March 25, 2015

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

Re: Notice Seeking Comment on Asset Management Products and Activities; Docket No. FSOC-2014-0001 ("Notice")

Dear Deputy Assistant Secretary Pinschmidt:

Better Markets, Inc.[1] appreciates the opportunity to provide comments to the Financial Stability Oversight Council ("Stability Council" or "FSOC") regarding the above-captioned Notice. The Notice requests comment on certain aspects of the asset management industry and seeks input on whether asset management products and activities may pose potential risks to the U.S. financial system.

**INTRODUCTION AND BACKGROUND**

Fifteen years ago, the financial services industry succeeded in achieving extensive de-regulation of its activities. For example, the Gramm-Leach-Bliley Act, enacted in 1999, allowed banks, investment firms, and insurance companies to form large, complex, interconnected financial companies, without giving any regulatory body meaningful authority to oversee the resulting holding company conglomerates. The Commodity Futures Modernization Act of 2000 prohibited any meaningful oversight of the over-the-counter swaps market. Our siloed financial regulators focused on their specific segment of the financial services industry without looking at the entire landscape, and in some cases had no oversight authority at all.

What followed was the worst financial crisis and near economic collapse since the Great Depression, costing millions of Americans their jobs, homes, and savings.[2] In the aftermath of the crisis, it was widely agreed that fixing our regulatory structure to prevent

[1] Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

[2] Better Markets, *The Cost Of The Wall Street-Caused Financial Collapse and Ongoing Economic Crisis is More Than $12.8 Trillion* (Sept. 15, 2012), *available at http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_2.pdf.*

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another crisis would require profound and innovative changes. Among them was the creation of a single financial regulator responsible for monitoring all financial markets, detecting any type of potential systemic risk, and taking appropriate action to address such threats. Following the crisis, both policy makers and financial industry participants voiced support for such a systemic risk regulator.

For example, Henry Paulson, former Secretary of the Treasury, explained, "We must create a systemic risk regulator to monitor the stability of the markets and to restrain or end any activity at any financial firm that threatens the broader market."[3] Paul Schott Stevens, President and CEO of the Investment Company Institute, explained in testimony before Congress that, "I believe an interagency council with a strong authority in a focused area, in this case monitoring and directing the response to risks that threaten overall financial stability, could, like the [National Security Council], serve the Nation well in addressing complex and multifaceted risks."[4]

Congress thus established the Financial Stability Oversight Council in 2010 as part of the Dodd-Frank Wall Street Reform Act ("Dodd-Frank Act"). FSOC, a council of fifteen federal and state financial regulators, was given the mission of identifying and responding to risks to the financial stability of the United States. To accomplish this goal, Congress gave the FSOC broad authority to:

- recommend supervisory priorities and principles to encourage primary regulators to take a harder look at potential problem areas, such as credit default swaps;

- designate nonbank financial companies that may pose risks as systemically important and require additional supervision by the Federal Reserve Board of Governors; and

- monitor the financial services marketplace, identify gaps in regulation, and make recommendations to Congress so that no financial products and activities would go unregulated.

The FSOC thus has a critically important role to play in protecting our markets and our economy from the potentially devastating consequences of undetected and unmitigated systemic risk.

Another lesson of the financial crisis was that at least some sectors of the asset management industry, specifically money market funds ("MMFs"), present a proven risk of systemically significant runs and that those runs can cripple the short-term credit markets. The most compelling example of MMF run risk was the Reserve Primary Fund, which broke the buck on September 19, 2008 due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. A massive run ensued, which spread to the prime MMF industry and

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3 Henry M. Paulson, *How to Watch the Banks,* NEW YORK TIMES (Feb. 15, 2010).
4 Paul S. Stevens, Testimony before the Senate Banking Committee, *Examining a Framework for Systemic Risk Regulation*, (July 23, 2009).

caused havoc in the short-term funding markets, which threatened to spill over into other markets and the economy more broadly.

The run abated only after the Treasury Department and the Federal Reserve had effectively guaranteed the entire $3.7 trillion MMF industry.[5] This unprecedented and, indeed, breathtaking action from the first days of the 2008 financial crisis conclusively demonstrates that MMFs are systemically significant and can spread destabilizing risk throughout our financial system.

