INVESTMENT ADVISER ASSOCIATION

2015 Comments & Statements

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November 2, 2015

Via Electronic Submission (www.regulations.gov)

Ms. Jennifer Shasky Calvery, Director
Financial Crimes Enforcement Network
P.O Box 39
Vienna, VA 22183

Re: Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers, Docket Number FINCEN-2014-0003, RIN 1506-AB10

Dear Ms. Calvery:

The Investment Adviser Association[1] ("IAA") appreciates this opportunity to comment on the Financial Crimes Enforcement Network's proposal relating to anti-money laundering compliance by certain investment advisers.[2]

We recognize the importance of detecting and preventing money laundering and terrorist financing in all aspects of the financial system, and we understand FinCEN's ongoing efforts to evaluate whether to extend anti-money laundering concepts to advisers and other non-bank financial institutions. We appreciate that FinCEN's proposed flexible, risk-based approach to AML compliance permits each covered adviser to tailor its AML program to match the nature and scope of its advisory business.

At the same time, we urge FinCEN to reconsider the scope of its proposal. The BSA does not need to be extended to *all* investment advisers[3] with respect to *all* of their activities in order to have a comprehensive anti-money laundering regime in the United States. We

[1] IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission ("SEC"). The IAA's membership consists of more than 550 firms that collectively manage approximately $16 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[2] *See Anti-Money Laundering Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers*, 80 Fed. Reg. 52,680 (Sept. 1, 2015), available at http://www.gpo.gov/fdsys/pkg/FR-2015-09-01/pdf/2015-21318.pdf (the "Proposal"). The Proposal would, among other things, require advisers registered or required to be registered with the SEC to establish anti-money laundering ("AML") programs as required by the Bank Secrecy Act ("BSA") and report suspicious financial activity by filing suspicious activity reports ("SARs") pursuant to the BSA. The Proposal follows a substantially similar 2003 FinCEN proposal to require certain advisers to establish AML programs. *See Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Investment Advisers*, 68 Fed. Reg. 23,646, 23,648 (May 5, 2003) (the "2003 Proposal").

[3] For simplicity, we use the terms "investment adviser" and "adviser" in this letter to refer to any investment adviser registered or required to be registered with the SEC, recognizing that there are other advisers not covered by the Proposal.

recommend that FinCEN carefully consider the varying types of advisers and the diversity of their advisory activities and client bases, and seek to extend the BSA only where doing so would fill a potential gap in our nation's anti-money laundering regime.

We also ask that certain other aspects of the Proposal be tailored to avoid duplication of regulatory efforts where the costs of compliance will significantly outweigh potential benefits. In many cases, advisers are only one of a series of financial institutions interfacing with a client in connection with a new advisory engagement, many of which already are required to perform AML reviews of the client. In other cases, advisers may have little or no direct contact with the ultimate client (as contrasted with other relevant intermediaries), or may deal with clients whose operations pose little or no money laundering risk. Certain aspects of the Proposal may not be necessary for these advisers, given that their advisory services and/or client base do not pose AML risks that justify application of the full array of AML obligations contemplated by the Proposal.

In this respect, regulators and the adviser community share a common objective: to balance the dual goals of maintaining the integrity and effectiveness of the proposed AML regime, while avoiding unjustified or duplicative regulatory burdens and costs on advisers whose operations pose no meaningful risk of money laundering. And we note that AML compliance costs—even on the risk-based basis contemplated by the Proposal—often are substantial. As discussed in Part V of this letter, we are concerned that the cost-benefit analysis reflected in the Proposal fails to correctly measure the substantial burden that these new programs would place on the industry, particularly with respect to smaller advisers, which constitute a majority of advisers in the industry.[4] By applying an asset-based "small entity" definition that primarily covers advisers that are not even eligible to register with the SEC (with limited exceptions),[5] FinCEN has not appropriately accounted for the rule's impact on the more than 6,000 SEC-registered advisers that have fewer than 10 non-clerical staff. In considering the economic burden of its proposal, FinCEN should consider these advisers to be small entities and take careful note of the potential ways in which the proposal might disproportionately impact them.[6]

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[4] In 2015, 57.3% of advisers registered with the SEC reported having fewer than ten non-clerical employees. INVESTMENT ADVISER ASSOCIATION & NATIONAL REGULATORY SERVICES, 2015 EVOLUTION REVOLUTION: A PROFILE OF THE INVESTMENT ADVISER PROFESSION 24 (2015), *available at* https://www.investmentadviser.org/eweb/docs/Publications_News/EVREV/evolution_revolution_2015.pdf (*hereinafter*, "EVOLUTION REVOLUTION").

[5] Section 203A(a)(1)(A) of the Investment Advisers Act of 1940 (15 U.S.C. § 80b-3a(a)(1)(A)) provides that "[n]o investment adviser that is regulated or required to be regulated as an investment adviser in the State in which it maintains its principal office and place of business shall register [as an investment adviser with the SEC], unless the investment adviser . . . [h]as assets under management of not less than $25,000,000." Although there are certain exceptions to this prohibition, less than 8% of advisers registered with the SEC in 2015 reported having less than $25,000,000 under management. *See* EVOLUTION REVOLUTION, at 10.

[6] We recognize that the Proposal elected to adopt the SEC's definition of "small entity," in an effort to create consistency and uniformity with the SEC's standards. However, by choosing the SEC's AUM-based standard over the standard published by the Small Business Administration, which instead considers a firm's annual receipts in

We believe that the changes we recommend would improve the efficiency of the Proposal's intended regulation of advisers by excluding or exempting from coverage certain firms or certain low-risk activities, enhance the ability of advisers to tailor the Proposal's AML requirements to their businesses, and enable advisers to rely on certain efforts of other AML-regulated entities in the financial system or within an adviser's own organization. This comment letter also discusses, and seeks guidance concerning, certain practical implications of the Proposal.

I. Background on the Investment Advisory Profession

As a preliminary matter, we feel compelled to clarify one point. The Proposal begins by noting FinCEN's concern that "[a]s long as investment advisers are not subject to AML program and suspicious activity reporting requirements, money launderers may see them as a low-risk way to enter the U.S. financial system."[7] We respectfully submit that this statement is simply not true and reflects a fundamental misunderstanding of the nature and scope of services provided by advisers. For reasons discussed below, advisers do not provide any way—much less "a low risk way"—for a client to bypass banks, broker-dealers, or other financial institutions covered by the BSA and enter the U.S. financial system.

Unlike other types of financial service providers, the client relationship for an investment adviser does not begin with an initial "deposit." Rather, it begins with the client entering into an investment management agreement with the adviser, pursuant to which the adviser agrees to manage the client's assets on a discretionary basis or provide non-discretionary investment advice that clients may implement in their own accounts. In either case, the actual physical custody of the cash and securities in the client's account is maintained by a "qualified custodian," such as a bank or broker-dealer,[8] and the client merely authorizes that bank or broker-dealer to accept investment management instructions from the adviser.[9] Accordingly, the

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determining its status as a small business (*see* 13 C.F.R. § 121.201), we believe the Proposal comes to a far different conclusion on the impact to small businesses than it otherwise would have. *See* Part V of this letter.

[7] Proposal, at 52,681.

[8] Advisers themselves rarely serve as qualified custodians. In 2015, only 78 advisers (or 0.7% of advisers) reported acting as qualified custodians in connection with their advisory services. See EVOLUTION REVOLUTION, at 20. That a small number of advisers serve as qualified custodians themselves is not a gap in the AML regime: in cases where the adviser acts as the qualified custodian, the adviser also is either a bank or broker and acting as a qualified custodian in such capacity—not as an adviser. Further, we note that, in 2015, only a very small number of advisers reported being entities that could be eligible under the so-called "Custody Rule" (17 C.F.R. § 275.206(4)-2) to serve as qualified custodians: only 4% are dually registered with the SEC as broker-dealers, only 0.2% are banks, and only 0.2% are futures commission merchants. *Id*. at 28. We further note that, notwithstanding the assertion in the Proposal that advisers "are often dually registered as a broker-dealer in securities or affiliated with" other BSA-defined financial institutions, our statistics find that less than 21% of advisers report an affiliation with a broker-dealer, and just over 7% report an affiliation with a bank or thrift institution. *Id*. at 29-30.

[9] As an example of the rigors imposed by the Custody Rule, a registered adviser asked the SEC staff whether, in the event that the adviser inadvertently received securities directly from a client, the adviser could simply forward those securities on to the client's qualified custodian rather than returning them to the client (to, in turn, be sent directly to

process for opening and funding a client account necessarily involves SEC-registered broker-dealers or regulated banking institutions that are already subject to extensive AML regulatory obligations under the BSA.

As a result, compared with other financial institutions involved in the account opening process, advisers in many cases may not be as well-positioned to view how the client's account is funded, where withdrawals from the account are sent, or whether there is unusual wire activity.[10] That said, we understand that under certain circumstances it may be possible for an adviser that has a direct relationship with an individual client to recognize behavior that may be suspicious. Even in that respect, however, FinCEN should understand that the typical advisory client relationship is fundamentally not an attractive medium for money launderers. In the traditional advisory model, the adviser—pursuant to a written contract with the client—provides continuous and regular supervision and/or management of the client's securities portfolios. This does not provide an expedient or cost-effective means to "transform" the character of illicit funds into legitimate assets of the accountholder. Customarily, advisers receive a percentage of assets under management and/or appreciation in value of the client's account as remuneration rather than compensation on a transaction by transaction basis. This percentage-based compensation structure aligns the interests of the adviser and the client and encourages a long-term adviser-client relationship. In the AML context, this type of compensation would impose a relatively substantial cost on persons intending to use advisers for money laundering activities.

Moreover, the vast majority of investment advisory relationships are created to achieve clients' investment objectives over the long term. Investment advisers thus anticipate that a client's assets will remain in the custodial account without frequent withdrawals or deposits that would interfere with the adviser's implementation of the client's selected investment strategy.[11] This expectation of stable and long-term retention of client assets in the custodial account is particularly true when the adviser possesses discretionary authority over a client's assets—*i.e.*, when the adviser is authorized to make investment decisions for the client without the client's consent for each transaction (although within the clients' established investment restrictions and

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the qualified custodian). The staff responded negatively, stating that, if the adviser did not return the securities to the client within three business days, "the adviser not only has custody but has also violated the amended rule's requirement that client securities be maintained in an account with a qualified custodian." *See* Staff Responses to Questions About the Custody Rule, *available at* http://www.sec.gov/divisions/investment/custody_faq_030510.htm (last updated Sept. 1, 2013) (Question II.1). Accordingly, the Custody Rule has the impact of removing many advisers from the chain of custody over funds transferred into and out of a client's custodial account.

[10] IAA acknowledges that there is significant variation among investment advisers with regard to their visibility to, and involvement in, funding and other cash transactions related to their clients' accounts. For example, advisers to retail clients may be more actively involved in facilitating the account opening and funding process for their clients, including forwarding wire instructions from the client to the custodian, while this may be less common among advisers to institutional clients. However, this does not alter the fundamental requirement under the Custody Rule that such transactions must be effected through other regulated financial institutions (except in the very limited circumstance where the investment adviser is itself acting as the client's qualified custodian).

[11] *Cf. Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 187 at 60619 (Sept. 26, 2002) (noting that entities requiring lengthy investment periods are less susceptible to money laundering).

guidelines). Such expectation is commonly enforced by the adviser through minimum account size thresholds for its client accounts, which may in some cases be coupled with other contractual conditions or limitations on liquidity. In light of these expectations, advisers generally are not attractive to money launderers that seek to quickly and frequently move funds in and out of the financial system without raising suspicion.

With this background, we discuss below certain advisers whose activities raise minimal money laundering concerns and that IAA believes may be excluded or exempted from the Proposal's intended AML regime.

II. The Proposal Should Provide Exclusions or Exemptions for Certain Types of Advisory Business

The Proposal imposes AML obligations on all investment advisers, irrespective of the nature of their clients or their types of advisory business. However, a significant number of these advisers provide services to clients and/or engage in advisory activities that do not, in IAA's view, raise money laundering risks that need to be addressed by FinCEN's proposed rules.

1. Advisory Services Not Involving Management of Client Assets.

Certain advisers provide non-management advisory services, such as nondiscretionary financial planning and publication of securities-related newsletters, impersonal "model portfolios" or research reports ("Non-Management Services").[12] In providing these types of services, advisers are functioning entirely outside of the "payment chain"—the adviser neither manages, directly or indirectly, the client's assets nor participates in the transmittal of any client funds to or from any recipient. Accordingly, in these circumstances, there is no risk that the adviser will be an entry point for money laundering activities, and the adviser would not have access to sufficient information about the client's account to detect suspicious financial activity. Indeed, in many instances, advisers may not even possess the names of or other identifying information about the "clients" who receive Non-Management Services. Applying AML regulations to the adviser in this context would not meaningfully contribute to the AML regime. We therefore request that FinCEN consider modifying the Proposal to provide that advisers need not include within the scope of their AML programs those clients to which they provide only Non-Management Services.

2. Advisory Services to AML-Regulated Entities, Such As Registered Investment Companies.

Investment advisers serve a diverse range of clients, including individuals, banks, mutual funds, pension funds, hedge funds, charitable organizations, corporations, and state or municipal entities. Certain types of advisory clients—most notably, banking institutions, registered

[12] As of April 8, 2015, 410 advisers reported on Form ADV that they have no clients. EVOLUTION REVOLUTION, at 14. Similarly, 585 advisers reported having no assets under management. EVOLUTION REVOLUTION, Supplemental information, line 359.

investment companies (e.g., mutual funds), insurance companies and registered broker-dealers—are already subject to the extensive AML requirements of the BSA (such entities, collectively, "AML-Regulated Entities"). Consequently, assets that an adviser receives from a client that is itself an AML-Regulated Entity have already been subject to an AML review before allocation to the adviser for management. Therefore, requiring an adviser to conduct an AML review of clients that are AML-Regulated Entities would be needlessly duplicative of AML protections already in place.

The foregoing also is true when clients enter into advisory contracts with an AML-Regulated Entity, which then enters into sub-advisory contracts with advisers ("AML-Covered Sub-Advisory Arrangements"). In AML-Covered Sub-Advisory Arrangements, the AML-Regulated Entity acts as the primary point of contact with its clients, is responsible for conducting due diligence and complying with AML requirements, and has the ability and authority to monitor and collect information about its clients' account activities. A notable example is the traditional, bundled "wrap fee" program sponsored by a registered broker-dealer unaffiliated with the program's sub-advisers. In this arrangement, clients traditionally enter into agreements for brokerage and advisory services with the registered broker-dealer sponsoring the program, which is subject to AML requirements under the BSA and is responsible for all client-level services (e.g., recordkeeping, account maintenance, reconciliation, etc.). The broker-dealer then enters into sub-advisory contracts with advisers to invest the client assets invested in the program, based on the parameters set by the sponsor. Therefore, a sub-adviser that provides advisory services under an AML-Covered Sub-Advisory Arrangement has minimal or no contact with the AML-Regulated Entity's clients and is asked to manage assets that have already undergone an AML screening. Further, the sub-adviser likely does not possess or have access to information about the AML-Regulated Entity's clients that would permit the sub-adviser to conduct an AML review that would add value to the AML review already conducted in the first-instance by the AML-Regulated Entity.

In both of these contexts, an additional layer of AML review by an adviser with respect to a client that is an AML-Regulated Entity or a client pursuant to an AML-Covered Sub-Advisory Arrangement would be duplicative and impose a substantial cost and burden on advisers without providing a commensurate improvement in the detection and prevention of illicit money laundering activities. We strongly recommend that the Proposal be amended to provide that an adviser is not required to include AML-Regulated Entity clients and AML-Covered Sub-Advisory Arrangements within the scope of its AML program. This approach would substantially reduce the overall regulatory burden of the Proposal without creating any gaps in AML protections. While the approach would entirely exempt advisers that exclusively serve AML-Regulated Entities, those entities (and their investors) are all covered. For example, an adviser to a mutual fund would be exempt, but the mutual fund itself would remain subject to the full panoply of AML protections.

We note that this requested relief would be conceptually consistent with the exclusion included in the 2003 Proposal that permitted advisers to exclude from their AML programs pooled investment vehicles that are themselves subject to, or sponsored by financial institutions

subject to, AML requirements under BSA rules.[13] IAA would welcome a similar effort to avoid overlapping and duplicative AML regulation in respect of the current Proposal.

3. Sub-Advisory Services.

Another common and important circumstance where we believe relief is warranted is in the context of sub-advisory relationships, where one adviser (the "Primary Adviser") takes responsibility for the day-to-day administration of a client's account and client-related account services (such as reporting and recordkeeping), but contracts with one or more unaffiliated advisers (each, a "Sub-Adviser") to make investment management decisions for the account (collectively, "Sub-Advisory Arrangements"). Sub-Advisory Arrangements can exist in a number of formats, including managed account "platforms," wrap fee programs, unified managed accounts and other sub-advised accounts, as well as collective investment funds where a Primary Adviser sponsors the fund and retains Sub-Advisers to manage the fund's investments. In all of these cases, the common factor is that the Primary Adviser or its designated agent(s) (but, importantly, not the Sub-Adviser) is responsible for soliciting potential investors and raising capital, collecting information and documentation regarding the investors' eligibility to invest under securities and other laws and regulations, and selecting and liaising with the custodians that will hold clients' assets. Furthermore, the Primary Adviser possesses the authority to appoint and replace each Sub-Adviser, which functions solely as a service provider that has the discrete responsibility of managing the assets allocated to it under the Sub-Advisory Arrangement.

In this regard, the arrangement is similar to those described in Part II.2 above in that, as a result of the legal and practical structure of Sub-Advisory Arrangements, a Sub-Adviser likely will not possess or have access to detailed information about the end-clients in the Sub-Advisory Arrangement and, therefore, is not well-positioned to conduct a meaningful AML review. In some cases, this lack of transparency may indeed be critical to the commercial (e.g., due to competitive concerns) or legal (e.g., due to varying privacy laws applicable to non-U.S. clients) viability of the Sub-Advisory Arrangement. Moreover, as an unaffiliated party involved in only the investment management aspects of the Sub-Advisory Arrangement, the Sub-Adviser often will not have investor-level visibility into the circumstances surrounding subscriptions, redemptions and other cash moves impacting the account. As such, the Sub-Adviser is unlikely to have visibility into the type of client-level account activity that might otherwise trigger suspicious activity reporting obligations.

Although we acknowledge that Primary Advisers currently may not be required to implement AML programs in connection with Sub-Advisory Arrangements, they generally

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[13] *See* 2003 Proposal ("In some instances, investment advisers that would be subject to the proposed rule advise pooled investment vehicles that are themselves required to maintain anti-money laundering programs under BSA rules, such as mutual funds, or that are sponsored or administered by financial institutions subject to such requirements. To prevent overlap and redundancy, the proposed rule would permit investment advisers covered by the rule to exclude from their anti-money laundering programs any investment vehicle they advise that is subject to an anti-money laundering program requirement under BSA rules.") (citation omitted).

would be required to do so under the Proposal. For these reasons, IAA believes that subjecting Sub-Advisers to AML obligations is likely not the most appropriate or effective means to implement AML protections in a Sub-Advisory Arrangement, and could prove disruptive to an important segment of the asset management industry. We therefore request that FinCEN relieve Sub-Advisers unaffiliated with their Primary Advisers from the AML requirements of the Proposal.

4. Advisory Services to Low-Risk Clients.

Certain advisory clients, although not themselves subject to extensive AML requirements, nonetheless present a low risk of suspicious activity. Pension plans, employees' securities companies ("ESCs"), and publicly traded corporations are notable examples. Pension plans are created to secure employees' (*i.e.*, plan participants') retirement benefits, are funded by contributions from participants' salaries and from the sponsoring employer, and participants are not permitted to withdraw their plan contributions for extended periods of time, in the ordinary course. ESCs are companies all of the outstanding securities of which are beneficially owned by current and former employees of a single employer (or group of affiliated employers), immediate family members thereof, and/or the relevant employer(s),[14] and are established to benefit, reward, and retain employees. Public corporations generate income from active business operations, are subject to significant audit, securities, and other regulatory requirements, and are heavily regulated by the SEC. For these reasons, advisory accounts for pension plans, ESCs,[15] and publicly traded corporations present a low risk of money laundering. Several other advisory clients would fall into this low-risk category, including those that are government entities, such as municipal or state agencies; governmental pension plans; non-profit organizations; higher education endowment funds; and multi-employer plans (so-called "Taft-Hartley plans"). Moreover, as noted above, even such low-risk accounts will often be held in custody with a financial institution that is already required to conduct BSA-compliant AML reviews of the account, adding an additional layer of security.

We ask that FinCEN recognize the minimal risk presented by these types of advisory clients and exclude from the Proposal's AML requirements advisers advising only such low-risk

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[14] ESCs are established pursuant to Section 2(a)(13) of the Investment Company Act of 1940, as amended (15 U.S.C. § 80a-2(a)(13)) and refer to "any investment company or similar issuer all of the outstanding securities of which (other than short-term paper) are beneficially owned (A) by the employees or persons on retainer of a single employer or of two or more employers each of which is an affiliated company of the other, (B) by former employees of such employer or employers, (C) by members of the immediate family of such employees, persons on retainer, or former employees, (D) by any two or more of the foregoing classes of persons, or (E) by such employer or employers together with any one or more of the foregoing classes of persons."

[15] We note that, in its proposed (but subsequently withdrawn) AML program rules for unregistered investment companies, FinCEN excepted ESCs and certain categories of employee benefit plans from the proposed AML program requirements, on the grounds that such structures are not likely to be used for money laundering purposes by third parties "given their size, structure and purpose." *Financial Crimes Enforcement Network; Anti-Money Laundering Programs for Unregistered Investment Companies*, 67 Fed. Reg. 187 at 60620 (Sept. 26, 2002).

clients, or clarify that advisers' AML obligations under the Proposal with respect to these entities would be effectively *de minimis*.

5. Application of the Proposal to Foreign Advisers.

FinCEN has asked for comment on whether the Proposal should apply to SEC-registered advisers that have no place of business inside the United States ("Foreign Advisers"). FinCEN has long recognized that the BSA does not apply to foreign financial institutions, foreign operations of U.S. financial institutions, and foreign bank branches, and has tailored its FAQs and examination manuals accordingly.[16] This jurisdictional approach was reflected in the 2003 Proposal, which defined "investment adviser" to include only those advisers "whose principal office and place of business is located in the United States,"[17] but that refinement was not carried forward into the current Proposal. Similarly, the SEC has a well-established position that the substantive requirements of the Investment Advisers Act of 1940, as amended (the "Advisers Act"), do not apply to Foreign Advisers with respect to their foreign clients.[18] By not taking into account the principal locations from which Foreign Advisers conduct their businesses, the Proposal would treat such firms differently than many other AML-Regulated Entities.[19] These limitations on extraterritoriality are very important, as many firms are located in jurisdictions where legal conflicts could arise between the Proposal's requirements and local confidentiality and privacy laws.

Consistent with the BSA's treatment of foreign bank branches and many other AML-Regulated Entities, the Proposal should not apply to Foreign Advisers. If FinCEN should determine otherwise, it must at a minimum clarify that the application of the Proposal relates solely to the U.S. clients of Foreign Advisers, and even in that regard, that Foreign Advisers may appropriately tailor their suspicious activity monitoring and reporting to comport with their local privacy and other laws.

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[16] *See* 31 U.S.C. § 5312(a)(2) (definition of the term "financial institution" does not include foreign branches or foreign financial institutions). *See also* FFIEC Bank Secrecy Act Anti-Money Laundering Examination Manual, at https://www.ffiec.gov/bsa_aml_infobase/pages_manual/OLM_041.htm ("overseas branches or subsidiaries may find it necessary to tailor monitoring approaches as a result of local privacy laws").

[17] *See* 2003 Proposal, at 23,652 (proposed definition).

[18] *See American Bar Association, Sub-Committee on Private Investment Entities*, SEC No-Action Letter (Aug. 10, 2006).

[19] For example, the suspicious activity reporting requirements for broker-dealers (*see* 31 C.F.R. § 1023.320(a)(1)), futures commission merchants and (commodities) introducing brokers (*see* 31 C.F.R. § 1026.320(a)(1)) apply to such firms "within the United States." We also note that many of the definitions for other regulated categories show a similar jurisdictional approach. *See, e.g.*,, 31 C.F.R. § 1010.100(d) (definition of "bank" refers to "[e]ach agent, agency, branch or office *within the United States* . . . ."); 31 C.F.R. § 1025.100(g) (definition of "insurance company or insurer" refers to "any person engaged *within the United States* as a business in the issuing or underwriting of any covered product"); 31 C.F.R. § 1010.100(lll) (definition of "loan or finance company" refers to "[a] person engaged in activities that take place *wholly or in substantial part within the United States* . . . .") (*emphasis added*). In light of the factors cited elsewhere in this letter, we are not aware of a compelling reason that Foreign Advisers should be treated differently than these other regulated businesses.

III. The Proposal Should be Amended to Ease the Practical Burden on Advisers in Implementing AML Programs

Under the Proposal, every adviser would be required to establish an AML program that is reasonably designed to prevent the adviser from being used for money laundering. The AML program would be required to meet four minimum requirements: (i) implementation of internal AML policies, procedures, and controls; (ii) designation of a person(s) responsible for administering the AML program; (iii) ongoing AML program training for appropriate persons; and (iv) independent testing of compliance. Below, we address certain practical issues concerning the manner in which the Proposal requires implementation of the AML program.

1. Approval.

The Proposal would require that each adviser's AML program be approved in writing by its board of directors or trustees, or if it does not have a board, by its sole proprietor, general partner, trustee, or other persons that have functions similar to a board of directors. IAA agrees that each adviser should ensure that its AML program receives approval and support at an appropriately high level of management. However, owners and principals may not be the appropriate parties to approve AML programs, as they may not be the most familiar with the operational aspects of the adviser's AML program or compliance program generally. We recommend instead that FinCEN's final rules permit approval by a member of senior management. This would be consistent with the corresponding rules for broker-dealers[20] and with the integration of the AML program into the adviser's existing compliance program.

2. AML Compliance Officer.

The Proposal also would require that the compliance officer responsible for the AML program be, among other things, knowledgeable and competent regarding FinCEN's regulatory requirements and have "full responsibility and authority to develop and enforce appropriate policies and procedures."[21] The Proposal further requires that the compliance officer be an "officer" of the adviser. We note that many advisers, by virtue of their organizational structures, may not generally have formally designated corporate "officers" who are well-suited to serving as the adviser's AML compliance officer. We recommend that the Proposal be amended to permit any sufficiently senior employee of the adviser (including its chief compliance officer)—or of any other entity within the adviser's organizational structure—to serve as the AML compliance officer, as long as such employee meets all of the other requirements set forth in the Proposal and is either a member of, or reports directly to, the adviser's senior management. This would ensure that the AML compliance officer has sufficient authority to oversee implementation of the AML program while also granting advisers flexibility to structure their operations.

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[20] *See* FINRA Rule 3310.

[21] Proposal, at 52,689.

There may be a minor point to clarify in this regard. As FinCEN notes in the Proposal, SEC Rule 206(4)-7 currently requires advisers to establish written compliance policies and procedures reasonably designed to prevent violation of the Advisers Act and its rules and to designate a chief compliance officer to oversee and implement those policies and procedures. We appreciate that FinCEN states that it "contemplates that investment advisers would be able to adapt existing policies, procedures, and internal controls in order to comply with the rules FinCEN is proposing today."[22] Many advisers may wish to integrate the Proposal's AML program requirement into their existing compliance programs under SEC Rule 206(4)-7, and also may decide to designate their chief compliance officer as the AML officer responsible for their AML program. We see nothing in the Proposal that would prevent an adviser from doing so. Although perhaps unnecessary, in adopting the final rule, FinCEN may want to expressly confirm that it shares that view.

3. Independent Testing.

Finally, the Proposal requires advisers to engage in periodic independent testing of their AML programs, with such testing to be conducted by qualified outside parties or by employees of the adviser. The Proposal prohibits the personnel tasked with independent testing from being involved in the implementation or oversight of the adviser's AML program.

We are extremely concerned that this requirement will place a substantial burden on advisers, especially smaller advisers that employ a limited number of individuals. For them, the requirement that the testing be independent is tantamount to a requirement to hire an external party. According to our most recent report on the adviser industry, 57.3% of advisers reported having ten or fewer non-clerical employees.[23] In fact, the median number of employees reported by SEC-registered advisers is eight.[24] It is unlikely that a smaller adviser will have employees that are sufficiently knowledgeable about the adviser's AML program but that are not already involved in its implementation or oversight to conduct the required review. As a result, they would have to retain qualified outside parties for independent testing. This could be a significant cost, with a significant impact, as these smaller firms are the least financially able to hire outside consultants.

We request that FinCEN provide flexibility in the independent testing requirement and permit smaller advisers to employ an internal testing program that may include employees involved in the AML program and/or ongoing BSA compliance. We note that advisers already are obligated to perform annual compliance reviews under SEC regulations, but the Proposal would preclude the knowledgeable compliance staff who perform these reviews from participating in advisers' independent AML testing and effectively integrating the testing into the

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[22] Proposal, at 52,686.

[23] EVOLUTION REVOLUTION, at 24.

[24] *Id*.

existing compliance program.[25] IAA believes that this constraint would place an unnecessary burden and expense on advisers, preventing them from allocating their valuable compliance resources in an optimal manner.

In addition, we appreciate the significant flexibility the Proposal provides regarding the frequency of independent testing and ask for confirmation that certain firms may choose to conduct testing on a less-than-annual basis (such as every two or three years) when, for example, a firm has a relatively stable and/or lower-risk client base (such as an adviser that manages money only for well-known institutional clients). We believe that this is a critical element to making the Proposal workable across the widely varied population of advisers registered with the SEC.

4. Look-Through Obligations of Advisers to Unregistered Pooled Investment Vehicles.

We appreciate FinCEN's risk-based approach that permits advisers to risk-rate their advisory services based on the money-laundering risks associated with particular types of clients. The Proposal notes, in particular, that an adviser acting as the primary adviser to a private fund or other unregistered pooled investment vehicle (a "Private Fund") "should have access to information about the identities and transactions of the underlying or individual investors" in the Fund and should consider the money-laundering risks presented by such investors[26]; the Proposal further recognizes the potential lack of transparency if those underlying investors are themselves entities.

We ask for confirmation that an adviser's obligation to assess money-laundering risks relating to the underlying investors of a Private Fund applies only when, and only to the extent that, the adviser is the primary adviser to that Private Fund (and not in the case of a Sub-Advisory Arrangement, as discussed in Part II above) and has access to information about the Private Fund's underlying investors. An adviser serving as the Private Fund's primary adviser should have information about that Private Fund's underlying investors in the ordinary course. It would not have that information, however, in an unaffiliated "fund-of-funds" structure. In that case, the adviser to an *investee* fund in the structure should not be required to "look through" and assess the risks presented by the underlying investors in an *investing* fund, unless such adviser also acts as the primary adviser to the investing fund and thus possesses (or has access to) information about such underlying investors in the ordinary course.

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[25] Such flexibility has been afforded by FinCEN in the past—for example, the rules governing AML programs for loan and finance companies provide that independent testing may be conducted "by any officer or employee of the loan or finance company," other than the designated AML compliance officer. 31 C.F.R. § 1029.210.

[26] *Id*. at 52,688.

IV. The Proposal Should Permit Advisers to Share SARs Within Their Organizational Structures and Provide Guidance on Coordinating with Custodians in respect of SAR Obligations

Investment advisers subject to the Proposal would be required to monitor client transactions for suspicious activity and to file SARs when the adviser knows, suspects, or has reason to suspect that a transaction involving $5,000 or more in assets involves suspicious activity as defined by relevant BSA rules. IAA recognizes that the examples of suspicious activity red flags set forth in the Proposal may have been drawn from IAA's 2003 comment letter,[27] and we appreciate FinCEN's consideration of our prior comments. IAA believes that these red flags are tailored to the types of suspicious activity that advisers could feasibly monitor.

We note that the Proposal does not authorize the sharing of SARs within an adviser's organizational structure absent further FinCEN guidance or rulemaking. The Proposal, however, recognizes that banks, broker-dealers, mutual funds, and certain other "financial institutions" currently are permitted by FinCEN interpretive guidance to share SARs within their corporate organizational structures, subject to certain limitations.[28] IAA urges FinCEN to issue similar guidance permitting the sharing of SARs within an adviser's corporate organizational structure (e.g., with the adviser's controlling company or affiliates (such as a pooled investment vehicle sponsored by the adviser)). To the extent advisers become subject to suspicious activity reporting requirements under the Proposal,[29] we ask that they be granted the same or similar flexibility as other financial institutions to share SARs, as well as AML-related personnel and training, within their organizations. IAA believes that this flexibility would facilitate and make more efficient efforts to identify money laundering and terrorist financing activities.

Further, IAA requests that FinCEN provide guidance concerning the ability of advisers to delegate aspects of account monitoring and to coordinate or integrate their related SAR reporting obligations with qualified custodians that hold client assets. Although the proposed rule would allow contractual delegation of AML obligations to qualified custodians, FinCEN should clarify that an adviser may reasonably rely on a certification from the qualified custodian to meet the adviser's obligations to "remain fully responsible" for the effectiveness of the delegated part of the adviser's AML program. As noted above in Part I, advisers rarely possess physical custody of clients' assets, which are in the vast majority of cases held at other qualified custodians such as banks and broker-dealers. Because such qualified custodians often will have the greatest visibility into account transactions, and will likely have greater experience with suspicious activity detection and reporting (given their longer experience with BSA regulation), it would be

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[27] *See* Proposal, at 52,691; ICAA Letter to Treasury re: Proposed Anti-Money Laundering Rules for Investment Advisers (July 2, 2003), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Archived_Comments_Statements/letterscompendium-2003.pdf.

[28] *See* Proposal, at 52,690.

[29] As noted above, we have asked for relief for certain types of advisers that pose no meaningful money laundering risks.

beneficial if advisers were permitted to coordinate (and potentially integrate) any SAR reporting obligations with their qualified custodians. Moreover, to the extent that suspicious activity is detected in a client's account, a lack of coordination among advisers and their qualified custodians could otherwise result in potentially duplicative reporting, costing advisers time and resources without otherwise enhancing the efficacy of anti-money laundering efforts. However, in the absence of clear FinCEN guidance on how these parties may be permitted to coordinate or combine their efforts in carrying out their regulatory responsibilities, we are concerned that the Proposal may yield a system that is needlessly costly (particularly for smaller advisers) and duplicative, and more fragmented, rather than integrated, across the financial industry at large.

V. The Costs of Complying with the Proposal are Potentially Significant

We understand that the cost and time burden for implementing the requirements of the Proposal will vary substantially depending on the size and type of adviser. In this regard, we appreciate FinCEN's risk-tailored approach to AML compliance, which provides advisers flexibility in creating their AML programs and would, in particular, not require smaller advisers to develop complex or cost-intensive AML compliance programs.

That said, IAA believes that the Proposal's cost and time burden estimates severely understate the burden ultimately imposed on advisers under the Proposal. In particular, FinCEN's estimated times for the implementation of an AML program (three hours per year), SAR recordkeeping and reporting (three hours per year) and currency transaction reporting (one hour per cash transaction report ("CTR")) are far too low.[30] If the Proposal is adopted in the form proposed, all advisers will be subject to the significant costs of implementing an AML regime to which they were not previously subject. These costs will naturally be highest at the largest and most complex firms, as even those who have voluntarily implemented an AML program will need to revisit and revise those programs and related computer software to comport with the new rule.[31] Smaller advisers, as noted above, will likely have to outsource the independent testing requirement—a cost that is not addressed in the Proposal—in addition to incurring the overall expense of implementing a new AML program. As a result, compliance costs arising from the Proposal could comprise a substantial portion of a small firm's compliance budget, diverting critical resources away from other risk areas (without materially advancing FinCEN's aims, as noted below). All of this presents a potentially significant burden.

And while costs may be high, as discussed at length in this letter, the AML benefits may be quite limited. Many advisers and advisory activities present little or no meaningful risk of money laundering or terrorist financing, a fact demonstrated by FinCEN's own estimation that each adviser will file only one CTR per year[32] and that smaller advisers will likely file fewer

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[30] *See id.* at 52,698.

[31] While we would expect significant variation among advisers, based on the relative size and complexity of their businesses, we note that a large institutional asset manager with multiple affiliated advisers recently advised us that they estimate spending over 100—and possibly as many as 300—hours, per year, per adviser, on AML compliance under the Proposal.

[32] *See id.* n.111.

than ten SARs per year.[33] That level of reporting—and the correspondingly marginal contribution to our nation's robust AML regime—may not justify its sizeable costs on the adviser industry as a whole.

As FinCEN considers the costs and benefits of this Proposal, it should more carefully consider costs on smaller advisers. The Proposal, in analyzing the impact on small advisers, applies a definition of "small entity" based essentially on having assets under management of less than $25 million—a definition that excludes substantially all of the advisers covered by the proposal.[34] Although we recognize that FinCEN consulted the SEC and the Small Business Administration in doing so, applying that definition is not appropriate in light of the fact that more than half of all SEC-registered advisers are, in fact, small businesses, with fewer than ten non-clerical employees. (Indeed, it is possible that an investment adviser may not be an "entity" at all, but may be a natural person acting as a "sole proprietorship.") By way of contrast, the size standards identified by the Small Business Administration would categorize a company providing "investment advice" as small if it had annual receipts of less than $38.5 million.[35] An adviser with a typical 1% fee structure would have to have $3.85 billion in assets under management to earn $38.5 million in fees. We also observe that, for other industry classifications, the Small Business Administration also employs headcounts as the relevant metric for assessing "small entity" status. However, neither of these factors was considered in selecting the "small entity" definition applied by the Proposal, and as a result, FinCEN readily concluded that the Proposal would not affect a substantial number of small entities. We strongly urge FinCEN to modify its definition of "small entity" to consider the size and complexity of the adviser's operations and staff, not just its assets under management, in order to analyze the true impact of the Proposal.

VI. Implementation Period Should be Extended to Provide a Reasonable Timeframe for Compliance

Under the Proposal, an adviser would be required to implement an AML program compliant with the Proposal on or before six months from the effective date of the final rules. The requirement to file SARs would begin to apply after the adviser's implementation of its AML program.

IAA believes that six months will be insufficient for many advisers to develop compliant AML programs and to put in place the systems, personnel and required disclosures necessary to implement their AML programs and to comply with the suspicious activity monitoring and reporting obligations and recordkeeping requirements set forth in the Proposal. This timeframe is particularly problematic because the Proposal would impose on advisers all of these obligations simultaneously. IAA therefore requests that FinCEN provide a more reasonable

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[33] *See id.* at 52,696.

[34] *See* Proposal, at 52,695 (noting that only an estimated 4% of SEC-registered investment advisers would fall within the SEC's "small entity" definition); *see also* Note 5 above.

[35] *See* 13 C.F.R. § 121.201.

timeframe for compliance to ensure that advisers can fully and effectively satisfy the Proposal's requirements. In this regard, we suggest that an 18-month implementation period may be more appropriate, to provide advisers time to update their operating budgets for the resulting compliance and implementation costs, upgrade and develop internal systems and policies, deliver necessary client disclosures and, where needed, source external service providers to provide independent testing and/or training.

* * *

We truly appreciate your consideration of our comments on this important Proposal. We trust that you will not hesitate to contact us if we may provide any additional information or assistance to you during this process. Please contact me or Paul D. Glenn, IAA Special Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully,

/s/

Robert C. Grohowski
General Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

David Grim, Director, Division of Investment Management
Diane Blizzard, Associate Director, Division of Investment Management
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September 11, 2015

Via Electronic Mail

Mr. Erik Remmler, Deputy Director
Ms. Amanda Olear, Associate Director, Registration and Compliance
Division of Swap Dealer and Intermediary Oversight
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Dear Erik and Amanda,

On behalf of the Investment Company Institute, the Asset Management Group of SIFMA, the Alternative Investment Management Association, the Managed Funds Association and the Investment Adviser Association (collectively, "Associations"), I am writing to withdraw the Associations' request for relief to net certain uncleared swaps when calculating the aggregate net notional test in CFTC Regulations 4.13(a)(3) and 4.5.

Discussions involving the Associations and the staff began in late 2012. In January 2013, the Associations submitted a letter requesting that the staff provide no-action relief allowing the netting of certain uncleared swaps.[1] The letter observed that the net notional test would count both the long exposure and the short exposure on offsetting swaps, thereby overstating a fund's actual exposure to the underlying commodity interests. It explained that alternative approaches to avoid this overcounting (*e.g.*, terminating a swap) would result in higher costs for, or otherwise disadvantage, fund investors. The letter incorporated the conditions that the staff had indicated would be necessary to obtain the requested relief.

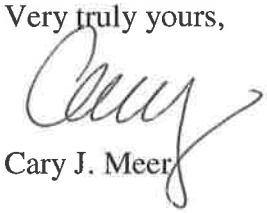
[1] *See* Letter to Gary Barnett, Director, Division of Swap Dealer and Intermediary Oversight, CFTC, from the Associations, dated January 25, 2013.

The Associations and the staff engaged in further discussions about the request over the next two and one half years. In August 2014, the Associations submitted a supplemental letter agreeing to an additional condition proposed by the staff.[2] In April 2015, the staff again proposed additional conditions to the requested relief. The Associations and their counsel discussed these proposed conditions with the staff at length. During a phone discussion on June 26, 2015, the staff appeared receptive to the Associations' suggestions for slightly revised language to one of those proposed conditions, but raised the possibility of yet another new condition to the relief.

The Associations appreciate the time and attention the staff has devoted to this matter over an almost three-year period. After discussions with their respective memberships, however, the Associations have concluded that they wish to withdraw their request. The Associations are concerned that, with all of the conditions that have been proposed, any relief granted by the staff would not meaningfully address the overstatement of a fund's commodity interest exposure under the net notional test.

The Associations look forward to working with the DSIO staff to address future questions and issues of importance to the industry as they arise.

Very truly yours,



Cary J. Meer

cc: Eileen T. Flaherty, Division of Swap Dealer and Intermediary Oversight, CFTC
Sarah Bessin and Rachel Graham, Investment Company Institute
Karen Barr, Robert Grohowski and Monique Botkin, Investment Adviser Association
Jennifer Wood, Alternative Investment Management Association
Jennifer Han, Managed Funds Association
Laura Martin, Asset Management Group, SIFMA
Robert Wittie, K&L Gates LLP

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[2] *See* Letter to Gary Barnett, Director, Division of Swap Dealer and Intermediary Oversight, CFTC, from the Associations, dated August 29, 2014.

August 11, 2015

Via Electronic Mail (rule-comments@sec.gov)

Mr. Brent J. Fields, Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Amendments to Form ADV and Investment Advisers Act Rules, SEC Rel. IA-4091, File No. S7-09-15, RIN 3235-AL75

Dear Mr. Fields:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Securities and Exchange Commission's proposed amendments to Form ADV, which would require advisers to report additional data about their business and their clients' investments, particularly in client accounts that are managed individually (referred to by the Commission as "separately managed accounts" or "SMAs").[2]

We fully support the Commission's goals in this important rulemaking, which marks the beginning of a series of proposed rulemakings designed to enhance the SEC's risk monitoring and regulatory safeguards for the asset management industry.[3] We concur that the collection and analysis of additional census-type data about SMAs will further strengthen the SEC's ability to oversee the asset management industry, including assessing industry trends and risks. Significantly, additional information will also help the SEC staff enhance its ability to conduct risk-based examinations of advisers, thus making the Commission more efficient and effective in overseeing the advisory industry. The IAA has long supported Commission efforts to better

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA's membership consists of more than 550 firms that collectively manage approximately $16 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[2] *Amendments to Form ADV and Investment Advisers Act Rules,* SEC Rel. IA-4091 (May 20, 2015) ("Proposal"), available at http://www.sec.gov/rules/proposed/2015/ia-4091.pdf.

[3] With this Proposal, the SEC contemporaneously proposed amendments to the Investment Company Act of 1940 to increase reporting obligations of registered investment companies. *See Investment Company Reporting Modernization,* SEC Rel. IC-31610 (May 20, 2015) ("Investment Company Reporting Proposal"), available at http://www.sec.gov/rules/proposed/2015/33-9776.pdf. In addition to these data reporting proposals, the SEC is also developing recommendations on liquidity risks and standards for mutual funds and ETFs, reviewing options for specific requirements for the use of derivatives by funds, studying new requirements for stress testing by large investment advisers and large funds, and considering provisions for transition plans after a major disruption in an investment adviser's operations. *See* Chair Mary Jo White, Statement at an Open Meeting on Investment Company and Investment Adviser Reporting (May 20, 2015), available at http://www.sec.gov/news/statement/modernizing-investment-company-and-investment-adviser-reporting.html.

leverage its resources and data to effectively and efficiently oversee and examine investment advisers.

We appreciate the Commission's efforts to design additional data reporting requirements "with a view towards minimizing as much as possible the burden on regulated entities and the investors they serve."[4] While the SEC should have access to appropriate data, it should always seek to collect that information in the most efficient and cost-effective way possible, with a particularly keen eye on the way costs disproportionately affect smaller advisers. We offer a number of comments along these lines, intended to help tailor the regulatory approach to be more targeted, while consistent with the Commission's goals. In particular, we suggest that:

- ***The threshold for reporting use of borrowings and derivatives should be adjusted.*** Increasing the basic $150 million reporting threshold for derivatives and borrowing use in SMAs to $500 million would alleviate reporting burdens and associated costs on approximately 3,000 small firms, while retaining more than 95 percent of the data sought by the Commission. We also recommend making the exclusion of small accounts optional, rather than mandatory—a change that would actually increase the amount of data reported to the SEC while simplifying the reporting process and reducing costs for advisers that choose to include those SMA assets in their reporting.

- ***Reporting clients' assets and derivatives exposures in SMAs should be confidential.*** While we understand the potential regulatory utility of additional SMA data, the Proposal may raise concerns about disclosure of client confidential information and advisers' proprietary information under certain circumstances. Moreover, the derivatives disclosure is likely to be difficult to interpret and place in the appropriate context, and as a result may potentially confuse or mislead investors. We strongly recommend that the SEC make responses to these particular sections of Form ADV non-public.

- ***If the Commission decides to require public disclosure of clients' assets and derivatives exposures in SMAs, then it should modify certain aspects of the disclosure.*** In particular, we recommend allowing advisers to use a generic response (such as "fewer than five") when only one or a few accounts fit a particular category and make adjustments to the information requested related to "gross notional" exposure and the value of derivatives.

- ***The Commission should take this opportunity to clarify Form ADV's questions on custody.*** While not necessarily related to the Commission's immediate goals of enhancing its data on SMAs, we strongly recommend that the Commission amend the questions on custody in Form ADV. These questions are a source of

[4] Commissioner Daniel M. Gallagher, Statement at Open Meeting on Modernizing and Enhancing Investment Company and Investment Adviser Reporting (May 20, 2015), available at http://www.sec.gov/news/statement/modernizing-ic-ia-reporting-commissioner-gallagher.html.

needless confusion for advisers. They could be easily amended in ways that would clarify Form ADV and generate more accurate, consistent responses from the industry.

In addition to these primary recommendations, we have several suggestions with respect to the disclosure on parallel managed accounts, custodians, the proposed amendments to the books and records rule, and responses to several of the SEC's specific request for comments. An Appendix attached to this letter provides specific and technical comments to proposed Items, terms, and the general instructions in Form ADV Part 1A.

Finally, we note that the proposed amendments to Form ADV Part 1A will affect all of the approximately 11,500 investment advisers registered with the SEC. They will need an appropriate amount of time to understand the new reporting requirements and ensure that their portfolio accounting and data management systems can capture the required data so that it can be reported on the revised Form ADV Part 1A. Accordingly, we respectfully request an implementation date of twelve months after the adoption of the final rules and form changes.

I. Reporting Thresholds

A significant part of the Proposal relates to reporting data on the net asset value ("NAV") of SMAs,[5] based on either adviser-level or account-level thresholds. Advisers with more than $150 million in SMA regulatory assets under management ("RAUM") would report data about derivatives and borrowings in those accounts. Advisers with more than $10 billion in SMA RAUM would report additional data, and report it as of year-end and mid-year dates. The Proposal would exclude reporting on SMAs with a NAV of less than $10 million. We have several comments on these adviser-level and account-level thresholds.

1. Adviser-Level Thresholds

As noted above, the Proposal has two adviser-level thresholds: $150 million in SMA RAUM and $10 billion in SMA RAUM. We support the $10 billion threshold, as we believe that it strikes the right balance between achieving the regulatory goal of obtaining additional information about the use of derivatives in separately managed accounts and the burdens that

[5] In general, a separate account is an individual client account advised by an adviser, established under an investment management or advisory agreement between the client and the adviser, whereby the agreement establishes the investment strategies, guidelines and/or restrictions that a particular client has directed the adviser to follow. SMAs are strictly separated from the adviser's own assets; they are not part of an adviser's own balance sheet and are generally held in a segregated account at an independent custodian. Separate accounts provide asset owners, rather than the adviser, with direct ownership and control of investment assets, without the rights and liabilities associated with the pooling of funds. We note that the term "separate account" has a different meaning in the insurance context. The Commission defines SMA to mean: "advisory accounts other than those that are pooled investment vehicles (i.e., registered investment companies [("RICs"], business development companies [("BDCs")], and pooled investment vehicles that are not investment companies (i.e., private funds))." Proposal at 8. We have further recommendations about the terms "SMA" and "NAV" in the Appendix under Item 5.K. and Section 5.K.(2).

will be imposed on larger advisers in tagging, sorting, and collecting the required data. We recommend, however, that the Commission increase the $150 million threshold to $500 million.

Advisers that cross this initial $150 million threshold would identify in new Item 5.K.(2) whether they engage in derivatives or "borrowing" transactions on behalf of any of their separately managed account clients.[6] We estimate, however, that if the regulatory threshold for collecting this data on derivatives and borrowings in SMAs were increased from $150 million to $500 million of SMA RAUM, the Commission would still obtain data on more than 95% of the SMA assets it proposes to collect, while alleviating the reporting burden and related costs on approximately 3,000 advisers.[7]

We do not believe that this marginal reduction in the data requested would frustrate the Commission's policy goals. By proposing the $150 million SMA and $10 million account thresholds, the Commission clearly recognizes that a complete data set is unnecessary to achieve its policy goals, and that the costs of collecting this information at the margin exceeds its benefit. We agree. Industry surveys have indicated that SMAs typically reflect a long-term investing mandate that utilize little leverage at the account level and few investments in derivatives.[8] We would expect that the SEC's more comprehensive data collection would confirm that this is true generally. Accordingly, it is not necessary to set a threshold that captures nearly all SEC-registered advisers managing SMAs for these purposes.[9]

In raising the threshold to $500 million, the Commission would alleviate the reporting burden on approximately 3,000 advisers. While we recognize that Section 5.K.(2)(b) requires less information than the similar disclosure for larger advisers, there is still a meaningful cost and resource burden associated with calculating these new reporting requirements. In particular, in order to make the required disclosure, every adviser subject to reporting will have to categorize

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[6] Comments on the term "borrowings" are in the Appendix.

[7] The use of maximum and minimum ranges makes this calculation imprecise. Using the maximum ranges from Form ADV data as of April 8, 2015 (the data set used in the IAA's *2015 Evolution Revolution* report), we estimate that the SEC would collect data on $37,813,740,821,411 in SMA RAUM from 7,257 advisers. Raising the threshold to $500 million would result in data on $36,839,399,090,198 from 3,703 advisers—97.4 percent of the data from 3,554 fewer advisers. Using minimum ranges from the same data set results in 95.7 percent of the data collected from 2,762 fewer advisers.

[8] A recent survey of separate accounts advised by large asset managers showed that nearly all (99%) of the separate accounts in the survey were long-only strategies, the majority (53%) of which were index strategies, and that very few used leverage. *See* Letter from Timothy Cameron, Head, SIFMA AMG, to Secretariat of the Financial Stability Board, Re: "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (Apr. 4, 2014), available at http://www.sifma.org/comment-letters/2014/sifma-amg-submits-comments-to-the-fsb-and-sec-in-response-to-ofr-study-and-in-regards-to-separate-accounts/.

[9] The Commission noted that it selected a $150 million threshold for SMAs because the Form PF threshold for advisers is $150 million or more in private fund assets. Proposal at 10, n. 16. Given the significant differences in the nature and extent of the data obtained through Form PF and that proposed for Form ADV for SMAs, as well as the differences in the Commission's policy goals underlying the two forms, we do not see any compelling reason to adopt the same reporting threshold.

and maintain SMA client information in the manner proposed—by calculating for each account its net asset value, dollar amount of borrowings, and gross notional exposure of derivatives. After excluding accounts with less than $10 million in SMA assets, the adviser would have to categorize accounts into three NAV ranges, then subcategorize them into four gross notional exposure ranges, then calculate the number and weighted average borrowings for each subcategory. For most advisers, all of this would require a modification of their current internal reporting systems.

