May 10, 2019

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Financial Stability Oversight Council
Attn: Mark Schlegel
1500 Pennsylvania Avenue NW, Room 2208B
Washington, DC 20220

Re: Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies; RIN 4030–ZA00

Ladies and Gentlemen:

The Investment Adviser Association[1] (**IAA**) appreciates the opportunity to comment on the proposed interpretive guidance[2] (**Proposed Guidance**) on nonbank financial company determinations published by the Financial Stability Oversight Council (**Council**). We support the Council's efforts to identify and mitigate systemic risk in the financial system but believe that the Council's existing approach of entity-specific designations has been flawed. We strongly support the Council's proposed activities-based approach to identifying, assessing, and addressing potential risks and threats to U.S. financial stability, as well as a more transparent and rigorous determination process in the unlikely event that a potential risk or threat cannot be addressed through an activities-based approach.

Our comments below are limited to the Proposed Guidance as it relates to asset managers and asset management.[3] Given the fundamental nature of asset managers and the regulatory regime under which they operate, we believe that an activities-based approach is more appropriate than the current systemic risk framework for nonbank financial entities, including the asset management industry. Indeed, an entity-based designation process is especially unsuited for

[1] The IAA is a not-for-profit association dedicated to advancing the interests of investment adviser firms registered with the Securities and Exchange Commission (**SEC**) under the Investment Advisers Act of 1940 (**Advisers Act**). The IAA's member firms manage more than $25 trillion in assets for a wide variety of individual and institutional clients, including pension plans, trusts, mutual funds, private funds, endowments, foundations, and corporations. For more information, please visit our website: www.investmentadviser.org.

[2] *Authority To Require Supervision and Regulation of Certain Nonbank Financial Companies*, 84 Fed. Reg. 9,028 (Mar. 13, 2019), available at https://www.govinfo.gov/content/pkg/FR-2019-03-13/pdf/2019-04488.pdf.

[3] Unless otherwise noted, we use the terms "asset managers" to include all SEC-registered investment advisers and "asset management" to include the diverse range of asset and investment management and advisory services provided by these entities.

asset managers. We do not believe that an asset manager would ever meet the criteria for an entity-specific determination under Section 113 of the Dodd-Frank Act. We nevertheless offer recommendations to ensure that the determination process is as rigorous and transparent as possible.

I. We Strongly Support an Activities-Based Approach

An activities-based approach to identifying, assessing, and addressing potential systemic risk in nonbank financial companies is warranted across all financial services industries, but is particularly appropriate for the asset management industry because asset managers do not individually pose systemic risk and they are also heavily regulated by the SEC, which is uniquely well-suited to address any related activities-based risks.

A. The Fundamental Nature of Asset Managers Does Not Pose Systemic Risk

As we have previously noted,[4] asset managers are fundamentally not a source of systemic risk because asset management is an agency business in which an asset manager's core function is to manage assets as an agent on behalf of others. An asset manager is neither a counterparty to nor a guarantor of its clients' investment risks. Asset managers are also separate legal entities from the funds and separate accounts they manage and there is no recourse to the asset manager in the event of losses in the funds or separate accounts. Moreover, asset management is highly substitutable. Asset managers thus do not pose systemic risk as individual entities. Indeed, the core features of asset managers and the robust regulatory frameworks around the asset management business serve to mitigate potential threats to financial stability.

Asset Managers are Agents, with No Balance Sheet Exposure from or to Clients. Asset managers act as agents in managing assets owned by clients that are seeking exposure to certain investment strategies. This relationship drives all aspects of the business. For example, there is an absolute separation between an asset manager's assets and liabilities and the assets and liabilities of the fund or account it manages or advises,[5] there is no legal obligation for an asset manager to back-stop investor losses or guarantee investment performance, and there are strict prohibitions on commingling client assets with asset managers' proprietary assets or

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[4] See Letter from the IAA and the Asset Management Group of the Securities Industry and Financial Markets Association to the Council on its Notice Seeking Comment on Asset Management Products and Activities (Mar. 25, 2015), available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/publications/150325cmnt.pdf.

