The **Systemic Risk Council**

Patrick Pinschmidt  
Deputy Assistant Secretary  
Financial Stability Oversight Council  
1500 Pennsylvania Ave., NW  
Washington, DC 20220

**SUBMITTED VIA FEDERAL eRULEMAKING PORTAL**

March 25, 2015

**Re: Notice Seeking Comment on Asset Management Products and Activities (FSOC-2014-0001)**

Dear Mr. Pinschmidt:

The Systemic Risk Council (the Council or we)\(^1\) is grateful for the opportunity to respond to the request for comment on asset management products and activities recently issued by the Financial Stability Oversight Council (FSOC),\(^2\) which builds on the FSOC’s earlier work in this area, including the September 2013 report issued by the Office of Financial Research (OFR)\(^3\) and the FSOC’s May 2014 public conference on the asset management industry.\(^4\) The Council has consistently supported empirical research on systemic risk. Indeed, we have specifically called upon the FSOC to activate a fully functioning OFR data-collection and analytics system, including the integration of data amassed by the various agencies represented on the FSOC.\(^5\)

The FSOC has requested comment on four key areas of potential systemic risk in the asset management industry: (i) liquidity and asset redemptions, (ii) the use of leverage, (iii) vital operational functions, and (iv) the resolution of asset managers, investment vehicles, and affiliates. We agree that these are likely to be the most fruitful areas of research and are hopeful that the FSOC’s request for comment will lead to a greater understanding of the linkages among participants in the asset management industry and between the asset management industry and other sectors of banking and finance. At the same time, we would emphasize the importance of continuing to devote substantial resources to

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1. The independent, non-partisan Systemic Risk Council ([www.systemicriskcouncil.org](http://www.systemicriskcouncil.org)) was formed by the CFA Institute and the Pew Charitable Trusts to monitor and encourage regulatory reform of U.S. and global capital markets, with a focus on systemic risk. The statements, documents, and recommendations of the private sector, volunteer Council do not necessarily represent the views of its supporting organizations. The Council works collaboratively to seek agreement on each of its recommendations. This letter fairly reflects the consensus views of the Council but does not bind its individual members.
improving the data-collection and modeling capabilities of the FSOC and the OFR in the interests of building an effective “early warning” system.

**Focus on Products and Activities**

The Council agrees with the Notice’s focus on identifying and understanding systemically risky products and activities in the asset management industry, alongside the important work that has been done to identify systemic entities.\(^6\) Congress established the FSOC to perform several functions in addition to the designation of systemically important financial institutions (SIFIs) and systemically important financial market utilities (FMUs) for enhanced supervision.\(^7\) The FSOC is responsible for collecting information from its member agencies and other federal and state authorities and offices. The FSOC is also charged with assessing risks to the U.S. financial system, directing the OFR to collect information from bank holding companies and nonbank financial companies, “monitor[ing] the financial services marketplace in order to identify potential threats to the financial stability of the United States,” and “identify[ing] gaps in regulation that could pose risk to the financial stability of the United States.”\(^8\) Consistent with this congressional mandate, the Notice focuses on the products and activities—and by extension, the linkages within the asset management industry and between the asset management industry and the banking industry—that are the likeliest sources of financial instability and systemic risk.

The Council agrees that “investment risk is inherent in capital markets, representing a normal part of market functioning.”\(^9\) Nevertheless, policymakers ought to have—but currently lack—the necessary data and analytical framework to perform a comprehensive assessment of the relative importance of these potential risks. The Notice affords a vital opportunity to explore enhancements to reporting and public disclosure in order to gain the desired insight and reduce or eliminate systemic risks that could threaten the banking industry and financial system at large. Both the scope and timeliness of reporting should be considered, as there is a lag in reporting and disclosure even from regulated mutual funds. Furthermore, when it has been demonstrated that certain products, activities, and structures employed by the asset management industry create, amplify, and transmit the risk of loss in ways that could be destabilizing to the financial system—most notably, securities lending—we believe that it is time to move forward with appropriate regulatory standards.