These costs and burdens—while not insurmountable—outweigh the marginal benefit of collecting the data from smaller advisers. We therefore respectfully request the Commission increase the reporting threshold from $150 million in RAUM attributable to SMAs to $500 million in RAUM attributable to SMAs for Section 5.K.(2), which will still allow the Commission to fulfill its regulatory goals in generally tracking borrowing and derivatives use.

2. Account-Level Thresholds

The Commission proposes to exclude accounts with a net asset value of less than $10 million from the reporting requirements in Section 5.K.(2). We appreciate the Commission's intent to eliminate reporting on smaller accounts, recognizing that the burdens outweigh the benefits of gathering data at the margins. However, some firms may find that it is actually more difficult to exclude these accounts, as it would require them to further analyze, categorize, and report SMAs in ways not currently captured by advisers' systems. Thus, this approach may not alleviate burdens but rather inadvertently increase the reporting burden on some firms. Therefore, we request that advisers be provided the *option* to exclude accounts under $10 million. We note that this approach has the potential to benefit both industry and the SEC, given that an adviser choosing to include all of its SMA assets in Section 5.K.(2) would actually be reporting *more* data to the SEC.[10]

3. Treatment of Sub-Advisory Relationships

For all reporting of aggregate information on derivatives and borrowings in SMAs in Section 5.K.(2), the Commission states that "if an adviser is a subadviser to an SMA, the adviser should only provide information with respect to the portion of the account that the adviser subadvises."[11] We support this idea with one clarification.

We recommend that advisers with affiliated sub-advisers should be permitted to select and identify which entity (whether the adviser or sub-adviser) is reporting data on the accounts it advises in Section 5.K.(1) on asset types, as well as in Section 5.K.(2) for the derivatives and borrowings exposures of the SMAs. The Commission should include instructions stating that

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[10] We asked participants on a recent IAA webinar whether they would include or exclude accounts smaller than $10 million if given that option. Out of 102 responses, 39 would exclude the accounts, 28 would include them (*i.e.*, would take advantage of the option we propose), and 35 were undecided.

[11] *See* Proposed Section 5.K.(2) of Schedule D.

either the adviser *or* the affiliated sub-adviser should complete and file Sections 5.K.(1) and 5.K.(2).[12]

II. Reporting SMA Asset Composition and Derivatives Exposures

The SEC seeks comment on whether the public disclosure of aggregate separately managed account information raises confidentiality concerns. More specifically, the SEC asks whether "disclosure of aggregate holdings, derivatives and borrowings in separately managed accounts raise concerns, in light of Section 210(c) of the [Investment] Advisers Act [of 1940 "(Advisers Act")], regarding the identity, investments, or affairs of any clients" and whether "disclosure [would] impact a client's selection of an investment adviser."[13]

1. Data on Aggregate Holdings, Borrowings, and Derivatives Should be Non-Public

Although we appreciate that the Commission proposed aggregate disclosure, we nevertheless have concerns that the data could be misused or misinterpreted. Section 5.K.(1) asks advisers to report the composition of SMA assets by asset type, and Section 5.K.(2) asks for aggregate data on derivatives and borrowing transactions. The nature of the data requested primarily serves a regulatory purpose, as it is intended to allow the SEC to more efficiently and effectively oversee the asset management industry. As explained in more detail below, however, it serves little public purpose and, in fact, could be potentially damaging to advisers and their clients. Accordingly, we strongly recommend that the SEC make responses to Sections 5.K.(1) and 5.K.(2) non-public.

We have two primary concerns with respect to this data. First, responses to Sections 5.K.(1) and (2) could indirectly disclose the identity of an adviser's clients and potentially proprietary information about their investments and the adviser's trading strategies. Section 5.K.(1) requires disclosure of asset types across all SMA client accounts. Advisers, both large and small, have concerns that this disclosure could unfairly reveal information about their asset allocation and quantitative model-driven strategies, which may be highly proprietary and customized. Section 5.K.(2) requires derivatives and borrowing data, broken down by three NAV ranges and four subcategories of gross notional exposure. There is a particular risk in this disclosure that an adviser could have one or a few accounts in a particular category, and that in those cases it might be inferred that a particular client has hired that adviser. For example, some public pension plans have to either publish or make available on request details of an award of business to an adviser under the plans' contracting rules. Assume that such a plan has a large mandate managed by an adviser that indicates a sole or a few clients in a particular category. It might be possible for an interested party to trace the adviser's reporting to attempt to determine the particular plan's portfolio profile and movements over time. While this is a concern for both

[12] We understand and seek confirmation that sub-advisers to mutual funds or pooled funds should not include these assets as SMA assets. We discuss this in the Appendix under Item 5.D., Client Type.

[13] Proposal at 14, 65-66. Section 210(c) prohibits the Commission from requiring an adviser to disclose the identity, investments, or affairs of any client of the adviser.

large and small advisers, the more detailed breakdown of derivatives exposures in Section 5.K.(2) makes it particularly troubling for larger advisers. We also share the concern highlighted in the SEC's request for comment that the public disclosure of responses to Section 5.K.(2) could harm an adviser's ability to attract clients, if clients choose to hire only advisers that already have enough existing clients in a particular NAV range to ensure that the prospective client's account would be part of truly aggregate disclosure.

Second, as discussed in more detail in the next section of this letter, we are concerned that the disclosure of exposures based on gross notional values for derivatives would be misleading in a public filing. While the information may serve regulatory purposes, such as for tracking overall industry trends on the volume of derivatives use, gross notional values are not a measure of leverage or risk. Regulators might be able to place the weighted average gross notional values required in Section 5.K.(2)(a) in the appropriate context; individual investors or others who might use Form ADV data are more likely to incorrectly assume the figures relate to some measure of risk. To the extent that an adviser employs derivatives or borrowings as part of an investment strategy, clients can better understand a plain English narrative explanation than the raw quantitative data that would be provided under the proposed items.[14]

The Commission can alleviate these concerns by making this data non-public. Under Section 210(a) of the Advisers Act, "the information contained in any registration application or report or amendment thereto filed with the Commission…shall be made available to the public, unless and except insofar as the Commission, by rules and regulations upon its own motion…finds that public disclosure is neither necessary nor appropriate in the public interest or for the protection of investors." Not all information in Form ADV is necessary or appropriate in the public interest. For example, certain information in Item 1, such as an adviser's CCO's email address or a sole proprietor's primary residential address, is suppressed from public release on the Investment Adviser Public Disclosure ("IAPD") website.[15] Given the nature of the proposed information about client holdings and derivatives exposure in proposed Sections 5.K.(1) and 5.K.(2), we urge the Commission to make a finding that public answers to these particular questions are neither necessary nor appropriate in the public interest or for the protection of investors.

If the Commission made this determination, the treatment of this particular data as non-public would be similar to the treatment of private fund information filed on Form PF. We recognize that under Section 204(b)(10) of the Advisers Act, as adopted by the Dodd-Frank Act, the Commission is expressly limited from disclosing publicly an adviser's "proprietary

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[14] Advisers are required to describe investment strategies in Item 8 of Part 2A of Form ADV, and for significant investment strategies, the material risks involved with the strategy.

[15] *See Fast Answers: Investment Adviser Public Disclosure (IAPD)* on the SEC's website at http://www.sec.gov/answers/iapd.htm. The Commission does not state what information on Form ADV Part 1A it suppresses.

information" in Form PF filings.[16] "Proprietary information" under Section 204(b)(10)(B) includes "sensitive, non-public information regarding" the investment or trading strategies of the adviser, analytical or research methodologies, trading data, computer hardware or software containing intellectual property, and any additional information the Commission considers proprietary.[17] In adopting Form PF, the Commission noted that it determined not to adopt certain questions on Form ADV in response to commenter concerns that "they would result in the public disclosure of competitively sensitive or proprietary information."[18] Although the Form ADV data is less extensive than some of the information on Form PF, the Proposal notes that some of the information requested is comparable to Form PF data. Thus, similar principles should apply to the collection on information in the Proposal, particularly to proprietary data related to the derivatives exposures and investments of an adviser's separately managed account clients.

It is our understanding that even if the SEC made this data non-public under 210(c), it could nevertheless be available to the public under a request under the Freedom of Information Act ("FOIA"). We suggest that, in addition to making the information non-public, the SEC should allow firms to request confidential treatment.[19] This approach would achieve the Commission's regulatory goals while fully protecting confidential and proprietary data about the adviser's business and its clients and preventing potentially misleading public disclosure about an adviser's clients' investments and gross notional derivatives exposures.

2. *If Public, There Should be a Generic Response Option for Categories with Few Accounts*

If the Commission determines that responses to Sections 5.K.(1) and (2) must be public, then we strongly recommend that the Commission make two changes that would mitigate some of our concerns. First, we recommend that the Commission permit advisers to give a more generic answer for the number of accounts, such as "fewer than five," in those instances where an adviser has a limited number of accounts in a certain category. We would recommend a similar option for Item 5.D (number of accounts per type of client). Given this option, an adviser

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[16] Section 204(b)(10)(A) states that, "[a]ny proprietary information of an investment adviser ascertained by the Commission from any report required to be filed with the Commission pursuant to this subsection shall be subject to the same limitations on public disclosure as any facts ascertained during an examination, as provided by section 210(b) of this title."

[17] Section 204(b)(10)(B) of the Advisers Act.

[18] *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, SEC Rel. No. IA-3221 (June 21, 2011) at 51 ("2011 Implementing Release"), available at http://www.sec.gov/rules/final/2011/ia-3221.pdf).

[19] *See* 17 CFR 200.83 (Commission Confidential treatment procedures under the Freedom of Information Act); *see also*, *Securities and Exchange Commission Confidential Treatment Procedure Under Rule 83*, at https://www.sec.gov/foia/conftreat.htm (rule applies in the context of examinations, inspections, and investigations, and in other cases where no procedures exist for requesting confidential treatment for particular categories of information).

would not have to identify one particular client in a client type category and risk inadvertently disclosing that client's identity or proprietary information.

Statistical information from Form ADV filings suggests that many advisers may benefit from this option to report "fewer than five." If the $150 million threshold were adopted as proposed, we estimate that 2,120 advisers that have 25 or fewer clients would have to report Section 5.K.(2) data. About two thirds of these (1,362) have 10 or fewer clients.[20] We assume that these advisers would have a high likelihood of having a small number of clients in one or more of the twelve NAV subcategories in Section 5.K.(2).

Second, we recommend the SEC change the proposed NAV breakpoints in Section 5.K.(2) so that the highest range begins at $500 million.[21] Accounts sized at $1 billion or greater are rare and therefore more likely to result in the isolation of a single account. A $500 million top threshold would reduce this risk by increasing the likelihood of having multiple accounts in the highest category.

III. Derivatives Disclosure and the Use of "Gross Notional" Concepts

As noted above, we are very concerned that the disclosure of certain metrics based on gross notional values for derivatives would be misleading in a public filing.[22] Gross notional values can often be very large amounts that do not directly represent the amount of money (or value) that is truly at risk.

Under the Proposal, all advisers would use gross notional exposure to determine the number of accounts in each NAV range in answering Section 5.K.(2). Advisers with at least $10 billion in regulatory AUM attributable to SMAs would provide the weighted average gross notional value (aggregate gross notional value of derivatives divided by the aggregate net asset

[20] Form ADV data as of April 8, 2015, which forms the basis for the IAA's *2015 Evolution Revolution* report, shows that:

SMA RAUM ≥ $150m < $10b	Maximum #	% of All Such Advisers
0 Clients	20	0.3%
1-10 Clients	1,362	20.2%
11-25 Clients	758	11.3%
26-100 Clients	1,089	16.2%
More than 100 Clients	3,507	52.1%
Total Advisers	6,736	

[21] Accordingly, the NAV ranges would be $10,000,000 - $249,999,999; $250,000,000 - $499,999,999; and $500,000,000 or greater.

[22] We question the use of gross notional exposure in general. However, our concerns are mitigated if the data is filed confidentially and used solely for internal regulatory purposes.

value of the relevant accounts) with respect to the six categories of derivatives.[23] This disclosure would come under the heading "Average Derivatives Exposures."

The Commission states that it is "proposing to collect information about gross notional exposure, borrowings, and gross notional value of derivatives" because it believes it is important for the Commission to "better understand the use of derivatives and borrowings by advisers in separately managed accounts."[24] The Commission states that it is "proposing to use these measures because they are commonly used metrics in assessing the use of derivatives and are comparable to information collected in Form PF."[25] The SEC seeks comment on whether gross notional exposures and gross notional values are appropriate measures of the use of derivatives, or whether there are alternative or additional measures that it should consider.

We are concerned that the disclosure of weighted average gross notional exposures would be misleading in a public filing. Many in the public might assume that this value is a measure of leverage or risk. It is not. Gross notional value, at best, is a measure of volume (*i.e.,* how many contracts are put in place) that does not take into account factors that may result in lower economic exposure, such as netting or the posting of collateral. While the Commission could use its judgment in interpreting this disclosure and avoid using it as a basis for making regulatory judgments about leverage or risk, the public would be less likely to understand its limitations.[26] Accordingly, we strongly recommend against its use in a public disclosure document.

If the Commission decides to make this disclosure public, it should allow advisers to adjust gross notional exposures to take into account various factors that reduce or better reflect risk, such as netting agreements that close out positions, adjustments to reflect duration, or whether or not the derivatives are centrally cleared.[27] More specifically, we recommend the

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[23] Comments on the specific categories of derivatives are in the Appendix.

[24] Proposal at 11 and n. 19 (noting that several commenters, including the IAA, to FSOC's Notice Seeking Comment on Asset Management Products and Activities, 79 FR 77488 (Dec. 24, 2014), discussed a variety of "measures for reporting leverage (which includes derivatives and borrowings)").

[25] *Id*. We note that Form PF, questions 13 and 44, request information on aggregate value of all "derivatives positions," and Instruction 15 states that "if a question requests information regarding a 'position' or 'positions,' you should determine whether a set of legal and contractual rights constitutes a 'position' in a manner consistent with your internal recordkeeping and risk management procedures (*e.g.*, some advisers may record as a single position two or more partially offsetting legs of a transaction entered into with the same counterparty under the same master agreement, while others may record these as separate positions)."

[26] If the Commission decides to make this disclosure public, the Commission should clearly explain in the Form what the gross notional exposure and gross notional value metrics measure and what they do not measure, including their uses and limitations.

[27] *See* FSB/IOSCO Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Mar. 4, 2015) at 39, n.60, available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf (in discussing gross notional exposure for investment funds, noting "the calculation of the global exposure as defined in EU regulation through the so-called 'commitment approach' allows adjustment of GNEs based on clearly-defined hedging and netting rules"). *See also,* Letter from PIMCO to FSB/IOSCO on Second Consultation (May 29, 2015), available at http://www.financialstabilityboard.org/wp-content/uploads/PIMCO.pdf; Letter from AIMA to FSB/IOSCO re:

Commission permit firms to net across "derivative positions" similar to its guidance to advisers of private funds, which allows an adviser to net across positions if doing so is consistent with the adviser's internal recordkeeping and risk management procedures.[28] Further, we request the Commission acknowledge, as in the guidance for Form PF, that in reporting the value of derivatives positions, an adviser should not include any closed-out positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the client.[29]

IV. Custody Questions in Form ADV Part 1A

The Commission asks "whether there are any ambiguities or concerns" that it should address in Form ADV, the instructions or the Glossary.[30] As we have noted in past comment letters,[31] Item 9 on custody is confusing in its use of the terms "you" and "your related persons." The General Instructions to Form ADV, Part 1A state that "'you' means the investment adviser (*i.e.*, the advisory firm)." However, the Advisers Act custody rule 206(4)-2 is broader and states that "you" [the adviser] are deemed to have custody if your related person has custody "in connection with advisory services you [the adviser] provide to your clients."

Response to the second FSB and IOSCO Consultation Paper on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (June 1, 2015) at 8, 12, available at http://www.financialstabilityboard.org/wp-content/uploads/Alternative-Investment-Management-Association-AIMA.pdf (noting that "GNE does not directly represent an amount of money (or value) that is at risk. It is a reference figure used to calculate profits and losses.")

[28] *See* Question 44.1 of the SEC's Division of Investment Management, *Form PF Frequently Asked Questions* (last updated Dec. 5, 2014) ("Form PF FAQs"), available at http://www.sec.gov/divisions/investment/pfrd/pfrdfaq.shtml?utm_source=page&utm_medium=/financial-reporting-network/insights/2014/updates-form-pf-frequently-asked-questions.aspx&utm_campaign=download ("Question 44 requires you to report the aggregate 'value' of all derivatives positions. Value is defined in Instruction 15 and requires that the fund report the gross notional value of its derivative positions without netting across positions. Instruction 15 defines 'positions' and requires advisers to determine whether a set of legal and contractual rights constitutes a single 'position' in a manner consistent with the fund's internal recordkeeping and risk management procedures. In accordance with this Instruction, you may only net across your positions if doing so is consistent with your internal recordkeeping and risk management procedures, regardless of whether your ISDA agreement with the swap dealer allows netting….").

We also request the Commission amend the text in Section 5.K.(2) to state: "the gross notional exposure of an account is the percentage obtained by dividing (i) the sum of (a) the dollar amount of any borrowings (b) the gross notional value of all derivative *positions*, by (ii) the net asset value of the account." (emphasis added).

[29] *See* Form PF FAQ 44.1, *supra* n. 28 ("Further in reporting the aggregate value of all derivatives positions in Question 44, you should not include any closed-out out [sic] positions, if those positions were closed out with the same counterparty and result in no credit or market exposure to the fund."). We also request the Commission confirm this guidance applies to reporting derivatives as an asset type in SMAs in Section 5.K.(1) of Schedule D.

[30] Proposal at 43.

[31] *See* IAA Letter to SEC re: Custody of Funds or Securities of Clients by Investment Advisers, File No. S7-09-09, Rel. No. IA-2876 (July 24, 2009); IAA Letter to SEC re: Rules Implementing Amendments to the Investment Advisers Act of 1940; File No. S7-36-10; Rel. No. IA-3110 (Jan. 24, 2011).

As a result of these differences and the definitional confusion around the term "custody,"[32] we make a number of recommendations in the Appendix that relate to Item 9 and the General Instructions. These improvements should assist in understanding disclosures about an adviser's custody practices and would benefit advisers, their clients and potential clients, and the Commission in its oversight of advisers.

V. Additional Recommendations

1. Parallel Managed Accounts

The Proposal would require, in new Section 5.G.(3) of Schedule D, that advisers or sub-advisers to RICs or BDCs "provide the [value of] regulatory assets under management of all parallel managed accounts" to the RIC or BDC which are proposed to include "any managed account or other pool of assets that the adviser advises and that pursues substantially the same investment objective and strategy and invests side by side in substantially the same positions as the identified RIC or BDC that the adviser advises."[33] The concept of parallel managed accounts was included in Form PF in order to ensure the reporting of the existence of accounts managed similarly to private funds and to implement aggregate reporting thresholds. This rationale, however, is not present with respect to accounts managed similarly to RICs or BDCs, and no reporting thresholds are relevant for RICs or BDCs on Form ADV. We question the benefit and relevance of this information and have several comments with respect to this new reporting requirement.

a. Identifying a Series of a RIC

Under the Investment Company Act and registration rules adopted by the Commission, a RIC is the "registrant" and has one Investment Company Act file number as a registrant. However, a typical mutual fund today operates as a series company or series trust, or a single corporation or state business trust established under one set of organizational documents and a board of directors or trustees, but offering investors several investment portfolios (series).[34]

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[32] The reporting of custody in Item 9 would be more consistent if the SEC staff would clarify when advisers have custody under various scenarios, including when they have authority to transfer funds under standing letters of authorization from their clients or transferring funds among the same client's accounts. This is a source of continuing confusion and inconsistent interpretations. The March 4, 2013 Office of Compliance Inspections and Examinations National Exam Program Risk Alert, "Significant Deficiencies Involving Adviser Custody and Safety of Client Assets," noted that failure by advisers to recognize they have custody is one of the biggest areas of concern. That Risk Alert, however, did not address the very common adviser authority to transfer client funds. The IAA and several major custodians of adviser client accounts are working with SEC staff to resolve some of these uncertainties.

[33] A parallel managed account in Form PF is defined as "any managed account or other pool of assets that you advise and that pursues substantially the same investment objective and strategy and invests side by side in substantially the same positions as the identified *private fund*." *See* Glossary of Form PF.

[34] *See, e.g.,* SEC Division of Investment Management Guidance Update No. 2014-06 (June 2014), available at https://www.sec.gov/investment/im-guidance-2014-06.pdf ("typical mutual fund today operates as a 'series company,' or a single corporation or state business trust established under one set of organizational documents and a

Each series may be managed by different advisers and sub-advisers and has its own investment objective and strategy and its own different types of portfolio holdings. Thus, the concept of a "parallel managed account" could only be applied in the RIC context on a series-by-series basis, given that each series of a fund may pursue different investment objectives and strategies. We recommend the Commission revise Section 5.G.(3) accordingly, to require identification of a particular RIC or series, as appropriate, for which an adviser has any "parallel managed account" and the RAUM attributable to that particular RIC or series, as appropriate.[35] We also urge the Commission to delete "or other pool of assets" in the definition of parallel managed account so as not to capture private funds, non-U.S. pools, and other pooled vehicles instead of managed accounts.

b. Calculating RAUM of Parallel Managed Accounts to RICs/BDCs

We also seek confirmation from the Commission that when calculating the value of a "parallel managed account" that holds derivatives in its investment portfolio, the adviser should use the market value of the derivatives held in the parallel managed account, instead of the gross notional value, if that is how the value of the account is reported to the account holder. This approach is consistent with the SEC staff's view on Form PF.[36]

2. Custodians

The Proposal would require advisers to file a separate Schedule D, new Section 5.K.(3) for each custodian that "holds 10 percent or more" of the adviser's SMAs and include location information for the custodian's office. We have several recommendations to this section.

First, a custodian should only be included if it has been appointed by clients for 10 percent or more of the adviser's separately managed accounts *and* serves as custodian for $1

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board of directors or trustees, but offering investors several investment portfolios (series). Organization as a 'series company' affords the mutual fund various operational cost savings. Each series, however, has its own investment objectives and policies, and its own set of shareholders separate from those of any other series. Each series also is a separate investment company for purposes of the investor protections afforded by the Investment Company Act of 1940 (1940 Act)."). Under Form N-1A, the SEC form used by registered investment companies to register under the Investment Company Act, the term "fund" means "the Registrant or a separate Series of the Registrant." A "series" is defined in Form N-1A to mean shares offered by a Registrant that represent undivided interests in a portfolio of investments and that are preferred over all other series of shares for assets specifically allocated to that series in accordance with rule 18f-2(a) under the Investment Company Act.

[35] This change would be consistent with Parts A.1 and A.2 of proposed Form N-PORT. *See* Investment Company Reporting Proposal.

[36] Question 11 of Form PF asks for the "value of all parallel managed accounts related to the reporting fund." Question 11 of the SEC's Form PF FAQs on reporting value states that, "[w]hen calculating the value of a parallel managed account for purposes of either determining whether it is a dependent parallel managed account that is aggregated with the reporting fund or reporting its value in Question 11, you should use the market value of the derivatives held in the parallel managed account, instead of the gross notional value, if that is how the value of the account is reported to the account holder."

billion or more of an adviser's SMA RAUM. This would provide a more meaningful indicator of a custodial relationship without being as burdensome or costly, especially for smaller advisers.

Second, we strongly urge the Commission to eliminate the requirement to identify the "location of the custodian's office responsible for the custody of the assets," as proposed in Section 5.K.(3)(c). The client selects the custodian and is responsible for its own custodial relationship. An adviser may not know the exact location of the client's selected custodian, and an office street address and location are not particularly meaningful or relevant, as most custody is an electronic recording of ownership rather than physical custody. As a result, many advisers do not maintain this physical location information, and it would be somewhat burdensome to gather this information. More importantly, however, the information is largely unnecessary, given that the custodian's SEC registration number (if a broker-dealer) or legal entity identifier will be included. Therefore, the SEC will easily be able to identify the legal entity that is the custodian to the clients' assets without imposing an impractical and burdensome reporting requirement.

Third, in some cases, custodians have more than one registration number or legal entity. We recommend that the Commission provide guidance as to how custodians should be grouped (*e.g.*, different legal entity or different registration number) for purposes of this disclosure. We note that the issue could become increasingly complex with respect to the use of international or affiliated custodians.

Finally, the Commission should clarify whether assets managed in a sub-advised account should be considered for this item.

3. Books and Records Related to Performance Data Communications

The Proposal would amend Advisers Act books and records rule 204-2(a)(7) to require advisers to maintain originals of all written communications received and copies of written communications sent by an adviser related to a new, fourth category of records—"the performance or rate of return of any or all managed accounts or securities recommendations." We do not think this new category is necessary, given that rule 204-2(a)(7)(i) currently requires advisers keep originals of all written communications received and copies of all written communications sent by the adviser relating to "any recommendation made or proposed to be made and any advice given or proposed to be given." To the extent the Commission believes the recordkeeping rule needs to expressly address performance figures, it could do so by amending rule 204-2(a)(7)(i). To the extent the Commission determines that it should be a separate category, the new section (iv) should precede the existing proviso in the rule that relates to unsolicited communications.[37]

[37] In the Federal Register, new section (iv) appears at the end of rule 204-2(a)(7). We do not think this was intended. We believe that it should have immediately followed subsection (iii) and preceded the proviso. As it appears in the Federal Register, it is unclear whether an adviser would be required to maintain records relating to

4. Information about the Use of "Third-Party Compliance Auditors"

The Commission seeks comment on whether advisers should be requested to provide information about the use of third-party compliance auditors and, if so, the types of information that should be requested.[38] For the reasons discussed below, we recommend that this disclosure not be included as part of this rulemaking.

As we noted earlier, we recognize the Commission's goals in obtaining more information for regulatory purposes and support efforts to enhance SEC examination and oversight of advisers. However, we have significant concerns about requiring advisers to disclose information about the use of third parties for compliance audits. Depending upon the nature and scope of the disclosure,[39] there could be unintended consequences such as negative or inaccurate inferences regarding an adviser's decision to use, or not to use, outside parties to conduct compliance reviews.

Advisers may engage one or more third parties—including law firms, accounting firms, compliance consultants, or other vendors—for various reasons relating to their compliance programs.[40] For example, advisers may hire an outside party to review certain compliance areas or to perform a gap analysis of the firm's compliance program. The purpose of that type of audit would be to simply confirm that the firm's policies and procedures work as intended or to identify areas in need of improvement. Some advisers may hire third parties for specified expertise or additional staffing capacity. Larger advisers, which typically have more resources, may hire multiple third parties for a number of different purposes. On the other hand, an adviser may instead choose to conduct compliance reviews in-house, for reasons including the significant costs associated with hiring third parties or the presence of a robust compliance program with internal audits or compliance resources from affiliated companies. Finally, some reviews may be conducted by or at the direction of attorneys pursuant to privileged engagements.

Given all of these variables, it is difficult to know how the fact that an adviser hired one or more third parties would be interpreted, and the prospect of incorrect negative inferences from the disclosure might discourage advisers from retaining assistance that might be otherwise appropriate. For example, disclosures relating to third party audits could be viewed as a "red flag" that the firm has identified a material compliance violation and has hired an outside auditor

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unsolicited market letters or other communications discussing the performance of securities that the adviser recommended to its clients.

[38] Proposal at 21.

[39] We note that views of commenters on this matter may differ significantly depending on the nature and scope of the required disclosure.

[40] According to a recent survey of registered investment advisers, reasons for engaging third parties may include, for example: conducting SEC mock examinations or annual reviews, drafting policies and procedures, or obtaining assistance in areas requiring highly specialized expertise (*e.g.*, cybersecurity). *See* 2015 Investment Management Compliance Testing Survey (available at: https://www.investmentadviser.org/eweb/Dynamicpage.aspx?webcode=PN_RB#AMOCS_Survey).

as a result. Conversely, some might view the fact that an adviser chose *not* to hire outside parties to perform compliance audits as a negative—an equally incorrect inference.

We are skeptical that the benefits of including an item on the use of third parties would be meaningful for clients or the SEC from a risk monitoring perspective given the variety of consultants, the differing services they may provide, and the customized scopes within these services. In light of these concerns, we recommend that this disclosure not be included as part of this rulemaking.

5. Securities Lending

The Commission requests comment on whether advisers should be required to report the use of securities lending and repurchase agreements in separately managed accounts.[41] For a number of reasons, we do not think that such a disclosure requirement would provide much meaningful information to the Commission.

Anecdotally, we understand that relatively few clients with separately managed account mandates engage in securities lending, although some large pension funds and other institutional investors may choose to engage in the practice. In any event, that decision to lend the client's securities is made by the client, not the adviser, pursuant to a securities lending agreement between the client and the custodian. Advisers often have little or no visibility to the securities lending arrangements that may be established by their clients from time to time, and may not even know when clients' securities lending agents have loaned client portfolio securities. As a result, disclosure of the value of securities that individual clients have on loan is not particularly relevant to reporting by advisers. The SEC should not require reporting in this area.

VI. The Commission Should Provide a Reasonable Compliance Date

The Commission seeks comment about whether advisers readily have access to the data and information requested by the proposed changes. We understand that many advisers do not have access to this data readily or in the format requested. For example, we understand that advisers do not currently break down their aggregate SMA assets into the asset types as specified in Section 5.K.(1) or characterize their client accounts according to NAV range, borrowing, and gross notional exposure, as specified in Section 5.K.(2). Advisers will need to develop, implement, and maintain reporting processes to identify clients, categorize clients and RAUM in the way the Commission is proposing, identify the data, ensure the collection of data is correct, and complete the mechanics of reporting the data on Form ADV.

We note that the Proposal estimates that "each adviser will spend, on average, 2 hours to complete the proposed questions regarding separately managed accounts."[42] We believe, however, that this estimate is substantially too low and that the time required for an adviser to

[41] Proposal at 15.

[42] Proposal at 58, n.111.

understand the new reporting requirements, identify all the data points required, ensure that its portfolio accounting and data systems are capturing the data as requested by the new reporting requirements, and report the new data will take significantly longer than two hours. Already, many of our members have taken quite a bit more time than that to interpret the proposed definitions and reporting requirements.

For all of these reasons, we respectfully request that the Commission provide a sufficient period of time to comply with the new information requests. We believe that an implementation date of twelve months **after** the adoption of the final rules and form changes would be appropriate in this regard. For example, if the new rules and forms were adopted in 2015, the Commission should require advisers with fiscal year ends on or after December 31, 2016 to file new Part 1 no sooner than their next annual updating amendment (*i.e.*, March 2017 for calendar year filers and later for others). In addition, we request that larger advisers be given sufficient time to create the required systems to capture mid-year data (for Sections 5.K.(1) and 5.K.(2)). Depending on the timing of the adoption of the amendments, the Commission might consider a phased-in approach where mid-year data is not required in the first year of reporting.

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We appreciate the opportunity to provide comments on the Proposal and would be pleased to meet with the Commission and its staff regarding our comments and to provide any additional information. Please contact the undersigned or Monique S. Botkin, IAA Associate General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully,

/s/

Robert C. Grohowski
General Counsel

cc: The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner

David Grim, Director, Division of Investment Management
Diane Blizzard, Associate Director, Division of Investment Management
Daniel Kahl, Assistant Director, Division of Investment Management

Appendix

Specific Comments on Proposed Amendments to Form ADV, Part 1A

Item 1: Identifying Information

- **Item 1.I. Social Media Disclosure.** We support the Commission's approach not to require disclosure of all the social media accounts of an adviser's employees or disclosure of whether an adviser permits employees to have social media accounts associated with the adviser's business and the number or percentage of employees that have those accounts. This information would be extremely burdensome to disclose and would not meaningfully benefit the Commission's regulatory oversight of advisers. The proposal to include an advisory firm's social media websites is more appropriate. We also request that the Commission clarify that advisers need only disclose public-facing social media sites used to promote the adviser's business to clients or potential clients.

- **Item 1.J. Chief Compliance Officer.** The proposed amendment would require disclosure if the chief compliance officer is "compensated or employed" by any person other than the adviser (or a related person of the adviser) for providing chief compliance officer services. In many instances, where the same individual serves as both adviser and RIC CCO, the RIC will be responsible for a portion of the CCO's compensation. We do not think it was the SEC's intent to collect this type of information in the proposed item, and we recommend the Commission clarify that these situations are excluded from the disclosure.

Item 5: Information About Your Advisory Business

- **Item 5.D. Clients (Type of Client).** The Commission has proposed to eliminate the percentage ranges of types of clients and instead require the exact number of accounts and RAUM attributable to specific client types. Given the historical use of ranges, many advisers with large numbers of clients typically employ some estimation in the categorization of client types. As stated in the Proposal, the Commission's goal is to obtain *aggregate* information about an adviser's separately managed accounts. The Commission should explicitly recognize in the adopting release the use of reasonable estimation or approximation reported in good faith. We also request that the Commission move the category "Corporations or other businesses not listed above" toward the bottom of the list, as it may conflict with insurance company and, possibly, foreign official institution.

  Sub-Advised RICs and Sub-Advised Pooled Investment Vehicles, Including Private Funds. For purposes of Form ADV Part 1A reporting on SMAs, we seek confirmation that an adviser can report a sub-advised registered investment company as an "investment company" client under Item 5.D.(d), even if the advisory contract is with another investment adviser. Likewise, we seek confirmation for purposes of Form ADV Part 1A reporting on SMAs that an adviser can report a sub-advised pooled investment vehicle, including a sub-advised private fund, as a "pooled investment vehicle" client under Item 5.D.(f), even if the advisory contract is with another investment adviser or other entity. This approach is consistent with the intent and purposes of the Proposal, which focuses on SMAs and excludes RAUM

attributable to RICs and pooled investment vehicles, including private funds. We also seek confirmation that insurance company separate accounts would not be considered SMAs.

Sovereign Wealth Funds and Foreign Official Institutions. Proposed Item 5.D(m) would require the number and RAUM of sovereign wealth funds and foreign official institutions. The Commission should consider further clarifying the definitions of these entities. For example, it is unclear whether the account of any government or quasi-government entity or agency would be included in this item.

- **Item 5.K. and Section 5.K of Schedule D: Separately Managed Accounts**
    - **Item 5.K. Use of the term "Separately Managed Account."** To calculate SMA RAUM, advisers would need to subtract amounts of RAUM attributable to RICs (other than pooled investment vehicles), BDCs, and pooled investment vehicles.[1] We have two comments with regard to the term "separately managed account." First, we seek confirmation from the Commission in the adopting release that "pooled investment vehicle (other than investment companies)" in Item 5(f) of Form ADV Part 1A and in the Proposal includes, in addition to private funds, funds that are not private funds, such as collective trusts, funds offered outside the U.S., or other pooled vehicles. Second, we note that because the term "separately managed account" is not defined in the Advisers Act or rules thereunder and has different meanings across the financial services industry, the term may prove to be confusing. For example, many financial services firms offer services called "managed account advisory services," "separately managed accounts," or other options where a client can select from a universe of investment advisers managing assets on a discretionary basis for the client and can select from a universe of pre-selected investment options (such as mutual funds or other investment options).[2]

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[1] SMA clients, excluding RICs, BDCs and pooled investment vehicles, would include the following remaining clients listed in Item 5.D: individuals (other than high net worth individuals), high net worth individuals, banking or thrift institutions, pension and profit sharing plans (but not the plan participants or government pension plans), charitable organizations, corporations or other businesses not listed, state or municipal government entities (including government pension plans), other investment advisers, insurance companies, sovereign wealth funds and foreign official institutions, and "other."

[2] For example, the Money Management Institute defines "SMA programs" to include:

> [M]anaged account programs sponsored by a financial institution such as a broker-dealer, bank, or investment adviser that offer discretionary investment advisory services to clients, typically pursuant to arrangements with other firms. SMA programs are not specifically defined by the rules of the [SEC], but include so-called "wrap fee" programs – which the SEC defines as programs "under which any client is charged a specified fee or fees not based directly upon transactions in a client's account for investment advisory services (which may include portfolio management or advice concerning the selection of other investment advisers) and execution of client transactions" – as well as programs where the customers receive the same complement of services in unbundled form. Unlike clients in pooled vehicles such as U.S. registered investment companies, in SMA programs clients retain direct and sole ownership of their account assets, which are held with a regulated custodian.

See http://www.financialstabilityboard.org/wp-content/uploads/Money-Management-Institute-MMI.pdf. The SEC's Division of Investment Management's topical reference guidance identifies these types of

Other entities offering "SMAs" in the financial services industry define them as individual portfolios of stocks and bonds run by specialist money managers based on a specific investment style. To prevent potential confusion, the Commission should address the current different uses of the term "separately managed account(s)" in the adopting release and could instead consider using a term such as an "individually managed account."

- **Section 5.K.(1) of Schedule D (Separately Managed Accounts)**

  - **Categorizing Asset Types**. The Proposal would require all advisers that manage SMAs to annually report the approximate percentage of RAUM attributable to SMAs on an aggregate basis invested in ten asset categories: exchange-traded equity securities, U.S. government/agency bonds, US. state and local bonds, sovereign bonds, corporate bonds – investment grade, corporate bonds – non-investment grade, derivatives, securities issued by RICs or BDCs, securities issued by pooled investment vehicles (other than RICs), and a category of "other" for which firms would include a general description of assets included. As a preliminary matter, we note that advisers may not generally maintain their client accounting and reporting systems in a manner that allows them to efficiently categorize assets based on the asset types as proposed by the SEC. The Commission should recognize that firms may categorize assets differently and should permit firms to use reasonable and documented systems and methodologies for determining in which category an instrument belongs and should explicitly recognize in the adopting release the use of reasonable estimation or approximation reported in good faith. In addition, the Commission asks whether it should require disclosure about investment strategies used in SMAs as opposed or in addition to asset types. We recommend the Commission not require disclosure about strategies in Part 1A, given the different definitions of strategies used by advisers and that such information is included in Part 2A of Form ADV.

  - **"U.S. Government/Agency Bonds."** With regard to "U.S. government/agency bonds," we seek clarification as to whether this includes investments such as agency collateralized mortgage obligations, agency debentures and agency strips, agency mortgage-backed securities, and U.S. Treasuries (including strips).

  - **"Corporate Bonds - Investment Grade."** With regard to the definition of "corporate bond - investment grade," the Proposal defines a security as investment grade if it is sufficiently liquid that it can be sold at or near its carrying value within a reasonably short period of time and is subject to no greater than moderate credit risk. We note the proposed definition is used in Form PF and in proposed Form N-PORT. Given the Commission's current focus on liquidity issues, particularly with regard to RICs, we suggest the Commission seek a consistent approach to liquidity-related concepts across various reporting and disclosure regimes.

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accounts as "Wrap Accounts/Separately Managed Accounts." *See* http://www.sec.gov/divisions/investment/guidance.shtml.

- **"Derivatives."** The Proposal does not define the term "derivatives." We recommend that the Commission not include a definition of derivatives. We understand Form PF requires disclosure of derivative positions. In the event the Commission seeks to define the term derivatives, the definition should be consistent with Form PF.

- **"Other."** We seek clarification as to what "other" would include (for example: cash and cash equivalents; sweep vehicles for uninvested cash; repurchase agreements; reverse repurchase agreements; payables for investments purchased either on a delayed delivery, when-issued or other firm commitment basis, or on a standby commitment basis; asset-backed securities; participatory notes (P-notes); exchange-traded notes; and/or convertible preferred stock).

- **Section 5.K.(2) of Schedule D (Separately Managed Accounts; Use of Borrowings and Derivatives)**

  - **Instructions.** The proposed instructions for Section 5.K.(2) require reporting of information on derivatives if the amount of RAUM attributable to SMAs is "at least $10 billion." This language is unnecessarily confusing, and we recommend the instruction be revised (and similar instructions elsewhere in the Form and instructions) to read if the remaining amount is "$10 billion or more…".

  - **Use of term "Net Asset Value."** We question the use of the term "net asset value" to identify relevant value thresholds for SMA reporting. The concept of "net asset value" is not generally applicable to individual investment advisory accounts, but rather to collective or pooled investment funds where an investor in a fund purchases and redeems fund interests based on NAV (*i.e.*, the value of the fund's interests by calculating assets less liabilities). However, in some instances, a client's accounting or valuation agent might provide a net asset value or fair market value upon which the adviser calculates its advisory fees. Thus, we recommend the Commission require the adviser to use either the value the adviser receives from the client's accounting or valuation agent or the value reported to the client, as an alternative to "NAV."

    If, however, the Commission determines to use the term "NAV" to require advisers to calculate the current value of an individual separate account, we request confirmation that an adviser may calculate NAV without deducting deferred compensation that might otherwise be a liability (such as performance fees) where the adviser does not deduct such deferred compensation when reporting the value of the account to the client.

  - **"Borrowing" Transactions (also used in Item 5.K.(2)).** The proposed definition of "borrowings" in the Form ADV Glossary includes secured borrowings and unsecured borrowings, collectively. The definition provides that secured borrowings are obligations for borrowed money in respect of which the borrower has posted collateral or other credit support and should include any reverse repos (*i.e.*, any sale of securities coupled with an agreement to repurchase the same (or similar) securities at a later date at an agreed price); and unsecured borrowings are obligations for

borrowed money in respect of which the borrower has not posted collateral or other credit support.

We seek clarification as to whether SEC guidance issued on the definition of "borrowing" in Form PF would apply to the definition of "borrowing" in Form ADV.[3] We note that some concepts of borrowing in Form PF for private funds may not translate to separately managed accounts.[4] Current Commission guidance is based on pooled investment vehicles that have a balance sheet.[5] Individual investment advisory separate accounts do not have balance sheets prepared under particular accounting standards.

- **"Interest Rate Derivative."** We note the definition for interest rate derivative in the Proposal does not include the additional clarifying note that the "information must be presented in terms of 10-year bond equivalents," as is included in Form PF.[6] We recommend the Commission harmonize the definition of interest rate derivative in Part 1 of Form ADV to the definition in Form PF. Further, in responding to Section 5.K.(2), firms should be permitted to rely on their existing practices when providing information about clients' interest rate derivatives for purposes of the proposed reporting, as provided for in Form PF.

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[3] *See, e.g.,* Form PF FAQ Question 12.1; Section 2b, Item D, Question 43 of Form PF ("Classify secured borrowing according to the legal agreement governing the borrowing (*e.g.*, Global Master Repurchase Agreement for reverse repo and Prime Brokerage Agreement for prime brokerage). Please note that for reverse repo borrowings, the amount should be the net amount of cash borrowed (after taking into account any initial margin/independent amount, 'haircut' and repayments). Positions under a Global Master Repurchase Agreement should not be netted."); Section 2a, Item A., Question 26 of Form PF ("[p]rovide the absolute values of short positions" when including exposures of hedge fund assets.)

[4] For example, we note that Form PF FAQ Question G.2 provides guidance on how to treat short positions, derivatives, repurchase agreements, total return swaps, and other financial instruments for purposes of calculating a private fund's gross asset value. The SEC has stated that if a private fund has a balance sheet, it may rely on the gross assets reflected on the balance sheet to calculate gross asset value, thereby permitting the adviser to rely on the applicable accounting standard. *See* Form PF FAQ, Question G.2 and Frequently Asked Questions on Form ADV and IARD: Item 7.B ("Form ADV FAQs"), available at https://www.sec.gov/divisions/investment/iard/iardfaq.shtml#item7b (citing the 2011 Implementing Release at 23, n. 83 ("We expect that advisers will continue to calculate their gross assets as they do today.")).

[5] In Form ADV FAQs: Item 7B, the SEC stated that, typically, in the case of a fund, "a short sale will be recorded as a short sale liability (because the fund has an obligation to replace the security) together with an asset for the proceeds received or due from the counterparty (e.g., cash received or due from a broker). In that case, the short sale liability would neither be included as an asset nor deducted from assets in the calculation of 'gross asset value,' although the proceeds received would be included in 'gross asset value.' However, if the fund takes a short position using a derivative, the derivative itself may have a positive fair value and be recorded as an asset. In this case, the short position would be included as an asset in the calculation of 'gross asset value.'"

[6] Form PF requires firms to report exposure for interest rate derivatives after adjusting to 10-year bond equivalents, instead of requiring advisers to report duration. We note that Commission in adopting Form PF stated that it is "giving advisers the option of instead reporting weighted average tenor or 10-year bond equivalents because we understand from comments received that advisers use a wide range of metrics to measure interest rate sensitivity. We expect that this revised approach will reduce the burden of reporting because advisers will generally be able to rely on their existing practices when providing this information."

- **"Equity Derivative."** The proposal defines "equity derivative" to include "listed equity derivative" and derivative exposure to unlisted securities. The Form PF FAQs provide guidance regarding the meaning of "listed."[7] We seek confirmation that the term "listed" as used in Form ADV has the same meaning as in Form PF.

Item 8: Participation or Interest in Client Transactions

- The Proposal states that "in order to address a frequent question from filers, [the SEC] propose[s] to clarify that advisers should answer Item 8 based on the types of participation and interest the adviser expects to engage in during the next year." We are concerned with a disclosure requirement about an adviser's potential practices in the future rather than on current practices. It may be difficult to predict what an adviser may do in the year ahead. Additionally, this may lead to unreported conflicts such as the scenario where an adviser does not expect to engage in an activity and then subsequently determines to engage in the activity after the Form ADV is filed, but does not anticipate engaging in the activity in the following year. An adviser should not be required to estimate potential activities it might engage in the Form ADV but rather disclose what activities it does engage in currently. Accordingly, the Commission should remove the language, "during the next year," and tailor the disclosure to current practices.

Item 9: Custody

- **New General Instruction to Form ADV Part 1A for Item 9:** The Commission should add a new General Instruction for Item 9 or revise the introduction instruction under Item 9 by adding a second sentence stating, "The term 'custody' as used in this Item is a specific defined term in rule 206(4)-2 of the Advisers Act and means more than actual physical custody of client assets. Please consult the definition in the rule before responding to these items." The Commission should also revise the General Instructions to Form ADV and the Form text to incorporate the Item 9 "Completion Reminder" that the Division of Investment Management emailed to registrants on March 5, 2014, which stated:

  > "All SEC-registered advisers that have custody of client assets should answer all questions in Item 9 of Part 1A of Form ADV. Each adviser's answers will vary depending on facts and circumstances. For example, advisers that have custody solely because they deduct fees from client accounts would respond 'no' in Item 9.A. Additionally, these advisers would likely respond 'no' in Items 9.B., and 9.D., and they likely would not need to provide information in Items 9.C. or 9.E. However, in Item 9.F., these advisers likely would need to indicate that there is at least one person acting as qualified custodian for their clients in connection with advisory services they provide to clients."

[7] *See* Question 26.1 of SEC Form PF FAQs ("The term 'listed equity derivatives' refers to the fund's exposures to derivatives for which the underlying asset is listed equities. For example, if a fund has purchased an over-the-counter option from a bank on the equity securities issued by a software company that are listed on a regulated exchange, you would include the delta adjusted notional value of the option under the sub-heading 'other listed equity derivatives' identified under the 'listed equity derivatives' asset class.")

- **Item 9.A.(1).** We recommend that the Commission amend the instructions under Item 9.A.(1) to state: "Subject to the exceptions below, answer 'yes' to Item 9.A.(1) if you are deemed to have custody because your related person has custody of client assets in connection with advisory services you provide to clients."

- **Item 9.A.(2).** We recommend that the Commission amend the second sentence of the instructions under Item 9.A.(2) to state: "If you are deemed to have custody of certain client assets because your related person (other than employees or officers of your firm) has custody of those client assets in connection with advisory services you provide to your clients, do not include the amount of those assets and the number of those clients in your response to Item 9.A.(2). Instead include that information in your response to Item 9.B.(2). However, if you have custody of client assets because individuals employed by your firm have custody of those assets (*e.g.*, by serving as trustee), do include those assets in your response to Item 9.A.(2)."

- **Item 9.B.** The Commission should clarify under Item 9.B that the adviser should respond only with respect to related persons that are not employees or officers acting in that capacity.

- **Item 9.D.** The concept of "qualified custodian" arises most substantively for the first time in Item 9.D. Confusion continues to exist about the difference between having "custody" and being a "custodian," and data in response to this Item is frequently misinterpreted by the press and is likely misinterpreted by clients and potential clients. Thus, we recommend that the Commission define "qualified custodian" in this question and provide a statement about the difference between having "custody" and being a "custodian."

- **Item 9.F.** We recommend the Commission include the following clarifications regarding acting as qualified custodian:

  > "If an adviser has custody regarding at least one client account, but does not have custody regarding all of its clients' accounts, in answering Item 9.F, the adviser should include only the total number of qualified custodians used by all advisory clients for whom the adviser has custody (by any means, physical or constructive, including by virtue of deducting fees directly from the account, acting as general partner of a limited partnership, etc.).
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> "If the same qualified custodian is custodian for multiple client accounts for which the adviser has custody (by any means), that qualified custodian should be counted once. Do not double count custodians."

- **Section 7.A.(8) of Schedule D.** Section 7.A.(8)(a) of Schedule D asks whether your "related person act[s] as a qualified custodian for your clients in connection with advisory services you provide to clients?" Section 7.A.8(b) asks whether, if so, you have overcome the presumption that you are not operationally independent from the related person. Some firms check the box for 8(b), even if the related person is not acting as a qualified custodian for clients as indicated in 8(a). The Commission should include a completeness check so that only firms that respond "yes" to 8(a) are permitted to respond to 8(b). In addition, instead of using the technical, double negative "overcome the presumption" formulation in the

instructions in Item 9.A and Section 7.A.(8)(b) of Schedule D, the Commission should use the simpler and clearer formulation in Item 9.D (*i.e.*, you have determined the related person to be operationally independent under rule 206(4)-2 of the Advisers Act).

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July 21, 2015

Via Electronic Filing

Office of Regulations and Interpretations
Employee Benefits Security Administration
Room N-5655
U.S. Department of Labor
200 Constitution Avenue, N.W.
Washington, DC 20210

Re: Definition of the Term "Fiduciary" (RIN 1210-AB32)

Ladies and Gentlemen:

The Investment Adviser Association[1] appreciates the opportunity to comment on the Department's expanded definition of "fiduciary" in the context of providing investment advice to retirement plans or their participants or beneficiaries (the "Proposed Regulation").[2] The IAA's members are investment advisers registered with the Securities and Exchange Commission, and as such provide fee-based asset management to their clients as fiduciaries under the Investment Advisers Act of 1940 (the "Advisers Act") and—with respect to their retirement plan clients—as fiduciaries under ERISA.

The IAA has long advocated that financial professionals providing investment advice about securities be required to act as fiduciaries in the best interest of their clients. Thus, we support the Department's goal to "better protect[] plans, participants, beneficiaries, and IRA owners from conflicts of interest, imprudence, and disloyalty."[3] We fully understand the basic concerns underlying the Proposed Regulation that millions of Americans—many of whom lack financial expertise—are now responsible for directing their own investments and must "depend on investment advice for guidance on how to manage their savings to achieve a secure retirement."[4] The Department has expressed particular concern regarding advice to individuals on rolling over their retirement assets into an IRA and recommendations regarding investments

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms that are registered with the Securities and Exchange Commission. For more information, please visit our web site: www.investmentadviser.org. The terms "investment adviser" and "adviser" throughout our comments refer to SEC-registered investment advisers.

[2] *Definition of the Term "Fiduciary;" Conflict of Interest Rule—Retirement Investment Advice*, 80 Fed. Reg. 21928 (Apr. 20, 2015), available at http://www.gpo.gov/fdsys/pkg/FR-2015-04-20/pdf/2015-08831.pdf.

[3] *Id.* at 21929.

[4] *Id.* at 21930.

within an IRA.[5] These individual retirement investors deserve to receive advice that is in their best interests.

While we support the Department's goals in this initiative, we have several concerns with the Proposed Regulation as drafted. As a preliminary, overarching matter, we are concerned that the Department's position on how to address conflicts of interest appears to be based in part on an overly simplistic focus on cost. For example, an option under consideration might encourage fiduciaries to limit the range of available investments to low-fee (typically passively managed) investment options as a means to address potential conflicts of interest. The Department's approach to a potential streamlined exemption and parts of its economic analysis suggest that it intends to promote passive over active management.

As fiduciaries, investment advisers consider a number of criteria about their clients and any potential investment recommendations in addition to fees, including client objectives, portfolio holdings, strategy, and risk-adjusted performance. The selection of investments and investment style should be left to the judgment of investment professionals based on all relevant criteria and circumstances related to both the investor and the potential investments. As long as the professional is required to act transparently and in the client's best interest, it is both inappropriate and inconsistent with any fiduciary standard that applies to investment advisers today, as well as the duty described in the Proposed Regulation, to prescribe what those fiduciaries may recommend.

We also submit a number of comments and recommendations on the substance of the Proposed Regulation. Given that investment advisers are ERISA fiduciaries under the current definition, the Proposed Regulation for the most part would not affect investment advisers, when they provide investment advice to ERISA clients for a fee under an investment management agreement. Nevertheless, as drafted, the Proposed Regulation could prematurely attach fiduciary status and trigger technical prohibited transactions prior to the establishment of an investment advisory relationship.

