

STATEMENT OF

**F. WILLIAM McNABB III
CHAIRMAN AND CHIEF EXECUTIVE OFFICER
THE VANGUARD GROUP, INC.**

ON BEHALF OF THE

INVESTMENT COMPANY INSTITUTE

BEFORE THE

**COMMITTEE ON FINANCIAL SERVICES
U.S. HOUSE OF REPRESENTATIVES**

ON

**EXAMINING THE DANGERS OF THE FSOC'S
DESIGNATION PROCESS AND ITS IMPACT ON THE
U.S. FINANCIAL SYSTEM**

MAY 20, 2014

EXECUTIVE SUMMARY

- Operating under a remarkably comprehensive regulatory framework, U.S. registered investment companies (“funds” or, where appropriate, “mutual funds”) help over 90 million investors achieve their most important financial goals. That regulatory framework, which serves both to protect investors and to mitigate risks to the financial system, again proved its worth during the global financial crisis.
- ICI and its members support appropriate regulation to ensure the resiliency and vibrancy of the global financial system. ICI is deeply troubled, however, by an ongoing process pointing to the possible designation of funds or their managers for enhanced prudential regulation and consolidated supervision by the Federal Reserve Board (“SIFI designation”).
- A focus on asset management by the Financial Stability Oversight Council in the U.S. and the Financial Stability Board globally raises the prospect that the FSOC, in the name of promoting financial stability, may seek to exercise its SIFI designation authority in a manner far broader than Congress intended and that sweeps beyond any demonstrably “systemic” risks.
- These efforts could result in extending the Federal Reserve’s supervisory authority to capital markets-based businesses that are beyond its areas of expertise. And they could lead to application of bank regulatory standards to funds or their managers—entirely out of keeping with the way in which these funds and their managers are structured, operated and currently regulated and with the expectations of investors and the capital markets.
- An objective assessment of the asset management industry must begin with a clear understanding of the fundamental distinctions between asset management and banking, including that asset managers act as agents, not principals. It is difficult to conceive of a situation in which a fund manager’s financial distress or activities could raise systemic concerns, given the manager’s agency role and the fact that economic exposures are those of each individual fund.
- SIFI designation of funds is equally unwarranted. Mutual funds use little to no leverage, and funds do not experience “financial distress” that can threaten financial stability. And history demonstrates that stock and bond mutual funds do not experience heavy redemptions even in periods of market stress. Finally, fund structure and regulation limit risk and risk transmission.
- Designation would be harmful to funds and their investors. A designated fund would be subject to bank-style prudential regulation—including capital and liquidity requirements—and to new fees and assessments, possibly including assessments to help shoulder the costs of “bailing out” a large, failing financial institution. Federal Reserve supervision also could come into conflict with a fund manager’s fiduciary duty to act in the best interests of the fund. Designated funds would face higher costs, making them more expensive for investors and less competitive.

- If regulators believe specific activities or practices pose risks to the market or to the financial system, they should use their considerable rulemaking authority to address those risks through activity-based regulation. In the case of activities or practices involving the capital markets, the Securities and Exchange Commission should drive the process for identifying issues and considering appropriate solutions.

I. INTRODUCTION

My name is Bill McNabb. I am chairman and chief executive officer of Vanguard, one of the world's largest mutual fund complexes. Vanguard is a family of more than 160 mutual funds holding assets of nearly \$3 trillion. Vanguard's core purpose is to take a stand for all investors, treat them fairly, and give them the best chance for investment success.

In this spirit, and in my capacity as chairman of the board of governors of the Investment Company Institute ("ICI"), I am pleased to appear before the Committee today to discuss the FSOC designation process and its implications for registered investment companies ("funds") and their investors. ICI's membership includes U.S. mutual funds, closed-end funds, exchange-traded funds and unit investment trusts with \$16.8 trillion in assets. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their investors, directors, and managers.

Over 90 million investors depend on funds in seeking to achieve their most important financial goals, such as saving for college, purchasing a home, or providing for a secure retirement. Funds and their managers operate under a remarkably comprehensive framework of regulation, including the Investment Company Act of 1940 ("Investment Company Act") and Investment Advisers Act of 1940. That framework has been enhanced over the years by Congress and the Securities and Exchange Commission ("SEC"), the primary fund regulator. The framework's major features—agency-based asset management, strict limits on leverage, daily mark-to-market valuation, exceptional transparency, and strong governance, among others—again proved their worth to investors during the global financial crisis. Notably, the regulatory framework serves both to protect investors and to mitigate risks to the financial system.

