November 1, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, N.E.
Washington, D.C. 20549

Re: Office of Financial Research of the Department of Treasury Report on Asset Management and Financial Stability

Dear Ms. Murphy,

The Association of Institutional INVESTORS (the "Association") appreciates the opportunity to provide the Securities and Exchange Commission ("SEC" or "Commission") with its comments regarding the Department of Treasury's Office of Financial Research ("OFR") report on Asset Management and Financial Stability (the "Report").[1]

The Association consists of some of the oldest, largest, and most trusted SEC registered institutional investment advisers in the United States. Our clients are primarily institutional investment entities that serve the interests of individual investors through public and private pension plans, foundations, and registered investment companies. Collectively, our member firms provide advisory services to more than 80,000 ERISA pension, 401(k), mutual fund, and similar investment entities on behalf of more than 100 million American workers and retirees. Our clients rely on us to prudently manage participants' retirements, savings, and investments. This reliance is built, in part, upon the fiduciary duty owed to these organizations and individuals. As such, the Association is uniquely positioned to provide insight regarding the institutional investment advisory industry and the OFR's analysis of the industry's potential vulnerabilities and risks. Our comments are intended to reflect not just the concerns of the Association, but also the financial interests of the companies, labor unions, municipalities, families, and individuals who our member firms ultimately serve.

The Association recognizes that the Financial Stability Oversight Council ("FSOC" or "Council") is undertaking efforts to identify and mitigate risks that may threaten U.S. financial stability. Further, the Association fully supports FSOC's determination to study the activities of institutional investment advisers "to better inform the Council's analysis of whether, and how, to consider such firms for enhanced prudential standards and supervision under Section 113 of the

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[1] Office of Financial Research, *Asset Management and Financial Stability* (Sept. 2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf [hereinafter OFR Report].

Dodd-Frank Act."[2] For the reasons outlined in this letter, however, the OFR Report should not serve as the basis for any policymaking or regulation as it pertains to the institutional investment advisory industry.[3]

In particular, this comment letter provides a high level overview of our observations that the Report: (I) is unsupported by adequate data and fails to address the criteria by which FSOC evaluates systemic risk; (II) misstates the role that institutional investment advisers play in the market and therefore misinterprets institutional investment advisers' activities as causing systemic risk; (III) attempts to demonstrate the potential for systemic risk by positing a series of mock scenarios that have never occurred and, had they occurred, would not threaten U.S. financial stability; and (IV) neglects to consider the mitigating controls of the extensive regulatory framework with which institutional investment advisers currently comply. Further, we believe that the Report ignores the vital role that institutional investment advisers play in the market, and their resilience during the 2008 financial crisis.

As described in this letter, in light of the shortcomings of the OFR Report, the Association believes that the SEC should urge the Council to withdraw the Report. We also encourage the SEC to take the leadership role on any further evaluation of the SEC registered investment adviser and SEC registered investment company industries.

I. The Report is Unsupported by Data, and Fails to Address the Criteria by which FSOC Evaluates Systemic Risk

A. The Report is Unsupported by Data

The Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act") created the OFR to serve as a resource to the Council and to collect financial data, conduct research and implement tools for measuring and monitoring risks to U.S. financial stability.[4] The OFR Report does not conform to the principles on which the OFR was established; communicates a misleading and inaccurate assessment of the institutional investment advisory industry; and overstates the systemic risks posed by institutional investment advisers collectively.

There is insufficient empirical data in the Report to reasonably lead to the Report's various conclusions. The Report has not analyzed information that is currently available to regulators regarding institutional investment adviser activities, including mutual fund financial statements and holdings, the Form PF, and the Form ADV, among others. This undermines OFR's analysis and evaluation of institutional investment advisers and presents an incomplete and inaccurate picture of the potential risks (or lack thereof) facing our financial system.

Our members offered to meet with OFR and provide data and other information. The OFR had ample opportunity to ask our members targeted questions about our industry. The OFR did

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[2] *Id.*

[3] While the OFR uses the term "asset managers" throughout its Report, the term "institutional investment advisers" more accurately describes our members, who are SEC registered investment advisers.

