

21 September 2016
Secretariat of the Financial
Stability Board
c/o Bank for International Settlements
CH-4002
Basel, Switzerland

Re: Consultative Document: Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities

Dear Secretariat of the Financial Stability Board:

CFA Institute appreciates the opportunity to provide comments to the Financial Stability Board (FSB) on the its Consultative Document on Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities (Consultation or Proposal). CFA Institute is a global, not-for-profit professional association of more than 148,800 investment analysts, advisers, portfolio managers, and other investment professionals in 158 countries, of which more than 142,100 hold the Chartered Financial Analyst® (CFA®) designation. Its membership also includes 147 member societies in 73 countries and territories.

CFA Institute represents the views of those investment professionals who are its members before standard setters, regulatory authorities, and legislative bodies worldwide on 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

CFA Institute supports efforts to monitor areas in the financial markets that present the potential to create systemic risks to the financial system. To be an effective use of resources, this monitoring should be based on a meaningful understanding of a particular industry, as well as recognition of the existing regulations that mitigate risk. We believe that many of the areas that are the subject of recommendations in the Consultation have already been addressed, or are the focus of pending regulations in major financial markets.

As recognized in the Consultation, the asset management industry already has weathered significant financial market disruptions with few cases that raised systemic risk concerns. Moreover, the industry has in place a number of safeguards to mitigate the potential for risks rising to systemic proportion. Thus, while many of the recommendations proffered by the FSB are unobjectionable, we question their need. More concerning is the rationales offered for a

number of the recommendations, as they appear to be based on conjecture and lacking an appreciation of regulations already in place or under consideration by primary market regulators.

Discussion

In this Consultation, the FSB considers risks to global financial stability by focusing primarily on four structural areas of the asset management which it perceives as present vulnerabilities:

- Liquidity transformation by investment funds¹;
- Leverage within funds²;
- Operational risk and challenges in transferring investment mandates in stressed conditions; and
- Securities lending activities of asset managers and funds.

Of these, the FSB considers the first two to be “key vulnerabilities.”

We appreciate the FSB’s efforts to suggest meaningful recommendations related to the asset management industry and perceived vulnerabilities that may contribute to systemic risk. CFA Institute supports attention to and proactive measures to address areas within this industry that could contribute to systemic risk and contagion. As we noted in our 28 May 2015 response to the Consultative Document promulgated by the FSB and IOSCO on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, we take seriously the need for the asset management industry, as well as other market sectors, to have procedures not only to safeguard investor interests in time of stress, but also to minimize the potential for contagion.

As regulators and monitoring bodies assess aspects of the asset management industry (and other related industries) with an eye to the characteristics and practices that may give rise to substantial disruptions in the future, it is important to weigh the past incidences of problems with the likelihood for future problems. We recognize that hindsight provides a convenient lens through which to evaluate business models in hopes of heading off future disruptions and also recognize this is not a perfect science. But we believe it imperative that “potential” problems that “may” derive from a certain practice be clearly distinguished from the *likelihood* of them occurring.

As we noted in our earlier response, the asset management industry is heavily regulated in the major capital markets, particularly in light of new regulations implemented by regulators in response to perceived shortcomings following the financial crisis of 2007-08. While regulation of asset management activities is not a perfect system and recognizing that addressing past problems does not guarantee future safety, we nonetheless question the presumptions underlying FSB’s recommendations. Specifically, we question the basis for this Consultation in that attention is being paid to certain aspects of a market sector that not only withstood the financial

¹ Money market funds are not included as part of this Consultation, but include other funds, public and private, including ETFs.

² Leverage considerations pertain to public, private, and closed-and open -ended funds, including ETFs.

crisis with relatively little disruption but that also appears to pose relatively reduced danger due to regulatory actions taken since the crisis.

In fact, throughout this Consultation, the FSB repeatedly notes the resiliency of, and lack of financial stability concerns associated with open-end funds and the asset management industry. But while non-money market funds generally have not created financial stability concerns in recent times, the FSB is concerned about potential structural vulnerabilities that might increase strains on liquidity or lead to contagion in the future. We think it is important to distinguish between actual structural vulnerabilities and the types of risks that are inherent in a vibrant capital market system. While we welcome efforts to mitigate potential vulnerabilities, we think it is also important not to impose restrictions in areas that do not pose the likelihood of systemic risks in times of severe market downturns or business continuity disruptions.

