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PUBLIC INTEREST COMMENT

Office of Financial Research Study Titled "Asset Management and Financial Stability"

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Comment Period closes November 1, 2013

INTRODUCTION

We appreciate the opportunity to comment on the Asset Management and Financial Stability report released by the Office of Financial Research (OFR) in September.[1] We particularly commend the Securities and Exchange Commission (SEC) for soliciting public comment on this important topic given the OFR's failure to solicit public input. The Mercatus Center at George Mason University is dedicated to bridging the gap between academic ideas and real-world problems and advancing knowledge about the effects of regulation on society. Thus, this comment does not represent the views of any particular affected party or special interest group but is designed to assist the SEC and other regulators as they review the OFR report.

SUMMARY

The report was prepared in order to assist the Financial Stability Oversight Council (FSOC) in "its analysis of whether—and how—to consider [asset management firms] for enhanced prudential standards and supervision."[2] A full response to the FSOC's request would have included an analysis of whether subjecting asset management firms to enhanced prudential standards and supervision would undermine financial stability—an issue that was not addressed in the OFR report. With respect to the matters the OFR did discuss, the analysis was incomplete and, in some areas, flawed. In many places, the OFR underscores the

1. Office of Financial Research, Asset Management and Financial Stability (Sept. 2013) [hereinafter OFR Report], *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.
2. *Id.* at 1.

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tentative or conditional nature of its conclusions.[3] The OFR also acknowledges "significant data gaps"[4] with respect to asset management firms and activities. Because of the report's inadequacies, the FSOC cannot reasonably rely on it as support for embarking on a process of designating asset managers as systemically important financial institutions.

The report suffers from several shortcomings. Most fundamentally, it fails to appreciate the heterogeneity of the asset management industry. Consequently, the report's identification and analysis of vulnerabilities in the asset management industry is flawed. The OFR's implicitly suggested remedy for these vulnerabilities—macroprudential oversight—could homogenize the industry and increase risk, an effect precisely the opposite of the one intended.

SHORTCOMINGS OF THE OFR'S ASSET MANAGEMENT REPORT

As an initial matter, attempting to look at the more than $50 trillion asset management industry as a cohesive whole in a thirty-page report is a difficult undertaking, at best. At worst, it fatally confuses the analysis by creating the impression that the entire asset management industry moves in lockstep. Even though the report acknowledges that there are differences among asset management firms and clients, it seems to fail to grasp the industry's heterogeneity.

Understanding how the diverse parts of the industry interact with one another and the rest of the financial industry during normal times and in times of crisis requires more detail than would have been possible in such a short report. Of greater concern is the possibility that a similar one-size-fits-all approach will be employed by the Federal Reserve Board of Governors in developing enhanced prudential standards for, and supervision of, designated asset managers.

The report fails to clearly draw the line between asset managers and the vehicles they manage, a line that is relevant to the issues being examined. The OFR notes the size of the largest mutual fund complexes and then observes that "higher concentrations could increase the market impact of firm-level risks, such as operational risk and investment risk, or increase the risk of fire sales."[5] Mutual funds are organized and managed separately from their investment adviser and the other funds in the same complex.[6] Thus, while there are firm-level risks, many risks are specific to the affected fund. Although funds are not operating companies with their own employees, each fund has a board of directors that oversees it and is charged with making key decisions in its best interests. Rather than precisely identifying risks that cut across the entire complex, the report seems to assume away the legal lines that separate the fund, the fund complex, and the adviser. These lines serve—albeit imperfectly—to isolate problems in one fund from spreading to another.

Each of the four "vulnerabilities" discussed in the report should have been put in more complete context. The first vulnerability cited by the report is a combination of two problems: "reaching for yield" and herding. The OFR is concerned that asset managers, in "reaching for yield," are able to take greater risks than the investors realize because of information asymmetries.[7] The report does not note that the portfolios of many of the investment vehicles run by asset managers are characterized by a greater degree

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3. *See*, *e.g.*, *id.* at 7 (noting that "a certain combination of fund- and firm-level activities within a large, complex firm, or engagement by a significant number of asset managers in riskier activities, *could* pose, amplify, or transmit a threat to the financial system") (emphasis added); *id*. at 10 ("During a crisis, the rapid unwinding of investments of cash collateral from securities lending *could* pose risks that could amplify fire sales and trigger runs.") (emphasis added); *id* at 12 ("Heightened redemptions from an asset manager's funds *could* increase market risks if there is a perception that the asset management firm itself is at risk of failure.") (emphasis added).
4. *Id.* at 24.
5. *Id.* at 3.
6. *See generally* Investment Company Institute, 2013 Investment Company Fact Book, Appendix A (discussing how investment companies operate) [hereinafter ICI Fact Book], *available at* http://www.icifactbook.org/fb_appa.html.
7. OFR Report, *supra* note 1, at 9.

of transparency than bank holdings.[8] The competitive nature of the asset management industry—which the report acknowledges—suggests that investors are able to demand the disclosures they need to monitor risk. Moreover, extensive regulatory disclosure mandates govern investment companies.[9] In addition, asset managers' short-term incentives to chase yield are offset by longer-term concerns about reputation.