We do not believe that the Department intended to attach fiduciary status to fee-based investment advisers under these circumstances. Accordingly, we have set forth below a number of suggestions to clarify that fiduciary status for such advisers begins only when the adviser has established an investment advisory relationship with a specific client and a specific investment mandate involving specific assets. In addition, we seek clarification as to how the Proposed Regulation would apply to recommendations of SEC-registered investment advisers, the provision of services to or marketing conversations with other financial services entities, and the operation of the financial reports and valuation carve-out.

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[5] *Id.* at 21938 ("Advisers to ERISA-covered plans are already required to adhere to the fundamental standards of prudence and loyalty, and can be held accountable for violations of the standards. Rather, the primary impact of the 'best interest' standard is on the IRA market.").

Finally, we recommend an effective date that is at least two years after publication of the final rule. The potential implications of the proposal are far-reaching, and investment advisers and other plan service providers will need to assess the potential fiduciary status of numerous entities. In addition, they will need to put into place systems to implement any resulting changes going forward.

I. Background

A. Investment Advisers' Disclosures to All Clients

The IAA's members are investment advisers registered with the SEC, and must satisfy fiduciary responsibilities to their clients under the Advisers Act.[6] This principles-based fiduciary standard applies to all of the adviser's clients, including ERISA plans and IRA owners. We have long maintained that all persons providing investment advice about securities to clients (regardless of the level of the client's sophistication) should be subject to the same high standard of care – the well-established fiduciary duty standard under the Advisers Act. This federal fiduciary standard requires investment advisers to act in the best interests of clients. The Advisers Act and the fiduciary standard provide an extensive framework for conduct and compliance, and impute an overarching duty on the part of investment advisers to put the interests of their clients first.[7]

Virtually all IAA members provide investment management services to their ERISA-covered plan and IRA clients on a discretionary basis. Discretionary investment advisers to plans are fiduciaries under section 3(21)(A)(i) of ERISA, and must satisfy fiduciary responsibilities both under the Advisers Act and under ERISA with respect to the assets they manage. Investment advisers that provide nondiscretionary investment advice to ERISA plans and IRA owners also are fiduciaries under section 3(21)(A)(ii) and therefore subject to both regimes.

In the typical arrangement between an investment adviser and each of its clients, including ERISA plans and IRA owners, the parties enter into a written contract that states a formula under which the adviser's compensation will be determined, generally a straightforward percentage of the assets under management, typically referred to as a "fee-based" arrangement. In addition, all advisers must specifically describe how they are compensated for advisory

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[6] This fiduciary duty has been upheld by the U.S. Supreme Court and reiterated by the SEC in various pronouncements over the years. *SEC v. Capital Gains Research Bureau*, 375 U.S. 180 at 186 (1963); *see, e.g., In re: Arleen W. Hughes*, Exchange Act Release No. 4048 (Feb. 18, 1948).

[7] *See, e.g.*, Letter from David G. Tittsworth, Executive Director, IAA, to Securities and Exchange Commission, dated July 3, 2013, available at https://investmentadviser.org/eWeb/docs/Publications_News/CSCurrent/130703cmnt.pdf (regarding the SEC's consideration of standards of conduct for broker-dealers and investment advisers providing personalized investment advice to retail customers).

services, provide a fee schedule, and describe conflicts of interest along with how they address such conflicts. This disclosure appears in Part 2 of Form ADV, a narrative disclosure brochure that is required under SEC rules to be provided to a client at or prior to the beginning of the advisory relationship.[8]

B. Additional Information and Disclosures for ERISA Plans

An ERISA plan generally will issue a request for proposal (RFP) from potential investment advisers, often with the assistance of a pension consultant.[9] In responding to the RFP, advisers provide detailed information about their experience, services and compensation. The process often includes a "finals presentation" in which potential advisers participate in substantive discussions with the consultant and/or potential client about their proposed engagement. After the plan selects an investment adviser through the RFP process, the parties extensively negotiate an agreement, typically with the assistance of counsel. The negotiations address numerous aspects of the relationship, and the form of agreement is often provided by the client, not the adviser. Therefore, clients establishing these accounts are well-versed as to the terms of the agreements, which reflect the client's or firm's original agreement and any negotiated changes to that agreement. The process is typically an arms-length process that more closely resembles an ordinary commercial transaction than a fiduciary relationship of trust and impartiality.

Beginning in 2012, an adviser's disclosures to the responsible ERISA plan fiduciaries must include the information required under the Department's rule under section 408(b)(2) of ERISA in order to avoid prohibited transaction concerns in the provision of services. These disclosures generally must be provided reasonably in advance of entering into the contract and updated promptly to reflect any subsequent changes. They must include a description of the services to be provided to the plan by the adviser and a description of all direct compensation, either in the aggregate or by service, that the adviser reasonably expects to receive in connection with the services, as well as other details about the arrangement.[10]

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[8] Parts 1 and 2A of Form ADV are filed through the Investment Adviser Registration Depository (IARD) and available to the public electronically at http://www.adviserinfo.sec.gov/IAPD/Content/IapdMain/iapd_SiteMap.aspx. In addition, Part 2A generally must be provided to clients and prospective clients at the time of or before entering into a contract, and must be promptly updated when the information becomes materially inaccurate. Part 2B, which also must be provided to clients, requires information about the specific employees giving advice to individual clients, including additional information about their compensation, and whether they receive any additional compensation, such as a sales award, for providing advisory services.

[9] The pension consultant may also request the adviser to provide information for the consultant's database regarding the adviser's qualifications, capabilities, and investment strategies.

[10] Although the 408(b)(2) disclosures are not required to be provided to IRA owners, much of the information required under the 408(b)(2) regulation nonetheless is provided to IRA clients in the Form ADV and the investment management agreement.

This information generally also must be provided to an individual participant who hires an adviser to provide advice concerning the individual's account within a plan rather than to the plan as a whole. Collectively, these disclosures fully inform the client as to the adviser's services and compensation prior to the advisory relationship.

II. Role of a Fiduciary: Treatment of Active Management

The Department appears to promote the superiority of low-fee (passively managed) investments as compared to higher-fee (actively managed) investments. In the preamble to the Proposed Regulation, the Department requests comment as to whether it should propose an additional "streamlined" prohibited transaction exemption that would apply to "high-quality, low-fee investments" and contain far fewer conditions than the proposed Best Interest Contract (BIC) Exemption.[11] This concept suggests that the Department favors passive over active management, given that lower-fee mutual funds, for example, tend to be those that are indexed to a particular benchmark and do not provide active management. In addition, the separate economic analysis of the benefits of the Proposed Regulation compares the fees currently paid by retirement investors to the fees available in index funds, implying that the Department favors passively managed funds.[12]

We submit that the Department should not base the availability of exemptive relief from the prohibited transaction rules on prescriptive limits on the investments available to fiduciaries. Doing so puts the Department in the untenable position of substituting its own judgment on investments for those of the fiduciary. The selection of investments and management style should be left to the judgment of plan fiduciaries and investment professionals based on all relevant criteria and circumstances related to both the investor and the potential investments. An investment professional considers a number of relevant criteria regarding each investment option, including expenses, historical performance data, benchmarks, investment objectives, portfolio holdings, turnover, relative risk, and risk-adjusted performance. As long as the professional is required to act transparently and in the client's best interest, it would be both inappropriate and inconsistent with the fiduciary duty in the Proposed Regulation and the Advisers Act to prescribe what those fiduciaries may recommend. Investment advisers, which are fiduciaries under the federal securities laws and ERISA, are in a better position than regulators to make these substantive investment decisions.[13]

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[11] 80 Fed. Reg. at 21948.

[12] *See, e.g., Fiduciary Investment Advice: Regulatory Impact Analysis* at 85-86. We also note similar issues in the Department's video accompanying the proposal. *See* http://www.dol.gov/featured/protectyoursavings/. Such a simplistic analysis does not take into account, among other things, the range of retirement clients' risk tolerances, non-retirement assets, and investment horizons.

[13] The Department considered including specific requirements concerning investment theories in connection with its regulation on participant investment advice under sections 408(b)(14) and 408(g) in 2010, but correctly concluded, based on public comment, that such requirements were not appropriate. *See* Investment Advice—Participants and Beneficiaries, 76 Fed. Reg. 66136, 66141 (Oct. 25, 2011). *See also* Letter from Karen L. Barr, General Counsel, IAA, to the Department of Labor, dated May 5, 2010.

Further, we maintain that the least expensive option is not necessarily the best option for each investor. A variety of approaches and styles can be appropriate components of the mix of investments in a retirement client's portfolio. Active management is unquestionably a generally accepted investment strategy. In addition, active management allows more flexibility, as appropriate, to hedge, engage in risk management, adjust to volatility or sideways markets, respond to interest rate changes, and deliver expert, sub-specialized management in niche markets, such as emerging and small-cap markets.[14] Conversely, investing solely in passively managed funds may not result in better overall performance over time and could lead investors to miss opportunities for better risk-adjusted returns or more appropriate diversification.

Accordingly, the Department should not offer an exemption requiring that investments by ERISA plans and IRAs be limited to low-fee, passively managed investments. Such an exemption may over-incentivize reliance on passive management that may not be in the best interests of clients. In addition, the Department's commentary should not include language or analysis that implicitly favors passive management.

III. Scope and Practical Concerns

The Proposed Regulation addresses the prong of the ERISA fiduciary definition that does not require discretionary authority or control and is generally inapplicable to discretionary investment advisers. The proposal nevertheless raises issues for discretionary and non-discretionary fee-based investment advisers, already ERISA fiduciaries under the current formulation with respect to their existing clients, to the extent that it may be interpreted to create a fiduciary relationship under ERISA and the Code before the adviser begins to provide its services to the ERISA plan or IRA owner. We do not believe that the Department intended this result, given the policy basis for the current proposal.

SEC-registered investment advisers fully recognize their fiduciary status under the Advisers Act and ERISA at the time that they enter into investment management agreements with their ERISA plan and IRA clients and begin providing investment advice concerning plan assets. Prior to entering into the agreement, the client has received the adviser's Form ADV, Part 2A and, with respect to ERISA clients, the disclosures required under ERISA section 408(b)(2), and has reviewed and agreed to the investment management agreement. To attach fiduciary status prior to this time could raise prohibited transaction issues before the adviser has provided any services to the client or received any compensation. We submit that additional protections and disclosures are not necessary in this context, especially in light of the straightforward fee structures typical of such arrangements.

Accordingly, we have set forth below a number of suggestions that would clarify the timing of fiduciary status for investment advisers under the Proposed Regulation. We also

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[14] *See, e.g.,* discussion of academic studies in Jones, Robert C. and Russ Wermers. 2011. "Active Management in Mostly Efficient Markets." *Financial Analysts Journal,* vol. 67, no. 6 (November/December 2011).

request clarification concerning (1) recommendations of SEC-registered investment advisers; (2) investment advice to financial services entities that are themselves ERISA fiduciaries by virtue of providing investment advice; and (3) valuation of plan investments.

A. The Revised Definition of Fiduciary is Overly Broad and Could Cover Activities by Investment Advisers Before They Provide Any Services to ERISA Clients

The proposed amendments to the definition of fiduciary would include as fiduciary activity any "recommendation as to the management of securities or other property." This language could be read to sweep within its scope a "recommendation" that the ERISA client hire the adviser to manage securities or other property. More specifically, our primary concern relates to the proposed definition of "recommendation" as "a communication that … would reasonably be viewed as a *suggestion* that the advice recipient engage in or refrain from taking a particular course of action."[15]

This language is so broad that a response to a request for proposal (RFP) or other presentation to a prospective client could potentially be covered by the definition.[16] Furthermore, the definition could sweep in other types of conversations between advisers and potential clients, including casual discussions during the sales process, such as the adviser's provision of "market color." Even the act of providing information to a plan consultant's database could trigger ERISA fiduciary status, if providing such information to a consultant were to be deemed a recommendation to hire the adviser.

Similarly, investment advisers or their affiliates might become ERISA fiduciaries if their marketing or wholesaling activities directed to intermediaries are deemed to be "recommendations," under the broad definition of that term, and the intermediary is a fiduciary to an ERISA plan or IRA client. As a practical matter, for example, a mutual fund distributor will have no way of knowing whether its interaction with an intermediary will contribute to that intermediary's decision to make a recommendation to an ERISA plan or IRA client, and cause the distributor to become an inadvertent fiduciary.

We do not believe this result was intended.[17] It would prematurely attach ERISA fiduciary status and create technical prohibited transactions that could prevent the advisory

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[15] 80 Fed. Reg. at 21960 (emphasis added).

[16] We also note that the "recommendation of a person" language in proposed § 2510.3-21(a)(1)(iv) could be interpreted to extend to advisers recommending themselves in pre-contract discussions.

[17] We appreciate that the Department responded to concerns expressed in our comments on the Department's 2010 proposal that pre-contract discussions should not be covered and that the Proposed Regulation does not "automatically assign fiduciary status to investment advisers." 80 Fed. Reg. at 21932. *See* Letter from Kathy D. Ireland, Associate General Counsel, IAA, to the Department of Labor, dated February 2, 2011. Unfortunately, the revised definition has not resolved this issue.

relationship from moving forward. This result would also be inconsistent with the ordinary ways in which ERISA plan fiduciaries carry out their responsibilities. For example, ERISA plan fiduciaries regularly issue RFPs as part of their fiduciary responsibility to research and compare potential investment advisers before selecting a particular manager. We maintain that ERISA fiduciary status should not attach if an investment adviser responded to a plan's RFP by discussing the investment philosophy and the types of investments it might recommend if the plan were to hire the adviser.[18] At this point in time, the adviser would not be "rendering investment advice for a fee," because it would not have established a relationship with the plan, and would not receive compensation for this activity.[19]

The incongruity of characterizing an adviser as an ERISA fiduciary at that moment is highlighted by focusing on those who fail to win the plan's business. Plan fiduciaries typically solicit responses to RFPs from multiple advisers in order to compare them. The plan fiduciary, however, will not choose all of these advisers to manage plan assets. Only the investment advisers with which the plan ultimately enters into investment management agreements should be ERISA fiduciaries and only at the time that such advisers actually manage the assets. The other advisers do not have any relationship with the plan, manage its assets, or receive any compensation; therefore, none of the advisers should be considered fiduciaries under ERISA prior to the plan's selection of an adviser.

Similarly, an adviser that already has an established ERISA fiduciary relationship with a plan client, or an affiliate of that adviser, may provide general investment-related information or commentary on matters beyond the scope of their existing relationship on an ad hoc basis, via educational newsletters or client conferences, or may discuss potential future services, sometimes as part of the client's consideration of a number of investment advisers. These discussions may take place in the context of client consideration of assigning the adviser an additional mandate, adding assets to an existing mandate, or changing investment guidelines. We note that, although the adviser is an ERISA fiduciary with respect to the plan assets under its management, it (or its affiliate, as applicable) would not be an ERISA fiduciary by virtue of these activities with respect to <u>other</u> assets of the plan, as provided in paragraph (c) of the Proposed Regulation.[20]

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[18] In addition, the adviser would not at this point (or in the context of discussing potential additional mandates described below) have sufficiently detailed information about the plan's current investments to provide investment advice.

[19] We also note that an adviser may meet initially with a potential advisory client about his or her investments before knowing whether the investments under discussion include ERISA or IRA assets.

[20] Paragraph (c) of the Proposed Regulation (and paragraph (c)(2) of the current regulation), provide that

> A person who is a fiduciary with respect to a plan by reason of rendering investment advice (as defined in paragraph (c)(1) of this section) for a fee or other compensation, direct or indirect, with respect to any moneys or other property of such plan, or having any authority or responsibility to do so, <u>shall not be deemed to be a fiduciary regarding any assets of the plan with respect to which such person does not have any discretionary authority, discretionary control or discretionary responsibility, does not exercise any</u>

The Department has also recognized this concept in the regulation under ERISA section 408(b)(2), which states that a prohibited transaction under section 406(b)(1) does not occur if the fiduciary does not use any of the authority, control or responsibility that makes such person a fiduciary to cause a plan to pay additional fees.[21] This is the case when an investment adviser is pitching future services—it is making a proposal to the plan fiduciary and does not have the authority to hire itself. The independent fiduciary makes the decision to engage the adviser. As in the RFP example above, the adviser may never manage the additional assets and therefore may never receive a fee based on the additional assets. In addition, if hired for the new mandate, the adviser would be required to provide new disclosures under section 408(b)(2); therefore, the client would be fully informed in advance of any change in fees that would result from the additional services.[22] The Department should clarify this issue, as set forth below.

1. The Proposal Should Be Amended to Address Pre-Contract Discussions

We request that the Department modify its proposal to clarify that fee-based SEC-registered investment advisers do not fall within the definition of "fiduciary" under ERISA prior to the establishment of a relationship with a specific client under a specific mandate to manage a particular account or set of assets as evidenced by an investment management agreement (generally, "pre-contract" discussions).[23] The Department could accomplish this result in two ways. First, it could apply the proposed revisions to the definition of fiduciary only to the types of activities to which the proposal is addressed (*e.g.*, commission- and other transaction-based

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> authority or control, does not render investment advice (as defined in paragraph (c)(1) of this section) for a fee or other compensation, and does not have any authority or responsibility to render such investment advice.

(emphasis added). As the remainder of this provision notes, the adviser may still be a party in interest and subject to co-fiduciary responsibilities with respect to the other plan assets.

[21] In particular, Examples 1 and 4 in 29 C.F.R. § 2550.408b-2(f) conclude that an investment adviser engaging in discussions to provide additional services for additional fees or to increase its fees do not raise prohibited transaction issues.

[22] 29 C.F.R. § 2550.408b-2(c)(v)(B)(*1*) thus anticipates that services and fees may change during the course of the service provider's contract and requires disclosures of such changes as soon as practicable but generally no later than 60 days after the service provider is informed of the change. This protocol suggests that changes to service agreements are routine and nothing in the regulation under section 408(b)(2) suggests that such changes raise prohibited transaction concerns.

[23] For the balance of this letter, the term "pre-contract" refers both to discussions before the adviser has a contract with an ERISA or IRA client and discussions with an existing client concerning an additional mandate, additional assets to be added to an existing mandate, or changes to investment guidelines.

activities that may be confusing to ERISA clients and IRA owners) and not to fee-based investment advisory services.[24]

Second, the Department could address this issue in the carve-outs to the definition of fiduciary. According to the preamble to the Proposed Regulation, "carve-outs are for communications that the Department believes Congress did not intend to cover as fiduciary 'investment advice' and that parties would not ordinarily view as communications characterized by a relationship of trust or impartiality."[25]

We submit that the discussions described above as "pre-contract" are not fiduciary under a similar rationale—the parties would not ordinarily view such communications as indicating a relationship of trust or impartiality. The Department therefore should clarify the non-fiduciary nature of these discussions either by modifying the existing "counterparty" carve-out or by adding a specific carve-out for pre-contract discussions relating to fee-based investment advisory services.

The "counterparty" carve-out in section (b)(1)(i) of the Proposed Regulation in its current form does not appear to cover the provision of services, given that it describes a transaction rather than the provision of services and uses the term "counterparty," which is not a term that typically applies in the context of a services agreement. To the extent that it may apply, it is limited to plans of a certain size and those that hire independent fiduciaries with responsibility for managing at least $100 million in plan assets.

We strongly submit that a carve-out for investment advisory services (regardless of whether the Department amended the counterparty carve-out or established a new carve-out) should not be limited to clients and fiduciaries of a certain size. The carve-out should apply to all clients, given that no investment advisory relationship would exist during pre-contract discussions, regardless of the nature of the client, and the fees paid under the actual contract would be straightforward and fully disclosed.

2. If Preliminary Discussions Trigger Fiduciary Status and No Carve-Out Applies, Then the Department Should Provide a Separate, Streamlined Exemption for Such Discussions

To the extent that the Department determines that the amended definition of "fiduciary" applies to fee-based investment advisers prior to their providing investment advisory services to a client and chooses not to cover such services under a carve-out, then we request that the Department develop a streamlined prohibited transaction class exemption that would permit pre-

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[24] For example, the Department could amend the definition of "recommendation" to exclude pre-contract conversations/information by fee-based investment advisers that will be ERISA fiduciaries once hired. We would also suggest amending proposed § 2510.3-21(a)(1)(iv) to refer to a recommendation of <u>another</u> person.

[25] 80 Fed. Reg. at 21941.

contract or pre-mandate discussions. For example, if the Department determined to apply the carve-out to only certain ERISA and IRA clients, then an exemption might be necessary to allow pre-contract discussions with respect to the remaining categories of clients.

We wish to stress, however, that creation of a new exemption would not be the best means for the Department to address the issue. The most logical and efficient approach from a policy standpoint would be for the Department to address our scope concerns through changes to the Proposed Regulation, a revised "counterparty" or seller's carve-out, or a new carve-out for pre-contract discussions. An exemption should not be needed because pre-contract discussions are not fiduciary in nature and should not be treated as such.[26]

The Department has included in its proposal a new prohibited transaction exemption, the BIC Exemption, to provide a structure under which those entities that became fiduciaries under the proposed amendments could receive commissions and other sales compensation. This proposed exemption, however, was not specifically designed to address pre-contract discussions concerning investment advisory services and contains a number of conditions that are either unnecessary or inappropriate for an advisory relationship.[27] As noted in the first section of the proposed exemption, it addresses prohibitions under ERISA and the Code against fiduciary advisers' receipt of "compensation that varies based on their investment recommendations," and "compensation from third parties in connection with their advice."[28] Neither of these issues arises in the context of pre-contract discussions of fee-based advisory services.

Furthermore, the covered transactions under the proposed BIC Exemption are limited to "compensation for services provided in connection with a purchase, sale or holding of an Asset by a Plan, participant or beneficiary account, or IRA, as a result of the Adviser's and Financial Institution's advice."[29] Furthermore, the conditions to the exemption include "transaction disclosures," which require various charts, website disclosures, and information to be made available upon request to the Department—all of which relate to the costs of purchasing, selling or holding particular assets and not to fee-based advisory services.

Thus, the BIC Exemption would not be appropriate for investment advisers with respect to pre-contract discussions of fee-based advisory services.[30] As noted above, a fee-based

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[26] Prematurely attaching fiduciary status in pre-contract discussions would raise difficult issues even if prohibited transaction relief were available. For example, the application of the prudent-man rule, co-fiduciary responsibility, and ERISA requirements would be problematic in this context.

[27] Furthermore, even with respect to sales activities, we believe that the conditions are unnecessarily complex.

[28] 80 Fed. Reg. at 21983.

[29] *Id*. at 21984.

[30] Further, the BIC exemption is too narrow with respect to the range of investments (defined as "Assets") that fee-based fiduciaries may appropriately employ. ERISA and IRA clients should have access to information concerning the full range of investments.

investment adviser already provides its services subject to a "best interests" fiduciary duty and pursuant to a written investment management agreement; therefore much of the rest of the proposed BIC Exemption would be unnecessary in this context.

Rather than trying to apply the BIC exemption in this context, the DOL should create a separate exemption that takes into account and, where necessary and not duplicative, builds on the extensive disclosures already provided by investment advisers during the period prior to their entering into investment advisory contracts with their clients. The conditions to such an exemption could include requirements to provide Form ADV and 408(b)(2) disclosures to both ERISA clients and IRA owners (as well as the proposed text of the investment management agreement) prior to the execution of the investment management agreement.[31] Such an exemption should make clear that it is permissible for advisers to include the 408(b)(2) disclosures in their Form ADV disclosure brochures, as this will be more manageable for both advisers and their clients.

Similarly, the proposed BIC Exemption would not appear to cover recommendations of registered investment advisers, including through referral programs and managed accounts.[32] These arrangements are already subject to the disclosure and fiduciary obligations under the Advisers Act, including its best interest standard. The Department should design a modified BIC exemption tailored to such arrangements, that could include the "best interests" standard as well as fee structures that mitigate conflicts.

B. Provision of Advisory Services to Other Fiduciaries

In addition to their services as asset managers to ERISA and other clients, SEC-registered investment advisers (or their affiliates) may provide non-discretionary advisory services to other financial services entities, some of which might be fiduciaries under ERISA. These services could include opinions, model portfolios, recommendations, and other advice that the entity may utilize, as it sees fit, in providing services to its ERISA clients.

Under the current regulation, fiduciary status for investment advice is based upon providing advice to a plan. The Proposed Regulation, however, would expand this to include advice to plan fiduciaries; therefore, advisers to financial services entities might trigger fiduciary

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[31] Another potential model for such an exemption could be the final regulation on investment advice to participants and beneficiaries under sections 408(b)(14) and 408(g). This model may be analogous in that fee-based investment advisers' compensation is level regardless of the specific investments chosen for the client, and the required disclosures in the existing participant investment advice regulation could be tailored to this context. 29 C.F.R. § 2550.408g-1.

[32] Managed accounts are often referred to as "wrap" accounts that combine investment management with brokerage commissions for one asset-based fee. Investment advisers that are compensated under a wrap fee program for sponsoring, organizing, or administering the program, or for selecting, or providing advice to clients regarding the selection of, other investment advisers in the program must provide their wrap fee program clients a separate brochure describing the program (Appendix 1 of Form ADV, Part 2A).

status even though such entities would not need the protections that the proposal is designed to provide. We urge the Department to either except this type of advice from the definition of fiduciary or to create a carve-out, for the reasons discussed below.

For example, in certain wrap fee arrangements, investment advisers provide non-discretionary advisory services in the form of generic model portfolios ("model providers") to the program sponsor or an overlay portfolio manager for its use in managing client accounts. The program sponsor or overlay manager generally has investment discretion and is therefore a fiduciary under ERISA with respect to plan and IRA clients. In this context, the model provider's only client is the financial services entity, the model provider only has contractual privity to the entity, and the model provider does not individualize its advice to a specific ERISA plan or IRA owner. Because the program sponsor or overlay manager already serves as an ERISA fiduciary with respect to the plan or IRA, we believe that imposing fiduciary responsibility on the model provider would not provide any additional protections to these clients. Furthermore, it is not clear how adviser model provider would be able to comply with ERISA's fiduciary responsibility provisions with respect to such underlying clients; indeed, it has no information about them (including their identities).

We recommend that the Proposed Regulation be revised to add a carve-out for this and similar situations in which an adviser provides investment advice to another financial services entity. For example, the Department could except from the definition of fiduciary, or create a specific carve-out for, investment advice to a financial services entity where the advice is not individualized to a specific ERISA plan or IRA owner.

C. Valuation Activities

The Proposed Regulation would add to the definition of fiduciary certain valuation activities in connection with specific transactions "involving the acquisition, disposition, or exchange" of securities or other property, subject to a carve-out in proposed subsection (b)(5)(iii) for valuations provided solely for purposes of compliance with reporting and disclosure requirements.[33]

The application of the Proposed Regulation is unclear, however, as to the status of routine information provided to plans and plan fiduciaries in addition to the information included in the carve-out. For example, advisers to funds may provide quarterly statements and performance reports to all fund investors, including ERISA plans. As a threshold matter, such information does not appear to fall within the proposed definition of fiduciary, because it is not provided in connection with a transaction. In carving out statements of value "solely for purposes of

[33] 80 Fed. Reg. at 21958. We appreciate the Department's response to the concerns raised by the IAA in its 2011 comment letter about the provision of valuation services directly to funds by adding the carve-out in proposed subsection (b)(5)(ii). Our current concerns relate to information provided to parties other than the funds, particularly plans and plan fiduciaries.

compliance," however, the Proposed Regulation suggests that other routine statements of value might fall within the definition, even though they do not relate to a specific transaction. This limitation could discourage advisers from providing information to ERISA plan clients other than that specifically required.

This issue could arise in a number of circumstances. For example, we are concerned that this language could be interpreted to attach fiduciary status to investment advisers providing investment advice to non-plan-asset vehicles in which ERISA plans invest, if they provide valuation information beyond that required under statute or regulation to the plans that invest in the fund.[34] This language also could raise uncertainty in the context of a separately managed account under which the adviser manages the assets of a single plan, if the adviser provided quarterly statements and performance information. Similar issues would arise if the plan's custodian, rather than the adviser, had valuation responsibilities under the arrangement, but the adviser provided input to the custodian as to the value of certain holdings in connection with quarterly statements provided to the plan.

We submit that the Department should clarify the scope of both the fiduciary definition and the valuation carve-out, and their inter-relation. Specifically, the Department should clarify that providing routine valuation information, regardless of whether it is required information, is not covered by the definition of fiduciary, in order to allow investment advisers to provide such information without triggering fiduciary status. Under this formulation, the carve-out in subsection (b)(5)(iii) would not be necessary.

IV. Transition Issues

Given the far-reaching changes that the final rule may produce and the continued uncertainty under the proposal concerning exactly which types of activities by investment advisers might be covered, the effective date of the proposed changes should be further extended to at least two years after publication of the final rule. This is necessary in order for advisers and other ERISA fiduciaries to assess the impact of the new rule, not only with respect to themselves, but also as to the plans' other parties in interest, especially in the context of prohibited transactions. Certain prohibited transaction exemptions, such as the statutory exemptions in sections 408(b)(15) (relating to certain block trades) and 408(b)(17) (relating to service providers), include conditions requiring that the party in interest in the transaction <u>not</u> be a fiduciary. The final rule, therefore, in broadening the universe of ERISA fiduciaries, could automatically limit the applicability of these and other exemptions that currently allow various transactions.

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[34] Under the Department's regulation defining plan assets, a collective investment vehicle with less than 25% in assets from benefit plan investors does not hold plan assets for purposes of ERISA; therefore, an adviser to such a fund generally is not a fiduciary to the plans that invest in such a vehicle. 29 CFR § 2510.3-101(f)(1).

Until the regulation is finalized, and clarification is provided on the issues raised in this letter, as well as issues affecting other service providers, plan fiduciaries and the financial services industry will not be able to assess its impact fully. Furthermore, after the regulation is finalized and clarified, plan fiduciaries will need time to apply the rule to their existing relationships and arrangements. Among other things, plan fiduciaries will need to identify new ERISA fiduciaries, and, in some cases, their affiliates.[35] Plan fiduciaries also should be given sufficient time to identify fellow fiduciaries in light of their co-fiduciary responsibilities under section 405(a) of ERISA. Finally, the final regulation will likely require data collection and conforming changes to service providers' systems; therefore, the effective date should recognize that service providers will require sufficient lead-time to work with their technology professionals to effect the required changes after they are identified.

V. Conclusion

We appreciate the opportunity to provide our views on these issues. Please do not hesitate to contact the undersigned if we may provide additional information or clarification regarding these matters.

Respectfully submitted,

-s- Kathy D. Ireland

Kathy D. Ireland
Associate General Counsel

cc: Phyllis C. Borzi, Assistant Secretary, EBSA
Judy Mares, Deputy Assistant Secretary, EBSA
Timothy Hauser, Deputy Assistant Secretary for Program Operations, EBSA
Joe Canary, Director, Office of Regulations and Interpretations, EBSA
Fred Wong, Office of Regulations and Interpretations, EBSA
Luisa Grillo-Chope, Office of Regulations and Interpretations, EBSA
Lyssa Hall, Director, Office of Exemption Determinations, EBSA

[35] *See, e.g.,* ERISA section 408(b)(17).

July 20, 2015

Via Electronic Mail

Mr. Martin Merlin
Director for Financial Markets
DG FISMA
European Commission

Re: Use of Dealing Commission under Article 24 of MiFID II

Dear Mr. Merlin:

The Investment Adviser Association (IAA) wishes to comment on the practical implications of ESMA's final technical advice to the European Commission regarding implementation of MiFID II. Our comments reflect the perspective of global investment managers affected by implementation of MiFID II as it relates to execution rates from brokers that include financial research as part of the brokers' overall services (*i.e.,* dealing commission). While we maintain the positions expressed in our two prior letters on this challenging topic,[1] we are writing again to stress that the changes contemplated are indeed significant. We urge the Commission to provide independent managers sufficient time to assess the impact of the rules on their business models and implement related compliance controls.

The IAA is a not-for-profit U.S. association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. Our membership consists of investment advisory firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment funds, endowments, foundations, and corporations. Many of our member firms manage, or have affiliates that manage, assets for clients in the European Union.

The new EU regulatory regime would mark a significant departure from current practice and existing regulatory requirements, and will require firms to make significant changes to compliance infrastructures.

We have concerns about the sweeping changes being contemplated and the related burdens that would be imposed on investment managers to come into compliance by the time MiFID II is to take effect. A requirement that independent managers "unbundle" dealing commission arrangements would represent a significant change for the global market. Due to the

[1] IAA Letter to Financial Conduct Authority (Oct. 9, 2014) (available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/141009cmnt.pdf); IAA Letter to ESMA (Jul. 31, 2014) (available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/140731cmnt.pdf).

nature of asset management, many investment managers operate their businesses on a global basis, utilizing brokers around the world to execute portfolio trades and provide research. EU rules on the use of dealing commission that differs from the rest of the world, including the U.S., would present significant practical and logistical issues that would have to be addressed in order to accommodate EU clients or international clients using EU managers. Advisers would be required to carefully assess these changes and implement substantial changes to their global compliance infrastructures to accommodate this new EU regime.

For example, many managers place their orders for securities transactions on a "block" basis, which generally benefits their clients, and orders from EU firms may be aggregated with orders from non-EU affiliates in a group that uses a fully integrated trading and research platform. This practice aims to achieve economies of scale and treat orders from different clients equitably. If the commissions related to these orders were deemed impermissible under EU or EU member state rules or otherwise restricted, managers may feel compelled to separate out clients within those jurisdictions from these otherwise advantageous arrangements. Thus, managers may choose to effectively "ring fence" the arrangements for EU clients and would have to structure their trading programs to minimize potentially negative consequences for EU clients. The manager would also need to change its systems to track payments for research on an ongoing basis (separately and apart from the broker's commission) in an effort by the manager to document the overall execution rate. In addition, there could be burdens associated with manual tracking if brokers do not provide data in an electronic and easily downloadable format.

Moreover, managers would have to consider and address many other operational and administrative issues. For example, firms that chose not to pay third parties directly would have to spend considerable time educating clients on the changes prior to obtaining client agreements to set up separate research accounts. In addition to having to demonstrate the quality of the research to be purchased, managers would also have to meet strict requirements regarding the governance, oversight, and administration of these accounts. As you can imagine, the negotiation of a research budget with each client that is reduced to writing and reviewed on an ongoing basis would result in a magnitude of administrative complexity that is far beyond that in place at firms currently.

Finally, we note that the lack of clarity that presently exists regarding the regime being considered presents a significant hurdle for investment managers as they consider changes to their compliance programs. Firms cannot even start the process of changing their compliance infrastructures until the new requirement is finalized and many technical questions with respect to the establishment and implementation of separate research accounts are answered. These questions include, for example, the treatment of omnibus and separate client accounts; how to resolve so called "free rider" situations where a client does not agree to a research budget but still receives the benefit of research paid for by other clients; clarity on how accounts are to be funded and the role of commission sharing agreements; potential tax consequences; and the implications of holding client money, which many managers are not authorized to do. In addition, it is far from clear that brokers in non-EU jurisdictions will be

willing to accommodate the establishment and implementation of separate research accounts for EU clients, or even be able to accept hard dollar payments for research on behalf of EU clients due to regulatory constraints in their home countries. We are also concerned that given the apparent wide range of views across various countries, unless the final rules regarding the use of dealing commission are agreed to and implemented by EU member states on a consistent basis, and not "gold plated," these compliance hurdles would increase greatly.

It is far from clear that research firms will be willing or able to change existing business pricing models to provide "unbundled" dealing commissions.

The proposals being considered appear to be based on the assumption that there either is or will be an established market for every service, including a "hard" execution-only cost for securities trades. This assumption is false. As we noted in our comment letter to ESMA, we believe that this information is not currently readily available and that brokers may not be willing or able to provide this information in the timeframe currently contemplated under MiFID II. In addition, some brokers may not cooperate in providing a value or even accept payments from an investment manager's own resources for such services. As noted above, this is particularly true with respect to brokers not operating within EU jurisdictions. Even if brokers provided estimated prices for these services, prices among brokers would inevitably vary, depending on the methodologies and assumptions underlying the estimates. Thus, we are concerned that managers would face difficulties in documenting compliance with this unbundling requirement, unless brokers have an established or consistent means of valuing research by the time MiFID II is to take effect.

The current timetable for compliance is not feasible, especially given the lack of clarity on key aspects of the proposed regime.

We understand that the Commission is expected to finalize the delegated acts by September 2015. We note that Parliament could then have up to six additional months to further scrutinize the directive, after which member states will have until July 2016 to transpose MiFID II. A noted above, it is vital that there not only be uniformity across member states but that there also be a workable obligation in place for brokers to provide the required information. It is only at that point that firms can reasonably be expected to begin to implement expensive changes to their compliance infrastructures. In effect, this means that firms will have a transitional period of only six months or less before the directive enters into force in 2017. This simply is not enough time, especially as infrastructure changes typically require budgetary allocations that are part of a broader business planning cycle. We expect that investment managers, particularly global firms, will need at least 18 months to adequately consider and implement the final measures that are adopted by member states across Europe.

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For the foregoing reasons, the IAA recommends that investment managers be granted additional time to comply with the relevant provisions governing dealing commissions. We appreciate your consideration of our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Bob Grohowski, General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/ Sanjay Lamba
Assistant General Counsel

July 20, 2015

Via Electronic Mail

Ms. Maria Teresa Fabregas Fernandez
Head of Unit C3 Securities Markets
DG FISMA
Rue de Spa 2
1000 Brussels

Re: Use of Dealing Commission under Article 24 of MiFID II

Dear Ms. Fabregas Fernandez:

The Investment Adviser Association (IAA) wishes to comment on the practical implications of ESMA's final technical advice to the European Commission regarding implementation of MiFID II. Our comments reflect the perspective of global investment managers affected by implementation of MiFID II as it relates to execution rates from brokers that include financial research as part of the brokers' overall services (*i.e.*, dealing commission). While we maintain the positions expressed in our two prior letters on this challenging topic,[1] we are writing again to stress that the changes contemplated are indeed significant. We urge the Commission to provide independent managers sufficient time to assess the impact of the rules on their business models and implement related compliance controls.

The IAA is a not-for-profit U.S. association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. Our membership consists of investment advisory firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment funds, endowments, foundations, and corporations. Many of our member firms manage, or have affiliates that manage, assets for clients in the European Union.

The new EU regulatory regime would mark a significant departure from current practice and existing regulatory requirements, and will require firms to make significant changes to compliance infrastructures.

We have concerns about the sweeping changes being contemplated and the related burdens that would be imposed on investment managers to come into compliance by the time MiFID II is to take effect. A requirement that independent managers "unbundle" dealing

[1] IAA Letter to Financial Conduct Authority (Oct. 9, 2014) (available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/141009cmnt.pdf); IAA Letter to ESMA (Jul. 31, 2014) (available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/140731cmnt.pdf).

commission arrangements would represent a significant change for the global market. Due to the nature of asset management, many investment managers operate their businesses on a global basis, utilizing brokers around the world to execute portfolio trades and provide research. EU rules on the use of dealing commission that differs from the rest of the world, including the U.S., would present significant practical and logistical issues that would have to be addressed in order to accommodate EU clients or international clients using EU managers. Advisers would be required to carefully assess these changes and implement substantial changes to their global compliance infrastructures to accommodate this new EU regime.

For example, many managers place their orders for securities transactions on a "block" basis, which generally benefits their clients, and orders from EU firms may be aggregated with orders from non-EU affiliates in a group that uses a fully integrated trading and research platform. This practice aims to achieve economies of scale and treat orders from different clients equitably. If the commissions related to these orders were deemed impermissible under EU or EU member state rules or otherwise restricted, managers may feel compelled to separate out clients within those jurisdictions from these otherwise advantageous arrangements. Thus, managers may choose to effectively "ring fence" the arrangements for EU clients and would have to structure their trading programs to minimize potentially negative consequences for EU clients. The manager would also need to change its systems to track payments for research on an ongoing basis (separately and apart from the broker's commission) in an effort by the manager to document the overall execution rate. In addition, there could be burdens associated with manual tracking if brokers do not provide data in an electronic and easily downloadable format.

Moreover, managers would have to consider and address many other operational and administrative issues. For example, firms that chose not to pay third parties directly would have to spend considerable time educating clients on the changes prior to obtaining client agreements to set up separate research accounts. In addition to having to demonstrate the quality of the research to be purchased, managers would also have to meet strict requirements regarding the governance, oversight, and administration of these accounts. As you can imagine, the negotiation of a research budget with each client that is reduced to writing and reviewed on an ongoing basis would result in a magnitude of administrative complexity that is far beyond that in place at firms currently.

Finally, we note that the lack of clarity that presently exists regarding the regime being considered presents a significant hurdle for investment managers as they consider changes to their compliance programs. Firms cannot even start the process of changing their compliance infrastructures until the new requirement is finalized and many technical questions with respect to the establishment and implementation of separate research accounts are answered. These questions include, for example, the treatment of omnibus and separate client accounts; how to resolve so called "free rider" situations where a client does not agree to a research budget but still receives the benefit of research paid for by other clients; clarity on how accounts are to be funded and the role of commission sharing agreements; potential tax consequences; and the implications of holding client money, which many managers are not

authorized to do. In addition, it is far from clear that brokers in non-EU jurisdictions will be willing to accommodate the establishment and implementation of separate research accounts for EU clients, or even be able to accept hard dollar payments for research on behalf of EU clients due to regulatory constraints in their home countries. We are also concerned that given the apparent wide range of views across various countries, unless the final rules regarding the use of dealing commission are agreed to and implemented by EU member states on a consistent basis, and not "gold plated," these compliance hurdles would increase greatly.

It is far from clear that research firms will be willing or able to change existing business pricing models to provide "unbundled" dealing commissions.

The proposals being considered appear to be based on the assumption that there either is or will be an established market for every service, including a "hard" execution-only cost for securities trades. This assumption is false. As we noted in our comment letter to ESMA, we believe that this information is not currently readily available and that brokers may not be willing or able to provide this information in the timeframe currently contemplated under MiFID II. In addition, some brokers may not cooperate in providing a value or even accept payments from an investment manager's own resources for such services. As noted above, this is particularly true with respect to brokers not operating within EU jurisdictions. Even if brokers provided estimated prices for these services, prices among brokers would inevitably vary, depending on the methodologies and assumptions underlying the estimates. Thus, we are concerned that managers would face difficulties in documenting compliance with this unbundling requirement, unless brokers have an established or consistent means of valuing research by the time MiFID II is to take effect.

The current timetable for compliance is not feasible, especially given the lack of clarity on key aspects of the proposed regime.

We understand that the Commission is expected to finalize the delegated acts by September 2015. We note that Parliament could then have up to six additional months to further scrutinize the directive, after which member states will have until July 2016 to transpose MiFID II. A noted above, it is vital that there not only be uniformity across member states but that there also be a workable obligation in place for brokers to provide the required information. It is only at that point that firms can reasonably be expected to begin to implement expensive changes to their compliance infrastructures. In effect, this means that firms will have a transitional period of only six months or less before the directive enters into force in 2017. This simply is not enough time, especially as infrastructure changes typically require budgetary allocations that are part of a broader business planning cycle. We expect that investment managers, particularly global firms, will need at least 18 months to adequately consider and implement the final measures that are adopted by member states across Europe.

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For the foregoing reasons, the IAA recommends that investment managers be granted additional time to comply with the relevant provisions governing dealing commissions. We appreciate your consideration of our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Bob Grohowski, General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/ Sanjay Lamba
Assistant General Counsel

July 20, 2015

Via Electronic Mail

Mr. Lee Foulger
Cabinet Member
Financial Stability, Financial Services and Capital Markets
European Commission
Rue de la Loi / Wetstraat 200
1049 Brussels

Re: Use of Dealing Commission under Article 24 of MiFID II

Dear Mr. Foulger:

The Investment Adviser Association (IAA) wishes to comment on the practical implications of ESMA's final technical advice to the European Commission regarding implementation of MiFID II. Our comments reflect the perspective of global investment managers affected by implementation of MiFID II as it relates to execution rates from brokers that include financial research as part of the brokers' overall services (*i.e.*, dealing commission). While we maintain the positions expressed in our two prior letters on this challenging topic,[1] we are writing again to stress that the changes contemplated are indeed significant. We urge the Commission to provide independent managers sufficient time to assess the impact of the rules on their business models and implement related compliance controls.

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MiFID II is to take effect. A requirement that independent managers "unbundle" dealing commission arrangements would represent a significant change for the global market. Due to the nature of asset management, many investment managers operate their businesses on a global basis, utilizing brokers around the world to execute portfolio trades and provide research. EU rules on the use of dealing commission that differs from the rest of the world, including the U.S., would present significant practical and logistical issues that would have to be addressed in order to accommodate EU clients or international clients using EU managers. Advisers would be required to carefully assess these changes and implement substantial changes to their global compliance infrastructures to accommodate this new EU regime.

For example, many managers place their orders for securities transactions on a "block" basis, which generally benefits their clients, and orders from EU firms may be aggregated with orders from non-EU affiliates in a group that uses a fully integrated trading and research platform. This practice aims to achieve economies of scale and treat orders from different clients equitably. If the commissions related to these orders were deemed impermissible under EU or EU member state rules or otherwise restricted, managers may feel compelled to separate out clients within those jurisdictions from these otherwise advantageous arrangements. Thus, managers may choose to effectively "ring fence" the arrangements for EU clients and would have to structure their trading programs to minimize potentially negative consequences for EU clients. The manager would also need to change its systems to track payments for research on an ongoing basis (separately and apart from the broker's commission) in an effort by the manager to document the overall execution rate. In addition, there could be burdens associated with manual tracking if brokers do not provide data in an electronic and easily downloadable format.

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consequences; and the implications of holding client money, which many managers are not authorized to do. In addition, it is far from clear that brokers in non-EU jurisdictions will be willing to accommodate the establishment and implementation of separate research accounts for EU clients, or even be able to accept hard dollar payments for research on behalf of EU clients due to regulatory constraints in their home countries. We are also concerned that given the apparent wide range of views across various countries, unless the final rules regarding the use of dealing commission are agreed to and implemented by EU member states on a consistent basis, and not "gold plated," these compliance hurdles would increase greatly.

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For the foregoing reasons, the IAA recommends that investment managers be granted additional time to comply with the relevant provisions governing dealing commissions. We appreciate your consideration of our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Bob Grohowski, General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

/s/ Sanjay Lamba
Assistant General Counsel

May 29, 2015

Via Electronic Mail (fsb@bis.org)

Secretariat of the Financial Stability Board
c/o Bank of International Settlements
CH-4002, Basel, Switzerland

Re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Ladies and Gentlemen:

The Investment Adviser Association ("**IAA**")[1] appreciates the opportunity to comment on the FSB and IOSCO's recent consultation on methodologies for identifying non-bank non-insurer ("**NBNI**") global systemically important financial institutions ("**G-SIFIs**").[2] Because the IAA's members are primarily U.S. asset management firms, we have a great interest in the FSB and IOSCO's work on this topic, particularly as it relates to asset managers.

This is a complex topic, and we appreciate that the FSB and IOSCO have published a second Consultation and are seeking additional input in order to consider every angle before moving forward.

Nonetheless, we are disappointed that this Consultation introduces a newly proposed methodology specifically for asset managers. Evidence gathered from the first consultation amply demonstrated that traditional asset management is not a source of systemic risk—not because the FSB and IOSCO's proposed methodology was flawed, but because asset management is fundamentally an agency business where the asset manager is neither a counterparty to nor a guarantor of its clients' investment risks. While the Consultation acknowledges this basic conclusion—that the core function of managing assets as an agent on behalf of others is not a source of systemic risk—it then proposes a new methodology based on hypothetical risks arising from some asset managers' non-core "other" activities.

That approach is misguided, both in singling out asset managers for a sector-specific methodology and, more fundamentally, in pursuing the designation of particular firms as G-

[1] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the U.S. Securities and Exchange Commission. The IAA's membership consists of more than 550 firms that collectively manage approximately $16 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations, and many of our members are part of a global financial services firm. For more information, please visit www.investmentadviser.org.

[2] "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (the "**Consultation**") published by the Financial Stability Board (the "**FSB**") and the International Organization of Securities Commissions ("**IOSCO**"), available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

SIFIs. Any specific activities that raise systemic risk concerns should be evaluated across all firms and sectors, not through designation of individual asset managers. The Financial Stability Oversight Council (the "**Council**") and the International Monetary Fund (the "**IMF**") appear to recognize this, and have shifted their focus to products and activities.[3] We would encourage the FSB and IOSCO to abandon the designation approach and refocus their efforts along a similar path.

In so doing, it will be important to fully evaluate the impact of current regulatory developments with respect to the U.S. asset management industry. The Securities and Exchange Commission (the "**SEC**"), which is the primary regulator of U.S. asset managers, is undertaking several substantial initiatives that will address financial stability concerns, including regulatory proposals for liquidity management, stress testing, transition planning, and enhanced data reporting.[4]

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[3] *See* Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001, available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf ("**Notice**") (the Council has directed staff "to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry") at 3.

See also International Monetary Fund's Global Financial Stability Report, available at http://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/c3.pdf ("given that the [asset management] industry is diverse and that differences in investment focus seem to matter significantly for funds' contribution to systemic risk, a product- or activity-based emphasis seems to be important") at 121.

[4] The SEC staff has proposed amendments to Form ADV (the registration and disclosure form for SEC-registered asset managers) that would require asset managers to report more data on separately managed accounts. Asset managers with large total separately managed account regulatory assets under management, and that manage accounts with large net asset values, would be required to report even more data under the Investment Advisers Act of 1940 ("**Advisers Act**"). *See* Amendments to Form ADV and Investment Advisers Act Rules, SEC Release No. IA-4091 (May 20, 2015) (Advisers Act data reporting proposal), available at http://www.sec.gov/rules/proposed/2015/ia-4091.pdf. The SEC has also proposed significant changes to registered investment company ("**registered funds**") reporting requirements, including rule changes that would require standardized, enhanced disclosure about derivatives in investment company financial statements under the Investment Company Act of 1940. *See* Investment Company Reporting Modernization, SEC Release Nos. 33-9776; 34-75002; IC-31610 (May 20, 2015), available at http://www.sec.gov/rules/proposed/2015/33-9776.pdf.

SEC Chair Mary Jo White indicated that "the staff is also developing recommendations to enhance the management and disclosure of liquidity risk by mutual funds and ETFs, and to update the liquidity standards for those investment vehicles. The staff is also reviewing options for specific requirements for the use of derivatives by funds, including measures to appropriately limit the leverage these instruments may create, in addition to enhanced risk management programs for such activities. And the staff is studying new requirements for stress testing by large investment advisers and large funds, as well as provisions for transition plans after a major disruption in an investment adviser's operations." *See* Chair Mary Jo White, *Statement at Open Meeting: Modernizing and Enhancing Investment Company and Investment Adviser Reporting* (May 20, 2015), available at http://www.sec.gov/news/statement/modernizing-investment-company-and-investment-adviser-reporting.html.

For more detailed information on the SEC's rulemaking agenda in this regard, *see* Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Remarks at The New York Times DealBook Opportunities for Tomorrow Conference Held at One World Trade Center, New York, NY (Dec. 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722; David W. Grim, Acting Director, Division of Investment Management, *Remarks to PLI Investment Management Institute 201*5, New York,

We are concerned, however, that the FSB and IOSCO may attempt to go forward with a designation approach, and therefore offer the following comments. We address only those aspects of the Consultation that relate to the proposed methodology for analyzing asset managers.[5] An Appendix contains responses to the questions in Section 7 of the Consultation on sector-specific methodologies for asset managers.

I. Asset Managers' Core Function Does Not Present the Necessary Indicators of Systemic Importance; A Sector-Specific Methodology for Asset Managers Is Unwarranted

According to the Consultation, the objective of the proposed assessment methodologies is to identify NBNI financial institutions whose financial distress or disorderly failure, because of their size, interconnectedness, substitutability, complexity, and cross-jurisdictional activities, would be transmitted to other financial firms and markets and potentially cause significant disruption to the wider financial system and economic activity at the global level.[6] Thus, in order for an asset manager to be a G-SIFI, its failure must significantly disrupt the global financial system and global economic activity. This is—intentionally and rightly—a very high standard, and one that even the largest and most complex asset management firms should not meet.

This conclusion is based on the fundamental nature of asset managers and the regulation of the asset management business, which, as described in more detail below, not only do not create, but indeed mitigate, potential threats to financial stability. These factors must remain central to the FSB and IOSCO's assessment of systemic risk in the asset management industry and consideration of whether a methodology dedicated to asset managers as a separate sector is warranted.

Asset Managers are Agents, with No Balance Sheet Exposure by or to Clients. As the Consultation recognizes, "[t]he core function of an asset manager is managing assets as an

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NY (Mar. 5, 2015), available at http://www.sec.gov/news/speech/remarks-pli-investment-management-institute-2015.html, and David W. Grim, Acting Director, Division of Investment Management, *Remarks to the IAA Compliance Conference*, Arlington, VA (Mar. 6, 2015), available at http://www.sec.gov/news/speech/remarks-iaa-compliance-conference-2015.html.

