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March 25, 2015

Mr. Patrick Pinschmidt
Deputy Assistant Secretary for the
Financial Oversight Council
United States Treasury
1500 Pennsylvania Ave NW,
Washington, D.C. 20220

Re: Note Seeking Comment on Asset Management Products and Activities,
Docket No. FSOC-2014-0001

Dear Mr. Pinschmidt:

The Institute of International Finance is pleased to provide comments on the Financial Stability Oversight Council's (FSOC) Notice Seeking Comment on Asset Management Products and Activities, published on December 24, 2014. This letter has been produced under the guidance of the IIF's Non-Bank Non-Insurer Working Group. In offering these comments, we believe it is important to reiterate the industry's support for targeted and proportionate measures designed to make the global financial system more stable while facilitating economic growth. In order to meet those goals, an assessment of whether new or different regulation is needed must be based on robust empirical analysis of the many beneficial attributes of financial services, the probability and magnitude of a potential threat to financial stability, and the effectiveness and efficiency of available regulatory responses.

While the IIF has traditionally focused on the work of global standard setters, and in this area the work that the Financial Stability Board (FSB) and the International Organization of Securities Commissions (IOSCO) are currently undertaking, we believe it is important to contribute our comments on the policy questions that the FSOC has asked, which are the subject of the consultation of the reference. In this regard, we believe the work and views of the FSOC will have important implications for the FSB/IOSCO process and global capital markets. Consistent with our previous positions, we believe it is of utmost importance that the work of the FSOC and other national policy makers be developed in close coordination with the relevant work of the global standard setters if they are to be effective and efficient in the global markets.

We note that the FSB/IOSCO published their second proposed NBNI G-SIFI methodology on March 4, 2015, three weeks before the comment deadline on the FSOC's notice. Thus, we regret that the FSB/IOSCO did not have the benefit of reviewing any comments on the FSOC's notice before publishing their second proposal. While we respect the autonomy of both the FSOC and the FSB in determining the timing of its consultations, we regret that the processes were not coordinated in such way so that the feedback on the FSOC consultation could have informed the new revised FSB proposals.

More generally, we believe it would be important for the FSOC to clarify the relationship between its consultative process and that of the FSB, given the overlap on many of the issues being considered, including whether any potential policy making by the FSOC will be guided by the FSB policies in these areas.

The IIF fully recognizes the importance of the FSOC's work to determine whether systemic risk of sufficiently high probability and magnitude to warrant a regulatory response could arise across different markets and market participants. This is a very challenging task which, if done correctly, can reinforce financial stability but otherwise may have unintended detrimental consequences on financial markets, those they serve, and economic growth. The Institute therefore appreciates the openness of the FSOC to industry perspectives and those of other stakeholders on this important subject.

FSOC's role in assessing potential systemic risk arising from asset management products and activities

We commend the FSOC for conducting its inquiry into "whether asset management products and activities may pose potential risks to the U.S. financial system," and for providing a forum for discussion on this issue. We believe that any reasonable public policy has to be based not only on theoretical considerations but also on solid data and sound empirical evidence. Against this backdrop we appreciate this consultation as an important step into the right direction. We believe that before proposing any additional piece of regulation, the FSOC should assess whether or not a plausible threat to financial stability ists[1]and to determine the probability and magnitude of any hypothetical threat based on robust empirical analysis. Given the potentially significant consequences of additional regulation intended to reduce systemic risk (and the negative effects that such regulation could have on the positive contribution of the asset management industry and capital markets to a well-functioning financial system and more broadly to economic growth), we believe the FSOC must first demonstrate whether a plausible threat to financial stability really exists and how certain policy measures can contain this risk.

Importance of Balance

With that in mind, we would like to encourage the FSOC to recognize the tangible progress that has been made on the implementation of many high priority regulatory reforms that have already been made or are at least underway.[2] Currently regulators that have authority to identify and regulate risk are looking at elements of the financial system, such as asset management[3], that did not cause the crisis and have per-

[1] "(…) unless there is a plausible threat to the core of the system or potential for damaging fire sales, I would set a high bar for supervisory interventions to lean against the credit cycle. Such interventions would almost surely interfere with the traditional function of capital markets in allocating capital to productive uses and dispersing risk to the investors who willingly choose to bear it."; *Powell, Jerome H.*, Financial Institutions, Financial Markets, and Financial Stability, Stern School of Management, February 18, 2015 (http://www.federalreserve.gov/newsevents/speech/powell20150218a.pdf), p. 16.