Moreover, we believe that current or pending regulations in relevant jurisdictions already address the issues underlying many of the recommendations. The Consultation notes that one-half of the world's open-end mutual funds are managed in the United States, with another third in Europe. Given these numbers, and given that regulators in both jurisdictions already have taken steps to alleviate practices that could contribute to systemic risk, we question the need perceived by a global body to propose additional regulations.

For example, the U.S. Securities and Exchange Commission (SEC) in 2015 proposed a number of regulations to increase the stability of the asset management area. These include a regulatory proposal requiring open-end funds (including open-end ETFs) to maintain a liquidity risk management program aimed at “reducing the risk that funds will be unable to meet redemption obligations and mitigating dilution of the interests of fund shareholders....” Other regulations proposed by the SEC last year sought to address the use of derivatives by investment companies; amendments to Form ADV that would allow, in part, the SEC to monitor industry trends that would inform it of emerging risks; and an investment company modernization act. It most recently proposed new regulations for the industry related to the need for business continuity plans (including a transition continuity plan) to ensure the smooth transition and servicing of accounts during times of significant stress. Given the percentage of assets held in, and managed by asset managers in the United States, we suggest that regulations proposed by the primary regulator for this sector should first be given time to take effect before new ones are considered and proposed. We encourage the FSB to take a closer look at those regulations and accompanying policy commentary.

In general, we do not oppose the various 14 recommendations that FSB proffers, as for the most part, they suggest a review of current practices and the consideration of best practices. Half of them recommend that IOSCO review existing guidance and, as appropriate, enhance it. To that degree, these recommendations highlight concerns raised by the FSB in the past and advocate for closer scrutiny. However, they do little to “move the needle.”

While we support meaningful measures to increase investor protection and financial market stability, we also note that investing in capital markets is not without risk. To that end, we believe that most of the perceived “residual risks” that drive the FSB recommendations are in the process of being addressed and thus not of the magnitude of potential risk that warrant additional regulatory measures.

We address these recommendations below.

A. Liquidity Mismatch Between Fund Investment and Redemption Terms and Conditions for Open-end Fund Units

Recommendation 1: Authorities should collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective. They should review existing reporting requirements and enhance them as appropriate to ensure that they are adequate, and that required reporting is sufficiently granular and frequent.

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

We agree with the Consultation statement following Recommendations 1 and 2 that “any additional requirements should be proportionate to the benefits they bring” to authorities and investors. We also agree that most jurisdictions already have in place specific requirements that address liquidity risk management practices on a daily basis and that impose oversight responsibilities on the fund’s manager or board of directors to ensure that redemption requests can be met.

As noted above, the SEC recently proposed extensive requirements for funds to have liquidity risk management programs.

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

We agree with the discussion in the Consultation accompanying this recommendation that “Authorities should require or have guidance that funds have robust liquidity risk management procedures in place so that asset holdings remain consistent with the terms and conditions governing fund unit redemptions.” We believe this approach is consistent with that taken in the SEC’s proposal on liquidity risk management programs. In keeping with our response to that proposal, we believe that guidance, rather than new regulations, is the best option.

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

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

We question whether the perceived “first-mover advantage” is a problem that warrants additional scrutiny, particularly given the regulations in the U.S. money market fund arena that now allow floating NAVs for institutional investors and the use of gates in the retail investor sector.

However, in keeping with the SEC’s proposal on liquidity risk management programs, we do support the option to use swing pricing in certain situations to mitigate the dilution of existing shareholder value. We also support providing disclosures to investors about how redemption requests will be handled in stressed situations. We recommend the use of gates and optional swing pricing as mechanisms to meet redemptions in times of severe stress, rather than the use of cash buffers.

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

In the US, the Dodd-Frank Act requires the SEC to implement rules that require large investment advisers and funds to conduct annual stress testing. SEC Chair White this spring reiterated the agency’s commitment to propose new regulations along these lines in the near future.

