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COMPETITIVENESS

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March 24, 2015

Financial Stability Oversight Council
Attn: Patrick Pinschmidt
Deputy Assistant Secretary for the
Financial Stability Oversight Council
1500 Pennsylvania Avenue, N.W.
Washington, DC 20220

RE: Notice Seeking Comment on Asset Management Products and Activities; Docket No. FSOC-2014-0001

Dear Mr. Pinschmidt:

The U.S. Chamber of Commerce ("Chamber") is the world's largest business federation, representing the interests of more than three million businesses of every size, sector and region. The Chamber created the Center for Capital Markets Competitiveness ("CCMC") to promote a modern and effective regulatory system for the capital markets in order to promote economic growth and job creation. The CCMC welcomes the opportunity to respond to the Financial Stability Oversight Council's ("FSOC" or the "Council") notice seeking comment on asset management products and activities ("Notice").[1]

The Chamber supports efforts to monitor and address systemic risk. We appreciate the Council's decision to seek additional information on the asset management industry before taking any further regulatory action that could include systemically important financial institution ("SIFI") designations under Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"). As such, before considering regulation of non-bank financial companies, specifically the asset management industry for the purposes of this letter, the FSOC should (i) focus its energy on market participants that are known to create or concentrate risks, (ii) finish reforms already underway, and (iii) comprehensively assess

[1] 79 Fed. Reg. 77488 (Dec. 24, 2014).

the individual and collective impacts of regulations that have been layered on firms and markets since the 2008 financial crisis before considering whether any more regulation is needed.

Accordingly, we strongly urge the FSOC to:

1. Develop a regulatory work plan that creates and coordinates a logical global sequencing for the collection and analysis of data and sound decision-making. To that end, before proceeding with any designation process or recommendations, the FSOC should:

(a) allow time for the Office of Financial Research ("OFR") to implement its Legal Entity Identifier ("LEI") Program to ensure that any designation or recommendation is based on sound, reliable, and trustworthy data and analysis; and

(b) coordinate the timing of proposals, corresponding public comments, the collection of data, and regulatory determinations with the work of the Financial Stability Board ("FSB") and other similar global authorities, so that designations and recommendations are based on a shared base of information and a synchronized opportunity for the public to comment and provide meaningful input.

2. FSOC should carefully assess the individual and collective impacts that both existing and post-financial crisis rules are having on economic growth and financial stability. FSOC should pause to analyze the impacts of previous regulatory reforms to determine whether they are working as intended, whether they are damaging the capital markets and ultimately the U.S. economy and whether more are needed for the asset management industry.

3. Fully develop the record so that any Council actions or policy recommendation would be based on a thorough and accurate understanding of the asset management industry and the capital markets in which it operates. This should include assessing the extensive regulatory regime already in place for asset managers and mutual funds, which among other things, already

imposes limits on the use of leverage, separates mutual funds from their advisers, and requires floating net asset value ("NAV"), which the FSOC has stated greatly reduces any systemic risk.

4. Conduct rigorous risk quantification and analysis that is grounded in empirical data and verifiable risk modeling.

5. Consider historical precedents and the ways in which investors' equity capital and the asset management industry have enhanced the resilience of financial system and the American economy in times of recession.

6. Conduct a thorough economic benefit analysis to support any and all actions directed at the asset management business so that the regulatory medicine is not more harmful than the market concern being treated.

Discussion

The asset management industry plays a key role in the American economy, and as such, the Chamber stands ready to provide ongoing input regarding the perspectives of U.S. Main Street businesses on potential regulatory initiatives impacting asset management options available to businesses and individual investors. We will defer commenting on the detailed operational aspects of the asset management business, which we will leave to our members. We do, however, wish to comment on the predicates, accurate or inaccurate, upon which the Notice and the questions that it poses appear to be based. In that regard, we urge FSOC to accurately calibrate the role that the asset management sector actually plays in the U.S. economy by promoting the efficient and effective deployment of capital and liquidity. The Chamber believes that the FSOC should use tools such as economic analysis to identify systemic risks, craft responses appropriate to that risk and ensure that such regulatory interventions do not have consequences harmful to economic growth and job creation.

Our analysis leads us to conclude that asset managers and asset management vehicles do not pose a material threat to U.S. financial stability. Asset management vehicles, such as mutual funds, allow average investors to have access to liquid, diversified investment vehicles, with professional asset management services, at a

reasonable cost. These vehicles allow the average retail investor to achieve their retirement goals, save for college, or buy a house. Unnecessary regulation on asset management products and activities will interfere with the ability of average Americans to achieve their financial goals. Moreover, narrowly tailored regulation, designed to address only those risks that could pose a material threat financial stability, will necessarily reduce the impact that such risk can have on asset management products and activities. In short, until the primary economic systemic risks are recalibrated, regulating the risk inherent in the asset management business is akin to having the tiller operator on a fire engine drive the engine. The tiller can only react to how the driver steers the engine.