[2] For details see chapter 6 of *FSOC*, 2014 Annual Report (http://www.treasury.gov/initiatives/fsoc/Documents/FSOC%202014%20Annual%20Report.pdf); and *FSB*, Overview of Progress in the Implementation of the G20 Recommendations for Strengthening Financial Stability - Report of the Financial Stability Board to G20 Leaders, November 14, 2014; (http://www.financialstabilityboard.org/wp-content/uploads/Overview-of-Progress-in-the-Implementation-of-the-G20-Recommendations-for-Strengthening-Financial-Stability.pdf).

[3] For the purpose of this letter we are differentiating money market mutual funds (MMMFs) from traditional asset management. As we will explain below MMMFs are different from traditional asset management and have been reformed twice in the U.S. since the recent financial crisis.

formed well in previous crises. In reviewing these businesses and their products and activities, regulators should adopt a balanced approach that focuses on actual and plausible sources of risk rather than theoretical ones.

This process is taking place at a time that much of the world is still suffering from low growth. While economic growth accelerates in mature economies—with the U.S. and the Euro Area in the driving seat—Emerging Markets are still lagging behind.[4] Thus, there is a common interest among policymakers, regulators, central banks and other authorities to assess whether the real sources of systemic risk have been adequately addressed and what the cost to the economy has been. In other words, there should be an assessment of whether reforms are working as intended or whether aspects of the reforms themselves need fixing[5] as well as to what can be done to promote economic growth and financial stability. A number of policy makers recognize that both are essential to produce sustainable growth[6] and they understand that asset management can contribute to delivering it.[7]

Asset Management as a Solution

On this point we agree with observation recently made by Lord Jonathan Hill, the European Commissioner responsible for financial stability, financial services and the European capital markets union (CMU), when he said that "[w]e do not make the economy stronger by making our financial services weaker. We need to move from a position where the industry is seen as being part of the problem to one where it is seen as part of the solution."[8] The European Commission's Green Paper on Building a Capital Markets Union builds on this notion and describes many of the ways in which capital markets and investment funds promote financial stability and economic growth.[9] The IMF,[10] FSB, IOSCO[11] and individual representatives of U.S. regulators like the Federal Reserve Board[12] have also recognized these benefits.

[4] For further details see e.g. *IIF*, February 2015 Global Economic Monitor: Year of Divergence; (https://www.iif. com/ publication/global-economic-monitor/february-2015-global-economic-monitor).

[5] See e.g. *Carney, Mark*, Regulatory work underway and lessons learned, Remarks at the 29th Annual G30 International Banking Seminar, Washington DC, October 12, 2014; (http://www.bis.org/review/r141015c.htm): "And we've learned about the unintended consequences of prudential capital and retention requirements on the securitisation market. Regulatory changes arguably treat asset-backed securities in ways that appear to be unduly conservative, particularly relative to other forms of long-term funding. Efforts to rebalance these incentives are now a priority."

[6] See e.g. *Hill, Jonathan*, Finance at your service – capital markets union as an instrument of sustainable growth, Brussels, February 4, 2015 (http://europa.eu/rapid/press-release_SPEECH-15-4144_en.htm), p. 1: "So we need both financial stability and growth: we need sustainable growth. That is the new Commission's number one priority."

7 *Id*., p. 2: "Well-functioning capital markets also help encourage greater diversity in funding, which reduces concentration of risk so they not only free up capital for growth but also support and strengthen financial stability. After all, it's important to remember that "capital markets" are not some abstract construct – they are someone's pension savings, someone's 'rainy day' money which is channeled to growth."

[8] *Id.*, p. 2.

[9] See *European Commission*, Green Paper - Building a Capital Markets Union, COM(2015) 63 final, Brussels, February 18, 2015 (http://ec.europa.eu/finance/consultations/2015/capital-markets-union/docs/green-paper_en.pdf).