[5] We note that many of our members serve as investment advisers to registered funds, non-U.S. public funds, and/or private funds (generally, "**funds**"). While we focus on asset managers here, we submit that the FSB and IOSCO's proposed methodology in the Consultation also is flawed with respect to its analysis of funds and therefore support the letters submitted by the Investment Company Institute and the Managed Funds Association. *See* letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Secretariat of the Financial Stability Board, dated May 29, 2015, and letter from Stuart J. Kaswell, Executive Vice President & Managing Director, General Counsel, Managed Funds Association, to Secretariat of the Financial Stability Board, dated May 29, 2015.

[6] According to the Consultation, "[t]he NBNI G-SIFI assessment methodologies aim to measure the impact that an NBNI financial entity's failure can have on the global financial system and wider economy, rather than the probability that a failure could occur." *See* Consultation at p. 10.

agent on behalf of others."[7] The nature of this agency business, where the adviser acts merely as an agent in managing assets owned by clients who are seeking exposure to certain investment strategies and their attendant investment results, is reflected in 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,[8] 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 using the assets of one client to meet the obligations of another client. 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 banks or broker-dealers, which often act as principals in their dealings with customers or act with respect to their own balance sheet in ways that might put their customers' assets at risk.[9] Prudential regulations are designed accordingly, to ensure that the firm can make good on its promises. Capital requirements for banks protect against depositors losing the value of their deposits and incentivize 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 help to manage the orderly liquidation of a broker-dealer and the transfer of customer assets to another broker-dealer.[10]

Asset managers make no such promises. Unlike banks or broker-dealers who 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 other counterparties' 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

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[7] *Id.* at 47.

[8] 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.

[9] The Consultation states that "asset managers tend to have small balance sheets and the forced liquidation of their own assets would not generally create market disruptions." Consultation at 48.

[10] 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.

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 than the risks 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.[11] 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.

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 expressly guarantee investment performance.[12] Instead, as the Consultation notes, "the client assumes the risk of investing."[13]

No Recourse. Asset managers are separate and distinct legal entities from their clients. 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 custodians in segregated accounts to maintain this strict separation from the adviser.[14] Creditors of the custodian and the asset manager do not have recourse to the clients' assets held in custody by the custodian.

Substitutability. The Consultation clearly recognizes that the asset management industry is large and diverse and asset managers generally are highly substitutable.[15] It

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[11] There is a difference between market or investment risk and systemic risk. In the words of the Council, "investment risk is inherent in capital markets, representing a normal part of market functioning." *Notice, supra* note 3, at 4. As Chair White recently noted, "Our objective . . . is not to eliminate all risk. Far from it. Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors." White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

[12] Although not legally required, it is theoretically possible that an asset manager might decide to support a fund to cushion investors against possible losses for moral, business, or reputational reasons. For example, this has occurred in the fixed NAV money market fund context. The SEC recently adopted rules bolstering the regulation of money market funds.

[13] *See* Consultation at p. 47.

[14] As the Consultation acknowledges, "Asset managers generally use third-party custodians to hold investor assets, as required by regulation or as a best practice." Consultation at 47.

[15] In the U.S., as of April 8, 2015, 11,473 investment advisers were registered with the SEC. *See* Investment Adviser Association and National Regulatory Services, "2015 Evolution Revolution Report: A Profile of the Investment

implies, however, that there are no substitutes for at least some strategies, as it notes that there are "numerous substitutes existing for *most* investment fund strategies" [emphasis added]. We think that even this limited concern is misplaced. Asset managers implement a diverse range of investment strategies. There are very few strategies that are so exceedingly unique that they are concentrated in just a few firms. In those rare cases, the uniqueness is likely a function of the strategy, not the instruments (equity, debt, derivatives) used to implement it.[16]

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 occur in an orderly fashion and do not deprive clients of essential or irreplaceable services.[17]

For all of these reasons, the distress or failure of an asset manager would not cause significant disruption to investor assets, much less to the wider financial system and economic activity at the global level. Accordingly, a specific G-SIFI sector methodology for asset managers is unwarranted.

II. Separately Managed Accounts are not Globally Systemically Risky

The Consultation suggests that, among the types of client accounts an asset manager manages, separately managed accounts ("**SMAs**")[18] might be "one of the channels through

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Adviser Profession," *forthcoming at* https://www.investmentadviser.org. Go to Publications >> Reports >> Evolution Revolution Reports >> 2015 Evolution Revolution Report.

According to the Consultation, "The responses received on the January 2014 Consultative Document noted that the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies." Consultation at p. 35. The Consultation also states that "asset managers primarily provide advice or portfolio management service to clients on an agency basis. This model makes their provision of this particular activity generally substitutable as there is considerable competition in the market place. For example, investors at any time may choose to move their assets to a different asset manager, to a different investment strategy or to a different investment fund. In addition, third-party custody arrangements facilitate the substitution of asset managers, depending on the circumstances." Consultation at 49.

[16] And in any event, it is important to recognize that ultimately people—not firms—implement strategies. In the event that a firm fails, the talent and skills of its personnel will not be "lost" or "in need of replacement" in any long-term or systemic sense.

[17] According to the Consultation, "Several responses [to the first consultation] stated that many asset managers may enter and exit the market on behalf of clients regularly in an orderly manner without any global systemic impact and that clients (including investment funds) readily move assets from one manager to another. Further, responses noted that in many cases where investors change asset managers, assets may never move from an existing custodian, and there may be no immediate sales of assets in the market." Consultation at 49.

See also Exhibit B to letter from BlackRock, Inc. to Secretariat of the Financial Stability Board, dated April 4, 2014, *Firm and Fund Closures and Related Events in the Asset Management Industry over the Past 25 Years*.

[18] We caution the FSB and IOSCO to be precise in their terminology regarding SMAs. Because the term "separate account" has a very different meaning in the insurance context, it is important to distinguish SMAs from insurance company separate accounts in order to avoid confusion. SMAs are individual client accounts that are not included on the asset manager's balance sheet and are generally held in a segregated account at an independent custodian. In contrast, an insurance company separate account, which is generally designed for investment-linked variable annuities, is reflected on the insurance company's balance sheet to the extent there is a call on the general account

which distress at the level of an asset manager might transmit risk to the wider financial system."[19] This concern seems to be based on the potential for substantial transfers of SMAs in a way that could adversely affect the global financial system.

SMAs do not present systemic risk concerns. SMAs are individual client accounts of securities and other assets owned by the client that are managed pursuant to specific investment guidelines and strategies of the individual client under an investment management agreement. Larger SMAs are generally owned by sophisticated investors. The investment management agreement is negotiated between the asset manager and the client, and is used to implement customized investment strategies and parameters established at the direction of a single investor. SMAs typically reflect a long-term investing mandate that utilizes little leverage at the account level and few investments in derivatives.[20] Securities lending is not common in SMAs, and in any event, the decision to lend the client's securities is made by the client, not the asset manager.

Moreover, separate accounts provide asset owners direct ownership and control of investment assets, without the pooling present in investment funds or other collective investment vehicles. As a result, separate accounts have no "first mover advantage"—because there is only one "mover"—and thus no risk of "runs." The Consultation appears to recognize these features of SMAs, noting that they generally do not present risks of "fire sales" or mass redemption.

We understand the FSB and IOSCO's concerns over the potential for the large-scale transfer of SMA accounts upon the failure of a large asset manager, but we believe that the possibility of systemic disruption is highly unlikely, even in such a scenario. In the ordinary course, clients generally may easily transfer SMAs to another asset manager in the event of unsatisfactory performance or in order to pursue different investment strategies simply by removing trading discretion from one manager and granting it to another, providing a high degree of substitutability. Sometimes the client may need to change custodians when changing asset managers but the client often has a direct contractual relationship with the custodian. In those cases, the assets never move and remain invested. If the custodian does change, it is common for the portfolio to be transferred in kind, in which case there is no liquidation event. In the unlikely event that a large SMA manager were to exit the business, it would follow a similar process, but on a larger scale. Accounts would either remain at the

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assets of the insurance company. *See* letter from the Asset Management Group of the Securities Industry and Financial Markets Association ("**SIFMA AMG**") to Secretariat of the Financial Stability Board, dated April 4, 2014, at note 1; *see also* letter from the Committee of Annuity Insurers to the Council, dated March 25, 2015, at 2-3.

[19] *See* Consultation at Note 64.

[20] A recent survey of separate accounts advised by large asset managers showed that nearly all (99%) of the separate accounts in the survey were long-only strategies, the majority (53%) of which were index strategies, and that very few used leverage. *See* Letter from Timothy Cameron, Head, SIFMA AMG, to Secretariat of the Financial Stability Board, Re: "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (Apr. 4, 2014), *available at* http://www.sifma.org/comment-letters/2014/sifma-amg-submits-comments-to-the-fsb-and-sec-in-response-to-ofr-study-and-in-regards-to-separate-accounts/.

same custodian with a different manager, or be transferred to a different custodian and different manager. The transfer would be handled in a clear and established manner so as not to raise systemic concerns. Nothing in the process would necessitate the large-scale fire sale of client assets.

For all of these reasons, SMAs do not present unique risks to financial stability and do not warrant separate treatment in the FSB and IOSCO's G-SIFI methodologies.

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

Asset management is a highly and comprehensively regulated business. In order to provide professional discretionary or non-discretionary investment advice to their clients regarding investments in stocks, bonds, and other securities, as well as other assets, including real estate, currency, and derivatives, asset managers are subject to various regulatory regimes. Depending on the scope of their particular business, asset managers may be regulated by the SEC, Commodity Futures Trading Commission (CFTC), UK Financial Conduct Authority (FCA), European Securities and Markets Authority (ESMA), and other national or regional securities regulators around the world. They may need to comply with regulations governing (to name a few), disclosure, conflicts of interest, short selling, soft dollars, and dealing commission. Many types of products or accounts implicate other regulatory regimes, such as those applicable to insurance or pensions.

Our focus in this letter is on U.S. asset managers, which are regulated by the SEC under the Investment Advisers Act of 1940 ("**Advisers Act**"). Like many countries, the regulatory regime in the U.S. includes a framework of 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.[21]

The fiduciary duty is overarching—an overlay on the specific rules and regulations to which asset managers are subject. These generally include, for example, anti-fraud provisions under various securities laws; rules governing safeguarding of client funds and securities; rules governing advertisements, marketing materials and other communications with investors; rules

[21] 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 as a matter of law, which includes both a duty of loyalty and a duty of care. For example, an adviser "should not engage in any activity in conflict with the interest of any client, and [an adviser] should take steps reasonably necessary to fulfill [its] obligations. [An adviser] must employ reasonable care to avoid misleading clients and [advisers] must provide full and fair disclosure of all material facts to [the adviser's] 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.

regarding 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) and rules on the supervision of employees; privacy regulations relating to client information; and recordkeeping and reporting rules.

Most importantly in the context of this Consultation, as fiduciaries, asset managers must invest their clients' assets pursuant to investment mandates determined by their clients. In this fiduciary capacity, asset managers actively manage portfolio risks associated with those mandates, applying their professional judgment to help clients achieve their investment goals without taking on unnecessary risks.

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 proposed form and rule amendments that will require asset managers to report even more data about their operations, including information on SMAs. The SEC also is undertaking initiatives to collect additional information about leverage, securities lending, and other areas.

We believe that taken as a whole, the regulatory regime for asset managers should mitigate concerns over systemic risk that would necessitate a separate G-SIFI methodology for asset managers.

IV. The SEC's Current Rulemaking Agenda Should be Taken Into Account with respect to U.S. Asset Managers

If the FSB and IOSCO pursue the approach we recommend of analyzing products and activities, it will be very important to fully evaluate the impact of the SEC's current initiatives with respect to the U.S. asset management industry. The SEC's rulemaking agenda includes regulatory proposals to proactively address the risks posed by asset managers and funds regarding liquidity management, stress testing, transition planning, and enhanced data reporting, as described in more detail below.[22]

Liquidity Management. SEC staff is developing recommendations for rulemaking to enhance controls on risks related to portfolio composition (the mix and impact of investments, liquidity, and leverage on a fund) and operations, including registered funds' fund-level controls in the areas of liquidity risk and the use of derivatives. SEC staff is considering broad risk management programs for mutual funds and exchange-traded funds (ETFs), as well as updated liquidity standards, disclosures of liquidity risks, or limits on leverage created by a fund's use of derivatives.[23]

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[22] *Supra* note 4.

[23] *Supra* note 4.

Stress Testing. SEC staff is considering appropriate ways to implement annual stress testing by large asset managers and large registered funds, as required under the Dodd-Frank Act.[24]

Transition Planning. The staff is preparing recommendations that would require asset managers to create plans for transitioning their clients' assets in the event of a market stress event, a major business disruption, an asset manager's dissolution or the departure of key personnel, or when an asset manager is no longer able to serve its clients.

Enhanced Data Reporting. SEC staff is developing recommendations to modernize and enhance data reporting to better assess and respond to risks at the registered fund level and across the asset management industry. These include rules with respect to the reporting and disclosure of registered fund investments in derivatives, liquidity and valuation of registered fund holdings, and securities lending practices. The staff has proposed amendments to Form ADV (the registration and disclosure form for SEC-registered asset managers) that would require asset managers to report more data on separately managed accounts. Asset managers with large total separately managed account regulatory assets under management, and that manage accounts with large net asset values, would be required to report even more data.[25]

We believe that these initiatives will enable the SEC to better monitor and address risks across the asset management industry in the U.S. If after studying whether these new regulations adequately address potential systemic risks, certain activities are still deemed to pose risks to the global financial system and wider economy, then the FSB and IOSCO should consider further recommendations focused on specific activities demonstrated to create systemic risk.

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[24] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4, at note 27, citing Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, section 165(i)(2), 124 Stat. 1423 (2010) (codified at 12 U.S.C. § 5365) ("The Dodd-Frank Act requires the Commission to establish methodologies for this stress testing of financial companies such as broker-dealers, registered investment companies and registered investment advisers with $10B or more in total consolidated assets—including baseline, adverse, and severely adverse scenarios—and to design a reporting regime for this stress testing, which must be reported to the Commission and the Federal Reserve Board.").

[25] The new proposal would require: (i) for all asset managers, the amount of separately managed account regulatory assets under management ("**RAUM**") invested in ten asset categories: (1) exchange-traded equity securities, (2) U.S. government/agency bonds, (3) U.S. state and local bonds, (4) sovereign bonds, (5) corporate bonds – investment grade, (6) corporate bonds – non-investment grade, (7) derivatives, (8) securities issued by registered investment companies or business development companies, (9) securities issued by pooled investment vehicles (other than registered investment companies), and (10) other (asset managers with $10 billion or more in separately managed account RAUM would report this data with a mid-year and year-end value); (ii) for asset managers with at least $150 million but less than $10 billion in separately managed account RAUM, the number of SMAs the asset manager advises with derivatives according to net asset value and gross notional exposure and the weighted average amount of borrowings in those accounts; and (iii) for asset managers with at least $10 billion in separately managed account RAUM, derivatives exposure and borrowing information, as well as the weighted average gross notional value of six categories of derivatives. *See* Advisers Act data reporting proposal, *supra* note 4.

V. G-SIFI Designation Would Not Achieve Regulatory Goals; The Focus Should be on Products and Activities

We support efforts to identify and mitigate systemic risk in the financial system. However, we fundamentally believe that the most effective way for the FSB and IOSCO to achieve their regulatory goals is a shift in focus from the designation of asset managers as G-SIFIs to the identification of, and perhaps further monitoring of, specific market-wide products and activities that could have a potential negative impact on the global financial system and wider economy.

The designation of an individual asset manager would lead, presumably, to additional constraints on that individual asset manager's activities.[26] In our view, this selective regulation of a small number of asset managers is a misguided approach that would likely have a number of adverse regulatory and market consequences. First, it would create an unlevel playing field, imposing additional costs and burdens on those managers designated as G-SIFIs. To the extent that those costs and burdens translated into higher operating expenses or reduced investment performance, investors could (and likely would) move their assets away from designated asset managers to other asset managers who can pursue the same or similar strategy.

Second, the imposition of prudential regulation on an asset manager as a G-SIFI could cause tension with its fiduciary duties to its clients. Prudential regulation is premised on actions that protect the safety and soundness of the institution and/or the system. Fiduciary duties are premised on doing what is in the client's best interest. Asset managers cannot—and should not be made to—make investment decisions for their own good or the good of the system as a whole. They must do what is right for their client. A prudential overlay on a firm designated as a G-SIFI could significantly impede that firm's ability to follow client directives and apply its own judgment premised on fiduciary duties, risk management, and regulatory compliance. The FSB and IOSCO have not shown that superimposing a prudential regulator's judgment over that of an asset manager acting in the best interests of its clients is justified.

Third, and perhaps most importantly, a designation approach ignores the practical reality that any risk in the asset management industry is not concentrated in individual entities, but rather broadly distributed and borne of practices engaged in by many industry participants across sectors. G-SIFI designation may constrain certain activity by a few large asset managers, but other asset managers may collectively account for more of that activity than the largest firms. As a result, the constraints on the largest firms would not eliminate and may not even meaningfully reduce the overall level of risk associated with those activities.

For all of these reasons, we see a designation approach as counterproductive to the overarching goal of reducing systemic risk. The better approach is to seek to address any risks

[26] Since no prudential measures to regulate supposed G-SIFI asset managers have been proposed, it is impossible to know precisely what would be achieved by any designation.

arising from the activities asset managers conduct and products they offer on an industry-wide basis that is not restricted to a small number of entities. This is consistent with the approach being taken by the Council and the IMF.[27]

We urge the FSB and IOSCO to refocus their efforts along those lines. In keeping with their mandates, the FSB and IOSCO should seek to explore whether activities-based regulation that would address financial stability concerns is lacking, and assess whether targeted regulatory enhancements would be necessary and appropriate.

VI. Conclusion

We appreciate the FSB and IOSCO's work on systemic risks and their efforts in publishing this second consultation to consider additional input before moving forward. But we continue to believe that, by virtue of their basic structural and regulatory characteristics, asset managers would not experience distress or fail in a way that would cause significant disruption to the global financial system and economic activity across jurisdictions. As a result, the newly proposed sector-specific methodology for asset managers is unwarranted and inappropriate. The FSB and IOSCO should abandon efforts to designate asset managers as G-SIFIs, and focus instead on addressing risks directly through monitoring or regulation of activities across all firms and sectors.

* * *

We appreciate the opportunity to provide comments on the Consultation and would be pleased to provide any additional information. Please contact the undersigned, Bob Grohowski, General Counsel, or Laura Grossman, Assistant General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully submitted,

Karen Barr
President and Chief Executive Officer

Appendix

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[27] The Council has directed staff "to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry", *Notice*, *supra* Note 3, at 3.

The IMF stresses the importance of a products or activities-based approach, asserting that "the analysis shows that larger funds and funds managed by larger asset management companies do not necessarily contribute more to systemic risk: the investment focus appears to be relatively more important for their contribution to systemic risk." *supra* Note 3, at 93.

APPENDIX

Responses to Questions in Section 7 of the Consultation

7.1 Definition of Asset Managers

Q7-1. Please describe any activities or services conducted by asset managers other than described above. In particular, please explain any other activities that, in your view, should be included in the scope.

We believe that the Consultation has identified the appropriate scope of asset manager activities and services. In determining whether to adopt a sector-specific methodology for asset managers, we encourage FSB and IOSCO to focus on core activities and services. An asset manager's core function is to manage assets as an agent on behalf of others. For the reasons described in detail in our letter, applying the methodology proposed in the Consultation to these core activities and services leads to the conclusion that the failure of an individual asset manager should not significantly disrupt the global financial system and global economic activity.

Any ancillary activities (*e.g.*, acting as a securities lending agent or providing risk management or pricing services) are not core asset management functions and are not widely or solely engaged in by asset managers. Therefore, the most effective way to address any perceived systemic risk posed by these activities would be further monitoring or regulation across industries and sectors, rather than through designating individual asset managers as G-SIFIs.

7.2 Transmission Channels

Q7-2. Please explain any potential systemic risks associated with the financial distress or default of an asset manager at the global level that are, in your view, not appropriately captured in the above description of each risk transmission channel. Are there elements of the relevant channel that have not been adequately captured? Please explain for the relevant channel separately.

We believe that the Consultation has appropriately captured the "transmission channels" by which the distress or failure of a market participant hypothetically could lead to losses on the part of counterparties or other market participants. However, although the concept of distress or disorderly failure is important to an analysis of systemic risks, as discussed in our letter, it is ill-fitting in the context of asset managers. Because of the nature of their business, asset managers simply do not fail in the same way that large, complex and highly leveraged financial institutions, such as banks, insurance companies, and investment banks might.

In order to achieve the overarching goal of reducing systemic risk, the better approach is to seek to address the risks arising from the activities and services identified in the

Consultation across all firms and sectors, rather than through designation of individual asset managers.

Q7-3. For the exposure/counterparty channel, to what extent does the assessment adequately describe the types of risks posed by asset managers' activities, such as securities lending, distinct from individual funds? Are there other activities that warrant further assessment?

The FSB and IOSCO are correct to focus on asset managers' activities "distinct from individual funds." And in this regard, the assessment adequately describes the types of risks posed by the identified activities. We submit, however, that these activities are not exclusive to or even prevalent among asset managers.

When considering any risks posed by asset managers' activities, we urge the FSB and IOSCO to keep in mind that asset management is fundamentally an agency business—asset managers are agents of their clients. The asset manager is not the asset owner. It does not lend its own securities. The asset manager does not act as the counterparty to or on behalf of its clients, and so cannot default in any way that would imperil client or counterparties' assets.

As described in our letter, the nature of an agency business limits systemic risk. The distress, failure, or resolution of an asset manager does not lead to counterparties' losses or impairment, create distress for other market participants, or create obstacles in transferring its business.

The Consultation notes that this transmission channel is intended to focus on "risks that asset managers may transmit to the global financial system when *their* distress or failure leads to losses or other impairment to *their* counterparties, including banks or brokers that have extended *them* financing or have direct trading linkages to *them*" [emphasis added].[1] We agree with this formulation, but would point out that asset managers do not have counterparties as a result of managing client assets and that there are few, if any, meaningful instances where the asset manager will have direct financing or trade linkages with a bank or broker-dealer.

Q7-4. For the asset liquidation/market channel, to what extent and under what circumstances might reputational or operational risks of the asset manager impact the entity's individual funds, contributing to high redemptions? How might it impact the transfer of SMAs?

We agree that a reputational or operational concern may lead to redemptions or clients otherwise leaving an asset manager. As noted in our letter, in the asset management business, clients hire and fire asset managers regularly. Clients can leave managers due to reputational concerns, such as compliance or regulatory problems or loss of key personnel. Even on a large scale, however, products and services offered by asset managers are structured in ways (such

[1] Consultation at 48.

as the use of third-party custodians) that minimize the risk of disruptions associated with those kinds of flows. For example, Strategic Insight recently studied the effects of star portfolio manager Bill Gross' departure from PIMCO in late September 2014. It found that:

> Interestingly, and despite extraordinary redemptions, the investment performance of the PIMCO fund roughly matched that of its peers (as compared to the Intermediate-Term Bond Morningstar Category) during the closing months of 2014.The nearly $80 billion of net liquidations out of this fund during the September to December 2014 period, representing over one-third of this flagship fund's assets, did not result in price dislocation for the fund or for the bond market.[2]

There are a number of potential reasons for this, including that asset managers employ a variety of portfolio risk management techniques, which may include stress tests and liquidity standards.[3] Large asset management firms in particular have very sophisticated risk management and monitoring tools. In addition, as outlined in our letter, SEC initiatives are underway to enhance risk management related to portfolio composition.[4] All of these techniques ensure that funds are able to handle redemption requests, even on a large scale.[5]

Many asset managers, including large ones, sustain reputational or operational risks without any global systemic impact. While reputational or operational risks of an asset manager could lead to transfers of some SMA accounts (while others may judge it prudent to remain), any such transfers are unlikely to raise systemic concerns. In ordinary times, clients may easily transfer SMAs to a different manager in the event of unsatisfactory performance or in order to pursue different investment strategies simply by removing trading discretion from one manager and granting it to another, providing a high degree of substitutability. Sometimes the client may need to change custodians when changing asset managers but the client often has a direct contractual relationship with the custodian. In those cases, the assets never move and remain invested. If the custodian does change, it is common for the portfolio to be transferred in kind, in which case there is no liquidation event. In the unlikely event that a

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[2] *See* Letter from Avi Nachmany to Jacob Lew, Secretary of the U.S. Treasury, attaching *Mutual Funds and Systemic Risk: The Reassuring Lessons of Stability Amid Past Periods of High Financial Markets Volatility*, Strategic Insight (Mar. 23, 2015), at 15, available at http://www.regulations.gov/contentStreamer?documentId=FSOC-2014-0001-0016&attachmentNumber=1&disposition=attachment&contentType=pdf.

[3] *See* Letter from Timothy Cameron, Head, SIFMA AMG, to Secretariat of the Financial Stability Board, Re: "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (Apr. 4, 2014), available at http://www.sifma.org/comment-letters/2014/sifma-amg-submits-comments-to-the-fsb-and-sec-in-response-to-ofr-study-and-in-regards-to-separate-accounts/ and the accompanying survey of some of the key characteristics of separate accounts, at 9-12.

[4] *See* Note 4 to our letter.

[5] Outside of the context of reputational or operational risk, analysis suggests that, in general, mutual fund investors do not act with a herd mentality, and some investors make countercyclical investment decisions. *See Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, Strategic Insight (Nov. 13, 2013), at 5.

large SMA manager were to exit the business, it would follow a similar process, but on a larger scale. Accounts would either remain at the same custodian with a different manager, or be transferred to a different custodian and different manager. Nothing in the process would necessitate the large-scale fire sale of client assets.

Q7-5. For the critical function/substitutability channel, are there any emerging activities that might be critical to a portion of financial clients that might in turn impair market functioning or risk management if no longer provided? Other than managing assets as an agent (i.e. core function), to what extent do asset managers engage in activities that may be relied upon by investors, financial institutions and corporations, and which are difficult to readily substitute? Is any asset manager difficult to substitute?

For the reasons set forth in our letter, we do not believe that asset managers engage in activities apart from their core function that are so critical and unique that the asset manager would be difficult to substitute. Asset managers do not typically themselves provide pricing services or act as a securities lending agent. Rather, asset managers may rely on affiliated or unaffiliated service providers to perform these functions, if such functions are part of their business model.

As explained in our letter, with respect to their core functions, asset managers are highly substitutable. The asset management market is large and diverse,[6] and in the unlikely event an asset manager went out of business, clients would move to one of many competitors. Asset managers are familiar with and are able to conduct transition management efficiently and quickly when necessary. If there were a delay in transferring the advisory contracts to another asset manager, this would not rise to the level of a systemic risk.

Transition management services are a highly evolved and sophisticated professional field within the industry, as leading asset managers and other service providers routinely assist in the restructuring or migration of assets from one asset manager to another. Transition management specialists help minimize transaction costs while managing investment and operational risks. Transitions are also facilitated by technology and other service providers such as custodians.

7.3 Materiality thresholds

Q7-6. Please explain any practical difficulties in applying the above proposed thresholds for an initial filter of the asset manager universe and limiting the pool of asset managers for which more detailed data will be collected and to which the sector-specific methodology (set out in Section 7.4) will be applied.

[6] In the U.S., as of April 8, 2015, 11,473 investment advisers were registered with the SEC. *See* Investment Adviser Association and National Regulatory Services, "2015 Evolution Revolution Report: A Profile of the Investment Adviser Profession," *forthcoming at* https://www.investmentadviser.org. Go to Publications >> Reports >> Evolution Revolution Reports >> 2015 Evolution Revolution Report.

The Consultation notes that the definition of the materiality threshold "is especially relevant for the activities where the asset manager does not act as an agent, but for its own account."[7] We agree, and submit that any materiality threshold should be based on the asset manager's balance sheet assets that reflect its own assets. The Consultation notes, accurately, that asset managers tend to have small balance sheets.[8]

When assessing an asset manager's balance sheet, please be aware that there is currently some uncertainty regarding the circumstances in which the assets of third party non-proprietary funds managed by the asset manager should be excluded from the asset manager's total assets, even if those funds are required to be consolidated under U.S. GAAP.[9] As a result, for some asset managers of private funds, a consolidated balance sheet may overstate the extent to which the asset manager's own balance sheet assets are at risk.

On the other hand, assets under management ("**AUM**") are not an appropriate indicator of systemic risk. For all of the reasons explained in our letter, given the agency model of asset managers, higher AUM does not translate into higher systemic risk. Accordingly, we see no merit in a threshold based on AUM.

Q7-7. Please provide alternative proposals, if any, for a more appropriate initial filter (with the rationale for adoption and quantitative data to back-up such proposals).

We think that a focus on an asset manager's own assets reflected on its balance sheet is the right approach, making alternative proposals unnecessary.

7.4 Indicators for assessing systemic importance

While, ultimately, we recommend that the FSB and IOSCO abandon the G-SIFI designation approach, we offer the following specific observations.

Size. An asset manager's size alone should not be used to assess systemic risk. Products and activities, rather than size, should be analyzed to determine the impact, if any, on risk to the global financial system. Further, the largest asset managers have sophisticated risk management processes in place and may have diversified businesses. Indeed, we are not aware of any empirical data or academic study indicating that larger asset managers are

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[7] *See* Consultation at 50.

[8] *Id.* at 48.

[9] Accounting standards currently require asset managers to consolidate certain investment funds that they manage on their balance sheets when preparing financial statements in conformity with U.S. generally accepted accounting principles ("**U.S. GAAP**"). However, in February 2015, the Financial Accounting Standards Board ("**FASB**") issued an Accounting Standards Update that amends the current guidance. *See* Financial Accounting Standards Board (FASB) Accounting Standard Update (ASU) No. 2015-02, Consolidation (Topic 810): Amendments to the Consolidation Analysis (Feb. 18, 2015), available at http://www.fasb.org/jsp/FASB/Document_C/DocumentPage?cid=1176164939022&acceptedDisclaimer=true. The amendments are effective for future reporting periods.

systemically riskier than smaller asset managers, or that the size of an asset manager has any impact on the financial system should an asset manager fail, experience distress, or otherwise dissolve. As a result, looking at an asset manager's size in isolation is not a useful initial filter.

Because size does not accurately capture the risk profile of an asset manager, size should not be a dispositive factor in assessing how to protect against systemic risk. As mentioned in our letter, a focus on size is also at odds with the Council and the IMF's view. Rather than size, a market participant's products and activities, regardless of sector, are much more likely to be indicators of activity that could cause "significant disruption to the global financial system and economic activity across jurisdictions."

Size: Net Assets Under Management. The Consultation states that where possible, AUM should be "split" according to assets managed in funds and SMAs. We do not believe that this classification has any bearing on assessing systemic risk at the asset manager level because, in either case, the assets of a fund or a separate account belong solely to the fund and its shareholders, or the separate account owner, respectively, and are not at risk should the asset manager fail. See the discussion under Section I, "Asset Managers' Core Function Does Not Present the Necessary Indicators of Systemic Importance; A Sector-Specific Methodology for Asset Managers Is Unwarranted" in our letter.

The Consultation also suggests that the transfer of certain bespoke positions in SMAs might necessitate an unwinding of positions that could have a material adverse effect on certain market segments. Although hypothetically possible, this scenario seems unlikely to present systemic risk. A bespoke strategy likely is a small part of a market segment, particularly if it is dominated by a single manager. Moreover, the failure of that dominant manager would not necessarily result in the rapid unwinding of the SMA positions. Instead, it is possible—and perhaps more likely—that the SMA client would be unable to transfer the account due to difficulty in finding another manager to replicate the strategy, resulting perhaps in a temporary loss of liquidity for the individual client, but no material adverse effects on the overall market or market segments.

Size: Balance Sheet Assets. We submit that the better indicator of risk and complexity is balance sheet assets, not AUM. However, asset managers tend to have small balance sheets and they do not include client assets on their own balance sheets.

Interconnectedness: Leverage ratio. We understand the FSB and IOSCO's concerns about leverage to the extent that leverage could magnify losses. However, leverage is not typically found at the asset manager level. Rather, if a client takes on a certain amount of leverage, it bears the risks, and those risks are restricted, monitored, and managed pursuant to the client's investment objectives.

Interconnectedness: Guarantees and other off-balance sheet exposures. As discussed in our letter, asset managers do not explicitly guarantee the performance or financial obligations of investment funds or clients they manage. There is no legal obligation for an asset manager to back-stop investor or client losses or guarantee investment performance. As a result, there is no reason to believe that asset managers should have significant off-balance sheet exposures. Therefore, while guarantees and other off-balance sheet exposures are an important risk

indicator, they have little bearing for asset managers. To the extent an entity engages in those activities, the activities should be evaluated across all firms and sectors to assess whether targeted regulatory enhancements would be necessary and appropriate.

Substitutability, measured by a percentage of the asset manager's revenues as compared to the total revenues attributable to the relevant business. The vast proportion of revenues for nearly all asset managers comes from their asset management fees—in other words, fees from their core function. As the Consultation recognizes and as our letter explains in more detail, the asset management industry is large and diverse and asset managers are highly substitutable, particularly with respect to that core function.[10]

Market share, measured by a percentage of the asset manager's AUM in a particular strategy as compared to the total AUM invested in the same strategy for all managers. We do not believe that market share is an important risk indicator. As we explain in our letter, asset managers implement a diverse range of investment strategies. There are very few strategies that are so exceedingly unique that they are concentrated in just a few firms. In those rare cases, the uniqueness is likely a function of the strategy, not the instruments (equity, debt, derivatives) used to implement it.[11]

Complexity: Impact of the organizational structure. An asset manager may have an affiliate that experiences distress or failure. However, for the same reasons that the distress or failure of the asset manager would not have an appreciable affect on fund assets or client accounts, any effect on the asset manager from its affiliates' potential distress or failure would be limited in scope. Take, for example, the impact of the failure of Lehman Brothers on its asset management subsidiaries. Within two weeks after it failed on September 15, 2008, Lehman Brothers entered into an agreement to sell its asset management businesses to two private equity firms. Within nine months, the asset management businesses were completely spun off from Lehman Brothers, operating as Neuberger Berman Group LLC under employee control. The failure of Lehman Brothers had an appreciable impact on the asset managers, but the asset management business was able to continue to operate largely intact even as the rest of the firm failed.

Complexity: Difficulty in resolving a firm. Difficulty in resolving a firm is an important indicator of systemic risk, but as explained in our letter, it would be far less difficult to resolve a large asset management firm than other large, complex financial services organizations. Even asset managers that are part of other businesses can be resolved separately and easily. See Section I, "Asset Managers' Core Function Does Not Present the Necessary Indicators of Systemic Importance; A Sector-Specific Methodology for Asset Managers Is Unwarranted" in our letter.

Cross-jurisdictional activities: Number of jurisdictions in which an asset manager has a presence. While cross-jurisdictional activities are an obvious risk indicator with respect to the

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[10] *Supra* Note 15 to our letter.

[11] And in any event, it is important to recognize that ultimately people—not firms—implement strategies. In the event that a firm fails, the talent and skills of its personnel will not be "lost" or "in need of replacement" in any long-term or systemic sense.

global nature of any impact of the distress or failure of a financial entity, activities in multiple jurisdictions are not necessarily more risky. Indeed, geographical diversification may mitigate risk. See also Section III, "The Regulatory Regime for Asset Managers Mitigates Concerns Over Systemic Risk" in our letter.

Q7-8. Please explain any proposed indicators set out above that, in your view, are not appropriate for assessing the relevant impact factors and its reasoning. What alternative indicators should be added and why would they be more appropriate?

As we discuss above, several of the proposed indicators are not appropriate because they do not translate meaningfully to the asset management industry. We do not have any suggestions for additional indicators. The FSB and IOSCO could use the indicators as currently proposed to reasonably conclude, as we have, that no asset manager should be designated a G-SIFI.

As an overarching alternative to the designation approach, we recommend focusing on products and activities, as well as assessing the SEC staff's current initiatives relating to registered fund liquidity management programs, annual stress testing for large asset managers and large registered funds, transition plans for investment advisers, and enhanced data reporting by asset managers.

Q7-9. What are the practical difficulties (e.g. data availability, comparability) if any with collecting data related to these indicators? Please clarify which items, the practical problems, and possible proxies that could be collected or provided instead.

We recognize that the FSB and IOSCO face challenges collecting data to implement the proposed methodologies. As noted in the Consultation, "Given different corporate structures and accounting methodologies, however, it may be difficult to measure the activities of the asset manager (i.e. the calculation of the asset manager's balance sheet may not include the balance sheets of all of the asset manager's affiliates or its off-balance sheet activities, to the extent they exist). Moreover, data regarding an asset manager's balance sheet assets is not as readily available as AUM."[12] Nonetheless, it is critical to evaluate the appropriate indicators, even if the relevant data is more difficult to collect. For reasons explained above, as they consider whether a sector-specific methodology is warranted for asset managers, the FSB and IOSCO should remain focused on the extent to which asset managers—separate and distinct from the funds they manage—place their balance sheets at risk. Assets under management is not an appropriate proxy.

Also, as noted, the SEC has proposed amendments to Form ADV (the registration and disclosure form for SEC-registered asset managers) that would require asset managers to report more data on separately managed accounts. Asset managers with large total separately managed account regulatory assets under management, and that manage accounts with large net asset values, would be required to report even more data.[13] The SEC also is undertaking initiatives to

[12] Consultation at 53.

[13] *See* Amendments to Form ADV and Investment Advisers Act Rules, SEC Release No. IA-4091 (May 20, 2015), available at http://www.sec.gov/rules/proposed/2015/ia-4091.pdf. The SEC has also proposed significant changes to registered investment company reporting requirements, including rule changes that would require standardized,

collect additional information about leverage, securities lending, and other areas that will enable the SEC to better monitor and address risks across the asset management industry in the U.S.

Q7-10. Which of the proposed indicators set out above, in your view, should be prioritized in assessing the systemic importance of an asset manager?

Because firms with large, leveraged balance sheets may be difficult to resolve, we believe that the extent to which a firm's own balance sheet assets are at risk, the extent to which a firm is leveraged, and the relative difficulty of resolving a firm should be prioritized in assessing systemic importance. Applying these metrics to asset managers—which typically have small and simple balance sheets, little or no leverage, and are relatively easy to resolve—we expect the FSB and IOSCO to conclude, as we have, that a sector-specific methodology for asset managers is unnecessary and unwarranted.

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enhanced disclosure about derivatives in investment company financial statements. *See* Investment Company Reporting Modernization, SEC Release Nos. 33-9776; 34-75002; IC-31610 (May 20, 2015), available at http://www.sec.gov/rules/proposed/2015/33-9776.pdf.

April 15, 2015

The Honorable Orrin G. Hatch
Chairman
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable Ronald L. Wyden
Ranking Member
Senate Committee on Finance
219 Dirksen Senate Office Building
Washington, D.C. 20510

Dear Chairman Hatch and Ranking Member Wyden:

We are writing in response to your invitation to stakeholders to submit ideas to the Committee's tax reform working groups on how best to reform the nation's tax code to make it simpler, fairer and more efficient. We applaud your efforts to improve the tax code and strengthen U.S. businesses, and we appreciate the opportunity to provide comments.

Specifically, we are writing to ask that you preserve the cash method of accounting for service pass-through entities, including partnerships and Subchapter S corporations, farmers and ranchers, and personal service corporations. The cash method of accounting is the foundation upon which these types of businesses have built their businesses for decades. Because these businesses are taxed at the owner level, forcing them to switch to the accrual method of accounting would result in an effective tax increase on their thousands upon thousands of individual owners that generate jobs and are integral to the vitality of local economies throughout our nation.

Under current law, there are two primary methods of accounting for tax purposes - cash and accrual. Under cash basis accounting, taxes are paid on cash actually collected and bills actually paid. Under accrual basis accounting, taxes are owed when the right to receive payment is fixed, even if that payment will not be received for several months or even several years. Internal Revenue Code section 448 allows the use of cash accounting for service pass-throughs; qualified personal service corporations; farmers and ranchers; and entities with average annual gross receipts of $5 million or less.

Proposals in the last Congress would have required any business with average annual gross receipts greater than $10 million to use the accrual method of accounting. By raising the threshold from $5 to $10 million, the proposals were intended to reduce recordkeeping burdens on small businesses. However, this expansion was paid for by forcing all other businesses currently using cash accounting to switch to accrual accounting. We do not oppose expanding the allowable use of cash accounting, but it is unfair and inconsistent with generally agreed upon tax reform principles to pay for good policy with bad policy that has no other justification than raising revenues. Further, there have been no allegations that the businesses affected by the proposals are abusing the cash method of accounting.

Pass-through entities account for more than 90 percent of all business entities in the United States and are represented across a diverse range of business professions and sectors. A substantial number of these businesses are service providers, farmers and ranchers that currently qualify to use cash accounting. These are businesses throughout America - farms, trucking, construction, engineers, architects, accountants, lawyers, dentists, doctors and other essential service providers - on which communities rely for services and jobs. These are not just a few big businesses and a few well-to-do owners. According to IRS data, there are over 60,000 Subchapter S corporations, 25,000 partnerships and at least 2,000 sole proprietors that would have to switch from cash to accrual accounting.

The negative impact of such a move would be significant:

Cash flow would be severely impaired. Businesses could be forced into debt to finance taxes, including accelerated estimated tax payments, on money they may never receive. Many cash businesses operate on very small profit margins, so accelerating the recognition of income could be the difference between being liquid and illiquid. Many cash businesses have contracts with the government, which is known for long delays in making payments that already stretch their working capital. Structured settlements and alternative fee arrangements can result in substantial delays in collections, sometimes over several years; taxes owed in the year a matter is resolved could potentially exceed the cash actually collected.

A bad crop year could make a farm go under. For farmers and ranchers, cash accounting is crucial due to the number and enormity of up-front costs and the uncertainty of crop yields and market prices. A heavy rainfall, early freeze or sustained drought can devastate an agricultural community. Farmers and ranchers need the flexibility and simplicity of cash accounting to manage their tax burden by evening out annual revenues that can fluctuate greatly from one year to the next.

Recordkeeping burdens would escalate, in cost, staff time and complexity. Cash accounting is simple - cash in/cash out. Accrual accounting is much more complex, requiring sophisticated analyses of when the right to collect income or to pay expenses is fixed and determinable. In order to comply with the more complex rules, businesses currently handling their own books and records may feel like they have no other choice than to hire outside help or buy expensive software.

These impacts are not about the size of a business or its gross receipts. Whether large or small, a business can have small profit margins, rely on government contracts, generate business through deferred fee structures or be wiped out through the vagaries of the weather. Cash diverted toward interest expense, taxes and higher recordkeeping costs is capital unavailable for use in the actual business, including paying wages, buying capital assets or investing in growth.

Proposals to limit the use of cash accounting are counterproductive to agreed-upon principles of tax reform. Tax reform should strengthen our economy, foster job growth, enhance U.S. competitiveness, and promote fairness and simplicity in the tax code. Accrual accounting does not make the system simpler, but more complex. Increasing the debt load of American businesses runs contrary to objectives to move toward equity financing instead of debt financing and will raise the cost of capital, creating a drag on economic growth and job creation. Putting U.S. businesses in a weaker position will put them at further disadvantage compared to foreign competitors. American businesses and their individual owners should not be asked to pay a significant price for reforms that will leave them in a worse position than when they started.

As discussions on tax reform continue, the undersigned respectfully request that the Committee and the working groups take our concerns into consideration and not propose to change the ability to use cash accounting. We would be happy to discuss any of these items further. Please feel free to contact Mary Burke Baker (mary.baker@klgates.com) or any of the signatories for additional information.

Thank you for your consideration of this important matter.

Sincerely,

American Council of Engineering Companies
American Farm Bureau Federation
American Institute of Architects
Americans for Tax Reform
American Institute of CPAs
Baker Botts LLP
Baker Donelson Bearman Caldwell & Berkowitz PC
Debevoise & Plimpton LLP
Dorsey & Whitney LLP
Dykema Gossett PLLC
Farmers for Tax Fairness
Federal Communications Bar Association
Foley & Lardner LLP
Hunton & Williams LLP
Investment Adviser Association
Jackson Walker LLP
K&L Gates LLP
Littler Mendelson PC
Miles & Stockbridge PC
Mitchell Silberberg & Knupp LLP
Morrison & Foerster LLP
Nelson Mullins Riley & Scarborough LLP
Ogletree, Deakins, Nash, Smoak & Stewart PC
Perkins Coie LLP
Richards, Layton & Finger PA
Ropes & Gray LLP
State Bar of South Dakota
Steptoe & Johnson LLP

cc:
The Honorable John Thune, Co-Chair, Business Income Tax Working Group
The Honorable Benjamin Cardin, Co-Chair, Business Income Tax Working Group
The Honorable Pat Roberts, Member, Business Income Tax Working Group
The Honorable Debbie Stabenow, Member, Business Income Tax Working Group
The Honorable Richard Burr, Member, Business Income Tax Working Group
The Honorable Tom Carper, Member, Business Income Tax Working Group
The Honorable Johnny Isakson, Member, Business Income Tax Working Group
The Honorable Bob Casey, Member, Business Income Tax Working Group

The Honorable Rob Portman, Member, Business Income Tax Working Group
The Honorable Mark Warner, Member, Business Income Tax Working Group
The Honorable Pat Toomey, Member, Business Income Tax Working Group
The Honorable Robert Menendez, Member, Business Income Tax Working Group
The Honorable Dan Coats, Member, Business Income Tax Working Group
The Honorable Bill Nelson, Member, Business Income Tax Working Group

April 15, 2015

Dear Members of the Senate Finance Committee Working Group on Savings & Investment,

The undersigned representatives of plan sponsors, service providers, and employers appreciate this opportunity to comment on the potential impact of tax reform on the private U.S. retirement system and the retirement security of millions of Americans.

Employer-sponsored retirement plans and individual savings arrangements have introduced tens of millions of American workers to retirement saving. Today, about 80 million households[1] have a combined $24.7 trillion earmarked for retirement within defined benefit plans, defined contribution plans, Individual Retirement Accounts (IRAs), and annuities.[2] Eliminating or diminishing the current tax treatment of employer-provided retirement plans and individual savings arrangements would jeopardize the retirement security of tens of millions of American workers, impact the role of retirement assets in the capital markets, and create challenges in maintaining the quality of life for future generations of retirees.

The tax treatment of qualified plans provides significant benefits to employers and employees by encouraging retirement saving. Employers obtain a tax deduction for plan contributions and employees largely save on a pretax basis. Upon retirement, retirees pay ordinary tax rates on the distribution from the plans. Employees do a better job saving for retirement when an employer plan is available. Payroll deduction facilitates the savings habit, and employer matching contributions as well as the Savers' Credit provide further incentives. A large majority of households with defined contribution plans say that the tax treatment of their retirement plans at work are a big reason to contribute and about nine out of 10 U.S. households think that the tax incentives for retirement saving should not be eliminated or reduced.[3] Moreover, a recent survey finds that the single best predictor of retirement readiness is participation in a work-based savings plan.[4]

There have been a number of proposals put forth as alternatives to the current tax treatment for retirement plans. However, there is substantial evidence that changing the tax

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[1] *See* Figure 1 in Sarah Holden and Daniel Schrass, "The Role of IRAs in U.S. Households' Saving for Retirement, 2014," *ICI Research Perspective* 21, no. 1 (January 2015); available at www.ici.org/pdf/per21-01.pdf.

[2] *See* Investment Company Institute, *Retirement Assets Total $24.7 Trillion in Fourth Quarter 2014* (March 25, 2015), available at www.ici.org/research/stats/retirement/ret_14_q4. These figures also include assets held in government-sponsored plans.

[3] *See* Figures 2 and 3 in Daniel Schrass, Sarah Holden, and Michael Bogdan, "American Views on Defined Contribution Plan Saving," *ICI Research Report*, Washington, DC: Investment Company Institute (January 2015); available at www.ici.org/pdf/ppr_15_dc_plan_saving.pdf.

[4] *See* Investment News, *A Survey of Retirement Readiness* (October 2, 2011); available at www.investmentnews.com/apps/pbcs.dll/article?AID=/20111002/REG/310029977. *See also*, Jack VanDerhei, "What Causes EBRI Retirement Readiness Ratings TM to Vary: Results from the 2014 Retirement Security Projection Model,®" *EBRI Issue Brief*, no. 396 (February 2014); available at www.ebri.org/pdf/briefspdf/EBRI_IB_396_Feb14.RRRs2.pdf. This research finds that one of the most important factors in determining whether Gen Xers would have sufficient retirement income is eligibility for participation in an employer-sponsored defined contribution plan.

treatment and/or lowering contribution levels will result in lower retirement savings and fewer workers being offered retirement plans by their employers. Studies by EBRI show that changing the tax deferral to a government matching contribution (while simultaneously making the employer contributions immediately taxable to the employee) or capping the contribution limits will reduce retirement savings at all income levels.[5] Moreover, small business owners may be less likely to offer a plan to their employees if contribution limits are lowered. Consequently, proposals to change the retirement savings system should focus on enhancing the current system, and not sacrificing it to pay for tax reform.

Plan sponsors, service providers, and employers remain committed to providing workers with retirement benefits that will help them prepare for a secure retirement. We are committed to working with the Committee and all of Congress to ensure that the current voluntary and flexible employer-provided and individual retirement plan system continues to flourish and benefit American workers.

Sincerely,

American Bankers Association
American Benefits Council
American Council of Life Insurers
American Retirement Association
Association for Advanced Life Underwriting
College and University Professional Association for Human Resources – CUPA-HR
The Committee on Investment of Employee Benefit Assets
ESOP Association
Financial Executives International Committee on Benefits Finance
Financial Services Institute, Inc.
Financial Services Roundtable
Insured Retirement Institute
Investment Adviser Association
Investment Company Institute
National Association of Insurance and Financial Advisors
NTCA–The Rural Broadband Association
Retirement Industry Trust Association (RITA)
Small Business Council of America
Small Business Legislative Council
Society for Human Resource Management
The ERISA Industry Committee
The Securities Industry and Financial Markets Association (SIFMA)
The SPARK Institute
U.S. Chamber of Commerce

[5] *See* Testimony of Dr. Jack VanDerhei, Research Director, Employee Benefit Research Institute before the House Committee on Ways and Means Hearing, "Tax Reform and Tax-Favored Retirement Accounts" (April 17, 2012); available at www.ebri.org/pdf/publications/testimony/T-172.pdf.

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IAA INVESTMENT ADVISER ASSOCIATION

March 25, 2015

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

Re: Financial Stability Oversight Council Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001

Dear Mr. Pinschmidt:

The Asset Management Group (the "**AMG**")[1] of the Securities Industry and Financial Markets Association ("**SIFMA**") and the Investment Adviser Association (the "**IAA**")[2] appreciate the opportunity to respond to the Notice Seeking Comment on Asset Management Products and Activities (the "**Notice**") published by the Financial Stability Oversight Council (the "**Council**").[3] The members of the SIFMA AMG and the IAA are primarily U.S.-based asset management firms. Our response will focus on the operation, structure, and controls of the products and services offered by our member firms as they relate to the Council's consideration of potential risks to the U.S. financial system.

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[1] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

[2] The IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the SEC. Founded in 1937, the IAA's membership consists of more than 550 firms that collectively manage approximately $14 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit www.investmentadviser.org.

[3] Financial Stability Oversight Council, *Notice Seeking Comment on Asset Management Products and Activities*, Docket No. FSOC-2014-0001, *available at* http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf [hereinafter "*Notice*"].

We value the Council's efforts to better understand the asset management industry and to focus its inquiries. We also appreciate the challenges the Council faces as it seeks to fulfill its mandate to identify and monitor risks to U.S. financial stability across the entire financial system. Our financial markets occupy a strong position relative to other markets around the world. They are governed by regulations that have adapted to market advancements in those markets through the years to make them efficient, resilient and transparent. These qualities encourage investment and enable investors to contribute to, and enjoy the growth of a thriving economy. We believe this regulatory regime should continue to evolve alongside financial and technical innovations, market growth and increasing globalization.

Our industry and the broader financial markets are currently adapting to a tremendous amount of new regulations that the Dodd-Frank Act and other U.S. and international work streams have produced. There are more regulations to come as those efforts have not yet finished. In that context, regulators and participants must work together to evaluate what, if any, further regulatory changes should be considered. To frame our response to the Notice, we respectfully offer three overarching and interrelated observations that inform our comments:

1. **The SEC and the Council have distinct but complementary roles, and the SEC is already assessing issues raised in the Notice. The SEC should lead further inquiries into these issues.**

We acknowledge the Council's present effort to evaluate whether any of the asset management industry's activities or products warrant the collection of additional information by regulators or otherwise require closer monitoring or action by the Council. It is important to emphasize, however, a point that the Council itself has acknowledged: the primary responsibility and expertise for assessing whether new data, regulations or other tools are necessary for asset management industry oversight should remain with the industry's primary regulator, the Securities and Exchange Commission (the "**SEC**" or the "**Commission**").

