria supported by rigorous economic analysis and models, the FSB and IOSCO seem to endorse a 'know it when you see it' approach that invites "a substantial amount of regulatory discretion" and "can also lead to bad government policy."[16] As the Nobel laureate Lars Peter Hansen observes, the discipline that comes from rigorous models and methods is critical both to advance the general understanding of these issues and because it could produce useful measurements of systemic risk to help counter the "temptation [of regulators] to respond to political pressures," which will be difficult to resist without rigorous support.[17] The absence of rigorous models and analysis supporting the Proposal raises serious concerns for the SIFI designation process and future international financial regulation.

In point of fact, the methodology for investment funds appears to be based only on an unsupported $100 billion materiality threshold and regulatory discretion. The Proposal contains no economic models, meaningful numerical metrics or supporting data. The absence of data is striking because much is available to the FSB, IOSCO and their members individually, and the Proposal emphasizes both its importance and the difficulty of attempting to conduct any analysis without it.[18]

We request, therefore, that the FSB and IOSCO analyze available data as they revise their methodology. If key data are unavailable, the appropriate conclusion is that regulators need to collect additional data in order to proceed, not that this unavailability somehow justifies proceeding based solely on regulatory discretion as the Proposal suggests.[19] We also request that the FSB and IOSCO publish and

[16] Lars Peter Hansen, "Challenges in Identifying and Measuring Systemic Risk," (Feb. 11, 2013), at 2, *available at* http://www.nber.org/chapters/c12507.pdf.
[17] *Id.*
[18] *See*, *e.g.*, *Proposal*, *supra* note 2, at 5-6.
[19] *Id.* at 6.

request comment on a revised methodology that includes, among other things, numerical metrics for impact factors, along with empirical analysis showing that they are indicative of systemic risk.

2. Additional information needed

We do not believe that the FSB and IOSCO have described with sufficient precision the system they hope to protect, the potential harm they seek to prevent, or their methods of measuring either. Thus, Fidelity requests that the FSB and IOSCO define and publish for comment key concepts, provide data and models to support the definitions, and describe their methods for measurement. For example, the Proposal does not define 'significant disruption', 'global financial system' or 'economic activity.' Clear definitions of these concepts are required in order for this methodology to be objective, rigorous, consistent and transparent.

3. Consequences

The Proposal also contains no discussion of the consequences of NBNI SIFI designation. In order for the models and explanations requested above to be effective, they must account for the consequences of designation. We are quite concerned that the unintended consequences of designation could significantly harm individual companies, their customers, financial markets and the global economy. Shareholders have invested $13 trillion in over 8,000 mutual funds in the U.S. alone.[20] These funds provide a means for over 90 million individuals to save for long-term goals such as buying a home, paying for college and funding retirement. In doing so, they provide long-term financing to businesses and governments and help drive economic growth. The stakes are too high to proceed without the necessary data, analysis and transparency. Consequently, we believe that the FSB and IOSCO must:

- Create and publish for comment a more objective, consistent, rigorous and transparent methodology;
- Explain how and why any designation would effectively reduce systemic risk;
- Carefully and transparently consider other regulatory options that may be lower risk, more effective, and more efficient before making a designation; and
- Rigorously examine the actual impacts of any designation.

Part Two

Q6-2 - Does the above description of systemic importance of asset management entities adequately capture potential systemic risks associated with their financial distress or disorderly failure at the global level?

We support much of the discussion in Section 6.2 of the Proposal. The discussion is incomplete, however, because it does not acknowledge that many funds simply cannot fail. In order for an entity to be Systemically Important, two conditions must be present: (i) it must be able to fail and (ii) its failure must significantly disrupt the global financial system and global economic activity. As we explain below, investment funds can only meet the first condition if they employ excessive leverage or have fixed

[20] *See* Investment Company Institute, "2013 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry" (2013), at 2, 18, *available at* http://www.ici.org/pdf/2013_factbook.pdf.

obligations that represent a substantial percentage of their assets. Most funds have neither. Further, several characteristics make it unlikely that a fund could meet the second condition, even if it met the first. As a result, many individual funds should not even be considered for SIFI designation as they are highly unlikely to create the type or scale of global systemic risk that this framework is intended to identify and address.

An Entity that Cannot Fail Cannot Be a SIFI

In order to be Systemically Important an entity must be able to fail. The ability to fail can be assumed in the G-SIFI assessment methodology designed for banks because banks do fail, and frequently.[21] All banks use leverage, as the business model of the entire industry is based on doing so. The susceptibility of banks to failure is inherent in the model because the liabilities of a bank with a leveraged balance sheet could easily exceed its assets and loss absorbing capital. The probability a particular bank will fail and the impact of that failure are functions of the degree of leverage it employs, among other factors.

Without excessive leverage or substantial fixed obligations, a fund cannot fail.[22] Most investment funds employ little or no leverage and a fund without leverage is 100% equity capital. This is a critical difference between investment funds and banks.

The G-SIFI frameworks, which are designed to address the potential impact of an entity's failure, are simply inapplicable to entities that cannot fail. Unfortunately, the FSB and IOSCO have endorsed an approach that ignores the probability of a company's failure and instead focuses solely on the impact of its failure.[23] That is controversial even for non-bank entities that can fail but rarely do, such as insurance companies. It is nonsensical for an investment fund with 100% equity capital that *cannot* fail.[24]

The Proposal also seems to equate runs in investment funds with bank runs and failures. The hypothesis appears to be that the problems of an individual asset manager or fund could prompt investors to behave in a way that disrupts the global financial system. Not only is this logically unsound, but the Proposal presents no data or verifiable economic models to support the claim.

The Proposal misperceives and overstates the risk of runs on funds. A run is primarily a banking concept that does not describe redemptions from funds. A bank's portfolio contains a high percentage of illiquid, hard-to-value assets, such as mortgages and commercial loans. A run on a bank occurs when

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[21] Between January 2008 and December 2012, 465 banking organizations in the United States failed. *See* Federal Deposit Insurance Corporation, "Failed Bank List," *available at* http://www.fdic.gov/bank/individual/failed/banklist.html.

[22] As acknowledged in the Proposal, investment funds generally may decline in value through market losses and redemptions and may ultimately liquidate, but those liquidations "represent an ordinary phenomenon" and historically have not created a "systemic market impact." *See Proposal*, *supra* note 2, at 31 n.39, 30 n.38. Investment funds do not "fail" in the same way banks and bank holding companies do unless they employ considerable amounts of leverage. Certain stable NAV money market funds may face liquidity pressure but, like other investment funds, they do not become insolvent. Other collective vehicles, such as pension funds do have fixed obligations. If their assets are insufficient to meet those obligations, they can be said to have "failed," but their liabilities are not redeemable on demand.

[23] *See*, *e.g*., *id.* at 2 n.7 ("The methodologies' emphasis is on identifying indicators that point to systemic impact on failure, rather than an institution's likelihood of failure").

[24] A quick aside about the consequences of designation clearly demonstrate the wrong-headedness of assuming that a fund composed of 100% equity can fail. Two of the primary consequences of SIFI designation are "higher loss absorbency capacity" (i.e., more capital) and resolution planning, both of which are intended to "reduce the probability and impact of their failure." A fund that is already 100% capital cannot add more capital, nor does it need additional resolution planning. *See* FSB, *supra* note 8.

depositors (or other short-term creditors) fear that the bank will be unable to pay them what they are owed. Driven by that fear and a low tolerance for losses, they demand repayment from the bank in sufficient numbers that the bank becomes illiquid and, ultimately insolvent.[25] Thus, the necessary ingredients for a run are: (i) substantial redeemable debt or fixed obligations, (ii) low tolerance for loss among creditors or holders of those fixed obligations, (iii) the potential inability to pay that debt or meet those obligations, and (iv) the absence of an effective mechanism to mitigate that risk.

U.S. mutual funds, on the other hand, lack the necessary ingredients for a run. These funds typically have little or no debt and are subject to strict limits on their ability to employ leverage. These limits, such as the 300% asset coverage requirement in the Investment Company Act of 1940,[26] are much tighter than the leverage limits that apply to banks, including the designated G-SIBs.[27] As a result, even though the value of a mutual fund's assets may decline, it is highly unlikely that the value of a fund's equity will be wiped out either by its creditors or market losses.