[10] See e.g. *International Monetary Fund*, Global Financial Stability Report October 2014 (https://www.imf.org/external/pubs/ft/gfsr/2014/02/pdf/text.pdf), p. 33: "From a financial stability perspective, credit intermediation through asset managers and markets has advantages over that through banks. For example, the investment risk is borne largely by investors in the fund, not the asset manager because there are no public guarantees like those the banking system has for deposits. Liquidity is provided mostly by markets, and not from bank holdings of liquid assets backed by central bank facilities. Finally, funds generally do not raise liabilities to fund assets and are therefore less leveraged than banks." (footnote omitted).

[11] See *FSB/IOSCO*, Consultative Document - Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, January 8, 2014 (http://www.financialstabilityboard.org/wp-

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High Standard to Justify Intervention in Capital Markets

In addition to the widely recognized economic and financial stability benefits created by collective investment funds, their managers and the capital markets more broadly, there are other factors that require a high standard to be met in order to justify regulatory intervention in the name of mitigating hypothetical systemic risk. These include: (i) prudential supervisors' evolving understanding of asset management[13] and relevant markets, (ii) a lack of empirical evidence that investment funds and their managers threaten financial stability and substantial evidence supported by sound theory that they do not[14], (iii) the difficulty of correctly diagnosing "dangerous" conditions in asset markets[15] and controlling investors' behavior even in real time, let alone under future unknown market conditions, (iv) relatively untested macroprudential tools[16], (v) ineffectiveness of partial solutions, and (vi) unintended consequences of intervention that could damage financial markets, individual investors and issuers they serve, and economic growth.

We agree with the recent call for restraint by Federal Reserve Board Governor Jerome Powell: "the Fed and other prudential and market regulators should resist interfering with the role of markets in allocating capital to issuers and risk to investors unless the case for doing so is strong and the available tools can achieve the objective in a targeted manner and with a high degree of confidence."[17]

Singling out of certain entities may distort markets and competition

With respect to risks (v) and (vi) above, we wish to emphasize that the IIF has consistently drawn attention to the shortcomings of approaches to systemic risk which rely on designating individual entities and the application of additional policy measures to these entities on a blanket basis. We believe such ap-

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content/uploads/pr_140108.pdf), p. 29: "In addition, from a purely systemic perspective, funds contain a specific "shock absorber" feature that differentiates them from banks. In particular, fund investors absorb the negative effects that might be caused by the distress or even the default of a fund, thereby mitigating the eventual contagion effects in the broader financial system."

[12] See e.g. *Liang, Nellie* (Director, Federal Reserve Board Office of Financial Policy Stability and Research), The Brookings Institution, Asset Management, Financial Stability and Economic Growth, February 9, 2015 (http://www.brookings.edu /~/media/events/2015/01/09-asset-management/20150109_asset_management_ transcript.pdf), p. 48: "(…) mutual funds in their current form have been around for a long time - 75 years now. And they've weathered all kinds of adverse market conditions without noticeably contributing to systemic risk. Indeed, they may provide a diversity of sources of funds for borrowers and may have had stabilizing influences on aggregate credit."

[13] "Academics, practitioners and regulators have been studying banks, their behaviour and failure, for several centuries. Analysing and managing the behaviour of asset managers is, by contrast, a greenfield site."; *Haldane, Andrew G.*, The age of asset management?, London Business School, London, April 4, 2014 (http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf), p. 14.

[14] As has been acknowledged by *FSB/IOSCO*, "funds close (and are launched) on a regular basis with negligible or no market impact"; see *FSB/IOSCO, supra* note 11, p. 30.

[15] "An important threshold question is whether supervisors will be able to correctly and in a timely manner identify "dangerous" conditions in credit markets, without too many false positives and without unnecessarily limiting credit availability by interfering with market forces."; *Powell*, *supra* note 1, p. 16.

[16] "I often hear the view that macroprudential policy should be the "first line of defense" for maintaining financial stability. Unfortunately, this approach expects too much of tools for which our understanding is imperfect."; *George, Esther L.*, Monetary and Macroprudential Policy: Complements, not Substitutes, Financial Stability Institute/Bank for International Settlements, Asia-Pacific High-Level Meeting, Manila, February 10, 2015 (http://www.kansascityfed.org/publicat/speeches/2015-George-Manila-BIS-02-10.pdf), p. 5.

[17] *Powell*, *supra* note 1, p. 17.

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proaches increase moral hazard[18] and distort competition. Against this background, the IIF would argue strongly from the very beginning that applying additional policy measures to a few individual entities or a subset of market participants is likely to be ineffective. This is especially true in highly substitutable markets like financial services in general and asset management in particular.

