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25 March 2015

Patrick Pinschmidt
Deputy Assistant Secretary
Financial Stability Oversight Council
1500 Pennsylvania Avenue, NW
Washington, DC 200220

Re: Notice Seeking Comment on Asset Management Products and Activities (Docket No. FSOC-2014-0001)

Dear Mr. Pinschmidt :

CFA Institute[1] appreciates the opportunity to provide comments to the Financial Stability Oversight Council (FSOC) on its Notice on Asset Management Products and Activities. CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide on issues that affect the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues that affect the efficiency, integrity and accountability of global financial markets.

Executive Summary

CFA Institute supports the monitoring of asset management firms for their potential to create risks to the financial system. We recognize the use of leverage, an inability to delay redemptions, and significant asset concentrations could transmit problems throughout the financial system. At the same time, regulations covering asset managers with the most assets under management prohibit the use of leverage and permit the use of mechanisms to delay redemptions. Even those that are permitted to use leverage – hedge funds and exchange-traded products (ETPs) – have built-in protections, such as redemption gates for hedge funds and market-based pricing that mitigate the potential for systemically transmitted failure. Moreover, asset management is fundamentally different from bank and insurance institutions in that, beyond the mechanisms noted above, asset managers typically don't own the assets they manage, and assets managed are typically marketable and highly liquid securities.

With regard to FSOC's queries regarding the potential for problems related to securities lending, CFA Institute recognizes the need to improve regulatory understanding about the size of this market, the types of instruments involved, and the frequency and depth of re-hypothecation of

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[1] CFA Institute is a global, not-for-profit professional association of more than 129,000 investment analysts, advisers, portfolio managers, and other investment professionals in 147 countries, of more than 122,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 144 member societies in 69 countries and territories.

collateral. In its traditional form – lending to other investors to enable them to short a security – the securities involved are typically marketable with deep and liquid markets that pose little difficulty to lenders, though these circumstances could change in times of market stress.

More problematic is the overnight lending of short-term, often unmarketable instruments to provide short-term funding. This overnight lending market may pose a greater risk for asset managers, though, most often the asset manager will not be the source of a systemic problem so much as a possible transmission mechanism. For this reason, such lending deserves monitoring.

We also support improved disclosures relating to the use of leverage by investment funds. Many investment funds use leverage to boost returns or to create index-tracking instruments. We believe that publicly traded instruments should have to disclose to the market their use of leverage through the use of debt and through both marketable and non-traded instruments. Prudential regulators also should be aware of leverage used by non-public funds.

Operational risk is an issue that the Securities and Exchange Commission (the SEC or the Commission) is addressing with its Regulation SCI (Systems Compliance and Integrity) as a way to lessen the potential for system wide problems that could cause losses for investors. These rules will apply to trading systems, clearing firms, self-regulatory organizations and plan processors, in particular, to ensure regular testing of their business continuity plans. We support these efforts.

Finally, we believe that the risk of market contagion as the consequence of the failure of a large asset manager is significantly reduced, though not eliminated, by both the marketability of the securities managed and the investment strategies established in offering documents or in direct mandates from clients.

Discussion

We appreciate FSOC's efforts to assess the systemic risk potential and implications of various products, investment vehicles, and practices in our financial services marketplace, with an eye to reducing that risk. The proactive analysis and promulgation of reasonable measures to address areas deemed to pose significant risk or that are detrimental to our domestic and global marketplace is an important endeavor, and one that CFA Institute supports. The market turmoil that befell global banking and capital markets during 2007 and 2008 had deleterious effects on investor trust and investment returns, and we believe it is prudent to take steps to mitigate such events in the future.

As FSOC recognizes in its Notice, the SEC is implementing or considering a number of initiatives that address areas of concern about systemic risk potential/implications in asset management. New money market fund regulations intended to provide safeguards against the potential for first-redeemer advantages/runs caused by increased calls for fund redemptions are being adopted. A number of other initiatives being considered reflect the very concerns raised in the FSOC Notice. In a December 11, 2014 speech, for instance, SEC Chair Mary Jo White called for rules:

> 1) To provide better data reporting about risks, including the use of derivatives, securities lending, and data related to separately managed accounts;

2) Calling on asset managers to implement controls to manage portfolio composition and to evaluate liquidity needs and the use of derivatives: and

3) To track risks associated with industry transitions such as the dissolution of an adviser or other potentially major disruptions.

We support these initiatives, and agree that the SEC and FSOC have complementary roles in addressing the overriding objectives in addressing systemic risk in the asset management sector. Given the SEC's announced efforts to address areas of potential risk, we reiterate our stance/view that FSOC should be slow to take actions to formally address or designate parts of the industry as systemically risky/systemically important and, instead, allow the SEC, as primary regulator of the asset management industry, to implement measures that directly respond to issues raised in this Notice.