We agree with the statement in the Proposal that, "from a purely systemic perspective, funds contain a specific 'shock absorber' feature that differentiates them from banks," which mitigates any potential "contagion effects in the broader financial system" by distributing any losses broadly to investors.[28] We manage our customers' money in an attempt to maximize the returns on their investments within the bounds of the relevant investment mandate but, as we discuss in more detail in our response to Q6-4, the risk of loss is prominently disclosed and is accepted by investors. Investors may lose money, but a loss creates no solvency risk for a fund without debt or substantial fixed obligations.[29]

Mutual funds also allow daily redemptions and, in support of that ability, are required to maintain at least 85% of their portfolios in liquid assets.[30] Funds also have a variety of liquidity management tools available to manage redemptions, as the Proposal acknowledges.[31] Further, most have variable share prices and mark the values of their underlying assets to market daily, such that redeeming investors receive the current market value of their investments.[32]

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[25] Those consequences help explain the FSB SIFI Framework and the creation of the federal safety net for banks in the U.S., including deposit insurance and Federal Reserve liquidity support.
[26] 15 U.S.C. § 80a-18(f)(1).
[27] *See* Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirements," Jan. 2014, *available a*t http://www.bis.org/publ/bcbs270.htm. This framework stipulates that banking organizations must maintain a minimum 3% leverage ratio, calculated by dividing an organization's Tier 1 Capital, as defined by the Basel III capital framework, *see* Basel Committee on Banking Supervision, "Basel III: A Global Framework for More Resilient Banks and Banking Systems," Dec. 2010, *available at* http://www.bis.org/publ/bcbs189.pdf, by all of the organization's on-balance sheet assets and certain off-balance sheet exposures. *See also Regulatory Capital Rules*, 78 Fed. Reg. 51101 (Aug. 20, 2013), *available at* http://www.gpo.gov/fdsys/pkg/FR-2013-08-20/pdf/2013-20143.pdf.
[28] *Proposal*, *supra* note 2, at 29.
[29] *See* note 22 above for a discussion of stable NAV money market funds.
[30] *See Revisions of Guidelines to Form N-1A*, Investment Company Act Release No. 18612, 57 Fed. Reg. 9828 (Mar. 12, 1992). Although the SEC has rescinded the Guidelines to Form N-1A, *see Registration Form used by Open-End Management Investment Companies*, Investment Company Act Release No. 23064, 63 Fed. Reg. 13916 (Mar. 13, 1998), the position taken in the Guidelines relating to liquidity continues to represent the staff's position. *See, e.g.*, "Valuation of Portfolio Securities and other Assets Held by Registered Investment Companies – Select Bibliography of the Division of Investment Management," *available at* http://www.sec.gov/divisions/investment/icvaluation.htm. The SEC subjects money market funds to further liquidity restrictions, requiring them to hold at least 95% of their portfolio in liquid securities and comply with additional daily and weekly liquidity requirements in order to meet reasonably foreseeable redemption requests. *See* 17 C.F.R. § 270.2A-7(c)(5).
[31] *See Proposal*, *supra* note 2, at 30.
[32] In the case of certain U.S. money market funds, which some believe are more susceptible to runs than other funds, the SEC is considering proposals that would make money market funds more similar to other registered funds.

Our experiences with investor redemptions across a variety of funds and asset classes, during a variety of market conditions, show that mutual funds can handle heavy redemptions. Redemptions are part of the normal business cycle and cannot properly be called "runs." That is not to say that high redemptions in the face of falling asset prices cannot be painful for investors (and investment managers).[33] No matter the volume, however, redemptions do not result in failure in the absence of leverage or substantial fixed obligations and data do not support that they pose risks to the financial system.

Impact of Failure

Designation is intended to mitigate the damage that a single entity's failure could have on the financial system.[34] In the G-SIFI context, the FSB assesses the impact of an entity's failure from a combination of factors, including size, complexity, interconnectedness and substitutability.[35] FSB policy measures are focused on reducing both the probability and impact of an entity's failure so that the government is less likely to be put in a position where it feels obligated to bail the entity out.[36] The FSB has posited that the likelihood of a bail out could encourage an entity to take excessive risks.

Investment funds do not present the systemic or moral hazard risks that the FSB measures are intended to address. Section 6.2 of the Proposal correctly recognizes some, but not all, of the characteristics of investment funds and their managers that are "important aspects worth considering" because they reduce or prevent any "global systemic impact" if a fund were to fail.[37] These characteristics include, among others: (i) a 'shock absorber' feature (in that losses are distributed broadly to equity investors who accept the risk of loss rather than concentrated in creditors or counterparties with less tolerance for loss) and an absence of government support that differentiate funds from banks, (ii) a high degree of substitutability; (iii) high mobility of investment fund assets, (iv) effective liquidity management tools, and (v) legal, regulatory and economic separations among funds and managers that insulate each from the other.[38] We discuss a number of these factors in greater detail above and in our responses to Q6-3 and Q6-4.

Although redemptions may ultimately lead a fund to close, we agree with the Proposal that such closures reflect investor preferences, are part of the normal business cycle, and have no systemic market impact. For example, Fidelity is currently in the process of liquidating a fund whose assets peaked in 2007. The fund, which was held by more than 30,000 retail and institutional accounts, has since suffered net outflows of more than 50%. We are liquidating the fund because we believe it offers limited growth potential given its history and ready substitutes. Shareholders will be able to exchange their shares into other Fidelity funds, redeem their shares, or remain in the fund until the liquidation, at which time they will receive the value of the shares they hold in cash.

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[33] Of course, for every security that a fund sells, there is a buyer who sees an investment opportunity and an effective transfer of the risk associated with that security from the selling fund to the buyer.
[34] *See, e.g.,* Basel Committee on Banking Supervision, "Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement," July 2013, at 2-3, *available at* http://www.bis.org/publ/bcbs255.pdf.
[35] *See*, *e.g*., *id*. at 2; FSB, *supra* note 8, at 1.
[36] *See* FSB, *supra* note 8, at 2.
[37] *See Proposal*, *supra* note 2, at 30.
[38] *Id*. at 29-30.

Funds that experience heavy redemptions or liquidate actually achieve one of the FSB SIFI Framework's primary goals without the need for designation or a special resolution mechanism – they "resolve" themselves in an orderly fashion with no discernable market impact. Liquidation follows an orderly process with minimal impact on shareholders and no discernible impact on the markets. As the FSB and IOSCO acknowledge, "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the [2000-2012] observation period."[39] In fact, "liquidations and consequent closures of CIS entities… represent an ordinary phenomenon that results more from gradual changes in investor sentiment (with consequent outflows) than as a deterministic response to an external shock."[40]

A Consistent Standard

The Proposal conveys regulators' intention that the NBNI G-SIFI methodology be consistent with the G-SIFI methodologies for banks and insurers. This desire for consistency seems to be borne of a recognition that all of these entities are part of the same global financial system and must threaten it in substantially the same way in order to be Systemically Important. The methodologies have all been "specifically designed to focus on the distress and failure of institutions and the mechanisms by which risks may be transmitted from entity to entity." Under the FSB SIFI Framework, SIFIs must share essential characteristics (i.e., be able to fail and transmit risk) regardless of industry. [41]

Long-Term Capital Management ("LTCM"), a highly leveraged hedge fund not regulated under the Investment Company Act, and the Reserve Primary Fund, a money market fund registered under that act, are the two examples commonly cited in this context. These funds both possessed characteristics that differentiate them from most mutual funds. Those differences, including the use of excessive leverage and the characteristics of some U.S. prime, stable net asset value, money market funds before the SEC reforms in 2010, are instructive.[42] The dearth of funds whose demise can be said to have disrupted the financial system is even more instructive. When compared to the number and severity of banking crises that have occurred, the absence of fund-related crises or even notable fund failures demonstrates that asset management regulation is effective and that a SIFI assessment methodology for investment funds is a solution in search of a problem.

Unfortunately, the FSB and IOSCO appear to assume that investment funds are capable of failing and transmitting risk like other candidates for designation despite recognizing that fund risk profiles are vastly different.[43] For example, funds enjoy no government support that would create moral hazard risk and, as discussed above, liquidations have required no special government resolution mechanism. Section 6.2 is incomplete for failing to consider fully the implications on the Proposal of the fact that these differences largely preclude funds (and their managers) from causing "*significant disruption to the global financial system and economic activity across jurisdictions*."[44]

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[39] *Id*. at 30 n.38.
[40] *Id*. at 31 n.39.
[41] *See id*. at 1-2, 1 n.5.
[42] We believe that the important lessons from these examples are: (i) excessive leverage can present systemic risk, (ii) the combination of characteristics of money market funds that differentiate them from other investment funds and warrant different regulation, and (iii) existing regulation of leverage and pending reforms regarding money market funds demonstrate the appropriate structural approach to regulating asset management.
[43] *See Proposal*, *supra* note 2, at 3, 29.
[44] *Id*. at 2.

<u>Q2-1</u> - Does the high-level framework for identifying NBNI G-SIFIs (including the five basic impact factors) adequately capture how failure of NBNI financial entities could cause significant disruption to the wider financial system and economic activity? Are there any other impact factors that should be considered in addition to those currently proposed or should any of them be removed? If so, why?

As we discussed in Part One of this letter, in order to be able to answer the first question in Q2-1, Fidelity believes that the FSB and IOSCO must first define and propose measures for the terms 'significant disruption', 'wider financial system' (or, as used elsewhere in the Proposal, 'global financial system') and 'economic activity.'

With respect to the second and third questions in Q2-1, Fidelity believes that excessive leverage should be a top level impact factor rather than just an indicator of interconnectedness. Fidelity agrees with the FSB and IOSCO that the failure or distress of a highly leveraged entity can cause harm to others in the broader financial system. We also believe that excessive leverage is itself a strong marker for the probability an entity will fail.

Fidelity also believes that existing regulatory scrutiny should be an impact factor. While we believe that there is no theoretical or empirical support for SIFI designation in the asset management sector broadly, we are confident that the comprehensive body of regulations that already governs U.S. mutual funds prevents them from being Systemically Important. These regulations effectively mitigate many of risks that concern the FSB, BIS, IOSCO and national regulators, such as leverage, liquidity, concentration, and lack of transparency. When considering whether a fund is Systemically Important, it is critical to consider whether that fund is already subject to constraints that effectively eliminate the possibility that it will fail or disrupt the global financial system.