The OFR also worries about herding behavior that can cause asset managers to concentrate their investments in the same securities, particularly illiquid ones.[10] Some herding is to be expected in funds with similar objectives and based on similar indices. In selecting securities, asset managers are governed by the investment objectives of the specific investment vehicle for which they are investing. The great variety of investors and investment vehicles and the conflicting nature of investment mandates translate to diverse holdings across the asset management industry. The OFR's concern seems to be that asset managers generate massive swings into and out of particular securities. A study cited by the OFR as evidence that distressed mutual funds were responsible for substantial sales during the crisis also found support for the broader proposition that "institutional ownership generally has a stabilizing influence on a stock's resilience—presumably because indirectly (mutual fund) invested capital has a lower propensity for 'flight to quality' than directly invested (retail) capital."[11] Large funds are inherently capable of affecting the movement of prices when they buy or sell, but that gives asset managers a particular incentive to be careful about when and how they buy and sell.

The second vulnerability that the report identifies is the possibility of a run in any collective investment vehicle that allows unrestricted redemptions.[12] The report explains that, in times of stress, investors benefit from redeeming early from a fund. Investors can redeem at a higher net asset value if they redeem before the fund's limited liquidity reserve is exhausted and it has to sell less liquid assets at a discount to meet redemptions. The report's reasoning runs counter to the rationale used by the FSOC in arguing for a floating net asset value as a run-prevention tool with respect to money market funds.[13] More generally, while the OFR is correct that early redeemers could benefit at the expense of remaining investors, mutual funds plan for and manage their redemptions to prevent this from happening.

The OFR worries particularly about one method for managing redemptions: sponsor support, in which asset managers step in to help a fund by, for example, purchasing impaired securities or injecting capital. The OFR explains that "investors who expect their investments to be protected by explicit or implicit backstops could be expected to redeem funds in larger numbers if there is any sign that protections are eroding."[14] The report relies on a study of past examples of sponsor support for money market funds to suggest that there might be an implicit expectation of support.[15] Money market funds, however, are not representative of other funds because their stable value is the feature of most importance to investors. Even if they were representative, arguments that money market fund investors—most of whom are institutional—expect sponsors unfailingly to provide support to maintain the $1 net asset

8. *See*, *e.g.*, Robert P. Bartlett, *Making Banks Transparent*, 65 Vanderbilt L. Rev. 293, 310 (2012) (noting that banks are intentionally less transparent than money-market funds).
9. *See* ICI Fact Book, *supra* note 6, at 216–17 (discussing disclosure requirements for mutual funds).
10. OFR Report, *supra* note 1, at 10.
11. Harald Hau & Sandy Lai, *The Role of Equity Funds in the Financial Crisis Propagation* 27 (Working Paper, Dec. 2012), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1742065.
12. OFR Report, *supra* note 1, at 12.
13. *See* FSOC, Proposed Recommendations Regarding Money Market Mutual Fund Reform 30 (2012) (explaining that "[a] floating NAV would also reduce the first-mover advantage that exists in [money market funds] today because investors would no longer be able to redeem their shares for $1.00 when the shares' market-based value is less than $1.00.").
14. OFR Report, *supra* note 1, at 14.
15. *Id.* (citing Steffanie A. Brady et al., *The Stability of Prime Money Market Mutual Funds: Sponsor Support from 2007 to 2011* 5-6 (Fed. Reserve Bank of Boston, Working Paper RPA 12-3, 2012)), *available at* http://www.bostonfed.org/bankinfo/qau/wp/2012/qau1203.pdf).

value are likely overstated.[16] Investors in other types of mutual funds, who routinely watch the value of their investments rise and fall without sponsors stepping in to soften these fluctuations, are even less likely to expect sponsor support.

The OFR report points to "inadequate risk management relating to reinvestment of cash collateral for asset management securities lending programs" to "illustrate how redemption-like risk can create contagion and amplify financial shocks."[17] The OFR uses the example of American International Group (AIG) and its securities lending activities (which exposed some of its life insurance companies to severe losses during the crisis) to explain this point. Frank Keane, whom the OFR cites, characterizes AIG's activities as "securities lending in name only" because it was used as "a mechanism for raising cash to support a high-yield enhancement reinvestment strategy with no collateral market purpose.[18] Others have also identified AIG's securities lending program as particularly risky.[19] Regardless of how AIG ran its program, redemptions by borrowers in a securities lending program run through AIG's regulated insurance-company participants is not an effective illustration of the effects that redemptions can have in the very different mutual-fund context.