At the same time, we have one concern with stress-testing, in that the programs used to conduct the tests have the potential to favor certain types of investment products, practices and redemption provisions. Herding in the commercial banking sector is one reason the sector has suffered systemic problems in the recent past. By comparison, the investment sector benefits not only from its agency structure, but also by the diverse investment horizon in which it invests. We fear that standardized stress-testing conducted by regulators could encourage unintended herding in the asset management sector, which we believe would create more systemic risk than less.

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

Recommendation 8: Authorities should provide guidance and, where appropriate and necessary, provide direction regarding open-ended funds’ use of extraordinary liquidity risk

management tools. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.

We agree with Consultation language that “use of such extraordinary liquidity risk management tools should be carefully considered in light of the potential spillover effects that may arise from their use.” Investors should be provided clear information about any extraordinary tools or the processes funds may use to manage liquidity risk in times of severe stress.

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

We note that commentary to this recommendation states that authorities may wish to consider “whether” and how funds and institutional investors should be incorporated into system-wide stress testing to gain a better understanding of collective behavior and effects on financial markets. We believe the “where relevant” part of this recommendation is pivotal and encourage more explanation about situations in which this may be advisable.

As noted above, we have concerns that system-wide stress-testing could lead to herding behavior by asset managers akin to what is largely prevalent in the commercial banking sector. Given that central banks are the entities most likely to conduct such system-wide testing, we have additional concern that the tests will not adequately consider the nature and structure of the asset management business, and its differences with commercial banking.

Questions in Consultation

In response to a question in the Consultation as to the characteristic that should be used to determine if an asset is illiquid, we support the proposed definition in the SEC’s proposal on risk management programs. That proposal suggested defining an asset as illiquid if there is the potential that it “may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by the fund.”

With respect to whether all open-end funds should be expected to use the same liquidity risk management tools or be allowed discretion, we support an approach that allows funds flexibility to use the tools that are appropriate in light of their asset compositions, risk-taking policies, use of leverage, structure, and asset or industry concentrations, among other characteristics. We support a principles-based approach with guidance to allow funds to conduct reviews and assessments based on the totality of attributes that in the aggregate have the potential to produce systemic risks.

B. Leverage Within Investment Funds

Recommendation 10: IOSCO should develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions. This would enhance authorities’ understanding of risks that leverage in funds may create, facilitate more

meaningful monitoring of leverage, and help enable direct comparisons across funds and at a global level. IOSCO should also consider developing more risk-based measure(s) to complement the initial measure(s) and enhance the monitoring of leverage across funds at a global level.

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

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

The Consultation notes that most jurisdictions have regulatory and supervisory measures that establish limits on leverage for certain types of individual funds but that there is not enough focus on when leverage may build across funds. It reasons that the lack of consistent and accessible information on leverage prevents a full understanding of which funds' use of leverage could contribute to risk. The above recommendations are intended for all types of fund leverage—both synthetic and financial.

Existing regulations in the United States already limit the use of leverage by mutual funds, which must be disclosed to investors. Moreover, certain regulatory schemes impose restrictions on managers to the largest funds from using leverage at all. Nevertheless, we recognize that monitoring the use of leverage in funds that are not subject to regulatory limits may provide useful information. Given the types of leverage practices that funds use, we question the ability to develop “simple” tracking measures that will provide meaningful information. Instead, we suggest identification and monitoring of certain structures used in global markets that may contribute to contagion risk, such as leverage bond LDI (liability-driven investment) funds.

C. Operational Risk and Challenges in Transferring Investment Mandates in Stressed Conditions

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

As we have noted in past comment letters, because asset managers do not own underlying assets and instead act as agents (rather than principals), we believe there is reduced risk for systemic disruptions or contagion resulting from disruptions to advisory businesses. Based on client objectives, funds and firms with similar operations should be able to take on the displaced assets and result in a smooth transitioning.

We note that the SEC has recently proposed that registered investment advisers be required to adopt and implement written business continuity plans (including transition plans) to address operational and other risks related to severe disruptions in operations. These requirements focus on measures to allow the continued smooth servicing of client accounts in times of significant stress. While we support the creation and implementation of plans to manage transitions in

periods of severe stress, we believe that regulations should not detail the specifics that each plan should address, but instead provide advisers with guidance and the commensurate flexibility.