Excessive Leverage

Leverage should be elevated to an impact factor for investment funds in recognition of the close connection between an entity's leverage and its systemic risk. All banks use leverage to varying degrees and so the G-SIB methodology does not need to be designed to identify banks that have leverage, but rather to evaluate the degree and nature of that leverage. Because investment funds do not universally employ leverage, it cannot automatically be assumed to exist. Therefore, any methodology designed to identify potential NBNI G-SIFI's should put a strong emphasis on excessive leverage, as well as evaluate the degree and nature of that leverage.

Fidelity agrees that the "greater a fund's leverage, the greater its potential impact on counterparties that have provided finance (counterparty channel) and on markets in the event of a disorderly and rapid de-leveraging (market channel)."[45] When an excessively levered entity experiences financial distress, the impacts of that distress can ripple through its many creditors. If those impacts are widespread and significant, they can disrupt the broader financial system.

Further, Fidelity believes excessive leverage is itself a proxy for a fund's probability of failure. Leverage allows a fund to augment its assets by multiples over its equity capital. Each dollar of capital

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[45] *Id*. at 34; Fidelity also agrees with the sentiments expressed elsewhere in the Proposal that leverage among finance companies and market intermediaries can also create stress on the broader financial system. *See id*. at 18 ("Leverage can amplify the impact of a finance company's distress on other financial entities") and at 24 ("The greater a market intermediary's leverage, the greater the potential impact of its distress or failure on the financial system").

can be transformed via leverage into much greater market exposure. That greater market risk can produce significant gains, but can also magnify losses. If the market price of a leveraged asset declines, the degree of loss is much greater than if the asset were unlevered. Likewise, a fund with a highly-leveraged capital structure can suffer financial distress or even failure from the cumulative effects of market price declines across its book of leveraged assets.

The near collapse of LTCM in 1998 exemplifies the degree to which excessive leverage can contribute to a fund's financial distress and magnify the effects of that distress in the broader financial system. Just prior to its near failure, LTCM's leverage ratio was more than 25-to-1.[46] Market volatility caused by Russia's devaluation of the ruble in August 1998 led it to suffer losses that were magnified because of the degree of leverage the firm employed.[47] In its post-mortem report on LTCM, the President's Working Group on Financial Markets ("PWG") found that:

> "In a volatile market, high levels of leverage increase the likelihood that a leveraged entity will fail, in part because the size of potential losses can seriously deplete and even wipe out the entity's net worth. When leveraged investors are overwhelmed by market or liquidity shocks, the risks they have assumed will be discharged back into the market. Thus, highly leveraged investors have the potential to exacerbate instability in the market as a whole."[48]

Recognizing the dangers that excessive leverage can pose outside of the investment fund sector, the PWG observed that other "financial institutions, including some banks and securities firms, are larger, and generally more highly leveraged, than hedge funds….The near collapse of LTCM illustrates the need for all participants in our financial system, not only hedge funds, to face constraints on the amount of leverage they assume."[49] Since excessive leverage can precipitate a fund's failure and cause harm to other firms, and that risk of failure is central to the FSB SIFI Framework, Fidelity believes that excessive leverage should be a separate impact factor, with significantly more weight given to it than to the other factors.

Existing Regulatory Scrutiny

Fidelity believes that the extent and nature of existing regulatory scrutiny should also be an impact factor. In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank")[50] requires that the Financial Stability Oversight Council ("FSOC") consider "the degree to which the company is already regulated by 1 or more primary financial regulatory agencies" when evaluating a non-bank financial company for potential designation.[51] Existing regulations set the boundaries for the activities in which an entity may engage. Activities that regulators believe could pose a risk may already be sufficiently restricted in some funds. Therefore, an analysis of the regulations by which an entity is bound must inform an assessment of the probability and impact of its failure.

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[46] *See* President's Working Group on Financial Markets, "Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management," Apr. 1999, at 12.
[47] *See id*.
[48] *Id*. at 23.
[49] *Id*. at viii.
[50] Pub. L. No. 111-203, 124 Stat. 1376 (July 21, 2010) [hereinafter *Dodd-Frank*].
[51] *Dodd-Frank* §113(a)(2)(H).

For example, U.S. mutual funds are subject to uniform limits on the amount of leverage they can employ.[52] The Investment Company Act of 1940 limits the amount of cash borrowings mutual funds can undertake by imposing a 300% asset coverage requirement.[53] Also, a series of pronouncements by the Securities and Exchange Commission has limited the degree to which funds can take on excessive leverage through the use of derivatives.[54] We believe these restrictions have worked effectively for many years, have served the interests of mutual fund shareholders and have enhanced financial stability. We also note that these restrictions are much more stringent than the new requirements being imposed on banks generally[55] and G-SIBs in particular.[56]

The regulations applied to U.S. mutual funds constitute a comprehensive layer of substantive limitations on activities that address a multitude of risks and include requirements regarding: liquidity, daily mark-to-market valuation,[57] redemption,[58] transparency (disclosure),[59] governance,[60] conflicts of interest, and transactions with affiliates, among many others.[61] The targeted, industry-wide regulation of the entities that constitute the mutual fund industry serves many purposes, including investor protection and market integrity, but it also promotes financial stability. As with other heavily regulated industries, if risks to the global financial system are detected in the investment fund industry and not already mitigated by the existing regime, the regime can be enhanced to address those risks. To the extent such risks are found in other segments of the capital markets, this structure should serve as a model for their effective and efficient regulation.

Q3-2 - In your view, are the above proposed materiality thresholds (including the level) for the NBNI financial entity types appropriate for providing an initial filter of the NBNI financial

[52] Mutual funds are limited by Section 18 of the Investment Company Act to very low levels of leverage. For example, open-end mutual funds are limited to a maximum debt-to-equity ratio of 1 to 2. *See* 15 U.S.C. § 80a-18. By contrast, traditional financial institutions historically could have a 9 to 1 or greater debt-to-equity ratio and still qualify as "well-capitalized" for regulatory purposes. In practice, most mutual funds operate with little leverage, if any, which the Senate Banking Committee recognized in its report on S. 3217 by noting that "a typical mutual fund could be an example of a nonbank financial company with a low degree of leverage." *See* S. REP. No. 111-176, at 48 n.14 (2010).
[53] 15 U.S.C. § 80a-18(f)(1).
[54] *See Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666, 44 Fed. Reg. 25128 (Apr. 18, 1979), *available at* http://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf. S*ee also Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, Investment Company Act Release No. 29776 (Aug. 31, 2011) (Commission Release), *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf ("A fund that invests in derivatives ... must consider the leverage limitations of section 18 of the Investment Company Act").
[55] *See* Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirement," *supra* note 27. S*ee also Regulatory Capital Rules*, 78 Fed. Reg. 62018 (bringing the United States substantially into compliance with the Basel III capital framework).
[56] *See* Basel Committee on Banking Supervision, *supra* note 34 at 12 (detailing the higher loss absorbency requirements for G-SIBs). In the United States, large banking organizations with $250 billion or more in total consolidated assets or $10 billion or more in foreign exposures are subject to more stringent requirements under the "advanced approach." *See Regulatory Capital Rules*, 78 Fed. Reg. 62,018.
[57] *See* 17 C.F.R. § 270.22c-1.
[58] Except in extraordinary circumstances, most mutual fund shareholders may redeem their investments on a daily basis.
[59] Mutual funds are required to describe their investment strategies in detail in prospectuses, statements of additional information, and semi-annual and annual shareholder reports. Furthermore, funds must disclose their entire portfolios four times per year. *See, e.g.*, 15 U.S.C. § 80a-29(e); 17 C.F.R. § 270.30b1-5. This disclosure typically describes each security held, including the issuer/issue, shares/principal amount, and fair value. If a fund holds derivatives contracts, the reference assets/indices notional values, fair values, number of contracts, counterparties and expiration dates are described.
[60] *See, e.g.*, 15 U.S.C. § 80a-10.
[61] In addition to the SEC's oversight of mutual funds' compliance with regulations under the Securities Act of 1933, the Securities Exchange Act of 1934, the Investment Company Act and the Advisers Act, the Internal Revenue Code sets requirements regarding a mutual fund's portfolio diversification and distributions of earnings and the Financial Industry Regulatory Authority oversees most mutual fund advertisements and sales materials.

universe and limiting the pool of firms for which more detailed data will be collected and to which the sector-specific methodology will be applied? If not, please provide alternative proposals for a more appropriate initial filter (with quantitative data to back-up such proposals).

Q6-11 - Should certain indicators (or impact factors) be prioritised in assessing the systemic importance of investment funds? If so, please explain which indicator(s) and the reasons for prioritisation.

Size alone is not useful for identifying potential systemic risk in any entity, but it is especially unhelpful for investment funds that lack the combination of characteristics that must be present to be Systemically Important. The $100 billion level proposed is arbitrary, and, given its insignificance relative to the global financial system, not useful for identifying any funds that could disrupt that system.