The SEC's professional staff in the Division of Investment Management ("**IM**"), economists specializing in asset management assessment in the Division of Economic and Risk Analysis ("**DERA**"), and market experts in the Office of Compliance Inspections and Examinations ("**OCIE**"), are best positioned to evaluate whether there may be potential information gaps related to the industry and to propose to the Commission appropriately tailored responses to emerging areas of focus. Although the SEC's regulatory regimes for investment funds and their managers are robust, it is reasonable to consider whether they can be improved in any way. Of the agencies represented on the Council, the SEC is the logical choice to conduct those evaluations and the agency best positioned to fashion and implement any enhancement for most of the industry.

The Commission has already embarked on a program to evaluate each of the issues outlined in the Notice. As SEC Chair Mary Jo White and other SEC officials have noted in a series of recent speeches,[4] the SEC has ably regulated advisers and funds for nearly 75 years,

[4] *See* Chair Mary Jo White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, Remarks at The New York Times DealBook Opportunities for Tomorrow Conference Held at the

guided by the SEC's three-fold mission: to protect investors; to maintain fair, orderly and efficient markets; and to facilitate capital formation. The SEC has consistently adhered to that regulatory mission, implemented mainly through rules and guidance promulgated under the Investment Advisers Act of 1940 ("**Advisers Act**") and the Investment Company Act of 1940 ("**Investment Company Act**") and has created a robust adaptable framework for addressing market developments and changes in the asset management industry. The process of determining whether further refinements are warranted and, if so, how they should be shaped, is a continual one that benefits from the SEC's unique experience and expertise, the notice and comment obligations under the Administrative Procedures Act,[5] and the focus on economic analysis and empirical data that guides the Commission's rulemaking process.

In this context, the Council plays an important role, but we emphasize that the Council should consider its role at this juncture as supportive of the SEC. As Chair White has noted, the Council is "an important forum for studying and identifying systemic risks across different markets and market participants."[6] To date, the Council has not offered any data or analyses to suggest that the asset management industry presents systemic risks. Nor has the analytical work performed by the Office of Financial Research ("**OFR**"), based on data collected by the SEC, uncovered structural or behavioral patterns of systemic concern.

As discussed throughout our response, we believe it is appropriate to look first to the SEC as it launches the Chair's initiatives to consider potential new tools to "enhance and strengthen" our industry's regulatory program through a process "driven by long-term trends in the industry and [informed by] the lessons of the financial crisis."[7] If the Council has performed thorough analyses on which it is basing the hypothetical risks described in the Notice, it should follow the example of the SEC's rulemaking process and publish that analysis so that commenters can address it directly. Similarly, if the Council is extrapolating from academic research, it should make that clear so that commenters can assess the conclusions in the research, the methods used to conduct it, and the assumptions and limitations that qualify it. Transparency will promote better discussion and enable the Council to determine whether any such research provides a reasonable basis for extrapolation or speculation regarding potential systemic risk.

One World Trade Center, New York, N.Y. (Dec. 11, 2014), *available at* (http://www.sec.gov/News/Speech/Detail/Speech/1370543677722; *see also* Chair Mary Jo White, *Chairman's Address at SEC Speaks 2015*, Washington, D.C. (Feb. 20, 2015), *available at* http://www.sec.gov/news/speech/2015-spch022015mjw.html#.VQH3uzvD9aQ (highlighting increased efforts in risk monitoring and plans to continue rulemaking under Dodd-Frank); David Grim, Acting Director, Division of Investment Management, *Remarks to PLI Investment Management Institute 2015*, New York, N.Y. (Mar. 5, 2015), *available at* http://www.sec.gov/news/speech/remarks-pli-investment-management-institute-2015.html#.VQH3QTvD9aQ (discussing regulatory initiatives on which IM will be focusing attention in 2015); Chair Mary Jo White, *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request*, Testimony before the U.S. House of Representatives Committee on Financial Services (Mar. 24, 2015), *available at* http://www.sec.gov/news/testimony/2015-ts032415mjw.html#.VRJtSTvD-M8 (testimony regarding the SEC's recent activities and initiatives and fiscal year 2016 budget request).

[5] 5 U.S.C. § 553.

[6] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry*, *supra* note 4.

[7] *Id.*

We appreciate that the Council acknowledges the SEC's initiatives to evaluate the hypothetical risks described in the Notice as they apply to regulated investment companies and investment advisers.[8] Based on the list of activities identified in the agency's unified agenda[9] and the scope of the measures outlined in Chair White's speech, the SEC's regulatory program for the asset management industry comprehensively addresses the areas outlined in the Notice. The Council plays a very important role in evaluating overall risks in the U.S. financial system, but we believe it is essential for the Council to rely on the expertise of the agencies its individual members represent. The SEC, as the primary regulator of the asset management industry, should lead the assessment of the issues raised in the Notice. If the SEC proposes measures to address any of them, it will do so with appropriate notice and comment. The Council should fully evaluate the SEC's analysis and the measures taken by the SEC to address issues raised in the Notice before considering any further specific action of its own with respect to the asset management industry.

Our member firms are meeting individually and collectively with the SEC staff and providing factual information, data, and experience-rich feedback on the issues under consideration. We look forward to continuing to work with our industry's primary regulator to provide relevant data and assist the SEC in determining the scope of potential proposals.

2. The scope of the Council's assessment of "systemic risk" must be appropriately defined and circumscribed.

The Council recognizes that "investment risk is inherent in capital markets, representing a normal part of market functioning."[10] In its work to study, monitor, and assess potential risks to the U.S. financial system as well as in the Notice itself, the Council and its staff have noted that there is a difference between market or investment risk and systemic risk.[11] As Chair White recently noted, "[the Council's] objective . . . is not to eliminate all risk. Far from it. Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors."[12]

Indeed, in Assistant Secretary Patrick Pinschmidt's remarks at a recent Brookings Institution event, he noted the importance of market risk to a vibrant economy; and he made

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[8] *Notice*, *supra* note 3, at 4.

[9] *See* Unified Agenda of Regulatory and Deregulatory Actions (Fall 2014), *available at* http://www.reginfo.gov/public/do/eAgendaMain?operation=OPERATION_GET_AGENCY_RULE_LIST&currentPub=true&agencyCode=&showStage=active&agencyCd=3235 (describing the SEC's intention to pursue initiatives relating to derivatives use by investment companies, fund liquidity management programs, transition plans for investment advisers, stress testing for large asset managers and large investment companies, and information reporting by investment advisers).

[10] *Notice*, *supra* note 3, at 4.

[11] *Notice*, *supra* note 3.

[12] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

clear that, by distinction, the Council is not interested in regulating market risk itself but, rather, circumstances where risk might be transmitted across sectors in such a way that it causes threats to the U.S. financial system.[13] The scope of the Council's mandate as it relates to the asset management industry (as with other more critical participants in the financial sector) is as a "forum for studying and identifying systemic risks across different markets and market participants."[14]

In this sense, we note that the Notice does not offer convincing predicates to explain how the various hypothetical risks it describes would, in the context of the asset management industry, be converted into systemic risks. Instead, many of the Notice's questions include vague terms as "fire sale", "stressed markets", and "stressed conditions" without defining them. The lack of clear definitions of these and other critical terms makes the exercise of responding to the questions in the Notice more difficult. Commenters can interpret the definitions in many different but equally plausible ways. This, in turn, will reduce the comparability of comments and impede the development of clear definitions and uniform objective standards.

The Notice also presents an imbalanced depiction of the industry. Financial stability can be both enhanced and reduced. As the Council explores asset management products and activities, it should consider the extent to which they enhance financial stability, not just the hypothetical ways in which they might threaten it. Unfortunately, the Notice does not account for the features of pooled vehicles and separate accounts that absorb or diffuse potential risks to the system throughout market cycles. Far from being a source for creating or exacerbating systemic risk, the asset management industry engages in activities and performs functions that consistently moderate such risks.

In addition, we are concerned that the Notice does not recognize the diversity in the industry that distinguishes activities and practices from client to client, account to account, and mandate to mandate. Given these significant variations, asset management activities even within the same investment adviser are not homogenous as they are applied to different portfolios of managed assets. A bank with a single consolidated balance sheet is very different from an asset manager acting as an agent for a variety of clients and whose own balance sheet is largely irrelevant. Although a top-down single point of view might be appropriate for considering banking firms, it is an inappropriate way to think about the asset management industry.

Investment funds and asset managers operate differently than other types of financial entities. Their structural, operational, and behavioral features make it inappropriate to

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[13] Patrick Pinschmidt, Deputy Assistant Secretary, Financial Stability Oversight Council, *Asset Management, Financial Stability and Economic Growth* (Transcript), The Brookings Institution Conference (Jan. 9, 2015), 53-58, *available at* http://www.brookings.edu/~/media/events/2015/01/09-asset-management/20150109_asset_management_transcript.pdf; *see also Remarks of Deputy Assistant Secretary of FSOC Office Patrick Pinschmidt at the Investment Adviser Association's (IAA) 2015 Compliance Conference* (Mar. 5, 2015), *available at* http://www.treasury.gov/press-center/press-releases/Pages/jl9988.aspx.

[14] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

focus on these entities as sources or amplifiers of systemic risk. Asset managers do not manage all of the assets identically. An asset manager with a large amount of "assets under management" is really a collection of many smaller and diverse accounts, each with its own characteristics, objectives, and risk profiles. Investment advisers and funds regularly shut down or have assets migrate from manager to manager with little market impact, but they very rarely fail. As noted elsewhere in this letter, these fundamental attributes of the asset management industry mitigate systemic risks, and we caution against measures that would diminish those positive benefits.

It is investors – not the fund or the asset manager – who ultimately own the assets and bear the investment risk in pooled vehicles. This limits the potential threat to financial stability. If an asset manager leaves the business, its clients' assets will be transitioned to a new manager or managed by the clients themselves, but there is no fundamental economic risk to the underlying client/investor and no threat to the stability of the financial system. The Financial Stability Board ("**FSB**") and International Organization of Securities Commissions ("**IOSCO**") recognized this critical point in their first consultative document, entitled *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemic Financial Institutions* ("**2014 Consultative Document**").[15] In particular, they noted that investment funds are highly substitutable, that asset managers are agents of their clients, that investors provide investment funds with a "shock absorbing" function that differentiates investment funds from banks, and that an investment fund's assets are not available to claim by creditors of the investment fund's manager.[16] Additionally, neither investment funds nor their managers guarantee investment results or backstop losses, and investors control their assets and select investment funds with strategies that meet their investment needs. These fundamental features of investment funds should inform the scope of the Council's assessment of systemic risk in the asset management industry.

Given the lack of clear definitions and concrete parameters in the Notice for the assessment of the asset management industry, we expect this exercise to be the first step in a lengthy and deliberative process to gather relevant and tangible information about whether there is any potential systemic risk in asset management products or services, and if so, to what extent. The next steps will be to define key concepts, establish a balanced framework for analyzing known systemic benefits as well as potential risks, and to gather relevant and tangible information necessary to take those steps.

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[15] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Jan. 8, 2014), at 5, *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf. In its second consultative report, FSB/IOSCO makes similar acknowledgements of the safeguards relating to asset managers and pooled vehicles*; see also* FSB/IOSCO, *Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Mar. 4, 2015) at 47, *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf /.

[16] *See* FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at 29-30.

3. **Thorough data analysis and appropriate coordination among regulators are essential steps to the formation of any potential regulatory responses.**

Any next steps in regulating the asset management industry should be undertaken only after obtaining and evaluating data to enable a more thorough and nuanced understanding of the products and services that comprise this heterogeneous industry. This theme is acknowledged in the Notice and has been underscored in recent papers and remarks by the Council and SEC staff. Not only is such a process an imperative under U.S. federal administrative law, but it also stands in stark contrast to the approach FSB/IOSCO more recently appears to be taking in its second consultative document on *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemic Financial Institutions* ("**2015 Consultative Document**"), where it has proposed arbitrary thresholds for identifying individual funds, asset managers, and other market participants for regulatory scrutiny without premising its methodology on any data.[17]

In recent remarks at the Brookings Institution, Mark Flannery, the SEC's chief economist and director of the DERA, noted his skepticism about the Council and FSB/IOSCO inquiries into asset management as a source of potential systemic risk. He suggested there are difficulties associated with the evaluation of systemic risk, as least as the inquiry has been framed by some regulatory bodies, and cautioned against new regulatory requirements absent better definitions, data, and analysis.[18] We note that the OFR has been collecting data on private funds since the enactment of Form PF, and registered investment company data has been publicly available for many years.[19] The analyses performed by the OFR to date may not be taking advantage of all available data and may not be sufficiently tailored to the unique characteristics of the asset management industry.

Until data is appropriately analyzed, reviewed, and presented in ways that permit regulators and the public to better identify information gaps and specific areas of potential systemic concern, it is premature for the Council to seek to propose changes to the current regulatory environment. Investment funds, their managers and other service providers, like many other market participants, have experienced a remarkable amount of regulatory change

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[17] *See* FSB/IOSCO, *Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Mar. 4, 2015), *supra* note 15. A review of the defects of the 2015 Consultative Document is beyond the scope of this letter.

[18] Mark Flannery, Chief Economist and Director of the Division of Economic and Risk Analysis, U.S. Securities and Exchange Commission, *Asset Management, Financial Stability and Economic Growth* (Transcript), Brookings Institution Conference (Jan. 9, 2015), 58-62. Mr. Flannery also noted that diversification of investments in pooled vehicles seems to spread and reduce market shocks/systemic risks and that roughly every 45 days the capital markets sustain losses equal to 25% of bank capital and those losses are absorbed without comment or issues. *Id.*

[19] The OFR's 2014 Report indicates that they will be "developing a suite of additional monitors and dashboards, focused on money market funds, hedge funds, and credit default swap markets." OFR, *2014 Annual Report*, at 4, *available at* http://financialresearch.gov/annual-reports/files/office-of-financial-research-annual-report-2014.pdf; *see also id.* at 15.

over recent years, the final elements of which are not yet written and cumulative effects of which are not yet apparent. A prudent systemic risk analysis should empirically evaluate the impacts of changes that have followed the recent credit crisis. There may be additional opportunities to design tailored data-gathering initiatives (indeed, both the SEC and the OFR have publicly discussed such possibilities),[20] but we suggest that an analysis of existing available data over a reasonable period of time should be the Council's focus at this stage.

We believe that Chair White and the OFR have outlined important steps that should be taken initially to enable the Commission and the industry to better monitor for risks at the fund level and across the asset management industry. But a clearer analysis of data and deference to the SEC as the primary regulator for the asset management industry are essential prerequisites to any concrete regulatory steps that might be considered by the Council. The SEC has the subject matter expertise to initiate and lead this effort to ensure that any additional proposals are evaluated effectively. Changes to the regulation of the asset management industry, unless appropriately tailored, could themselves create systemic risks. In light of the significant regulatory changes that asset managers continue to incorporate into their businesses since the adoption of Dodd-Frank and other international regulations, we urge the Council to refrain from making specific recommendations for the asset management industry until a more appropriate time, and by no means before the SEC's rulemaking agenda for asset managers and funds has been implemented.

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I. Liquidity and Redemptions[21]

The first section of the Notice asks whether there are features of asset management products and services that might create first mover advantages, especially for products investing in less liquid assets. In particular, the Notice states that "the Council is focused on exploring whether investments through pooled investment vehicles that provide redemption rights, as well as their management of liquidity risks and redemptions, could potentially influence investor behavior in a way that could affect U.S. financial stability differently than direct investment."[22]

Different pooled vehicle structures have different redemption profiles and thus different liquidity requirements, ranging from funds that offer daily liquidity (e.g., open end

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[20] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4; *see also* Richard Berner, Director, OFR, Remarks at the Financial Regulation Summit: Data Transparency Transformation (Mar. 24, 2015), *available at* http://financialresearch.gov/public-appearances/2015/03/24/financial-regulation-summit/.

[21] Each of the following sections offers general observations in connection with the four topics of the Council's inquiry before addressing the specific questions posed in the Notice.

[22] *Notice*, *supra* note 3, at 6-7.

mutual funds) to other types of funds that provide liquidity via listing on an exchange with correspondingly lower liquidity profiles in their portfolios (e.g., listed closed-end funds). In addition to being highly redeemable and liquid, from a pure size perspective, mutual funds have the most assets available for ready redemption of any category of pooled investment.[23] As a result, a focus on mutual fund liquidity and redemptions is understandable. Indeed, mutual fund managers and the SEC have always been focused on the implications of liquidity in the management of such vehicles. In the ordinary course, a certain amount of sales to manage activity is to be expected, as the purchase and sale of underlying assets is part of overall portfolio management. In times of more significant redemptions, a certain amount of additional transaction activity, to respond to increased redemption demands, may be inevitable. The questions are whether these sales: (i) are economically any different from sales by investors who hold the same assets directly or through other structures; and (ii) would cause asset price movements that threaten the stability of the financial system, not just investment performance. For reasons discussed below, we believe the answers to those questions are "no" and that regulatory intervention designed to address hypothetical systemic risks may itself be more harmful than beneficial.

We also note that the landscape of pooled investment vehicles is much broader and more varied when private funds are considered. Private funds can bring multiple investors together – often institutional investors and other sophisticated investors. Private funds can focus on specific strategies, sectors, risk tolerances, or leverage profiles. Some are actively traded and some follow a long-term buy and hold strategy. These funds have their own liquidity profiles, investor objectives, and tools to manage redemptions. While these funds are not registered investment companies, they bring a significant amount of heterogeneous investor interest and liquidity into the capital markets. The variation of strategies and instruments and approaches also helps to illustrate that investors in accounts and funds – registered or private – are not a standardized group.

In addition, it is important to emphasize that different investors have different investment objectives, time horizons, and risk tolerances. Retail investors may manage fund investments in a brokerage account differently than they manage funds in their retirement plan. Institutional investors may have a longer time horizon and more internal investment processes to make methodical decisions. Aside from the investment vehicle itself, the variation in investor behavior supports the point that pooled investment vehicles investors do not tend to act in concert.

From an economic perspective, there is no material difference between the liquidity profile of a direct investment in securities and an investment in those same securities through a pooled fund. There is considerable evidence, explained by sound theory, effective regulation and market practices, that investors do not redeem en masse from variable net asset

[23] As of January 2015, mutual funds represented $15.73 trillion (including $2.69 trillion in money market funds), and ETFs and closed-end funds represented $1.955 trillion and $289.14 billion respectively. Investment Company Institute, "Statistics," *available at* http://www.ici.org/research/stats/trends/trends_01_15, http://www.ici.org/research/stats/etf/etfs_01_15, and http://www.ici.org/research/stats/closedend/cef_q4_14.

value ("NAV") investment funds.[24] Risks associated with liquidity and redemptions in collective funds and other asset management products have never posed a threat to U.S. financial stability.[25] Nor are we aware of any empirical evidence that would show this to be the case for separately managed accounts. The suggestion that they might under some speculative circumstances is an untested hypothesis that is at odds with that empirical data, theory, and experience and assumes that investors make investment decisions without regard to other factors, such as their financial circumstances, needs and goals (e.g., investing in a diversified portfolio to seek to achieve their retirement savings goals).

Speculation is not enough to justify regulatory intervention in capital markets. The stakes are too high for that, and there is always a risk that regulatory intervention would not work as intended or would create unintended negative consequences – both of which could be harmful to efficient and orderly markets and capital formation. On this point, we agree with Federal Reserve Governor Jerome Powell's recent warning that "the Fed and other prudential and market regulators should resist interfering with the role of markets in allocating capital to issuers and risk to investors unless the case for doing so is strong and the available tools can achieve the objective in a targeted manner and with a high degree of confidence."[26]

There is a substantial risk that regulatory intervention targeting asset prices and investor behavior in unknown future market conditions could get it exactly wrong. Regulatory intervention could create unintended consequences that could harm individual investors saving for long-term goals like retirement, increase issuers' cost of capital, negatively impact the diversity and resiliency of markets, and slow U.S. economic growth as a result. Rather than reducing the hypothetical risk, these effects may create other risks that regulators will feel obligated to "solve."[27] This outcome is made more likely if new regulation covers only part of the capital markets and some of its participants (i.e., investors in funds but not other asset

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[24] *See, e.g.*, Sean Collins, *Why Long-Term Fund Flows Aren't a Systemic Risk: Multi-Sector Review Shows the Same Result*, ICI Viewpoints (Mar. 4, 2015), *available at* http://www.ici.org/viewpoints/view_15_fund_flow_04 (noting that outflows from funds tend to be muted, even during periods of financial market turmoil; and that even during periods of stress when funds in aggregate are seeing outflows, some funds typically are seeing inflows).

[25] Note that, in our response to the Notice, we are not addressing issues that may relate to money market funds, which have been the subject of considerable regulatory activity since 2008.

[26] Governor Jerome H. Powell, *Financial Institutions, Financial Markets, and Financial Stability*, Speech at the Stern School of Business, New York, N.Y. (Feb. 18, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/powell20150218a.htm. Governor Powell's view is consistent with the views of other current and former policymakers at the Federal Reserve, including Ben Bernanke and Esther George, as discussed in note 28, *infra*.

[27] A commonly cited example is the reduction in fixed income liquidity that many attribute to the institution of the Volcker Rule and Basel III capital requirements. *See, e.g.*, Robert Stowe England, *Basel II, Banks, Bond Trading and the Volcker Rule*, Institutional Investor (Dec. 12, 2013), *available at* http://www.institutionalinvestor.com/Article/3288912/Basel-III-Banks-Bond-Trading-and-the-Volcker-Rule.html#.VRHiCjvD-M8.

owners) and relies on untested and, with respect to liquidity risk and redemptions in collective funds, undefined "macroprudential tools."[28]

Risks related to liquidity and redemptions in funds are already mitigated by regulation and market practices. A distinguishing feature of collective investment products is that they are designed to take into account anticipated liquidity and redemption pressures. Collective investment vehicles are structured in different ways, presenting varied redemption incentives and profiles. These heterogeneous features have evolved over time, and the range and mix of existing products have inured to the benefit of both investors and the markets. This evolution has been accompanied by the development of regulations and market practices that are calibrated to protect investors and market integrity.

Not surprisingly, there is very little academic research on the subject of liquidity risk and investor behavior. What little there is should be reviewed carefully in this context to account for the methods by which it was produced and the assumptions and limitations that qualify its results.[29] We are aware of no research that substantiates the hypothetical connection between liquidity risk in collective investment funds and the stability of the U.S. financial system.[30]

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[28] *See* Governor Ben S. Bernanke, *Remarks by Governor Ben S. Bernanke*, Speech before the New York Chapter of the National Association for Business Economics, New York, N.Y. (Oct. 15, 2002), *available at* http://www.federalreserve.gov/Boarddocs/Speeches/2002/20021015/default.htm ("...I worry about the effects on the long-run stability and efficiency of our financial system if the Fed attempts to substitute its judgments for those of the market. Such a regime would only increase the unhealthy tendency of investors to pay more attention to rumors about policymakers' attitudes than to the economic fundamentals that by rights should determine the allocation of capital."); *see also* Esther L. George, President and Chief Executive Officer, Federal Reserve Bank of Kansas City, *Monetary and Macroprudential Policy: Complements, not Substitutes*, Speech at Financial Stability Institute/Bank for International Settlements, Asia-Pacific High-Level Meeting, Manila, Philippines (Feb. 10, 2015), *available at* http://www.kansascityfed.org/publicat/speeches/2015-George-Manila-BIS-02-10.pdf (cautioning people not to rely too heavily on untested macroprudential tools to mitigate the risks the central banks are creating with their monetary policies).

[29] In one of the few attempts at an empirical analysis of investor behavior based on historical mutual fund outflow data, the evidence presented does not itself suggest effects of systemic consequence. *See* Qi Chen, Itay Goldstein, Wei Jiang, *Payoff Complementarities and Financial Fragility—Evidence from Mutual Fund Outflows* (Jan. 2008), *available at* https://faculty.fuqua.duke.edu/~qc2/bio/Chen%20Goldstein%20Jiang%20Fund%20Run%20200801.pdf. Among this study's limitations, its authors reviewed data from 1995-2005; excluded retirement shares; only reviewed equity funds, not bond funds; and it appears as if they consider institutional share classes to represent institutional investors exclusively and did not realize that those can be purchased by intermediaries that aggregate retail investors' investments (i.e., omnibus accounts).

[30] *See, e.g.*, Jeremy C. Stein, Member, Board of Governors of the Federal Reserve System, Comments on "Market Tantrums and Monetary Policy," a paper by Michael Feroli, Anil K. Kashyap, Kermit Schoenholtz, and Hyun Song Shin, Remarks at the 2014 U.S. Monetary Policy Forum (Feb. 28, 2014), *available at* http://www.federalreserve.gov/newsevents/speech/stein20140228a.pdf. Former Fed Governor Stein concluded that regulators do not "know enough about the empirical relevance of the AUM-run mechanism, to say nothing of its quantitative importance, to be making recommendations at this point." *Id.* at 6.

Pooled funds provide many individual investors exposure to asset classes that they could not reach without investing collectively. Pooled vehicles provide opportunities for diversification for investors, and these varying exposures held by millions of diverse investors with similarly diverse personal circumstances and investment objectives can serve as a bulwark against systemic pressures.[31] The breadth of different types of investors with different needs, objectives, and limitations provides greater resiliency than if all market participants took the same approaches to investing. FSB and IOSCO have recognized that distributing losses broadly to investors mitigates systemic risk, noting that "from a purely systemic perspective, funds contain a specific 'shock absorber' feature that differentiates them from banks," which mitigates any potential "contagion effects in the broader financial system…." [32]

The most commonly held investment companies, mutual funds, are required to hold at least 85 percent of their assets in securities that can readily be sold.[33] In addition, with very limited exceptions, mutual funds must provide shareholders with redemption proceeds within seven days of any redemption request.[34] At the same time, mutual fund investors do not tend to redeem en masse. In part, this is because these funds are the primary savings vehicles for retirement income; about two-thirds of the total assets in all U.S. equity and balanced mutual funds are held in retirement accounts; and a significant portion of fund investments in taxable accounts are oriented toward long-term savings and retirement, often through defined contribution and asset allocation programs. Where such investments are made pursuant to such programs, particularly defined contribution plans, fiduciaries are managing the plans and evaluating key elements of the investments, including their liquidity profiles. Analysis suggests that mutual fund investors, even when they are not participating in asset allocation or defined benefit programs, do not act with a herd mentality, and some investors make countercyclical investment decisions.[35] Accordingly, portfolio trading is not driven by redemption pressures.

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[31] If an investor sells $2000 of a stock, there is $2000 of selling in the market that needs $2000 of buying in turn. Collective funds allow such sales to be conducted by a pool and in a diversified context, minimizing risk and broadening access to markets among investors.

[32] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at 29.

[33] *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992), *available at* https://www.sec.gov/rules/other/1992/33-6927.pdf; SEC Division of Investment Management, IM Guidance Update No. 2014-01 at 6, n. 12 (Jan. 2014), *available at* http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf (explaining that the 1992 Guidelines are Commission guidance and remain in effect).

[34] Investment Company Act § 22(e). As a practical matter, three-day settlement requirements under Exchange Act Rule 15c6-1 (imposing a maximum time period on broker dealers for the payment of funds and delivery of securities) effectively take most fund investments to a T+3 settlement timeline. The SEC staff has instructed funds to assess the mix, including level of cash reserves, lending and credit facilities and percentage of holdings to determine whether, under normal circumstances, funds will be able to facilitate compliance with the three-day settlement standard. *See* Letter from Jack W. Murphy, Associate Director and Chief Counsel, Division of Investment Management, to Paul Schott Stevens, General Counsel, Investment Company Institute (May 26, 1995).

[35] *See Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, Strategic Insight (Nov. 13, 2013), at 5. When asked what would cause them to invest more of

Indeed, monthly turnover ratios from 1986 through 2013 fluctuated within a predictable range of 2-3% of assets including during periods of market volatility.[36]

Other pooled investment products address redemption and liquidity in other ways. Closed-end funds are structured differently and offer a different redemption profile than open-end (mutual) funds. While mutual funds continuously offer new shares to the public, closed-end funds may only occasionally offer new shares. Investor liquidity is usually found through the exchange listing process rather than from direct redemptions from the fund. Closed-end funds may also engage in periodic repurchase offers as well.

Some private funds maintain daily liquidity, while others may permit only periodic redemptions. Private funds may also be structured with the ability to suspend or manage redemptions with more flexibility than mutual funds. Private funds may also use gates which can provide that, if aggregate redemption requests for a period exceed a designated percentage, each investor's redemption will be honored pro rata up to the aggregate amount permitted to be redeemed. As with other types of funds, private funds can make in-kind distributions, dissolve the fund and liquidate or seek to renegotiate instead of suspending redemptions or selling into a down market. As with other types of advisers, private fund advisers act as fiduciaries to their fund clients and are subject to anti-fraud provisions under the Advisers Act. In addition, private funds disclose all of these features to their funds' investors so they are aware of the possibility of limited liquidity, which they take into account in making their investment in a private fund.[37]

We note that Chair White has stated that she has directed SEC staff to consider whether a supplemental set of risk management programs should be required for mutual funds and exchange traded funds ("**ETFs**") to address potential risks related to their liquidity and derivatives use, as well as to ensure comprehensive oversight of these programs.[38] The SEC staff is considering options for specific requirements, such as updated liquidity standards and disclosures of liquidity risks.[39] The Chair's direction to the SEC staff and the staff's evaluation that is currently underway are the appropriate starting points for determining whether any potential action related to the liquidity or redemption features of pooled vehicles is warranted. The SEC could then conduct the necessary rigorous empirical evaluation through a transparent process informed by public comment.

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their savings, 14% of respondents (U.S. investors) to the Center for Applied Research, Folklore of Finance, 2014 survey responded that they would do so when "markets [were] falling significantly." *See generally* State Street Center for Applied Research Study 2014, *The Folklore of Finance: How Beliefs and Behaviors Sabotage Success in the Investment Management Industry*, available at http://www.statestreet.com/ideas/articles/folklore-of-finance.html.

[36] *Id.*

[37] Many of the responses below focus primarily or address the inquiries from a regulated fund perspective; however, certain responses provide additional context for other forms of collective investment pools.

[38] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

[39] *Id.*

1. **How does the structure of a pooled investment vehicle, including the nature of the redemption rights provided by the vehicle and the ways that such vehicles manage liquidity risk, affect investors' incentives to redeem? Do particular types of pooled investment vehicles, based on their structure or the nature of their redemption management practices, raise distinct liquidity and redemption concerns (e.g., registered funds, private funds, or ETFs)?**

Pooled investment vehicles have varied structures and present different redemption incentives and profiles. In all cases, however, the nature of and controls imposed by statute or contract over funds mitigate concerns about risks associated with liquidity and redemptions in collective funds, as evidenced by the behavioral patterns of investors (as observed over decades of activity). These controls also effectively eliminate the potential for shareholder redemptions in pooled vehicles to threaten U.S. financial stability. Further regulations to limit or remove the ability of various vehicles to allow investors to take market risks would diminish investor choice, reduce liquidity in the markets whose relative illiquidity regulators are concerned about, and harm capital formation and the overall growth of markets and the U.S. economy.

Mutual funds have features designed to offer investors the ability to purchase and redeem interests at net asset value on a daily basis. To ensure that they can meet such requests, mutual funds can invest no more than 15 percent of their assets in illiquid investments.[40] Overseeing an investment adviser's management, a mutual fund's board has a duty to monitor funds' liquidity and pricing practices. Section 22(e) of the Investment Company Act forbids suspension of the right of redemption or postponing the date of payment more than seven days after the tender of mutual fund shares, absent limited circumstances. Investment advisers structure and manage mutual fund portfolios carefully in order to ensure that the fund has assets available to satisfy redemption requests. Liquidity management practices include maintaining cash or cash equivalents, investing in liquid securities, and making arrangements for standby or emergency sources of liquidity to meet large or unexpected redemptions, including lines of credit (committed or uncommitted). Funds advised by related advisers might share lines of credit when funds otherwise share costs. Access to such credit is afforded on a pro rata or otherwise equitable basis, but liabilities are several (i.e., one fund is not liable for another's borrowing).

Given these structural and practical characteristics, mutual fund portfolio managers are able to accommodate investor redemptions, even in periods of market volatility. Historical analysis of fund flows shows that over the past three decades, during every financial crisis, capital preservation net withdrawals by mutual fund investors were consistently limited in magnitude. Net outflows averaged under 2% of assets monthly, and atypical high redemptions were very short in duration.[41] During October 2008, stock fund portfolio managers sold on a net

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[40] *See Revisions of Guidelines to Form N-1A*, *supra* note 33.

[41] *Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, *supra* note 35, at 1.

basis an amount equal to only 0.4% of all assets held in such funds.[42] The typical profile of mutual funds and fund complexes, where investors have diverse investment objectives and preferences, has contributed to the fact that the asset management industry has never encountered harmonized redemption behaviors that could be associated with the notion of "herding" or forced sales.[43] Such characteristics have also contributed to mutual funds' exceptional resilience and have also enhanced financial stability. As Nellie Liang of the Federal Reserve stated recently,

> [M]utual funds in their current form have been around for a long time – 75 years now. And they've weathered all kinds of adverse market conditions without noticeably contributing to systemic risk. Indeed, they have provided a diversity of sources of funds for borrowers and may have had stabilizing influences on aggregate credit.[44]

ETFs have many of the same basic features of open-end mutual funds, with some distinctions. The assembly of ETFs in initial creation units by authorized participants and the function of market makers regularly seeking to arbitrage differences between the basket and share NAV serves to add liquidity and stability to the price of the product. Concerns have been raised from time to time that liquidity in ETFs relies on these participants, especially for bond ETFs. A recent Investment Company Institute ("**ICI**") study concluded, however, that only about one-fifth of total activity in bond ETFs is transacted in the primary market (i.e., through creations and redemptions with authorized participants).[45] The majority of the trading activity in bond ETFs occurs in the secondary market, and these trades are accomplished without any intermediation by authorized participants.[46] These secondary market transactions do not create transactions in the underlying bonds, because only the ETF shares are changing hands.[47] The same study reported that, over the first seven months of 2013 (when bond prices moved sharply downward in response to indications that the Federal Reserve might begin to curtail its buying program), and the nominal interest rate on the 10-year Treasury bond rose 90 basis points, there was ample liquidity in secondary market trading in ETFs, and by some measures liquidity actually rose.[48]

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[42] *Id.* "During that month, stock net liquidations by portfolio managers equaled to less than one-third of stock fund investors' net redemptions. Such investor net redemptions were under 2% of all stock fund assets under management during the same month." *Id.*

[43] *Id.*

[44] Nellie Liang, Director, Program Direction Section, Office of Financial Stability Policy and Research, Board of Governors of the Federal Reserve System, *Asset Management, Financial Stability and Economic Growth* (Transcript), The Brookings Institution Conference (Jan. 9, 2015), at 48.

[45] Shelly Antoniewicz, *Plenty of Players Provide Liquidity for ETFs*, ICI Viewpoints (Dec. 2, 2014), *available at* http://www.ici.org/viewpoints/view_14_ft_etf_liquidity.

[46] *Id.*

[47] *Id.*

[48] *Id.*

Private funds are typically structured in ways that offer different redemption opportunities for their investors. For some private funds, daily liquidity is offered and funds operate similar to a registered investment company. Others, particularly hedge funds, use a variety of methods to impose limits on the ability to redeem. For example, some private funds specify windows where they honor redemption requests (typically ranging from 15 to 180 days). These notification requirements enable the manager to efficiently raise capital to cover redemption requests or to sell assets in an orderly fashion to raise cash to fund such requests.[49] As noted above, private funds can suspend redemption requests or invoke other tools in the event of anticipated redemption pressure, and the more sophisticated investors who purchase these funds are apprised of these features as they make their investments.

In evaluating the liquidity characteristics and redemption features of various pooled investment vehicles, we believe it is important not to look at any one type of product in isolation or to look at pooled funds that might own certain assets and ignore the other potential purchasers of the same assets. It is more appropriate to acknowledge that the variety of pooled investment vehicles offered by participants in the asset management industry provides investors with a range of choices and promotes investment opportunities bringing additional capital into the market. The fewer barriers to entry for fund sponsors and investors, the more likely investors will be incentivized to allocate capital into the financial markets. Discouraging certain structures based on presumptions about hypothetical investor reactions to market dislocations without any evidence of a threat to financial stability and/or imposing further restrictions on investments in certain types of pooled funds, could affect capital formation and the smooth functioning of the markets. Likewise, investors may choose to invest in individual securities and lose the benefits of diversification and professional management offered in connection with asset management products.

On any given day, a fund will likely have subscriptions as well as redemptions. If circumstances arise that encourage a movement from one type of investment by one group of investors, there may be an attendant round of opportunistic purchasing by other investors or pooled investment vehicles that want to gain exposure to the same sector. Thus, markets themselves typically stay in equilibrium. One fund's decision to sell an investment will not typically lead to crisis in a product line, sector, region or industry.[50] Taken together, movements are typically effected in orderly ways.[51] For purposes of the Council's review and as acknowledged by a former Federal Reserve Chair, there is an efficiency provided by the diversity of funds, products with different features, and portfolio managers with different

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[49] Hedge funds often have a "lock up" commitment. This further helps the manager engage in orderly, predictable cash management.

[50] *See* Sean Collins, *Why Long-Term Fund Flows Aren't a Systemic Risk: Past is Prologue*, Investment Company Institute (Feb. 18, 2015), *available at* http://www.ici.org/viewpoints/view_15_fund_flow_01 (describing a "closed-loop system" wherein some bond fund outflows are recycled as inflows into other bond funds).

[51] *See, e.g.,* Hanjiang Zhang, *Asset Fire Sales, Liquidity Provision, and Mutual Fund Performance* (Dec. 2009). Forced trades by distressed funds generate temporary downward price pressure on securities held in common by these funds, but other fund managers are able to consistently identify and purchase "fire sale" stocks and benefit from providing liquidity to distressed funds. *Id.* at 2. Overall performance remains robust in such circumstances. *Id.*

investment theses that cannot be matched by planning by central bankers or the substitution of other blunt regulatory tools.[52]

Regulation should instead encourage innovation, which can often attract new capital into asset classes that have been distressed. Banks are not as active in making markets; thus, the counterweights of market ebbs and flows are diminished, and it is increasingly important to find ways to attract capital into those areas of the market in order to normalize markets and provide buyers when others wish to sell. Such movements at times may represent volatility, but ultimately can work to reduce systemic risk rather than increase it. Such incentives cannot be managed or coordinated by central regulation or oversight, as the market's incentives are strong and self-effecting.

2. **To what extent do pooled investment vehicles holding particular asset classes pose greater liquidity and redemption risks than others, particularly during periods of market stress? To what extent does the growth in recent years in assets in pooled investment vehicles dedicated to less liquid asset classes (such as high-yield bonds or leveraged loans) affect any such risks?**

Different kinds of vehicles holding different asset classes pose different liquidity or redemption profiles, but we have not seen evidence to suggest that this is a problem, much less one of systemic significance. A review of recent market performance presents illustrative data for the Council's consideration on this question. High yield and leveraged loan funds have seen periods of lagging returns and steep withdrawals relative to other asset classes since early 2014.[53] Significant redemption activity, however, has not caused problems either for particular funds, their class of funds as a whole, or the underlying assets in these funds.[54] No material effects have been felt across the wider financial system in spite of sometimes record migrations or outflows. This trend is consistent with historical patterns observed by asset management

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[52] *See* Governor Ben S. Bernanke, *Remarks by Governor Ben S. Bernanke*, Speech before the New York Chapter of the National Association for Business Economics (Oct. 15, 2002) ("I think for the Fed to be an 'arbiter of security speculation or values' is neither desirable nor feasible . . . . First, the Fed cannot reliably identify bubbles in asset prices. Second, even if it could identify bubbles, monetary policy is far too blunt a tool for effective use against them . . . . But there is the additional difficulty that the prices of equities and other assets are set in competitive financial markets, which for all their undeniable foibles are generally highly sophisticated and efficient.").

[53] *See, e.g.,* Matthew Fuller, *Outflows From Leveraged Loan Funds Deepen For 22nd Consecutive Withdrawal*, Forbes (Dec. 11, 2014), *available at* http://www.forbes.com/sites/spleverage/2014/12/11/outflows-from-leveraged-loan-funds-deepen-for-22nd-consecutive-withdrawal/ (discussing deepening cash outflows from bank loan funds); and Kristen Haunss and Luca Casiraghi, *Leveraged Loan Funds Seen Plunging 41% After Record Year*, Bloomberg (Dec. 15, 2014), *available at* http://www.bloomberg.com/news/articles/2014-12-16/leveraged-loan-funds-seen-plunging-40-after-record-year (highlighting the record twenty-second week of withdrawals ending December 10, 2014).

[54] *See* Peter Eavis, *Mutual Fund Industry May Face New Rules*, DealBook/NY Times (Dec. 11, 2014), *available at* http://dealbook.nytimes.com/2014/12/11/mutual-fund-industry-may-face-new-rules/?_r=0 (discussing $24 billion in orderly retail outflows from leveraged loan funds from April through December 2014).

industry market analysts.[55] It should be noted that the market for these assets and the markets for the investment vehicles holding these assets are small compared to overall debt markets and therefore do not have the capacity to have an impact on financial stability.[56]

As described more generally in response to Question 5, asset managers manage liquidity and redemptions using a variety of tools, including maintaining cash or other highly liquid instruments on hand, establishing lines of credit, redemption fees, interfund lending arrangements, or other tools to deal with withdrawals. These tools serve to dampen the potential effects on performance and other investors in the funds, but also serve to enhance stability. Certain asset classes might not be highly liquid, but managers have a wide gamut of tools available at their disposal to manage exposures in times of significant redemptions.

When assessing whether there is a threat to financial stability, whether additional regulation is needed, and whether it could be addressed effectively and efficiently, regulators must also analyze the effectiveness of existing regulatory limitations and tools (including cash, loan facilities, and in-kind redemption) that have evolved to manage their liquidity. Funds typically provide disclosures for investors outlining the risks, including liquidity risks, that can be associated with investing in pools of less liquid assets such as high-yield bonds and leveraged loans. Importantly, imposing additional requirements on these or other particular types of funds would encroach on investor choice and result in harmful effects on participants in other sectors of the U.S. financial system. In some circumstances, pooled vehicles provide an important means of financing for issuers and sectors that might otherwise find difficulty in securing capital as a result of other regulatory changes. Moreover, in some market conditions, these types of funds might even present lower risk profiles than other, more liquid fund classes.[57] Investors need to be able to take risks into account and decide whether they believe they will be paid for taking on those risks. Imposing additional leverage or liquidity requirements on funds that invest in less liquid asset classes would have a negative effect on capital formation and (ironically) reduce liquidity in markets whose relative illiquidity already concerns regulators.

Additionally, we note that Chair White has asked the SEC staff to consider potential mechanisms to provide more transparency about portfolio holdings and the liquidity

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[55] *See generally Perspectives on Taxable Bond Fund Redemption Patterns*, Strategic Insight (Nov. 6, 2009) (analyzing historical redemption patterns of taxable bond funds over 20 years and determining redemption rates remained within a narrow band).

[56] Other recent examples of periods of heavy redemptions that were handled without creating systemic risk include the "Taper Tantrum" of June 2013, loan fund redemptions in 2011 and 2014, and the municipal bond disturbance in December of 2010 fueled by analyst Meredith Whitney's forecast of "hundreds of billions" of municipal defaults. Because of Volcker rule and Basel capital changes, banks are acknowledged to have decreased their inventories and participation in the bond markets, and yet all the bond market disturbances noted above were handled by asset managers without dislocation. There were large price and yield movements, but no failure of the market to clear.

[57] *See, e.g.*, Thomas M. Idzorek, James X. Xiong, and Roger G. Ibbotson, *The Liquidity Style of Mutual Funds*, Financial Analysts Journal, Volume 68, Number 6 (June 2012), at 38 (discussing the outperformance of mutual funds that held less liquid stocks and attributing this characteristic to superior performance in down markets, especially market crashes).

risks associated with various types of funds.[58] She has also asked the staff to review options for specific requirements, such as updated liquidity standards and disclosures of liquidity risks. We welcome a dialogue with the Commission on what, if any, further steps may warrant additional evaluation.

3. **To what extent might incentives to redeem shares in a pooled investment vehicle or other features of pooled investment vehicles make fire sales of the portfolio assets, or of correlated assets, more likely than if the portfolio assets were held directly by investors?**

We recognize that the Council is focusing on pooled investment vehicles in the Notice, but it is worth noting that the OFR in its September 2013 Report appears to acknowledge that separate accounts[59] pose no real forced sale concerns.[60] No systemic risks result from such an incentive to redeem. The primary reasons some investors, particularly institutional or high net worth investors, prefer separate accounts over commingled investment vehicles include the ability to negotiate fees, tailor investment guidelines, and avoid tax inefficiencies (part of which comes from owning assets outright rather than as partial interest in the assets of a fund that may see purchases and redemptions). Such account owners are not holding the assets to avoid forced sales or seek first mover advantages. We also note that asset managers with management of many separate accounts will not manage each account in the same way. Each account may have its own strategy, risk appetite, return objectives, investment guidelines, cash flows and other attributes. Accordingly, even though all of those separate account assets may be under the management of a single asset manager, there is no basis to assume that all will be managed in the same way. This is particularly true in a time of market distress when each client may be communicating its own desires about how its account is managed.

At the same time, we note that, for reasons discussed above, the most widely held pooled vehicles typically do not see precipitous redemptions, and there is no reason to believe they will in the future. Retail funds are held by millions of account holders who have never acted in harmonized redemption patterns associated with the "herding" theory mentioned in the

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[58] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

[59] As a general matter, for questions that touch on the subject of separate accounts, we refer you to SIFMA AMG's April 2014 letter to the Secretariat of the Financial Stability Board and the accompanying survey of some of the key characteristics of separate accounts. *See* Letter from Timothy Cameron to Secretariat of the Financial Stability Board, Re: "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions"; "Asset Management and Financial Stability" Study by the Office of Financial Research (Apr. 4, 2014), *available at* http://www.sifma.org/comment-letters/2014/sifma-amg-submits-comments-to-the-fsb-and-sec-in-response-to-ofr-study-and-in-regards-to-separate-accounts/ ("Separate Account Letter").

[60] *See* OFR Report, *Asset Management and Financial Stability* (Sept. 2013) at 15, *available at* http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf ("Redemption risk is not prevalent in separate accounts . . . . However, significant securities sales from separate accounts could still amplify a market impact.").

Notice and its implication of systemic risk concerns.[61] Even when pension plans or other institutional investors determine to transition to a new asset manager resulting in a large redemption request, such significant redemptions are managed aptly by asset management firms using liquidity management techniques described in our response or by making use of professional services offered by transition managers.[62] All the market participants involved in such transitions have an interest in avoiding disruptions to the value and performance of the assets involved. Incentives are aligned between investors and their asset managers to seek to minimize the impact of the sale into the market and avoid downward pressure on price.

Even in circumstances of volatility or stress, where pooled vehicles see outflows that result in sales of underlying assets, academic literature indicates that, despite exerting greater price pressure on sales of less liquid stocks, those price differences typically revert in subsequent months.[63] This dynamic illustrates markets functioning efficiently and the lack of a systemic issue. More broadly, even when funds close, they do so without necessitating a forced sale of portfolio assets. The FSB and IOSCO have acknowledged in their 2014 Consultative Document that "funds close (and are launched) on a regular basis with negligible or no market impact" and that "even when viewed in the aggregate, no mutual fund liquidations led to a system market impact [from 2000 to 2012]."[64]

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[61] *Mutual Funds and Systemic Risk: The Reassuring Lessons from Past Periods of High Financial Markets Volatility*, *supra* note 35, at 1.

[62] *See* Section III, *infra*, "Operational Risk" (discussion relating to substitutability and ready transferability of funds and mandates).

[63] *See, e.g.*, Azi Ben-Rephael, *Flight-to-Liquidity, Market Uncertainty, and the Actions of Mutual Fund Investors* (Mar. 2014), at 2-3 ("We find that, on average, following the beginning of the crisis, illiquid stocks experience a larger price decline relative to liquid stocks, which accumulates over a period of two months. We find that these differences are temporary and revert during the subsequent three months.").

[64] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at 30, note 38; *see also* FSB/IOSCO, *Consultative Document (2nd) – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at 34 (new consultation noting that "[r]esponses to the January 2014 Consultative Document… argued that fire sales by investment funds do not pose a global systemic risk" and "that asset sales from redemptions are not likely to materially impact market prices under normal conditions…").

4. **To what extent does the potential for terminations of securities loans that would trigger redemptions from cash collateral reinvestment vehicles or other asset sales pose any distinct financial stability concerns? To what extent do investment vehicles reinvest cash collateral in assets with longer maturities relative to the lender's obligation to repay the collateral, which may increase liquidity risk? How much discretion do lending agents have with respect to cash collateral reinvestment? To what extent do lending agents reinvest cash collateral in vehicles managed by the same firm that manages the investment vehicle lending the securities?**

Securities loans are collateralized, and the collateral is invested conservatively. The value of collateral is always at or greater than 100% of the value of the loan, and it is marked to market daily.[65] Although the termination of a securities loan generally causes the lender to unwind the investment of its cash collateral, given the conservative nature of those investments, the liquidation of positions is not systemically significant.

For asset managers that engage in securities lending,[66] these programs are executed under carefully circumscribed conditions. Lenders are typically large institutional investors who often employ a lending agent[67] to arrange, manage, and report on lending activity. Borrowers are typically large institutions such as broker-dealers, investment banks, and market makers. Hedge funds, which are often significant participants in securities lending markets, usually borrow from a broker-dealer. A lender looks to its agent to take collateral from a borrower, plus margin. The collateral position is monitored daily, and margin is maintained above market value. Typically, securities lending positions are overcollateralized by 2 to 5%. Collateral is often reinvested in money market funds or similar conservative investment pools, with those reinvestments limited by the terms of lending agreements.[68] Asset managers and fund boards monitor these programs, and the end result is that the lender fund receives an incremental return with an appropriately modest amount of risk. It is not unusual for affiliates to act as lending agents under the same strict controls governed by contracts.[69] For affiliated lending programs, asset managers and boards have to administer and ensure that these programs are executed in keeping with the SEC exemptive orders under which they are permitted to operate. Lending entities typically obtain certificates of compliance from agents or borrowers to ensure programs are complying with the governing exemptive orders.

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[65] For additional discussion on collateralization, please see Section II ("Leverage"), *infra.*

[66] According to a February 2015 SIFMA AMG member survey, 57% of respondents engage in securities lending across a wide variety of fund types. *See infra* Appendix B, at B-3.

[67] Often these agents are large custodial banks; for funds within large asset management complexes, the manager might fulfill this role.

[68] Of respondents to the SIFMA AMG survey, all firms engaging in securities lending give instructions with regard to the types of vehicles in which collateral can be reinvested, most set guidelines around maturity and other considerations, and for more than half securities lending is limited to 2a-7 funds. *See infra* Appendix B, at B-3.

[69] All respondents engaging in securities lending report utilizing a third party agent or affiliate. *See infra* Appendix B, at B-3.

There may be counterparty and cash collateral investment risks associated with securities lending programs, but these are both investment risks for the lending fund. That same fund exists to take investment risk, and its manager has incentives to manage risk in keeping with the objectives and agreements under which it operates. In the event of a securities loan termination, the lending agent would act on behalf of the lender to enforce rights under the securities lending agreement. Collateral is used to buy back securities, and the borrower is responsible for any penalties or charges for a late return. The lender is typically indemnified under a lending agreement to account for losses due to a default or shortfall to cover the borrower's obligations. During the financial crisis, several securities lending counterparties faced challenges; however, lending agents were able to liquidate collateral, which was sufficient to repurchase replacement securities without disrupting the markets and without significant losses to lenders.

Academic surveys of securities lending practices in stressed circumstances have identified no appreciable effects on returns, volatility, skewness, or bid-ask spreads.[70] Likewise, maturity mismatches do not present an issue. This is because client agreements restrict the types of securities available to lend, borrowers must be approved, and agents are limited in the types of instruments in which they may invest cash collateral. The type of reinvestment made with cash collateral is typically money market or similar instruments of extremely high quality and with relatively brief durations that are highly liquid and tightly regulated. We note that the OFR has described "data gaps in the repo and securities lending markets" as a "top priority for the OFR" and has laid out plans for voluntary collection of data relating to both bilateral repo activity and securities lending during the course of 2015.[71] We will be happy to continue to provide information to the SEC and the OFR if it might be helpful in this regard. Of note, the report acknowledges the SEC's obligations under Section 984(b) of the Dodd-Frank Act, mandating that the SEC adopt rules to increase the transparency of information available to brokers, dealers, and investors about securities lending. We look to assist the SEC as it conducts additional evaluation in this area.

