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Steven T. Mnuchin
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

Via Federal Express

Re: A Financial System That Creates Economic Opportunities: Asset Management and Insurance

Dear Secretary Mnuchin:

CFA Institute[1] appreciates the opportunity to provide comments to the U.S. Department of the Treasury on its report, "A Financial System that Creates Economic Opportunities—Asset Management and Insurance" (Treasury Report or Report). CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide about issues affecting the practice of financial analysis and investment management, education and licensing requirements for investment professionals, and on issues affecting the efficiency, integrity and accountability of global financial markets.

Executive Summary

We appreciate the recognition in the Treasury Report of the differences between the asset management industry and banking sector in terms of systemic risk implications. Accordingly, we agree with a number of the Report's recommendations, namely:

- Recommending using an activities-based framework, rather than entity-based evaluations for identifying systemic risks;
- Rejecting the call for stress-testing of investment advisers and investment companies;
- Calling for the SEC to withdraw its proposed business continuity rule; and
- Rejecting prudential regulation of the asset management industry as the most effective way to mitigate risks.

[1] CFA Institute is a global, not-for-profit professional association of more than 159,000 investment analysts, advisers, portfolio managers, and other investment professionals in 166 countries, of whom more than 150,000 hold the Chartered Financial Analyst® (CFA®) designation. The CFA Institute membership also includes 151 member societies in 70 countries and territories.

In addition, we agree with the Report's conclusions that non-money market funds are seldom the source of "runs" that occur during financial meltdowns that contribute to contagion.

Background

As an organization, CFA Institute strongly supports meaningful measures to ensure investor protections. We also recognize that investing in our capital markets is not without risk, and that unnecessary restrictions aimed at curtailing risks could lead to undesirable results, including limited investor returns, the shifting of risks to less-transparent markets and instruments, and diluting the robustness of our capital markets. Finding the balance between encouraging capital formation and investor protection is often a challenge.

The global financial meltdown of 2007-09 made this balance more difficult. Regulators and policymakers have been sensitive to sectors and practices within the financial services arena that could contribute to risk contagion in the future and have sometimes undertaken actions to mitigate those risks. Given the magnitude of harm caused by that crisis, we appreciate actions to "get ahead" of the next crisis, while we also recognize the ongoing difficulties in identifying "natural" risks that are inherent in our financial markets and those that may ultimately lead to systemic contagion.

Nevertheless, we believe whatever actions are taken to get ahead of the next crisis need to do so in a way that is cognizant of the manner in which risk is managed and where it is borne. We note that this Treasury Report recognizes the different realities inherent in banking and asset management. We also note the Report's suggested approach for dealing with potentially systemic problems in asset management is by monitoring and controlling the risks embedded within specific products. We have expressed similar perspectives in the past. Having made such distinctions, we believe the Treasury can move forward in a more effective way to reduce the risk of serious systemwide problems in the future.

Discussion

We are strongly supportive of the discussion in the Report that recognizes and distinguishes between the systemic risk implications of the asset management and the banking industries. Often as regulators and policy makers have grappled with identifying potential pockets of systemic risk, CFA Institute has expressed concern about a tendency for regulators to equate the systemic risks in the asset management industry with those of the banking sector. We have felt this risk equivalence is not warranted by either the nature or structure of the two industries. Specifically, we question whether a systemic risk issue exists in regard to the vast majority of registered and regulated open-end funds. Efforts to apply barriers to contagion and to implement additional measures appropriate to the banking sector in order to address potential risks in asset management have missed their intended marks.

For example, unlike the banking industry, investment and asset managers typically sell not only the products but also the risk of investing in those products to their clients, and then manage the

underlying assets on behalf of those same clients. We have pointed to these fundamental differences in comments to regulatory, policy-setting and research bodies, both in the United States and in Europe.[2]

We comment below on aspects of the Report with which we agree, as well as disagree. We focus our comments on recommendations that affect the asset management industry.

Aspects of the Treasury Report on Which CFA Institute Agrees

Recommending shifting to an activities-based framework (rather than entity-based evaluations) for identifying systemic risks, in recognition of the fundamental differences between the banking, asset management and insurance industries

Consistent with this recommendation, CFA Institute has commented on multiple occasions that the asset management industry differs from the banking industry in fundamental ways. These differences demand different analyses when considering the potential for systemic risk contagion. Unlike banks that guarantee depositors' principal, asset managers serve as agents for their client portfolios and investments. As noted above, asset managers do not own the assets and are constricted by client directives and risk tolerances in their handling of client money. Returns from the investment funds that managers create and sell to their clients are not guaranteed but are paid to clients in accordance with changes in the market value of the portfolio assets.

One other important difference between asset managers and the banking industry are the rules restricting the ability of investment funds regulated under the Investment Company Act of 1940 (the "1940 Act") to incur indebtedness. Whereas banks are highly leveraged institutions — even under more robust capital requirements, liabilities at most banks will amount to 10 times or more their equity capital — 1940 Act investment funds have significant restriction on the amount of indebtedness they can incur. Investment funds that are able to use leverage are typically small, have more diverse and unique investment strategies, and typically impose investment limits to permit them to be nimble in search of higher returns.

