INVESTMENT COMPANY INSTITUTE

**MEMO# 28866**

March 27, 2015

# ICI Letter to FSOC on Asset Management Products and Activities; Testimony to Congress on FSOC Accountability, Transparency

[28866]

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TO: BROKER/DEALER ADVISORY COMMITTEE No. 13-15
TRANSFER AGENT ADVISORY COMMITTEE No. 14-15 RE: ICI LETTER TO FSOC ON ASSET MANAGEMENT PRODUCTS AND ACTIVITIES; TESTIMONY TO CONGRESS ON FSOC ACCOUNTABILITY, TRANSPARENCY
As we previously informed you, the Financial Stability Oversight Council (FSOC or Council) issued a notice last December requesting comment on asset management products and activities. [1] The Notice focused on four areas: (1) liquidity and redemptions; (2) leverage; (3) operational functions; and (4) resolution. ICI has filed a lengthy comment letter with FSOC providing data and analysis to support our view that funds registered under the Investment Company Act of 1940 ("regulated funds") and their managers do not pose risks to U.S. financial stability—either as a general matter or in any of the four specific areas highlighted in the Notice. The letter states that, if the Council's review of industry-wide asset management products and activities identifies demonstrable risks related to regulated stock and bond funds, and the Council believes such risks require regulatory action, the Securities and Exchange Commission has the necessary expertise and regulatory authority to propose any enhancements it determines may be advisable. The letter is available on ICI's website, and the executive summary to the letter is provided below. [2]

On March 25, ICI President & CEO Paul Schott Stevens testified before the U.S. Senate Committee on Banking, Housing and Urban Affairs at a hearing focused on FSOC accountability and transparency, particularly FSOC's processes for designating nonbank financial companies as systemically important financial institutions (SIFIs). His written testimony, which is available on ICI's website, argues in support of amendments to the Dodd-Frank Wall Street Reform and Consumer Protection Act to permit primary regulators and individual firms to de-risk as an alternative to SIFI designation. [3] It discusses how inappropriate and harmful the current remedies in the Dodd-Frank Act would be were they ever applied to a regulated fund or its manager.  The testimony urges that Congress revisit these remedies and look to the SEC, not the Federal Reserve Board, for enhanced oversight in the case of any fund's or fund manager's designation.

## Executive Summary – Comment Letter to FSOC on Asset Management Products and Activities

A. Liquidity and Redemptions

- The Council asks whether mutual funds pose unique and systemic risks by virtue of the requirement under the Investment Company Act that they provide investors the ability to redeem shares on a daily basis.  We explain in detail that the answer is no: the structure and regulation of mutual funds, the nature of their shareholder base, and the empirical evidence provide no support for this supposition.
- Daily redeemability is a defining feature of mutual funds.  This means that liquidity management is not only a regulatory compliance matter, but also a major element of investment risk management, an intrinsic part of portfolio management, and a constant area of focus for fund managers.
- Liquidity management is a nuanced, fund-specific, and fluid process, and there is no "one size fits all" approach.  It involves active monitoring of a fund's individual holdings, overall portfolio, and shareholder base.
- The Council's inquiry overlooks the dynamics of mutual fund cash flows.  Funds typically receive cash from investor purchases of new fund shares, interest payments and dividends on portfolio securities, maturing bonds, or sales of portfolio securities.  We provide data illustrating these features for high-yield bond funds; notably, some investors continue to purchase shares of high-yield bond funds even during periods of market stress.
- The Notice suggests a "waterfall" theory of liquidity management, positing that in times of stress, a fund may sell off the more liquid part of its portfolio first to meet investor redemptions, thereby concentrating liquidity risk on investors remaining in the fund.  Contrary to this theory, falling securities prices cause the share of a portfolio invested in cash and liquid assets to rise.  Fund managers can then use some of these assets to meet redemptions and still maintain a relatively constant allocation to cash and liquid securities.  We provide data showing that, as a result of this rebalancing, funds' holdings of cash as a percent of their assets tend to remain relatively stable, even during periods of redemptions.
- Just as investors are both purchasing and redeeming fund shares even during periods of market stress, funds also are routinely in the markets buying and selling securities month-in and month-out, in bull markets and in bear markets.  This continuous buying and selling of securities—whether precipitated by portfolio rebalancing, accommodation of fund flows, or the investment decisions of fund portfolio managers—helps to add liquidity to the market.
- The Notice also lays out a hypothesis in which mutualization of trading costs creates a unique incentive for fund investors to redeem heavily in the face of a market decline.  We explain how this hypothesis fails to consider certain regulatory characteristics of funds and tools that fund managers currently have to mitigate trading costs and foster more equitable treatment of fund shareholders.  Investor behavior provides evidence that any mutualized trading costs must not be sufficiently large to drive investor flows.  We consistently observe that investor outflows are modest and investors continue to purchase shares in most funds even during periods of market stress.
- The Council is interested in whether the growth in assets in funds focused on less liquid asset classes has caused an increase in investor redemptions.  We provide a

case study of high-yield bond funds, the assets of which have increased substantially in the last several years with no increase in the tendency of investors to redeem during periods of market stress.;