It is likely that the designation of certain entities as 'systemic' will result in 'systemic' activities shifting from such an entity to other, non-designated entities. For example, designation of an investment fund as 'systemically relevant' and applying limits and costly policy measures to it and not to its competitors would likely render the fund unattractive and prompt investors to redeem a substantial portion of its assets and to transfer them to a competitor that offers the same product or service without the regulatory burden due to the highly substitutable nature of the industry.

However, it is not at all obvious that a simple reallocation of business within the regulated industry and towards non-systemic entities will be the outcome. Instead, the effect may well be to drive some activities outside of the regulated sector.[19] Such movement is unlikely to reduce systemic risk, but it would make the activities less visible. The incentives created could equally likely result in changes in business models and product mixes whose effects on systemic risk are hard to know in advance.

Regulatory focus is appropriately on products and activities

To cope with these challenges the IIF has consistently argued that policy should focus primarily on the underlying activities involved and their associated risks, should be sufficiently forward looking, and should take into account the variety and complexity of activities rather than focusing on a few of the entities that conduct those activities.[20] In general, we believe that the application of targeted regulation to properly identified risks on an activity- or industry-wide basis is the most appropriate response.[21] Therefore we applaud the FSOC for seeking deeper insight "whether asset management products or activities could create, amplify, or transmit risk more broadly in the financial system in ways that could affect U.S. financial stability". We agree and encourage the FSOC to focus on products and activities but suggest expanding the scope of their inquiry to include all capital markets participants that might offer a given product or engage in an activity. We are convinced that such an approach is better suited to foster financial stability than it is to attempt to identify and regulate risk by focusing exclusively on asset management and far better than designating a few individual funds as 'systemic'.

[18] "There is reasonable concern that designating a small number of nonbank-affiliated firms would increase moral hazard concern"; *Tarullo, Daniel K.*: Regulating Systemic Risk – Remarks at the 2011 Credit Markets Symposium, March 31, 2011, p. 7 (http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf).
[19] See, e.g., *Powell*, *supra* note 1, p. 16, noting the ineffectiveness of partial solutions: "Finally, another issue to consider when contemplating such intervention is that, particularly in the United States, activity is free to migrate outside the commercial banking system into less regulated entities."
[20] See *IIF*: "Shadow Banking": A Forward-Looking Framework for Effective Policy, June 2012, p. 1 (http://www.iif.com/regulatory/article+1099.php).
[21] "(…) potential contagion effects are best contained by directly addressing them, rather than by trying to indirectly address them through designating a large number of nonbank-affiliated institutions under section 113 of the Dodd-Frank Act. This direct approach would, I believe, yield maximum financial stability benefits at the lowest cost to financial intermediation, financial firms, and financial supervisors"; *Tarullo, supra* note 18, p. 11.

Preliminary inquiry

We applaud the FSOC for undertaking this inquiry and engaging the public but there is a need to recognize that this inquiry is only at an early stage. We are concerned that key terms are opaque and require definition, modeling and measurement in this context. What is a "period of market stress"? How long is it? How is "stress" defined and its magnitude measured? What does it mean to "complicate resolution"? We are concerned that leaving such important concepts vague and relying excessively on regulatory discretion will make it difficult to identify systemic risk accurately and determine whether it has been reduced.

The next steps should be in our view to review existing data, identify any gaps, fill them efficiently, analyze all available data to determine empirically whether there is a threat to U.S. financial stability and measure its probability and magnitude. Such thorough analysis could finally build the basis for potential policy recommendations.

Data sources are available and should be exploited

A significant amount of data is already available. We deem these data as crucial in monitoring and assessing potential risks in the asset management industry. For example, fund managers in the United States have to file information such as financial statements, comprehensive holdings (including derivatives exposure) and custody information with the U.S. Securities and Exchange Commission (SEC). A thorough analysis of this trove of information should provide valuable insights into the functioning of the investment fund industry and its role in the capital markets and provide a better understanding of the risks that it may or may not present.

In general, data transparency and availability have also increased significantly in recent years. In fact, it was one of the main regulatory initiatives initiated by the G20 to increase market transparency by moving over-the-counter (OTC) derivatives trading onto organized platforms. Regulators are in the process of implementing new rules requiring the reporting of data on the trading of OTC derivatives to trade repositories. This will provide regulators with a full picture of all OTC derivative positions for the entities they regulate and enable market-wide risk monitoring. The collection of all this market data only makes sense if it will be studied to determine if there are additional risks that should be addressed and to design specific and targeted regulation.