The SEC and the FSOC took a number of steps to strengthen oversight of MMFs. However, that process is not complete and, in our view, more needs to be done. It is possible that there are other systemic risks associated with the asset management industry and, accordingly, the FSOC has been examining asset management activities and products more closely.

That effort began with a report from the Office of Financial Research ("OFR"), which purported to be a general study of the asset management industry ("OFR Report"). Released in September 2013, the OFR Report was issued to provide "a brief overview of the asset management industry and an analysis of how asset management firms and the activities in which they engage can introduce vulnerabilities that could pose, amplify, or transmit threats to financial stability."[6] The study was met with widespread criticism for its lack of rigor and transparency, including from Better Markets. [7]

To its credit, after the response to the OFR Report, FSOC announced in July 2014 that it would review the asset management industry more closely by "undertak[ing] a more focused analysis of industry-wide products and activities," rather than by reviewing individual firms.[8] The Notice seeking comment represents FSOC's effort to gather data as it undertakes that analysis.[9]

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5 *See* SEC DIVISION OF RISK, STRATEGY, AND FINANCIAL INNOVATION, RESPONSE TO QUESTIONS POSED BY COMMISSIONERS AGUILAR, PAREDES, AND GALLAGHER, at 12 (Nov. 30, 2012), *available at* http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

6 Office of Financial Research, *Asset Management and Financial Stability* (Sept. 2013), at 1, *available at* http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf.

7 *See* comments submitted to the SEC regarding the OFR Report at http://www.sec.gov/comments/am-1/am-1.shtml; *see also* Better Markets, *Comment Letter Re: Public Feedback on OFR Study on Asset Management* (Nov. 1, 2013), *available at* http://www.sec.gov/comments/am-1/am1-24.pdf.

8 U.S. Treasury Department Office of Public Affairs, Financial Stability Oversight Council Meeting July 31, 2014, *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031%202014.pdf.

9 *See*, e.g., Debevoise & Plimpton, *Client Update: FSOC Gets Curious: Are Asset Managers' Products and Activities Creating Systemic Risk?* (Jan. 8, 2015), *available at* http://www.debevoise.com/~/media/files/insights/publications/2015/01/fsoc%20gets%20curious.pdf.

**OVERVIEW OF THE COUNCIL'S REQUEST FOR COMMENT**

The Council requests information about four specific areas of potential systemic risk within the asset management industry. In each area, the Council seeks information to determine if such risks exist and, if so, how such risks to financial stability could be mitigated:

- Liquidity and Redemptions - The Council focuses this request on whether pooled investment vehicles that provide redemption rights (e.g., MMFs) could influence investor behavior in stability-affecting ways, and to what extent redemption- or liquidity-risk management practices and competitive pressures could cause or amplify risks.

- Leverage - The Council focuses this request on the ways in which leverage could increase the risk of fire sales, and on management practices for evaluating and addressing leverage risk.

- Operational Risk - The Council focuses this request on how risks from technological and human error could affect financial stability, including the transfer of client accounts or assets from one manager to another, as well as risks from having a large number of asset managers rely on a limited number of third parties for management services. The Council also asks about operational interconnections between asset managers and their investment vehicles and about asset manager best practices.

- Resolution - The Council focuses this request on the interconnection between vehicles and firms which could cause financial instability in periods of stress, such as whether the failure of a manager or affiliate could provide counterparties with the option to accelerate, terminate, or otherwise affect their investments.

**SUMMARY OF COMMENTS**

Better Markets offers the following comments, representing core principles that should guide FSOC as it evaluates the asset management industry.

**First**, FSOC should establish priorities and explain its choices. FSOC has a duty to scrutinize the entire financial system for potential sources of systemic risk. However, in addition to being comprehensive, it must also establish priorities, and ensure that while it reviews the asset management industry, it has not diverted its resources and attention away from other more pressing and already identified sources of actual or likely systemic risk. And, as it ranks its priorities, it should explain how it arrived at that hierarchy.