[5] In some cases, an asset manager may invest in a fund that it manages. Having this "skin in the game" aligns an asset manager's interests with those of the fund investors. In its capacity as a fund investor, the asset manager is treated the same as any other investor and the basic principle of separation between the assets and liabilities of the asset manager and the fund holds.

using the assets of one client to meet the obligations of another. As agents, asset managers do not put their own capital at risk when they engage in financial markets on behalf of third parties (*i.e.*, their clients).

This is a fundamental and critical distinction between asset managers and other types of financial services entities, such as banks or broker-dealers, which often act as counterparties in their dealings with customers or act with respect to their own balance sheet in ways that might put their customers' assets at risk. Prudential regulations are designed accordingly, to ensure that a firm holding a customer's assets can make good on its promises. Capital requirements for banks protect against depositors losing the value of their deposits and provide incentives to banks not to take risks with their own balance sheets that would endanger the bank or the banking system—in other words, to operate prudently. Similarly, capital requirements for broker-dealers help to ensure that they can make good on their promises, settle trades and maintain and protect customer assets entrusted to them, and manage their orderly liquidation and the transfer of customer assets to another broker-dealer.[6]

Asset managers do not have similar relationships with investors. Unlike banks or broker-dealers which can default on obligations to their depositors or customers, asset managers do not accept deposits, hold client assets, or clear or settle trades. They are not counterparties to or on behalf of their clients, and so cannot default in any way that would imperil client or client counterparty assets. Rather, fund investors or separate account clients bear *investment* risk. They invest with the specific goal of capturing market returns associated with specific investment strategies or indexes. The asset manager acts only in the capacity of agent, and makes no promises that would protect against investment losses experienced by clients.

As a result, the risks to an asset manager's balance sheet are quite different from the risks, for example, to a bank's balance sheet, and the concepts of "distress" and "disorderly failure" derived from the banking context have little relevance to asset managers. Investment losses do not constitute "distress"; unlike bank depositors, fund investors and separate account clients are not promised a gain on their investment or a return of their principal. And if an asset manager leaves the business, its clients' assets are transitioned to another manager or managed by the clients themselves, with little or no direct economic consequence to the client.

[6] The primary purpose of the net capital rule (Rule 15c3-1 under the Securities Exchange Act of 1934) "is to ensure that registered broker-dealers maintain at all times sufficient liquid assets to (1) promptly satisfy their liabilities—the claims of customers, creditors, and other broker-dealers; and (2) to provide a cushion of liquid assets in excess of liabilities to cover potential market, credit, and other risks if they should be required to liquidate." See Key SEC Financial Responsibility Rules, available at https://www.sec.gov/about/offices/oia/oia_market/key_rules.pdf, at 130-131.

No Guarantees. In the same way, any concerns about investment products that rely on the offering institution's financial health and its ability to back obligations incurred by those investment products should not apply to asset managers. Asset managers are not counterparties to their clients' trades and do not guarantee investment performance.

No Recourse. Asset managers are separate and distinct legal entities from their clients, including when their clients are investment funds. Assets of a fund or a separate account belong solely to the fund and its shareholders, or the separate account owner, respectively, and never become the property of the asset manager. All gains and losses of the fund or separate account are thus borne only by the fund shareholders or separate account owners and do not affect any of the asset manager's other clients. Client assets are held by qualified custodians in segregated accounts to maintain this strict separation from the adviser. Creditors of the custodian and the asset manager do not have recourse to the clients' assets held in custody by the custodian.

Substitutability. The asset management industry is large and diverse and asset managers generally are highly substitutable.[7] Asset managers implement a diverse range of investment strategies. This high degree of substitutability does not mean that firms do not fail. Like all businesses, asset managers fail or close from time to time, but those failures would occur in an orderly fashion and, in any event, would not deprive clients of essential or irreplaceable services.

For all of these reasons, the material financial distress of an asset manager should never cause severe damage to the broader economy, much less a threat to the financial stability of the United States. Accordingly, individual Council designations are not warranted for the asset management industry. Rather, we believe it is more appropriate for the Council to follow an activities-based approach to address identified potential risks raised by asset managers, and we strongly support this approach.