The third vulnerability discussed in the report is leverage. The OFR's principal concern appears to be the use of derivatives by registered investment companies to increase leverage. Derivatives, of course, also can play a risk-mitigating role.[20] They can be used to reduce interest-rate or other risks in a fund portfolio. In addition, derivatives can give a fund the desired exposure to a particular market, segment, or security without the costs associated with directly holding securities.[21] While there is a real potential for derivatives to harm particular funds, the SEC already closely regulates funds' use of derivatives and, as the OFR report noted, is considering additional regulatory measures.[22]

The final vulnerability that the OFR considers is asset management firms themselves as a source of risk. The OFR uses two studies to support its claim that "instability at a single asset manager could increase risks across the funds that it manages or across markets through its combination of activities."[23] Yet both studies are focused on intra-fund complex risk transference. Neither study addresses the transfer of risks outside of a fund complex to the market as a whole. To the contrary, both studies found that fund complexes were strengthened by the intra-complex transfers.[24] These studies admittedly raise

16. Based on recent data, more than sixty percent of money-market fund assets are in institutional funds. Investment Company Institute, Money Market Mutual Fund Assets (Oct. 24, 2013), http://www.ici.org/research/stats/mmf/. Institutional investors are well aware of the possibility that money-market funds can deviate from the $1 stable net asset value the funds try to maintain and that sponsors may not step in with support.
17. OFR Report, *supra* note 1, at 15.
18. Frank M. Keane, *Securities Loans Collateralized by Cash: Reinvestment Risk, Run Risk, and Incentive Issues* 6 (Fed. Reserve Bank of New York, Current Issues in Economics and Finance, Vol. 19 No. 3, 2013) http://www.newyorkfed.org/research/current_issues/ci19-3.pdf.
19. *See, e.g.*, Financial Stability Board, Securities Lending and Repos: Market Overview and Financial Stability Issues: Interim Report of The FSB Workstream on Securities Lending and Repos 9 (Apr. 27, 2012) (the reinvestment of cash collateral by securities lenders "can mutate from conservative reinvestment of cash in 'safe' collateral into more risky reinvestment of cash collateral in search of greater investment returns (prior to the crisis, AIG was an extreme example of such behavior)."), *available at* http://www.financialstabilityboard.org/publications/r_120427.pdf.
20. *See generally* René Stulz, *Should We Fear Derivatives?*, 18 J. Econ. Persp. 173 (2004).
21. Independent Directors Council of the Investment Company Institute, Task Force Report: Board Oversight of Derivatives 7-11 (2008), *available at* http://www.ici.org/pdf/ppr_08_derivatives.pdf.
22. Securities and Exchange Commission, *Use of Derivatives by Investment Companies under the Investment Company Act of 1940*. Concept Release, 76 Fed. Reg. 55,237 (Sept. 7, 2011).
23. OFR Report, *supra* note 1, at 18 (citing Utpal Bhattacharya, Jung H. Lee & Veronika K. Pool, *Conflicting Family Values in Mutual Fund Families*, 68 J. FIN. 173 (2013); José-Miguel Gaspar, Massimo Massa & Pedro Matos, *Favoritism in Mutual Fund Families? Evidence on Strategic Cross-Fund Subsidization*, 61 J. FIN. 73 (2006)).
24. *See* Bhattacharya et al., *supra* note 23, at 198–99 (documenting that affiliated funds of mutual funds "offset severe liquidity shortfalls of other funds in their fund complex. We show that, though this action reduces their own investment performance, this sacrifice does benefit the family. It improves the investment performance of the mutual funds that receive such liquidity because it prevents them from doing fire sales"); Gaspar

conflict-of-interest concerns, but they do not support the contention that asset managers are a source of market instability.

In addition to these four vulnerabilities, the report raises concerns about transmission channels, including the relationships that asset managers have with banks, pricing services, credit rating agencies, and service providers.[25] As with the failure of any large company, the failure of a large asset management company could have a material effect on the service providers and other counterparties with which it deals. The report does not identify anything unique about asset management firms that makes their relationships with third parties a particular cause of concern.

The OFR concludes with a call for more data in order to facilitate "effective macroprudential oversight."[26] As the report's cursory overview of the asset-management industry hints, the asset-management industry is one composed of diverse, highly competitive players with different and conflicting objectives. The industry functions well without the central discipline that macroprudential regulation would seek to impose upon it. Attempting to fit the asset management industry into a bank regulatory scheme might have the unintended consequence of further homogenizing the financial sector so that it is less able to meet investors' needs and more vulnerable to financial market shocks.

The FSOC asked for the OFR's help in analyzing the asset management industry as part of the FSOC's consideration of whether asset management companies should be subjected to heightened regulatory oversight. The OFR, perhaps not surprisingly, responded to this open-ended mandate by looking at the asset management industry through an imprecise, unfocused lens. The resulting report does not provide a basis upon which the FSOC can designate asset managers under section 113 of Dodd-Frank.

et al., *supra* note 23, at 101 (finding potential increase in the value of an asset manager due to intra-family subsidies).
25. OFR Report, *supra* note 1, at 21.
26. OFR Report, *supra* note 1, at 26.