While it is appropriate, necessary, and consistent with the FSOC’s statutory mandate to monitor and evaluate the need for further data collection from or regulation of the asset management industry to address systemic risk, we believe that the FSOC should also consider how existing authority—such as the authority of the Board of Governors of the Federal Reserve System (the Board) over member banks, bank holding companies, savings and loan holding companies, foreign banking organizations, SIFIs, and FMUs, as well as the information that the Board is able to obtain through the services provided by the Federal Reserve Banks to the banking industry—may best be deployed to monitor and, potentially, to limit the transmission of systemic risks to the banking sector. The same also applies with respect to the existing authority of the Securities and Exchange Commission (SEC) and of other relevant U.S. regulators. Even if the data do not indicate the existence of significant systemic risks, the FSOC may be able to identify discrete

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\(^6\) Notice, *supra* n. 2, at 77489 (“[FSOC] is now seeking public comment in order to understand whether and how certain asset management products and activities could pose potential risks to U.S. financial stability.”).

\(^7\) 12 U.S.C. § 5322(a)(2)(H) and (J).

\(^8\) 12 U.S.C. § 5322(a)(2)(A), (C), and (G).

\(^9\) Notice, *supra* n. 2, at 77489 (“The [FSOC] recognizes that investment risk is inherent in capital markets, representing a normal part of market functioning.”).
steps that asset managers should take to plan for the transfer of clients’ assets under specific stressed circumstances.

**Bridging Data Collection Gaps**

There are a number of areas in which the Council believes that greater data collection efforts and, in some instances, regulatory measures would be beneficial to the FSOC and its constituent agencies.

- **Interrelationships with the Banking Sector.** Post-crisis, a key objective of financial regulation has been that creditors—rather than taxpayers—bear the losses arising from the failure of banking organizations. Instrumental to achieving this end will be increasing regulators’ knowledge of the types of asset managers and the types of investment vehicles that hold bank liabilities, how much they hold, the concentrations of such liabilities within the asset management industry, and the impact of the failure of a large bank on various types of managed funds.\(^{10}\) Even less is currently known about the converse—that is, the overall counterparty and investment exposures of banks to asset managers and the funds they manage. For instance, when the Reserve Fund “broke the buck” in September of 2008, it precipitated a run on other money market funds, which disrupted a vital source of short-term funding for the banking industry. Banking regulators were ill-prepared for this phenomenon and were forced to quickly put together an emergency, taxpayer-supported backstop for money market funds. In recent remarks, SEC Chairman Mary Jo White stated that the SEC staff is currently developing recommendations to expand and update data reporting requirements for the asset management industry.\(^{11}\) We urge the FSOC and the banking agencies to coordinate their efforts with the SEC’s initiatives in this area to facilitate a thorough understanding of the relationships between managed funds and banks and the likely effect that distress in one sector will have on the other.

- **Leverage.** We have previously noted our concern with the consequences of leverage on financial institutions and the financial system.\(^{12}\) Chairman White has also identified the use of derivatives in mutual funds and exchange-traded funds as a key area of focus by the SEC staff in its consideration of enhanced data reporting and of measures to limit leverage.\(^{13}\) While most managed funds do not employ leverage to the same degree that banks do, we encourage regulators to consider carefully whether there are potential improvements to the current data collection regime (e.g., for registered investment advisers) that would allow regulators to track the presence and concentrations of leverage in the asset management industry, particularly as it arises from the use of derivatives, and whether tighter constraints on leverage for certain types of funds may be warranted.

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\(^{10}\) In those jurisdictions in which the resolution of large banks is in part dependent upon junior bail-in bank debt, such as the European Union, regulators should track the holdings of bail-in debt, with the objective of gauging the ability of pension funds, life insurers, and other asset managers to withstand possible debt write-downs or debt conversions.


\(^{13}\) White Speech, supra n. Error! Bookmark not defined..
• **Liquidity and Redemption Management.** The use of leverage is even more problematic when employed by funds that promise daily redemptions but whose underlying investments are highly illiquid. Liquidity and redemption provisions in investment vehicles should be examined across the industry to determine their sufficiency in distressed conditions. If properly managed, redemption demands need not be a source of regulatory concern. We note that Pimco’s Total Return Bond Fund has met redemption demands for roughly half of its assets over the past year, without market disruption. By contrast, a highly leveraged fund whose assets represent a significant share of the total market could quickly find itself in a “fire sale” to meet redemption requests, forcing prices down for other funds invested in the same asset classes. Managed funds that meet this profile should be a high regulatory priority.