**Second**, whatever industry or activity FSOC does investigate, it must ensure that its analysis is rigorous and data-driven. Fortunately, the Notice that is the subject of this comment letter reflects the FSOC's commitment to gathering the empirical data it needs to properly assess the risks in the asset management industry. However, if it cannot obtain all of the necessary data, FSOC must pursue all means at its disposal to obtain it, including, if necessary, requesting that OFR subpoena the information. To the extent that additional regulatory reporting or data-access requirements are necessary, FSOC should highlight that fact and make recommendations to relevant agencies and policy makers to ensure that is has all the information-gathering tools it needs to fulfill its mission.

**Third**, while conducting a review of asset managers, FSOC should revisit MMFs specifically. History, including the collapse of the Reserve Primary Fund, confirms that the MMF sector can create, amplify, and propagate systemic risks. The FSOC appropriately issued proposed recommendations in 2014 to spur action by a deadlocked SEC on MMF reforms. While the SEC ultimately did act to address some of the issues, its reforms were incomplete and insufficient. Unless there is clear and convincing evidence that the SEC intends to implement additional adequate reforms, FSOC should once again issue recommendations that will appropriately eliminate the systemically destabilizing run risk that remains in MMFs.

**Finally**, asset managers are interconnected with the larger financial system, and are major participants in the larger short-term wholesale funding markets. Without prejudging the issues in any way, FSOC should conduct an in-depth evaluation of the short-term financing, including in particular the roles played by broker-dealers and asset managers.

## COMMENTS

### I. FSOC should establish priorities and explain its choices, including its decision to scrutinize the asset management industry.

FSOC faces an inevitable tension between the need to search exhaustively for potential systemic risk in our financial markets, and the need to address the most serious risks as expeditiously as possible. It has a duty to scrutinize the *entire* financial system for potential sources of systemic risk, yet it must ensure that while it reviews any one industry or activity, it has not diverted its resources and attention away from other more pressing and already identified sources of possible systemic risk. And, as it ranks its priorities, it must explain its judgments.

This thorough, comprehensive, prioritized, and transparent approach is key to the FSOC's credibility and success. Policy makers, market participants, and above all the public at large must have confidence that the FSOC is exercising sound, independent judgment in identifying the financial market sectors that are most in need of scrutiny.

The OFR Report unfortunately undermined that confidence, as we noted in our letter when the SEC requested comments on the OFR study. As we said then, OFR exhibited an "inexcusable lack of transparency and disclosure regarding how and why the OFR Report came about as well as how its analysis . . . was conducted." The OFR Report should have adequately explained how FSOC decided to consider the study of asset managers at the expense of the "known systemic risks" in other sectors of the financial market.

Recently, the FSOC admirably provided fresh evidence that it is committed to transparency. In February, the Council approved procedures to enhance communication with companies moving through the designation process as well as the public.[10] Moving forward, the FSOC must articulate why it chooses to review, and possibly designate, the asset management sector of the financial industry, while other known systemic risks have yet to be addressed. For example, the largest and too-big-to-fail banks and non-banks – those which caused the financial crisis – remain overleveraged, undercapitalized, interconnected, and the resolution options for these massive institutions remain the subject of intense debate and uncertainty. In short, the Council must strike the right balance in determining its priorities and transparently explain its judgments.

## II. <u>FSOC's analysis must be extensive, grounded in fact and law, and contain concrete support for any assertions made.</u>

Any analysis into the asset management industry, or any other industry or activity FSOC evaluates in the future, must be rigorous and data-driven based on the factors proscribed in law.