[4] OFR Annual Report, Preface at III (2012), *available at* http://www.treasury.gov/initiatives/wsr/ofr/Documents/Preface-and-Executive-Summary.pdf.

not, however, engage in any meaningful discussion with institutional investment advisers. All of the meetings were at a superficial level and at no time did OFR take advantage of our members' offers to provide data. The Report was written without an opportunity for dialogue about the accuracy of the limited data findings, implications of conclusions, or acknowledgement of competing views of industry or regulatory experts.

As the Commission may be aware, recent reports have emphasized that, "[w]hile FSOC and OFR have made some progress, continued efforts to improve the entities' accountability, transparency, and collaboration are needed."[5] This lack of accountability, transparency, and collaboration is reflected in OFR's lack of an adequate process in developing the Report and the fundamental deficiencies contained therein.

B. The Report Fails to Address the Criteria by which FSOC Evaluates Systemic Risks

The Association believes that all of the information that FSOC and OFR collect to assess the institutional investment adviser industry's risk should relate back to FSOC's established criteria for determining systemic importance, namely: (1) interconnectedness, (2) substitutability, (3) size, (4) leverage, (5) liquidity and maturity mismatch, and (6) existing regulatory scrutiny. Additionally, in assessing the industry's risk, FSOC's and OFR's assessment should consider how enhancing the established prudential standards would eliminate and prevent systemic risk.

The Association believes that the Report does not properly assess institutional investment advisers under the criteria for determining systemic importance. As outlined in this letter, the Report makes conclusions regarding institutional investment advisers' systemic importance, but it does not provide sufficient empirical data to support these conclusions. The Report does not establish an actual correlation between risk and the institutional investment advisers' size, concentration, and activities. Additionally, the Report does not evaluate the effectiveness of existing regulations and disclosures in the industry, including the SEC's investor protection regulations and other major swap (or security-based swap) participant ("MSP") and systemically important financial institution ("SIFI") requirements mandated under the Dodd-Frank Act. This disregard for FSOC's established criteria in determining systemic importance is not only counterproductive to the agency's efforts in identifying risk, but it could also lead to improper and unnecessary regulation of the industry in the future.

The Report fails to consider the actual systemic importance that the postulated risks may cause, if any. Further, the Report does not assess how the established prudential standards would eliminate and prevent the potential systemic risk of asset managers, if any were found. As such, the Report does not properly respond to FSOC's request to help it understand "whether—and how—to consider such firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Act."[6] Further, the inaccuracies found in the Report may result in improper regulation under the existing enhanced prudential standards, which are bank-centric and would not properly address the potential risks presented by the industry, if any.

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[5] Government Accountability Office, Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of their Decisions at 51 (Sept. 2012), *available at* http://www.gao.gov/assets/650/648064.pdf.
[6] OFR Report, *supra* note 1.

II. The Report Reflects a Profound Misunderstanding of the Institutional Investment Advisory Industry

As described throughout this letter, the Report reflects a general misunderstanding of the role of institutional investment advisers. Institutional investment advisers do not generally invest their own assets or act as principal in market transactions. Institutional investment advisers assist their institutional clients by providing advisory services to manage client investment portfolios according to detailed investment management agreements negotiated with each client in accordance with the client's own investment guidelines and objectives. The Association believes this foundational misconception in the Report has resulted in the Report's misinformed conclusions.

Further, the Report asserts that some institutional investment adviser activities may cause "vulnerabilities" that could pose systemic risks to the U.S. financial stability. It notes that increased concentration in the industry and connections between institutional investment advisers' activities and other market activities could contribute to systemic risk. The Report makes unsupported assumptions regarding institutional investment advisers' behaviors that reflect fundamental misconceptions about their role and their activities in the financial markets. Thus, the Association submits that the OFR should withdraw its assessment of institutional investment advisers to properly consider: (1) the distinct agency relationship between an institutional investment adviser and its clients; and (2) the lack of correlation between size and concentration.

A. Institutional Investment Adviser Balance Sheets are Not at Risk when Acting on an Agency Basis

The Report acknowledges that institutional investment advisers act as agents on behalf of clients rather than using the institutional investment adviser's balance sheet assets, in contrast to banks and other types of financial entities.[7] However the Report fails to connect institutional investment advisers' activities with the actual level of risk they may present.