Furthermore, it has to be considered that the SEC is about to expand existing data requirements. In general, the staff of the SEC is currently developing recommendations for the Commission to modernize and enhance data reporting for both funds and advisers. A special focus shall be given to the reporting and disclosure of investments in derivatives, the liquidity and valuation of holdings, and securities lending practices.[22] Upon availability, these data will provide supervisors, policy makers and the general public with additional and very helpful insights.

[22] See *White, Mary Jo*: Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry – The New York Times DealBook Opportunities for Tomorrow Conference Held at One World Trade Center, New York, N.Y., December 11, 2014, p. 4 (http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#. VQhH-cOFZvGw).

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Learning from history

We are aware of two examples from the investment fund industry—Long Term Capital Management (LTCM) and Reserve Management Company (sponsor of the Reserve Fund)—where failure threatened or contributed to systemic stress in the U.S. financial system. In our view, these examples deserve detailed analysis to understand the sources of systemic risk connected to the respective business models. Upon closer examination, these instances in fact demonstrate activity related risk and unique attributes of the funds involved that differentiate them from others.

LTCM managed the Long Term Capital Portfolio, a private fund with approximately $5 billion of assets[23] that experienced significant distress in September 1998. As the *President's Working Group on Financial Markets* observed, LTCM, from its inception, had a prominent position in the community of hedge funds, both because of the reputation of its principals—among them two 1997 Nobel laureates in economics with substantial reputation in the economic theory of financial markets—and also because of its capital stake.[24] Compared with the trading practices of other hedge funds and other trading institutions the LTCM Fund stood out with respect to its opaqueness, its low degree of external monitoring, and its high degree of leverage. At the time of its near-failure the LTCM Fund was the most highly leveraged large hedge fund reporting to the U.S. Commodities Futures Trading Commission (CFTC). The use of excessive leverage with a mismatch of funding resulted in an inability of the fund to withstand market movements. The fund was unable to meet margin calls and had to liquidate positions. A consortium of banks acquired capital interests in the fund for approximately $3.65 billion. Over the next year, the positions were unwound in an orderly fashion with a small profit to the banks.

The President's Working Group on Financial Markets concluded that "excessive leverage can greatly magnify the negative effects of any event or series of events on the financial system as a whole. (…) Although LTCM is a hedge fund, this issue is not limited to hedge funds. 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".[25] Based on its findings the *Working Group* recommended a plethora of regulatory and statutory measures covering disclosure and reporting, supervisory oversight, counterparty risk-management, capital adequacy, etc. many of which were implemented or are being considered again in light of the experiences with the impact of leverage during the recent financial crisis.

Reserve Management Company managed the Reserve Primary Fund that "broke the buck" in 2008 due to its investments in Lehman Brothers debt securities. Reserve Management Company had less than $100 billion in assets under management across all of the funds it managed for clients, ranking it #81 among U.S. asset managers overall as of December 31, 2007, and #14 against managers of money market mutual funds (MMMFs). Cash management products were the only strategies managed by Reserve Management. Following this incident at the height of the financial crisis, investors who were already fearful about liquidity made significant redemption requests to similar stable net asset value institutional prime MMMFs, and the Federal Reserve, the U.S. Treasury and certain foreign agencies stepped in to create a series of

[23] LTCM's balance sheet on August 31, 1998, included over $125 billion in assets. Using the (non-deteriorated) January 1, 1998, equity capital figure of $4.8 billion, this implies a balance-sheet leverage ratio of more than 25:1; see *The President's Working Group on Financial Markets*: Hedge Funds, Leverage, and the Lessons of Long-Term Capital Management, Apr. 1999, p. 12 (http://www.treasury.gov/resource-center/finmkts/Documents/hedgfund.pdf).
[24] *Id,* pp. 10 et seq.
[25] *Id,* p. viii.

programs to calm the markets. Investors in the Reserve Primary Fund ultimately received 99.04% of their assets, and Reserve Management Company ceased actively managing money.