Furthermore, the pool of funds resulting from only a size-based screen will be both over- and under-inclusive. It is likely to miss potential sources of risk and will cause national regulators to waste resources examining funds that are not Systemically Important, such as U.S. registered mutual funds. Instead, we propose a multi-factor materiality threshold that couples a modified size metric with at least one other factor, such as excessive leverage.

Arbitrary

The Proposal states that the "materiality threshold figures are broadly consistent with the G-SIB and G-SII methodologies."[62] We disagree. The G-SIB methodology only requires banks with more than €200 billion in assets and those classified as G-SIBs the previous year to report on the 12 G-SIB indicators.[63] Most G-SIBs have more than $1 trillion in assets. Even the largest investment funds are small relative to the largest G-SIBs and the global financial system.[64] They also operate with little or no leverage and fund their asset portfolios almost entirely with equity capital.[65]

The Proposal provides no support for applying a materiality threshold to investment funds that is less than half that applied to banks, especially because the probability and impact of failure for a typical bank are inherently much greater than for an investment fund. Further, banks present significant moral hazard risk because they receive explicit government support. The size threshold for NBNI's should, therefore, be set no lower than €200 billion and should be indexed for inflation to ensure that the methodology continues to provide meaningful results.

Size Alone Is an Inappropriate Materiality Threshold

The size of an investment fund alone is not indicative of materiality to the global financial system or potential systemic risk. Unless a size metric is calibrated appropriately and combined with other, more useful metrics, the methodology is likely to miss areas of potential risk and force regulators to expend

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[62] *Proposal*, *supra* note 2, at 9.
[63] *See*, Basel Committee on Banking Supervision, *supra* note 34, at 2 ("Reporting guidance has been added that will require all banks with an overall size exceeding EUR 200 billion (as measured by the Basel III leverage ratio measure of exposure), as well as bank that have been classified as a G-SIB in the previous year, to make publicly available the 12 indicators used in the assessment methodology").
[64] *See* Investment Company Institute, *supra* note 20.
[65] This stands in stark contrast to G-SIBs. For example, the largest U.S. G-SIB reported $2.2 trillion in total liabilities at year-end 2013, including nearly $1.3 trillion in deposits. *See* JPMorgan Chase & Co., Annual Report (Form 10-K), at 75 (Feb. 20, 2014).

scarce resources on areas not deserving attention. For example, this threshold would have missed the Reserve Primary Fund, which had only $62 billion in assets under management when it "broke the buck." On the other hand, a regulated fund with $100 billion primarily in high quality, highly liquid assets, such as U.S. Treasuries or large-cap equities, and little or no leverage would not warrant a detailed review – let alone designation – and yet would be identified by this threshold.

Further, a size threshold will result in a pool that is only as good as the day the data was gathered. A fund's size is a function of both asset values and investor flows and can change significantly in short periods of time. The prices of a fund's underlying securities move daily. Flows are based on investor preferences at a given time and change in response to a variety of factors, sometimes rapidly. As a result, funds that are above $100 billion today may be much smaller in the future, while funds that are smaller today could have more than $100 billion in less than a year. If this assessment takes place annually, it will necessarily be lagging.

We have not seen any data demonstrating a causal relationship between the size of an investment fund and the probability or impact of its failure. This may explain why other methodologies have adopted multi-factor materiality screens. For example, the first stage of the U.S. process is designed to narrow the universe of companies to a smaller subset, much like the process the FSB and IOSCO are proposing.[66] Stage 1 contains six thresholds for size, interconnectedness, leverage, and liquidity risk and maturity mismatch. A company is subject to further evaluation only "if it meets both the size threshold and any one of the other quantitative thresholds."[67] Although the FSOC process has a number of conceptual flaws, it correctly recognizes that size alone is not an indicator of systemic risk but, instead, is relevant only to the extent it magnifies the potential impact of the other factors in the framework.

Excessive Leverage

We believe that regulators should use a materiality screen that couples size with excessive leverage when determining whether any funds warrant further review. Assuming *arguendo* that any investment fund could be Systemically Important, that fund would need to be both large and excessively leveraged and not simply large. Excessive leverage is indicative both of the probability a fund will fail and of the disruptions that failure could have on the broader financial system.[68] As the FSB and IOSCO note in the Proposal, size and leverage both have the same relationship to the same transmission channels

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[66] *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637, 21641-42 (FSOC Apr. 11, 2012).
[67] *Id*. at 21642.
[68] Many of the entities that have experienced severe financial distress and failed during previous crises employed excessive leverage. *See* The Financial Crisis Inquiry Commission, *The Financial Crisis Inquiry Report: Final Report of the National Commission on the Causes of the Financial and Economic Crisis in the United States* (Jan. 2011), at xix, *available at* http://www.gpo.gov/fdsys/pkg/GPO-FCIC/pdf/GPO-FCIC.pdf ("In the years leading up to the crisis, too many financial institutions . . . borrowed to the hilt, leaving them vulnerable to financial distress or ruin if the value of their investments declined even modestly. For example, as of 2007, the five major investment banks—Bear Stearns, Goldman Sachs, Lehman Brothers, Merrill Lynch, and Morgan Stanley—were operating with extraordinarily thin capital. By one measure, their leverage ratios were as high as 40 to 1…"); *see also* Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, Speech at the Peterson Institute for International Economics, Washington, D.C. (June 8, 2009), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20090608a.htm ("By 2007… high leverage had pervaded the financial system. Systemic risk arose not because the illiquidity or insolvency of one firm would directly bring down another, but because of parallel hedging or funding strategies practiced by highly leveraged firms with substantial short-term liabilities that threatened large segments of the market").

– namely, the greater a funds' size or leverage, the greater the potential for a fund to impact its market or counterparties.[69]

The initial stage of the methodology to identify potential NBNI G-SIFIs should screen the universe of investment funds for excessive leverage and size separately, and then look for overlap between the two populations. This would result in a better starting point for further analysis than any pool of funds identified by using either factor alone as a screen.

This approach is also consistent with similar approaches endorsed by the FSB and its members.[70] For example, the FSOC has adopted a leverage ratio of 15:1 as one of several numerical indicators to identify companies for further evaluation and potential designation.[71] The Basel Committee on Banking Supervision, however, sets a simple, transparent, non-risk-weighted leverage ratio of 3% for banks, which are inherently more likely to be Systemically Important than investment funds.[72] As noted above with respect to the size threshold, we see no justification for holding investment funds to a higher standard than the internationally agreed upon standard that is applied to banks. We believe, therefore, that a materiality threshold should be set at 33:1, but certainly no lower than 15:1.

Transparency

Ultimately, however, no matter how well a methodology is designed, it is unrealistic to expect that it will identify a subset that includes all of the entities engaging in activities that could pose risk. It is imperative that the FSB and IOSCO be transparent with their final methodology, especially if they continue to focus on entities, by publishing any thresholds they will use when applying the relevant factors and indicators. Clarity on how regulators will determine whether an investment fund is Systemically Important will allow investors and asset managers to evaluate the costs and benefits of engaging in these behaviors.

We believe that this impact on investors and managers would be a benefit to the system and not, as the Proposal seems to indicate, "potential arbitrage."[73] If the goal of this exercise is to reduce risk in the global financial system, then regulators should strive to have as few funds as possible engaged in activities that could disrupt it. Full transparency would allow fund managers to factor potential systemic risk impacts into their decisions, both reducing risk across the system and helping to mitigate the risk that regulators miss something when applying the factor-based screens.

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

[69] *See Proposal*, *supra* note 2, at 33-34.
[70] We also believe that excessive leverage should be an impact factor that is measured on a risk-weighted basis. Please see our responses to Q6-5 below.
[71] *See Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. at 21643.
[72] *See* Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirement," *supra* note 27. *See also* our response to Q6-2 above.
[73] *Proposal*, *supra* note 2, at 11.

Among the four levels of focus listed in the Proposal, Fidelity believes that the individual investment fund level is the most appropriate. Although a focus on activities would be far superior (as we discuss more fully in response to Q6-4 below), focusing the methodology on individual investment funds is better than the alternatives.

Asset managers on a stand-alone entity basis

We support the Proposal's recognition that asset managers on a stand-alone basis inherently lack many of the key characteristics that must be present for a company to be a G-SIFI. [74] In fact, the Proposal supports our conclusion that asset managers as stand-alone entities *cannot* be Systemically Important. The FSB and IOSCO do, however, briefly mention two possible reasons to focus on asset managers as stand-alone entities: (i) managers may conduct certain firm-level activities, such as risk management or securities lending and repo transactions and (ii) managers are exposed to operational and reputational risks.[75] The Proposal does not provide any support for the notion that these factors could make an asset manager a SIFI and we do not believe that asset managers as stand-alone entities merit focus as possible SIFIs.

(i) Services performed by adviser

First, the activities that an asset manager conducts on behalf of investment funds do not increase the probability or impact on the global financial system of the *manager's* failure.[76] Asset managers are hired by investment funds to serve as their agents and to provide a range of services in that capacity in exchange for a fee. The services may include portfolio management, trading, compliance, and, in some cases, back office administration. The investment risk associated with the fund's portfolio of assets, along with any gains, belongs to fund investors and not to the manager.

Second, the assets of the fund never become assets of the manager nor are they commingled with assets of another fund. The assets are not available to the manager to use for its own purposes, nor are they available to the manager's creditors or to investors in (or creditors of) other funds. In fact, most funds employ third-party custodians to hold fund assets for their investors, as required by regulation or as a best practice.