For example, in an effort to support its theory that the failure of a large institutional investment advisory firm could be a source of risk to the broader financial system, the Report refers to the tendency of institutional investment advisory companies to have small balance sheets, and *correctly* notes that they are not required by U.S. regulation to set aside liquidity or capital reserves.[8] While the Report recognizes that institutional investment advisers are in an agency business, this discussion reflects a fundamental misunderstanding of the business of institutional investment advisers as agents and advisers. Clients understand that the value of their investments may go up or down and that the institutional investment adviser does not guarantee performance in any way. This is evidenced in the various types of disclosure documents that are provided to clients, such as Form ADV or other types of pooled vehicle offering documents. In the event of an investment loss, clients do not have recourse to their institutional investment adviser's assets, nor do institutional investment advisers' creditors have recourse to the asset manager's client investments. Thus, unlike a bank, an institutional investment adviser's balance sheet is not relevant to the performance of its client's investment.

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[7] *Id.*
[8] *Id.* at 19.

Further, because of the nature of the agency relationship, the size of an institutional investment adviser's balance sheet relative to its assets under management is not a relevant indicator of an institutional investment adviser's systemic risk profile. For this reason, the absence of any U.S. regulation requiring institutional investment advisers to set aside liquidity and capital reserves in connection with their balance sheets reflects deliberate and sound regulatory policy – not a regulatory oversight.

In fact, institutional investment advisers' activities are strictly limited in their risk by the investment guidelines and parameters that are contractually agreed to with their clients. Investments are typically advised against a stated benchmark or other objective, and subject to specific guidelines that govern the products and asset classes in which client assets may be invested, concentration levels are specified and other investment restrictions with which the adviser must comply are established under the terms of the investment advisory agreement, prospectus, or other pooled vehicle offering documents. Therefore, while institutional investment advisers invest client assets, clients ultimately set, acknowledge, or otherwise consent and agree to the parameters of the mandate or fund's investment strategy, and given their level of sophistication, generally go through various levels of consultation before determining their desired risk tolerance. Further, as detailed in this letter, the Dodd-Frank Act, and other laws regulating investment advisers, have established mechanisms to oversee and control risky activities.

Moreover, the SEC, in its role as investor protector, already ensures that investors' interests are safeguarded by regulating the disclosures and fiduciary duties related to institutional investment adviser activities. This existing regulatory regime is appropriate because it focuses on protecting investors rather than safety and soundness of the advisers, which are not relevant parameters when the assets under management are not the firms' own.

B. The Report Misconstrues the Correlation Between Size and Risk

The Report notes that the institutional investment advisory industry consists of highly competitive and highly concentrated firms.[9] The Report focuses on large institutional investment advisers by noting that "ten firms each have more than $1 trillion in global assets under management (AUM)."[10] While the Report highlights these higher concentrations, it does not discuss how such concentrations could increase the market impact of firm-level risks. Rather, the Report downplays the importance of diversity in clients of a large institutional investment adviser, which includes pension plans, endowments, foundations, central banks, sovereign wealth funds, corporations, pooled investment vehicles, corporations, among others.[11] Such diversity of beneficial ownership of the assets advised by a large institutional investment adviser contributes to market stability by spreading gains and losses among diverse market participants.

Moreover, the Report inappropriately focuses on size as a factor contributing to risk. The Report repeatedly draws the conclusion that, by virtue of an institutional investment adviser's size,

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[9] *Id.* at 3.
[10] *Id.*
[11] Similarly, the mutual fund industry had a Herfindahl-Hirschman Index number of 465 as of December 2012. *See* Investment Company Institute, 2013 Investment Company Fact Book, *available at* http://www.ici.org/pdf/2013_factbook.pdf.

such institutional investment adviser "could be a source of risk" without any evidence to support this assertion. However, the Report fails to connect institutional investment advisers' activities with the level of risk they may present. In fact, given their capital and management characteristics, larger firms are likely more insulated than smaller firms to potential risks.