### *A. Any FSOC analysis must track the ten-factor analytical framework in Section 113, as well as the six factors in FSOC's rule.*

The Dodd-Frank Act sets forth the framework that FSOC must follow when evaluating the possible exercise of its designation authority. Congress required FSOC to undertake a ten-factor analysis.[11] In 2012, FSOC released a final rule and interpretive guidance outlining how it would apply that statutory standard. It established (1) a three-stage process it will utilize in the designation process; (2) a six-factor analysis it will use to implement the ten-factor analysis when reviewing companies; and (3) three channels the Council believes are most likely to transmit the "negative effects of a nonbank financial company's material financial distress or activities to other firms and markets."[12]

The OFR Report failed to live up to those standards. It did not reflect any application of the six- or ten-factor tests nor the three-stage process, discuss how its findings would be used in connection with a possible designation, or review asset managers under FSOC's identified risk-transmission channels. Rather, as we said, "the Report adopt[ed] an arbitrary analytical framework" and it "provide[d] little empirical support" to help FSOC decide whether or not to engage in designations of industry participants.[13]

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10 Financial Stability Oversight Council, *Supplemental Procedures Relating to Nonbank Financial Company Determinations* (Feb. 4, 2014).

11 Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. 111-203, §§ 113(a)(2), (b)(2).

12 Financial Stability Oversight Council, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637, 41 (Apr. 11, 2012).

13 We repeat our issues with the OFR Report not simply to be critical, but as a reference point of how FSOC must do better moving forward.

With any review, such as this undertaking of the asset management industry, FSOC must be guided by the framework set forth in the Dodd-Frank Act and its own regulations, and its application of that framework must be transparent.

*B. Any FSOC analysis must be based on robust and extensive data.*

Any analysis of the asset management industry undertaken by FSOC must be based on comprehensive empirical data. This empirical approach was not reflected in the OFR's Report. For example, while it included a number of snapshots aimed at conveying rudimentary information about the asset management sector, it failed to include specific information that could provide a detailed and dynamic profile reflecting money flows, interconnections, and the actual track record of asset management firms during the 2008 crisis and other periods of market instability. It also cited anecdotal information as a basis for its assertions.

As a result of this lack of empirical support, the OFR Report drew very few helpful judgments or conclusions. Many observations were couched in such vague terms that they provide little useful information. For example, the OFR Report stated that "Some activities highlighted in this report that **could** create vulnerabilities—**if** improperly managed or accompanied by use of leverage, liquidity transformation, or funding mismatches . . ."[14] Elsewhere the OFR Report stated that "The failure of a large asset management firm **could** be a source of risk, **depending** on its size, complexity, and the interaction among its various investment management strategies and activities."[15] Such hypothetical and conditional statements provide little meaningful information.

By virtue of the request for data in the pending Notice, it appears that the Council is fully committed to developing a sound empirical foundation for any findings or actions it may undertake. If FSOC finds it does not have access to sufficient data, it must aggressively pursue it by all means at its disposal. The Council must request data from industry, as it is appropriately doing now, or, to the extent that additional regulatory reporting or data access requirements are necessary to provide such information, it should highlight that fact and make recommendations to relevant agencies and policy makers.

## III. As part of its analysis, the FSOC should review the SEC's July 2014 MMF reforms, identify areas where additional reforms are necessary, and, absent further action by the SEC, take steps to implement those changes.

The financial crisis made it abundantly clear that money market funds present a serious risk of systemically significant runs that can have far-reaching disruptive effects on our markets. In the most compelling example of MMF run risk, the Reserve Primary Fund broke the buck on September 19, 2008 due to losses on debt instruments issued by Lehman Brothers Holdings, Inc. Those losses were sufficient to break the buck even though Lehman-related assets comprised only 1.2 percent of the fund's total assets. When the fund sponsors

[14] OFR Report at 1.
[15] OFR Report at 18.

declined to provide support, a run immediately ensued. Within two days, investors sought to redeem $40 billion from the fund. This required the fund to sell tens of billions of dollars in assets immediately so that it could pay for the flood of shareholder redemptions. This fire sale in turn depressed asset values, further weakening the fund.

The run quickly spread through the prime MMF industry, and during the week of September 15, 2008 investors withdrew approximately $310 billion (or 15 percent) of prime MMF assets. This caused immediate havoc in the short-term funding markets by triggering a vicious cycle of asset fire sales, depressed prices, redemption requests, more asset fire sales, and rapidly evaporating liquidity. The run abated only after the Treasury, on September 19, 2008, established the Temporary Guarantee Program for Money Market Funds, and the Federal Reserve established a variety of facilities to support the credit markets frozen by the MMF crisis.[16]

For the first time in history, the Treasury Department and the Federal Reserve had effectively guaranteed the entire $3.7 trillion MMF industry. This unprecedented action from the first days of the 2008 financial crisis starkly illustrates the systemic significance of MMFs and their capacity to propagate destabilizing risk quickly throughout our financial system.