The Chamber also notes that the Securities and Exchange Commission ("SEC") has been entrusted by Congress with the responsibility for supervising and regulating investment companies and investment advisers for 75 years. During this lengthy period, the SEC has been extremely effective in regulating open-end registered investment companies ("mutual funds") in a manner that has allowed investors to benefit from a wide range of investment strategies under a regulatory structure that has never been the source of any material risk to U.S. financial stability.[2] As a result of the SEC's unrivaled experience with investment companies (including mutual funds) and investment advisers, we believe that the FSOC should defer to the SEC in regard to the regulation of this sector.

This effort initiated by the FSOC to develop an administrative record will be critical to any future Section 113 systemically important financial institution ("SIFI") designations or Section 120 recommendations with respect to asset managers or asset management vehicles. Accordingly, we urge FSOC to redouble its efforts to accurately evaluate the nature of the asset management industry and develop realistic risk models. Those goals can only be reached if there is a comprehensive global appreciation of the roles that investor behavior, regulatory requirements and industry practices have on the creation of risk.

[2] The term "mutual funds" as used in this letter does not include money market funds ("MMFs"), closed-end funds and exchange-traded funds.

Our concerns are discussed in greater detail below.

I. FSOC Must First Develop A Regulatory Work Plan That Creates A Logical Sequence For The Collection And Analysis Of Data And Sound Decision-Making

As an initial matter, we note that a critical factor—the pace and sequencing of FSOC actions—was not addressed in the Notice. As we have continually asserted, designating companies as SIFI's before the future regulatory scheme that will be applied to them is established by the Federal Reserve Board and shared with the public makes little logical or regulatory sense. If such a process is followed with regard to asset managers and mutual funds and the role that they play in supporting the American economy, FSOC should be particularly concerned about the impact of poorly devised regulation on the economy.

We note that asset managers, as any business, will react to new regulatory constraints, but not always in the ways that the regulation anticipates. Indeed, recent changes in regulation of MMFs are already having an adverse impact on credit availability and market liquidity in the U.S.[3]

The decision to subject any company or market to additional (unidentified) layers of new regulation for "macroprudential" purposes exposes FSOC to legal challenge. If the quantity and quality of regulation that will be applied to a company or industry is not known, then FSOC could not have reasonably determined that regulation would lessen the threats it purportedly poses to U.S. financial stability. Such a finding is fundamental to evaluating a potential threat to the stability of the U.S. financial system and the extent to which it may be lessened by additional regulation.

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[3] *See* Cordell Eddings and Elizabeth McCormick, Fidelity Move Creates $100 Billion Gap for Banks, BloombergBusiness (Feb. 5, 2015). This report indicates that the 2014 Amendments (as defined below) affecting MMFs has already resulted in higher borrowing costs for the country's bank lenders. In response to the 2014 Amendments, one of the largest prime MMFs that banks rely on to purchase their commercial paper will soon move to buying only U.S. government-backed securities leaving a $100 billion funding hole in the commercial paper market.

A logical sequencing of a systemic regulatory analysis of the asset management industry should include:

(i) collection of data, facts and all relevant material through the implementation of the LEI Program and through other administrative means;

(ii) communication, discussion and debate with impacted investors, issuers (governments and private companies), other market participants and the public;

(iii) rigorous empirical analyses by the OFR and FSOC staff of data in consultation with relevant industry regulators, including rigorous quantitative analysis of risk models which take into account historical precedents, the likelihood that risks will occur and the economic impact if they do;

(iv) additional formal and informal communication with the private sector to determine if any identified risks in fact have a systemic significance;

(v) coordination with international entities that are also evaluating the issues;

(vi) adoption of the enhanced prudential regulatory scheme that will be applied to designated companies;

(vii) public discussion of how any regulatory alternatives would reduce risk or where other actions may be used to reduce such risks and whether any action is required;

(viii) a continuing reanalysis and recalibration of the need for regulation needed in light of the changes being made to the risk model by increased prudential regulation of large bank holding companies, SIFIs, and in light of the reforms applied to markets and individual participants since the crisis; and

(ix) appropriate cost benefit and economic impact statements.

We believe very strongly that if FSOC attempts to impose untested "macroprudential" regulation on asset managers or asset management vehicles to reduce a speculative risk that is unsupported by empirical data, it is unlikely to produce the intended benefits but it will undoubtedly have a damaging impact on capital formation, market depth and liquidity. In this case, the investors involved will be retail mutual fund purchasers—average American consumers.