III. In Reaching Its Conclusions on the Vulnerabilities of the Industry, the Report Suggests a Series of Improbable Events that, Even if they Were to Occur, are Unlikely to Pose a Threat to the Financial System

A. Institutional Investment Advisers are Unlikely to Succumb to the Scope and Scale of "Vulnerabilities" Described in the Report

The Report asserts that certain "key" factors render the institutional investment advisory industry vulnerable to shocks and purports that such shocks could eventually pose risks to the broader financial system. These factors are generally described as: (i) "reaching for yield" and "herding" behaviors; (ii) redemption risks, (iii) leverage, and (iv) firms themselves as sources of risk.

In describing some of these "vulnerabilities" in the institutional investment advisory industry, the Report makes several conclusions about institutional investment advisers' behaviors without identifying and properly weighing existing risk mitigation activities.

For example, the Report assumes that institutional investment advisers will reach for yield, engage in herding, or sell holdings in fire sales given competitive factors and margin and liquidity constraints. The OFR's assertion that institutional investment advisers are vulnerable to reaching for yield, herding, or fire sales, fails to recognize the fact that institutional investment advisers – particularly large institutional investment advisers – actively manage risk and are experienced in mitigating risk on behalf of clients in times of market stress. In the event of a market dislocation, institutional investment advisers are more likely to provide liquidity to the market and purchase assets that are being sold in fire sales by other firms that are seeking to support their balance sheets. Additionally, as described in this letter, the institutional investment advisory industry already has regulatory restrictions and incentives in place to help mitigate such risks. Some of these restrictions and incentives include cash buffers, liquidity requirements, and restrictions on redemption.

Additionally, in its discussion of redemption risk, the Report hypothesizes that any collective investment vehicle offering unrestricted redemption rights could face the risk of large redemption requests in stressed markets. The Report concludes that increased redemptions from funds could increase market risks if there is a perception that the asset management firm is at risk of failure. The Report fails to adequately consider that registered funds and other collective investment vehicles are subject to specific liquidity requirements rendering it unlikely that the fund would fail as a result of increased redemptions.[12] Assets may go down in value during periods of large

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[12] In fact, there are numerous effective tools at the SEC's disposal to prevent harmful impacts from rapid redemptions. These include the ability to delay a shareholder payment up to seven days; to suspend redemptions entirely upon approval from the SEC that an emergency exists; and the ability to redeem shares "in-kind" rather than in cash, precluding a mutual fund from having to meet redemptions by selling portfolio securities. *See* Section 22(e) of the Investment Company Act of 1940. Collective investment vehicles that are offered by asset managers who are part of a banking entity also have provisions built into the governing documents for such funds that prevent harmful impacts to

redemptions, but this is a risk of investing that institutional clients understand. In fact, investors in pooled investment vehicles receive extensive disclosures regarding the risks of loss.

In making these conclusions, the Report also fails to take into account that a significant portion of the assets under management of a number of the largest institutional investment advisers identified by OFR[13] are "passively" or "indexed" managed and are not subject to some of the factors or "vulnerabilities" the Report highlights (e.g. "herding," "reaching for yield," and leverage). The Report concludes that these factors or behaviors could contribute to artificial increases in asset prices and amplify market volatility if markets face sudden shocks. These assumptions ignore existing risk mitigation activities by institutional investment advisers, as well as their fiduciary obligations and current regulatory framework. Moreover, it is unclear and entirely unsubstantiated how the occurrence of one or more of these events would trigger a systemic failure at the firm, let alone a contagion effect that could threaten the entire U.S. financial system.

Further, the Report does not adequately consider that clients of asset managers often have long-term investment horizons, lessening the prospect that redemptions and fire sales would perpetually occur or that they would be of such scale and scope so as to cause shocks to the firm itself. As discussed below, even if client assets lose value during a period of market stress, this does not support the proposition that the institutional investment advisers may threaten U.S. financial stability.

B. The Report's Assessment of Separate Accounts as a Source of Risk is Based on Incorrect Assumptions

The Report highlights separate accounts as a specific source of risk. Particularly, OFR notes that investors may expect their investments to be protected and adds that support provided to investors in separate accounts is not prominently disclosed. And, while the Report recognizes that "managers are not required to provide such support," it claims that "competitive pressures or protecting firms' reputations may oblige it."[14] Such an assumption is inaccurate. Institutional investment advisers' clients make informed decisions and fully acknowledge and understand that institutional investment advisers do not have an obligation to guarantee losses on investments. This point is established in the contractual agreements between managers and their clients.