We believe that a complementary and collaborative approach will best serve both investors and the marketplace, by allowing the primary regulator to address areas within its explicit oversight jurisdiction, while freeing the FSOC to meet its mandate to identify potential threats to the stability of the financial industry. We believe this approach not only honors the original intent of the creation of the FSOC, but also will produce the most efficient and complete treatment of potential systemic risks to financial stability posed by the asset management industry.

Specific Comments

In its Notice, FSOC seeks information in four areas: liquidity and redemptions; leverage; operational risk; and resolution. While a number of these areas overlap in terms of potential concerns, we provide comments below generally in these four areas.

Liquidity and Redemption

FSOC is seeking specific comment on the potential risk interplay in the asset management area relating to liquidity risks and redemptions. In particular, FSOC is concerned about instances where the benefit to first redeemers is so significant that it could cause investors to initiate a run on a fund during times of market stress. The Council asks in the Notice "whether such redemption incentives could make fire sales more likely in the asset markets in which the pooled investment vehicles invest, as well as in correlated or broader asset markets."

As noted above, liquidity management by fund managers is a major focus for the SEC based on its recognition that portfolio composition and the ability to meet redemptions in times of market stress may be tightly linked. Moreover, the SEC is considering stress-testing requirements for large investment advisers and funds as an additional means of identifying and managing risk.

In the meantime, the Commission has introduced a number of measures that address the FSOC's concern about runs on the market in times of market stress. Among those measures, mutual fund managers must manage and mitigate redemption risk through well-established liquidity management mechanisms. To this end, at least 85% of mutual fund assets must be in liquid instruments that can be sold within seven days. There is general recognition that such expectations may be challenged during times of market stress for many types of funds. To that end, funds also have the ability to retard contagion due to heavy demand by delaying redemptions for seven days during times of stress, by borrowing against fund assets to meet those redemption requests, or by making “in-kind” redemptions.

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

Money market funds did contribute contagion during 2007 and 2008, largely due to their role as a funding source for commercial banks and the mismatch in maturities of their assets and liabilities. Since July 2014, the SEC has adopted changes aimed at reducing the potential for “runs,” including new rules requiring floating net asset values (NAVs) for the pricing of institutional prime money market fund shares. Stable NAVs are permitted only for funds invested solely in government securities and for funds available for retail investors. Non-government money market funds must use liquidity fees and redemption gates to deter runs on the market from excessive redemptions demands. While these new rules remain untested, we believe they ultimately will reduce the incentive for large institutional investors, in particular, to seek first redemption advantages.

The Notice also seeks comment on how redemptions associated with securities lending could increase financial instability. In particular, FSOC raises the possibility of risk brought about by redemption incentives of pooled investment vehicles. In particular, they are concerned with the potential that lenders that have reinvested cash collateral from securities borrowers may face liquidity issues should the securities loans be terminated, thus requiring repayment of the cash collateral. It asks whether such redemptions will increase during times of financial stress and whether there are broader implications for the financial markets.

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

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

Entities most at risk in securities lending markets, however, are those borrowing the securities for their short selling strategies. “Shorts” are at a disadvantage because a) they must borrow shares for their strategies, b) the vast majority of investors are long investors, and c) they face the potential for being ”squeezed” by long investors. The risk of getting squeezed is a function of long investors recognizing the need for the shorts to repurchase the securities at some point in the future, and thus bidding up the price for the securities and undermining the shorts’ position. In such circumstances, therefore, the shorts lose by having to repurchase the securities at a higher price while long investors benefit from the increase in price. The securities lenders also may squeeze the shorts by requiring the securities be repaid prior to when it would be convenient for the shorts. Again, the borrowers must repurchase the securities and potentially bid up the price in the process.

Nor do we see a potential systemic event arising as a consequence of shorts terminating their borrowings and demanding repayment from securities lenders. We recognize the potential for disruptions for specific firms arising in this manner, but not system wide disruptions. For this type of situation to rise to a systemic level would require en-masse termination of short positions, and simultaneous demands for return of collateral. For this to occur, a general expectation of increasing securities values would be needed. We believe it is unlikely for such a situation to occur without significant regulatory intervention as occurred in October 2008 when regulators restricted the ability of investors to short bank stocks. Even then, the resulting rise in the value of the underlying securities as shorts moved aggressively to repurchase shares to unwind their short positions reduced the potential harm to the lenders.

More potentially problematic is securities lending for the funding needs of large institutions. Overnight repurchase agreements, in particular, are a means of lending less-liquid, short-term instruments overnight in return for cash to providing needed funding. In general, though, we would expect that most such problems would develop elsewhere and affect the securities lending market, rather than originating in the securities lending market and causing problems in other parts of the financial system.

In expressing concern about ways in which asset managers may not appear to prevent or mitigate risks to an investment vehicle and overall financial system, the Notice mentions that investor preferences about the vehicle’s investment strategy and portfolio allocation, or pressure to outperform benchmarks may encourage a vehicle to continue investments in certain asset classes that limit its cash or liquid holdings.

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

Leverage

The Council is especially interested in how private funds and separately managed accounts obtain leverage. It recognizes that mutual funds are limited in use of leverage, but nevertheless is interested in the nature and extent to which they obtain leverage, including funds’ use of derivatives. It also seeks information on how different investment vehicles obtain leveraged market exposures as distinct from hedging risks related to other investment positions.

