MFDF

MUTUAL FUND DIRECTORS FORUM
The FORUM for FUND INDEPENDENT DIRECTORS

March 25, 2015

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

Re: Request for Comment on Asset Management Products and Activities (FSOC-2014-0001)

Dear Mr. Pinschmidt:

The Mutual Fund Directors Forum ("the Forum")[1] welcomes the opportunity to comment on the request for comments by the Financial Stability Oversight Council ("the Council") on Asset Management Products and Activities ("the Request").

The Forum is an independent, non-profit organization for investment company independent directors and is dedicated to improving mutual fund governance by promoting the development of concerned and well-informed independent directors. Through education and other services, the Forum provides it members with opportunities to share ideas, experiences and information concerning critical issues facing investment company independent directors and also serves as an independent vehicle through which Forum members can express their views on matters of concern.

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As has been pointed out by numerous other commentators, the asset management industry, considered broadly, is less likely than other segments of the financial services industry to be a source of systemic risk, largely because asset managers typically act as agents for other investors.[2] We will not repeat those arguments here, but strongly urge the Council to analyze the

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1 The Forum's current membership includes over 887 independent directors, representing 122 mutual fund groups. Each member group selects a representative to serve on the Forum's Steering Committee. This comment letter has been reviewed by the Steering Committee and approved by the Forum's Board of Directors, although it does not necessarily represent the views of all members in every respect.

2 *See, e.g.,* Mike McNamee, *Viewpoints: Simple Answers to the Federal Reserve's Quandaries*, INVESTMENT COMPANY INST. (Feb. 24, 2015), http://www.ici.org/viewpoints/view_15_fed_response (citing ICI studies on fund investor behavior that show that mutual funds are unlikely to pose serious run risk in times of financial stress).

nature and extent of any risks posed by asset managers in the context of the types of risks posed by other groups that play key roles in the markets and the financial services industry.

We thus believe that the Council's decision to focus on "products and activities" in the asset management industry is absolutely correct. Asset managers act as agents for underlying investors, and it is the investors who bear the economic risks of investment losses rather than the asset managers themselves. Thus, it makes little sense to focus on specific firms in the industry – the business models and the types of products of the largest asset management firms differ greatly. Further, regulatory incentives that may arise from treating some managers as systemically important while not similarly regulating competing asset managers may encourage investors to move assets from one manager to another. We therefore strongly encourage the Council to continue analyzing the asset management industry in a manner that does not have the potential to distort the competitive landscape and thereby distort investors' decision-making processes.

Given the interests of our members, the independent directors of mutual funds, our letter focuses on one important asset management product – mutual funds. Our members oversee the activities of individual funds and fund complexes on behalf of fund investors who rely on mutual funds to save for their first home, their children's education, their retirement, and other important life events. The underlying stability of U.S. and global financial markets is of fundamental importance to fund investors and hence to our member directors as well.

While we appreciate the efforts of the Council to identify and seek to mitigate risks to that financial stability, we encourage the Council to recognize the importance of mutual funds to their investors. Imposing new, unnecessary, or duplicative regulations on the fund industry in order to eliminate whatever systemic risk it is thought to pose can only result in added costs that will ultimately be borne by individual investors and detract from their ability to save for and invest in their futures. Additionally, we ask that the Council consider the extensive oversight of mutual funds already provided by the Securities and Exchange Commission (the "Commission") and fund directors before suggesting any additional regulations. Both the Commission and fund directors are well-positioned to consider the need for additional risk mitigation in the context of the broader regulatory structure that applies to mutual funds. Our more specific comments follow.

The Securities and Exchange Commission Should Continue to Play the Lead Role in the Regulation of Asset Managers and Asset Management Products

The Council has a unique role under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("the Dodd-Frank Act") in assessing the overall systemic risks present in the United States financial system and both taking and recommending further regulatory action to mitigate identified systemic risks. Looking at broad categories of the financial services industry such as the asset management industry is clearly within the Council's purview. However, as the

Council assesses the asset management industry, we urge it to recognize the fundamental role that the Commission plays in regulating the industry.[3]

As the Request recognizes, the Commission has broad regulatory authority over investment advisers and investment companies (including mutual funds, closed-end funds, and exchange-traded funds); it also has important regulatory authority with respect to hedge funds, private equity funds, and other types of private funds. Separately, the Commission regulates other aspects of the financial services industry upon which asset managers rely, including broker dealers and exchanges. As the primary regulator in these fields, the Commission is able to regulate holistically, helping to ensure that the markets function fairly and effectively on behalf of all who use them and rely on them.

In addition, the Commission has demonstrated an increasing sensitivity to questions of systemic risk in many of its recent regulatory initiatives. In fact, in 2009 the Commission established the Division of Economic and Risk analysis which is charged with identifying, analyzing, and responding to risks and trends associated with financial products. In addition, the Commission's regulatory agenda, as highlighted in recent speeches by its Chair, makes clear that the Commission is focusing on many of the issues raised in the Request.[4] At the end of the day, the Commission's experience in regulating and understanding the asset management industry leaves it in the best position to address these issues and analyze the full effect of any possible regulatory changes on the industry, on investors, and on the financial system. We believe that the Commission's ability to oversee a broad swath of the industry and balance factors ranging from investor protection to the mitigation of risks inherent in the system is critical to ensuring that markets operate fairly, efficiently, and without imposing unidentified and unmitigated risks to overall financial stability.