II. FSOC Must Garner Public Confidence That Its Analysis Is Of The Asset Management Industry Is Objective and Balanced.

The Chamber is concerned that the OFR in its 2013 review of the asset management industry did not seek guidance from industry experts, particularly the SEC.[4] The OFR's Report on Asset Management and Stability ("OFR Report"), prepared at the request of the FSOC, was replete with flawed data and analysis apparently without meaningful input from the government agency responsible for regulating the asset management industry for the last 75 years. As a result, as was expressed by many comments submitted to the SEC, the OFR Report failed to (i) distinguish the basic differences between an asset manager and its clients, (ii) recognize the numerous regulatory regimes already in place, (iii) appreciate the significance of long-term investor behavior, or (iv) take note of current risk mitigating industry practices.

Previous SIFI designations of insurance companies further provide cause for concern. Consistent with comments on the OFR Report, the Council's independent member having the most insurance expertise dissented to the designations of Prudential and MetLife because they were based on "scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems."[5] Similarly, the OFR Report was characterized as being, among other

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[4] *See* Sarah N. Lynch, Memos Show SEC-Treasury Dispute Over 2013 Asset Management Study, Reuters (Apr. 7, 2014), available at http://www.reuters.com/article/2014/04/07/sec-documents-assetmanagers-idUSL2N0MZ0UL20140407.

[5] *See* Resolution Approving Final Determination Regarding Prudential Financial, Inc., Dissents of Voting and Nonvoting Members of the Council, View of Ray S. Woodall Jr., the Council's Independent Member having Insurance Expertise (Sept. 19, 2013), available at www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf; and Views of the Council's

things, "based on unsupported arguments, speculation or theories" that demonstrated a fundamental misunderstanding of the asset management industry.[6]

Regulation requires public confidence, among many other things, in order to work efficiently and avoid unintended consequences. We urge FSOC to continue to work toward achieving that confidence and avoid the type of flawed analysis that the OFR Report represented.

III. FSOC Must Perform A Rigorous Analysis Of Systemic Risk Before Designating Any Entity As A SIFI

In order to reduce systemic risk, FSOC must be able to define and measure it. Otherwise, no one, not the FSOC or anyone else, can evaluate whether its proposals are sound or whether they are effective once implemented. We urge the FSOC to ensure that any Council actions or policy recommendations are based upon a foundation of rigorous, economically quantifiable risk models and analysis. Any systemic risk identified by the FSOC that serves as the basis for a policy recommendation or other action must not be so attenuated from the realm of possibility as to seem contrived or concocted. Unfortunately, several actions already taken by FSOC have not been based on such a rigorous real-world risk analysis.[7] To avoid a similar result with any potential regulation of an asset management product, or activity or vehicle, the FSOC's risk modeling must economically quantify:

1. the nature of the risk or event;

2. historical evidence of such risk, or the lack thereof;

3. conditions necessary for such a risk or event to occur;

Independent Member Having Insurance Expertise, Dissenting View of Ray S. Woodall Jr. (Dec. 18, 2014), available at, www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.

[6] *See* Letter from Thomas P. Vartanian, Dechert LLP, to Elizabeth Murphy, Secretary, SEC, submitted October 31, 2013, at 2.

[7] For example, the improbable string of hypothetical events that served as the basis for FSOC designations, such as runs on life insurance policies, which have not occurred and could not reasonably occur under the protections afforded by state insurance law, fail to inspire confidence in the FSOC's willingness to engage in rigorous empirical risk analysis.

4. the probability that such a risk or event will materialize;

5. factors that could mitigate the probability of the risk or event materializing or its impact; and

6. the economic harm that the event would actually and directly cause.

The adoption of an analytical framework that includes these hard data points will provide the public some confidence that the FSOC process is a meaningful exercise, rather than one that is based on preconceived notions of the asset management business. That is exactly what sound administrative practice and the law require. The Notice and subsequent comments should help guide the Council in making any determinations with respect to the asset management business.