B. The Robust Regulatory Regime for Asset Managers Further Mitigates Concerns Over Systemic Risk

We also strongly support the proposed approach of "allowing relevant financial regulatory agencies, which generally possess greater information and expertise with respect to

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[7] As of April 10, 2018, 12,578 investment advisers were registered with the SEC. See Investment Adviser Association and National Regulatory Services, "2018 Evolution Revolution Report: A Profile of the Investment Adviser Profession," available at https://higherlogicdownload.s3.amazonaws.com/INVESTMENTADVISER/aa03843e-7981-46b2-aa49-c572f2ddb7e8/UploadedImages/resources/Evolution_Revolution_2018_v7.pdf.

company, product, and market risks, to address potential risks, rather than subjecting the companies to new regulatory authorities."[8] The frameworks for regulating asset managers and registered investment companies[9] under the Advisers Act and Investment Company Act of 1940 (**Investment Company Act**), respectively, are comprehensive and robust and have served investors and the markets well for almost 80 years. In addition, the SEC has recently spearheaded regulatory initiatives to address broader risks that may be posed by the asset management business. Some of these are directed at the asset manager itself, while others are targeted at funds and separately managed accounts (**SMAs**), which are core types of clients to which many asset managers provide asset management services. These include initiatives regarding liquidity management, use of derivatives, stress testing, and enhanced data reporting, as described in more detail below.

Asset management is a highly regulated business, subject to numerous specific rules and interpretive guidance, most of which are derived from the overarching fiduciary duty asset managers owe to their clients. As fiduciaries, asset managers have a duty to act in the best interests of their clients and are subject to duties of both loyalty and care, including an obligation not to subordinate clients' interests to their own.[10]

The fiduciary duty is overarching—an overlay on the specific rules and regulations to which asset managers are subject. These include, for example, the anti-fraud provisions under various securities laws and rules governing the safeguarding of client funds and securities, advertisements, marketing materials, and other communications with investors, the adoption and maintenance of compliance policies and procedures (and an annual review of the effectiveness of such policies and procedures), codes of ethics (governing personal trading), supervision of

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[8] Proposed Guidance at 9030.

[9] Registered investment companies (**registered funds**) include open-end registered investment companies (mutual funds), closed-end funds, ETFs, unit investment trusts, and money market funds.

[10] In *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963), the Supreme Court held that Section 206 of the Advisers Act imposes a fiduciary duty on asset managers as a matter of law, which includes both a duty of loyalty and a duty of care. For example, an asset manager "should not engage in any activity in conflict with the interest of any client, and [it] should take steps reasonably necessary to fulfill [its] obligations. [An asset manager] must employ reasonable care to avoid misleading clients and [they] must provide full and fair disclosure of all material facts to [their] clients and prospective clients." *Information for Newly-Registered Investment Advisers*, SEC (Nov. 23, 2010).

Asset managers that provide investment management services to retirement plans that are covered by the Employee Retirement Income Security Act of 1974 (**ERISA**) on a discretionary basis also are fiduciaries under ERISA, and must satisfy fiduciary responsibilities both under the Advisers Act and under ERISA with respect to the assets they manage for such retirement plans.

employees, privacy regulations relating to client information, and recordkeeping and reporting rules.

As fiduciaries, asset managers must invest their clients' assets pursuant to investment mandates determined by their clients. In this fiduciary capacity, asset managers manage portfolio risks associated with those mandates, applying their professional judgment to help clients achieve their investment goals consistent with the clients' risk profile.

Asset managers are required to, and do, expend significant efforts on designing and maintaining appropriate compliance programs, including in the area of client asset protection—a requirement that is reinforced and monitored through regulators' examinations and enforcement and public and private disclosure of information through regulatory reporting on various disclosure forms. Indeed, as discussed in more detail below, the SEC has adopted form and rule amendments that require asset managers to report even more data about their operations.

