AMERICANS FOR FINANCIAL REFORM
ACCOUNTABILITY ★ FAIRNESS ★ SECURITY

Americans for Financial Reform
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March 27, 2015

RE: "Notice Seeking Comment on Asset Management Products and Activities", Docket FSOC-2014-0001

To Whom it May Concern:

Americans for Financial Reform ("AFR") appreciates this opportunity to comment on the above-referenced notice (the "Notice") by the Financial Stability Oversight Council (the 'FSOC'). AFR is a coalition of over 200 national, state, and local groups who have come together to advocate for reform of the financial industry. Members of AFR include consumer, civil rights, investor, retiree, community, labor, faith based, and business groups.

AFR supports the FSOC's engagement in the oversight of asset management activities. We believe that practices of the asset management industry can affect the stability of the entire financial system in a variety of ways. The Dodd-Frank act specifies that the statutory purpose of the FSOC is precisely to assess, identify, and respond to risks to the stability and integrity of the financial system that may emerge from activities of non-bank financial companies, as well as banks. So it is entirely appropriate for the FSOC to play a role in oversight of asset management firms, although this role may be limited to informal cooperation between FSOC and the primary regulator, or to making recommendations using the FSOC's Section 120 authority.

The significance of the asset management industry to financial stability can be seen in the history of financial disruptions in U.S. markets. With the exception of the S&L crisis, asset management practices have played a significant role in every major financial stability event of the last thirty years. Some prominent examples include:

- The 1987 stock market crash, which was related to portfolio insurance implemented using program trading by asset managers. The crash triggered emergency Federal Reserve liquidity support and threatened the solvency of a major clearinghouse.

- The Long Term Capital Management failure in 1998 involved the failure of a major hedge fund that was overleveraged using derivatives strategies. As LTCM's failure threatened its prime brokers which were major banks, informal government intervention to negotiate an orderly wind down was necessary.

- Asset managers played a significant role in the 2008 financial crisis, although they were not its central players. The most important link to the fund management industry involved

> the role of money market funds. The exit of money market funds from commercial paper markets during 2007 helped trigger extraordinary intervention by the Federal Reserve, and the run on money market funds in late 2008 triggered a government bailout. However, funds were significantly involved in other ways – for example, hedge funds originated subprime CDOs that helped fuel the crisis, and the failure of two credit hedge funds helped trigger the collapse of Bear Stearns.[1]

Yet seeking a smoking gun in terms of the ability of asset managers to singlehandedly 'cause' a financial crisis may miss the point. Simply because asset managers play such a vital role in deploying a vast stock of assets, their decisions and behavior are central to the financial system and can impact the real economy. A key mechanism here is large-scale fire sales of assets by asset managers, which can create spillover effects on banks and the broader economy. Recent research demonstrates that hedge funds create major spillovers within the financial sector during periods of financial stress.[2] Another recent study provides powerful evidence that bond fire sales by mutual funds during the financial crisis created direct economic harm to real economy companies, reducing investment and profitability over a period of years.[3]

The argument is frequently made that asset managers are simply passive agents of investors, and their decisions therefore do not have any independent impact on the system. Yet fire sales occur precisely when asset managers make discretionary decisions on behalf of their investors that contribute to unexpected difficulties in redeeming investor funds during stressed periods. Such decisions can have significant spillover effects on the broader economy if they occur during a period of financial disruption. Both investors and the public should be able to expect that such decisions are made responsibly.

The large asset portfolios managed by asset managers also make them important players in securities lending markets, which are a key source of funding and collateral to other parts of the financial system. The reinvestment of cash collateral from securities lending can also directly support real economy loans. Asset managers are playing an increasingly important role as intermediaries in securities lending markets, including as providers of credit guarantees to market participants.[4] A disruption in securities lending markets, or poor risk management practices in such a market, could have a major impact on financial stability.

Even beyond their role as major holders of bonds and commercial paper, asset managers have some flexibility to compete directly with banks and investment banks in providing funding,

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[1] Eisinger, Jesse and Jake Bernstein, "The Magnetar Trade: How One Hedge Fund Helped Keep the Housing Bubble Going", Pro Publica, April 9, 2010.

[2] Adams, Zeno & Füss, Roland & Gropp, Reint, 2013. "Spillover effects among financial institutions: A state-dependent sensitivity value-at-risk approach," SAFE Working Paper Series 20, Research Center SAFE - Sustainable Architecture for Finance in Europe, Goethe University Frankfurt.

[3] Aslan, Hadiye, and Praveen Kumar, "Spreading the Fire: Investment and Product Market Effects of Bond Fire Sales", American Finance Association Conference Paper, January 5, 2015.