In contrast, the Council does not itself have primary jurisdiction over any financial services provider or product, including mutual funds. It also lacks the lengthy history and special expertise that the Commission possesses in asset management. Given these facts, the Council should exercise its powers judiciously, taking significant account in any individual matter of the views and conclusions of the regulator that does have primary jurisdiction. When the primary regulator examines issues of system-wide risks as part of its overall regulatory program, the Council should be hesitant to substitute its own judgment, though action by the Council would be warranted where a primary regulator abdicates its responsibilities with respect to systemic risk.

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3 Clearly, the Commission does not regulate the entirety of the industry. For example, commodities funds and commodities advisers are regulated by the Commodities Futures Trading Commission. Likewise – and assuming that "asset management" is defined fairly broadly -- insurance companies, pension funds, and even activities like bank-sponsored common trusts are subject to different regulatory regimes.

4 *See, e.g.*, Mary Jo White, "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry" (Dec. 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722.

Mutual Funds, Overseen by Independent Directors, Should Be Recognized as Distinct Products within the Asset Management Industry

While the Request does, at times, recognize the regulatory regime that governs mutual funds, many of the questions are directed more broadly at "pooled investment vehicles." Unlike other pooled asset management vehicles such as hedge funds, mutual funds (or, more formally, registered investment companies) are extensively regulated under the Investment Company Act of 1940 (the "Investment Company Act"). This regulatory regime sharply distinguishes registered funds from other asset management vehicles and renders them less likely to pose systemic risk. Among other things, the Investment Company Act imposes standards and limitations on:

- The use of leverage and borrowings by registered funds;
- The portfolio liquidity of registered funds;
- The ability of registered funds to invest in illiquid and levered securities;
- The manner and timeframe within which registered funds accept and meet redemption requests; and
- The manner in which portfolio securities are valued and net asset values are computed.

Given the manner in which registered mutual funds are regulated, we believe that the Council should treat them as a distinct "asset management product" in its review of the asset management industry. Regardless of investment strategy, all registered funds must comply with the strictures of the Investment Company Act. Moreover, any careful examination of this regulatory structure should reveal that it not only makes mutual funds the preferred investment vehicle for millions of American investors, but also significantly reduces the risks that funds pose to the financial system as a whole.[5]

The Regulatory Regime Governing Mutual Funds, Particularly Oversight by Independent Directors, Provides Protection for Mutual Funds from Systemic Risk

In addition to making mutual funds more suitable for retail investors, the regulations governing leverage, liquidity, valuation, and redemption activity tend to reduce the risk of sudden runs on a fund (and significantly reduce the risk that knowledgeable investors will attempt to exit the fund at an advantageous price above the true net asset value). Most importantly, the limitations created by the Investment Company Act result in products that use

[5] For example, the Request poses numerous questions on the manner in which pooled vehicles' use of leverage, including leverage derived from the use of derivatives, may increase systemic risk in times of financial stress. While registered funds can employ small amounts of leverage and do use derivatives, their ability to do so is sharply restricted by provisions in the Investment Company Act that limit the amount a fund can borrow and generally prohibit funds from issuing senior securities. While these provisions are generally viewed as protecting investors, it is worth noting that they find their origin in the collapse of over-leveraged funds in the period following the 1929 market crash – a situation that might be thought of in terms of systemic risk and one that was clearly dealt with by adoption of the Investment Company Act in 1940. *See, e.g.,* Matthew Fink, *The Rise of Mutual Funds: an Insider's View* 9-10, 14-19 (2008).

less aggressive investment techniques, and are thus less susceptible to rapid changes in value that may prompt runs.

Moreover, a fund's compliance with these restrictions is not solely controlled by a manager who may have conflicts or divided loyalties; rather, a fund's compliance with regulatory requirements is ultimately overseen by a board that is independent of the manager. Fund boards are extremely valuable because they add a qualitative approach to a regulatory system that is mainly quantitative in nature (that is, it sets specific standards that funds must meet with respect to liquidity, average portfolio duration, and so forth) and often relies upon a one-size-fits-all approach. They accomplish this in two ways – by overseeing the fund's compliance with the law and by seeking to ensure that the fund is operating in the interests of its investors. Boards also supplement the efforts of regulators by being able to respond quickly to the specific situations their funds face and by having the flexibility to develop focused solutions, within the context of the regulatory structure, based on the facts and circumstances of the funds they oversee.

Redemption Costs

The Council specifically asks a number of questions regarding whether "[some] investors could have an incentive to redeem before other investors to avoid sharing the costs associated with other investors' redemptions."[6] As outlined briefly above, the liquidity requirements imposed on mutual funds under the Investment Company Act (combined with the manner in which funds are required to value portfolio securities) are intended, in part, to minimize the costs of meeting redemptions by ensuring that adequate cash and saleable securities are available to meet redemption requests within the statutory seven-day period.