Liquidity Management and Leverage. The SEC adopted rules to enhance the management and disclosure of liquidity risk by mutual funds and ETFs.[11] The staff is also considering reproposing rules for the use of derivatives by funds in addition to enhanced risk management programs for such activities.[12]

Enhanced Data Reporting. The SEC modernized and enhanced data reporting to better assess and respond to risks at the registered fund level and across the asset management industry. The SEC adopted significant changes to registered fund reporting requirements, including (1) changes that are designed to promote effective liquidity risk management—thereby reducing the risk that funds will be unable to meet their redemption obligations—and enhance disclosure regarding fund liquidity and redemption practices;[13] (2) reporting of a fund's portfolio holdings and other portfolio level information to facilitate risk analyses and SEC oversight (Form N-PORT); (3) inclusion of specific standardized information related to derivatives in fund financial statements (Regulation S-X); and (4) increased disclosures relating to fund securities lending activities (Forms N-1A, N-3, and N-CSR),[14] and more.

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[11] See Investment Company Liquidity Disclosure, SEC Release No. IC-33142 (Sept. 10, 2018), available at https://www.sec.gov/rules/final/2018/ic-33142.pdf.

[12] See Director of the SEC's Division of Investment Management Dalia Blass, Keynote Address at the ICI Securities Law Developments Conference (Oct. 25, 2018), available at https://www.sec.gov/news/speech/speech-blass-102518.

[13] See Investment Company Liquidity Risk Management Program, Investment Company Act Release No. 32315 (Oct. 13, 2016), available at https://www.sec.gov/rules/final/2016/33-10233.pdf.

[14] See Investment Company Reporting Modernization, SEC Release Nos. 33-10231; 34-79095; IC-32314 (Oct. 13, 2016), available at https://www.sec.gov/rules/final/2016/33-10231.pdf. See also Investment Company Reporting

The SEC staff also has adopted amendments to Form ADV (the registration and disclosure form for SEC-registered asset managers) to require asset managers to report more data on separately managed accounts. Asset managers with large total SMA regulatory assets under management and that manage accounts with large net asset values are now required to report even more data under the Advisers Act, including information about engaging in borrowing or derivative transactions in SMAs.[15] This information assists SEC staff in identifying and monitoring these exposures in SMAs as part of the staff's risk assessment. The information obtained in the most recent Form ADV filings shows that the use of borrowings and derivatives in SMAs is relatively modest.[16]

Stress Testing. In order to increase their resiliency and transparency, and address heavy redemptions and potential contagion in times of stress, SEC staff has imposed targeted stress testing requirements for money market funds.[17] We do not believe that any other stress testing is necessary given the agency and non-balance sheet nature of investment management.

We agree that the primary financial regulator, in this case the SEC, is in the best position to assess whether additional targeted regulatory enhancements are necessary and appropriate. We believe that, taken as a whole, the regulatory regime for asset management should mitigate concerns over systemic risk and that any newly identified risks would be best addressed through an activities-based approach. In this regard, the Council should also recommend that the Federal Reserve Board fulfill its statutory obligation under Section 170 of the Dodd-Frank Act to exempt certain "types or classes" of nonbank financial entities from designation.[18] For the reasons detailed above, we recommend that asset managers should be exempted as a class from systemically important financial institution (**SIFI**) designation.[19]

Modernization Rules, A Small Entity Compliance Guide, available at https://www.sec.gov/divisions/investment/guidance/secg-investment-company-reporting-modernization-rules.htm.

[15] See Form ADV and Investment Advisers Act Rules, SEC Release No. IA-4509 (Aug. 25, 2016) (Advisers Act data reporting release), available at https://www.sec.gov/rules/final/2016/ia-4509.pdf.

[16] See 2018 Evolution Revolution Report, *supra* note 7.

[17] See Money Market Fund Reform; Amendments to Form PF, SEC Release No. 33-9616 (July 23, 2014), available at https://www.sec.gov/rules/final/2014/33-9616.pdf.

[18] 12 U.S.C. § 5370.

[19] We also recommend that the Council consider whether an exemption for the asset management business of a SIFI would be appropriate.

C. We Recommend Refinements to the Proposed Activities-Based Approach

We support the Council's proposed approach of looking to primary financial regulatory agencies to address potential activities-based risks. In that regard, the Council should encourage regulators not to take a "one-size-fits-all" approach but rather to appropriately tailor regulations or guidance to the unique attributes of the regulated businesses. This is key for the asset management industry given the diverse range of asset managers and asset management models. We also urge the Council in any final guidance to recommend that the primary financial regulator consider the cumulative effect of all regulations on regulated entities of all sizes an ongoing basis.

