COMMITTEE ON CAPITAL MARKETS REGULATION

February 15, 2013

The Hon. Neal S. Wolin, Acting Chairman
Financial Stability Oversight Council
United States Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, DC 20220

Dear Acting Chairman Wolin:

The Committee on Capital Markets Regulation (the "**Committee**") appreciates the opportunity to comment on the authority of the Financial Stability Oversight Council ("**FSOC**") to designate certain non-bank financial companies as "non-bank systemically important financial institutions" ("**non-bank SIFIs**"),[1] as well as on FSOC's recent Section 120 recommendation to the Securities and Exchange Commission ("**SEC**") regarding money market mutual fund ("**MMMF**") reform.[2]

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent, empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, which contains fifty-seven concrete recommendations for making the U.S. financial regulatory system more integrated, effective, and protective of investors in the wake of the 2008 financial crisis.[3] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

The Committee has commented extensively on the issue of SIFI designation with respect to both banks and non-banks.[4] We generally oppose singling out banks or non-banks for enhanced supervision and regulation, as we believe such designation will both introduce competitive distortions into the marketplace and increase moral hazard. Furthermore, as we have previously commented, certain types of financial institutions do not generally pose systemic risk,

[1] *See generally* Title I of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010) (to be codified at 12 U.S.C. § 5301).
[2] Financial Stability Oversight Council, "Proposed Recommendations Regarding Money Market Mutual Fund Reform" (November 2012), http://www.treasury.gov/initiatives/fsoc/Documents/Proposed Recommendations Regarding Money Market Mutual Fund Reform - November 13, 2012.pdf.
[3] Comm. on Capital Mkts. Reg., The Global Financial Crisis: A Plan For Regulatory Reform (May 2009), http://www.capmktsreg.org/pdfs/TGFC-CCMR_Report_285-26-0929.pdf.
[4] See Letter from Comm. On Capital Mkts. Reg. to Lance Auer, Deputy Assistant Secretary, U.S. Treasury Dep't (Dec. 19, 2011), http://capmktsreg.org/2011/12/fsoc-comment-regarding-its-authority-to-require-supervision-and-regulation-of-certain-nonbank-financial-companies/ [hereinafter Dec. 19 Letter], Letter from the Comm. On Capital Mkts. Reg. to Timothy Geithner, Chair, Fin. Stability Oversight Council (Nov. 5, 2010), http://www.capmktsreg.org/pdfs/2010.11.05_Volcker_Rule_letter.pdf, Letter from the Comm. On Capital Mkts Regulation to Lance Auer, Deputy Assistant Secretary, U.S. Treasury Dep't (Feb. 22, 2011), http://capmktsreg.org/2011/02/fsoc-authority-to-require-supervision-and-regulation-of-certain-nonbank-financial-companies/.

including asset managers (mutual fund managers as well as managers of private funds, like hedge funds and private equity funds) and traditional insurers, because their bankruptcy would not set off a chain reaction of financial institution failures, with the possible exception of firms performing critical or unique functions, where such functions could not continue in bankruptcy or be easily transferred to another institution.

Of course, any institution performing a critical function should be regulated to avoid any risks it may pose, whether operational, market, credit, liquidity, or other risks, quite apart from the institution's failure, but such regulation does not necessitate non-bank SIFI designation. We believe that institutions performing similar functions should be similarly regulated, whether by the SEC, Commodity Futures Trading Commission ("**CFTC**") or the Federal Reserve ("**Fed**"). We support regulatory reorganization so that there is sensible, efficient, non-duplicative regulation of financial firms by the most appropriate agency. Absent such reorganization, we believe FSOC should encourage financial regulators to perform their duties rather than simply designate individual financial institutions as SIFIs in order to provide an additional layer of regulation in the form of Fed oversight.