Securities regulations do not allow mutual funds to be levered without providing disclosure of this to investors in the Prospectus and Statement of Additional Information. The SEC recognizes, however, that more than disclosure may be required, and that while derivatives are often used to manage risk, they can also become a source of risk. To that end, SEC staff is currently reviewing options for new requirements aimed at better managing of these risks, including whether to require “broad risk management programs” as well as whether to limit the amount of a fund’s leverage from the use of derivatives.

With regard to leverage, certain types of investment funds, including hedge funds, private equity funds and leveraged ETPs, use leverage to boost return and, in the process, can increase the potential for systemic problems in certain conditions. Indeed, CFA Institute supported monitoring of hedge fund activities in the United Kingdom prior to the 2007-2008 market turmoil[2] as a means of tracking potential systemic risks to U.K. financial markets and, in particular, the interaction between hedge funds and prime brokers. Ultimately, though these firms did not cause that market crisis and many failed without receiving sovereign bailouts. We also note that unleveraged investment strategies can produce significant risks as a consequence of investment concentrations and lack of liquidity.

We also note that investors in certain synthetic ETPs face losses as a consequence of a number of risks. Institutions creating synthetic ETPs can use the cash raised to fund illiquid assets, creating the potential that they cannot meet promised on-demand liquidity provisions. Moreover, the ability to obtain such funding could disappear in certain market conditions, leaving the institutions with capital and liquidity deficiencies that could lead to disruptions in the market for their sponsored ETPs. But we would expect these issues would not create problems of the magnitude that would affect the broader financial system.

Operational Functions

The Council particularly is interested in (1) risks associated with the transfer of significant levels of client accounts or assets from one manager to another, especially relating to the transfer of separately managed accounts, and (2) risks when multiple managers rely on one or a limited number of third parties to provide important services (eg, asset pricing and valuation of portfolio risk management).

It notes that the industry relies significantly on technological systems and that there is a need for strong operational controls in the industry that are vulnerable to a number of operational risks, from cyber-attacks to normal system disruptions. FSOC is interested in understanding whether any operational risks to asset managers could have broader implications for financial stability.

The SEC’s recent adoption of Regulation Systems Compliance and Integrity (Regulation SCI) is intended to lessen the direct impact on investors and market participants of technological glitches. Under Regulation SCI, certain alternative trading systems and clearing agencies, as well as self-regulatory organizations and plan processors must routinely test their business continuity plans and have in place a framework for taking corrective action in case of systems failures. In

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

addition, large investment advisers and funds now have to perform annual stress testing. However, the SEC recognizes that more needs to be done.

In her December 2014 speech, Chair White specifically called for more and better data and information that would help draw conclusions about the areas and assets most at risk, as well as a call for firms to have plans in place for transitioning client assets. She noted that SEC staff is currently in the process of developing recommendations for requiring advisers to have transition plans for client assets in times of major disruptions.

CFA Institute supports these steps and believe Reg SCI is an important and needed step to mitigate and lessen the effect of technological problems on markets and investors. We also support Chair White's call for data collection to help the Commission thoughtfully consider ways to increase the possibility for the smooth transitioning of client assets from a failed institution to one that will assume those clients' accounts.

Resolution

In its Notice, FSOC expresses interest in knowing what impact the failure or closure of an entity could have on markets, or the overall economy, and whether there are "specific financial interconnections" that could present risks. It asks about the implications of a private fund's failure and about issues that would make the resolution of an asset manager or investment vehicle with international operations more complex.

In our comments to the SEC in regard to the President's Working Group Report on Money Market Fund Reform in April 2011[3], we suggested mechanisms to manage the resolution of mass redemptions in times of high market stress. These mechanisms included advance-notice periods for redemptions, the use of in-kind distributions, temporary suspensions of redemptions, or pro-rata redemptions for redeeming investors. We noted that such mechanisms should be used only in periods of high market stress, and that the SEC would have to carefully restrict such declarations to those related to market-wide stresses. We believe such mechanisms applied by other asset managers will, in most cases, mitigate and lessen the negative effects of the failure of a private fund and prevent the contagion of failure to other firms within the financial system.

Finally we are aware that there are structures in other markets that could trigger wider contagion risk. In particular, some leverage bond LDI (liability-driven investment) funds may have difficulty recapitalizing in distressed markets. The inability of some of these funds to recapitalize quickly enough could create severe dislocations and potential contagion across developed financial markets.

Conclusion

We appreciate FSOC's efforts to assess the potential systemic risk posed by the asset management industry. As noted above, we support the view that the FSOC has good reason to monitor the asset management sector to stay abreast of potential systemic developments, though

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

we believe direct oversight and regulation for the sector needs to remain with the SEC due to its knowledge and experience with the sector's business models. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or James C. Allen, CFA at james.allen@cfainstitute.org or 434.951.5558.

Sincerely,

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