[4] Cetorelli, Nicola, "Hybrid Intermediaries", New York Federal Reserve, Staff Report 705, December, 2014.

taking on leverage and arranging loans directly for end users. The ability to do this varies significantly with the type of fund. It appears that private equity and hedge funds in particular may be taking on an increased role in both direct credit provision and arranging securitized credit. The freedom of more conventional asset managers to pursue these strategies will depend on a number of factors, including coverage of funds under the Investment Company Act and the specificity and detail of client/investor mandates. But the large amount of funds invested in separate accounts not covered by restrictions in the Investment Company Act, as well as the sometimes vague and broad nature of client mandates means that even some more conventional asset managers could be free to innovate new roles in credit provision.

The important role played by asset managers in the financial markets does not itself determine the nature of the regulation that should be applied to them. However, at a minimum we believe that the FSOC and FSOC member agencies should work closely with the Securities and Exchange Commission (SEC), as the primary regulator of asset management firms, in oversight of asset manager activities that have implications for broader financial sector stability. The Dodd-Frank Act grants various statutory powers to the FSOC that would permit stronger action upon a determination that the action by the primary regulator is inadequate.

We believe that goals of this oversight should include:

- Ensuring appropriate management of liquidity and redemption risk. Poor management of these risks may trigger large-scale fire sales, or loss of investor funds when promises regarding the liquidity of investor funds do not match the true liquidity characteristics of the underlying assets.

- Monitoring and if necessary addressing the buildup of inappropriate levels of leverage, including embedded leverage in instruments or derivatives, that may also trigger fire sales when funds are suddenly called on to deleverage.

- Ensuring appropriate transparency of fund positions to both investors and regulators.

- Setting ground rules for the stress testing procedures mandated in Section 165(i)(2) of the Dodd-Frank Act, ensuring that procedures are of high quality, and that such stress testing is informed by and also informs the understanding of systemic risks across the financial regulatory community.

- Ensuring protection of client assets in case of the failure of an asset manager.

- Monitoring situations in which rules applying to asset managers regarding risk management differ widely from rules applying to other financial entities for reasons unrelated to legitimate distinctions in business models or government safety net coverage, and preventing inappropriate regulatory arbitrage from such differences.

- Incorporating data from asset manager oversight into the process of identifying and assessing threats to the financial stability of the United States.

We are encouraged to see that most of these goals align well with both the questions asked in the Notice and the goals laid out by Chairman White for the SEC in her speech of December, 2014.[5] We hope and expect that the SEC will address these issues in its initiative on asset management.

Some Specific Concerns Regarding Current Asset Management Practices

It is our belief that current practices and regulatory oversight in at least some areas of the asset management industry currently fall short in relation to some of the goals outlined above. We look forward to reading the responses of asset managers to the specific queries in the Notice regarding current practices, as we expect that these responses will be informative on the details of different asset manager approaches to these issues.

Based on our review of current regulations as they apply to asset managers, we have a number of specific concerns as to the level of oversight currently applied to asset management activities.

It is also worth noting that there is vast diversity in the nature of asset management activities, including fund size, leverage, strategies, and relationships with investors. The effects of a failure in risk management or disclosure at a fund or funds will of course vary depending on the nature of the fund(s) and its activities. We believe that the FSOC should prioritize its engagement based on the likelihood that such failures will impact the broader financial system.

Asset Manager Information Disclosures

Regulatory disclosures by asset managers appear gravely inadequate for assisting regulators and in some cases investors in understanding fund risks. Disclosure requirements vary:

- Portfolio (position level) data is available to both regulators and investors for mutual funds and liquidity funds ('40 Act products).

- Generalized and aggregated information from Form PF is available to regulators for private funds such as hedge and private equity funds, as well as private liquidity funds.

- For separately managed accounts (SMAs), very little data appears to be available to regulators beyond a general and unverified statement of whether a separate account tracks a particular hedge fund strategy.

There appear to be serious disclosure issues for each of these categories of funds. While full position-level data on securities portfolios is available periodically for registered funds, current derivatives disclosure requirements appear very poor. Derivatives data is generally aggregated

[5] White, Mary Jo, "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry", December 11, 2014.

based on nothing more than current accounting values. Risk and exposure metrics that show the potential losses or gains to the fund if market prices change are often not available to investors or apparently to regulators. Counterparty data is also often not available. This is a very serious issue as embedded leverage cannot be assessed and highly significant risks can be missed. The use of derivatives in registered funds is growing. According to Morningstar data total derivatives use by funds increased by over 300% between 2007 and early 2014.[6] Improving derivatives disclosures for registered funds should be a high priority for regulators. New disclosure rules should require derivatives data to be sufficiently granular that regulators and market participants can do their own independent calculations of risk exposure, rather than relying on aggregated metrics of total risk calculated according to opaque fund internal models.