We believe that there are virtually no situations, including during recent periods of market stress, when long-term fund investors have borne material costs related to other investors' redemption activity.[7] If the Council is going to impose restrictions on the industry based on this occurring, it should identify situations in which this has occurred and created significant additional risk in the financial system as a whole. That said, there could be severe outlier situations in which sudden and extensive redemptions might impose costs on non-redeeming shareholders, either because of increases in transaction costs associated with selling portfolio securities in stressful circumstances or because portfolio managers are forced to sell securities into falling markets at a price less than what they believe the security's fundamental value to be. While these situations should be rare, they are also inherent in the nature of a pooled product, where many investors, often retail investors, assume this risk as a cost of obtaining the diversification and professional management that a mutual fund offers them.

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6 Release at 7.

7 This may have occurred over a decade ago when some funds failed to update the value of foreign securities in circumstances under which there was a difference between when the underlying foreign markets closed and the fund priced its portfolio securities. This practice allowed some investors to "market time" a fund, which adversely affected the fund and its shareholders. While these situations may have been unfair to non-redeeming fund investors, they did not pose any systemic risk. Moreover, the problem was easily addressed by requiring that funds fair value securities in their portfolio – even listed securities – under appropriate circumstances.

We also note that the mere fact that a fund manager may need to sell a portfolio security into a falling market is not reason to conclude that mutual funds (or any other type of investment vehicle) pose systemic risk. As the Request recognizes, markets do fall – the Council appropriately notes its recognition "that investment risk is inherent in capital markets, representing a normal part of market functioning."[8] Investors sell assets for numerous reasons, including a belief that the asset will fall in value in the future, a desire to shift to a different asset, or a need to raise cash for other purposes. When many investors determine to sell the same asset, it may well fall sharply and quickly in value. Mutual funds are not exempt from this process – when the market for a particular type of asset or class is dropping, funds known to hold that type of asset may be subject to more and larger redemption requests than is ordinarily the case.

While these circumstances may be painful for asset owners (and may even induce more holders of the asset to sell, further compounding the effect), this too is a normal part of capital market functioning. Indeed, it is part of the process of finding a price at which buyers will be attracted to the market. In the vast majority of cases, financial regulators, including the Council, should permit this process to function, and not conclude that the fact that an asset may fall in price rapidly to a level below its inherent value is a form of systemic risk against which the markets must be protected. Instead, to justify any regulation, and particularly any limits on the price discovery function in capital markets, the Council must rigorously distinguish between markets that seem chaotic and irrational and situations that truly do pose a risk to the financial system as a whole. In addition the Council should be mindful that by focusing on the registered fund industry, which is just one of many inputs into the market price for securities, the Council could inadvertently create pricing distortions and thereby eliminate the intended regulatory protections for investors.

Industry Utilities

The Council asks a number of questions on the risks created when asset managers "rely on one or a limited number of third parties to provide important services."[9] We agree that this is a relevant issue for the Council to consider. However, we believe it would be a mistake to attribute this risk to the asset management industry.

In particular, systemic risk may well arise from the provision of essential services by a small number of utility-like providers. However, the importance of these providers is not limited to the asset management industry. For example, the Release identifies custody, brokerage, asset pricing, and valuation as the types of third-party services that could give rise to this concern.[10] While it is correct that the failure of a provider of these services could have a significant impact on the markets – perhaps even an impact that would affect overall market or economic stability – this risk cannot be attributed to the asset management industry.

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8 Release at 4.

9 Release at 17.

10 Release at 18.

Instead, the Council must consider this issue separately. Services of the type identified by the Council are crucial to all market participants, not just asset managers. Hence, the risks posed by the potential failure of a provider of these services is not a risk inherent in the asset management industry, but rather a risk that asset managers, like other market participants, face and must take steps to mitigate. Given the importance of these services, the Council might well choose to investigate separately whether they pose a systemic risk that ought to be addressed by the Council or by some other financial regulator. But the risk of their failure and the potential consequences of such a failure should not be used as a predicate to determining that asset managers themselves pose or create systemic risk.

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In conclusion, we very much appreciate the opportunity to participate in the Council's examination of asset management activities and products on behalf of our independent director members. As our comments, and the likely comments of many other industry participants, demonstrate, asset management in general is a very limited source of systemic risk, and the mutual fund segment of the asset management industry is even less likely to pose risk. Hence, while we agree that the Council should analyze the activities and products of asset managers, we believe that the Council should be very hesitant to propose or recommend potentially costly new regulations or limitations on activities that would harm an industry that plays a significant role in the capital markets. This is particularly true of mutual funds, as new regulation in this area would impose costs directly on those who ultimately rely most strongly on the capital markets – Americans who depend on capital markets to save for retirement and other life events.

We would welcome the opportunity to discuss our comments with you in more detail. Please feel free to contact me at 202-507-4491 or Susan Wyderko, the Forum's President, at 202-507-4490 if you would like to follow up on any of our comments.

Sincerely,

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Executive Vice President and General Counsel

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