Over the last several years, ICI has actively supported U.S. and global efforts to address the abuses and excessive risk taking highlighted by the global financial crisis and to bolster areas of insufficient regulation, such as with respect to the OTC derivatives markets. As both investors in the capital markets and issuers of securities, ICI members support appropriate regulation to ensure the resiliency and vibrancy of the global financial system.

Nevertheless, ICI is deeply troubled by the process being pursued by the Financial Stability Oversight Council ("FSOC")—and a parallel process underway in the global arena that is being coordinated by the Financial Stability Board ("FSB")¹—pointing to the possible designation of funds or

¹ The Financial Stability Board was established by the G20 "to coordinate at the international level the work of national financial authorities and international standard setting bodies and to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies." *See*

<http://www.financialstabilityboard.org/about/overview.htm>. The U.S. members of the FSB are the U.S. Treasury Department, the Federal Reserve Board, and the Securities and Exchange Commission.

their managers for enhanced prudential regulation and consolidated supervision by the Federal Reserve Board (“Federal Reserve”). The Dodd-Frank Wall Street Reform and Consumer Protection Act authorizes the FSOC to designate nonbank financial companies for this purpose—commonly referred to as “SIFI” (systemically important financial institution) designation. But the design of that law suggests that the use of SIFI designation should be reserved for *rare and compelling* cases—*i.e.*, where regulators have determined, on the basis of a thorough and reasoned analysis, that a specific company poses significant risks to financial system stability that cannot otherwise be adequately addressed through enhancements to existing regulation or by other regulatory authorities.

We have become increasingly concerned that the FSOC, in the name of promoting financial stability, may seek to exercise its SIFI designation authority in a manner far broader than Congress intended and that sweeps beyond any demonstrably “systemic” risks. A September 2013 report issued by the Treasury Department’s Office of Financial Research (“OFR”) and a January 2014 FSB consultation paper set forth improbable risks to U.S. or global financial stability that funds, their managers, or asset management activities could pose. Recent press reports have indicated that the FSOC is evaluating at least two firms, each of which has a large asset management business, for possible designation. If the FSOC continues down this path, it could result in extension of the Federal Reserve’s supervisory authority to companies whose business is rooted in the capital markets and which the Federal Reserve does not have the expertise to regulate. And it could mean the application of bank regulatory standards that are entirely out of keeping with the way in which funds and their managers are structured, operated and currently regulated and with the expectations of investors and the capital markets.

We are not alone in raising concerns. Members of Congress in both parties, including members of this Committee and its Chairman, have expressed concerns in letters to senior government officials and during Committee hearings.²

In Section II below, we highlight several ways in which asset management (and, more particularly, funds and their managers) are fundamentally different from banking. Section III explains why SIFI designation of a fund manager is unwarranted, and why even the very largest funds likewise are not SIFIs. In Section IV, we discuss the investor harm and market distortion that would stem from such a SIFI designation. Finally, in Section V, we explain why activity-based regulation is a better

² See, e.g., Letter to The Honorable Jacob Lew, Chairman, FSOC; The Honorable Janet Yellen, Chair, The Federal Reserve System; and The Honorable Mary Jo White, Chair, SEC, from Rep. Jeb Hensarling (R-TX), Chairman, House Financial Services Committee, and the respective Subcommittee Chairmen, dated May 9, 2014; Letter to The Honorable Jacob Lew, Chairman, FSOC, from Sen. Mark Warner (D-VA), dated May 9, 2014; Letter to The Honorable Jacob Lew, Chairman, FSOC, from Reps. Dennis Ross (R-FL) and John Delaney (D-MD) and 39 other members of the House Financial Services Committee, dated April 9, 2014; Letter to The Honorable Jacob Lew, Chairman, FSOC, from Sens. Mark Kirk (R-IL), Thomas Carper (D-DE) and others, dated January 23, 2014.

approach to addressing identified risks.³ These points are discussed in greater detail in ICI's comment letters on the OFR study and the FSB consultation.⁴

II. ASSET MANAGEMENT IS FUNDAMENTALLY DIFFERENT FROM BANKING

As regulators examine the potential for systemic risk in the asset management sector, ICI is concerned that many of those involved in the process are predisposed to view the world through a banking lens and to think of financial activity conducted outside of banks as "shadow banking." Both the FSOC and the FSB are dominated by banking regulators. Prudential standards and other requirements imposed via SIFI designations are designed to mitigate bank-like risks. And OFR's Asset Management and Financial Stability report, which recognizes on its very first page that asset managers act as agents on behalf of their clients, loses sight of this characteristic in its analysis.