5. **How do asset managers determine whether the assets of a pooled investment vehicle are sufficiently liquid to meet redemptions? What liquidity and redemption risk management practices do different types of pooled investment vehicles employ both in normal and stressed markets, and what factors or metrics do asset managers consider (e.g., the possibility that multiple vehicles may face significant redemptions at the same time, availability of back-up lines of credit) in managing liquidity risk?**

As described above, asset managers manage pooled vehicles that present a variety of liquidity profiles and operate under a variety of requirements. Managers of mutual funds are

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[70] *See, e.g.*, Steven Kaplan, Tobias Moskowitz, and Berk Sensoy, *The Effects of Stock Lending on Security Prices: An Experiment* (Aug. 2012). Conducting a randomized stock lending experiment using data sets from stressed periods in September 2008 and from June to September 2009, researchers found no evidence that removing sizable quantities of lendable shares had effects on returns, volatility, skewness, or bid-ask spreads. *Id.*

[71] OFR, *2014 Annual Report*, *supra* note 19, at 107; *see also* Berner, *supra* note 20.

under an obligation to invest no more than 15% of any fund's assets in illiquid securities.[72] The test typically applied is that an asset is considered liquid if it could be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the asset is valued by the fund. This determination is made with respect to the fund's ability to sell individual securities. The ultimate duty to oversee this evaluation rests with directors of the mutual fund. Typically, the board delegates the evaluation and ongoing monitoring of liquidity to the asset manager. Asset managers use various risk management tools to actively monitor and evaluate liquidity profiles of accounts they manage, including assessing the diversification and liquidity of holdings, conducting stress tests with market shocks or interest rate movements, and examining past redemption history. Indeed, daily liquidity management is an essential function of the risk management regime for most asset managers. The specific tools and approaches vary widely, and there is no single correct approach; however, the objective is the same: to prudently manage liquidity to accommodate redemption demands under all market environments. Historically, mutual fund managers have done well at meeting this objective.

Fund procedures and investment guidelines lay out what the mutual fund's tolerance may be to deal with stressed markets and large redemptions. Some funds have established approaches that inform how they reduce illiquid assets and increase cash in appropriate circumstances. Delegation to the manager is circumscribed by a fund's investment guidelines, prospectus disclosure, and board oversight.

More broadly, different funds (both mutual funds and other pooled vehicles) use a number of different liquidity management tools, including cash, lines of credit, and other facilities, to manage redemptions.[73] In anticipation of potential volatility, some fund complexes have increased their funds' ability to borrow to meet withdrawals.[74] Credit lines can be asset specific or omnibus. Depending on the fund's governing documents, interfund lending facilities (in the case of mutual funds, subject to regulatory limits via SEC exemptive orders) can help an asset manager manage credit needs of individual funds while providing well-controlled investment opportunities to lending funds.[75] Funds also have the ability to deliver in-kind redemptions to investors. For ETFs, institutional funds, or private funds, providing redemptions in kind can be a useful tool.

A fund's portfolio manager is obligated as a fiduciary to manage the fund in the best interest of all shareholders when processing redemptions. If the manager deems the best

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[72] The number is lower for money market funds, but these products are not discussed in this response. Private funds may have different restrictions as well, depending on their investment thesis and the governing documents under which they operate.

[73] 79% of SIFMA AMG survey respondents report having access to a line of credit to manage outflows from their mutual funds, with lines of credit ranging from 0.3 up to 14.30 percent of the AUM of the funds. Around 64% have drawn on that line at some point within the last five years. *See infra* Appendix B, at B-1.

[74] Miles Weiss, *BlackRock Leads Funds Raising Credit Lines Amid Review*, Bloomberg (Jan. 21, 2015), *available at* http://www.bloomberg.com/news/2015-01-21/blackrock-leads-funds-raising-credit-lines-amid-review.html.

[75] Only 8% of SIFMA AMG members surveyed state that they engage in inter-fund lending to address liquidity issues. *See infra* Appendix B, at B-1.

outcome for the shareholders will be to sell assets immediately, it will do so; if selling over more days will achieve the best price for shareholders, the manager will do this instead. Some mutual funds have guidelines to indicate how much cash the fund can hold in ordinary and challenging times. Funds investing in less liquid asset classes, such as bank loans or high yield debt, typically hold relatively higher levels of cash and liquid assets to meet redemptions during stressed market conditions. Historical redemption levels in a fund may factor into a fund manager's decision about what level of cash and liquid assets is appropriate to hold. Some funds disclose these holdings guidelines, which can assist shareholders in assessing whether a fund is meeting its objectives.

6. **To what extent could any redemption or liquidity risk management practices (e.g., discretionary redemption gates in private funds) used in isolation or combination amplify risks?**

We do not believe that the use of these liquidity management tools, whether in isolation or combination, serves to amplify risks. In fact, we believe liquidity management tools serve to mitigate such risks. We note generally our previous remarks in the introduction to this section and in response to the first question where we discuss the historical data that supports our view. Private funds may be structured to permit temporary suspensions of redemptions or the imposition of redemption fees or gates that limit redemptions in times of stress. In fact, the added flexibility that private funds have to manage redemptions beyond limitations that apply to mutual funds can provide a moderating influence in circumstances where they are experiencing selling pressure. Such funds also have access to lines of credit to manage flows during redemption periods.

7. **To what extent can competitive pressures create incentives to alter portfolio allocation in ways that may be inconsistent with best risk management practices or do not take into account risks to the investment vehicle or the broader financial markets?**

At a fundamental level, investors invest in funds to gain a particular exposure consistent with the fund's investment objectives, policies, and restrictions, all of which are disclosed in relevant fund documents. There are thorough controls surrounding portfolio management: policies and procedures, investment guidelines, adherence to the strategy as set forth in a prospectus or disclosure document and contractually agreed upon by a manager, internal controls over risk management, fiduciary duties, and contractual liability. Further, complexes with multiple funds or separate accounts must allocate investment opportunities equitably, or they risk regulatory consequences. SEC-registered investment advisers have a fiduciary obligation of fair allocation at all times; any purchase or sale decisions are always made within that overarching fiduciary duty.

Within the confines of an investment mandate and in keeping with applicable regulatory limitations, an asset manager seeks a return it believes can be reasonably obtained on its investment portfolios. As witnessed by examples of orderly migration of assets from complex

to complex and the entry and exit of managers and funds from the asset management industry, the competitive pressure and variety of approaches undertaken by asset managers across the industry has its own disciplining approach.[76] The manager's success rises and falls with the vehicle. Firms are therefore incentivized to take risks into account when constructing portfolios. In a market environment where 81 percent of investors own mutual fund shares offered through investment professionals (outside of employer-sponsored retirement plans),[77] investors are being served by professionals who operate under obligations to seek appropriate investment opportunities for their clients.

8. To the extent that liquidity and redemption practices in pooled investment vehicles managed by asset managers present any risks to U.S. financial stability (e.g., increased risks of fire sales or other spillovers), how could the risks to financial stability be mitigated?

We do not believe that liquidity and redemption practices pose a threat to financial stability. The asset management industry is very diverse in terms of the managers themselves as well as the types of funds and investments managed. At one end of the spectrum are daily liquidity mutual funds, and on the other end are private equity funds that restrict investor redemptions for the term of the fund. Similarly, the types of investments range from highly to less liquid. We would ask the Council to describe with greater specifically the circumstances in which there are concerns that the dynamics underlying the practices we have discussed might arise and their connection with U.S. financial stability. We would then welcome an empirical study to evaluate the validity of the underlying assumptions.

Meanwhile, from a regulatory perspective, given the breadth and complexity of both the types of funds as well as the investments of such funds, a prescriptive rules-based approach is not necessary, and would in fact be ill suited to addressing systemic risk. For example, a prescriptive rule requiring fund managers to hold a certain percentage of cash or cash equivalents may reduce the liquidity of the assets that were of concern in the first place, as managers would have fewer funds available to buy and sell such assets.

Our view is that there are no obvious regulatory proposals relating to liquidity and redemption that would have more than a marginal benefit and actually mitigate risks. There are a variety of good practices that are currently observed in the industry, but requiring managers to adopt them will likely only impose costs while potentially creating unanticipated adverse side effects.

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[76] *See* discussion *infra* Section IV, Resolution.

[77] *2014 Investment Company Fact Book: A Review of Trends and Activities in the U.S. Investment Company Industry*, 54th edition, *available at* http://www.ici.org/pdf/2014_factbook.pdf, at 96.

9. What additional information would help regulators or market participants better assess liquidity and redemption risks associated with various investment vehicles, including information regarding the liquidity profile of an asset class or of a particular type of investment vehicle?

Pooled products vary considerably but are subject to a range of protections and controls overseen by fiduciaries. Advisers must manage assets in accordance with the provisions of a prospectus, contract, or offering memorandum while making use of their skills, experience, and tools to retain their mandate and to not lose the engagement to a competitor.

As noted above, from Chair White's December 2014[78] and February 2015 speeches,[79] SEC Acting Director of the Division of Investment Management David Grim's March 2015 speech,[80] and our interactions with SEC staff, we understand that the SEC is exploring whether there may be appropriate additional steps to take surrounding liquidity and redemption practices and risks associated with asset management products, including stress testing. We have already briefed the SEC staff on various steps taken by some asset management firms to engage in stress testing and will continue to provide information and briefings as the SEC staff evaluates potential recommendations. We further understand that the OFR is reviewing and has announced plans to gather other relevant data from volunteers over the course of 2015. We look forward to constructive engagement with the SEC and to providing data to inform the staff's evaluation and consideration of whether additional steps need to be taken, and if so, the appropriate approach.[81]

Reducing risk is not a costless exercise. Risk is rarely reduced without either transferring it (potentially to less-regulated spaces) or imposing a cost somewhere else in the system. We strongly encourage a view that does not see risk as inherently bad, but recognizes that some degree of risk is necessary to encourage innovation, investment and capital formation. Additional requirements relating to liquidity and redemptions may stymie innovation and/or lead to higher fees and fewer choices for investors. Because pooled vehicles are major contributors to financial markets and come in many forms, it is not appropriate to view them through a single lens or as inherently "risky."

II. <u>Leverage</u>

We appreciate the Council's effort to better understand and evaluate ways in which pooled investment vehicles make use of leverage. For further information more generally

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[78] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4; *see also* White, *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request*, *supra* note 4.

[79] *See* White, *Chairman's Address at SEC Speaks 2015, supra* note 4.

[80] *See* Grim, *supra* note 4.

[81] We note, too, that the CFTC and the Council have access to similar data on commodity pools (which may include certain mutual funds) through Form CPO-PQR.

on this subject, we refer the Council to SIFMA AMG's November 2011 letter in response to the SEC's concept release and request for comments on the use of derivatives by pooled investment vehicles and similar accounts, along with SIFMA AMG's April 2014 letter to the FSB and IOSCO on its 2014 Consultative Document.[82]

As the Notice defines the term, leverage is created when an investor effects a transaction that results in exposure[83] that exceeds the amount of equity capital used to initiate the investment. In this sense, leverage is not itself inherently "good" or "bad", but it can boost potential investment returns and magnify losses. Such losses can increase the potential for forced asset sales to meet redemption requests or address collateral needs arising from credit terms. In theory, extreme amounts of leverage may increase the quantity of risk and limit a fund's ability to survive significant market fluctuations. In rare circumstances, these risks may also have potential implications for U.S. financial stability, as evidenced by the 1998 failure of hedge fund manager Long Term Capital Management ("**LTCM**"), itself an anomalous and singular instance of high leverage and flawed duration management.[84]

As the Council is aware, leverage can be thought of in terms of, or established through, a variety of different instruments and strategies with different profiles. Strategies that can result in leverage include secured financings, margin credit, prime brokerage financing arrangements, borrowings from banks, issuances of preferred shares by closed-end funds, and securities lending transactions.[85] Derivative instruments such as futures, options, swaps, and swaptions can be utilized to create leverage, but those same instruments may also be utilized in an unlevered strategy if sufficient coverage is retained to offset future obligations. Leveraged transactions can be further differentiated based on whether the investor's potential losses are capped or not. For example, transactions such as the purchase or sale of futures contracts can result in an investor incurring future liabilities that exceed the investor's initial contributed capital. Unless sufficient assets are maintained to cover the resultant liabilities, these transactions can create what is sometimes referred to as "indebtedness leverage." Yet even for this kind of leverage, only the assets of the fund are at risk since it is the legal entity that took on the obligation. Other transactions can increase the investor's market exposure without incurring future liabilities and subjecting it to contingent losses, such as the purchase of a call option. These transactions are sometimes referred to as "economic leverage" because the investor's potential gain is known but its liability is capped at the value of its initial contributed capital. These varied instruments present different ways to manage and disperse risk and, if judiciously deployed, can enhance investment returns both absolutely and on a risk-adjusted basis.

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[82] *See* Letter to Elizabeth Murphy, Secretary, SEC, from Timothy W. Cameron, Esq., *Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (Release No. IC-29776, File No. S7-33-11)* (Nov. 23, 2011), *available at* http://www.sec.gov/comments/s7-33-11/s73311-51.pdf; and Separate Account Letter, *supra* note 59.

[83] Exposure for a foreign currency is not regarded as a separate "exposure" for this purpose.

[84] As discussed below, even with the leverage problems involved with Long Term Capital Management, the firm's resolution was managed in an orderly way and did not lead to systemic issues. *See, e.g.*, Roger Lowenstein, *When Genius Failed: The Rise and Fall of Long Term Capital Management* (2001).

[85] *Notice*, *supra* note 3, at 13.

Furthermore, we believe that the use of various, sometimes countervailing leverage strategies by multiple market participants provides safeguards against systemic market risk and serves as an incentive for growth, innovation, and risk transfer.

As the Council notes, many pooled investment vehicles significantly limit their use of leverage to comply with statutory as well as self-imposed investment restrictions. Chief among the statutory limitations is Section 18 of the Investment Company Act (and the associated SEC guidance thereunder), which limits a registered investment company's ability to issue or sell "senior securities" which often take the form of indebtedness. Section 18(f)(1) prohibits an open-end mutual fund from incurring indebtedness other than certain types of borrowings, and then only if the fund maintains at least 300% "asset coverage".[86] Similarly, Section 18(a)(1) prohibits a closed-end fund from incurring indebtedness unless the fund maintains at least 300% asset coverage.[87] An investment company's use of derivatives is subject to a separate set of restrictions. If a registered fund invests in a derivative, it must cover its exposure to the instrument by holding liquid assets equal to the leveraged exposure or hold an offsetting position equal to the leveraged exposure.[88]

Some registered funds have adopted written investment policies that impose more conservative leverage limits than those mandated by the Investment Company Act. For example, some funds require that indebtedness leverage (i.e., borrowing) be used solely for liquidity management purposes (e.g., to satisfy anticipated investor redemptions or backstop trade failures). In general, most mutual funds operate and are financed with equity capital and do not rely on borrowed money.[89]

Hedge funds have historically employed more leverage than registered funds and other types of private funds, but many private funds do not use leverage at all, and funds that use leverage typically maintain average gross leverage ratios of 2.0 or less. A 2011 Columbia University Business School working paper found that the average gross leverage ratio for the hedge fund industry was 1.5 as of October 2009 and 2.1 for the period December 2004 through

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[86] "Asset coverage" in this context means the ratio of: (i) the value of the total assets of the fund less all liabilities other than the subject indebtedness to (ii) the value of the subject indebtedness. We note that there are many nuances as to how coverage should be calculated.

[87] Under Section 18(f)(1) of the Investment Company Act, a closed-end fund can employ additional leverage through the issuance of preferred stock, provided that the fund maintains at least 300% asset coverage. Listed closed-end funds are not subject to redemption terms and as such have an asset base that is less volatile and able to manage larger amounts of leverage, as permitted under the Investment Company Act. *See* Investment Company Act § 18(f)(1).

[88] *See, e.g., Securities Trading Practices of Registered Investment Companies*, Investment Company Act Release No. 10666 (Apr. 18, 1979), *available at* https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf , 44 FR 25128 (Apr. 27, 1979) ("Release 10666"); *see also Registered Investment Company Use of Senior Securities–Select Bibliography* ("Senior Security Bibliography"), *available at* http://www.sec.gov/divisions/investment/seniorsecurities-bibliography.htm.

[89] *See, e.g.*, Release 10666, *supra* note 88; Senior Security Bibliography, *supra* note 88.

October 2009.[90] By contrast, the gross leverage ratio for investment banks during the same period was 14.2 and for the broader financial sector was 9.4.[91] Even the more recent general data reviewed by the OFR, taken from Form PF reports filed by private funds with net assets of at least $500 million representing more than 80 percent of private fund assets, paint a picture of limited leverage across most kinds of funds. Indeed, OFR found that the ratio of gross assets (assets under management based on the current market value of assets and uncalled commitments) to net assets (gross assets under management minus outstanding indebtedness or other accrued but unpaid liabilities) for most types of hedge funds (macro, multi-strategy, equity, credit, event driven) hovered just above or below 2.0 from June 2012 through March 2014.[92] We note that many private funds are not, in fact, operated as levered funds at all. Some private funds operate with similar leverage limitations as registered investment companies. Those same private funds create liquidity and encourage investment and ultimately contribute to stability.

That same analysis noted the decreased use of borrowing by hedge funds and, where there is borrowing, the prevalence of using reverse repos or other secured borrowing sources, primarily obtained from prime brokers.[93] In addition, haircuts on term securities financing transactions have increased since the crisis.[94] In relative terms, these figures are far lower than in the banking system where leverage ratios are routinely in excess of 10 times net assets. For hedge funds, leverage exposures affect the underlying fund, not the adviser, so leverage does not have the same broad contagion reach as in the case of a bank. Furthermore, the risk of another LTCM – regularly and often singularly cited by the Council and other bodies in connection with evaluating the broader industry – is remote. LTCM's leverage ratio of 30 in 1998 stands out today as a distinct anomaly in the asset management industry, both in historical and current terms.[95] Leverage ratios at comparable hedge funds during the same time were far

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[90] Andrew Ang, Sergiy Gorovy & Gregory B. van Inwegen, *Hedge Fund Leverage* (Jan. 25, 2011), 17, *available at* https://www0.gsb.columbia.edu/faculty/aang/papers/HFleverage.pdf. For these purposes, we have adopted the simple "gross leverage ratio" definition used in the working paper, which is the ratio of: (i) the sum of long and short exposure to (ii) net asset value. *Id.* at 4. The illustrative example used in the paper presents a hedge fund that obtains $10 in cash from its investors, uses the cash proceeds to purchase $10 worth of long securities, then borrows $50 and uses those proceeds to purchase an additional $50 worth of long securities. *Id.* at 30. In this case, the net asset value of the hedge fund is $10, or the difference between its assets ($60 in securities) and its liabilities ($50 in borrowed cash). *Id.* The fund's gross leverage ratio is 6.0, or: (i) the sum of its long and short exposures ($60) (i.e., $60 in long position plus $0 short position) to (ii) its NAV ($10). *Id.*

[91] *Id.* at 25.

[92] OFR, *2014 Annual Report*, *supra* note 19, at 114, Figure 6-6. For relative value funds the ratio has been higher, "but has been declining [to around 4] since 2012." *Id.* at 114.

[93] *Id.* at 115.

[94] *See* ICMA European Repo Council, *Haircuts and Initial Margins in the Repo Market,* (Feb. 8, 2012), 13, Table 6.1, *available at* http://www.icmagroup.org/assets/documents/Maket-Practice/Regulatory-Policy/Repo-Markets/Haircuts%20and%20initial%20margins%20in%20the%20repo%20market_8%20Feb%202012.pdf .

[95] Lowenstein, *supra* note 84, at 234.

lower[96] and remain at low levels, as discussed above. What is more, certain banks loaned to or executed derivatives contracts with LTCM with virtually no visibility into the fund's portfolio, driven in part by the desire to gain more of LTCM's business.[97] The failure of LTCM is therefore as much about the challenges of since-improved underwriting processes as it is about the challenges of a single exorbitantly levered investment vehicle.

Although the Notice focuses on pooled vehicles, it also poses general questions about separate accounts. These accounts are not subject to regulatory leverage restrictions, but a 2014 survey that SIFMA AMG conducted of 12,197 accounts at nine managers indicated that a mere 1.7% of them employed leverage, and the average gross leverage ratio for such accounts was 1.35.[98] As a complement to the quantitative separate account data requested in the survey, respondents were also asked to describe the risk management processes that they employ in the management of separate accounts. The survey found that that 100% of respondents monitor counterparty risk for their separate accounts and employ robust procedures to this end. We also note that the counterparty risk landscape has changed with the introduction of central clearing and SEF platforms, as discussed in greater detail elsewhere in this letter. Similarly, we observed that separate account managers often monitor a number of traditional portfolio risk measures in the course of separate account management, including duration, convexity, volatility, concentration risk, and liquidity risk. Specific approaches and metrics will vary by manager and by instrument and mandate, but some degree of portfolio risk management is common. Many of the asset managers responding to the survey also reported using stress test analyses to observe the sensitivities of portfolios to particular factors, as well as value-at-risk models.[99] Nevertheless, we acknowledge Chair White's desire to obtain additional information regarding the investment activities of separate accounts, and we look forward to working with the SEC and its staff to offer efficient and practical ways to provide such information as may be useful to the staff's evaluation.[100]

The use of derivatives more generally has been one of the most significant areas of regulatory action in recent years.[101] Changes in the wake of Dodd-Frank include moving from

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[96] *See id.* at 25.

[97] *Id.* at 46-48, 106.

[98] Separate Account Letter, *supra* note 59.

[99] *See id.*

[100] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

[101] *See, e.g.,* Concept Release on *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, 76 Fed. Reg. 55237-01 (Sept. 7, 2011); *see also* Norm Champ, Director, Division of Investment Management, *Remarks to the Practising Law Institute, Private Equity Forum* (June 30, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370542253660#.VP38zzvD9aQ (providing an approach to 1940 Act regulatory issues associated with leverage); Andrew J. Donohue, Director, Division of Investment Management, *Remarks Before the Practising Law Institute's Investment Management Institute 2010* (April 8, 2010), *available at* http://www.sec.gov/news/speech/2010/spch040810ajd.htm (discussing the Commission's review of methods to obtain leverage in the context of Section 1(b) of the 1940 Act); Andrew J. Donohue, Director, Division of Investment Management, *Investment Company Act of 1940: Regulatory Gap Between Paradigm and Reality?*, American Bar Association Spring Meeting (April 17,

bilateral to cleared swaps, accompanied by further capital and margin requirements. The cumulative goal is to reduce the contagion risk that a counterparty default might have on multiple market participants. All market participants will need to see if this is borne out as this transformation is being effected. An unavoidable consequence of the new regulations is that counterparty risk will now be concentrated among a few central counterparty clearinghouses ("**CCPs**"). Without downplaying the benefits of the new CCP regime, we believe that the industry and regulators must carefully consider the impact that even a single CCP failure would have on the larger marketplace and prioritize measures to reduce the probability and impact of such a failure.

Nevertheless, we note Chair White's decision to evaluate funds' use of leveraged investment exposures and the obligations that such instruments can create.[102] In particular, we understand that SEC staff are reviewing options for specific requirements that could include new measures to "appropriately limit the leverage created by a fund's use of derivatives."[103] Such changes should only come after meaningful dialogue and must be premised on notice and comment rulemaking and informed by careful evaluation of data during the agency's evaluation of any potential proposal.

Similarly, we welcome the opportunity to evaluate and assist any further analysis from the SEC, the Council or OFR on the use of leverage by private funds. To date, the information collected by the SEC and other regulatory bodies and evaluated by OFR includes assets under management and basic information on the use of leverage, counterparty credit risk exposure and trading practices; but at this point we have seen relatively little publicly from OFR by way of analysis on the issue of leverage. The data we have seen on leverage (including its relatively low levels and its sourcing from secured sources) does not present a portrait of practices that raise systemic concerns. We hope that any such inquiry will look first and in more depth to Form PF or other currently accessible data to better understand current leverage practices and whether they are actually problematic from a systemic risk perspective. Any next steps should come first from the SEC and be informed and calibrated by experiences and lessons derived from regulatory experiences with Form PF data.

Even as we acknowledge the Commission's evaluation of next steps toward more comprehensive data on the use of leverage, we caution, echoing previous remarks we have made on the use of leverage,[104] that the transformation of the regulatory structure applicable to the U.S. derivatives markets is still in its infancy. We expect that evolution of this regulatory area and market will continue to change conventional wisdom about derivatives transactions. We believe

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2009), *available at* http://www.sec.gov/news/speech/2009/spch041709ajd.htm (discussion of leverage under the 1940 Act and the Commission's analysis and concerns related to leverage and derivatives).

[102] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4; White, *Examining the SEC's Agenda, Operations, and FY 2016 Budget Request*, *supra* note 4.

[103] *Id.*

[104] *See* Letter from Timothy W. Cameron, Esq. to Elizabeth Murphy, Secretary, SEC, Re: Use of Derivatives by Investment Companies under the Investment Company Act of 1940 (Release No. IC-29776, File No. S7-33-11) (Nov. 23, 2011).

that it is still too early—not just for the SEC, but for the Council as well—to fully, much less adequately, assess the effect or reach of new regulations mandated under Title VII of the Dodd-Frank Act. While the SEC has made progress to implement final rules under Title VII and the Title VIII clearing regime as of the date of this letter, the entire structure remains several years from completion. We believe common and uniformly understood legal standards around these regimes will result in better data and, by extension, better regulation.

1. How do different types of investment vehicles obtain and use leverage? What types of investment strategies and clients employ the greatest amount of leverage?

The Notice provides a good general survey of some of the typical instruments used by pooled investment vehicles to obtain and deploy leverage. Funds and fund managers vary their approaches to obtaining levered exposure in response to investor demands, portfolio investment objectives and restrictions, and changing market conditions.[105] Instruments do not necessarily create leverage on their own but rather operate in relation to other portfolio holdings. We also note that instruments that create "leverage" are not always used to increase risk. Funds may utilize derivatives to create economic exposure or to isolate and hedge certain risk factors, which can be done more efficiently through derivatives than through the traditional securities market.

We caution that simple measures of levered exposure (e.g., gross notional) can be crude and misleading. For example, short-term Eurodollar futures contracts are a leading form of laying on a hedge; such transactions require high notional amounts, so there are significant open interests and volumes. Yet such transactions do not really represent "leverage" if they are used to reduce interest rate risk in the portfolio, and they are relatively low risk because these instruments are very liquid and have low volatility. For example, to reduce the duration of a fund by 1 year using Eurodollar futures, the notional principal amount of such futures would need to equal 400% of the fund's assets. Such a strategy gives the appearance of leverage but in fact results in risk reduction. Accordingly, we caution that using gross or net notional amount outstanding as simple measures of leveraged exposure could generate misleading data and have

[105] Just a partial list of typical transactions – borrowings, preferred stock issuances, bank credit lines, prime broker credit lines, tender option bond inverse floaters, reverse repurchase agreements, "to be announced" (TBA) mortgage backed securities, or "when issued" bonds, total return swaps to purchase an equity or fixed income asset, fixed income or equity purchased futures or forward contracts, foreign exchange forward contracts (buying a currency other than the fund's base currency), credit default swaps, or sold put options (where the higher the strike price as a percentage of current prices, the more this is tantamount to a simple purchase of an asset) – gives a sense of the available range of instruments or transactions that may result in levered long asset positions in the absence of offsetting exposures. In addition, short asset exposure could be undertaken in a variety of ways, including total return swaps where the return stream attributable to an asset the fund does not own is sold, sold call options on an underlying asset that the fund does not own, fixed income or equity sold futures or forwards where the underlying asset is not owned, or foreign exchange forward contracts (selling currency other than the fund's base currency, where the currency in question is not owned).

unintended consequences. Moreover, in light of the recent focus on derivatives, we fear that a regulatory regime that channels pooled investment vehicles into a more limited array of instruments or strategies could have deleterious effects on the industry as a whole, including lulling investors into a false sense of security, stifling innovation, and preventing investors from properly hedging or reducing risks.

In terms of which types of products tend to use the most leverage, we note that closed-end funds typically employ the greatest amount of structural leverage among registered investment companies and disclose this practice clearly to investors. Because a closed-end fund is not subject to subscription/redemption requests, its capital base has stability that allows the closed-end fund to employ a higher degree of leverage. A majority of closed-end funds that use leverage are fixed-income funds that incur short-term indebtedness through committed credit facilities or issue preferred stock. Such closed-end funds invest the proceeds of this leverage in long-term or otherwise higher yielding assets. Rarely are the funds designed to use leverage to exploit an arbitrage trading relationship between different assets. The committed credit facilities employed by closed-end funds typically have stated maturity terms to avoid the need for de-leveraging and are structured to reflect the nature and risks of the fund's particular assets. We note that closed-end funds have regulatory leverage limits, so even as they may use more leverage than open-end mutual funds, they do not employ unlimited leverage.

Open-end funds that may use a credit facility might do so primarily to manage redemption requests that are either significant in size or received in a volatile market. Importantly, a fund's ability to sell assets in a controlled manner and make use of other tools to meet redemption requests can limit overall market volatility. Credit facilities are typically committed facilities provided by banks with stated maturity dates rather than "on-demand" facilities.

The SEC has announced plans to develop recommendations to modernize and enhance data reporting relating to the use of leverage. As outlined by Chair White, such proposals include reporting and disclosing fund investments in derivatives. We look forward to interacting with the staff on these issues and, if the Commission determines any further regulatory provisions may be appropriate, we also believe that the SEC would be well positioned to undertake careful economic analysis and to engage in appropriate notice and comment proceedings to determine whether rulemaking might be appropriate. As described above, any further regulatory processes should be informed by and reflect lessons incorporated from the agency's experiences with Form PF data.

2. To what extent and under what circumstances could the use of leverage by investment vehicles, including margin credit, repos, other secured financings, and derivatives transactions, increase the likelihood of forced selling in stressed markets? To what extent could these risks be increased if an investment vehicle also offers near-term access to redemptions?

We do not agree with the premise that investment vehicles experience forced sales; there is no historical evidence or fact-based data to support this concern. Various features of investment vehicles, including the statutory provisions and risk management techniques

described above, make the likelihood of forced selling remote. As conditions change, different firms deploy various risk tools. Likewise, different firms and the products they oversee have different tolerances, and the whole system itself exists as a dynamic equilibrium. New participants come into sectors of the market when others leave because they have reached a risk limit or subjective risk tolerance or otherwise see better opportunities elsewhere.

If the Council were to indicate more specifically the circumstances in which it believes the dynamic described might arise and its connection to U.S. financial stability, we would be pleased to provide information to address this issue. We would likewise invite a study based on empirical evidence related to what appears to be the question's underlying hypothesis.

3. How do asset managers evaluate the amount of leverage that would be appropriate for an investment strategy, particularly in stressed market conditions? To what extent do asset managers evaluate the potential interconnectedness of counterparties? How do lenders or counterparties manage their exposures to investment vehicles?

As a threshold matter, we note that leverage is one investment tool among many available to asset managers. The use of the tool depends on the investment opportunities, the monetary costs of the leverage, and the client's risk appetite. For example, a mutual fund's board may have approved the use of leverage but may not be comfortable using it in the current environment. A different board, however, may want to use leverage to the maximum. The use of leverage at any given time must be weighed with the attendant risks and costs, just like any other investment tool at the manager's disposal.

If leverage is a structural component of an investment product's overall strategy, the asset manager should (and generally does) conduct extensive analysis before formulating appropriate leverage targets and limits, including by evaluating the following:

- Historical volatility of the product's asset class and potential likelihood the product will reach a point where de-leveraging is required. This analysis may include stress testing (focused on the particular type of fund at issue) as well. This analysis will be used in establishing the appropriate amount of "cushion" between the target and/or maximum amount of permitted leverage and any statutory, regulatory or contractual maximum.

- The relative liquidity of the asset class in normal markets and in hypothetical stressed markets. Such evaluations would suggest, for example, very different leverage limits for highly liquid large-cap equity strategies as compared to lower-liquidity emerging market fixed-income strategies. Liquidity evaluations often consider anticipated selling volumes and the likelihood that forced sales would be effected in a crowded marketplace alongside other distressed sellers.

- Anticipated credit covenants or borrowing base restrictions imposed by the lenders or counterparties.

- Whether the potential gains from deploying leverage justify the added NAV and liquidity risk.

- With respect to traditional borrowings, the stability of the anticipated credit facility and the likely logistical hurdles of replacing the facility in response to unanticipated events.

As described in the Notice and referred to above, regulations and contracts impose various limitations on the types and amounts of leverage that asset managers of registered funds, unregistered funds, and managed separate accounts may deploy. As we discussed above, some of these are imposed under the Investment Company Act or regulations thereunder,[106] while others are imposed by investment advisory agreements, the terms of the leveraging instruments themselves, and the fund's or separate account's other governing documents.

In the context of open-end funds, the combination of statutory requirements and the obligation to follow the investment policies laid out in the fund prospectus typically require the fund to be mindful of relevant regulatory leverage ceilings, particularly in non-stressed markets. The precise manner of managing these positions will vary depending on the preferences of a manager and the relative volatility of the underlying asset that is being levered: the greater the potential volatility of the asset, the greater the cushion below the statutory/regulatory leverage limit within which the manager is required to operate. Additionally, managers carefully monitor their exposures among different counterparties and lenders.

Although asset managers have minimal visibility into the interconnectedness of their counterparties, they address potential risks posed by such interconnectedness in several ways. To the extent any registered or unregistered fund, including a fund that provides exposure to an alternative asset class, invests in derivative investments, the fund's manager would consider the credit risk of the derivative counterparty when determining the appropriate maximum limit of exposure to that counterparty. A manager's evaluation of counterparties often takes into account the compliance requirements associated with the Investment Company Act, which, among other things, prohibits registered investment companies from purchasing or

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[106] For example, as we noted above, Section 18 of the Investment Company Act limits a registered mutual fund's ability to issue or sell "senior securities" (i.e., incur indebtedness in the case of open-end mutual funds). *See* Investment Company Act § 18. Other Investment Company Act provisions impose indirect limits on leverage by restricting portfolio concentration. Under Section 5, for example, mutual funds must designate themselves to be "diversified" or "nondiversified" and must adjust their portfolios to comply with specified limits applicable to such designations. *See* Investment Company Act § 5. The SEC has stated that a fund generally is concentrated in a particular industry or group of industries if the fund invests or proposes to invest more than 25% of the value of its net assets in a particular industry or group of industries. Securities and Exchange Commission, Concept Release, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*, 17 CFR Part 271 (Aug. 31, 2011), *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf, at 65.

otherwise acquiring any security issued by or any other interest in the business of any person who is a broker, a dealer, is engaged in the business of underwriting, or is either an investment adviser of an investment company or an investment adviser registered under the Advisers Act.[107] Funds and managers also seek to reduce counterparty risk through careful review and negotiation of contractual protections, robust collateral exchange agreements, and clear termination provisions. Many also use multiple counterparties to limit credit exposures and apportion risk.

Similarly, managers take care in sourcing the leverage facilities for their products. Managers often will have a stable of available leverage providers offering similar types of facilities so that, in the event a leverage provider terminates a facility, a replacement can easily be substituted rather than subjecting the fund to forced sales of the relevant levered asset.

While we understand that lenders and derivative counterparties adopt risk management techniques similar to those employed by asset management firms, they are also managing larger books of exposures and doing so using very sophisticated internal and external modeling and monitoring tools. For example, we believe broker-dealers with OTC derivatives exposure continually net in-the-money and out-of-the-money contracts to ensure a balanced book. Indeed, a series of OCC reports indicate that broker-dealers were able to reduce more than 80% of their derivatives exposures through netting from 2007 through the first quarter of 2011, a period that encompasses the financial crisis.[108] In accordance with International Swaps and Derivatives Association ("**ISDA**") protocols, broker-dealers also require asset managers to post various types of margin, including initial margin and variation margin calculated on net exposure. Broker-dealers also enter into separate derivatives contracts with each other to offset exposures presented by customer loans. To affirm our beliefs, we would strongly recommend that the Council direct this question to these market participants and the SEC as well.

Similarly, lenders almost always require that a fund either pledge specific collateral, which is often in excess of the loan amount, or grant the lender a first priority lien on the fund's assets. For registered mutual funds, lenders are further protected by the statutory limitations on the amount of leverage that fund may use.

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[107] *See, e.g.*, Investment Company Act § 12(d)(3). Rule 12d3-1 provides that, notwithstanding Section 12(d)(3), a registered investment company may acquire any security issued by a person that, in its most recent fiscal year, derived more than 15 percent of its gross revenues from securities related activities, provided that immediately after the acquisition of any security, the investment company: (1) may not have invested more than 5 percent of the value of its total assets in the securities of the issuer; (2) may not own more than five percent of the outstanding securities of that class of the issuer's equity securities; and (3) may not own more than 10 percent of the outstanding principal amount of the issuer's debt securities. *See* Rule 12d3-1 under the Investment Company Act.

[108] *See* ISDA, *Counterparty Credit Risk Management in the US Over-the-Counter (OTC) Derivatives Markets* (August 2011), *available at* http://www2.isda.org/attachment/MzQzMQ==/CounterpartyCreditLossesAug2011.pdf, at 4.

4. What risk management practices, including, for example, widely-used tools and models or hedging strategies, are used to monitor and manage leverage risks of different types of investment vehicles? How do risk management practices in investment vehicles differ based on the form of leverage employed or type of investment vehicle? How do asset managers evaluate the risk of potential margin calls or similar contingent exposures when calculating or managing leverage levels? How are leverage risks managed within SMAs, and to what extent are such risks managed differently than for pooled investment vehicles?

Asset managers employ a variety of tools and models to evaluate their products' risk exposures and thus their actual or effective leverage levels. For example, traders in the fixed income markets have traditionally measured their exposure to changes in market interest rates in terms of duration-equivalence, while also evaluating market exposure to account for different volatilities and correlations. More generally, managers often evaluate, among other risk measures, tracking error relative to a pre-specified benchmark index and Value at Risk ("**VaR**"), each of which factors in leverage exposures.

For various instruments, asset managers might simulate changes in market and global macro conditions to assess the potential impact on leverage. Stress tests and so-called "scenario analyses" are common tools, calibrated to the particular type of fund being evaluated, used to see how margin and leverage levels and cash flow needs would change in the case of adverse or volatile market conditions. Stress test and scenario analysis models typically address leverage exposures on an instrument-by-instrument basis *and* on a portfolio-wide basis, since risk-reducing transactions can increase leverage exposure in parts of a portfolio while decreasing leverage exposure in others.

Outside of the fund context, SIFMA AMG's 2014 survey of separate accounts indicated that less than 4% of the separate accounts with over $75 million in assets employed leverage and less than 2% of all separate accounts did. The average gross leverage for separate accounts that employ leverage was 1.35.[109] As we noted above, the survey also elicited information about risk management processes used in the management of separate accounts. It found that that 100% of respondents monitor counterparty risk for their separate accounts and employ robust procedures to this end. Similarly, the survey observed that separate account managers monitor a number of traditional portfolio risk measures in the course of separate account management, including duration, convexity, volatility, concentration risk, and liquidity risk. Many of the responding asset managers also reported using stress test analyses to observe the sensitivities of portfolios to particular factors, as well as VaR models.[110]

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[109] Separate Account Letter, *supra* note 59. For purposes of SIFMA AMG's survey, leverage was defined as long market value that exceeds NAV for equities or gross market exposure minus margin for derivatives. Long-only accounts that used derivatives for hedging or benchmark replication purposes were excluded.

[110] *Id.*

Pooled vehicles and separately managed accounts employ the same general variety of risk management tools and are monitored in similar ways, examined individually and collectively, by the firms that manage them.

5. Could any risk management practices concerning the use of leverage by investment vehicles, including hedging strategies, amplify risks?

A strength of the asset management industry is that individual firms and managers use different tools and take different approaches to managing risks related to leverage. This heterogeneity strengthens markets in two ways. First, the heterogeneity makes for more access to capital and fosters growth of markets. New risk management products beget new markets and new market participants. Second, risk management heterogeneity ensures that the attendant risks of leverage are not as systemic as they would be if risk management practices were homogeneous. For example, if an asset manager is forced to sell a leveraged instrument due to an ill-devised strategy or in response to global macro changes, other market participants will capitalize on the opportunity to buy the instrument at a discounted price, thus ensuring that the net impact of the sale is limited to the selling manager. Additionally, all asset managers should not be required by regulation to use the same risk metrics and employ the same risk tolerances.

Nevertheless, the existence of multiple risk management products and strategies suggests that regulators must carefully consider how leverage is measured. In particular, the liquidity, volatility and duration of the underlying levered assets are critical variables in assessing the impact of leverage. For example, a fund whose sole assets are three month Eurodollar futures levered five-to-one will likely have a much lower risk profile than a fund whose sole assets are three-month emerging markets index futures levered just two-to-one.

Asset managers, as a best practice, adjust leveraged exposures carefully and incrementally in response to small market movements, rather than waiting until leverage ceilings are breached before taking drastic remedial action. And leverage ceilings, just like leverage strategies and products, may vary from firm to firm among asset managers. We believe this is a positive characteristic.

6. To what extent could the termination of securities borrowing transactions in stressed market conditions force securities lenders to unwind cash collateral reinvestment positions? To what extent are securities lenders exposed to significant risk of loss?

We appreciate the Council's focus on securities lending practices, especially in light of Dodd-Frank's mandate that the SEC develop rules designed to increase the transparency of information available to brokers, dealers and investors with respect to securities lending practices.[111] The termination of a securities loan compels the lender to satisfy its liability for the

[111] Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 984, 124 Stat. 1376, 1932- 33 (2010). Notably, in over 30 years, we are aware of only four instances of borrower default in the industry.

cash collateral. In almost all cases, the lender will unwind its investment of the cash collateral, redeeming its investment in the money market fund or collateral investment pool, and use the redemption proceeds to return the cash collateral. But the premise of this question seems not to acknowledge that overcollateralization and the conservative nature of the investments involved in securities lending mitigate any systemic risk concerns. In a securities lending transaction, an investor lends its portfolio securities to a borrower who is obligated to return identical securities to the investor at a future date.[112] As security for the loan, the investor receives collateral, which is typically, but not always, cash.[113] For pooled vehicle lenders, such as mutual funds, securities lending transactions are often effected by an agent that lends the securities on the fund's behalf and takes in and administers the collateral.[114] The loan is over-collateralized at amounts ranging from 102%-105% of the value of the loaned securities.[115] When the loan is collateralized with cash, the cash collateral is generally invested in short-term money market instruments, in Rule 2a-7 money market funds, or in similarly conservative investment pools. The income generated from the investment of the cash collateral is returned to the lender, after deducting fees due to the agent and the rebate rate due to the borrower (which is essentially interest paid to the borrower on the cash collateral). Loans and collateral are marked to the market every day, with the borrower generally being required to deposit additional collateral if the collateralization level falls below 100%. From start to finish, the securities lending transaction is straightforward, controlled, managed, and audited to reduce risk. Borrowers are typically highly rated financial institutions. The use of collateralization levels greater than 100% is intended to permit the lender to repurchase its loaned securities in the unlikely event of a borrower insolvency or in the event that a borrower fails to return loaned securities.

Securities lending does not result in significant leverage, but it does carry four observable and controllable risks: counterparty risk, reinvestment risk, market/liquidity risk, and operational risk. Counterparty risk is the risk that the borrower defaults and fails to return borrowed securities, triggering the process of liquidating collateral and repurchasing lent securities. Although the failure of multiple counterparties could lead to systemic consequences, counterparty risk is mitigated by lending to well-capitalized, high quality borrowers, extensive and ongoing credit reviews, daily collateral mark to market, and indemnification from lending agents in the event of a default. Reinvestment risk is the risk that invested cash collateral incurs losses or underperforms relative to other investment options. This risk is mitigated by establishing conservative reinvestment guidelines, monitoring weighted average maturity, credit quality, sector allocations, and issuer diversification; maintaining sufficient ongoing liquidity; in-

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[112] *See, e.g.*, *Securities Lending by U.S. Open-End and Closed-End Investment Companies* and relevant SEC No-Action Letters cited therein, *available at* http://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm; *see also* Mutual Fund Directors Forum, *Report of the Mutual Fund Directors Forum: Practical Guidance for Fund Directors on the Oversight of Securities Lending* (May 2012), *available at* http://www.mfdf.org/images/uploads/newsroom/Board_Oversight_of_Securities_Lending_May_2012.pdf.

[113] *See, e.g.*, *Securities Lending by U.S. Open-End and Closed-End Investment Companies*, *supra* note 112.

[114] *See, e.g., id.*

[115] Mutual Fund Directors Forum, *supra* note 112, at 3.

house cash management; and obtaining non-cash collateral. Market/liquidity risk, or the risk that market movements affect security value following default causing difficulties or deficiencies related to liquidation, is mitigated by overcollateralization and collateral schedules with limits on credit quality and concentration limits. Finally, operational risk, which derives from potential processing, bookkeeping or other errors related to compliance or other actions, is mitigated by daily reconciliations, control and confirmation procedures, review of SAS 70 or SSAE 16s, and due diligence of agents.

The Investment Company Act and the SEC guidance issued thereunder impose additional constraints on the securities lending practices of registered mutual funds. For example, a registered fund: (1) is not permitted to lend securities without the approval of its boards and then only in accordance with robust policies; (2) must be entitled to terminate its securities loans at any time; (3) may only accept collateral in the form of cash, U.S. government or agency securities, or irrevocable letters of credit; and (4) may not loan securities with a total value in excess of one-third (33 1/3%) of the mutual fund's gross asset value, which includes collateral received under the loans (i.e., 50% of net assets).[116]

We acknowledge the plans announced by SEC Chair White to consider enhanced reporting and disclosure requirements related to securities lending practices.[117] Disclosures related to securities lending practices, if appropriately tailored, could potentially assist investors and counterparties in making informed choices about where they deploy their assets and how they engage in lending practices. However, if such potential disclosures are considered, care must be taken to not permit changes to turn securities lending into a one size fits all practice, which could lead to concentration, stifle innovation, and foster risks that do not currently exist.

7. To the extent that any risks associated with leverage in investment vehicles present risks to U.S. financial stability, how could the risks to financial stability be mitigated?

Our answers to questions 7 and 8 of this section are combined below.

8. What are the best metrics for assessing the degree and risks of leverage in investment vehicles? What additional data or information would be useful to help regulators and market participants better monitor risks arising from the use of leverage by investment vehicles?

Issues surrounding leverage have been an area of particular focus for U.S. financial regulators since the financial crisis in 2008. Dodd-Frank enacted numerous measures

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[116] *See, e.g.*, *Securities Lending by U.S. Open-End and Closed-End Investment Companies*, *supra* note 112; *see also* Mutual Fund Directors Forum, *supra* note 112.

[117] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

to control instruments deemed to have been harmful or potentially problematic. Similarly, measures like the Volcker Rule have been used to try to address systemic risk concerns.

These measures are still in their infancy, and at least some have not been codified by rulemaking, including many of the Dodd-Frank Title VII rules at the SEC and the Commodity Futures Trading Commission ("**CFTC**"), and many of the clearing-related measures under Title VIII. There is much unfinished work to do on that agenda, including streamlining data quality, aggregating across swap data repositories, and dissecting data from Form PF.

As a first step toward evaluating risk mitigation and determining best metrics for measuring leverage, we refer again to the initiatives announced by Chair White this past December and reaffirmed in other recent remarks by SEC staff to enhance data reporting and risk management related to portfolio composition. The SEC has dedicated staff in IM, DERA, and OCIE developing analytical tools in each area outlined by the Chair.

We further invite the SEC and OFR to share more detailed analysis of the results of Form PF data, including any findings, to evaluate the adequacy of those tools. This should be instructive in developing appropriately tailored metrics or mitigation techniques for pooled investment vehicles.

We also recommend that the Council enlist its international counterparts to evaluate the merits of various approaches for measuring leverage exposures. Many asset managers are subject to multiple international regimes that employ different leverage metrics. For example, the European Union's AIFM Directive and its UCITS guidelines set forth two distinct methodologies for calculating leverage,[118] while the Basel III concept of gross "notional" exposure results in yet another methodology.[119] These different metrics present challenges for asset managers' operations, and also make it very difficult for international regulators to learn from one another while regulating our markets. In that regard we encourage the Council to continue to support the Global Financial Markets Association's ("**GFMA**") Legal Entity Identifier ("**LEI**") initiative. This program has already enhanced the industry's ability to identify and monitor global market participants, and it promises to facilitate a consistent and integrated view of exposures.

Finally, leverage metrics must also account for the fact that there are different ways to measure leverage for different types of instruments or investment strategies. Indeed,

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[118] European Commission, *Commission Delegated Regulation (EU) No. 231/2013* (Dec. 19, 2012), *available at* http://ec.europa.eu/internal_market/investment/docs/20121219-directive/delegated-act_en.pdf; Committee of European Securities Regulators, *CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS* (July 28, 2010), *available at* http://www.esma.europa.eu/system/files/10_788.pdf. Notably, some managers have pointed to the AIFMD commitment leverage measure as a better representation of economic exposure than the UCITS approach because it takes into account netting arrangements and the use of derivatives for hedging purposes.

[119] *See* Basel Committee on Banking Supervision, Basel III Leverage Ratio Framework and Disclosure Requirements (Jan. 2014), *available at* http://www.bis.org/publ/bcbs270.htm, 12-13. Some managers note the limitations of the Basel measures, which were designed for banks, in the context of asset managers.

leverage is not an independent risk factor; it is a component – a multiplier, in a sense – of the aggregate impact of several component risks, including credit risk, market risk, liquidity risk, and volatility. For example, it is extremely difficult to compare, in a useful manner, the impact of levering a long-duration illiquid instrument with the impact of levering an exchange-traded short-duration instrument, and portfolio managers rarely manage a portfolio thinking in terms of levering on an instrument-by-instrument basis.

III. Operational Risk

Products and services offered by asset management firms are structured in ways that minimize the risk of disruptions associated with operational risk, even under conditions of extreme market volatility. Managers do not themselves hold the assets of fund companies or separate accounts that they oversee; rather, those assets are held at a third-party custodian, typically a bank subject to the oversight of prudential regulators. Furthermore, managers and funds routinely enter and exit the asset management industry.[120] Clients and investors also routinely enter and exit the market and reallocate assets among strategies and products. Such departures and changes, even in periods of stress, do not lead to fire sales or disorder.[121] In fact, the flexibility inherent in the structure of asset management firms may help dampen or limit operational risk because the overall industry is not dependent on any firm or small subset of firms as single points of stress or failure, and the frequency of such changes on a continual basis means that transition processes are familiar and predictable.

Asset management firms, operating in a highly competitive environment, invest considerable resources to manage operational risks that could adversely affect the assets they manage or prompt clients to move their assets to a new manager. Even if an isolated manager were to fail to adequately address one or more risks, it would not in itself create a systemic risk event. Indeed, operational risk management is a highly developed area in the asset management industry, characterized by seasoned internal practices and controls and often supported or evaluated by experienced third-party providers. Potential disruptions can come from a variety of evolving sources, and managers recognize that they must be vigilant in identifying potential issues and planning how to prevent or mitigate them. In part, this attentiveness reflects the highly competitive environment in which asset managers operate and the demands of clients who want to ensure that these managers are delivering consistent, reliable services.

Some asset management firms, in addition to compliance and audit functions, have well developed enterprise risk management ("**ERM**") practices built upon widely followed frameworks. The Committee of Sponsoring Organizations ("**COSO**") ERM framework, consisting of key components and strategic objectives, is a typical evaluation and monitoring tool

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[120] In 2013 alone, 424 mutual funds were merged or liquidated, and 48 mutual fund sponsors left the business without any impact or distress. Investment Company Institute, "*Orderly Resolution" of Mutual Funds and Their Managers* (July 15, 2014), *available at* http://www.ici.org/pdf/14_ici_orderly_resolution.pdf, at 2.

[121] *See id.* at 3 (summarizing the number of mutual funds that have been merged or liquidated in each year from 1996 through 2013).

employed by many fund complexes.[122] In larger and more sophisticated asset managers, operational risks can be addressed by an ERM framework that works to identify key risk elements within the firm and how those elements are monitored and risks mitigated.

Most of the internal tools for operational risk associated with client changes are focused on organizing efficient and effective communication, identifying potential issues, and ensuring appropriate coordination and escalation among internal and external parties. While individual firms organize their processes in different ways depending on their business model and size of operations, successful management of operational risk comes from project management that relies on a common set of associated tools and controls to facilitate the process. Firms may gather metrics on such information as performance of brokers in the settlement process, performance of the firm in continuity exercises, and root cause analysis of issues that may arise. Many firms have executive dashboards to provide trend analysis on a variety of metrics. These types of metrics are usually monitored and made available to management on a periodic basis with immediate escalation of any significant issues. In order to be effective, these approaches must be tailored to each firm's operations, which inherently means that they will differ from firm to firm. One approach will not be appropriate or sustainable for all investment managers. This means that attempting to impose such a framework by rulemaking will likely not be effective.