In the case of private funds, Form PF represents a truly significant advance over the almost complete lack of data available to regulators prior to the crisis. However, Form PF is far from a reliable guide to the full risks of these funds. For hedge funds, position-level data is not available, and hedge fund data is reported at a highly aggregated level and based on internal estimates by fund managers that are highly unlikely to be consistent from fund to fund. For example, the liquidity of fund assets is estimated by each advisor on a good-faith basis, and the impact of risk factors on the fund's portfolio is also estimated with no information given on the methods or models used to determine the estimate. It is difficult to see how reliable data on basic matters like the effective leverage (including embedded leverage) of hedge funds could be generated from the Form PF data.

Private equity funds also report on Form PF. However, only aggregated data on controlled portfolio companies is available, except for the case of financial sector portfolio companies which are reported on an individual basis.

The least information is available on separate accounts. Funds do voluntarily provide information on some separately managed accounts that track conventional registered fund products. But given the scale of the SMA market the general lack of information is disturbing. According to the Office of Financial Research, almost half of funds managed by registered investment advisors are in SMAs -- $10 trillion out of $23 trillion.[7]

It is difficult to see how effective oversight of stress testing, liquidity risk, or redemption risk at funds could be achieved without significantly better data on both hedge funds and SMAs. We also do not believe that systemic risk can be assessed properly based on the currently available data. We recommend that the FSOC cooperate with the SEC in setting up a regime under which such data can be collected by regulators without making proprietary business strategies public.

[6] "Derivatives in '40 Act Products", Morningstar Presentation at Securities and Exchange Commission, September 15, 2014.
[7] Office of Financial Research, "Asset Management and Financial Stability", September, 2013.

Derivatives Risk Management at Asset Managers

The 1940 Investment Company Act places strict limitations on leverage at funds, the issuance of senior securities, and diversification. Unfortunately, these limits are designed for conventional securities and the extensive use of derivatives threatens to undermine them in a number of ways. For example, derivatives can be used to obtain implicit or embedded leverage without actually borrowing funds, derivatives have senior status in bankruptcy, and derivatives counterparty risk may be quite concentrated even if reference assets appear diversified.

Unfortunately, the SEC has not sufficiently addressed these issues in guidance or rules. Our understanding is that the basic approach to derivatives risk at funds was set out in a series of releases and no-action letters between 1979 and the late 1980s. The fundamental approach adopted at that time was based on 'offsetting' or 'coverage' – that is, if a fund has sufficient assets designated to 'cover' a derivatives risk, or an offsetting derivatives exposure, then derivatives usage would not violate '40 Act limitations.[8] To our knowledge this approach has not been fundamentally changed since. There was a 2011 concept paper released on this subject acknowledging that change may be called for, but we are not aware of significant reforms adopted in the wake of that paper.[9]

As implemented by the SEC, the 'coverage' or 'offsetting risk' approach appears seriously inadequate for effective management of derivatives risks. Cover assets are simply designated and are not meaningfully segregated, and the coverage is based on accounting value rather than a stress scenario of potential exposure. Likewise, the 'offsetting risk' requirement does not appear to be backed up by meaningful standards on hedging models. There also appear to be no meaningful requirements on counterparty risk. Thus, derivatives risk management requirements for funds lag far behind similar risk management standards in banking, and arguably lead to violations of the Investment Company Act restrictions on fund risks.

The lack of effective SEC requirements for derivatives risk management appears to have led to a situation where risk management practices vary widely between different funds, with some funds instituting risk management that is closer to state of the art and other funds being more lax. It should be a major priority for the FSOC to work with the SEC to explore actual risk management practices to determine if there are major risks that are going unaddressed, and also to work with the SEC to raise the bar on the minimum risk management practices that will be tolerated in registered funds.

Liquidity and Redemption Risk Management at Asset Managers

The inability to redeem illiquid assets on a large scale is a major risk that could trigger 'run-like' demand for redemption by investors, forcing broad fire sales of securities. Academic studies

[8] American Bar Association, "Report of the Task Force on Investment Company Use of Derivatives and Leverage", Committee on Federal Regulation of Securities, ABA Section on Business Law, July 6, 2010.

show that the benefits to early redemptions created by underlying illiquid assets trigger faster withdrawals by investors.[10] In the current environment, sustained low interest rates have led to large inflows into high-yield loan funds that could have difficulty selling their assets if increases in interest rates cause investors to exit this asset class.