An objective, unbiased assessment of the asset management industry must begin with a clear understanding of how asset management differs from banking. Fundamental distinctions related to funds and their managers are outlined below, and discussed in more detail throughout this testimony.

- **In asset management, managers act as agents, not as principals. A fund and its investors, not the fund manager, bear the risk of the fund's investments.** Acting as agent, a fund manager manages the fund's portfolio pursuant to a written contract and in accord with the fund's investment objectives and policies as described in the fund's prospectus. Fund management fees compensate the manager for managing the fund as a fiduciary and agent and for providing ongoing services that the fund needs to operate. The manager does not own the fund's assets and it may not use those assets to benefit itself or any other fund. Investment gains and losses experienced by a fund are solely attributable to that fund and its investors.
- **In asset management, there is no need for capital requirements or "loss absorption."** Fund investors understand that portfolio results, positive or negative, belong to them alone and accept the risk that their investments may lose value. Unlike with bank deposits, the risk of loss is inherent in an investment, including an investment in a fund.
- **In asset management, there is no need for government bailouts.** The concept of public bailouts is inapposite to funds and their managers. If a fund's manager went bankrupt, the

³ This testimony does not focus on issues specific to money market funds. As noted by the Office of Financial Research in its September 2013 report entitled "Asset Management and Financial Stability," money market funds have undergone major reforms since the financial crisis and additional reforms remain under active consideration at the SEC. We believe this is the most appropriate way to address any remaining concerns regulators may have regarding those funds. In no event would SIFI designation be necessary or appropriate for a money market fund.

⁴ See Letter to the Secretariat of the FSB from Paul Schott Stevens, President & CEO, ICI, dated April 7, 2014, available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf; Letter to Elizabeth M. Murphy, Secretary, SEC from Paul Schott Stevens, President & CEO, ICI, dated Nov. 1, 2013, available at http://www.ici.org/pdf/13_ici_ofr_asset_mgmt.pdf.

manager would have no access to the fund’s assets, assets of any other funds it manages, or other client assets. There would be no expectation of government intervention to prop up the manager. The fund’s board of directors would simply hire another asset management company to manage the fund. In the case of funds themselves, investors are not promised gains on their investment, or even a return of the principal amount they invested. As noted above, fund investors and the broader marketplace understand that all investment results—gains and losses, no matter how big or small—belong to the fund’s investors on a *pro rata* basis. Indeed, many funds had sharp declines in value during the financial crisis (most have since recovered that lost value). But there was never any suggestion, expectation or need for the government to step in and “rescue” a fund.

- **In asset management, there is no need for resolution planning.** As noted above, a fund’s board of directors has the ability to replace the fund’s manager. And in the event of a fund closure, federal and state laws already provide a clear process for a fund to make a *pro rata* distribution to its investors and wind up its affairs under the oversight of the fund’s board of directors. Funds thus have no need for bank-like “resolution planning,” and regulators have no need for additional authority to protect against a fund’s “disorderly failure.”

III. SIFI DESIGNATION OF FUNDS OR THEIR MANAGERS IS UNWARRANTED

Under the Dodd-Frank Act, SIFI designation is contemplated only for nonbank financial companies whose “material financial distress,” or whose activities, could threaten U.S. financial stability.⁵ This standard is rooted in the actual experience of the global financial crisis, when the distress or disorderly failure of certain large, interconnected and highly leveraged financial institutions—banks, insurance companies and investment banks—required direct intervention by the U.S. government, and taxpayer bailouts, to repair the damage.

It is difficult to conceive of a situation in which a fund manager’s financial distress or activities could give rise to systemic concerns. In providing investment management and other services to funds, the manager acts in an agency capacity. The economic exposures, the impact of any use of leverage, and the interconnections with counterparties are those of each individual fund—*not* of the fund manager.

So does that suggest SIFI designation might be better targeted to funds themselves? That is the direction in which the FSB appears to be heading. Its proposed threshold for identifying which funds to evaluate as potential global SIFIs is US\$ 100 billion in assets—and only 14 funds worldwide meet

⁵ Section 113(a) of the Dodd-Frank Act states that the FSOC may determine that a U.S. nonbank financial company shall be subject to Federal Reserve supervision and enhanced prudential standards if it determines that “material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the [company], could pose a threat to the financial stability of the United States.”

that threshold. All of them are U.S. funds. And where the FSB may lead, we fear, the FSOC may choose to follow.

But the answer to the question above—“might SIFI designation be better targeted to funds themselves?”—is emphatically, “no.” There are several compelling reasons why even the largest funds are *not* SIFIs. Each of these reasons is briefly described below.