Dodd-Frank sets forth a $50 billion threshold for subjecting bank holding companies to enhanced prudential standards. In the spirit of treating systemically important banks and non-banks similarly, we support FSOC's decision to use a bright-line asset threshold for non-bank SIFI designations. However, as suggested in the Committee's letter of February 22, 2011, for non-banks that meet the Stage 1 $50 billion threshold, FSOC should reconsider excluding the asset managers and traditional insurers from SIFI designation. Congress clearly envisioned such categorical exemptions when it included the "safe harbor" provisions of Section 170, which direct the Fed to consult with the FSOC and adopt regulations "exempting certain types or classes of U.S. nonbank financial companies . . . from supervision by the Board of Governors." We believe that asset managers and traditional insurers should be so exempted, but we also note that, if the nature of any of these industries changes or should an asset manager or insurer enter into new lines of business that pose risks to the financial system, we would expect that these non-banks might then more appropriately be considered for SIFI designation.

The Committee also believes that no single money market fund or money market fund complex poses systemic risk. While the industry as a whole does raise legitimate systemic risk concerns, due to its short-term funding and exposure to contagious runs as evidenced by the 2008 financial crisis, these would be better addressed by industry-wide policies and not through the SIFI designation of particular firms.

Asset Management Firms

The asset management industry has evolved over recent decades to include a wide array of products, from registered mutual funds to hedge funds, private equity funds, real estate investment trusts, and separately managed accounts. These funds and accounts may invest in an almost endless variety of instruments and strategies, including publicly traded securities, private equity, fixed income, commodities, or real estate, *inter alia*. This letter addresses two of these sub-categories, private equity and money markets, in further detail below.

An initial question arises as to how and what to measure when determining whether an asset management firm meets the $50 billion threshold. One possibility is to look at the balance sheet of the manager itself; however, managers themselves do not often maintain large balance

sheets. Rather, they collect management and performance fees from clients and typically distribute these to their principals. Furthermore, investment managers of publicly offered mutual funds, privately offered hedge funds, and private equity funds are typically registered under the Investment Advisers Act of 1940 and as such are subject to extensive regulation by the SEC and required to maintain investor funds in segregated accounts.

Another possible approach is to measure the funds invested, or total assets under management ("**AUM**"), of a particular asset manager. The Committee believes that AUM is not reflective of the systemic risk posed by a manager or its funds. The nature of AUM demonstrates why designation would be an ineffective and therefore inappropriate regulatory approach to asset managers or funds. For example, managers often offer a wide range of funds with different investment strategies, asset or sector focuses, and target investor audiences. These different strategies may exhibit very different performance in times of crisis, and, as discussed below, different investors may react differently to poor performance. Designating a fund or a manager as a non-bank SIFI would not prevent investors who want exposure to an asset class or strategy from moving their assets to an undesignated manager or fund that could provide it. These and other characteristics of the asset management business make it fundamentally incompatible with the SIFI designation authority and the regulatory regime that comes with it.

The Committee believes that is inappropriate to regard aggregate AUM as an indicator of systemic risk. Furthermore, asset managers' funds are generally not interconnected. Registered investment advisers are required to maintain separate custody of fund assets and are subject to conflict of interest rules that do not permit the adviser to manage a fund to benefit an affiliated fund. Furthermore, many of the funds that asset managers organize and advise are registered with the SEC and are subject to additional regulation under the Investment Company Act of 1940 (the "**Investment Company Act**"),[5] which imposes strict restrictions on a registered fund's ability to borrow as well as further restrictions on its relationship with affiliated entities. All these measures suggest that negative performance in one of an asset manager's funds, whether a mutual fund, hedge fund, private equity fund or other private fund, would not necessarily extend to other funds managed by the same manager.