This episode demonstrates that the run on stable net asset value institutional prime MMMFs did not occur because of the size of the Reserve Fund but because of what its vulnerability made investors fear about the balance sheets of similar funds.[26] The combination of characteristics of stable net asset value MMMFs and certain of their investor demographics historically present unique risks that differentiate them from other investment funds. The SEC's recent rules[27], as well as regulation under consideration in the European Union, are designed to address these risks.

The importance of leverage

In our view history leads to the conclusion that the potential for systemic risk may rather be embedded in the failure of a certain asset class or a specific business model than in the operations of a single firm.[28] However, where a single firm has caused systemic disruption it generally results from highly leveraged operations which have accumulated significant under-protected exposures or have caused disruption through their lack of substitutability. This is consistent with the recently published FSB/IOSCO NBNI G-SIFI framework[29] and Dodd-Frank statutory directives to the FSOC[30]. Both recognize that failure of a leveraged entity can be destabilizing if its default threatens the solvency of other leveraged firms and the destabilizing effects will be compounded if the failed entity provides a critical function or service that cannot be replaced easily.

However—and not at least due to the experiences gathered in the LTCM crisis, the use of leverage in a number of investment products is subject to extensive regulation. For example, U.S. mutual funds are subject to specific leverage limitations, both in connection with borrowing and the use of derivatives. In the European Union regulatory regimes under both the UCITS (Undertakings for Collective Investment in Transferable Securities) and the AIFMD (Alternative Investment Fund Managers) framework similarly include explicit limits or disclosure obligations related to leverage. In fact, these limits on investment funds are much tighter than the limits on even the largest G-SIBs.

While private funds in the U.S. are generally not subject to regulatory leverage restrictions, many agree to abide by leverage limits in their offering materials and provide transparency to investors regarding current leverage levels. Additionally, regulatory and market changes implemented since 2008 have significantly reduced exposures and the systemic risk that a private fund can pose. Central clearing, netting of risk positions, mandated changes to documentation and collateral practices, increased dealer requirements and other changes have significantly reduced counterparty risk, fundamentally changed trading practices, improved dealer risk management and therefore mitigated the potential impact of the insolvency of a private fund.

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[26] See *Tarullo, supra* note 18, p. 3.
[27] See Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166, July 23, 2014 (79 FR 47735 – August 14, 2014).
[28] See *Tarullo, supra* note 18, p. 6.
[29] "Leverage was added for investment funds and asset managers, as the FSB and IOSCO consider it to be an important potential source of risk for these entities"; *FSB/IOSCO*, Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Institutions, March 4, 2015, p. 12; (http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf).
[30] "The extent of the leverage of the company" is the first of a number of indicators the FSOC has to take into consideration when determining whether a nonbank financial company poses a threat to the financial stability of the United States; see Section 113(a)(2)(A) Dodd-Frank Wall Street Reform and Consumer Protection Act.

In principle, we agree with the FSOC that "exposures created by leverage establish interactions between borrowers and lenders—and possible further interconnections between lenders and other market participants—through which financial stress could be transmitted to the broader financial system." Indeed, if losses on investments where leverage is employed coincide with significant and not adequately managed exposures, losses may be incurred by counterparties (borrowers, trading partners) and may ultimately destabilize entities that might be systemically important in their own right. Even though we believe the current regulatory framework and common industry practices provide sufficient safeguards against such a theoretical scenario we nevertheless support the initiative by the SEC to review options for specific improvements such as to appropriately limit the leverage created by a fund's use of derivatives.[31]

Resolution of asset management firms and replacement of managers

As the FSOC,[32] the FSB and IOSCO (in their first NBNI G-SIFI consultation)[33] have acknowledged, there is no evidence of a threat to financial stability from the resolution of investment funds and their advisers and significant evidence demonstrating that their resolution does not threaten financial stability. This is not surprising for many reasons:

First, the probability of failure is extremely low. Most funds and their managers operate with little or no leverage. Without excessive leverage or substantial fixed obligations, a fund cannot fail. Therefore, any policy action should tackle these problems in the first place.

As we have explained above, in the case of LTCM as well as in the case of the Reserve Fund distress in specific products based on leverage or fixed obligations ultimately led to the closure of the asset management firm that sponsored those products. While in each instance the product level distress had market impact, the ultimate closures of the asset management firms that managed the products were hardly newsworthy. Beyond LTCM and the Reserve Fund, there have been multiple examples of hedge funds dissolving or experiencing heavy losses with no systemic impact. As a conservative estimate, over one hundred major hedge fund product closures have occurred since 2006 with little evidence of systemic consequences.