OFR's suggestion that separate accounts are not transparent is also inaccurate, primarily because separate accounts already have extensive financial reporting obligations at the entity level. There is no data at the account level and a report at the account level would not present a full picture of the entity's exposure. However, existing entity level data and disclosures, such as the reporting requirement for institutional investment advisers and swap reporting requirements described in this letter, provide a more holistic view of a separate account's activities. The OFR Report simply fails to take the existence of this data into account.

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shareholders due to rapid redemptions; including generally the ability to redeem "in-kind" or suspend redemptions under certain market or other conditions and apply market effect charges to the redeeming shareholder(s).

[13] OFR Report, *supra* note 1 at 5; Figure 2.

[14] *Id.* at 14.

C. The Report Fails to Credibly Demonstrate how the Occurrence of one or more "Vulnerabilities" at the Firm-Level would Pose a Threat to U.S. Financial Stability

Notwithstanding the speculative description of vulnerabilities within the industry, the Report fails to establish why or how any of these scenarios would amount to a threat to the stability of the entire financial system. The Report claims, for example, that a "certain combination" of fund level and firm-level activities could pose or amplify a threat to the financial system. The Report then concludes that certain "connections" between institutional investment adviser activities and other market activities could contribute to the transmission of such risks from one market sector to another, and thereby contribute to system-wide leverage and risk transfer. These series of simulated events are unsupported and fail to distinguish between risks that may be posed or sustained at the product-level as opposed to the firm-level.

Fund assets are not cross-subsidized with assets of other funds, and thus, in the context of redemption risk, it is difficult to see how the potential termination of one fund would cause other funds to also suffer redemptions and close. Even if a fund were to experience a precipitous decline of asset prices, the Report fails to demonstrate in any credible fashion how such an event would cause a large institutional investment adviser to fail, or how such large institutional investment adviser's risk would then be transmitted throughout the entire financial system.

More realistically, if a fund were to experience increased redemptions during a period of market stress, clients, mutual fund boards as well as sponsors of collective investment vehicles are generally free to terminate the institutional investment adviser and transfer their investments to a different firm or manager, without liquidating or exposing their investments to market risk. The Report does not establish how the purported vulnerabilities are reasonably or sufficiently connected so as to cause widespread risk throughout the broader financial system.

IV. The Report Fails to Consider the Existing Supervision of, and Comprehensive Regulatory Framework Applicable to, Institutional Investment Advisers

The Report's assumptions and conclusions fail to recognize the importance that FSOC gives to "existing regulatory scrutiny."[15] In particular, institutional investment advisers are highly regulated and are subject to a multitude of federal and state regulations covering almost every aspect of their operations and business activities. Of note, many institutional investment adviser clients are also separately regulated, which adds additional guardrails around the activities that an institutional investment adviser may undertake for those clients. For example, pension plans are regulated by ERISA, investment by governments and municipalities are regulated by local laws, registered advisers and funds are regulated by the Commission, collective investment trusts are regulated by state and federal banking laws, and insurance companies are regulated by state insurance regulations.

As the Commission is aware, registered advisers, their activities and the products they offer are subject to extensive supervision and regulation by the SEC. These regulatory obligations arise

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[15] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2012), *available at* http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Authority%20to%20Require%20Supervision%20and%20Regulation%20of%20Certain%20Nonbank%20Financial%20Companies.pdf.

under the Investment Adviser's Act of 1940, the Investment Company Act of 1940, the Securities Act of 1933, ERISA, and most recently, the Dodd-Frank Act and associated regulations. Institutional investment advisers are also subject to a comprehensive set of regulations in connection with offering investment advisory services with respect to commodities and commodity interests pursuant to the Commodity Exchange Act, as implemented and enforced by the Commodities Futures Trading Commission ("CFTC").