The Proposal acknowledges many of these considerations, which "distinguish the risk profile of a fund from that of its manager."[77] In support of their decision to exclude managers from the methodology, the FSB and IOSCO note that the services that a manager performs create no exposures between the manager and the financial system.[78]

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[74] Sections 6.2.1 and 6.2.2 of the Proposal explore the nature of the asset management business, the differences between asset management and banking, and the implications of those differences for the FSB SIFI Framework, including the rationale for focusing the proposed assessment methodology on investment funds asset managers and not on asset managers on a stand-alone basis. In our response to Q6-2 above, we highlight a number of those statements with which we agree.
[75] *See Proposal*, *supra* note 2, at 32.
[76] The fact that the FSB and IOSCO focus on *activities* conducted by the asset manager lends support for our discussion below in response to Q6-4 that the FSB and IOSCO should identify those activities that it views as risky and then apply targeted, industry-wide regulation to mitigate any potential harms, rather than selectively applying regulation to a small subset of investment funds or their managers.
[77] *Proposal*, *supra* note 2, at 29-30.
[78] *See*, *e.g*., *id*. at 30 ("It is therefore the portfolio of assets that creates the respective exposures to the financial system") and at 30 n.36 ("Any interconnectedness does not emanate from the manager's balance sheet, but is the consequence of the manager's activities in relation to the management of assets held in the portfolio").

The manager directs the investment of the fund's assets but does not guarantee their value or performance results. The manager's discretion to invest fund assets is also subject to a host of regulatory, legal and contractual limits. Those limits come from a variety of sources, such as the fund's governing documents, securities laws, market conduct regulations, and corporate laws that create fiduciary duties to investors. The FSB and IOSCO acknowledge that the investment manager must manage a fund's assets "on behalf of investors according to its investment objectives, strategy and time horizon" and within the limits set by applicable regulations.[79] In the case of U.S. mutual funds, those limits are enforced by many, including the SEC, states' attorneys general, independent trustees, and the investors themselves who can redeem their investments on demand.

The limited discretionary authority managers have over investment fund assets stands in stark contrast to the broad discretion banks have to take proprietary risk for their own accounts. A bank borrows money from its depositors and invests it for its own benefit. A bank's investments and financing model create direct exposures between the bank, its creditors, the governments that support it, and companies in the financial system with which it transacts.

Those interconnections differentiate banks from asset managers because any economic exposures and connections with others in the financial system exist only at the fund level and have no ties to the manager's balance sheet. Because investors bear "both upside rewards and downside risks from movements in the value" of fund assets, fund performance cannot threaten a manager's solvency in the way that a bank can be threatened by its investments.[80] Given the legal separation between managers and their funds, any losses to the fund would not impact the balance sheet of the adviser or *vice versa*. Likewise, because of the legal separation between managers and their funds, regulators should not attribute managed assets to investment managers in order to make the managers seem worthy of further scrutiny.

(ii) Operational and Reputational Risk

The Proposal suggests that operational and reputational risks may support a decision to focus on asset managers on a stand-alone basis. We disagree. All companies face these risks and asset managers are no different. Elsewhere in this letter, we discuss why operational problems or reputational damage suffered by an individual asset manager could not disrupt the global financial system via runs on investment funds. We also point out that even if one assumed such a scenario were possible, SIFI designation would not prevent it.

Groups of Entities: Funds and Their Managers or Families of Funds

Fidelity supports the decision by the FSB and IOSCO not to focus on groups of funds or funds and their managers collectively. To analyze them collectively, one would be required to ignore legal, management and ownership separations as well as operational distinctions among individual funds and

[79] *Id*. at 29-30.
[80] *See*, *e.g*., *id*. at 29. As Fidelity has described in other comment letters, the inherent differences between the business of investment management (built on the agency model) and the business of banking explain why they are, and should continue to be, regulated differently. *See* Letter from Scott C. Goebel, Senior Vice President and General Counsel, Fidelity Mgmt. & Research Co. to Elizabeth M. Murphy, Secretary, U.S. Sec. and Exch. Comm'n (Nov. 1, 2013), at 23-27, *available at* http://www.sec.gov/comments/am-1/am1-19.pdf; Letter from Scott C. Goebel, Senior Vice President and General Counsel, Fidelity Mgmt. & Research Co. to the Financial Stability Oversight Council (Dec. 19, 2011), at 3-7, *available at* http://www.regulations.gov/contentStreamer?objectId=0900006480f85ce6&disposition=attachment&contentType=pdf.

their managers. Further, the results of such an analysis would be misleading and would not provide any meaningful insight into systemic risk. Collective analysis also would not enable national regulators to overcome the many practical and legal impediments to collective regulation.

(i) No Basis to Support Collective Analysis

We do not believe there is a sound basis for collective analysis. The Proposal asserts that it "may be necessary to examine the asset manager and all assets under its management" collectively because, it claims, the asset manager determines "the investment management strategy and risk management practices."[81] This statement suggests that all funds managed by an asset manager may be acting in concert, which is untrue for any diversified manager.

First, as stated earlier in the Proposal, *investors* select funds based in large part on their investment strategies and that, if a given strategy fails to attract sufficient interest or performs poorly, investors will withdraw their money.[82] Although a manager may launch a fund with a given strategy, the manager cannot control someone's decision to invest or redeem. If a fund does not appeal to investors, whether because of poor performance or otherwise, investors will leave. Furthermore, the manager is bound by "a fund's objectives and the regulations to which it is subject."[83] The manager makes buy, sell and hold decisions within those parameters and has no discretion to alter those characteristics without investor consent and, in the case of U.S. mutual funds, the consent of the fund's independent trustees.

Second, there is not a single strategy for all assets under management. With few exceptions, managers with any significant amount of assets under management are diversified. They offer a wide array of funds that employ different strategies, in different asset classes, focus on different industry sectors and geographies and appeal to diverse investor populations. For example, Fidelity offers to both retail and institutional shareholders a comprehensive line-up of equity, fixed income and high yield mutual funds. Further, Fidelity offers different types of mutual funds within each category. Within its line-up of equity mutual funds, for example, Fidelity offers funds ranging from broad-based, large-cap funds to funds that focus on a particular sector (e.g., biotechnology, consumer staples, health care or telecommunications).

The type of concerted action suggested by the Proposal is inconsistent with our experience. At Fidelity, decisions to buy, sell or hold securities are made independently by each portfolio manager, without firm-level direction. Each portfolio manager decides whether a security is best suited for a fund given its investment objectives and prospectus limitations. Many times, portfolio managers at Fidelity take opposing views on one security or another. For example, in 2013, there were more than 100,000 security trades between Fidelity mutual funds and accounts. In each case, at least one Fidelity portfolio manager placed an order to buy a security while another Fidelity portfolio manager placed an order to sell that same security contemporaneously. Of course, because lot sizes and trading days do not always correspond, and because regulations restrict some funds and accounts from trading between each other, there were even more instances in which two Fidelity funds traded in the opposite direction in the same security during the period.

Third, blending the assets of individual funds for the purpose of collective analysis could mask the concentration of risk in an individual fund. For example, if a highly leveraged, illiquid fund were

[81] *Proposal*, *supra* note 2, at 32.
[82] *See id*. at 30.
[83] *Id*. at 29.

analyzed together with a group of unleveraged highly liquid funds, the concentration of risk in the single fund would be hidden rather than highlighted.

Fourth, portfolio managers embed risk control into each fund as part of the security selection and portfolio construction processes, which will differ depending on each fund's shareholder expectations, risk tolerance and investment mandate (e.g., large, mid, value, growth, international, emerging market, etc.). For example, equity value fund managers usually build in considerable margin of safety (i.e., downside protection) as they analyze what to own. Equity growth fund managers, on the other hand, tend to adjust position sizes according to the potential upside opportunities balanced by the risks inherent in new products, technologies or services. Investors expect this differentiation to be evident in the management of each fund.

(ii) U.S. Regulatory Impediments

Collective designation and regulation would be impossible in the United States because the authority to designate non-bank financial companies for heightened regulation is entity-specific. Regulators may not disregard the differences among funds or funds and their managers or to treat them as if they were subsidiaries of a single holding company. Although the FSOC is empowered to designate a firm by designating the holding company of a conglomerate and thereby subjecting it and its subsidiaries to consolidated supervision,[84] it is not empowered to make a single designation determination for multiple, legally separate asset management entities such as groups of funds or funds and their managers.[85]

Likewise, Section 165 of Dodd-Frank does not allow the Federal Reserve Board to disregard or overcome these facts when regulating a designated entity. Even if the FSOC were permitted to designate a group collectively, the legal, regulatory and operational separations among funds and their advisers would render unworkable any effort to treat the designated entities as a group when applying the enhanced standards and supervision required for designated companies.[86]

These impediments to collective designation and regulation are relevant because national regulators will be expected to implement the methodology by designating and regulating any G-SIFIs. The G-SIFI methodology will have no practical effect, however, if it cannot be applied at the national level, by national regulators, in compliance with domestic law.