IV. FSOC Should Focus on Significant Risk Mitigating Factors In Any Evaluation Of Mutual Funds

In assessing the contributions that mutual funds make to financial stability and considering whether they threaten it in any way, the FSOC should take note of how systemic risk is reduced or eliminated by the nature of regulation, the structure of a fund, the relationship and impact of advisers, and finally, investor behavior. The historical performance of mutual funds, particularly during the 2008 financial crisis, provides a logical starting point.

a. The Regulatory and Operational Environment for Asset Managers and Mutual Funds Has Been Well Designed by the SEC to Fulfill the SEC's Mandate of Investor Protection, Orderly Markets and Capital Formation; As a Result It Also Enhances Financial Stability

Mutual funds are constructed in a way that naturally reduces and, in some instances, eliminates systemic risk. Most prominently, mutual funds are required to register with the SEC and comply with a comprehensive regulatory regime under the Investment Company Act of 1940 (the "1940 Act"). Among other things, the 1940 Act is designed to protect mutual fund shareholders from overreaching by their advisers or other affiliated persons. This regulatory regime has endured for 75 years

and, to our knowledge, has produced a category of investment vehicle that has never had any significant adverse impact on financial stability.

The reason behind the success of the 1940 Act is that it contains many provisions, and the SEC has promulgated rules, that mitigate systemic risk, including:

- maintaining a portfolio consisting of 85% liquid assets;[8]
- prohibiting the issuance of senior securities by open-end funds;[9]
- daily calculation of net asset value and forward pricing;[10]
- maintaining 300% asset coverage for borrowings;[11]
- segregating, earmarking or offsetting assets equal to 100% of any obligation to a counterparty created through the use of derivatives;[12]
- limiting a fund's exposure to its counterparties through collateral control requirements and the use of qualified custodians;[13]
- limiting a fund's investment concentration in a single industry to 25% (unless otherwise disclosed in the fund's prospectus) of the fund's holdings;[14]
- limiting a fund's investment in any one financial firm to 5%.[15]

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[8] *See* Revisions of Guidelines to Form N-1A, Investment Company Act Release No. 18612 (Mar. 12, 1992).
[9] *See* 1940 Act § 18.
[10] *See* Rule 22c-1under the 1940 Act.
[11] *Id.*
[12] *See, e.g.*, Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979), 44 Fed. Reg. 25128 (Apr. 27, 1979).
[13] *See* 1940 Act § 17(f) and rules thereunder.
[14] *See id.* § 12(e)(2).
[15] *See id.* § 12(d)(1).

The 1940 Act and rules promulgated by the SEC also provide for transparency to shareholders, regulators and the public through required disclosures and daily valuation.

Mutual funds are organized as separate legal entities from their advisers and are required to keep simple capital structures. The balance sheet of a mutual fund is legally separate from its adviser's balance sheet; the adviser's creditors have no recourse to the mutual fund, and vice versa. Therefore, the risk of a hypothetical failure of one is contained to limit the financial impact on the other.

Mutual funds also have simple, transparent and uncomplicated legal structures. They are organized as business trusts or corporations, often with assets and liabilities segregated among different series of the trust or company thereby providing a clear delineation of which assets are tied to which financial instruments and ultimately which shareholders.

They also have strict governance standards. Section 10(a) of the 1940 Act requires that a mutual fund's board of directors be composed of at least 40 percent independent directors. As a matter of practice, mutual fund boards operate with a majority of independent directors. The board of directors is tasked with overseeing the mutual fund's operations and charged with ensuring that the investment adviser is properly executing the mutual fund's investment strategies in pursuit of the fund's investment objective. Of particular importance, is the fiduciary standard placed on mutual fund directors in renewing the investment adviser's contract on a yearly basis. The ultimate role of a mutual fund's board of directors is to serve as independent watchdogs for the protection of the fund's shareholders.

Mutual fund regulation and operational industry practices also help to mitigate counterparty exposure to financial companies that may experience financial distress. Mutual fund diversification requirements that limit exposure to any particular industry, especially with respect to investment limits in other financial companies, greatly reduce mutual fund exposure to systemic risk created by other companies.

The SEC has been proactive with respect to addressing the concerns following the 2008 financial crisis. For example, in March 2010, the SEC adopted amendments to its Rule 2a-7 governing the operation of money market funds ("MMFs") ("2010

Amendments").[16] The 2010 Amendments addressed liquidity issues with MMFs by requiring MMFs to hold instruments that can readily be converted to cash and to reduce the maximum maturity of portfolio holdings.

Again, in August 2014, the SEC adopted amendments requiring that institutional MMFs with portfolios that were not limited to government securities to operate on a floating NAV basis, instead of a stable NAV ("2014 Amendments").[17] The 2014 Amendments also mandated liquidity fees for non-government MMFs in certain circumstances. Additionally, the 2014 Amendments implemented discretionary liquidity fees and temporary suspension of redemptions by non-government MMFs under certain circumstances.