D. Securities Lending Activities of Asset Managers and Funds

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

The FSB notes its concerns about risks from securities lending activities by market participants, including asset managers. These include “maturity/liquidity transformation and leverage associated with cash collateral reinvestment, pro-cyclicality associated with securities financing transactions, risk of fire sales of collateral securities, and inadequate collateral valuation practices.” Another concern is the risk associated with when there are agent lender indemnifications. Even though it notes that “very few asset managers seem to be currently involved in providing such indemnifications, the scale of exposures can be as large as that of some global systemically important banks.”

The consultation notes that there seem to be safeguards already in place for funds that lend securities as beneficial owners and for asset managers that act as agent lenders. But the practices and tools may vary across jurisdictions. The recommendation derives from the concern that although “a limited number of large asset managers act as lenders, authorities currently don’t have sufficient information/data on the agent lender activities to monitor trends and potential risks to financial stability associated with any indemnification they provide to lending clients.”

We understand the FSB’s concern about material risks developing in the securities lending markets, particularly as a result of financial institutions attempting to get around other regulatory barriers and we support collection of relevant data for monitoring purposes. Nevertheless, we believe there are fundamental differences between securities lending activities and the kinds of lending conducted by commercial banks that reduce the likelihood of such risks in asset management.

For one thing, securities loans are secured by marketable instruments with publicly available values. The cost of such loans is generally a function of the availability of securities to borrow, making securities borrowing profitable more expensive for low-liquidity instruments.

We see two primary risks in securities lending. First, there is the risk that a price increase for securities lent to a short seller will put the borrower into bankruptcy and the securities borrowed into the short’s bankrupt estate. The second is for a securities lender, who acquires overnight liquidity with the exchange of securities to another institution, to become insolvent overnight, thus trapping the liquidity in the insolvent institution.

In the instance of the short seller, the problem is caused by an increase in value of the lender’s assets leading to a potential for loss for the short seller. It is the rise in value, then, that puts the borrower into bankruptcy. We do not believe these circumstances warrant significant regulatory

action as they are rare, and the amounts borrowed and lent insufficient to either cause financial ruin to the securities lender or lead to financial meltdown of the system.

More troubling, though, are the repo transactions between financial institutions. In these cases, it is the seller who poses the greatest risk, as they are exchanging collateral – presumably high-quality securities such as Treasury bonds or similar sovereign obligations of other OECD nations – for the excess cash of the buying institution. Should the seller become insolvent overnight, the buyer would lose access to its cash, thus reducing its own liquidity and potentially causing it to face insolvency, as well. At the same time, the value of high-quality collateral such as Treasuries has shown a tendency to increase in value as worried investors seek risk-free assets to insulate them from financial market stress. Moreover, as such assets are readily marketable, the holder of the Treasuries would be able to sell the securities in return for cash, thus replenishing its liquidity.

Ultimately, the difficulties resulting from this latter type of securities lending will depend on three primary issues: 1) the magnitude of the transactions between the parties; 2) the aggregate direction and quantity of similar transactions within the financial system; and 3) the type of collateral used. The most important proximate issue in this case relates to the quality of the collateral used. Market participants already partially address this issue by giving varying levels of “haircuts” on the borrowing value of lower-quality assets relative to higher-quality and higher-liquidity assets. Moreover, regulations already exist to prevent public investment funds from acquiring significant concentrations in securities backed by certain assets, issuers or the like, and limitations on the acquisition of illiquid assets. Likewise, rules in Europe were created post-crisis to require the use of only high-quality assets as collateral for certain types of derivatives transactions, for example.

Therefore, while we agree with the FSB’s concern about the need for regulatory awareness about the magnitude and type of securities lending within their markets, we do not support the implied equivalency between securities lending and traditional commercial bank lending. Furthermore, we believe the two largest fund markets already have addressed many of these concerns.

Conclusion

We appreciate efforts by the FSB to provide relevant recommendations related to mitigating residual concerns about the potential systemic risk posed by the asset management industry. We believe that to a great extent regulatory, legislative and industry actions that have been taken or are in progress already respond to these concerns. Should you have any questions about our positions, please do not hesitate to contact Kurt N. Schacht, CFA at kurt.schacht@cfainstitute.org or 212.756.7728; or Linda Rittenhouse at Linda.rittenhouse@cfainstitute.org or 434.951.5333.

Sincerely,

/s/ Kurt N. Schacht

/s/ Linda Rittenhouse

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