Rather than rely on total AUM, FSOC has suggested that it may aggregate the assets held by certain investment funds and then designate each fund as a non-bank SIFI. More specifically, FSOC "may consider the aggregate risks posed by separate funds that are managed by the same adviser, particularly if the funds' investments are highly similar or identical."[6] Dodd-Frank does not authorize such an interpretation. Specifically, it does not empower FSOC to treat separate legal entities as though they were a single entity or to assume that they are part of a structure that would make consolidated analysis and supervision appropriate if, as is the case with legally separate entities like investment funds, they are not part of such a structure.

Certain individual mutual funds reach the Stage 1 $50 billion threshold, although no individual hedge fund does. If FSOC aggregates funds when conducting its analysis, fund families will also exceed that threshold. However, when considering aggregation, in addition to the holdings, FSOC should also make distinctions based on the target audience for these funds. The aggregate risk posed by a group of funds with "highly similar or identical holdings" may not

[5] *See generally* Investment Company Act of 1940, 15 U.S.C. §§ 80a-1 (2012).
[6] FSOC Nonbank Designations Rule, Final Rule and Guidance Memorandum, 12 C.F.R. 310, at 29 (2012) (on file with author).

be substantially greater than the risk posed by each individual fund if investors are dissimilar in terms of their risk tolerance, investment objectives, or average investment sizes. This may be the case, for example, where an asset management firm sponsors funds with similar investment objectives for retail and institutional investors. As was observed during the 2008 financial crisis, institutional and retail investors have very different propensities to redeem, due to their relative investment time horizons, liquidity needs, and redemption rights. Thus, an institutional money market fund might exhibit more volatile redemption patterns and thus pose greater risk than a retail product managed by the same manager holding precisely the same investments.

Private Equity Managers

Private equity managers constitute a subset of asset management firms. Like other asset management firms, the Committee believes that they do not pose systemic risk. Both private equity managers and their funds have limited counterparty exposure to other financial institutions. Private equity firms do not present substitutability concerns, because they do not provide products or services necessary for the operation of the financial system. Private equity investing is long-term by its nature and does not create maturity mismatches. Neither does it rely on short-term credit. Private equity managers generally employ only modest amounts of leverage[7] and generally do not concentrate their investments in any particular industry. Thus, no particular industry is uniquely dependent on private equity as a funding source.[8] As with other asset managers, private equity managers are typically registered with and regulated by the SEC. Furthermore, with respect to managers who manage multiple private equity funds, these are discrete pools of segregated assets which by their nature exhibit little overlap across funds, so the poor performance of one private equity fund should not affect the viability of the other private equity funds. Thus, it would generally not be appropriate to aggregate the assets of different private equity funds.

Traditional Life and Property Insurance Companies

The Committee has previously expressed its belief that traditional life and property insurance companies should be excluded from designation as non-bank SIFIs.[9] Traditional insurance companies' liabilities are long-term in nature, particularly as compared with the liabilities of other non-bank financial institutions. In fact, it was traditional insurers' self-funding through insurance premiums, lack of reliance on short-term funding, lack of leverage, and high levels of substitutability that allowed these firms to weather the 2008 financial crisis relatively unscathed. No traditional insurer showed any evidence of posing systemic risk during the financial crisis. For example, the systemic risk posed by AIG was not from its traditional life and property insurance activities. Rather, AIG's large losses and liquidity crisis were due to the credit protection that AIG Financial Products sold on multi-sector collateralized debt obligations that were exposed to U.S. subprime mortgages[10] and reinvestment of cash collateral in mortgage backed securities by AIG's securities-lending subsidiary.[11] Any insurance company that engages

[7] ELI TALMOR & FLORIN VASVARI, INTERNATIONAL PRIVATE EQUITY 7 (2011).
[8] Robert J. Shapiro & Nam D. Pham, The Role of Private Equity in U.S. Capital Markets 8 (October 2008), http://www.sonecon.com/docs/studies/RoleofPEinUSCapitalMarkets-FINAL.pdf.
[9] Dec. 19 Letter.
[10] *See* Hal S. Scott, Interconnectedness and Contagion 70 (Nov. 21 2012), http://www.capmktsreg.org/pdfs/2012.11.20_Interconnectedness_and_Contagion.pdf.
[11] FIN. CRISIS INQUIRY COMM'N, THE FIN. CRISIS INQUIRY REPORT, 272, 345, 376, 377 (2011).

in such activities on significant scale should be eligible for non-bank SIFI designation. We note recent efforts by the International Association of Insurance Supervisors to identify "non-traditional" insurance activities. Once defined, the Committee would expect that insurance regulators closely supervise insurance companies and monitor the extent of any such activities to prevent insurers from engaging in these activities on any significant scale.