Of potentially more significant interest, asset managers are keenly focused on business continuity planning, disaster recovery, data protection, and cybersecurity issues – not just because of regulatory requirements,[123] but also as a business imperative. To this end, there are a variety of measures in place, both regulatory and market driven, to control operational risks. In addition, we note that there is a wide raft of regulations and guidance from the SEC, OCC, and others relating to operational risk procedures of asset managers and requirements

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[122] *See* COSO, *Enterprise Risk Management – Integrated Framework, Executive Summary* (Sept. 2004), available at http://www.coso.org/Publications/ERM/COSO_ERM_ExecutiveSummary.pdf ("[e]nterprise risk management is a process, effected by an entity's board of directors, management, and other personnel, applied in strategy setting and across the enterprise, designed to identify potential events that may affect the entity, and manage risk to be within its risk appetite, to provide reasonable assurance regarding the achievement of entity objectives" (internal emphasis omitted)).

[123] Rule 206(4)-7 under the Advisers Act requires each investment adviser to adopt and implement written policies and procedures reasonably designed to prevent the adviser from violating the Advisers Act. These policies and procedures should include business continuity plans because an adviser's fiduciary obligation to its clients includes taking steps to protect the clients' interests from risks resulting from the adviser's inability to provide advisory services after, for example, a natural disaster. *See* Final Rule: Compliance Programs of Investment Companies and Investment Advisers, Advisers Act Release No. 2204 (Dec. 17, 2003), *available at* http://www.sec.gov/rules/final/ia-2204.htm (discussing the need for advisers to establish a reasonable process for responding to emergencies, contingencies, and disasters, and that an adviser's contingency planning process should be appropriately scaled, and reasonable in light of the facts and circumstances surrounding the adviser's business operations and the commitments it has made to its clients); *see also* "SEC Examinations of Business Continuity Plans of Certain Advisers Following Operational Disruptions Caused by Weather-Related Events Last Year," National Exam Program Risk Alert, Vol. II, Issue 3 (Aug. 27, 2013) available at https://www.sec.gov/about/offices/ocie/business-continuity-plans-risk-alert.pdf. .

related to ensuring compliance by service providers and other vendors.[124] They include redundancies among essential systems and back-up trading sites.[125]

Similarly, in the aftermath of the May 2010 Flash Crash, asset managers worked with exchanges and other market intermediaries as the SEC and self-regulatory organizations established more finely calibrated "limit up-limit down," circuit breaker, and halt mechanisms that now assist asset management firms by limiting precipitous movements in the markets. The practical result of regulatory requirements, existing business imperatives, and the competitive incentives of asset managers is that the industry has successfully weathered market glitches, hurricanes, blizzards, floods, and terrorism.[126] However, that success is not taken for granted, as evidenced by the money invested by firms to prevent or mitigate the effects of these or other potential impairments.

There are a variety of third-party service providers offering essential services such as custody, pricing or other functions on which asset managers rely. Mutual funds, with independent boards, have fiduciary duties to select service providers including advisers, sub-advisers, pricing agents, transfer agents, custodians and accountants. In many cases, however, investment advisers only operate as sub-advisers and do not have primary responsibility for the selection and oversight of custodians. For example, most institutional separate account clients select and retain their own custodian, so the investment adviser has no direct role in the oversight of that relationship. In either case, market participants often work with and through third parties and service providers, and there are ongoing communications, contractual provisions, and diligence seeking to provide comfort about the quality and resiliency of the services being provided.[127]

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[124] *See, e.g.*, Rule 206(4)-7 under the Advisers Act; *see also* Inv. Adv. Act Rel. No. 2204 (outlining requirements relating to investment advisers); Rule 38a-1 under the Investment Company Act; Inv. Co. Act Rel. No. 26299 (requirements relating to registered investment companies); Comptroller's Handbook on Asset Management Operations and Controls (Jan. 2011), at 14 (describing outsourcing and vendor oversight, business continuity and contingency planning, and information security requirements for bank-sponsored asset management operations); FINRA Rule 4370 (describing business continuity requirements for FINRA member firms); NFA Rule 2-38 (describing similar requirements for NFA member firms).

[125] In February 2015, OCIE issued its preliminary observations on its examinations of 57 registered broker-dealers and 49 registered investment advisers to better understand how broker-dealers and advisers address the legal, regulatory and compliance issues associated with cybersecurity. The vast majority had adopted written security policies, and many use external standards and other resources to model their information security architecture and processes. Office of Compliance Inspections and Examinations, *Cybersecurity Examination Sweep Summary*, National Exam Program Risk Alert, Vol. IV, Issue 4 (Feb. 3, 2015), *available at* http://www.sec.gov/about/offices/ocie/cybersecurity-examination-sweep-summary.pdf.

[126] In particular, the August 27, 2013 National Exam Program Alert (*see* "SEC Examinations of Business Continuity Plans," *supra* note 123) tallied a review of 40 advisers in areas affected by Hurricane Sandy and noted a range of practices to address critical systems issues, continuity of operations, and contingency practices among the firms. Among their observations, the staff noted that advisers generally switched to back up sites or systems in advance of issues.

[127] As part of such an engagement, an asset management firm would seek assurances related to the services of a third party in the form of an auditor's report evaluating the service provider's operations and controls provided in a standard protocol known and presented as an SSAE 16 report (formerly a SAS 70 Report).

To ensure that they can continue to provide services through varying market conditions, service providers conducting critical functions such as custody services or who serve as central counterparties must themselves be supervised. As mentioned previously, some of these are banks that are already subject to the oversight of prudential regulators. Nevertheless, with increasing regulatory demands, these third parties are themselves going through periods of consolidation, and asset managers are finding that they must rely on a smaller pool for certain critical services. We understand that this is an area of some focus by the SEC and the other supervisory regulators of the entities at issue. Moreover, we appreciate that evaluating the obligations and challenges presented by these entities requires grappling with complicated, and in some ways contradictory, considerations. On one hand, it might be helpful to lower some of the barriers to entry to permit more entities to enter the service provider space in order to increase competition and offer managers more choice. New entrants may need regulatory flexibility that recognizes their specific risks and needs as they develop infrastructure, expand their platforms, and service new clients. At the same time, strong infrastructure and risk controls around resiliency and redundancy, testing, substitutability, and transition and resolution planning are important considerations in connection with the critical functions that key service providers perform.

We note that the Chair and the SEC's chief economist have referred to the newly promulgated Regulation Systems Compliance and Integrity ("Reg SCI"), which sets basic resiliency and continuity requirements for certain market participants (such as exchanges and clearing agencies) deemed to be performing critical functions, as a potential model for further regulatory expectations for other market participants.[128] Reg SCI already has market-wide testing requirements for SCI entities to designate members and participants to engage in annual testing exercises. We believe it will be advisable for regulators and market participants to work together to address these risks prudently and appropriately.

Custodians, market infrastructure providers such as central securities depositories ("**CSDs**") and international central securities depositories ("**ICSDs**"), and CCPs have an important role in maintaining control of client funds and securities. Effective oversight of these entities is critical to the resiliency and integrity of asset managers. Assets held by custodians are segregated from both the banks' balance sheet and other customers', and are therefore fully recoverable in the event of insolvency. Custodians typically used by U.S. asset managers are large banks, subject to prudential regulation and supervision by the U.S. banking regulators. All major U.S. custodians are subject to the heightened prudential standards for systemically important financial institutions under the Dodd-Frank Act, and four of the largest providers of such services are among the eight U.S. banks designated as G-SIBs (Globally Systemically Important Banks) by the FSB, and thus subject to even higher levels of regulation. In addition to heightened prudential standards, all such banks are subject to U.S. regulatory stress testing, which tests their ability to sustain severe economic shocks. These banks are also subject to U.S. living will requirements; for custody banks, the ability to seamlessly provide critical custody services is a key factor in the living will. Effective regulation of financial market utilities ("**FMUs**"), such as CSDs and ICSDs, is also critical to addressing possible operational risks for

[128] *See* 17 CFR Parts 240, 242 and 249, "Regulation Systems Compliance and Integrity" (Feb. 3, 2015); *see also* Flannery, *Asset Management, Financial Stability and Economic Growth* (Transcript), at 62.

the asset management industry. Such utilities hold the register of shares on behalf of investors and serve as the book of record for assets held, regardless of the custodian used, and ensure the clearing and settlement of securities transactions. As a result, such utilities, in combination with custodians, are important elements in protecting the interests of asset managers and their clients (beneficial owners). Similarly, asset managers' reliance on the resiliency of other FMUs, particularly CCPs, continues to increase, as regulatory mandates and market practice shift many formerly over-the-counter transactions to central clearing.

In the United States, FMUs are regulated under Title XIII of the Dodd-Frank Act; eight firms have been designated by the Council as systemically important, and therefore subject to enhanced regulatory standards under Title XIII. The effective regulation and supervision of these, and similar, entities, is critically important to the asset management industry.

We note that Chair White has announced that the SEC staff will be focusing attention on transition planning by asset management firms and potentially developing recommendations to require investment advisers to create transition plans to prepare for major disruptions in their business.[129] The goal of ensuring that asset managers and clients are prepared to deal with transition management is a shared priority and, as discussed more thoroughly below, an already well-advanced and sophisticated professional field within the industry. We further note that Chair White also announced plans around potential rulemaking relating to annual stress testing by large asset managers and large funds, as required under the Dodd-Frank Act.[130] Stress testing is a tool used by some asset managers. Members of SIFMA AMG have already briefed SEC staff on key aspects of the stress testing programs at asset management firms and look forward to further dialogue with the staff as they consider these issues.

Finally, as the Council evaluates operational risks at asset management firms and their potential effects on the wider financial system, we urge the Council to consider the multiple operational testing practices already underway or that may be instituted for asset managers. Taken together, the time that will be devoted to market-wide testing under Reg SCI, any additional Reg SCI-like requirements in contemplation for other market participants such as asset managers themselves, as well as additional Dodd-Frank related stress testing that the SEC is considering, will require considerable resources. Asset management firms already engage in

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[129] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 ("The staff is therefore developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business. The process of creating such a plan in advance of an actual severe disruption in the adviser's operations could better prepare advisers and their clients to deal with a transition and its attendant risks if one were required.").

[130] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4, at note 27, citing Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, section 165(i)(2), 124 Stat. 1423 (2010) (codified at 12 U.S.C. § 5365) ("The Dodd-Frank Act requires the Commission to establish methodologies for this stress testing of financial companies such as broker-dealers, registered investment companies and registered investment advisers with $10B or more in total consolidated assets—including baseline, adverse, and severely adverse scenarios—and to design a reporting regime for this stress testing, which must be reported to the Commission and the Federal Reserve Board.").

extensive testing through their normal business continuity planning and disaster recovery efforts, as well as from maintenance of or upgrades to existing systems, or from conducting other of their own idiosyncratic testing to ensure continuity and resiliency. Any additional requirements should be carefully considered within this context. We look forward to working collaboratively with the SEC and other market participants on the various forms of testing that may be appropriate. We view interaction between asset management firms and their primary regulator as a first and fundamental set of steps before the Council considers any further action.

1. **What are the most significant operational risks associated with the asset management industry and how might they pose risks to U.S. financial stability? What practices do asset managers employ to manage operational risks (e.g., due diligence, contingency planning)?**

Asset managers are highly incentivized to avoid potential operational risks. As described above, asset managers engage in substantial planning and diligence to safeguard their operations from risks across a spectrum of issues. If a single or even multiple firms encounter challenges, other firms are available to compete to assume responsibility and manage the assets and liabilities.[131] Further, operational challenges facing a single manager or set of managers do not in themselves present risks to U.S. financial stability. The inherent structure of the asset management industry provides a degree of flexibility and resilience that does not depend on any particular investment adviser. A change of investment adviser requires no change of custodian and no transfer of assets.

Nevertheless, we acknowledge that new sources of risk are being identified within the financial system and that asset managers are re-allocating or refocusing resources on these risks. A very current example of an operational risk to the financial services industry is the threat of cyberattack. This is not a unique risk to asset managers and, in fact, asset managers likely have a lower risk profile than banks or broker-dealers given the nature of client information retained and external access points. That said, spending at many firms has risen precipitously in recent years to address this risk. Historically, technology budgets have been mostly spent on tools, with an ever-expanding array of staff required to operate and use them. More recently, budgets are also being spent on incident planning (including gap analyses, formalizing policies and procedures, and training exercises) to enable asset management firms to defend themselves against not only the attacks themselves, but from regulatory and reputational risks that could follow in the wake of an incident.

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[131] For example, at the May 2014 FSOC Roundtable, Citadel described the process of purchasing distressed portfolios from two firms, a resolution effected within 36 hours by two private parties acting in their own interests and without the intervention of any government entity. Letter from Timothy W. Cameron, Asset Management Group, Head, and Managing Director, Securities Industry and Financial Markets Association, and John Gidman, President, Association of Institutional Investors, to Jacob J. Lew, Secretary of the U.S. Department of the Treasury, Re: Comments Summarizing the Financial Stability Oversight Council's May 19, 2014 Conference on Asset Management, SEC File No AM-1, at 10, *available at* http://www.sifma.org/comment-letters/2014/sifma-and-investors-group-submit-letter-to-us-treasury-summarizing-the-fsoc-s-conference-on-asset-management/.

Adequately addressing cybersecurity risk is a topic that also benefits from governmental support and coordination. In this regard, we acknowledge the important role played by other agencies, including the FBI, Treasury, and Federal Financial Institutions Economic Council ("**FFIEC**"), in providing better information and standard-setting guidance to aid in the prevention of cyberattacks. To date, the work of coordination across the financial sector has been episodic and limited, but it is improving. Although asset management firms, like other financial services industry participants, are already devoting significant resources to this issue, there are greater efficiencies that could be captured by better coordination and information sharing. As a coordinating body for other financial regulators, the Council should consider playing a more active role in fostering information sharing and best practices across the broader financial services sector to address this issue; this is an area of core competency for the Council and reflects a risk that can be transferred between sectors of the economy.

Another area of focus relates less to asset managers themselves than to the service providers on which they rely. As noted above, there are a relatively limited number of custodians of sufficient size to service the assets of larger asset management firms. In the case of FMUs, there may be a single provider in any particular market. There has been and will continue to be a dramatic shift toward a more central role performed by CCPs as various Dodd-Frank provisions come into effect. The Council should continue to monitor and encourage improvements to this part of the regulatory system to avoid unintended risks. While asset managers conduct diligence and develop contracts for service level expectations, asset managers do not have unlimited transparency into third parties or the authority of a regulator. Regulators should continue to consider whether expectations are sufficient or appropriate for the risks involved.

Like other market participants, asset managers also face the demands of increasing operational complexity that comes from programming systems to reflect the promulgation of new rules and agency expectations focused on data handling and reporting requirements, clearing mandates, execution, management, and analysis. If the SEC creates a tick pilot or alters fee structures, if it sets new margin requirements, or if regulators like the SEC and the CFTC create disparate requirements for swaps and securities-based swaps, then such changes and complexity can themselves pose operational risks. We provide these examples as a general cautionary note to the SEC and the Council regarding any additional significant new requirements, particularly before the completion of Dodd-Frank rulemaking or the SEC's or CFTC's market structure initiatives and Title VII rulemaking. We urge the Council to refrain from recommending any further requirements where Chair White has announced plans to evaluate potential initiatives for asset management firms across each area described in the Notice.

2. **What are the risks associated with transferring client accounts or assets from one manager to another and how do these risks vary depending on the nature of the client, the asset types owned by the client (e.g., derivatives), or how the asset type is traded or cleared? For certain asset classes or strategies, are the number of asset managers offering a comparable strategy so concentrated that finding a substitute would present challenges? How rapidly could investment management accounts be transferred, including during a time of financial market stress?**

Client or asset transfers are a well-managed part of the asset management business, and clients routinely instruct firms that have been given a management mandate to transfer the management of assets to another firm. As client custodians maintain the client funds and securities, there is typically no actual movement of assets – only a change in the authority to make investment decisions. Transition management strategies are a well-developed area of expertise, as leading asset management firms and other service providers routinely assist in the restructuring or migration of assets. This process is a common cycle, effected every day as clients reallocate assets. As was noted by one participant in the May 2014 Council roundtable, in the industry "the process of being hired and fired happens thousands of times a day."[132]

Asset management businesses are very familiar with and are able to conduct transition management efficiently and quickly when necessary. There are firms that provide transition management services specializing in helping asset owners minimize transaction costs while managing investment and operational risks. Additionally, transition managers help asset managers minimize costs to the rest of the client base and to the clients entering and leaving commingled funds. Investment funds also close regularly with little market impact. A recent Morningstar study found that 4 in 10 U.S. mutual funds operating ten years ago closed before 2014.[133] Similarly, the FSB and IOSCO acknowledged in their 2014 Consultative Document that "funds close (and are launched) on a regular basis with negligible or no market impact," and "even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact [from 2000 to 2012]."[134]

Protections exist to insulate clients from harm during such transfers.[135] Custody arrangements facilitate the movement of accounts or funds between managers. In the circumstance of a mutual fund, the arrangements are governed by a contract between the fund and the custodian and in general the custodian would simply need instructions from the board authorizing a new adviser to transact on the fund's behalf. Because the clients themselves

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[132] John Gidman, quoted in Cameron, *supra* note 131, at 13.

[133] Taylor Tepper, *Mutual Funds Gone Down the Drain,* Money Magazine (Mar. 7, 2014), *available at* http://time.com/money/2795219/mutual-funds-gone-down-the-drain/.

[134] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Jan. 8, 2014), at 30 & at note 38.

[135] The "asset management infrastructure . . . really put[s] the end investors a very far distance away from the trials and tribulations of their asset manager." Ken Griffin, quoted in Cameron, *supra* note 131, at 13.

typically control the appointment and maintenance of a custodian, the clients merely provide an instruction to the custodian to indicate that a different asset manager now has authority to manage the mandate. The custodian itself segregates client assets and receives instructions for changes in adviser authority. Indeed, U.S. asset segregation and custodian arrangements are a "substantial safeguard" that European regulators have acknowledged and seek to imitate in designing their own recovery and resolution frameworks for non-bank institutions.[136] In times of stress, including 2008, enormous transfers were effected without incident. In most respects, the only "delay" associated with such transfers may be regulatory in nature or related to receiving confirmations of the movement of the assets.[137]

3. **What market practices, processes, and systems need to be in place to smoothly effect transfers of client accounts or assets by asset managers and/or custodians? What differences exist in information technology systems, processes, or data formats that could pose operational risk, particularly when markets are stressed? Are there specific risks related to foreign clients, foreign custodians, foreign assets, or the use of offshore back-office operations?**

Most of the transfer work related to the movement of client accounts is effected by a custodian. The assets are segregated at the custodian; they belong to the client, not the manager. Asset managers are acting as agents, and creditors of the asset manager would have no claim on the assets of the client.

Transitions can take a variety of forms. In some cases, a client may request that the existing manager liquidate assets and the client can reallocate the cash or designate another asset manager to invest the cash. In other cases, a client will ask a successor manager to review the list of assets and determine which should be retained and which should be liquidated. In other cases, the custodian or sometimes a transition manager will be retained for the purpose of managing a transition to minimize friction. For example, if a client wants to move a significant amount of assets in S&P 500 stocks from one manager to another, it would not be unusual for each manager simply to update its own internal books to manage the changes, while the custodian makes note that it will receive investment instructions from a different manager. Standard portfolio accounting systems are designed to handle changes in contributions and redemptions of securities, sales and purchases, cash flows, and other standard data. For larger managers, portfolio accounting systems routinely handle institutional-level volumes. In general, firms do not face challenges related to systems themselves. Rather, they must take care in coordinating who is doing what and when. For example, moving an account as of a certain date

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[136] *See* Kay Swinburne, European Parliament Committee on Economic and Monetary Affairs, *Report on Recovery and Resolution Framework for Non-Bank Institutions* (Oct. 22, 2013), *available at* http://www.europarl.europa.eu/document/activities/cont/201310/20131023ATT73307/20131023ATT73307EN.pdf.

[137] Alan Greene, cited in Cameron, *supra* note 131, at 13. Although most securities can be transferred without difficulty, the transfer of OTC derivatives requires asset owners to call upon legacy advisers for assistance, which can increase costs and expose asset owners to some market risk. As more products move from an OTC to a cleared environment, we expect this challenge to be further alleviated.

requires care in planning and preparation, but a simple Excel spreadsheet may be all that is needed to share asset lists and project plans among asset managers, clients and custodians. In a transfer, recordkeeping is carefully maintained under requirements set by the Investment Company Act and the Advisers Act and under the terms governing custodial agreements, and transfers can proceed quickly. The optionality of effecting a change of investment adviser helps to mitigate the associated risks. As noted above, in some cases, a transition may not even require sales of assets. In circumstances where assets are actually to be sold, there may be additional incidental time associated with effecting the transactions advantageously and clearing the trades.

With regard to risks for foreign clients, custodians or operations, we note that most large custodians have global operations, and this aids significantly in the ability of asset management firms to oversee smooth transfers. We acknowledge that interactions with some foreign entities or service providers can bring delays as records and instructions are verified and firms meet the requirements of other jurisdictions. There are additional operational requirements associated with local country accounts, setting up to trade some currencies, or working with a new and unfamiliar custodian, but these processes are routine for managers dealing with any new client or client that is changing a mandate. Thus, these features of international work do not raise significant issues, but call for additional time that may be required for resolving issues. While such challenges are not always easy, they are part of daily operations for firms with an international overlay.

4. **While asset liquidation is not required for, and is not typically associated with, the transfer of client accounts, are there any significant risks of asset liquidations in the event of a large-scale transfer of accounts or assets from an asset manager?**

No. Although such circumstances would rarely present themselves (that is, transfers are often effected without the need for assets to be liquidated), asset managers are fiduciaries subject to a duty of care in managing client assets, including, if necessary, liquidating appropriately. As discussed in several places throughout this letter, significant numbers of pooled vehicles and separate accounts are transferred regularly and seamlessly – irrespective of size (we question what is meant by "large-scale" in an industry where institutional clients allocate assets in the billions) and complexity (the industry has seen managers merge with others or relinquish a mandate without disruption). If circumstances should warrant liquidations (for example, if a client seeks that outcome), it is in the interest of both the asset manager and the client to liquidate in an orderly, responsible fashion.

5. **To what extent do asset managers rely on affiliated or unaffiliated service providers in a concentrated or exclusive manner for any key functions (e.g., asset pricing and valuation, portfolio risk modeling platforms, order management and trade processing, trading, securities lending agent services, and custodial services)? What would be the impact if one or more service providers ceased provision of the service, whether due to financial or operational reasons, or provide the service in a seriously flawed manner? To what extent do potential risks depend upon the type of service provided, whether the provider is affiliated with the asset manager, or whether the**

service provider is non-U.S. based? What due diligence do firms perform on systems used for asset pricing and valuation and portfolio risk management?

Asset managers use the services of various affiliated or unaffiliated service providers. Typical business-continuity planning and disaster relief programs articulate the importance of back-ups and explicitly lay out contingency plans around service providers. The issue of finding alternative service providers does present challenges. There has been significant consolidation in the wake of regulatory and accounting pressure, and there are steep barriers to entry for new providers to join the ranks of existing custodians, accountants, and pricing services. While such consolidation raises general challenges for the industry (including limitations on the number of service providers industry members are able to turn to and rising costs associated with a small array of providers), this changing dynamic could be viewed by regulators as a positive change (fewer entities to regulate), a risk (an increase in single points of failure and a concentration of operational risk for the broader financial system), or a combination of both.

In the aftermath of the credit crisis, there has been considerable diligence imposed on the pricing process by the SEC and the Public Company Accounting Oversight Board ("**PCAOB**"), which has raised the bar for public accounting firms in the preparation of financial statements. As a result, pricing vendors are under much more scrutiny and provide much more transparency into their analyses. Most funds and advisers conduct regular diligence efforts on pricing vendors, and major vendors are regularly meeting with boards and managers.

There is less concentration among, and less reliance on, vendors to provide portfolio risk management, and firms vary widely in their use of such service providers. There are vendor applications to help gather and analyze data, but the key is how the data is used. The diligence that a client conducts is chiefly about the portfolio risk program rather than a particular system.

For its part, the SEC has embarked upon a review in the market structure space of single points of failure. The agency and market intermediaries are working on a series of resiliency standards and redundancy requirements relating to service providers. We also reiterate that Chair White recently announced that the SEC has launched an initiative regarding transition planning and stress testing,[138] which we expect will also evaluate the role of service providers. We will welcome the opportunity to provide input on any potential regulatory assessment the agency conducts.

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[138] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 ("The staff is therefore developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business…. The staff is also considering ways to implement the new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act.").

6. **What operational interconnections exist between the asset manager and the investment vehicles it manages, among investment vehicles managed by the same asset manager or affiliated managers, or between the asset manager and its affiliates? For example, to what extent do asset management firms rely on shared personnel, technology, or services among affiliates? Could any of those interconnections result in operational risk transmission among affiliated investment vehicles or asset managers in the event of a failure and resolution of an affiliate? Do market practices ensure that operational interconnections are sufficiently documented to allow for an orderly continuation of an investment vehicle's operations if the asset manager or affiliated or independent third-party service providers were to declare bankruptcy?**

Most asset management firms make use of shared personnel, technology and services among affiliates as a matter of course. Interconnectedness is inherently an issue of scale. Given that fixed costs are high, it is typically uneconomical to launch and advise a single pooled vehicle. Accordingly, an adviser would more customarily provide services to multiple funds or accounts to overcome high fixed costs. In theory, this raises the risk that a single issue at one entity would affect other funds or market participants; but in fact the added scale and specialization also mitigates risk, because each party is stronger and more sophisticated than it might be if it were acting on its own. An integrated business model that houses adviser, sub-adviser, distributor and custodian under one corporate roof potentially has greater internal coordination as well.

7. **What are best practices employed by asset managers to assess and mitigate the operational risks associated with asset management activities performed by service providers, whether affiliated with the asset manager or not, and how common are these practices across the industry? What agreements or other legal assurances are in place to ensure the continued provision of services? What are asset managers' contingency plans to deal with potential failures of service providers, and how might these plans be impacted by market stress?**

Asset managers seek assurances for activities performed by service providers by conducting due diligence prior to hiring and entering into service level agreements ("**SLAs**") with their service providers. Asset managers may also engage or otherwise rely on third parties to assess service providers and implement controls to mitigate potential weaknesses. For key services, many asset managers require SSAE 16 (previously SAS 70) reports to evaluate the key internal controls of the service providers. Depending on the service provider or the service at issue, asset management firms also keep regular metrics (e.g., performance evaluations of custodians to review failed trades, overdrafts, or other issues) and maintain regular communication with service providers to mitigate issues as they arise. Most firms have regular interactions (e.g., with pricing vendors), but there are also more formal diligence visits that occur on a regular basis. Although legal assurances are built into contracts with such providers, the practical way in which issues are handled between asset managers and service providers is as a business matter: dissatisfied managers may seek out the services of another provider in

circumstances where a vendor underperforms or otherwise raises concerns on the part of the manager or a fund board, which typically has oversight responsibility for key relationships.

Where an asset manager uses the services of an affiliated vendor, the asset manager may have better visibility into operations and could have more control over that service provider, even if it exists as a separate entity. However, asset managers are under an obligation to act as fiduciaries to their clients; therefore, they must evaluate performance of affiliated service providers under the same standard as they would the services provided by an unaffiliated entity. As such, ultimate responsibility and accountability to clients cannot be outsourced by asset managers to service providers. In addition, a service provider is usually contractually liable to an asset manager if it does not perform according to the parties' agreement.

8. **To the extent that any operational risks in the asset management industry present risks to U.S. financial stability, how could these risks to financial stability be mitigated?**

We reiterate our remarks made earlier in this section of our response, and focus here on cybersecurity, concentration risk among certain service providers and intermediaries, and settlement delays of leveraged loans. Cybersecurity is a shared area of focus for all participants in the financial services industry. Asset management firms are taking those threats seriously, and we believe the Council is in a good position to foster information sharing on best practices and incident management across firms overseen by the Council's various members and the other agencies with which they interact.

Also important to any conversation about operational risks for the asset management industry is the role performed by certain service providers and intermediaries. As Dodd-Frank requirements come to maturity, market participants will come to look even more to central clearing parties, and there is considerable unfinished work among the Council member agencies in bringing that regime to completion. As it stands, there is also concentration risk created by the increased use of CCPs, and the increased regulatory costs to serve as a CCP (or a SEF or as other new or existing types of service providers or intermediaries) will mean fewer entrants to serve asset managers and other market intermediaries. Similarly, there is also concentration among other service providers relied on by the industry, such as custodians for pooled investment vehicles and prime brokers for hedge funds.

As one further matter for consideration, but one that does not rise to a level of systemic concern, we take the opportunity to note that settlement delays relating to leveraged loans currently affect both buyers and sellers of such loans. We raise it here as a potential example where further operational efficiency could mitigate risk, as the market has grown over

the past decade.[139] The settlement of trades in such instruments is still fairly manual and involves longer settlement times than many other financial instruments.[140]

There may be a number of reasons attributable for a delay in settlement of loans, including the nature of the underlying loan itself. For example, distressed loans or loans that are the subject of restructurings may require additional documentation (e.g., additional representations and warranties) and further diligence (e.g., a review of the court docket for documentation as well as a chain of title review) before the loan can be transferred. In addition, loan settlements may be delayed due to the occurrence of certain events under the credit agreement. These include but are not limited to interest rate changes, credit agreement amendments, or voting on consents. During such intervening periods, trades are not permitted to settle so that the respective administrative agents can adjust their books and records accordingly.

From a trading perspective, the market convention is that, despite the delays in settlement, trades may occur on a trade date irrespective of whether or not the actual settlement has occurred. While certain documentation (e.g., a multilateral netting agreement) has been developed by industry associations such as the Loan Syndications and Trading Association ("**LSTA**") to address the fact that a seller of a loan may not in fact own it at the time of sale, it would be prudent to work towards an industry solution to reduce the time delay in the settlement of loans. There have already been large steps taken by the industry through the establishment of independent, electronic, web-based platforms where all parties to a given loan trade may perform or verify key tasks related to effectuating settlement.[141]

There have been a number of recent initiatives to standardize the settlement and clearing process for bank loans, but these initiatives have not been widely supported due to concerns over costs and the potential loss of flexibility in structuring loans. We believe regulators should work in tandem with the asset management industry and arrangers of leveraged

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[139] Trading volume for leveraged loans in the United States reached a record level of approximately $153 billion for the fourth quarter of 2014 (*see* The Loan Syndications & Trading Association, *The 4Q 2014 LSTA Secondary Trading Study* (Feb. 4, 2015), at 24), with a total of $628 billion for 2014 annually. *See id.* at 20. Viewed in perspective, U.S. collateralized loan obligations ("CLOs") accounted for roughly 62% of non-bank institutional lending for the fourth quarter of 2014. *Id.* at 6.

[140] *See generally* MarketClear data, *available at* www.clearpar.com. ClearPar-reported settlement times for 2013 overall had an average settlement time of T+22.8, whereas for 2014 it was around T+21.1. ClearPar data suggests that, for the period beginning October 1, 2014 and ending December 31, 2014, agent banks (with 100+ trades) had settlement times ranging from 8 to 85 days, purchasers (with 100+ trades) in general had settlement times ranging from 10 to 45 days, and loan sellers (with 100+ trades) in general had settlement times ranging from 16 to 37 days. Further, LSTA data suggests that as of the end of 2014, settlement times for par loans reached a two-year low of T+15 from T+18 business days. *See* The Loan Syndications & Trading Association, *supra* note 139, at 25.

[141] Such tasks include trade affirmation (via allocation) and confirmation; matching of trade terms; communication of credit events; person contact information center; posting of know your customer ("KYC") documentation (administration and tax forms); review of documentation provisions; signature / execution of relevant documentation; corroboration with third parties (agent bank, LC issuer, counsel) for consent; coordination for agreement of settlement time; and retainer / repository for upstream (predecessor transfer documentation).

loans to encourage building on the existing electronic settlement framework, ultimately seeking to reduce settlement times for leveraged loans in line with those for bonds.

We understand from OFR's announced plans that data gathering efforts will continue in 2015. But we believe that the most appropriate initial steps are linked to the data gathering and evaluation announced by Chair White around transition planning and stress testing. Such initial review and the opportunity to evaluate and digest the wide-ranging set of new regulatory requirements impacted by Dodd-Frank and on primary regulators are important initial steps before determining what, if any, additional measures might be warranted.

IV. Resolution

We appreciate the Council's recognition that asset management firms and investment vehicles have wound down their affairs without presenting a threat to U.S. financial stability; that investment vehicles managed by asset managers have separate legal structures; and that the assets of such vehicles are not legally available to the asset manager, its affiliates, or parent for satisfying its financial obligations or those of any affiliate.[142] As the Council and other regulators and experts have noted in a variety of contexts, these characteristics distinguish the asset management business from banking and other financial products and service providers.[143] They also explain why the resolution of investment funds and investment advisers has historically had no discernible market impact, let alone threatened financial stability.[144]

The asset management business is inherently different from that of banks. There are fundamental differences between the concepts of deposits and investments. Depositors in banks are guaranteed immediate access to their money, so the risk parameters they undertake are different from investment-taking risks. Investors place money with asset management firms

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[142] *Notice*, *supra* note 3, at 23-24; *see also* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 (discussing the Commission's focus on improving transition planning).

[143] *See, e.g.,* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4, *see also* Pinschmidt, *supra* note 13, at 53-58.

[144] *See, e.g.*, FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies, supra* note 15, at 29-30. As articulated by Scott. C. Goebel at Fidelity, "Funds that experience heavy redemptions or liquidate actually achieve one of the FSB SIFI Framework's primary goals without the need for designation or a special resolution mechanism – they 'resolve' themselves in an orderly fashion with no discernible market impact. Liquidation follows an orderly process with minimal impact on shareholders and no discernible impact on the markets. As the FSB and IOSCO acknowledge, 'even when viewed in the aggregate, no mutual fund liquidations led to a systemic market impact throughout the [2000-2012] observation period.'" Letter from Scott C. Goebel, Senior Vice President, General Counsel, Fidelity Management & Research Co., to Secretariat of the Financial Stability Board, Re: Consultative Document on Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, at 10 (Apr. 7, 2014), *available at* http://www.sec.gov/comments/am-1/am1-45.pdf (citing FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, *supra* note 15, at note 38).

intentionally to take risk and receive full disclosure of the various risk factors. Custody concepts are very different, as asset managers are not in possession of client funds and securities. The structure of the business with separation among investment advisers, sub-advisers, funds, boards and custodians provides flexibility and resiliency; it also facilitates easy resolution through normal processes. There is less reliance on a single point of failure, and it is far easier for another market participant to step in if an entity can no longer provide services. For these and other reasons, the factors that require special resolution planning and a unique resolution mechanism in the banking context to preserve financial stability simply do not apply to the asset management business.

As established by Congress, the Council's mandate is to identify threats to U.S. financial stability, but the resolution of asset managers does not present such a threat. As discussed more fully below, investment funds, their managers and affiliated service providers have historically been resolved regardless of market conditions. Their resolutions through these processes have not threatened financial stability and there is no empirical support for an assertion that they are likely to in the future. Accordingly, there is no need for a new or special resolution regime for asset management entities of the sort that is under development for SIFIs.

Based on the experience of the 2008 crisis, Congress and other policymakers have deemed the resolution of certain entities to be an essential component in reducing a potential source of systemic risk.[145] But the entities to which this imperative was directed should not be confused with asset management firms and vehicles, which do not share the same fundamental characteristics as those entities. Indeed, the Council states this plainly in the opening paragraphs of the Resolution section of the Notice:

> The Council recognizes that asset management firms and investment vehicles have closed without presenting a threat to financial stability. The Council notes that an investment vehicle has a separate legal structure from the asset manager, any parent company, or any affiliated investment vehicles under the same manager. In addition, the assets of the investment vehicle are not legally available to the asset manager, its parent company, or affiliates for the purpose of satisfying their financial obligations or those of affiliated investment vehicles.[146]

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[145] The Financial Stability Board (FSB) has also made proposals aimed to assure the availability of debt that is convertible into equity should a firm fail, thereby providing for absorption of losses and possible recapitalization without the need for injecting public capital. *See* Financial Stability Board, *Adequacy of Loss-Absorbing Capacity of Global Systemically Important Banks in Resolution* (Nov. 10, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/TLAC-Condoc-6-Nov-2014-FINAL.pdf. *See also* Governor Daniel K. Tarullo, *Dodd-Frank Implementation*, Speech before the Committee on Banking, Housing, and Urban Affairs, U.S. Senate (Sept. 9, 2014), *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20140909a.htm ("We have also worked with the Financial Stability Board (FSB) to reach global agreements on resolution regimes for systemic financial firms and on a set of shadow banking regulatory reforms."); Department of the Treasury, *Financial Regulatory Reform: A New Foundation*, *available at* http://www.treasury.gov/initiatives/Documents/FinalReport_web.pdf ("We recommend the creation of a resolution regime to avoid the disorderly resolution of failing BHCs, including Tier 1 FHCs, if a disorderly resolution would have serious adverse effects on the financial system or the economy," at 16.).

[146] *Notice*, *supra* note 3, at 23-24.

Funds and their managers enter and leave the industry routinely in all market conditions. By one estimate, excluding data for ETFs and closed-end funds, over 9,500 mutual funds were merged or liquidated between 1996 and 2013, or an average of 528 per year.[147] Between 2000 and 2013, 651 mutual fund sponsors left the business, or an average of 46.5 per year.[148] These mergers and liquidations happened through varying market conditions, but occurred with little notice and with no appreciable impact on U.S. financial markets. The breadth of the market in terms of many different advisers, sub-advisers, and varieties of funds and separate accounts also mitigates the effect and potential impact of any single actor on the systemic risk scale.

We do not believe there is theoretical support for the inquiry into resolution for asset managers: the differences between the structure, economics, regulation and oversight of banking institutions (on one hand) and asset managers and their pooled vehicle and separate account clients (on the other) help explain why resolution is a complex and potentially destabilizing endeavor for large banking firms and a routine matter for the asset management industry.

The products and services offered by asset management firms serve specific needs of investors, different from other aspects of the financial service industry. Because managed assets are held differently, there is ready substitutability of one asset management firm for another. There are various protections afforded to asset manager clients, such as the custodial practices and other features described throughout our response.[149] Investors are not promised returns on their investments, and investment results – whether gains or losses – are apportioned to pool investors on a pro-rata basis or borne exclusively by clients with separate accounts. Asset managers are fiduciaries to their clients acting as agents of the funds or separate accounts they manage. They provide services in exchange for a fee, take no balance sheet risk with respect to a fund's or an account's investment performance, and have no ability to use a client's assets for their own purposes.[150] Beyond ensuring that an adviser has sufficient resources to employ staff and purchase tools and systems in order to provide services, the actual balance sheet of an adviser is irrelevant. The assets of the adviser are separate from the assets of each client to

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[147] Investment Company Institute, *supra* note 120, at 2-3.

[148] *Id.*

[149] For example, open-end mutual funds have a 300% asset coverage requirement. 15 U.S. Code § 80a–18(a)(1)(A), *available at* http://www.gpo.gov/fdsys/pkg/USCODE-2011-title15/pdf/USCODE-2011-title15-chap2D-subchapI-sec80a-18.pdf. *See also* Paul Scott Stevens, President and CEO, Investment Company Institute, *Financial Stability and U.S. Mutual Funds*, Mutual Fund Investment Management Conference (Mar. 17, 2014), *available at* http://www.ici.org/pressroom/speeches/14_pss_mfimc ("... mutual funds make little or no use of leverage"); SIFMA Press Release, *SIFMA AMG Survey Shows Separate Accounts Do Not Pose Systemic Risk* (Apr. 11, 2014), *available at* http://www.sifma.org/newsroom/2014/sifma_amg_survey_shows_separate_accounts_do_not_pose_systemic_risk/ ("Less than 4% [of Asset Managers surveyed] employed large SMAs surveyed employ leverage and the average leverage reported for these accounts is modest.").

[150] "[A]sset managers are essentially unlevered…." Andrew Haldane, Executive Director, Financial Stability and Member of the Financial Policy Committee, *The Age of Asset Management?*, Speech at the London Business School (Apr. 4, 2014), at 12, *available at* http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf.

which it acts as agent to provide investment advice. Of course, any particular asset manager could have poor investment performance or client service or otherwise fail to obtain or retain clients and investors. At that point, its business may wither. An investment adviser failure would also be irrelevant to the stability of the financial system since any "interconnectedness does not emanate from the manager's balance sheet."[151]

In fact, not only does the current process work well, but it also functions more seamlessly than normal bankruptcy processes.[152] Funds and managers are essentially self-resolving in the sense that clients can take their assets to another manager. When a fund does need to liquidate, it follows an established and orderly process by which the fund liquidates its assets, distributes the proceeds pro rata to investors, and winds up its affairs. This process is effected routinely and without consequences to the broader financial system.

More commonly, funds self-resolve or merge as opposed to liquidate. These mergers follow well-established practices outlined extensively in existing regulations. Rule 17a-8 of the Investment Company Act governs the merger of affiliated funds and provides safeguards to ensure that the transaction is in the best interests of the shareholders.[153] Under this rule, a merger of a registered investment company and one or more other registered investment companies is exempt from sections 17(a)(1) and (2) of the Investment Company Act if the "Surviving Company" is a registered investment company and if the board of the "Merging Company" determines that the merger is in the "best interests" of the company and that existing shareholder interests will not be diluted as a result.[154] This process happens regularly under Rule 17a-8 and takes place under board oversight. As an additional safeguard, in the event the transaction should happen under extraordinary conditions, the SEC may invoke its Section 22(e) authority to allow temporary suspension of redemptions.[155] Private funds have even more flexibility to manage such changes without some of the technical requirements of the Investment Company Act. Transitions for separate accounts are even more seamless, as the client merely instructs its custodian to take investment direction from a different investment adviser.

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[151] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies,* (Jan. 8, 2014),at 30, fn. 36. "Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank. Asset managers are, to a large extent, insolvency-remote." Andrew Haldane, "The Age of Asset Management?" speech at London Business School (Apr. 4, 2014), at 6, available at http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf.

[152] *See, e.g.*, Goebel, *supra* note 144, at 10 ("Liquidation follows an orderly process with minimal impact on shareholders and no discernible impact on the markets").

[153] *See* Rule 17a-8 under the Investment Company Act.

[154] *See id.* Sections 17(a)(1) and (2) of the Investment Company Act prohibit transactions of certain affiliated persons and underwriters. *See* Investment Company Act §§ 17(a)(1)-(2).

[155] *See* Investment Company Act § 22(e) (suspension of right of redemption or postponement of date of payment; "The Commission shall by rules and regulations determine the conditions under which (i) trading shall be deemed to be restricted and (ii) an emergency shall be deemed to exist within the meaning of this subsection").

The simple fee-for-service agency model of an asset manager, independent custodians, monitoring (both fund specific and enterprise wide) conducted by managers, regulators, investors and their representatives (such as independent fund trustees, consultants, etc.), and disclosures offered to investors and their representatives ensure that potential problems are identified early and that their potential impacts on the services investors are receiving can be minimized or avoided by transferring assets long before anything resembling an actual resolution is required. By the point a fund or manager may be winding down its affairs, responsibility for its clients' assets likely would have been transferred to another investment adviser; therefore, it would be systemically irrelevant when its resolution commenced.

Likewise, transitions from one fund or manager to another are facilitated by technology, the extensive experience of investors (retail investors can often switch investments with a few clicks of a mouse), managers and other service providers such as custodians, and by a highly evolved and competitive range of transition management services used by mutual fund complexes to migrate client assets within a fund group or from one manager to another. A key objective for any transition protocol is protecting the best interests of clients and minimizing disruption or harm. Indeed, firms compete with one another for management mandates on their ability to bring assets over while minimizing volatility, friction, and expense, and to enable investors to move their assets seamlessly if they should determine to do so later.

In terms of any broader focus on practices by asset managers, we note that Chair White has called for regulatory enhancements to address the circumstance where an adviser is no longer able to serve its client, including the ongoing servicing of client needs while assets are "swiftly transferr[ed]" from one asset manager to another.[156] Importantly, Chair White has emphasized the differences between the risks involved in winding down an adviser's affairs and those of other financial firms or banking concerns.[157] She also made clear her appreciation for the fact that advisers routinely exit the market without significant impact.[158] More recently, Acting IM Director Grim has acknowledged that advisers operate in these circumstances in keeping with their fiduciary obligations and under provisions such as the Rule 206(4)-7 compliance program requirements relating to business continuity.[159] Nevertheless, they have

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[156] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 ("A third focus of our regulatory enhancements is on the impact on investors of a market stress event or when an investment adviser is no longer able to serve its clients. There are several risks associated with such events. For example, during an adviser's dissolution or following the departure of key personnel, an adviser may face challenges in serving its clients' needs while also swiftly transferring its asset management services to another firm.").

[157] *See id.* ("…it is important to recognize that the risks associated with winding down an investment adviser are different than those associated with other kinds of financial firms.").

[158] *See id.* ("Client assets are not the assets of an adviser, and advisers routinely exit the market without significant market impact.").

[159] David Grim, Acting Director, Division of Investment Management, *Remarks to 2015 IAA Compliance Conference* (Mar. 6, 2015), *available at* http://www.sec.gov/news/speech/remarks-pli-investment-management-institute-2015.html#.VQH3QTvD9aQ ("For instance, as part of the compliance programs required by rule 206(4)-7 under the Advisers Act, registered investment advisers are required to adopt and implement written policies and procedures reasonably designed to prevent the adviser from violating the Investment Advisers Act.").

both focused attention on challenges that could occur if there are restrictions on investors' abilities to access or move assets away from an adviser or other de facto limitations imposed by illiquid assets or market conditions.[160] In pursuing any of the enhancements Chair White has discussed, the SEC changes may heighten focus on the process.

We expect to work closely with staff at the SEC as the Chair evaluates the need for and design of any potential enhancements, and we agree that good transition planning is in the interests of investors and markets alike. Such initiatives would need to contemplate what circumstances, beyond imprecise notions of "market conditions" or "periods of stress," would warrant putting such transition plans on standby or in motion. It will be critical that the SEC approach any evaluation of potential proposals for further regulatory steps with precision by identifying clearly what gaps need to be addressed and what tools of measurement will be used to establish baselines and evaluate progress, and by conducting careful economic analysis of the costs and benefits likely to be associated with any regulatory changes.

As with other areas of inquiry raised by the Notice, care should be taken to avoid overly prescriptive approaches to dictating practices at asset managers, as such measures could themselves create the risk of concentration that does not currently exist. Specifically, if managers are reduced to a constrictive range of assets or management tools, the risks associated with those tools are amplified because more managers are relying on them. In addition, a regulatory imperative that steers managers towards certain asset classes on the grounds of liquidity or relative ease of transferability may have the very adverse impact of drawing liquidity away from other parts of the market and exacerbating the very problem such directions intend to solve. The existence of discretion and diversity among investors, asset managers, other service providers and their respective practices are key reasons why the industry has been resilient through numerous economic downturns.[161] Indeed, this resilience has been acknowledged and cited as a source of U.S. resiliency and economic growth worthy of emulation, according to European Union and European Securities and Markets Authority ("**ESMA**") regulators.[162]

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[160] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 ("For example, if there are restrictions on investors' ability to access or move assets away from an adviser – or, more generally, de facto limitations imposed by illiquid assets or market conditions – a clear transition plan for that adviser could benefit investors and the market.").

[161] *See* Liang, *Asset Management, Financial Stability and Economic Growth* (Transcript), 48-53, at 48 ("And they've weathered all kinds of adverse market conditions without noticeably contributing to systemic risk. Indeed, they may provide a diversity of sources of funds for borrowers and may have had stabilizing influences on aggregate credit.").

[162] "[Establishing the Capital Markets Union will] provide us with a deeper, safer, more liquid and more integrated capital market that can serve the economy much better and reduce our dependence on bank intermediated funding." Jonathan Hill, *Answers to the European Parliament Questionnaire to the Commissioner-Designate Jonathan Hill: Financial Stability, Financial Services and Capital Markets Union*, at 4, *available at* http://blogs.ft.com/brusselsblog/files/2014/09/Hillanswers.pdf; *see also* Jonathan Hill, *The Rule of Financial Markets Can Play in Growth and Jobs*, Speech at SIFMA, New York, N.Y. (Feb. 27, 2015), *available at* http://europa.eu/rapid/press-release_SPEECH-15-4523_en.htm ("[D]eveloping stronger and deeper capital markets [is a priority for the EU] . . . . Europe has traditionally been much more dependent on the banking system than you are in the US. Medium-sized companies here receive five times

We are nevertheless pleased to offer some observations on the subject of resolution and to respond to the specific questions posed by the Council in an effort to enhance its collective understanding of asset management products and services.

1. **What financial interconnections exist between an asset manager and the investment vehicles it manages, between an asset manager and its affiliates, or among investment vehicles managed by the same or affiliated asset managers that could pose obstacles to an orderly resolution? To what extent could such interconnections result in the transmission of risk among asset managers and affiliated investment vehicles? Do market practices ensure that any financial interconnections are sufficiently documented to allow for an orderly continuation of operations if an asset manager, investment vehicle (e.g., private fund), or affiliate were to become insolvent, declare bankruptcy, or announce an intent to close?**

There are no financial interconnections among asset managers and their affiliates or the funds and accounts they manage that should impede a firm's orderly resolution. The limited financial interconnections that do exist are well documented. Asset managers serve as fiduciary agents to the funds or accounts they manage. The fundamental characteristics of the business, including its structure and economics, regulation, and independent oversight, help explain why there are no "obstacles to an orderly resolution" as posed as a question in this Notice.

As described throughout our response, asset management is a fiduciary business, where the manager and other service providers are hired to perform well-defined, regulated and documented services as agents for the fund or account. The asset manager's performance is overseen by multiple parties, including its own management, auditors and regulators, the management, auditors, regulators, fiduciaries and other representatives of the fund or other entity for which it is providing the service. Furthermore, the assets of a fund or account are separate structurally and economically from the manager and other service providers. Finally, to the extent that there are limited exceptions to the general rule of separation among these entities and financial interconnections beyond the fee-for-service, they are well regulated and documented, which would facilitate an orderly resolution.

Fundamentally, asset managers are fiduciaries to their clients, and the asset management industry is an agency business in which the investors are hiring specialists to provide portfolio management services. These services fit into a well-defined and comprehensive regulatory regime established and evolved from the 1940s onward. As a result, in keeping with its fiduciary duties under the Advisers Act and regulations promulgated thereunder, along with contractual obligations, an adviser manages any portfolio it oversees in accordance with the investment objectives and policies associated with the fund or account. Those relationships are governed by a robust regulatory regime aimed at protecting investors and supporting market integrity. Those regulatory obligations include general prohibitions on

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as much funding from capital markets as they do in the EU . . . the US venture capital market is five times bigger than it is in the EU.").

principal trading with clients. These features distinguish the "manager/fund" relationship from the regime overseen by banking regulators, where there is no agency relationship, and the assets and liabilities of customers are consolidated on the bank's balance sheet and used in the bank's business. Conversely, the asset management industry's existing regulatory structure and objectives mirror and cover as a practical matter many of the concerns the Council seeks to monitor. By circumscribing the freedom of the manager and limiting losses to investors, the structure both protects and limits harm to those same investors and mitigates threats to the U.S. financial system.

Rules governing the nature of the relationship between advisers and funds limit the types of financial interconnections that exist and establish a robust compliance, regulatory, and monitoring environment. An adviser's obligations are spelled out under various regulations and by contract. As is well known to the Council, there are multiple layers of internal and external oversight of a fund, its service providers and their interactions with each other. Overseeing the entire process for mutual funds is a board that typically has a significant majority of independent members. The board also seeks to fulfill its fiduciary obligations and ensure compliance with mandates established under the federal securities laws.

In terms of the structure of typical mutual funds or separate accounts, each has a separate legal status distinct from that of its manager and any other funds or accounts managed by the same adviser. Under Rule 206(4)-2 of the Advisers Act, investment advisers that are deemed to have custody of client funds and securities must, among other things, maintain those interests with a "qualified custodian" (typically a bank or a broker-dealer) in an account either under the client's name or under the adviser's name as agent or trustee for its clients. Mutual funds are also required under the Investment Company Act to maintain custody of fund assets separate from the assets of the fund manager at an eligible custodian, typically at a bank.[163] These "qualified custodians" must maintain client funds in special accounts, subject to a variety of safeguards and regulations.[164] Losses are borne by the entity, not the manager, as the manager acts as an agent pursuant to a contract.

2. Could the failure of an asset manager or an affiliate provide counterparties with the option to accelerate, terminate, or net derivative or other types of contracts of affiliates or investment vehicles that have not entered insolvency?

Although managers leave the industry, failures of sizable asset managers are exceedingly rare and have not, by themselves, had an effect on other market participants. That is not to say that a failure of a large private or mutual fund may not have economic consequences for investors, the asset manager, counterparties or other market participants. However, economic risk is isolated to the particular fund or account facing the counterparty. Larger scale failures of note in the recent past have had materially different fact patterns. As noted above, the LTCM failure, for example, operated in a very different environment with very different derivative

[163] Rule 206(4)-2 under the Advisers Act.

[164] *See id.*

structures and counterparty risk oversight. While there may be larger questions about the role of money market funds in general, the Reserve Money Market Fund wind-down did not involve derivative contracts where acceleration or termination was at issue. More commonly, mutual funds or other clients will terminate an adviser, or the asset manager will lose its mandate and assist clients in moving assets to a new asset manager. For reasons discussed above, these types of movements do not invoke any resolution scenario of the type contemplated by the Council.