Another factor driving an increase in illiquidity of underlying assets in the system is the growth of alternative or 'liquid-alt' funds. These funds promise daily liquidity to investors despite the fact that the underlying assets include a wide range of potentially illiquid and complex assets, traded using hedge-fund like strategies that make heavy use of derivatives. As of November 2014, it is estimated that there are $300 billion in assets under management at 'liquid-alt' funds, up from just $50 billion at year end 2008, and growth is accelerating rapidly.[11] Industry sources estimate continuing growth of 9% a year in this asset class, leading to $20 trillion in assets under management by 2020.[12]

It is dangerous to allow funds to take advantage of investors' assumption that conventional registered mutual funds are relatively safe and liquid, while at the same time permitting them to hold assets that far more complex and illiquid than those that have traditionally been held by registered funds. Fortunately, the SEC itself appears to understand this and has recently made liquid-alt funds a priority for examination and enforcement. The FSOC should work with the SEC in this effort, and should ensure that the expertise in examining stressed market liquidity that exists at other FSOC members is available to the SEC as well. Both the SEC and the FSOC should consider whether broader advance restrictions on the types and assets and strategies permissible in a registered fund are called for.

In the general examination of redemption risk management, it is important that the FSOC and the SEC bring a financial stability perspective to bear. An excessive reliance on mechanisms such as redemption 'gates' (or the ability to suspend redemptions) during stressed periods can trigger broader panics in the market even if it temporarily protects an individual fund from redemption pressures. Such mechanisms cannot be a substitute for wise choices about the assets and management of the fund. Redemption fees can be preferable, but only if they are 1) not excessive and are aligned with the true costs that early redeemers impose on other members, and 2) go into the fund itself as opposed to being paid to the asset manager. A redemption fee paid to the manager creates a serious conflict of interest in the management of this tool, while a moderate redemption fee that goes into the fund properly aligns incentives between long-term and short-term investors in the fund.

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9 http://www.sec.gov/rules/concept/2011/ic-29776.pdf

10 Chen, Qi and Goldstein, Itay and Jiang, Wei, Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows (February 2007). Available at SSRN: http://ssrn.com/abstract=966661 or http://dx.doi.org/10.2139/ssrn.966661

11 Financial Industry Regulatory Authority, "2015 Regulatory and Examinations Priorities Letter", January 6, 2015.

12 PWC, *Asset Management 2020: A Brave New World* (Dec. 2013)

Regulators should also strive to avoid excessive reliance by funds on redemptions in kind, as such redemptions are not likely to be welcomed by investors during a stressed market period and will likely only fuel the flames of market disruption and disorderly selling.

Asset Manager Stress Testing Practices

Many of the issues discussed above are related to fund performance under stressed conditions. Stress tests are a key element of risk management for funds. Stress tests are also an area where close and continued cooperation between the SEC, the FSOC, and other FSOC members will pay large dividends. Other FSOC members such as the Federal Reserve (banks) and the CFTC (clearinghouses) are engaged in implementing stress testing procedures that will also involve assumptions and methods highly relevant to stress testing for asset managers. Likewise, the lessons learned through asset manager stress testing will be relevant to stress tests for other types of financial entities. We thus urge the FSOC to be engaged in the stress testing process for asset managers, if only on an informal and advisory basis, and to serve as a conduit for stress testing assumptions, methods, and results between different member agencies.

Where appropriate, stress testing practices for asset managers should comply with the basic principles set out by international regulators based on their examination of the failure of bank stress testing during the crisis.[13] Particularly important principles here are that stress testing should not rely exclusively on historical data but should be forward looking and incorporate extreme but plausible conditions, should cover a range of scenarios, be integrated into business planning, cover counterparty risk, and should take into account system-wide feedback effects. We believe that these principles are not met at many significant fund managers today.

At the same time, asset managers are not banks and stress testing for capital adequacy obviously has some fundamental differences as compared to stress testing for liquidity and redemption risk. Asset managers do not hold capital so asset value losses due to stress may be less relevant than the firm's success in liquidating assets and returning funds to investors. In addition, bank stress tests are useful so long as the magnitude of the stress aligns with the magnitude of potential future capital losses, even if the exact stress scenario is not realized. Asset managers would have a much greater concern with the specific details of the scenario and which asset classes are most impacted, which is extremely difficult to predict beyond a few generalities that hold broadly. This means that stress testing procedures should not be seen as a substitute for restrictions on the complexity and illiquidity of assets that may be found to be necessary based on regulatory examination of fund portfolios and redemption risk management techniques.

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[13] Basel Committee on Banking Supervision, "Principles for Sound Stress Testing Practices and Supervision", Bank of International Settlements, May 2009.