B. Leverage

- We strongly concur with the Council's focus on leverage as a practice that, without appropriate controls and under certain circumstances, could have implications for financial stability. As seen during the global financial crisis, declining asset values quickly can erase a highly leveraged company's equity, resulting in cascading losses among the company's creditor firms.
- As the Notice recognizes, the use of leverage by regulated funds generally is limited by the Investment Company Act. And, in fact, the very largest regulated funds barely are leveraged.
- The Notice seeks to explore the connection between the use of leverage by investment vehicles and negative impacts on lenders, counterparties, and other market participants, and the extent of any implications for U.S. financial stability. We explain why it is difficult to conceive how a regulated fund could ever be the source, or transmitter, of such impacts. In particular, regulated funds primarily act as providers of capital (through their long positions in debt and equity investments) to financial and operating companies, various governments, and the U.S. Treasury. As a result, regulated funds—and, by extension, their investors—are typically the bearers of risk posed by their counterparties (e.g., by reason of the fund's purchase of debt issued by a bank).
- The Notice acknowledges that regulated funds may use derivatives for purposes other than obtaining leverage. Given the importance of derivatives as an integral tool in modern portfolio management, we explain in some detail how funds may use derivatives to implement their investment strategies and manage risk.
- The Notice poses several questions relating to securities lending transactions. We explain that regulated funds are among the most conservative of securities lenders, operating under strict regulatory limits. Those regulated funds that do engage in securities lending often lend a relatively small percentage of their portfolio, and their conservative investment of cash collateral should allay any concerns on the part of the Council.

C. Operational Risk

- The Notice asks about potential risks that may arise when multiple asset managers rely on a small number of service providers for important services. We briefly describe regulated funds' use of service providers—typically highly regulated financial entities in their own right—and the robustness of the selection and ongoing oversight relating to these relationships. We then address the Council's question, with specific attention to the role of pricing vendors. We explain how regulated funds use pricing vendors and oversee their services, and how a fund would determine its net asset value per share in the absence of security values from a pricing vendor for one or more of the fund's portfolio holdings.
- In our view, the most significant source of operational risk for regulated funds is unanticipated business interruptions, regardless of the cause. We explain that the regulated fund industry is well positioned to respond to such risks when they arise. Among the reasons for this are robust business continuity planning by funds and their key service providers, technology and processing improvements that enable the continuation of certain activities during unscheduled market events, and involvement

by the SEC and FINRA.
- We briefly address the importance of continued efforts—by all financial institutions and their regulators—with respect to cybersecurity.

D. Resolution

- The Council expresses interest in the extent to which the failure or closure of an asset manager, investment vehicle, or affiliate could have an adverse impact on financial markets or the economy. We discuss characteristics that distinguish mutual funds and their managers from the kinds of large, complex, and highly leveraged institutions whose distress or disorderly failure during the financial crisis caused (or absent government intervention might have caused) negative repercussions for the financial system at large.
- Mutual funds do not experience "disorderly failure." Mutual funds do not guarantee returns to investors, and investors know a fund's gains or losses belong to them alone. Unlike banks, mutual funds use little to no leverage. Without leverage, it is virtually impossible for a fund to become insolvent—i.e., for its liabilities to exceed its assets. A fund that does not attract or maintain sufficient assets typically will be merged with another fund or liquidated through an established and orderly process.
- Fund managers likewise are unlikely to fail and highly unlikely to do so in the kind of disorderly manner that might pose risks to financial stability or require any government intervention. The main reason is the agency nature of the asset management business: acting as agent, a fund's investment adviser manages the fund's portfolio under a written contract. A fund manager does not bear the fund's investment risks; those risks are borne entirely by fund shareholders. As a result of their agency role, fund managers typically have small balance sheets with limited assets and liabilities. We are unaware of any notable fund manager in its own right filing for bankruptcy protection. Should resolution be necessary, it would be a very straightforward process.
- The Notice correctly acknowledges that "asset management firms and investment vehicles have closed without presenting a threat to financial stability." There are a number of "exit strategies" available to funds and managers, all of which can be accomplished within the existing regulatory framework (and on an expedited basis, if need be). We provide data showing that from 2000-2014, large numbers of mutual funds and fund sponsors left the business each year (e.g., through fund liquidations or mergers and sales or mergers of fund management businesses). Even when these exits occur during, or are precipitated by, a period of severe market stress, they do not occasion disorder broadly affecting the investing public, market participants, or financial markets.
- Several features of the structure and regulation of mutual funds, along with the dynamic and competitive nature of the fund management business, facilitate "orderly resolution" of funds and their managers and help explain why certain concerns suggested by the Notice are unlikely to arise. These features include the independent legal character of a fund and Investment Company Act provisions concerning separate custody of fund assets, restrictions on affiliated transactions, and board oversight. The industry is very competitive, and mutual funds and their managers are highly substitutable. No single mutual fund or fund manager is so important or central to the financial markets or the economy that the government would need to intervene or offer support to protect financial stability.
- Historical experience demonstrates that the existing legal and regulatory framework works well. As the primary regulator of mutual funds and their managers, the SEC has the necessary expertise and regulatory authority to propose any enhancements it

determines may be advisable.

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**endnotes**

[1] FSOC, Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001 (Dec. 18, 2014) (“Notice”), available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.

[2] A copy of ICI’s comment letter is available at http://www.ici.org/pdf/15_ici_fsoc_ltr.pdf.

[3] ICI’s written testimony is available at http://www.ici.org/pdf/15_senate_fsoc.pdf.

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