More broadly, however, the migration of assets from an asset manager or the closure of one of its affiliates would not typically result in affording counterparties with options to terminate, accelerate, or net derivative or other contracts, as the asset manager is not the principal in the trade. Rather, the client or fund is generally the principal. Consequently, as long as the dealer agrees that the underlying fund or account is a good credit, the relationship will continue despite the change in the manager.

To be clear, under typical bilateral derivatives protocols, if a manager to a fund undergoes a change in control, or if the fund is transitioning to entirely new management, the fund must obtain the consent of the counterparty, as this is a qualifying event that would permit the termination of the agreement. Typically, the counterparty is a well-capitalized bank or broker-dealer. Existing contracting standards govern agreements with these counterparties, such as the ISDA contracts for derivatives.[165] ISDA's Credit Support Annex ("**CSA**") outlines unilateral or bilateral collateral-posting requirements, and also contains provisions for material adverse changes.[166] The CSA also details rules for termination of contracts.[167] Based on our collective experiences, as a practical matter, we are unaware of any circumstances where counterparties have not agreed to continue with existing agreements where there have been changes of managers.

Likewise, there has been a considerable evolution in tri-party custodian and collateral agent holding arrangements since the crisis. The result of this work is that the pledgor, the secured party and the custodian set forth the custodian's obligations to comply with the instructions of the parties with respect to the collateral in the account based on negotiated parameters.

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[165] Commonfund Institute, *Managing Counterparty Risk in an Unstable Financial System*, (Nov. 2012), 7, *available at* https://www.commonfund.org/InvestorResources/Publications/White%20Papers/2012%2011%20Managing%20Counterparty%20Risk%20(Belmont).pdf.

[166] *Id.*

[167] *Id.*

3. **In what ways, if any, could the potential risks associated with liquidity and redemption or leverage discussed in Sections I and II, respectively, impact the resolution of an asset manager or investment vehicle in times of financial stress?**

As discussed more broadly in sections I and II above, we do not agree that the risk factors discussed in previous sections raise concerns about the resolution (or, more practically speaking, the transition plans) of asset managers. It is not clear why an asset manager's resolution would be complicated by fund-portfolio-level risks as suggested by this question. Liquidity and redemption and leverage risks are managed within established conservative regulatory parameters as well as more specific limits set under the investment objectives of individual funds or mandates established by separate accounts. Moreover, as explained above, risks that do exist are borne by investors at the pooled vehicle or separate account level without systemic implications.

Investors need not wait for an asset manager's resolution. They can redeem their investment from a fund or fire the manager and manage their assets themselves or hire a replacement manager. More frequently, however, funds are resolved through mergers or liquidations. If funds are merged, the surviving fund assumes the assets and liabilities of the absorbed fund. If a fund is liquidated, there is likewise a process that encourages managers and mutual fund boards to seek the best returns for shareholders and requires that they apportion proceeds pro rata.[168] Although the question does not make clear what metrics would distinguish "times of financial stress," mergers and liquidations have been carried out routinely throughout varying investment cycles—including the recent financial crisis—without difficulty or particular incident. Our discussion above on leverage limitations under which funds operate and liquidity and redemption management practices applies in this context.

Existing safeguards established by regulations and contracts would also protect industry participants and investors should certain unlikely events actually occur. If a fund manager did face solvency issues, the board could exercise authority to terminate the contract. If an asset manager did need to go through a resolution, the process would require the firm simply to liquidate its own assets such as real estate and equipment, while its liabilities would be limited to leases, service contracts, and personnel expenses. Fund assets would remain with the fund custodian immune from creditors of the asset manager. If the asset manager happened to own shares of the fund it managed, it would receive pro rata proceeds like other shareholders. For separate accounts, assets would similarly be immune from the adviser's creditors, and the mandate and assets would migrate to the care of a new manager or simply be returned to the underlying clients.

We question the idea of importing the banking notion of resolution to asset management firms where it seems facially inapplicable. Meanwhile, we acknowledge that Chair White's determination to evaluate whether additional work is needed on transition planning, already a highly developed and well-known field within the industry, represents a distinct and

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[168] For a more detailed survey of the liquidation process, *see* Jack Murphy, Julien Bourgeois, and Lisa Price, *How a Fund Dies*, The Review of Securities & Commodities Regulation, Vol. 43, No. 21 (Dec. 1, 2010).

appropriate area for further focus by our primary regulator.[169] We encourage the Council to defer to the SEC's leadership in this area for the asset management industry.

4. **Are there interconnections that exist between asset managers and other financial market participants that in times of financial stress could transmit risks? For example, are there risks that securities lenders indemnified against borrower default by an asset manager lending agent may terminate their loans if the asset manager were to fail?[170] If so, could those terminations have disruptive consequences if counterparties face an unexpected requirement to return borrowed securities upon early loan terminations?**

We do not believe that these interconnections exist between asset managers and other parties in any appreciable way to warrant concern. As acknowledged by the FSB and IOSCO in its 2014 Consultative Document, there are few, if any, direct financial interconnections between the manager and other financial market participants. According to the FSB and IOSCO, "[e]conomic exposures are created at the fund level as they emanate from the underlying asset portfolio held by the fund. It is therefore the portfolio of assets that creates the respective exposures to the financial system."[171] Further, the report acknowledges that "any interconnectedness does not emanate from the manager's balance sheet."[172]

In connection with securities lending activity specifically, the potential loss exposures that are being indemnified against are among the smallest risks confronting the funds. As noted by the FSB and IOSCO, "[I]ndemnification is not triggered unless the borrower's obligations exceed the value of the collateral plus margin obtained from the borrower during the most recent mark to market" in the range of 102 to 112 percent.[173] This collateral is also in itself of the highest credit quality.

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[169] *See* White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4 ("The staff is therefore developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business.").

[170] Securities lending agents often indemnify lenders against borrower default, and under indemnification agreements must cover the shortfall between the value of the securities on loan and the value of the collateral pledged by the borrower (but typically not losses resulting from cash collateral reinvestment).

[171] FSB/IOSCO, *Consultative Document – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (Jan. 8, 2014), *supra* note 15, at 30.

[172] *Id.* at 30, note 36.

[173] Cited in BlackRock, *Securities Lending: Balancing Risks and Rewards*, ViewPoint (May 2012).

5. **For asset managers, investment vehicles, or affiliates that operate internationally, in what ways could cross-border resolution complicate an orderly insolvency or resolution in one or more jurisdictions? Do contracts with service providers, such as custodians or prime brokers, allow for assets to be custodied, or subcustodied, at offshore entities, and what are the implications for resolution?**

No, the international operations of a fund or its manager would not appreciably "complicate" the orderly resolution of either, nor would the presence of an "affiliate." An asset manager and its fund client would be resolved under the laws of the jurisdiction in which it was incorporated, as would its manager. For the overwhelming number of our members and the funds or accounts they manage, U.S. law would apply. To the extent a fund or account invests in foreign assets, the asset manager typically hires a U.S. custodian that retains a foreign sub-custodian and guarantees its performance. In the event that a foreign sub-custodian fails to perform, the fund or account is typically indemnified by the U.S. custodian.[174]

Because assets are registered in the name of a fund instead of the manager, the transitioning of assets in pooled vehicles introduces a change of beneficial ownership. In developed markets, securities may transfer between accounts free of payment. However, some emerging markets do not allow this process. As a result, securities for those markets may need to be liquidated or purchased directly by the outgoing or incoming fund managers in the market. This transition process may reduce cost savings, and there could be delays associated with the uncertainties presented by a particular country's situation and circumstances. It should not, however, ultimately affect the resolution (whether by merger, liquidation, or transfer) of a fund.

6. **What contingency planning do asset managers undertake to help mitigate risks to clients associated with firm-specific or market-wide stress?**

Because funds and their managers are at little risk of insolvency, the concept of "firm-specific stress" most likely involves operational issues within the firm. In response to this aspect of the question, we refer to the range of best practices and protocols discussed in the operational risk section above, but underscore again that firms have highly developed management tools in place to mitigate risks, including the routine practice of transitioning firms in widely varying market conditions, and the array of SEC and other rules that are enforced irrespective of market conditions.[175]

The reference to "market-wide stress" could be interpreted to refer to asset-price volatility, illiquidity, an operational failure at a CCP, geopolitical crises or some other pressure.

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[174] Furthermore, with respect to U.S, mutual funds, there is a robust regulatory regime in place governing the custody of funds outside of the U.S. *See* Rule 17f-1 under the Investment Company Act; *see also* Rule 17f-7 under the Investment Company Act.

[175] Asked about their primary strategic business priorities over the next ten years, institutional participants (including asset managers, asset owners, and intermediaries) responding to the Center for Applied Research Influential Investor Survey 2012 responded that "expanded risk management capabilities" was their number one priority. *See generally* State Street Center for Applied Research Study 2014, *supra* note 35.

To the extent one or more of these circumstances arises and the issue is operational, asset management firms plan for and anticipate such events, and material risks are fully disclosed to any pool investor; once again, we refer you to our responses in the operational risk section. To the extent that the issue presented would have financial consequences, asset managers likewise plan for those circumstances as part of their portfolio management process.

7. **To the extent that resolution and liquidation in the asset management industry present risks to U.S. financial stability, how could the risks to financial stability be mitigated?**

Simply stated, resolution and liquidation in the asset management industry do not present risks to U.S. financial stability. Fund mergers and liquidations are a routine part of the industry and have been readily managed through various market cycles. In 2013 alone, 424 mutual funds were merged or liquidated, while 48 mutual fund sponsors left the business; these events occurred with little notice beyond the parties directly involved and created no distress in the markets.[176] Since the onset of the crisis, thousands of other mutual funds have been merged or liquidated, and hundreds of sponsors have left the business without incident. Separate accounts are launched, transitioned and terminated on a daily basis, and clients can easily move assets due to the independence of the client's custodian from their asset manager.

We appreciate the Council's efforts to monitor evolution in our financial markets and to look for collateral effects of changes since the onset of the financial crisis. One particular area where we agree the Council should be focusing its attention and could benefit the asset management industry is with respect to certain categories of service providers, particularly custodians and central counterparties. In this area, only a few large players offer services and concentrate market risk. Several elements currently restrict the number of players in this space; starting up new businesses in these areas is costly, and new regulatory requirements and other barriers to entry leave asset managers relying on a limited pool of entities.

In recent remarks, Governor Tarullo noted the imperative to complete certain reforms associated with central counterparties and the need to do more to complete certain reforms of these entities and banks charged with establishing viable resolution plans.[177] To the extent that asset managers will increasingly be called upon to transact derivatives and other financial transactions through central clearing parties, we agree that it is essential to ensure that those institutions are sound and stable and provide appropriate transparency to market participants. Further, in circumstances where a CCP experiences the failure of a member or a rapid change in the value of instruments it trades, it may look to clearing members for support. We acknowledge the work of the Committee on Payments and Market Infrastructures ("**CPMI**") at the Bank of International Settlements and by IOSCO, as well as by the SEC, CFTC, and the Federal Reserve to ensure the safety of CCPs. We note that CPMI and other international and

[176] Investment Company Institute, *"Orderly Resolution" of Mutual Funds and Their Managers* (July 15, 2014), at 2-3.

[177] *See* Tarullo, *supra* note 145.

U.S. regulators are continuing to discuss potential new reforms, including optimal default coverage standards. Those efforts are not without controversy; however, we support a robust dialogue and point to this as an area of core competency for the Council to assist in the gathering of information.

8. What data currently are available or should be collected to monitor activities that may affect a resolution?

We support the Council and OFR in their efforts to promote the LEI initiative. For years, the financial services industry has been challenged by the fragmented collection of identifiers used to designate an entity as a party to a financial transaction. The financial crisis of 2008 underscored the need for a single entity code so that transaction counterparties and regulators could analyze the monetary exposure and risk profile of counterparties. In this regard, we note the statement of policy from the OFR entitled "Statement on Legal Entity Identification for Financial Contracts," which is aimed at requiring financial counterparties to acquire and use LEIs when completing transactions.[178] That work continues at the Treasury, but we encourage the Council to promote the framework, governance, and implementation of a global LEI system.

We also believe that the Council should promote coordination and information reconciliation among CCPs who are still struggling with establishing norms for reporting to the CFTC and have yet to have a full regulatory framework in place at the SEC or in other jurisdictions. Such efforts will pay dividends not just for the asset management industry, but also for other financial markets participants who must look to these entities increasingly in the aftermath of the promulgation of Dodd-Frank's central clearing mandates.

We encourage the SEC and the OFR to make use of and appropriately share information gained from Form PF. To date, we have seen relatively little use made of the data that have been collected at considerable expense by asset management firms. To the extent that the information already collected provides either crude measures or misleading information on the health of or use of investment tools by these funds, we would like to work with the SEC to refine the evaluation methodology (recognizing that there are many variations, variables and systems issues that make changing or expanding such methodologies challenging) before taking steps to suggest any additional data collection requirements for existing reporting firms or a wider set of entities.

We note once again that Chair White announced in December that the SEC staff will be proposing recommendations for information and protocols affecting mutual funds, ETFs, separately managed accounts, and other investment management products and services.[179] We look forward to providing information to the SEC staff and working with them to appropriately evaluate these issues and suggest how the agency might shape its program. The SEC should be

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[178] *See generally* Department of the Treasury Office of Financial Research, *Statement on Legal Entity Identification for Financial Contracts*, Statement of Policy with Request for Comment (Nov. 23, 2010), *available at* http://www.treasury.gov/initiatives/Documents/OFR-LEI_Policy_Statement-FINAL.PDF.

[179] White, *Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, supra* note 4.

well positioned to learn a number of lessons from its program of collecting data from private funds and money market funds as it considers whether to seek additional information from funds and separately managed accounts.

We believe that there are other issues and participants in the markets that should be higher priorities for the Council than resolution in the asset management business. Pooled investment vehicles rely on or will increasingly rely on a number of these entities. CCPs are an example that we have noted, along with other service providers that stand as switching points along the investment process. We do not want to overstate concerns about custodians, whose practices are generally sound and who have the backing that comes with being a banking enterprise. But unlike the broader asset management industry, which is characterized by competition, substitutability, and regular instances of migration, mergers or liquidation, the pool of custodians and some other service providers – like CCPs – available to asset managers is relatively small. Consequently, their increasingly pivotal roles warrant careful attention. In contrast to the case for heightened interest in these entities, we see no empirical or theoretical support for concern regarding the resolution of investment funds or their managers.

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We appreciate the opportunity to comment afforded to us by the Council and stand ready to provide any additional information or assistance the Council might find useful. Should you have any questions, please do not hesitate to contact Tim Cameron at 202-962-7447 or tcameron@sifma.org, or Karen Barr at (202) 293-4222 or karen.barr@investmentadviser.org.

Sincerely,

Timothy W. Cameron, Esq.
Managing Director
Asset Management Group – Head
Securities Industry and Financial Markets Association

Karen L. Barr
President & Chief Executive Officer
Investment Adviser Association

cc: Hon. Jacob J. Lew, Secretary, U.S. Department of Treasury
Hon. Mary Jo White, Chair, U.S. Securities and Exchange Commission
Hon. Timothy G. Massad, Chairman, U.S. Commodities and Futures Trading Commission
Hon. Janet L. Yellin, Chairman, Board of Governors of the Federal Reserve
Hon. Thomas J. Curry, Comptroller, Office of the Comptroller of the Currency
Hon. Martin J. Gruenberg, Chairman, Federal Deposit Insurance Corporation
Hon. Luis B. Aguilar, Commissioner, U.S. Securities and Exchange Commission
Hon. Daniel M.. Gallagher, Commissioner, U.S. Securities and Exchange Commission
Hon. Kara M. Stein, Commissioner, U.S. Securities and Exchange Commission
Hon. Michael S. Piwowar, Commissioner, U.S. Securities and Exchange Commission
Lona Nallengara, Chief of Staff, U.S. Securities and Exchange Commission
David Grim, Acting Director, Division of Investment Management, U.S. Securities and Exchange Commission

APPENDICES

SIFMA AMG SURVEY
FSOC NOTICE SEEKING COMMENT ON ASSET MANAGEMENT PRODUCTS AND ACTIVITIES

The Financial Stability Oversight Council's ("FSOC" or "Council") Notice Seeking Comment on Asset Management Products and Activities states that, "the Council's analytical process will depend importantly on the existence and availability of high-quality data and information, which are essential to the ability of the Council to carry out its statutory purposes."[180] In order to assist the FSOC in its efforts, we asked members of SIFMA's Asset Management Group (the "AMG")[181] to respond to a survey on issues under consideration by the Council. This executive summary summarizes the questions asked in this survey and the findings.

The survey asked respondents to answer a number of questions about tools available to manage risks. Based upon the results of the survey, we note that asset managers utilize a wide range of tools to manage liquidity and redemption pressures. Firms have sophisticated tools and processes to monitor and analyze both intra-day and historical changes in shareholder activity in relation to the market environment, and the ability to analyze portfolios to determine which holdings could be efficiently liquidated at a reasonable cost to satisfy redemptions.

Our members reported that temporary cash funds and sweep vehicles provide the first layer of liquidity to manage shareholder redemptions. Asset managers also arrange committed lines of credit to be used across their funds in case of high levels of redemptions, or lines of credit dedicated to specific funds or a small set of funds.

Individual members provided details regarding the tool sets available to address liquidity and redemptions. They noted, for example, to enable the sale of securities when needed, investment guidelines determine minimum liquidity thresholds, including guidelines for loan funds requiring a minimum amount of assets that have contractual settlement periods, or a maximum amount of below investment grade bonds. Asset manager tools provide for qualitative driven liquidity "scores," which are informed by the experience of market practitioners as well as the security type, maturity, sector, credit quality, embedded optionality, and other attributes that influence investor demand. To address redemptions, our members reported that asset managers may also use redemptions-in-kind, staggered cash outflows, extended notification required for redeeming, redemption gates, and closing the pool to new investments.

The survey also asked our members about derivatives, including whether derivatives are used to replicate the performance of a benchmark for a cash component of the fund. In response, more than half of the surveyed asset managers (64%) reported that they use derivatives for this

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[180] Financial Stability Oversight Council, Notice Seeking Comment on Asset Management Products and Activities, Docket No. FSOC-2014-0001, *available at* http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf

[181] The AMG's members represent U.S. asset management firms whose combined assets under management exceed $30 trillion. The clients of AMG member firms include, among others, registered investment companies, endowments, state and local government pension funds, private sector Employee Retirement Income Security Act of 1974 pension funds and private funds such as hedge funds and private equity funds.

purpose, however at least one asset manager noted that this is done for equity funds but not fixed income funds.

The survey also asked asset managers how they manage outflows from mutual funds. In response, nearly 80% of surveyed asset managers noted that they have access to a line of credit, and 64% also noted that they have drawn on the line of credit within the last five years. Some asset managers, however, have only drawn down on the line a few times, while others noted that they have done so with some frequency.

More than half of the surveyed asset managers (62%) reported that they also stress test their funds. Of those asset managers that stress test, 89% stated that they test for the purposes of testing for a gain/loss profile of a portfolio. The number of factors the tests account for vary widely, from three factors to up to 2800 factors. Additionally, 57% of those that reported they stress test stated that they use additional metrics for funds that utilize leverage. Most (86%) indicated that the test varies by product. All asset managers who responded that they stress test their funds also stated that they report the test results to the Fund Directors. However, the frequency of these reports varies. Most firms noted that they report quarterly, but some firms responded that they report up to 8 times per year.

The survey also focused on securities lending. More than half of the surveyed asset managers (57%) responded that they engage in securities lending for many types of funds, including equity, fixed income, asset allocation, exchange traded funds ("ETFs"), and mutual funds. All of the firms who responded that they engage in securities lending also noted that they utilize a third party securities lending agent or affiliate, and all give instructions with regard to the type of vehicles in which collateral can be reinvested. Of those that engage in securities lending, 80% set guidelines around maturity and other considerations. For a subset of those engaging in securities lending, 63%, securities lending is limited to 2a-7 funds.

The AMG survey also gleaned information regarding the length of time it takes from start to finish to transfer an account from one asset manager to another. In the vast majority of cases, the transfer can be done in one day. For other asset classes (emerging market high yields, for instance), the transfer can take months. However, even in these situations, there is often a transition manager who takes over immediately upon notification of the change. The assets are in the possession of the client's custodian bank, and the asset manager authority is by appointment. As the assets are already in the client's name, or the custodian nominee name, there is little time needed operationally to make the change. The duration of the time it takes to transfer an account is a result of the change that is introduced to the portfolio. Respondents explained that there would first be discussions between the client and the new asset manager as to how much change should be introduced to the portfolio to bring it in line with the new manager's preferred portfolio models. If the client is changing the actual investment discipline of the portfolio, additional time is needed to restructure the investments from one asset class to another.

We, and the investment managers who participated in this survey, have provided this information to better inform regulator consideration of asset management products and activities. We welcome the opportunity to engage further on this topic if warranted. Should you have any questions, please do not hesitate to contact Tim Cameron at 202-962-7447 or Lindsey Keljo at 202-962-7312.

Survey of Asset Managers in Connection with Asset Management Products and Activities

Do your funds engage in interfund lending to address liquidity issues?	
NO 92%	**YES 8%**

Do you have access to a line of credit to manage outflows from your mutual funds?	
NO 21%	**YES 79%**
	The line of credit covers from 0.3 up to 14.30 percentage of the AUM of funds.
	1. 64% have drawn down on the line of credit in the last five years.
	From those that drew on the line of credit in the last five years, 67% said they did so more than 5 times; 17% said five times, and 17% said twice.

What tools do you use to manage liquidity and redemption pressures?
Futures, cash and line of credit.
All stocks considered for research must meet our minimum liquidity thresholds. When evaluating liquidity, we focus on how each stock would impact our ability to transact the entire portfolio. We use Bloomberg to obtain the trading volume data used in our analysis.
Investment guidelines that help ensure minimum liquidity, including guidelines in loan funds requiring a minimum amount of assets that have contractual settlement periods, or a maximum amount of below investment grade bonds. We measure ownership of equities with respect to daily average trading volume and monitor cases where a fund is relatively high against this measure; action steps can include closing funds to new investment. We arrange committed lines of credit to be used across the funds in case of high levels of redemptions; in some cases we arrange lines dedicated to a specific fund or a small set of funds. We monitor and provide information to portfolio managers of threats to liquidity including (a) investor concentrations in the funds they manage, (b) percentage of the fund holdings that are in challenging liquidity categories, such as equities that are a high percent of daily average trading volume, or below investment grade debt and (c) results of stress tests We apply a special framework called the “mobility measure” to a subset of our funds that simulates both stressed redemptions, stressed asset prices, and stressed cash requirements stemming from derivative products. The measure uses a 1 month, 99% worst case stress period, and require these funds to meet a threshold level for this measure. In the event of redemptions, we have the ability but do not expect to use: redemption in kind delays of up to a week in providing cash to the investor.
Temp Cash Funds/sweep vehicles provide the first layer of liquidity to manage shareholder initiated cash flows. Use of the line of credit follows this, along with the sale of underlying portfolio securities which, in our Funds, are generally very liquid.

Varies depending on funds but use following in different combinations: asset-in-kind transitions, stagger cash outflows, extended notification period before client allowed to redeem, NAV and dealing suspensions, close pool to new investments, liquidate pool, swing pricing, monitor cash flows, side pockets and redemption gates.
The successful management of liquidity to accommodate shareholder redemptions calls for at least two basic decision support capabilities: (1) the ability to characterize changes in shareholder activity as a function of the market environment; and (2) the ability to analyze current portfolio holdings to determine precisely which holdings could be liquidated at reasonable cost to satisfy redemptions. Our suite of portfolio analysis tools provides the first of these capabilities by allowing managers to monitor the status of intraday shareholder activity, as well as to examine historical shareholder patterns and to associate these patterns with underlying market conditions. Our tools provide the second capability in various forms, primarily by allowing managers to efficiently sort, filter, and group portfolio holdings according to key security attributes correlated with liquidity, including quantitative measures of market risk. Moreover, other components of our tool suite provide managers with the ability to construct a sector process resulting in a qualitatively driven liquidity "score," informed by the experience of various market practitioners, indicating the potential difficulty of selling a security as a function of its type, maturity, sector, credit quality, embedded optionality, and other attributes that may influence investor demand.
The portfolio managers for the funds may use ETFs and/or futures to equitize cash and to allow for more liquid execution. Additionally, they may utilize short settlement through brokers, access broker capital and/or maintain high cash levels or cash-like instruments as needed. The firm also has a Valuation & Liquidity Oversight Committee that is designed to provide oversight and administration of the policies and procedures governing the fair valuation and liquidity determination of securities held in the firm's portfolios. For institutional clients, the funds utilize large order notifications and may also redeem certain clients in kind under certain circumstances.
Historical flows analysis, stress testing, minimum liquidity requirements, risk factor exposure monitoring, and concentration limits.
2. Liquidity buffers, as determined by the portfolio managers 3. Various internal reports 4. The fund boards have approved redemption-in-kind procedures for extraordinary circumstances
Withdrawal restrictions, delayed payment, in kind redemptions, liquidity facilities (credit lines)
Note we have a committed and uncommitted line. Redemptions in kind. Monitoring our liquidity based on stress tests.
Generally speaking, liquidity and redemption risk is low for mutual funds. That said, we have developed internal reporting to monitor various factors - such as market risks and liquid asset holdings - with the aim to help prepare our funds for periods of market stress

Do you use derivatives to replicate the performance of a benchmark for a cash component of the fund?	
NO 36%	**YES 64%**

Do you stress test?	
NO 38%	**YES 62%**
	Of those that do stress test, 89% stress test for the

	purposes of testing the gain/loss profile of a portfolio.
	The stress tests account from 3 to up to 2800 different factors.
	57% utilize additional metrics for funds that utilize leverage.
	86% said that the test varies by product.
	100% of those that perform stress test report the stress test to the Fund Directors.
	The frequency of report to the Fund Directors varies. Most firms report quarterly, some firms report up to 8 times per year.

Do you engage in securities lending?	
NO 43%	**YES 57%**
	The types of funds engaging in securities lending: Equity, Fixed-income, Asset Allocation, ETFs, Mutual Funds, bank maintained collective and common trust funds, US RIC Funds, US Fiduciary Trust Funds.
	The percentage of funds engaging in securities lending ranges from 0.0048 to 80.
	100% give instructions with regard to the types of vehicles in which collateral can be reinvested when engaging in securities lending.
	80% set guidelines around maturity or other considerations.
	For 63% the reinvestment of securities lending collateral is limited to 2a7 funds.
	100% utilize a third party securities lending agent or affiliate.

How long from start to finish does it take for one asset manager to transfer an account to another asset manager?
Depends on asset class, for vanilla stocks and bonds it could be 1 day, for more esoteric products, it could be months.

Few days.
Typically 6 months for registered funds. The process often involves Board approval, shareholder approval and implementation.
The answer depends on the type of strategy, the account size, the markets in which the holdings are based, and whether the transfer will be in-kind or sell to cash, among other factors. For example, a $100 million International Equity account could be liquidated to cash in less than one day, with the average daily volume at 3%.
From one day to a few months, depending on the asset class.
This is not a function of our business, as such operations are performed by the firm's service providers.
Generally, once pre-execution planning and analysis is complete, it will only take a few days to transition a client account. In limited circumstances, the transition has taken longer due to a variety of factors including market impact. In those cases, the transitions could have been implemented much more rapidly, but a more deliberate and careful approach was developed, reviewed with, and approved by the clients involved.
A transition from one manager to another takes place essentially in a day. There would be discussions between the client and the new Asset Manager as to how much change should be introduced to the portfolio to bring it in line with the new managers preferred portfolio models. The key is that the assets are in the possession of the client's custodial bank and the manager authority is by appointment. If a client is changing the actual investment discipline of the portfolio, then of course there is some additional time needed to restructure the investments from one asset class to another. The duration of time is a result of the significance of the change. (For example Fixed Income to Global Small Cap Equity would require some time). Most events can take place over just a couple of trading days, and then the standard market settlement practices. The smaller cap markets tend to have less daily liquidity by name, and these transitions have taken longer should liquidation of the account be necessary versus a transfer of securities in kind. If a client is changing the actual investment discipline of the portfolio, then of course there is some additional time needed to restructure the investments from one asset class to another. The duration of time is a result of the significance of the change. (example Fixed Income to Global Small Cap Equity would require some time). In my experiences on transitions in general, most events can take place over just a couple of trading days, and then the standard market settlement practices. The smaller cap markets tend to have less daily liquidity by name, and this transitions have taken longer should liquidation of the account be necessary versus a transfer of securities in kind.
The time to transition an account to another asset manager varies based on the asset classes of the mandate. If the portfolio is in developed markets it may only take 3-5 days. As the assets are already in the client's name or the custodian nominee name, there is little time needed to operationally make the change.
One month if the new manager has an existing relationship with the client's custodian; three to six months if the new manager has no pre-existing relationship with the custodian.
Generally, a client should be able to instruct their bank to start taking instruction from a new manager/transition manager within one business day. Factors such as mandate changes, changes in beneficial owner or securities to be traded may impact the timeline.
A transfer could take place within 5 business days if all management and trading agreements are in place.
With traditional stocks and bonds 2- 4 days. The addition of derivatives and currency forwards would increase that time frame.

January 13, 2015

Via Electronic Mail

Mr. Christopher J. Kirkpatrick
Secretary
Commodity Futures Trading Commission
Three Lafayette Centre
1155 21st Street, NW
Washington, DC 20581

Re: Records of Commodity Interest and Related Cash or Forward Transactions; RIN 3038-AE23

Dear Mr. Kirkpatrick:

The Investment Adviser Association ("IAA")[1] appreciates the opportunity to submit comments to the Commodity Futures Trading Commission ("CFTC" or "Commission") regarding the CFTC's proposed amendments to recordkeeping Regulation 1.35(a) under the Commodity Exchange Act ("CEA").[2] The Proposal seeks to codify and expand certain no-action relief, issued by the CFTC staff subsequent to the adoption of amendments to Regulation 1.35(a) in 2012, to exempt commodity trading advisors ("CTAs"), as members of a designated contract market ("DCM") or swap execution facility ("SEF"), from the oral recordkeeping requirement in Regulation 1.35(a). We strongly support the proposed oral recordkeeping exemption for CTAs. In addition, we request that the Commission exempt CTAs from the written recordkeeping requirements under Regulation 1.35.

I. Background of Regulation 1.35

The CFTC amended Regulation 1.35(a) on December 17, 2012 to integrate provisions of the Dodd-Frank Wall Street Reform and Consumer Protection Act for futures commission merchants ("FCMs"), certain introducing brokers ("IBs"), retail foreign exchange dealers ("RFEDs"), and certain other registrants that are members of DCMs or SEFs. Regulation 1.35(a) requires that these registrants keep full, complete, and systematic records of all transactions relating to their business of dealing in commodity interests and related cash or forward

[1] IAA is a not-for-profit association that represents the interests of investment adviser firms registered with the Securities and Exchange Commission (the "SEC"). Founded in 1937, the IAA's membership consists of more than 550 advisers that collectively manage approximately $14 trillion for a wide variety of individual and institutional investors, including pension plans, trusts, investment companies, private funds, endowments, foundations, and corporations. For more information, please visit our website: www.investmentadviser.org.

[2] *See* Records of Commodity Interest and Related Cash or Forward Transactions, CFTC Release RIN 3038–AE23, 79 Fed. Reg. 68140 (Nov. 14, 2014) ("Proposal"), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2014-26983a.pdf.

transactions and record all *oral* communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of a transaction in a commodity interest, whether communicated by telephone, voicemail, mobile device, or other digital or electronic media, and to keep those records for one year.[3] The 2012 Regulation also requires FCMs, IBs, RFEDs, and all members of a DCM or SEF to record and keep all *written* communications provided or received concerning quotes, solicitations, bids, offers, instructions, trading, and prices, that lead to the execution of a transaction in a commodity interest or related cash or forward transactions, whether communicated by telephone, voicemail, facsimile, instant messaging, chat rooms, electronic mail, mobile device, or other digital or electronic media, and to keep those written records for five years.[4] Furthermore, the Regulation requires that the records be maintained in a "form and manner identifiable and searchable by transaction."[5] The Commission excluded commodity pool operators ("CPOs"), as well as swap dealers, major swap participants, and others, from the oral recordkeeping requirements. CTAs, however, as members of DCMs or SEFs, were not excluded from such requirements.

The 2012 Regulation did not contemplate the CTA business model, and it created significant compliance costs and obstacles for CTAs. Thus, at the request of industry participants, including the IAA, the CFTC staff subsequently provided no-action relief to CTAs from certain aspects of the oral recordkeeping requirements of Regulation 1.35(a).[6] The

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[3] *See* Adaption of Regulations to Incorporate Swaps—Records of Transactions, CFTC Release RIN 3038-AD53, 77 Fed. Reg. 75523 (Dec. 21, 2012) ("2012 Regulation"), available at http://www.cftc.gov/ucm/groups/public/@lrfederalregister/documents/file/2012-30691a.pdf.

[4] *See* 2012 Regulation.

[5] Regulation 1.35(a)(1).

[6] The CFTC staff granted an initial request for no-action relief for CTAs from these requirements in 2013, but the relief only extended until May 1, 2014. *See Time-Limited No-Action Relief for Certain Members of Swap Execution Facilities from the Requirement to Record Oral Communications Pursuant to Commission Regulation 1.35(a)*, CFTC Letter No. 13-77 (Dec. 20, 2013), available at: http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/13-77.pdf. Thereafter, in March 2014, the IAA, in support of other requests for no-action relief, requested that CFTC staff exempt CTAs that participate on a SEF from Regulation 1.35(a). *See* IAA Request for Interpretive Guidance and Relief on Application of Rule 1.35(a) to Asset Managers, Letter to CFTC from Karen L. Barr, IAA General Counsel (Mar. 18, 2014), available at https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/140318cmnt.pdf. On April 25, 2014, the CFTC issued further no-action relief to CTAs that are members of DCMs or SEFs for failure to comply, prior to December 31, 2014, with the requirement under Regulation 1.35(a) to record oral communications in connection with the execution of swaps. *See Time-Limited No-Action Relief for Certain Members of Swap Execution Facilities and Designated Contract Markets from the Requirement to Record Oral Communications, Pursuant to Commission Regulation 1.35(a), in Connection with the Execution of Swap Transactions*, CFTC Letter No. 14-60 (Apr. 25, 2014), available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-60.pdf. The relief in CFTC Letter 14-60 expired December 31, 2014. On December 16, the CFTC staff issued CFTC Letter 14-147 to provide two areas of further relief for CTAs from certain recordkeeping requirements under CFTC Regulation 1.35(a). First, the letter expands the no-action relief provided in CFTC Letter 14-60 issued on April 25, 2014 to registered CTAs that are members of DCMs or of SEFs from the requirement to record *all* oral communications, not just those that led to the

Proposal seeks to codify the no-action relief provided by the CFTC staff since the Regulation's adoption in 2012. Specifically, the Proposal would exclude members of DCMs or SEFs that are CTAs from the oral recordkeeping requirements.[7]

In addition, the Proposal would modify the requirement to maintain records in a "form and manner identifiable and searchable by transaction" to a requirement that records must be "searchable"[8] and kept in a format that allows for "identification of a particular transaction."[9] The CFTC explained that this change eliminates a requirement to link or otherwise identify a record of communication that leads to the execution of a transaction with a particular transaction.[10]

II. The Proposed Amendments to Regulation 1.35(a) to Exempt CTAs from the Oral Recordkeeping Requirements are Appropriate

The IAA strongly supports the Commission's proposed amendments. The Proposal would exclude members of a DCM or SEF that are CTAs from the requirement to record all oral communications. As the Commission notes, "many CTAs who are members of DCMs or SEFs and have discretionary trading authority do not have routine discussions with end-clients regarding transactions in commodity interests."[11] The Commission further notes that the Proposal "balance[s] CTAs' recordkeeping burden by excluding them from the oral recordkeeping requirement of Regulation 1.35(a),"[12] consistent with the Commission's "goals of balancing its interest in protecting customers and ensuring market integrity, with the burdens of affected market participants."[13] We agree and appreciate the Commission's acknowledgment that "many CTAs who are members of a DCM or SEF have discretionary authority over their

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execution of swap transactions, as was the case under CFTC Letter 14-60. Second, the letter provides no-action relief to market participants that do not link or identify records of oral and written communications that lead to the execution of a transaction in a commodity interest and related cash or forward transactions to a particular transaction. *See* DSIO and Division of Market Oversight, *No-Action Relief from Certain Recordkeeping Requirements under Commission Regulation 1.35(a)*, CFTC Letter No. 14-147 (Dec. 16, 2014), available at http://www.cftc.gov/ucm/groups/public/@lrlettergeneral/documents/letter/14-147.pdf. The relief is available until the earlier of December 31, 2015 or the effective date of any Commission action with respect to the Proposal.

[7] Proposed Rule 1.35(a)(4)(vi).

[8] *See* proposed Regulation 1.35(a)(2) ("[a]ll records required to be kept pursuant to paragraph (a)(1) of this section shall be searchable.")

[9] Proposal at 68142.

[10] Proposal at 68143.

[11] Proposal at 68142.

[12] *Id*.

[13] Proposal at 68143.

customers' accounts and would not be having routine telephone conversations with customers that lead to the execution of an order on a DCM or SEF."[14]

The Proposal would remove unnecessary and expensive regulation affecting CTAs as market participants. The costs and burdens to record and maintain oral communications are significant and would not serve any important policy objective. For example, CTAs would need to initially purchase or develop and implement significant new technologies, systems and procedures, as well as implement employee training, in order to comply with the expansive coverage of current Regulation 1.35(a) requirements, at great cost and with little benefit. We understand from member firms that the costs to initially implement such systems could start in the hundreds of thousands of dollars per firm. Furthermore, ongoing costs associated with such recordkeeping requirements would also be extensive.[15]

We also note that CTAs are already subject to extensive recordkeeping requirements under CFTC Regulation 4.33.[16] Further, the IAA's CTA member firms also are investment advisers registered with the Securities and Exchange Commission under the Investment Advisers Act of 1940 ("Advisers Act"). Our members manage their clients' assets as fiduciaries and generally on a discretionary basis. These dually-registered CTAs maintain extensive records

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[14] *Id.* In CFTC Letters 14-60 and 14-147, the CFTC staff recognized that many CTAs that are members of DCMs or SEFs and have discretionary trading authority do not have routine discussions with end-clients regarding transactions in commodity interests.

[15] The Proposal requests comment on whether to only exempt small CTAs from the oral recordkeeping requirement. We strongly disagree with such an approach. As discussed above, the costs and burdens to implement the required systems would be burdensome and onerous, regardless of the size of the firm. Accordingly, the Commission should not make a distinction for the burden to a CTA depending on size of firm or volume of transactions.

[16] For example, under Regulation 4.33, CTAs must keep copies of each confirmation or acknowledgment of a commodity interest transaction, and each purchase and sale statement and each monthly statement received from a FCM, a retail foreign exchange dealer or a swap dealer, as well as an itemized daily record of each commodity interest transaction of the commodity trading advisor, showing the transaction date, quantity, commodity interest, and, as applicable, price or premium, delivery month or expiration date, whether a put or a call, strike price, underlying contract for future delivery or underlying commodity, swap type and counterparty, the FCM and/or retail foreign exchange dealer carrying the account and the introducing broker, if any, whether the commodity interest was purchased, sold (including, in the case of a retail forex transaction, offset), exercised, expired (including, in the case of a retail forex transaction, whether it was rolled forward), and the gain or loss realized; however, that if the trading advisor is a counterparty to a swap, it must comply with swap data recordkeeping and reporting requirements, as applicable. We note that Regulation 1.35(a) requires that the records be kept in accordance with the requirements of CFTC Regulation 1.31. However, current Regulation 1.31 is outdated and unworkable. In this regard, the IAA submitted a joint petition for rulemaking in July 2014 to amend CFTC Regulations 1.31, 4.7(b) and (c), 4.23 and 4.33 to seek amendments to the recordkeeping rules. *See* Joint IAA, MFA, AIMA Petition for Rulemaking to Amend CFTC Regulations 1.31, 4.7(b) and (c), 4.23 and 4.33 (July 21, 2014) ("Petition for Rulemaking"), available at:
https://www.investmentadviser.org/eweb/docs/Publications_News/Comments_and_Statements/Current_Comments_Statements/140721cmnt.pdf.

under the Advisers Act relating to their advisory business and client transactions.[17] Under SEC Advisers Act rules, these CTAs are not, however, required to maintain oral communications with their clients.

Finally, we note that the Proposal would not impact the CFTC's ability to provide market oversight because the CFTC would maintain access to oral communications under CFTC regulations that require swap dealers, FCMs, DCMs, and SEFs to maintain oral and written records of their business with CTAs. In addition, Regulation 4.33, as discussed above, requires CTAs to maintain detailed records of their transactions on behalf of clients that are available to the CFTC.

III. The CFTC Should Exempt CTAs from Written Recordkeeping Requirements under Regulation 1.35

We appreciate the Commission's proposal to amend Regulation 1.35(a) to eliminate the requirement for CTAs to record oral communications. We also urge the CFTC to further exempt CTAs from the written recordkeeping requirements under Regulation 1.35.[18] CTAs that are discretionary asset managers manage client assets pursuant to contractual agreements with clients and are subject to specific recordkeeping requirements under CFTC Regulation 4.33, as noted above,[19] as well as the Advisers Act recordkeeping requirements. An exemption from Regulation 1.35 for CTAs would alleviate duplicative written recordkeeping regulations while still permitting the Commission to "promote market integrity and protect customers."[20] Regulation 4.33 requires CTAs to maintain extensive records relating to their transactions in commodity interests for clients.[21] On the other hand, the types of records contemplated in

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[17] *See* Advisers Act Rule 204-2 (requiring record retention by SEC-registered investment advisers, of, among others: (i) all written communications received and sent relating to: any receipt, disbursement, or delivery of funds or securities; and the placing or execution of purchase or sell orders; (ii) portfolio management records, including memorandum of each order to buy or sell any security or of instructions received by the adviser regarding the purchase, sale, receipt or delivery of any security, showing: the terms and conditions of the order, instruction, modification or cancellation; the account for which the order was entered and the date of entry; the bank, broker or dealer by or through whom the order was executed (where appropriate); and designation of orders entered pursuant to use of a discretionary power; and (iii) additional records if the adviser has custody of the client funds and securities.)

[18] We do not address the threshold question of whether CTAs are or should be subject to Regulation 1.35(a) by virtue of being a "member" of a DCM or SEF. The CEA defines a "member" in Section 1(a)(34) as having trading privileges on the registered entity or derivatives transaction execution facility. However, some SEF rulebooks identify as members participants with varying levels of access and/or functionality and use of the SEF.

[19] In addition, CTAs (and CPOs) registered with the SEC could provide the CFTC with the same access to their SEC-required records as required to be provided to the SEC.

[20] *See* 2012 Regulation, 77 Fed. Reg. at 75528.

[21] Regulation 4.33 requires that CTAs maintain, among other records, with respect to clients or subscribers, records of all transactions and confirmations of each commodity interest transaction, as well as records of each commodity

Regulation 1.35 are more akin to those records created and kept by FCMs and IBs, rather than by CTAs (*e.g.*, trading cards, signature cards, and street books).[22] Market participants with whom CTAs engage, such as FCMs, IBs, and DCMs/SEFs, already are subject to recordkeeping requirements and would maintain the exact same set of records covered in Regulation 1.35. Moreover, if CTAs were exempt from Regulation 1.35's written recordkeeping requirements, the Commission would continue to have access to searchable written records of CTAs under Regulation 4.33 relating to each commodity interest transaction, showing important details of the transaction and swap data reporting requirements. Therefore, the application of Regulation 1.35's written requirements to CTAs is duplicative and unnecessary, and we request the Commission exempt CTAs from the application of Regulation 1.35, including the related written recordkeeping requirements thereunder.

IV. The Commission Should Grant the IAA's Petition for Rulemaking and Amend Recordkeeping Regulation 1.31 and Recordkeeping Rules

In the Proposal, CFTC Commissioner Giancarlo seeks comment regarding any perceived need to revise Regulation 1.31 given advancements in technology and current business practices.[23] As noted above, the IAA and other industry groups recently filed a Petition for Rulemaking seeking amendments to CFTC Regulations 1.31, 4.7(b) and (c), 4.23 and 4.33. Our recommended changes to Regulation 1.31, include, for example, eliminating the requirements to keep records in their native (and potentially outdated) format and to retain third-party technical consultants. Many CTAs (and CPOs) find compliance with Regulation 1.31 unduly burdensome, infeasible, and costly, due to the requirement to implement outdated technology and disregard developments in standard market practices with respect to electronic recordkeeping and third-

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interest transaction and books and records of all other transactions in all cash market transactions. Regulation 4.33(a)(3) requires CTAs to maintain all powers of attorney and other documents, or copies thereof, authorizing the CTA to direct the commodity interest account of a client or subscriber of the CTA, which would capture any instructions changing or limiting the CTA's discretionary authority. *See* Proposal at 68144. However, to the extent the CFTC determines Regulation 4.33 is not sufficient for the Commission's stated regulatory purposes in the Proposal, the CFTC should instead consider amending Regulation 4.33 to address any recordkeeping concerns the Commission may have for CTAs. Regulation 4.33 also requires CTAs to maintain books and records in accordance with the electronic recordkeeping requirements in Regulation 1.31. *See* Petition for Rulemaking. In addition, under Advisers Act Rule 204-2(f) governing those CTAs and CPOs that are registered with the SEC, a firm that determines to discontinue its advisory business must arrange for the preservation of its records for the remainder of the period specified in the recordkeeping rule before its ceases to conduct business. Such an adviser must notify the SEC of the exact location where its records will be maintained during this period. *See* Advisers Act Rule 204-2(f) (requiring that "[a]n investment adviser subject to [the recordkeeping rule 204-2], before ceasing to conduct or discontinuing business as an investment adviser shall arrange for and be responsible for the preservation of the books and records required to be maintained and preserved under this section for the remainder of the period specified in this section, and shall notify the Commission in writing [ ] of the exact address where such books and records will be maintained during such period.")

[22] *See* Rule 1.35(a)(1).

[23] *See* Proposal at 68148 (Appendix 3--Dissenting Statement of Commissioner J. Christopher Giancarlo).

party recordkeepers.[24] Thus, we again urge the Commission to grant the IAA's Petition for Rulemaking and address these issues related to outdated recordkeeping requirements in Regulation 1.31.

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The IAA appreciates the Commission's consideration of our comments. We look forward to working with you on these important issues. If you have any questions or require additional information, please contact the undersigned or Kathy D. Ireland, IAA Acting General Counsel, at (202) 293-4222.

Respectfully submitted,

/s/ Monique S. Botkin

Monique S. Botkin
IAA Associate General Counsel

Cc: The Honorable Timothy G. Massad, Chairman
The Honorable Mark P. Wetjen, Commissioner
The Honorable Sharon Y. Bowen, Commissioner
The Honorable J. Christopher Giancarlo, Commissioner

Mr. Thomas J. Smith, Acting Director, Division of Swap Dealer and Intermediary Oversight
Mr. Erik Remmler, Deputy Director, Division of Swap Dealer and Intermediary Oversight
Ms. Katherine Driscoll, Associate Director, Division of Swap Dealer and Intermediary Oversight

[24] *See* Petition for Rulemaking, supra n. 16.

January 8, 2015

Filed electronically via ESMA website: www.esma.europa.eu

Mr. Steven Maijoor
Chair
European Securities and Markets Authority
CS 60747
103 rue de Grenelle
75345 Paris Cedex 07, France

Re: ESMA Call for Evidence – AIFMD Passport and Third Country AIFMs

Dear Mr. Maijoor:

The Investment Adviser Association (IAA) appreciates the opportunity to comment on the European Securities and Markets Authority's (ESMA's) Call for Evidence on the Alternative Investment Fund Managers Directive (AIFMD) passport and third country AIFMs.[1] The IAA is a not-for-profit US association that represents the interests of investment adviser firms registered with the US Securities and Exchange Commission (SEC). IAA's membership consists of investment advisory firms that manage assets for a wide variety of institutional and individual clients, including pension plans, trusts, investment funds, endowments, foundations, and corporations, and many of our members manage assets on behalf of clients in the European Union.[2] Our comments in response to the Paper are generally limited to the utility of the national private placement regimes.

Functioning of the National Private Placement Regimes

Q15: What have been the benefits of the National Private Placement Regimes (NPPR) to you?

Under Article 42 of the AIFMD, non-EU AIFMs are able to market AIFs to professional investors and, in EU Member States where this is permitted, to certain retail investors in an EU

[1] *See* ESMA, Call for Evidence: AIFMD Passport and Third Country AIFMs, ESMA/2014/1340 (Paper), Nov. 7, 2014, available at: http://www.esma.europa.eu/system/files/2014-esma-1340_call_for_evidence_aifmd_passport__3rd_country_aifms.pdf. *See also,* Directive 2011/61/EU on Alternative Investment Fund Managers, available at http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32011L0061 (depending on the advice of ESMA and the criteria in the Directive, a delegated act should be adopted to extend the passport to EU AIFMs marketing non-EU AIFs in the Union and to non-EU AIFMs managing and/or marketing AIFs in the Union, and another delegated act should be adopted to terminate the application of national private placement regimes). The AIFMD notes that ESMA's opinion and advice need not necessarily conclude that the national private placement regimes must be brought to an end in all EU Member States.

[2] For more information, please visit our website: www.investmentadviser.org.

jurisdiction under that particular jurisdiction's NPPR.[3] Article 42 permits non-EU AIFMs to market any AIF into the EU as long as they comply with certain requirements, including reporting and disclosure, and cooperation agreements are in effect between the relevant jurisdictions.[4]

We encourage ESMA to recommend that the European Commission maintain the NPPR under Article 42. Many non-EU firms continue to operate under and rely on Article 42 and would face significant challenges if the AIMFD passport were turned on for these firms and the NPPR were eliminated. These firms have determined to comply with Article 42, which would be a reasonable and rational alternative to non-EU firms operating under the potential AIFMD passport. The NPPR is operating as intended by providing some flexibility to individual EU Member States in setting standards for private placements, and these jurisdictions continue to monitor and address the potential risks and activities of AIFMs. Thus, the protections under Article 42 are robust and effective.[5]

If the EU eliminated the NPPR, some AIFs would be eliminated unfairly as investment options for EU investors. For example, some AIFs may provide valuable investment options for investors who wish to obtain portfolio exposure to a particular asset class or seek international diversity. Given these protections and benefits of the NPPR, we recommend ESMA provide an opinion not to eliminate the NPPR and to continue to permit this type of marketing under the NPPR.

Finally, we note the importance of permitting private placement requirements that do not replicate all or substantially all of the AIFMD requirements, which can result in regimes as

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[3] A "professional investor" under the AIFMD means an investor which is considered to be a professional client or may, on request, be treated as a professional client within the meaning of Annex II to the Markets in Financial Instruments Directive (MiFID – 2004/39/EC) . A "retail investor" under the AIFMD means an investor who is not a professional investor. *See also,* Article 43 concerning the marketing of AIFs by AIFMs to retail investors.

[4] Article 42 also limits the NPPRs to those non-EU AIFMs whose home countries are not listed as a "Non-Cooperative Country and Territory" by the Financial Action Task Force.

[5] For example, to rely on Article 42, non-EU AIFMs must provide significant disclosure to investors, including, among other information: (1) a description of the strategy and objectives of the AIF, master-feeder structure information, a description of the types of assets in which the AIF may invest, techniques employed and all associated risks, investment restrictions, circumstances in which the AIF may use leverage, types and sources of leverage permitted and the associated risks, restrictions on the use of leverage and any collateral and asset reuse arrangements, and the maximum level of leverage which the AIFM is entitled to employ on behalf of the AIF; (2) a description of when the AIF may change its investment strategy; (3) a description of contractual arrangements; (4) the identity of the AIFM, the depositary, auditor and other service providers and a description of their duties and investors' rights; (5) the valuation procedure and pricing methodology for valuing assets of the AIF; (6) a description of the AIF's liquidity risk management, including redemption rights; (7) a description of all fees, charges, and expenses borne by investors; and (8) the historical performance of the AIF. The AIFM must also disclose to investors the annual report required by Article 22.

burdensome and costly as registering as an AIFM. Some of our members have experienced difficult administrative and procedural burdens in the implementation of certain Member States' NPPRs that may cause firms to avoid certain jurisdictions. In that regard, we encourage ESMA to consider reforms to the NPPRs and would welcome the opportunity to work with ESMA to share the experiences of non-EU AIFMs under the NPPRs.

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The IAA appreciates the opportunity to provide our views on these issues and would be pleased to provide any additional information. Please contact the undersigned or Kathy D. Ireland, Acting General Counsel, at (202) 293-4222 with any questions regarding these matters.

Respectfully Submitted,

/s/ Monique S. Botkin

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