In response to this near collapse of the MMF industry, the SEC and the Council have taken a number of steps to enhance oversight of MMFs and to improve their resiliency.

- In February 2010, the SEC adopted MMF rule amendments that strengthened the liquidity, credit quality, and maturity standards governing portfolio investments.[17]

- In August 2012, the FSOC Chairman, Treasury Secretary Geithner at the time, sent a letter[18] to the FSOC members calling upon them to take action on MMFs in response to former SEC Chair Mary Schapiro's announcement that the SEC was deadlocked and would not propose, let alone finalize, additional MMF reforms.[19]

- In November 2012, FSOC issued Proposed Recommendations Regarding Money Market Mutual Fund Reform.[20] FSOC set forth a proposed "determination" that the activities and practices of MMFs could create or increase the risk of significant liquidity, credit, and other problems within U.S. financial markets. It also set forth

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16 *See* SEC DIVISION OF RISK, STRATEGY, AND FINANCIAL INNOVATION, RESPONSE TO QUESTIONS POSED BY COMMISSIONERS AGUILAR, PAREDES, AND GALLAGHER, at 12 (Nov. 30, 2012), *available at* http://www.sec.gov/news/studies/2012/money-market-funds-memo-2012.pdf.

17 Securities and Exchange Commission, *Money Market Fund Reform*, 75 Fed Reg. 10,060 (Mar. 4, 2010).

18 U.S. Treasury Press Release, *Secretary Geithner Sends Letter to FSOC Members on Necessary Money Market Fund Reforms* (Aug. 27, 2012), *available at* http://www.treasury.gov/connect/blog/Pages/geithner-fsoc-letter.aspx.

19 SEC Press Release, *Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform* (Aug. 22, 2012), *available at* http://www.sec.gov/news/press/2012/2012-166.htm ("SEC Press Release").

20 Financial Stability Oversight Council, *Proposed Recommendations Regarding Money Market Mutual Fund Reform*, 77 Fed. Reg. 69455 (Nov. 19, 2012), *henceforth* "FSOC Proposal."

three proposed recommendations for MMF reform. This was an important and critically necessary step to stimulate additional regulatory action by the primary regulator, the SEC.

- In June 2013 the SEC proposed, and in July 2014 the SEC finalized, a rule strengthening MMF regulation ("Rule").[21] The Rule made two major changes to Rule 2a-7: it required a floating net asset value ("NAV") for institutional prime funds, and it imposed liquidity fees and redemption gates. It additionally increased disclosure, asset diversification, and stress testing requirements, and it implemented new tax treatments for funds.

The FSOC should be applauded for taking aggressive action to discharge its duties to identify and seek to eliminate known and possible systemic risks in the MMF markets. The SEC also deserves credit for its July 2014 rule implementing additional measures to control the risks presented by MMFs. However, the SEC's measures were simply not sufficient and material destabilizing run risks remain high. Accordingly, the FSOC should take additional steps to ensure that the SEC implements further changes, including, as necessary, once again invoking Dodd-Frank Act Section 120 authority to recommend heightened MMF standards to the SEC.[22]

*A. The SEC's July 2014 Rule implemented some valuable reforms for MMFs.*

The SEC's Rule requires institutional prime funds to float their net asset values up to four decimal points, and to use market-based pricing method, rather than amortized pricing. The Commission explained that moving to a floating NAV will "mitigate the incentive to redeem due to the mismatch between the stable NAV price and the actual value of fund shares."[23] Furthermore, the Commission wrote that it applied the floating NAV only to institutional prime funds because those funds "are more vulnerable to credit events (compared to government funds) and that have an investor base more likely to engage in heavy redemptions (compared to retail investors) because of, among other reasons, the first mover advantage created by the funds' current valuation and pricing practices."[24]

The SEC Rule also gives MMFs the discretion to impose liquidity fees of up to 2% and/or gates of up to 10 days if the fund's weekly liquid assets fall to less than 30% of the fund's total assets. Further, the rule requires funds to impose a 1% redemption fee if the

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21 Securities and Exchange Commission, *Money Market Fund Reform; Amendments to Form PF*, 79 Fed. Reg. 47736, *henceforth* "SEC Release."