• **Securities Lending and Repurchase Agreements.** The recent financial crisis made clear that securities lending and repurchase agreements, similar to the use of derivatives, can introduce liquidity risks to investment vehicles. For example, if an investment vehicle were to engage in aggressive securities lending, it could have difficulty recalling the loaned securities under certain stressed circumstances. If the investment vehicle faced significant redemption requests but did not have access to its securities, it would be forced to liquidate its collateral, which could cause disruption of that asset sector or the financial system more broadly, depending on the quality of the collateral and other market conditions. While some steps have been taken to address the adequate margining of collateral, securities lending remains a known risk to the financial system and one area where we believe that appropriate regulatory standards are long overdue. Clear guidance on securities lending for all market participants is needed, and, given the cross-market aspects of the problem, this seems a particularly opportune area for the FSOC to take the lead in coordinating rulemaking efforts.

• **Separate Accounts.** More data is greatly needed with respect to the risks of separately managed accounts, particularly where an asset manager handles an account for a single client or a limited number of clients. We would encourage the FSOC also to coordinate its efforts in this area with those of the SEC and any other relevant regulator.\(^\text{14}\)

• **Regulatory Arbitrage.** The FSOC may also wish to examine the risks of regulatory arbitrage between the banking and managed funds sectors. Under rules recently finalized by the SEC, money market funds that cater to retail investors or invest primarily in government securities are still permitted to maintain a stable net asset value (NAV).\(^\text{15}\) In addition, sponsor support of money market funds is still permitted, although the provision of support must be immediately disclosed to the public.\(^\text{16}\) The continued ability to offer stable NAV money market funds gives banking organizations an incentive to move large deposit accounts off their balance sheets and into their sponsored money market funds, where bank capital rules do not apply. However, investors in such funds may incorrectly assume that their banking affiliates will support them should they “break the buck.” The use of implicitly backed structured investment vehicles outside the scope of bank capital requirements was a source of significant stress during the financial crisis when such vehicles suffered losses and required substantial sponsor support. Regulators should be vigilant to ensure that history does not repeat itself with respect to these funds.

\(^{14}\) *Id.*
\(^{16}\) *Id.*, at 47822.
Conclusion

We commend the FSOC for undertaking a comprehensive review of the asset management industry, consistent with its statutory responsibilities to identify and address systemic risks. We encourage the FSOC to work closely with its constituent agencies, and particularly the SEC, in addressing the systemic risks associated with asset managers. It seems clear that additional data collection is needed to understand the potential systemic risks in many areas of asset management and that further data analysis may well warrant additional regulations pertaining to leverage, liquidity, and redemption policies for high-risk funds. In other areas, such as securities lending, the risks are known and ripe for regulatory standards. In all areas, we would encourage the FSOC to work closely with the SEC in light of that agency’s considerable expertise and long experience in overseeing the asset management industry. Finally, the FSOC should consider whether and to what extent any future regulatory-driven market developments and products (e.g., bail-in debt issued by banks) could affect the asset management industry in a manner that gives rise to additional systemic risks.

Respectfully submitted,

Sheila Bair, Chair
On behalf of the Systemic Risk Council
www.systemicriskcouncil.org
Systemic Risk Council Membership

Chair: Sheila Bair, The Pew Charitable Trusts, Former Chair of the FDIC

Senior Advisor: Paul Volcker, Former Chair of the Federal Reserve Board of Governors

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• Chester Spatt, Tepper School of Business, Carnegie Mellon University, Former Chief Economist, Securities and Exchange Commission
• Lord Adair Turner, Former Chair of the U.K. Financial Services Authority and Former Chair of the Financial Stability Board’s Standing Committee on Supervisory and Regulatory Cooperation
• Nout Wellink, Former President of the Netherlands Central Bank and Former Chair of the Basel Committee on Banking Supervision Settlements

* Affiliations are for identification purposes only. Council members participate as individuals, and this letter reflects their own views and not those of the organizations with which they are affiliated.