Beyond MMFs, the SEC is currently pursuing a comprehensive program to consider whether and how to enhance its regulation of mutual funds and asset managers. As described by SEC Chair Mary Jo White in a speech in December 2014,[18] the SEC and its staff will focus on portfolio composition risk and operational risk.

b. The Structure of Mutual Funds Mitigates Systemic Risk

In addition to the legal and regulatory restrictions already imposed on mutual funds, the structural characteristics of mutual funds *do not* raise and historically *have not* raised systemic risk concerns. Mutual funds are pooled vehicles that provide individual investors access to the investment markets in ways they would be unable to absent the availability of such vehicles. Their scalability is in stark contrast to companies like banks which cannot react so readily to market dislocations.

Mutual fund investors knowingly expose themselves to the potential gains and losses of the fund in which they invest and bear both the upside and downside risk in the value of the mutual fund's underlying assets. Because of this basic premise, and other features such as the floating NAV (discussed below), the FSB and International

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[16] Money Market Fund Reform, 75 Fed. Reg. 10060 (Mar. 4, 2010).
[17] Money Market Reform; Amendments to Form PF, 79 Fed. Reg. 47736 (Aug. 14, 2014).
[18] Enhancing Risk Monitoring and Regulatory Safeguards for the Asset-Management Industry. Speech of Mary Jo White, SEC Chair to The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014) ("Chair White's Speech").

Organization of Securities Commissions ("IOSCO") made the following observation—

> [F]rom 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.[19]

The regulatory structure and operations of mutual funds are fundamentally different from banks, and similar financial institutions that operate through the use of leveraged capital where depositors and creditors rely on the institution's capital cushion for payment of their claim. A mutual fund investor's stake is fully tied to the NAV of the mutual fund which may increase or decrease at any time depending on the fund's underlying assets.

Further contributing to the stabilizing effect of mutual funds is that investors in mutual funds have a long-term investment horizon. As of mid-2014, the overwhelming majority of mutual fund investors were individuals focused on retirement savings.[20] This fact was recognized by the FSB which, after reviewing industry data for U.S. mutual funds for the period 2000 through 2012, concluded that—

> 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 U.S. 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.[21]

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[19] FSB-IOSCO, Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014) at 29 (the "Consultation").
[20] ICI Research Perspective, Characteristics of Mutual Fund Investors, 2014, at 1, 2013 (Nov. 2014).
[21] Consultation at 30 n. 38 (emphasis added).

The other conclusion derived from this data is that mutual funds are not so interconnected that a fund's closing, liquidation or even *hypothetical* failure would cause a disruption in the market. The FSB, in recognizing that mutual funds are highly substitutable, stated that:

> Moreover, 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).[22]

c. *FSOC Established That Mutual Fund Floating NAV Mitigates Systemic Risk*

The FSOC itself has endorsed the view that the floating NAV of a mutual fund helps prevent systemic risk by dramatically reducing the risk of shareholder runs on a mutual fund. Its recommendation that MMFs use a floating NAV supports the proposition that the losses in incurred in a mutual fund's portfolio are borne by its shareholders as the exclusive equity owners.[23] There is no meaningful historical precedent to suggest that they would spread to other parties or become the responsibility of U.S. taxpayers.

The FSOC has stated that the floating NAV used by mutual funds operates to mitigate systemic risk. In its proposed recommendations for MMF reform under Section 120 of the Dodd-Frank Act, the FSOC stated that the use of a floating NAV by MMFs will "reinforce the principle that investors, not fund sponsors or taxpayers, are expected to bear the pro rata risk of loss in MMFs, as they do in other investment vehicles."[24] The FSOC took the position that—

> A floating NAV would make gains and losses on MMF investments a regular occurrence. . . . Losses – which are inevitable in an investment product – would no longer be obscured by valuation and rounding conventions, but

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[22] *Id.* (emphasis added).
[23] *Id.* at 69467.
[24] *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, 77 Fed. Reg. 69455, 69467 (Nov. 19, 2012).

> would be borne by shareholders and reflected in a fund's share price just like all other mutual funds.[25]

V. Asset Managers Do Not Pose A Systemic Risk

Asset managers do not add risk to the asset management vehicle as to which they provide services or to the financial system. Regulatory requirements and the nature of the asset management business ensure that the success or failure of asset managers and the vehicles they operate are not interdependent. The asset management business is also highly transferable.