(iii) Runs

The Proposal also hypothesizes that reputational risk to a manager or one of its funds "may create runs both on the asset manager as well as on its funds" or within a family of funds, but does not provide any further details or support.[87] As explained in our response to Q6-2 above, the concept of a run is inapplicable to most funds. Likewise, the concept is inapplicable to asset managers. When speculating about the possible danger of a run on funds, the Proposal acknowledges that "there is no run on the

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[84] *See Dodd-Frank* § 165(a)(2)(A) (2010) (in prescribing more stringent prudential standards, the Federal Reserve Board may consider companies' "financial activities (including the financial activities of their subsidiaries)").
[85] See *Dodd-Frank* § 102(a)(4)(B)(i) (limiting the definition of "U.S. Nonbank Financial Company" to a company that is "incorporated or organized under the laws of the United States or any State"). Additionally nothing in Section 113 of Dodd-Frank authorizes group designations.
[86] *See*, *e.g.*, Letter from Paul Schott Stevens, President & CEO, Inv. Co. Inst., to the Financial Stability Oversight Council (Feb. 25, 2011), *available at* http://www.ici.org/pdf/24994.pdf.
[87] *Proposal*, *supra* note 2, at 32, 30 n.36.

manager."[88] Further, it is highly unlikely that an idiosyncratic event would cause investors to lose faith in both a manager and all of its funds' strategies. If investors abandon a particular asset manager's funds, they are likely to pursue the same strategies by investing in the funds of another manager or directly in the underlying assets.

Families of Funds in Particular

The FSB and IOSCO request comment on whether it would be appropriate to focus on "families/groups of funds following the same or similar investment strategy that are managed by the same asset manager."[89] We do not believe such a focus is appropriate. First, the practical and procedural impediments to analyzing, designating and regulating a group of funds collectively would remain. Second, the group of funds would need to be acting in concert, which, as we addressed above, is unlikely at best. Further, establishing the existence of a family of funds would require evidence beyond simply being managed by the same asset manager, having similar names, following a similar investment strategy or investing in the same asset class.

Individual Investment Funds

Among the four options presented in Q6-3, Fidelity believes that the focus on investment funds is most appropriate. We agree with much of the rationale for the proposed focus on funds and the related statements in the Proposal, especially those in Section 6.2.1. Focusing on asset managers is inappropriate for the very same reasons that focusing on funds is appropriate. These reasons, which we describe more fully above, include (i) the agency nature of the business, (ii) the ownership of fund assets by the fund and its shareholders with strict legal separation from the asset manager, (iii) the fact that investment risk and reward are borne by the fund shareholders, and (iv) the fact that any economic exposures or connections with others in the financial system are created at the individual fund level.

Q6-4 - Should the methodology be designed to focus on whether particular activities or groups of activities pose systemic risks? If so, please explain the reason why and how such a methodology should be designed.

Yes, Fidelity believes that the methodology should be designed to focus on activities rather than entities. Any risk associated with an investment fund is most likely to be created by a practice that is (or could easily be) employed by many other funds and participants in the capital markets. It will not be unique to a small subset of individual funds. As discussed in the response to Q2-2, we note that funds are not the only market participants engaging in investment activities. Individual investors, sovereign wealth funds, corporate and municipal pension and benefit plans, endowments, corporate treasurers and many others are simultaneously engaged in similar investment activities, many of which are larger in asset size than investment funds.

We believe, therefore, that analysis and regulation focused on activities are the only effective means for the FSB and IOSCO to identify and mitigate such a risk. Selective application of an undefined body of additional regulation to a subset of investment funds will not mitigate those risks effectively. Further, doing so ignores the wealth of experience that national regulators have in overseeing the capital markets.

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[88] *Id*. at 30 n.36.
[89] *Id*. at 31.

(i) Key characteristics of investment fund business make designation ineffective

In response to Q6-2 and Q6-3 above, we highlight a number of the statements in the Proposal that underscore the unique characteristics of the investment fund business. These characteristics include: (i) funds hire advisers to serve as their agents or contractors, (ii) there is a strict legal distinction between a fund and its adviser, and (iii) the business is fee-based with no principal risk-taking.

Further, as the FSB and IOSCO acknowledge by excluding the Substitutability Channel from their discussion in Section 6 of the Proposal, the investment fund business is intensely competitive with highly substitutable products and highly mobile assets and participants. Funds are aggregation points for individual investors. Investors' goals and risk tolerances drive their investment decisions, such as fund selection. Investors may choose to invest in individual securities directly or instead to take advantage of the diversification, scale and expertise that a fund manager can offer.

Assets flow in and out of funds due to changing investor preferences as well as the relative performance of funds against their peers. We measure fund fees and performance in single basis points *because customers are highly attuned to those metrics*. Investors can (and will) elect to move their investments elsewhere in the face of high fees or lagging fund performance.

For example, the Investment Company Institute ("ICI") reports that over 700 sponsors managed mutual fund assets in the United States in 2012; and intense competition has prevented any single firm or group of firms from dominating the market.[90] Competition to attract funds from investors has also affected the number and types of funds offered by fund sponsors. Fund sponsors create new funds to meet investor demand, and they merge or liquidate (or reposition) funds that do not attract sufficient investor interest. There is no shortage of choices and, if one sponsor launches a successful fund, there are typically low barriers to other sponsors that wish to launch similar funds. The ICI reports that over 8,000 mutual funds were available to U.S. investors at the end of 2012.[91] Of course, mutual funds are just one product within the broader asset management sector and the United States is just one market for investors. There were over 73,000 mutual funds available worldwide.[92] U.S. mutual funds must also compete with other products, including almost 10,000 hedge funds.[93]

Because of these characteristics, selective application of requirements to individual funds designated as G-SIFIs would be an ineffective way to mitigate systemic risk in the capital markets, no matter what those requirements are. If an investment fund were designated, that fund would be subject to added costs and other constraints that would not apply to its competitors. While the requirements that would be imposed on investment funds as G-SIFIs have not yet been proposed, it is instructive to consider the consequences of both G-SIB designation and the designation of nonbanks in the U.S. Requirements such as enhanced capital, leverage, liquidity and other regulatory tools are, perhaps, appropriate for banks and other entities that employ significant leverage and take proprietary risks, but are wholly inappropriate for nonbank agency businesses that do not require capital to absorb losses. For investment funds, those new requirements would be entirely irreconcilable with their structures and business models.

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[90] *See* Investment Company Institute, *supra* note 20, at 24.
[91] *Id.* at 18 (figure 1.11).
[92] *Id.* at 202 (table 61.
[93] *See* Hedge Fund Research, Inc., "HFR Global Hedge Fund Industry Report – Year End 2013" (Jan. 2014) at 22.

As the Proposal recognizes, funds have very different risk profiles from other financial entities:

> "Unlike banks, for instance, where capital is set aside to protect depositors and other creditors against the risk of losses, investment management is characterised by the fact that fund investors are knowingly exposed to the potential gains and losses of a fund's invested portfolio."[94]

Businesses that act primarily as their customers' agents manage or service assets on behalf of their customers, as opposed to borrowing from them and taking proprietary positions with those funds as banks do with their deposits. So while bank depositors generally neither benefit from bank profits nor bear the risk of default within the limits of deposit insurance, "fund investors bear both upside rewards and downside risks from movements in the value of the underlying assets."[95]

If regulators designate a short list of funds, the costs and other regulatory burdens applied to them and not to their competitors would likely render the designated funds uncompetitive and prompt investors to redeem a substantial portion of their assets.[96] Shareholders could (and likely would) simply move their assets to another undesignated fund employing a similar management strategy without the uncertainty and costs of designation, thereby recreating the same undesirable set of conditions elsewhere. In fact, if most shareholders redeem, regulators will have precipitated the liquidation of a fund they had just designated as important to the global financial system. Even redemption short of liquidation would result in the designated fund becoming too small to threaten the stability of the system. An annual process focused on evaluating and designating individual investment funds will inevitably put regulators in a position of trying, and failing, to chase assets as they move from fund to fund.

(ii) Methodology and regulation should employ existing regulatory models to focus on activities

The activities in which investment funds engage often are not unique to a particular fund, a small subset of funds or even limited to investment funds. Even if one fund or a few funds employ strategies that make them uniquely risky, others could easily follow suit. The significant number of funds available to investors, the intense competition in the industry and the high degree of substitution, mean that particular activities (e.g., securities lending, repo, etc.) are not limited to a small subset of the largest funds, but, rather, are conducted by a host of funds and other market participants.

If the goal is to reduce risk across the global financial system, then regulators must deal with the activities that create that risk consistently across the system. Regulators must restrict those activities not only across *all* funds, but across all market participants. If instead, regulators insist on selecting a handful of funds for different regulation, investors will flee and seek the same risk exposure in another fund with fewer restrictions and less cost, while other market participants continue to conduct the same activities.

Designating individual funds will not decrease the amount of risk in the system. As a result, Fidelity believes that the methodology should focus on activities rather than entities. Doing so will help

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[94] *Proposal*, *supra* note 2, at 29.
[95] *Id.*
[96] In contrast, bank funding, based on core deposits, is relatively sticky. Increased costs to banks due to enhanced prudential standards are also incremental, with relatively small differences among banks. It is therefore unlikely that a bank could face a rapid downsizing as customers seek other financial intermediaries.

regulators to design targeted market-wide solutions for identified risks and will build on the experiences that national regulators have developed over many years in regulating the capital markets effectively.