22 Section 120 gives FSOC the authority to "provide for more stringent regulation of a financial activity by issuing recommendations to the primary financial regulatory agencies to apply new or heightened standards and safeguards" if it "determines that the conduct, scope, nature, size, scale, concentration, or interconnectedness of such activity or practice could create or increase the risk of significant liquidity, credit, or other problems . . ."

23 SEC Release at 76.

24 SEC Release at 76.

fund's weekly liquid assets fall below 10% of its total assets "unless the fund's board of directors . . . determines that such a fee would not be in the best interest of the fund."

The SEC has applied this combination of liquidity fees and gates to prime and tax-exempt funds, but not government funds. The Commission explained that this "hybrid approach" acts "as a floor for board consideration when liquidity has been significantly depleted."[25] With respect to the discretionary nature of the rule, the SEC explained it was fearful that an automatic trigger "may create the risk of imposing costs on shareholders, such as those related to board meetings or liquidity fees themselves, when funds are not truly distressed or when liquidity is not abnormally costly."[26]

To summarize, the Commission has applied the following rules to the following types of money market funds:

| Type of Fund | Fees and Gates | Floating NAV | Amortized Accounting |
|---|---|---|---|
| Institutional Prime ($932.98 billion)[27] | ✓ | ✓ | ✓ |
| Retail Prime ($509.53 billion) | ✓ | | |
| Tax-Exempt (Municipal) ($261.86 billion) | ✓ | | |
| Government (Treasury) ($968.02 billion) | | | |

*B. Additional changes to retail prime and municipal funds are necessary.*

The SEC made significant and important changes to institutional prime funds by requiring a floating NAV up to four decimal points and amortized accounting, to mitigate run risk. However, the floating NAV should be applied to all MMFs. This uniform approach is necessary to further mitigate run risk; to ensure greater fairness for investors who elect not to redeem when a fund is under stress; to ensure greater transparency; and to make clear to all investors that MMFs are investments, not bank products with a guarantee of principal protection.

25 SEC Release at 58.
26 *Id.*
27 Numbers as of Mar. 5, 2015. Investment Company Institute, *Money Market Fund Assets March 5, 2015*, *available at* http://www.ici.org/research/stats/mmf/mm_03_05_15.

This recommendation is consistent with the Council's own views. In its 2012 proposed recommendations, the Council set forth a number of new regulatory measures governing MMFs that could be applied in combination, not just in the alternative. The first was to require that "all MMFs operate with a floating NAV."[28] The rationale was to better align investor expectations with "their risk-return preferences," to ensure that investors bear the risk of loss rather than a fund sponsor or the government, and to reduce the first-mover advantage.

Another FSOC proposal was to retain the fixed NAV for all funds, but require funds to maintain a NAV buffer of up to one-percent and implement a three-percent minimum balance at risk ("MBR") on investments above $100,000, with redemption for that MBR available only after 30-days. This proposal was to ensure that investors who otherwise would have a first-mover advantage "share in losses caused by redemptions," creating a disincentive to redeem during times of stress.[29]

The optimal approach, at a minimum, is to require a floating NAV for all MMFs as the Council suggested, for the reasons cited above. If the floating NAV is not adopted across the board, then the mandatory capital buffer proposed by FSOC is an essential measure that must be adopted.[30] The FSOC should pursue these reforms in connection with its assessment of the asset management industry.