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[31] See *White, supra* note 22, p. 5.

[32] See FSOC, Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001(http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf), p. 23: "The Council recognizes that asset management firms and investment vehicles have closed without presenting a threat to financial stability."

[33] See *FSB/IOSCO*, *supra* note 11, p. 30: "funds close (and are launched) on a regular basis with negligible or no market impact. In other words, the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies (funds are highly substitutable). A fund may close for a variety of reasons, for example not attracting sufficient investor interest or performing poorly over a given period, leading investors to gradually withdraw their money." and p. 30 footnote 38: "According to relevant industry data for US mutual funds, for instance, from 2000 to 2012, on average 671 new funds were launched per year, compared to an average of 291 liquidations (and 296 mergers). Moreover, throughout the same period, mutual fund launches have outnumbered liquidations, except in 2009, when liquidations were more numerous by a very narrow margin. In addition, even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the observation period. Part of the explanation may be that many US investors hold mutual fund shares for retirement purposes. As such, these investors' investment horizon could be long-term, whereby they would prefer to remain invested rather than cash-out during a market downturn."

Second, the impact of failure is also extremely low for many reasons, some of which the FSOC and other regulators have acknowledged. For example, the asset management industry is highly substitutable.[34] We agree with the FSOC that "clients have routinely replaced asset managers without significant impact in non-stressed situations". We also agree that other characteristics that the FSOC has recognized, such as the separate custody of fund assets and the legal and economic separateness of funds and their managers, help explain why resolution of funds and their managers is systemically irrelevant.[35] Even though we do not foresee "delays or other obstacles associated with transferring client accounts to other managers or transitioning client assets to another custodian, particularly in a stressed scenario", we nevertheless think that the initiative by the SEC to identify best practices to follow when transitioning client assets may be beneficial.[36] Such plans may be helpful in preparing advisers and their clients to deal with a transition and its attendant risks in a crisis. We note, however, that managers and other service providers already process a high volume of asset transfers daily and the past crisis exposed no weakness in the process that threatened U.S. financial stability. We believe that reflects the degree of practice and planning in the industry already. With that in mind, we look forward to reviewing any proposals the SEC may release on the matter.

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Conclusion:

The IIF has consistently argued that policy should focus primarily on the underlying activities involved and their associated risks, should be sufficiently forward looking, and should take into account the variety and complexity of activities rather than focusing on a few of the entities that conduct those activities. Against this backdrop, we support the FSOC's approach to focus on products and activities but suggest to expand the scope of the inquiry to include all capital markets participants that might offer a given product or engage in an activity. We are convinced that such an approach is better suited to foster financial stability than it is to attempt to identify and regulate risk by focusing exclusively on asset management and far better than designating a few entities as 'systemic'.

We believe that the application of targeted regulation to any properly identified risks on an activity- or industry-wide basis would be the most appropriate response. However, any policy measures related to products and activities in asset management should not by necessity based on the bank model but should be tailored appropriately to the specifics of the relevant products and activities. Diversification and innovation are major benefits of capital markets and asset management. We are concerned that providers of asset management products and activities may either disappear or adapt to look more like banks if they are treated like a bank. If they disappear, competition and efficiency will be reduced. If regulation requires financial services providers to become more homogenous, they will be more susceptible to a common shock.

Finally, every search for hypothetical risk and every solution–assuming a risk is found to exist—must account for the acknowledged benefits and strike the right balance. This will take a great deal of additional analytical work. It must be done thoughtfully and empirically in order to produce the desired result: a resilient efficient financial system that promotes economic growth.

[34] *Id*.
[35] See *FSOC*, *supra* note 32, p.23.
[36] See *White*, *supra* note 22, p. 5.

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We hope these comments are useful as the FSOC considers the way forward in this area. Given the complexity of these issues, we believe direct dialogue with the industry is essential and appreciate the FSOC's willingness to engage in that dialogue. The IIF and its Non-Bank Non-Insurer Working Group stand ready to provide additional views or clarifications.

Should you have any questions on the issues raised in this letter, please contact myself (aportilla@iif.com), or Thilo Schweizer (tschweizer@iif.com).

Very truly yours,

Andres Portilla