Moreover, when assessing the systemic risk potential of a certain financial sector, it is important to weigh whether extreme distress or failure of individual participants in that sector would likely cause widespread and severe disruption to the continued operation of the global financial system.

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[2] See 4 December 2013date letter from James C. Allen and Linda L. Rittenhouse to Elizabeth Murphy, Secretary Securities and Exchange Commission on "OFR Report on Asset Management and Financial Stability;" 21 September 2016 letter from Kurt N. Schacht and Linda L. Rittenhouse to Secetariat of the Financial Stability Board on "Consultative Document: Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities;" 28 May 2015 letter from Kurt N. Schacht and Linda L. Rittenhouse to Secretariat of the Financial Stability Board on "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions;" 25 March 2015 letter from Kurt N. Schacht and James C. Allen to Patrick Pinschmidt, Deputy Assistant Secretary, Financial Stability Oversight Council; 12 January 2016 Kurt N. Schacht and Linda L. Rittenhouse to Brent J Fields, Secretary, Securities and Exchange Commission on "Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release;" and 18 September 2017 letter from Kurt N. Schacht and Linda L. Rittenhouse to Shane Worner, General Secretariat of the International Organization of Securities. Commissions on "Public Comment on Open-ended Fund Liquidity and Risk Management—Good Practices and Issues for Consideration."

The asset management sector has a high degree of "substitutability," where many providers could readily assume the services of an asset manager should that manager fail. Given the nature of the industry, the familiarity among participants in the industry with the operations, processes, subject matter and regulations all increase the likelihood that existing asset management firms could assume the servicing of client accounts in the case of economic distress or failure of an incumbent service provider. Analysis of investment funds and asset managers therefore should consider a range of factors, including asset concentrations, correlations with asset concentrations in other parts of the financial sector, mismatches in the maturities of the assets of money market funds vis-à-vis the timing of potential withdrawals, and the degree of operating and financial leverage used by the funds and managers. While size is a factor to consider as a first-tier analysis for systemic risk of entities, firms and sectors, we believe it should be only an initial filter in winnowing the pool of market participants, and not necessarily determinative of systemic risk potential. The size of any sector or firm needs to be carefully viewed in terms of the total mix of activities, interconnectedness, and involvement in services or with products that are of a nature that could affect markets to the extent that it would be systemic.

Rejecting the call for stress-testing of investment advisers and investment companies (as currently required under the Dodd-Frank Act)

Programs used to conduct stress testing may favor certain types of investment products, practices, and redemption provisions. We fear that standardized stress-testing mandated by regulators could encourage unintended herding in the asset management industry[3]. We believe that herding that occurred in the commercial banking sector contributed to its systemic problems, whereas the asset management sector benefits from its agency structure, as well as diverse investment instruments, strategies, issuers and horizons.

Calling for a principles-based approach to liquidity risk management rulemaking and rejecting the regulatory approach that requires "bucketing" of assets as part of liquidity risk management programs and recognizing the existing leverage, liquidity, diversification, and control requirements with which asset managers must already comply

In comments to the SEC on its liquidity risk management program proposal, CFA Institute recommended that the Commission consider a more principles-based approach providing guidance, rather than mandating the proposed requirements. We particularly argued against a rule that would require open-end investment companies, including open-end exchange traded funds, to classify the liquidity of fund portfolio assets. We believe that such an approach fails to fully account for a) the nature and liquidity of 1940 Act companies' investment portfolios, and b) the changing nature of "asset buckets" or the role that funds' time horizons serve. In fact, such a requirement would increase a tendency for funds to make investment decisions that are similar to other funds, which ironically could increase systemic risk potential. Moreover, the asset

[3] See 12 January 2016 letter from Kurt N. Schacht and Linda L. Rittenhouse to Brent J. Fields, Secretary, Securities and Exchange Commission on Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release.

management industry is heavily regulated, especially in light of the new regulations that have been implemented since the 2007-09 financial crisis, in response to perceived shortcomings.

Recommending that the SEC withdraw its proposed rule imposing additional business continuity requirements, given the principles-based rules that already exist

While strongly supporting the overriding goal to protect investors and their accounts in times of stress, CFA Institute has questioned the need for an additional regulation imposing business continuity requirements on investment advisers. In comments to the SEC on its proposal to create new Rule 206(4)-4 under the Investment Advisers Act of 1940 (the "Advisers Act"),[4] we noted that registered advisers generally already have established continuity plans which are regularly examined as part of the SEC's examination process. Moreover, the proposal itself noted the additional costs that advisers would incur if the rule were adopted, and that those costs may well be passed on to investors.

We believe that advisers take seriously the need to have adequate business continuity plans as part of their keeping safe client assets that are entrusted to them, and already have procedures in place. For example, existing Rule 206(4)-7 of the Advisers Act already addresses in a general way the need for advisers to have such plans. It requires them to adopt and implement written policies and procedures to prevent Advisers Act violations, including the obligation to address business continuity plans to the degree they are relevant. To supplement this overarching obligation, we recommended that in lieu of a new rule that the SEC use a principles-based approach—clarifying that a regulatory mandate exists to create and maintain business continuity plans and providing guidance on the particulars that those plans should include.