*C. Consider replacing fees and gates with a permanent minimum balance at risk.*

The SEC's Rule implemented discretionary fees and gates for all non-Treasury MMFs when certain triggers were met. The Commission explained that this hybrid approach of both fees and gates would allow funds flexibility in times of crisis, depending on the extent to which there is a liquidity crisis:

> Liquidity fees provide investors continued access to their liquidity (albeit at a cost) while also reducing the incentives for shareholders to redeem shares. Liquidity fees, however, will not outright stop redemptions. In contrast to fees, redemption gates stop redemptions altogether, but do not offer the flexibility of fees. Because redemption gates prevent investors from accessing their investments for a period of time, a fund may choose to first impose a liquidity fee and then, if needed, impose a redemption gate.[31]

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28 FSOC Proposal at 66.

29 FSOC Proposal at 72. The Council did note that neither of these proposals would put an end to runs. With a floating NAV, "the incentive to redeem before others may remain, in part, because each MMF has a limited supply of liquid assets with which to meet redemptions." FSOC Proposal at 67. With a capital buffer and MBR, the reform would not be "sufficient to stop a run on an MMF if investors anticipate very large losses in that fund," but it would be large enough to prevent fund contagion. FSOC Proposal at 71.

30 Jill E. Fisch, *Working Paper: The Broken Buck Stops Here: Embracing Sponsor Support in Money Market Fund Reform* at 42 (Nov. 2014), http://ssrn.com/abstract=2456255.

31 SEC Release at 48.

However, discretionary fees and gates may do more harm than good. In her dissent to the Rule, Commissioner Kara Stein detailed several shortcomings of redemption gates and the SEC's implementation.[32] First and foremost, she noted, "a fund that drops a gate likely would need to build liquidity to meet redemption requests when the gate is lifted. This means the fund is likely to stop re-investing maturing securities during the gated period, or will invest primarily in government securities, thereby cutting off funding to issuers." Rather, any rule should encourage MMFs to invest, or at least not discourage MMFs from investing, in non-Treasury securities.

Commissioner Stein also noted that when one fund puts in place a gate, investors "likely will redeem assets from other funds," causing contagion. This contagion, which "could freeze the wholesale funding markets in much the same way as occurred during the recent financial crisis," is just a rule should be designed to prevent.[33] Additionally, even before a gate is imposed at any one fund, gates exacerbate run risk near the point of the trigger at which they would be implemented.[34]

An MBR could address these concerns, and help prevent run risk and contagion. Such an MBR would ensure that all fund participants have capital at risk in times of crisis, regardless of when their investments were redeemed, and would negate any first mover advantage. FSOC should work toward ensuring that this reform is also applied to MMF regulation.

## IV. <u>FSOC should consider reviewing the use of short-term financing, in addition to the asset managers who provide it.</u>

The asset management industry provides important options for investors, and important sources of credit for a wide variety of commercial and municipal borrowers. However, another facet of asset management deserves FSOC scrutiny: the heavy reliance on short-term financing, especially by broker-dealers, which is supplied in large measure by MMFs.

When over-leveraged broker-dealers such as Lehman Brothers were afflicted by crisis in 2008, their downward spiral and the contagion they spread throughout the financial system subsided only when their investment banks were purchased by commercial banks (e.g. Merrill Lynch) or became bank holding companies and received a backstop by the Federal Reserve's discount window (e.g. Goldman Sachs and Morgan Stanley), among numerous other bailout programs.

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32 Statement of Commissioner Kara M. Stein (July 23, 2014), *available at* http://www.sec.gov/News/PublicStmt/Detail/PublicStmt/1370542553868.

33 *Id.*

34 Marco Cipriani, Antoine Martin, Patrick McCabe, and Bruno M. Parigi, *Gates, Fees, and Preemptive Runs*, FEDERAL RESERVE BANK OF NEW YORK (Aug. 18, 2014), *available at* http://libertystreeteconomics.newyorkfed.org/2014/08/gates-fees-and-preemptive-runs.html.