Money Market Mutual Funds

Secretary Geithner recently suggested that FSOC should consider designating MMMFs as non-bank SIFIs in order to address the systemic risk posed by the MMMF industry.[12] In order to designate an MMMF as a non-bank SIFI, FSOC would have to determine that MMMFs managed by a specific asset manager (an "**MMMF complex**") pose systemic risk. The Committee does not believe that FSOC should so designate any MMMFs as non-bank SIFIs.

MMMFs are SEC-registered mutual funds pursuant to Rule 2a-7 under the Investment Company Act. Rule 2a-7 allows MMMFs to price their shares at $1.00 if the fair market value of their securities does not deviate by more than 0.5% per share above or below $1.00. Rule 2a-7 subjects MMMFs to very restrictive portfolio requirements. MMMFs are only permitted to invest in very short-term, high quality, marketable debt instruments in a diversified manner and without any leverage.

There are four primary types of MMMFs: Treasury MMMFs, which invest primarily in U.S. Treasury obligations and Treasury repos; government MMMFs, which invest primarily in Treasuries, Treasury repos, agency debt securities, and agency repos; tax-exempt MMMFs, which invest primarily in short-term municipal securities; and prime MMMFs, which are taxable funds that invest in short-term securities of the highest quality, including Treasury and government securities and repos, as well as certificates of deposit, commercial paper, and other securities issued primarily by the financial sector. Importantly, each type of MMMF has a different investment portfolio based on the specific fund's objectives. Like many mutual funds, certain MMMFs are offered primarily to either retail investors or institutional investors. Thus, because not all MMMFs hold investments that are "highly similar or identical" and, as discussed above, because retail and institutional investors in MMMFs have historically exhibited different propensities to redeem, FSOC should not automatically aggregate all of an asset manager's MMMFs when making a SIFI designation.

The financial crisis confirmed the significance of these differences among MMMFs. After Lehman Brothers' failure on September 15, 2008, prime MMMFs experienced outflows of $310 billion that were eventually halted by government intervention, whereas government MMMFs experienced inflows of $192 billion.[13] Although retail prime MMMFs and institutional prime MMMFs invest in similar securities, retail prime MMMFs did not experience a run similar to institutional prime MMMFs.[14] According to FSOC statistics, 95% of the MMMF redemptions following Lehman Brothers' failure came from institutional prime MMMFs.

[12] Letter from Timothy Geithner, Secretary, U.S. Treasury Dep't to Fin. Stability Oversight Council, at 3 (Sept. 27, 2012), http://www.treasury.gov/connect/blog/Documents/Sec.Geithner.Letter.To.FSOC.pdf.
[13] *See* Fin. Stability Oversight Council, Proposed Recommendation Regarding Money Market Mutual Fund Reform, at 25–26 (November 2012), http://www.treasury.gov/initiatives/fsoc/Documents/Proposed Recommendations Regarding Money Market Mutual Fund Reform - November 13, 2012.pdf
[14] *See* id., at 25.