Asset managers act as agents in a fiduciary capacity for their clients, not as a principal. As such, the assets they manage are not on their balance sheet. Furthermore, the financial performance of the investment adviser and its clients are independent of one another. To the extent an investment adviser incurs debt or becomes leveraged, its creditors would have no recourse to its client's assets. Additionally, a mutual fund's performance is not guaranteed by its investment adviser. Indeed, the Council noted that—

> [A]sset management firms and investment vehicles have closed without representing a threat to financial stability. The Council notes that an investment vehicle is a separate legal structure from the asset manager, any parent company, or any affiliated investment vehicles under the same manager. In addition, the assets of the investment vehicle are not legally available to the asset manager, its parent company, or affiliates for the purposes of satisfying their financial obligations or those of affiliated investment vehicles.[26]

Should an investment adviser to a mutual fund experience financial distress, it would not have any impact on the mutual fund's assets. The 1940 Act and rules thereunder strictly regulate how mutual fund assets are custodied and provide numerous barriers that prevent an investment adviser from obtaining or commingling

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[25] *Id.* at 69466.
[26] Notice at 77494.

mutual fund assets. Furthermore, a mutual fund's investment adviser may have its advisory agreement terminated at any time, without financial penalty, by the fund's board or shareholders. As a result, should an investment adviser to a mutual fund experience financial difficulty to the point where it can no longer function, the mutual fund's board of directors and shareholders may act to replace the investment adviser on short notice and with minimal disruption, if any, to the fund's pursuit of its investment objective. These rules contribute to the high substitutability of any asset manager, no matter how large it may be.

The data support this conclusion. Asset managers are highly substitutable from a competitiveness perspective, as no single firm or group of firms dominates the asset management market.[27] As noted in the ICI Factbook, "of the largest 25 fund complexes in 2000, only 13 remained in this top group in 2013."[28] Moreover, the competitive nature of the asset management business ensures that no one asset manager is irreplaceable. Should a mutual fund's board or shareholders decide to replace an asset manager, they would have a wide range of capable asset managers to choose from.

Lastly, the asset management business is highly transferable because of the non-principal nature of the business. FSOC recognized as much in its statement describing the basis for its determination to designate American International Group, Inc. ("AIG") as a SIFI. In discussing the factors that led to AIG's designation, the FSOC stressed the limited relevance of its asset management business, stating the following—

> The Council considered the extent to which assets are managed rather than owned by AIG, and *the extent to which ownership of assets under management is diffuse.* [Emphasis in original] The relevance of this factor to AIG is limited. *If AIG were to experience financial distress, its asset management business likely could be transferred to other asset managers, and*

[27] 2014 Investment Company Factbook, 54th edition at p. 27 ("ICI Factbook").
[28] *Id.*

> *therefore it is unlikely that AIG provides a critical function as a third-party asset manager.*[29]

Thus, FSOC has recognized that unlike banks, insurance companies and other financial institutions that could have a systemic impact in the case of their failure, asset managers do not have assets and liabilities of the funds they manage on their balance sheet meaning that the transfer of an asset management business is therefore readily achievable. The cumulative result of the regulatory regime and the nature of the asset management business is that asset managers simply do not pose a systemic risk.

Although not immune from failure, the asset management business is not one that is highly susceptible to it. Unlike banks, insurance companies, and other financial institutions that invest their own assets as principals, investments advisers manage client assets on an agency basis. Because of this, asset management firms require very little overhead as they depend on human capital, not an inventory that must be financed through equity or debt investments. And, although asset managers typically receive fees based on a percentage of a mutual fund's assets, losses incurred by a mutual fund do not directly correlate to a loss for the investment adviser. A mutual fund's exposure to an asset class associated with high risk characteristics is not transmitted to its investment adviser's balance sheet.

VI. The Free Flow Of Capital Into And Out Of Asset Management Vehicles Is Critical To Maintaining A Dynamic Capital Markets Sector

As the FSOC recognized, "investment risk is inherent in capital markets, representing a normal part of market functioning."[30] In that regard, asset management vehicles are not the primary creators of risk in the system, but rather manage existing investment risks for investors—a critical function in the American economy.

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[29] Basis of the FSOC's Final Determination Regarding American International Group (Jul. 8, 2013), at 12. (emphasis added)
[30] Notice at 77489.

The American capital markets system was more effective in absorbing the shock of financial distress than other bank-centric economies with less developed capital markets. Indeed, Sir Jon Cunliffe, Deputy Governor of Financial Stability for the Bank of England, noted that "it is very probable that one of the reasons the U.S. has recovered faster from its financial crisis than Europe is that in the U.S. banks do not dominate the provision of finance to anything like the same degree as in the EU."[31] Sir Cunliffe also noted that the recession in the U.S. was further mitigated because when the banking system in the U.S. was in a state of distress, "a well-developed alternative existed to help meet the financing needs of the real economy."[32]

Attempting to place prudential bank-like standards on asset managers and asset management vehicles will likely impair the ability of this sector to effectively and efficiently perform its critical function which is the core of the capital markets system. Accordingly, an analysis of the asset management industry must recognize the fundamental point that mutual fund investors contribute equity to the funds, which in turn use that equity to purchase financial assets. FSOC should consider the role and importance of that equity financing, especially in light of the capacity constraints that have been placed on other providers of financing through the regulation of banks, investment banks, insurance companies and other traditional financial services companies and market intermediaries.