In the buildup to the crisis, these brokers utilized repo and interbank markets to obtain cheap short-term capital. When these markets were functioning, these brokers could roll over their nightly and other short term obligations without difficulty. However, inexpensive capital brought with it heightened liquidity risk, which materialized at the height of the crisis. According to a 2013 speech given by New York Federal Reserve President William Dudley, this type of short-term funding "create[d] the potential for a firm to fail in an extraordinarily rapid manner [and] also served as a channel through which the effects of those failures were widely propagated throughout the broader financial system."[35]

The measures taken after the financial crisis affecting this area have generally concerned clearing banks. The New York Fed's Tri-Party Repo Infrastructure Reform Task Force successfully initiated several reforms to the repo market's infrastructure through voluntary changes by the clearing banks.[36]

However, little has been done to deal with broker-dealers' use of short-term funding for what are effectively long-term costs and expenses. Federal Reserve Bank of Boston President Eric Rosengren expressed a belief in a November 2014 speech that, while "[s]ome may assume that broker-dealer runs should not be a concern, now that most of the largest broker-dealers are in bank holding companies," this is in fact not the case.[37] In fact, "the Dodd-Frank legislation has made it even more difficult for banks to fund their nonbank affiliates, even during periods of financial stress."[38]

Federal Reserve Governor Daniel Tarullo expressed his concern at the lack of progress on this issue in testimony to the Senate Banking Committee: "We have yet to address head-on the financial stability risks from securities financing transactions and other forms of short-term wholesale funding that lie at the heart of shadow banking."[39] And as President Dudley pointed out, the status quo requires neither group "to fully bear the externalities associated with their actions. Instead they anticipate that emergency liquidity would be made available in the event of a future systemic crisis."[40]

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35 Statement of President William C. Dudley at the Workshop on the Risks of Wholesale Funding, Federal Reserve Bank of New York, New York City (Aug. 13, 2014), *available at* http://www.newyorkfed.org/newsevents/speeches/2014/dud140813.html.

36 Tri-Party Repo Infrastructure Reform, FEDERAL RESERVE BANK OF NEW YORK, *available at* http://www.newyorkfed.org/banking/tpr_infr_reform.html.

37 Statement of President Eric S. Rosengren to the Association of Supervisors of Banks of the Americas, Lima, Peru (Nov. 5, 2014), *available at* http://www.bostonfed.org/news/speeches/rosengren/2014/110514/110514text.pdf.

38 *Id.*

39 Statement of Governor Daniel K. Tarullo before the Senate Committee on Banking, Housing, and Urban Affairs (Feb. 6, 2014), *available at* http://www.federalreserve.gov/newsevents/testimony/tarullo20140206a.htm.

40 Statement of President William C. Dudley at the New York Bankers Association's 2013 Annual Meeting and Economic Forum, The Waldorf Astoria, New York City (Feb. 1, 2013), *available at* http://www.newyorkfed.org/newsevents/speeches/2013/dud130201.html.

While a number of officials have recognized the need to regulate broker-dealers' use of short-term financing, such regulations do not appear to be forthcoming at the SEC. It was reported a year ago that the SEC was considering new leverage rules on brokers, including placing a cap on brokers' borrowing, requirements for a reserve of liquid assets, and setting a maximum leverage ratio for broker-dealers, but no rule has been proposed.

Even if the SEC were to propose a rule, there is reason to question whether it would comprehensively address the problem. Chair White has noted that any proposal would "avoid a rigidly uniform regulatory approach solely defined by the safety and soundness standard that may be more appropriate for banking institutions."[41] However, it is the safety and soundness of these large brokers that matters for financial stability purposes.

Thus, in addition to reviewing asset managers, FSOC should consider evaluating whether additional regulations should be applied to the use of short-term financing, particularly by broker-dealers. This remains a very important issue: Seven years after the financial crisis, short-term debt remains over-utilized and under-regulated.

**<u>CONCLUSION</u>**

We hope these comments are helpful in your consideration of the asset management industry.

Sincerely,

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41 Dave Michaels, *Shadow Banking Deals Prompt SEC Plan to Cap Broker Leverage*, BLOOMBERG BUSINESS (Mar. 20, 2014), *available at* http://www.bloomberg.com/news/articles/2014-03-20/shadow-banking-deals-prompt-sec-plan-to-cap-leverage-for-brokers; Andrew Ackerman, *SEC Weighs New Rules to Rein In Brokerages*, WALL STREET JOURNAL (Mar. 20, 2014), *available at* http://www.wsj.com/articles/SB10001424052702304026304579451722051977950.

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