The Association is particularly concerned with the failure of the Report to take into consideration the Dodd-Frank regulatory framework and the multitude of CFTC and SEC implementing rules, both final and proposed, that are aimed at reducing the systemic risk of financial entities, including institutional investment advisers. In particular, while noting the risks of derivatives and their use by institutional investment advisers, the Report fails to take into account that Title VII of the Dodd-Frank Act provides for the registration and comprehensive regulation of MSPs, who are large traders in the swap market that are not swap dealers.[16] The Dodd-Frank Act and the CFTC and SEC rules require that a financial entity register as an MSP with the CFTC and/or SEC if, for example, it maintains a "substantial position" in any of the major swap categories, or if it is highly leveraged relative to the capital it holds.[17] Once designated as an MSP, an entity must comply with additional regulations pertaining to capital and margin, reporting and recordkeeping, daily trading records, business conduct standards, documentation standards, duties, designation of chief compliance officer, and with respect to uncleared swaps and segregation requirements.

Title VII of the Dodd-Frank Act also imposes clearing and trade execution requirements on certain derivatives products, creates comprehensive recordkeeping and reporting requirements, and enhances the CFTC's enforcement authorities with respect to all entities transacting in swaps (or security-based swaps), not just those required to register as an MSP. Moreover, as a result of requirements under the Dodd-Frank Act, swap transaction data is now available for regulators to analyze at newly created swap data repositories. Unfortunately, these new regulations and available data, which are specifically aimed at reducing systemic risk, are not adequately considered or analyzed in the Report.

The Association believes that the regulatory framework applicable to institutional investment advisers addresses each of the categories that the FSOC also must consider under Section 113 of the Dodd-Frank Act. By failing to take into account the existing and proposed regulations applicable to institutional investment advisers and their activities, the Report is flawed.

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[16] Section 721 of the Dodd-Frank Act generally defines an MSP as a participant that meets any of the following categories: (1) A person that maintains a substantial position in any of the major swap categories determined by the [CFTC], excluding positions held for hedging or mitigating commercial risk and positions maintained by certain employee benefit plans for hedging or mitigating risks in the operation of the plan; (2) A person whose outstanding swaps create substantial counterparty exposure that could have serious adverse effects on the financial stability of the United States banking system or financial markets; or (3) A financial entity that is "highly leveraged relative to the amount of capital it holds and that is not subject to capital requirements established by an appropriate Federal banking agency and that maintains a 'substantial position in any of the major swap categories. 7 U.S.C. §1a(33)(A).
[17] Further Definition of "Swap Dealer," "Security-Based Swap Dealer," "Major Swap Participant," "Major Security-Based Swap Participant" and "Eligible Contract Participant," 77 FR 30,596 (May 23, 2012).

V. Conclusion

The Dodd-Frank Act mandated FSOC to carefully collect information to assess the risks in the financial system and make recommendations regarding enhanced prudential standards for SIFIs. The Association fully supports the Council's efforts to study the institutional investment advisory industry in order to gain a better understanding of whether such firms present risks to the broader financial markets, and if so, how such firms should be considered for enhanced supervision.

For the reasons described in this letter, the OFR Report falls short of a reasoned and empirical review and should not serve as the basis of any regulatory action or determination. In light of the shortcomings of the OFR Report, the Association believes that the Commission should request that the Council withdraw the Report at its earliest convenience. Any future assessment of the institutional investment advisory industry must be based on empirical and comprehensive data, and should seek input from the industry, preferably through a more formalized notice and comment process. Further, as a member of the Council with the most expertise in regards to the institutional investment advisory industry, the Association believes that the SEC should take the leadership role in directing any future undertaking pertaining to this matter.

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The Association thanks the SEC for the opportunity to comment on the Report and appreciates its attention to the concerns highlighted in this letter. The Association welcomes the opportunity to further discuss the concerns we raised in this letter as well as serve as a resource to as the SEC as it considers institutional investment advisers' systemic importance. If you have any questions, please do not hesitate to contact the undersigned at [redacted] or [redacted]

On behalf of the Association of Institutional INVESTORS,

John R. Gidman

CC: Jacob J. Lew, Secretary of the Treasury
Mary J. Miller, Under Secretary for Domestic Finance, Department of Treasury
Richard Berner, Director, OFR
Members of FSOC