Treasury MMMFs, government MMMFs, tax-exempt MMMFs, and retail prime MMMFs have not been proven to pose systemic risk. Further, the 2008 financial crisis did not conclusively demonstrate that any individual institutional prime MMMF posed systemic risk. During the crisis, the value of assets held by all prime MMMFs were in doubt. The failure of the Reserve Primary Fund was not the sole or primary cause of the run on institutional prime MMMFs. This account of the crisis is supported by the fact that the run on institutional prime MMMFs began even *before* the failure of the Reserve Primary Fund. The Committee believes that any systemic risk posed by the institutional prime MMMF industry cannot be addressed by designating particular funds or complexes as systemically important, because investors in designated entities could simply shift their capital to smaller MMMFs or other products with substantially similar characteristics.

The major systemic risk posed by mass redemptions from an institutional prime MMMF is the dependence of large banks on funding from such funds. As of November 9, 2012, there were only five institutional prime MMMF complexes with assets over $50 billion: Fidelity with $159 billion; JPMorgan with $110 billion; Blackrock with $106 billion; Federated with $88 billion; and BNY Mellon (Dreyfus) with $50 billion. Rule 2a-7 permits an MMMF to invest up to only 5% of its assets in the securities of an individual issuer (excluding government securities),[15] so even the *largest* institutional prime MMMF complex could provide a large bank with only $7.95 billion in funding. Considering that large banks have balance sheets typically exceeding $1 trillion, losing funding from an institutional prime MMMF complex alone could not endanger a large bank. For example Deutsche Bank has $2.8 trillion in assets: the largest institutional prime MMMF complex could provide Deutsche Bank with less than 0.3% of its funding.

Furthermore, large banks' reliance on funding from U.S. prime MMMFs is limited. As of September 30, 2012, U.S. prime MMMFs provide the largest U.S. bank holding companies with the following funding (expressed as a dollar amount and percentage of total funding): Goldman Sachs $36.5 billion, or 3.8%; Bank of America $64 billion, or 3%; JPMorgan $51 billion, or 2.2%; Citigroup $42 billion, or 2.2%; and Wells Fargo $17.5 billion, or 1.3%. Large foreign banks rely to a similar extent on U.S. prime MMMFs: Barclays $84.5 billion, or 3.3%; Deutsche Bank AG $61 billion, or 2.2%; Société Générale $31 billion, or 1.9%; Credit Agricole $31.5 billion, or 1.4%; BNP Paribas $33.5 billion, or 1.3%; and HSBC $24.5 billion, or 0.9%. Since approximately one-third of prime MMMFs are held by retail investors, the extent of large banks' reliance on institutional prime MMMFs is substantially less. These findings suggest that reforming prime MMMFs may not significantly reduce the likelihood of a bank failure.

However, even if large banks are not overly dependent on money market funds, there could still be a concern with the economic impact of a run on such funds given their large size and impact on the economy. Nonetheless, that problem should be addressed by policies aimed at the entire prime money market fund industry, not through the designation of particular funds as non-bank SIFIs.

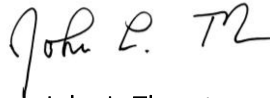
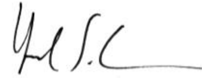
[15] 17 C.F.R. 270.2a-7(c)(4)(i)(A) (2010).

Operational Risk and Critical Function

If a non-bank financial institution performs a unique and critical function for the financial system that would be significantly impaired in bankruptcy, there should be a workable plan to transfer that function to another institution in the event of a bankruptcy. Furthermore, if an institution's failure, whether or not it results in bankruptcy, would have a significant impact on the financial system and pose widespread operational, market, credit, liquidity, or other risks, the institution should be regulated to control such risk. FSOC has recognized that it and its member regulators have multiple tools to address such risks and that SIFI designation may well be an inappropriate tool for many of them. Given those factors and the significant impact that SIFI designation can have on individual companies, industries, financial markets, and the U.S. economy, we recommend that FSOC (i) carefully assess any identified risk, including the firms, activities, or industries that may present it, and the tools available to mitigate it, (ii) conclude that designation is the most appropriate tool to mitigate the risk presented by a company, and (iii) provide a rationale for that conclusion before it makes any designation determination.