In that regard, we urge the FSOC to consider holistically the ability of both the American capital markets system and asset management vehicles to absorb systemic events and act as a beneficial cushion to the financial system. We urge the FSOC to consider the following conclusion from a recent study:

> Banks are more likely to supply loans during a "normal" downturn, thus smoothing the impact of the recession. But their shock-absorbing capacity is impaired when the downturn is associated with a financial crisis. In this case,

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[31] *See* Financial Stability, the Single Market and Capital Markets Union, speech by Sir Jon Cunliffe, City of London Corporation and Open Europe Conference, London (Jan. 20, 2015) ("Cunliffe Speech"). *See also* Hugo Dixon, Unlocking Europe's Capital Markets Union, Centre for European Reform (October 2014) asserting that the "[t]he shock-absorbing capacity of capital markets is particularly high when funding is provided in the form of equity" and the "ability of capital markets to act as shock-absorbers depends on the risks . . . being transferred from bank balance sheets to the capital markets . . . ."

[32] Cunliffe Speech.

> recessions in countries with bank-oriented systems are three times more severe than in those with a market-oriented financial structure.[33]

Mutual funds accounted for a substantial portion of private sector equity investments in the U.S. totaling approximately $8.2 trillion at the end of 2013.[34] Considering the importance of equity financing as a shock absorber to a capital markets-based system , it would make little sense to restrict its amount and flexibility by applying bank-like prudential regulations to some of its most significant sources—mutual funds and the managers that advise them. Mutual funds provide an efficient cost-effective manner for investors to deploy their funds for productive uses in the economy using professional management and benefitting from economies of scale and for issuers to raise capital at ever-lower costs.

As was recently noted by Douglas J. Elliott, Fellow, at the Brookings Institution—

> One might argue that it may be appropriate to regulate asset managers even if they simply transmit risk . . . . However, I believe this would be a mistake. It is likely to push investors' money into channels that are not restricted in this way, dampening socially useful asset management activities and creating new regulatory risks. Mutual funds, for example, have worked quite well over the years as part of the U.S. financial system and they operate under many constraints to protect investors. It would be a shame if a large part of their assets moved to channels with fewer regulatory constraints and less history by which to judge them by.[35]

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[33] Gambocorta, Yang and Tsatsaronis, Financial Structure and Growth, BIS Quarterly Review, March 2014.

[34] ICI Factbook, at p. 188. Mutual funds accounted for 24% of U.S corporate equity investments at year-end 2013. ICI Factbook at 13.

[35] *See* Douglas J. Elliott, Fellow, The Brookings Institution, Systemic Risk and the Asset Management Industry (May 2014).

With this perspective and recent events in mind, we urge the FSOC to consider the critical and beneficial role in the U.S. economy played by the asset management industry when considering any possible regulatory actions or recommendations.

VII. The FSOC Should Conduct Cost-Benefit Analyses To Ensure That Risk Mitigation Does Not Come At The Cost Of Impeding Ordinary Investors' Access To The Capital Markets Or Issuers' Access to Financing

The imposition of regulatory mandates that could hamper the efficient functioning of the asset management industry should only be considered where there are clear cost-benefit outcomes that would support such actions. The concept of pooled asset management vehicles such as mutual funds began with the intention "to provide an opportunity to diversify small investors with limited means."[36] In fact, one of the first pooled investment vehicles was formed to provide "the investor of moderate means the same advantages as the large capitalists…by spreading the investment over a number of different stocks."[37]

Today, mutual funds inject a substantial portion of the investment into federal, state and local governments and public companies that might not be similarly available if individual investors were left to invest on their own. Simply put, mutual funds provide investors with efficient, low cost and professionally managed access to the capital markets. We urge the FSOC to balance any identified risks with the benefits discussed herein. The regulatory medicine that is administered should not be more harmful than the market condition that is being treated.

VIII. The FSOC Must be Open and Transparent With the Public in Connection With this Notice or any Future Proceedings

Whether in connection with this Notice process or otherwise in future proceedings, the public must have a solid understanding of the FSOC's intentions with regard to asset management to meaningfully participate in this effort. In that regard, FSOC should inform the public of:

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[36] ICI Factbook, Appendix A at 224.
[37] *Id.*

1. How it views its role with regard to the asset management industry relative to the primary jurisdiction of the SEC.

2. The basis for its authority over asset management vehicles relative to the size of the balance sheet, which balance sheet(s) it will evaluate in that regard, and how it would apply the definitional requirements of Title I related to identifying asset management vehicles as "nonbank financial companies."