For example, the SEC, as the primary regulator for registered mutual funds and their advisers, has used an activity-based framework successfully for over 70 years, focusing industry-wide regulations on specified risks. As discussed in our response to Q2-1 above, the regulations applied to mutual funds collectively address a multitude of risks, such as leverage, liquidity, transparency, governance, conflicts of interest, and diversification, among many others. Although these regimes were designed to protect investors and create efficient, robust markets, they also enhance the stability of the financial system by addressing many of the topics that preoccupy the FSB, IOSCO and national regulators today.

There are numerous examples of regulatory reforms that apply broadly to products, markets and activities. Although already robust, both the U.S. and Europe took steps to strengthen their activity-based regulatory schemes in the wake of the 2008 crisis. They also worked to fill gaps that previously existed between functional regulators, thereby enabling both new supervisory bodies and existing functional regulators to detect and mitigate many risks, including threats to financial stability. New regulations have addressed linkages that could transmit losses rapidly among financial institutions in their new provisions on payment, clearing and settlement. Enhanced regulation of the derivatives markets applies central clearing and minimum margin requirements broadly instead of to a few large market participants. In the U.S., for example, Dodd-Frank extended certain regulatory requirements to previously unregulated segments of the industry, requiring private fund advisers to register with the SEC and to comply with extensive reporting requirements, including non-public reporting of portfolio holdings.

Beyond the sweeping changes that were made in the wake of the crisis, regulators have continued to use this model to address issues as they arise. In some cases, the means to address issues has been to increase transparency. For example, the European Commission (EC) recently released a proposal that would impose reporting requirements on Securities Financing Transactions (SFTs), which include lending or borrowing of securities and commodities, re-hypothecation of collateral, repo transactions, and reverse repo transactions. The EC determined that it was not necessary to limit or prohibit the use of SFTs as such by specific restrictions. The EC believes that by refraining from regulation beyond introducing transparency, the proposal "is limited to the measures necessary to allow for an effective removal of the risks posed by shadow banking entities."[97]

In other cases, regulators have elected to impose extensive restrictions on certain activities in order to address issues in the capital markets. For example, the Reserve Primary Fund broke the buck after Lehman's bankruptcy induced a market-wide liquidity shock in September 2008. Some other money market mutual funds also experienced stress, as did every participant in the financial system. Although the Reserve Primary Fund may have worsened the financial crisis by contributing to the overall negative market sentiment, it certainly did not cause the crisis. Instead, the fund's difficulties resulted from multiple regulatory and business failures that originated in highly leveraged banks and similar businesses.

Those market events would not have been prevented and their impacts would not have been lessened by designating the Reserve Primary Fund a G-SIFI. Appropriately, regulatory reforms adopted in response to the stress experienced by money market funds during the crisis apply broadly and enhance

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[97] European Council, "Proposal for a Regulation of European Parliament and of the Council on reporting and Transparency of Securities Financing Transactions," Jan. 1, 2014, at 6, *available at* http://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52014PC0040&qid=1396292413178&from=EN.

existing regulation of money market funds. Specifically, the 2010 changes to SEC Rule 2a-7 targeted liquidity, maturity, risk, transparency, and the ability to suspend redemptions. The amendments to Rule 2a-7, in combination with other significant changes to the regulatory structure of our capital markets, have increased the ability of money market funds to absorb large, unexpected redemptions. The SEC has also proposed additional options to strengthen further the resiliency of certain types of money market mutual funds. Those proposals would not apply to only a few money market funds or their managers, but would instead apply to all funds of the type or types that the SEC believes present unaddressed risks.

We believe any methodology designed to identify and address systemic risk in any segment of the investment fund industry should follow a similar approach. In a speech last year, Governor Tarullo stressed that, "international efforts to develop new regulatory mechanisms or approaches should build on experience derived from national practice in one or more jurisdictions."[98] If regulators identify a risk, they should look first to the existing regulatory structures to solve it, leveraging the wealth of experience that national regulators have developed in overseeing the capital markets effectively for many years. Further, by restricting an activity, or set of activities, in a product or across the industry or relevant market, regulators can address the risk effectively in total rather than incompletely and ineffectively in a few funds.

(iii) An alternative approach

If the FSB and IOSCO are determined to use a factor- and indicator-based framework to identify a small subset of investment funds for analysis, the analysis could and should still result in (i) the identification of an activity, or combination of activities that creates systemic risk and (ii) an industry-wide solution. As we mentioned above in response to Q3-2, entities engaging in potentially risky activities will inevitably be missed no matter how well this methodology is designed. The subset of funds examined should be viewed as a sample that can be used to identify potentially risky activities rather than simply a list of potentially risky entities.

In the process envisioned by the FSB and IOSCO, regulators will look closely at each fund identified by the initial materiality thresholds (which, as we have suggested in Q3-2 above, should be both leverage and size). Assuming *arguendo* that they identify a few funds whose activities threaten the global financial system, we believe that regulators should *not* designate each of these funds individually because G-SIFI designation will be ineffective.

Instead, regulators should analyze specifically how these particular funds could disrupt the global financial system. What are the characteristics of each fund that make it unique from others in the initial subset that did not end up on the final list? In what activities does each fund on the final list engage that create systemic risk? Once regulators have identified the fund activities that could threaten the system, they should propose regulations that would restrict those activities in all investment funds and other market participants that could conduct them. This is the most effective approach to regulating risk in

[98] Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, "International Cooperation in Financial Regulation," Remarks at the Cornell International Law Journal Symposium: The Changing Politics of Central Banks (Feb. 22, 2013), at 12, *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20130222a.htm. Governor Tarullo went on to observe that the, "challenges encountered during the initial effort to devise an LCR in the Basel Committee, with little or no precedent of national quantitative liquidity requirements from which to learn, should counsel caution in trying to construct new regulatory mechanisms from scratch at the international level." *Id.*

asset management and risk in the capital markets more broadly. It is also consistent with the principles for international regulatory coordination espoused by leading policymakers.[99]

Q2-2 - Is the initial focus on (i) finance companies, (ii) market intermediaries, and (iii) investment funds in developing sector-specific methodologies appropriate? Are there other NBNI financial entity types that the FSB should focus on? If so, why?

As discussed in our response to Q6-4, the methodology should be revised to focus on identifying activities that could present systemic risk. If the FSB and IOSCO continue to focus on individual entities in the asset management sector, they should broaden the scope of the assessment to consider the largest pools of investable assets, including public pension funds, sovereign wealth funds, and government sponsored entities, such as Fannie Mae and Freddie Mac. Some of those pools, such as pension funds, have fixed obligations. Because these entities can be much more significant to the markets in which they invest than individual investment funds, they should be included in any analysis of NBNI asset management entities.

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

Although we believe that the methodology should be abandoned in favor of an assessment of activities, we offer comments on several indicators in the event the FSB and IOSCO continue to develop a methodology focused on individual entities in the asset management sector. Regardless of its focus, any methodology employed by the FSB and IOSCO to identify systemic risk should be objective, rigorous, consistent and transparent.

Unfortunately, the Proposal falls short of that standard, in part because some of the indicators are not indicative of systemic risk or are too ambiguous to be applied consistently. We request that the FSB and IOSCO revise the framework to include more information and rationale for these indicators and publish it for a comment.

Indicator 1-1: Net assets under management (AUM or NAV) for the fund – A simple measurement of fund size will not be indicative of the fund's systemic importance. We disagree with the theory that a larger fund will necessarily have a greater impact on counterparties and markets.[100] Liquidating a large portfolio of short-term U.S. Treasury bills would be easier and would have less market

[99] *See generally* Exec. Order No. 13,609, Promoting International Regulatory Cooperation, 3 C.F.R. 255 (2013), available at http://www.gpo.gov/fdsys/pkg/CFR-2013-title3-vol1/pdf/CFR-2013-title3-vol1-eo13609.pdf; Kathleen L. Casey, Commissioner, U.S. Securities and Exchange Commission, "The Role of International Regulatory Cooperation and Coordination in Promoting Efficient Capital Markets," Speech at the Instituto Bruno Leoni, Milan, Italy (June 12, 2012), *available at* http://www.sec.gov/news/speech/2010/spch061210klc.htm
("A benefit of [international] cooperative efforts for national regulators is that, to the extent they choose to implement [international] principles in accordance with their governing law, the underlying analysis of a broad array of experts worldwide significantly enhances the transparency and credibility of the resulting law or regulations"); Mary Miller, Assistant Secretary for Financial Markets, U.S. Department of the Treasury, Remarks at the Annual Washington Conference of the Institute of International Bankers, *available at* http://www.treasury.gov/press-center/press-releases/Pages/tg1442.aspx ("We should strengthen international coordination and always keep in mind our collective goals to protect the safety and soundness of our markets; to achieve a level playing field globally; and to realize the economic benefits of global finance ... To protect our economy from risks that arise outside the United States, and to provide a fair and level playing field for U.S. firms, we need comparable international standards. And it's important to realize the benefits of setting high standards, not just in terms of reducing risks and promoting financial stability but also in terms of attracting investors and capital").
[100] *See Proposal*, *supra* note 2, at 33.

impact than liquidating a portfolio of other assets. Therefore, we recommend using a risk-adjusted measure of size. The Basel III methodologies for risk-weighting bank assets and for bank liquidity analysis provide examples of such an approach.[101] For example, risk-adjustments should be made to account for (i) the diversification, interest rate, credit, liquidity and other market risks of a fund's portfolio, and (ii) the way it is funded (i.e., characteristics and provider).