Thank you for considering our position. Please do not hesitate to contact us at (617) 495-5221 if we may be of any further assistance.

Respectfully submitted,

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February 15, 2013

The Hon. Neal S. Wolin, Acting Chairman
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United States Department of the Treasury
1500 Pennsylvania Avenue, NW
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Dear Acting Chairman Wolin:

The Committee on Capital Markets Regulation (the "**Committee**")[1] appreciates the opportunity to comment on the Financial Stability Oversight Council's ("**FSOC**") recent Section 120 recommendation to the Securities and Exchange Commission ("**SEC**") regarding money market mutual fund ("**MMMF**") reform.[2] The Committee's comments will focus on the FSOC's recommendation that the SEC require MMMFs to adopt a floating net asset value ("**NAV**").

Since 2005, the Committee has been dedicated to improving the regulation of U.S. capital markets. Our research has provided an independent and empirical foundation for public policy. In May 2009, the Committee released a comprehensive report entitled *The Global Financial Crisis: A Plan for Regulatory Reform*, containing fifty-seven concrete recommendations for making the U.S. financial regulatory structure more integrated, effective, and protective of investors in the wake of the 2008 financial crisis.[3] Since then, the Committee has continued to make recommendations for regulatory reform of major areas of the U.S. financial system.

The sole point of this letter is to say that the Committee does not believe the FSOC proposal for a floating NAV, would reduce the systemic risk of contagion, a run by uninsured short-term creditors that spreads across financial intermediaries that rely on such funding. Even if MMMF investors knew the true value of an MMMF's assets during a crisis, they would still fear further declines and would run in order to avoid further losses. Thus, even if MMMFs were to have floating NAVs, there would still be a "first mover advantage" during a crisis.[4] Professor Jeffrey Gordon's study of European MMMFs, which are available with both fixed and floating NAVs, provides empirical

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[1] One of the members of the Committee does not agree with the position taken in this letter.

[2] Financial Stability Oversight Council, Proposed Recommendation Regarding Money Market Mutual Fund Reform (November 2012).

[3] Comm. on Capital Mkts. Reg., The Global Financial Crisis: A Plan For Regulatory Reform (May 2009), http://www.capmktsreg.org/research.html.

[4] Squam Lake Working Group comment letter to FSOC RE: FSOC Proposed Recommendations Regarding MMF Reform, January 17, 2013.

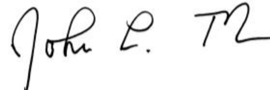
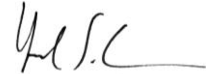
support for the Committee's position. Gordon found that, during the crisis, investors in floating NAV MMMFs were just as likely to run as investors in stable NAV MMMFs.[5]

It is indeed possible that the FSOC floating NAV recommendation would *increase* the likelihood that MMMF investors would run during a crisis. According to Professors Samuel Hanson, David Scharfstein, and Adi Sunderam, a floating NAV requiring MMMFs to mark their assets to market would exacerbate the possibility of fire-sale market spirals, further amplifying contagion.[6]

The Committee is currently studying possible approaches to reducing the risk of contagion and will at a later date offer its concrete recommendations in this regard. The Committee does not believe, however, that the FSOC's floating NAV recommendation would reduce the risk of a run by MMMF investors. Indeed, in certain respects, a switch to floating NAV may make runs more likely. In short, a floating NAV is a false palliative for contagion.

Thank you for considering our position. Please do not hesitate to contact us at (617) 495-5221 if we may be of any further assistance.

Respectfully submitted,

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[5] Gordon, Jeffrey, Gandia, Christopher, "Money Market Fund Run Risk, Will Floating Net Asset Value Fix the Problem?" Columbia Law and Economics Working Paper No. 426, September 23, 2012.
[6] Hanson, Samuel, Scharfstein, David, Sunderam, Adi, "An Evaluation of Money Market Fund Reform Proposals," December 20, 2012, at 22.