While we support the overall activities-based approach set forth in the Proposed Guidance, we urge the Council to focus its review on those products, activities and practices that have potential/likely systemic impact. The Council should thus focus on: (1) activities, products, or markets that are new, untested, and unregulated; (2) fundamental changes in existing products, markets or activities, and key service providers or market participants; (3) cross jurisdictional risks that may result in products or activities that are not adequately monitored or regulated; and (4) historical sources of financial disruptions.

We also recommend that the four framing questions, which are proposed to guide the Council's analysis of any potential risk, focus on the *likelihood,* rather than the mere *possibility,* of triggering potential risk, transmitting adverse effects to financial markets or market participants, impacting the financial system, and impairing the financial system in a manner that could harm the non-financial sector of the U.S. economy. An assessment of likelihood should include a consideration of mitigating factors as well. The Council should also, insofar as possible, require that answers to the framing questions be based on empirical and/or historical analysis.

In addition, the products, activities, practices, and associated risks that the Council reviews should be of the scope and size that would likely have a significant impact on the U.S. economy as a whole. Any damage should need to be material and long-lasting to meet the Council's standard. Short-term volatility, which is typical of price discovery in healthy markets, should be distinguished.

II. We Support the Proposed Approach to Individual Entity Determination With Some Refinements

We generally support the proposed approach that "[t]he Council will pursue entity-specific determinations under section 113 of the Dodd-Frank Act only if a potential risk or threat cannot be addressed through an activities-based approach."[20] This approach appropriately relies on the expertise of the primary financial regulators to address identified risks in the first instance. Because of the fundamental nature of asset management, discussed above, we believe that even the largest and most complex asset management firms would not meet this "last resort" standard. However, given the enormous consequences for a company that is designated as a SIFI, we offer some recommendations to help strengthen the determination process.

First, we cannot overstate the importance of working closely with a company's primary financial regulatory agency throughout the determination process. In the case of asset managers, the SEC has the best expertise and historical perspective.

Second, the Council should consider how the regulations that result from designation (*e.g.*, minimum capital requirements, liquidity ratios, living wills) should be tailored to specific types of nonbank financial companies, which have fundamentally different characteristics from one another and from banking entities.

Third, the determination process could benefit from more specificity in a few areas. We recommend further clarity around some of the terminology that is proposed to be used in assessing risk, including "impairment of financial intermediation or of financial market functioning," "severe damage on the broader economy," "overall stress in the financial services industry," and "a weak macroeconomic environment." Should the Council determine to use quantitative metrics, we urge the Council to propose any such metrics for public notice and comment.

Fourth, the Council's cost-benefit analysis should be based on direct costs of SIFI designation rather than estimates, and also consider indirect costs of designation and attendant prudential regulation, which could include costs that would be borne by the company's counterparties, shareholders, and the U.S. economy. We also recommend that the Council look to the recommendations of the Government Accountability Office (GAO) to develop a framework for measuring the impact of designation prior to designation and review those results on a regular basis—at least annually—thereafter.[21]

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[20] Proposed Guidance at 9029.

[21] See United States Government Accountability Office, *Financial Stability: New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions*, GAO-15-51 (Sept. 2012), available at https://www.gao.gov/assets/650/648064.pdf.

Finally, we believe that if the Council determines that the risk posed by a U.S. company does not warrant SIFI designation, the guidance should also make clear that the Council will not support designation of that company by the Financial Stability Board as a global SIFI.

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We commend the Council for issuing the Proposed Guidance and we appreciate the opportunity to provide comments. Please do not hesitate to contact the undersigned at (202) 293-4222 if we can be of further assistance.

Respectfully,

Gail C. Bernstein
General Counsel

cc: Honorable Steven Mnuchin, Secretary
U.S. Department of Treasury

Honorable Jerome H. Powell, Chairman
Board of Governors of the Federal Reserve System

Joseph M. Otting, Comptroller of the Currency
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Honorable Jelena McWilliams, Chairman
Federal Deposit Insurance Corporation

Honorable Jay Clayton, Chairman
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Honorable J. Christopher Giancarlo, Chairman
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