Noting that the "runs" that occur during times of financial stress/crises and systemic risk contagion typically do not occur in non-money market funds

We agree that a decade ago, money market funds faced challenges with respect to redemption requests and "runs" that contributed to a contagion effect in the markets. However, regulations implemented by the SEC since 2008-09 addressing liquidity limits and allowing the use of gates during times of extreme stress have substantially reduced the danger of contagion during market distress.

We also have repeatedly questioned whether a systemic risk issue exists with respect to the vast majority of open-end funds. The 1940 Act already imposes a robust barrier against that kind of contagion. Even when tested by the conditions faced during the 2007-09 financial crisis, non-money market funds did not trigger the types of challenges posed by money market funds. Regulations in place for these funds that mitigate concerns raised in times of stress include requirements that asset managers manage redemption risk through well-established liquidity management mechanisms, including a requirement that at least 85% of investments must be in assets that could be sold within seven days. Moreover, non-money market funds can hold back

[4] 16 September 2016 letter from Kurt N. Schacht and Linda L. Rittenhouse to Brent J. Fields, Secretary, Exchange Commission on Business Continuity and Transition Plans.

redemptions for up to seven days during times of stress, can borrow against fund assets to meet redemption requests, and may adopt policies that allow them to make "in-kind" redemptions.

All this said, we do agree that in the case of our largest asset management firms, the robustness of their systems and operations to ensure smooth functioning in times of great market volatility are important. During inevitable market panics, it is these firms and their systems that will experience extreme pressures on infrastructure, client service systems, trading and reporting platforms that must perform in extremis. Any seizing of the operational systems in this regard could result in substantial systemic, knock-on effects which should be studied and understood as to whether further back up or "stress" testing is warranted.

Rejecting prudential regulation of the asset management industry as the most effective means of mitigating risks

CFA Institute has long-questioned the approach by regulators to implement measures aimed at addressing potential systemic risk implications of the asset management industry. Distinct from the banking industry, asset managers do not own the underlying assets, but rather act at the direction of their clients and in accordance with investment objectives. The asset management industry is already heavily regulated, with additional regulations having been implemented in response to the financial crisis of 2007-09. We believe that even the failure of a large asset manager would pose a significantly reduced risk of market contagion due to the marketability of the securities managed, the investment strategies already established and the substitutability described above—either through offering documents or direct client mandates.

Discussion in the Report of standards of conduct for financial professionals.

We particularly want to comment on certain aspects of the Report's discussion of the DOL's fiduciary duty rule that calls on the DOL and SEC to work together to address both retirement and non-retirement assets, and the role of the SEC to regulate through FINRA appropriate marketing and disclosure materials.

In a recent letter[5] to the SEC, CFA Institute called upon the SEC to take certain actions to clarify the use of the "investment adviser" title. We have long advocated for a uniform fiduciary duty rule for personalized investment advice. While we had hoped the SEC would take the first steps to implement such a rule, absent that, we have supported the DOL's fiduciary rule as a step forward. In this letter to the SEC, we called upon the SEC and DOL to work together to create "a legally and economically consistent structure that has the effect of creating regulatory parity for investment advice, whether for retirement or non-retirement purposes."

In our letter, we also urged the SEC to require registered representatives (registered with FINRA) to provide proper disclosure of their role. Specifically, we believe they should have to provide "prominent, clear, complete, consistent and ongoing disclosure to their clients that they do not legally represent the interests of the retail customer/account holder." Not only is this type

[5] See 10 January 2018 letter from Kurt N. Schacht, CFA, James C. Allen, CFA, and Linda L. Rittenhouse to the U.S. Securities and Exchange Commission on Standards of Conduct for Investment Advisers and Broker-Dealers.

of disclosure common to professional sales relationships, it clearly puts the investor on notice that the broker is not operating under a fiduciary standard in that relationship as service provider.

Aspects of the Treasury Report on Which CFA Institute Differs

Urging Further Study on the Use of Swing Pricing

While we do not support an option allowing funds to use full swing pricing, we do support the SEC's proposal to allow funds to use partial swing pricing in certain situations to mitigate the dilution of shareowner value resulting from transaction costs related to purchases and redemptions. In our comment letter to the SEC on its proposal,[6] we noted our concerns with several potential pitfalls associated with swing pricing, including increased volatility, tracking errors, and investor misperceptions about funds' performance that could led to market distortions. Nevertheless, partial swing pricing would allow adjustments to the net asset value only when the net purchase or redemptions exceed an established threshold. We believe this approach will reduce dilution on assets while resulting in lower volatility than full swing pricing.

We believe the measures recommended by the SEC in its proposal by which funds could opt to use swing pricing are appropriate. We also support the proposed requirements that the fund boards, including a majority of their independent directors, should have to approve the fund's initial swing policies and procedures.

Conclusion

We appreciate, and are supportive of, many of the recommendations contained in this Report. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org, 212.756.7728 or Linda Rittenhouse at linda.rittenhouse@cfainstitute.org, 434.951.5333.

Sincerely,

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[6] See footnote 3, *supra*.