Indicator 2-1: Leverage Ratio – For the reasons discussed in response to Q2-1, we believe that leverage in an investment fund should be an impact factor, not simply an indicator of interconnectedness. Furthermore, it would be inappropriate to use a gross leverage ratio like the one suggested in the Proposal to *analyze* leverage in order to determine a fund's systemic importance. Although in our response to Q3-2 we recommend a simple, non-risk-weighted, leverage ratio as a *materiality threshold* to narrow the universe, a risk-weighted leverage ratio should be used during any additional analysis. The Basel III risk-weighting methodology for bank assets is one example of such an approach.

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

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

These proposed indicators may be more useful if used to monitor for sudden changes. A sudden shift in either direction may signal a problem, whereas a high stable ratio may not. A fund may represent a large percentage of daily trading volume in an asset, but that does not mean it lacks substitutability unless one assumes an absence or scarcity of other buyers, which may be inaccurate. These ratios also do not account for the synthetic exposure to many assets that is available to investors.

These indicators also raise questions about definition and implementation. How will they be measured and over what time period? How is "asset" defined? Does it mean an individual security or will it be defined more broadly? Will assets like exchange-traded derivatives and mortgage-backed securities that roll regularly be included? How relevant is turnover in an index fund?

Further, as we discuss in response to Q6-8 below with respect to "investment strategies," we believe that it will be difficult if not impossible to categorize or classify funds appropriately across jurisdictions, product types and investor demographics. Funds may be labelled, marketed and regulated differently but employ similar strategies and invest in many of the same assets.

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

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

Indicator 5-3: Counterparties established in different jurisdictions

[101] Although the G-SIB methodology includes only one indicator of size, "the measure of total exposures used in the Basel III leverage ratio," that is not simply a measure of gross exposures. *See* Basel Committee on Banking Supervision, *supra* note 34, at 6. For example, it permits some netting of securities finance obligations and the application of the standardized credit conversion factors from the Basel risk-based capital framework to calculate a bank's exposure to off-balance-sheet items in order to reflect more accurately their potential risk than a gross measure would. *See*, *e.g.*, Basel Committee on Banking Supervision, "Basel III Leverage Ratio Framework and Disclosure Requirements," *supra* note 27. The risk-based analyses of a bank's assets and its liquidity risk profile, for purposes of calculating its capital and liquidity requirements – both of which are intended to reduce the probability and impact of a bank's failure – are much more finely calibrated and risk-sensitive.

There is no evidence of direct correlation between the *number* of jurisdictions to which a fund is exposed and the probability or impact of its failure. Simple totals of the number of jurisdictions in which a fund invests, is sold, or is exposed are not indicative of the relevance of that fund to those jurisdictions or the global financial system. Furthermore, these proposed indicators ignore the benefits of diversification, which may reduce both the probability and impact of a fund's failure. In fact, if applied, these indicators could discourage geographic diversification.

The Proposal assumes that "[f]unds that invest globally may have a larger global impact than funds that invest in the securities of only a few jurisdictions,"[102] but the opposite is at least as likely, if not more so, to be true. For example, a fund with a diverse portfolio of small investments in large liquid markets may have a much smaller global impact than a more concentrated fund.

In addition, the concept is not clearly defined and so will be difficult to operationalize and unhelpful in identifying systemic risk. What is meant, for example, by "invest globally" and "securities of only a few jurisdictions"? Does it mean to invest in (i) securities traded in foreign jurisdictions, (ii) issued by entities incorporated in foreign jurisdictions, or (iii) issued in a fund's domestic jurisdiction, by entities incorporated in that jurisdiction, that have significant international operations, sources of revenue or other securities listed in foreign jurisdictions?

Beyond the ambiguity of the concept, Indicator 5-1 appears to weight equally all jurisdictions and all levels of investment in or exposure to those jurisdictions. Even if this were a valid indicator of systemic importance, it would be inappropriate to weight minimal exposure to a small jurisdiction equally with significant exposure to a jurisdiction that is more integral to the global financial system. Similarly, it would be inappropriate to weight diversified exposure to an asset in that jurisdiction equally with concentrated exposure.

We believe that regulations already limit the number of jurisdictions in which most funds are sold / listed so we question the value of Indicator 5-2. We also question the value of Indicator 5-3, as we disagree that a fund's liquidation will be more complex if a fund's *counterparties* are located in different jurisdictions. The fund itself is only organized under the law of a single jurisdiction and the bankruptcy and other laws of that jurisdiction will govern its liquidation.

Q6-7 - Is the definition of "net AUM" and "GNE" appropriate for assessing the "size" (indicators 1-1 and 1-2)?

We believe that size alone is not indicative of systemic risk regardless of how it is measured. Assuming that it is coupled with leverage, a measure of size as an indicator must be risk-weighted. Please see our responses to Q6-5.

Q6-8 - Is the definition of "investment strategies" sufficiently clear for assessing the "substitutability" (indicator 3-3)?

We believe that indicator 3-3 is flawed conceptually. If a strategy or an asset class has fewer than "10 market players globally," it is not likely to be important to the global financial system. Given the high substitutability and level of competition in asset management, an asset class or strategy with so few

[102] *Proposal*, *supra* note 2, at 36.

investors will be too small to matter. For the same reasons, a fund is unlikely to corner an important market.[103]

We also believe that "investment strategy" is and will continue to be too difficult to define and implement. In conducting a global assessment, it will be impossible to consistently identify and describe the strategies employed by funds across jurisdictions, product types and investor demographics. Funds may be labelled, marketed and regulated differently but employ similar strategies and invest in many of the same assets.

For example, a dividend and income fund, a sector equity fund (e.g., natural resources or utilities) and a global market neutral fund may hold many of the same securities but have very different investment strategies. On the other hand, three global large cap growth funds registered in different jurisdictions and marketed to different types of investors may manage their assets very differently even though they appear to pursue the same strategy.

Q6-9 - Would collecting or providing any of the information included in the indicators present any practical problems? If so, please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

A significant amount of data is already reported to regulators. For example, U.S. investment funds and their managers report vast amounts of data to U.S. regulators. Fidelity and/or the funds it manages file information such as financial statements, comprehensive holdings (including derivatives exposure), and custody information with the SEC on forms such as 13D, 17h, ADV, NCSR, N-MFP, N-Q, N-SAR, and PF. One can get a sense of the scope and scale of the data already available by considering the amount of information reported on just one of these forms. Based on a recent report by SEC staff, over 2,300 advisers covering over 18,000 private funds have filed Form PF, pertaining to nearly $7.3 trillion in private fund assets.[104] We believe that any additional request for information should be made only after carefully reviewing available information and using any comparable data already provided. Regulators should conduct a cost-benefit analysis before requesting new information that imposes significant reporting burdens.

Q1-1 - In your view, are the three transmission channels identified above most likely to be the ones transmitting financial distress of an NBNI financial entity to other financial firms and markets? Are there additional channels that need to be considered?

The three transmission channels accurately describe how the failure of a financial entity could adversely impact other financial firms and markets. The three channels are not, however, equally applicable to all types of entities. As we discuss above, it is extremely unlikely that an investment fund could be Systemically Important. The limited applicability of these channels to investment funds supports our position and our explanation in response to Q6-4 that attempting to regulate funds through SIFI designation is inappropriate.

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[103] *See id.* at 35.

[104] *See* U.S. Securities and Exchange Commission, "Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports," July 25, 2013, *available at* http://www.sec.gov/news/studies/2013/im-annualreport-072513.pdf.

We appreciate the opportunity to comment on the Proposal. Fidelity would be pleased to provide any further information or respond to any questions that the FSB or IOSCO may have.

Sincerely,

cc: Jacob J. Lew, Secretary of the Treasury and Chairman of the Financial Stability Oversight Council
Richard Berner, Director of the Office of Financial Research
Richard Cordray, Director of the Consumer Financial Protection Bureau
Thomas J. Curry, Comptroller of the Currency
John Ducrest, Commissioner of the Louisiana Office of Financial Institutions
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
John Huff, Director of the Missouri Department of Insurance, Financial Institutions and Professional Registration
David Massey, Deputy Securities Administrator, North Carolina Department of the Secretary of State, Securities Division
Debbie Matz, Chairman of the National Credit Union Administration
Michael McRaith, Director of the Federal Insurance Office
Melvin Watt, Director of the Federal Housing Finance Agency
Mark Wetjen, Acting Chairman of the Commodity Futures Trading Commission
Mary Jo White, Chair of the Securities and Exchange Commission
S. Roy Woodall, Jr., Independent Insurance Expert
Janet Yellen, Chair of the Board of Governors of the Federal Reserve System

Luis Aguilar, Commissioner, Securities and Exchange Commission
Daniel Gallagher, Commissioner, Securities and Exchange Commission
Kara Stein, Commissioner, Securities and Exchange Commission
Michael Piwowar, Commissioner, Securities and Exchange Commission