3. How the OFR Report relates to the FSOC's consideration of the asset management industry, and whether (i) it is relying on it or otherwise including it in the administrative record, (ii) it has considered the comments made to the SEC on the Report; and (iii) it is considering asking OFR to revise it the report, and if so, how?

4. Whether FSOC intends to conduct and disclose robust economic analyses to support each step or action that it may consider as the SEC is required to do when it proposes rules.

Additionally, FSOC should be open and transparent and disclose whether it is considering:

1. the designation of asset management complexes as SIFIs, and if so, on what timeline and sequence relative to prudential and other global actions being considered;

2. making recommendations to one or more regulatory agencies under Section 120 of the Dodd-Frank Act;

3. employing cost-benefit analyses in connection with any asset management related actions that it may decide to take;

4. publishing metrics that it plans to use in connection with any evaluation of the asset management industry; and

5. how the actions of the FSB will relate to the FSOC's evaluation of the asset management industry.

IX. FSOC Should Require OFR To Complete And Implement Its LEI Program To Better Obtain Risk Related Information Before Proceeding To Evaluate The Asset Management Business and Other Capital Markets Participants

The Chamber fully supports the implementation of the OFR's LEI Program. A uniform system for global market participants to report data to regulators will enable regulatory bodies such as FSOC and the SEC to monitor threats to the global financial system in a more timely and accurate manner. The LEI system has already been implemented by the CFTC and its European counterparts with respect to swaps data reporting and we look forward to the same system being implemented for all financial products and transactions worldwide.

Importantly, however, the LEI program will provide higher quality data for the OFR and FSOC to better understand and track systemic risks and the market participants that transmit or create such risk. Considering the important role that asset managers and asset management vehicles, especially mutual funds, play in the American economy, any Council actions or policy recommendations regarding their regulation must be based on a full and accurate assessment of the facts. This includes the ability to evaluate accurately the actual interconnectedness and risk transmission of each market participant without making flawed assumptions or using purely conjectured hypotheticals as was evident in the OFR Report. Only then will market participants have confidence that any regulatory measures will be based on a full understanding of the facts rather than a predisposed, predetermined action.

X. The Baseline For Any Agency Action Should Take Into Consideration The Appropriate Factors With Regard To Asset Management Complexes

After the LEI program is established and high quality, reliable data is assessed, only then should the FSOC consider whether mutual funds and their managers pose a systemic risk. In doing so, the FSOC should carefully consider the factors discussed herein, which include:

a. the fund governance requirements and the role of independent directors with respect to a particular fund;

b. the regulatory requirements and industry practices with respect to (i) liquidity, (ii) redemptions, (iii) diversification, (iv) leverage, (v) custody requirements, (vi) restrictions on affiliate transactions, (vii) liquidation and resolution of funds, and (viii) the lack of impact of asset manager problems on client funds;

c. the effects that additional regulation would have on mutual fund investors (including the manager's ability to fulfill its fiduciary duties to them), issuers and their access to capital, capital markets and the U.S. economy; and

d. the high substitutability of funds and asset managers.

Finally, to reiterate the two most important factors, (i) the SEC has developed comprehensive, adaptable highly effective framework for regulating the asset management industry and an expertise of the asset management industry that is unrivaled both in its collective knowledge and its success in managing systemic risk, and (ii) the asset management industry is the single biggest driver of a capital markets system that helped absorb the shock of a severe recession three times more effectively than other markets globally.

Conclusion

The Chamber continues to be hopeful that the Council is carefully evaluating the overwhelming evidence that asset managers and asset management vehicles do not pose a threat to U.S. financial stability, and that subjecting any asset manager to SIFI designation would be unjustified, ineffective and destructive. The goals of the FSOC are to identify potential sources of systemic risk, determine whether they require additional regulation, and evaluate available regulatory responses to select the most optimal solution. When determining whether to take action on an individual company or make policy recommendations, it is incumbent on the Council to consider it in the context of the broader, enhanced regulatory regime through an economic impact analysis. Without such analysis, any action the Council takes could create a false sense of security and be both counterproductive and harmful.

We appreciate the Council's decision to seek additional information on the asset management industry before taking any further action. We recognize the Council has a very hard mission to perform. If the Council does not use the right tools in the appropriate manner, it can itself cause great damage to the economy and itself cause systemic harm. Calibrated responses and tools can achieve a balance of managing risk and allowing the economy to achieve its growth potential.

Sincerely,

David Hirschmann