A. Mutual Funds Use Little to No Leverage

History amply demonstrates that companies that are highly leveraged pose greater risk to the financial system than those that are not. In past financial crises, leverage has played a key role because in times of strain it can act as a multiplier, turning small losses into larger ones and creating risks that can shake the system overall. When one highly leveraged firm holds the debt of another highly leveraged firm, losses can mount exponentially and spread quickly.

Former Federal Reserve Chairman Alan Greenspan is one of many authorities who have recognized the role of leverage as the fuel of financial crises. Emphasizing the central role of leverage in the 2008 financial crisis, Chairman Greenspan recently wrote:

Subprime [mortgages] were indeed the toxic asset, but if they had been held by mutual funds or in 401(k)s, we would not have seen the serial contagion we did. ... It is not the toxic security that is critical, but the degree of leverage of the holders of the asset. ... In 2008, tangible capital on the part of many investment banks was around 3 percent of assets. That level of capital can disappear in hours, and it did. And the system imploded.⁶

Mutual funds, as Chairman Greenspan’s remarks suggest, typically have little or no leverage. The maximum ratio of debt-to-assets allowed by law is 1-to-3, which translates into a maximum allowable leverage ratio of 1.5-to-1. Many mutual funds stay well below this maximum limit. In fact, the very largest U.S. funds—those in the FSB’s sights—have an average leverage ratio of just 1.04-to-1. By contrast, the largest U.S. commercial banks on average have leverage ratios that are ten times higher.

B. Funds Do Not Experience “Financial Distress” That Can Threaten U.S. Financial Stability

The concept of “financial distress” has little relevance to funds. All investment results belong to a fund’s investors on a *pro rata* basis. If a fund doubles in value, it is the investors who reap this reward. And if the fund plunges in value, it is the investors who absorb the impact of those losses.

⁶ Alan Greenspan, “How to Avoid Another Global Financial Crisis,” *The American*, March 6, 2014, available at <http://american.com/archive/2014/march/how-to-avoid-another-global-financial-crisis>.

A fund will have thousands or perhaps millions of investors, with varying degrees of risk tolerance. Long-term investors, or those following a specific asset allocation strategy, will be much more willing to stay the course and maintain their investment in a fund whose NAV is declining. Investors with a lower tolerance for investment risk or a shorter investment horizon, on the other hand, may decide to sell their fund shares in order to seek to eliminate the prospect of further losses. It is worth noting that during the financial crisis and ensuing global recession, many funds experienced sharp declines in value, but as discussed below, only modest redemption activity. Now that asset prices have recovered from their recession lows, most of those funds have gained back that lost value—as have the investors who stayed the course.

Funds and fund managers do, of course, exit the business. In fact, hundreds of funds close or reorganize each year for a variety of reasons, including the inability to attract or maintain sufficient assets, mergers with funds offering duplicate or similar strategies, departures of key portfolio managers, or poor investment performance. When a mutual fund liquidates, it follows an established and orderly process to distribute its remaining assets *pro rata* to its investors and wind up its affairs, in accordance with provisions of the Investment Company Act and state law and under the oversight of the fund’s board of directors. Thus, such funds have no need for bank-like “resolution planning,” and regulators have no need for additional authority to cope with “disorderly failures” of these funds.

C. History Demonstrates That Stock and Bond Mutual Funds Do Not Experience Heavy Redemptions, Even in Periods of Market Stress

The OFR study on asset management and the FSB consultation on investment funds both posit that mutual funds (the shares of which are redeemable on a daily basis) could face the risk of large redemption requests in times of market stress, causing the sale of fund assets at depressed prices and transmitting risk to the broader financial system. Since the inception of mutual fund investing in the U.S. almost 75 years ago, the historical evidence is consistent and compelling: stock and bond funds have never faced such a scenario, not even during the global financial crisis of 2007-2008. Indeed, across a range of adverse market events and conditions, sales of stocks and bonds by mutual funds represent a modest share of overall market activity—a fact that reflects the nature today of their largely retail investor base and the long-term financial goals of most fund investors.

More than 95 percent of mutual fund shares are held by retail investors, and for many of them, saving for retirement is their primary investment goal. In addition, nearly 80 percent of those who invest in mutual funds outside of employer-based retirement accounts rely on the advice of a financial professional. This combination of retirement saving and the use of financial professionals leads investors to pursue investment strategies with an eye toward diversification and the long term. It should come as no surprise, therefore, that the volatility of flows into and out of stock mutual funds has steadily declined since the 1980s, coinciding with the growth of retirement assets and the use of mutual funds in retirement accounts.

This long-term focus of mutual fund investors, in our view, has two important implications for financial stability. First, redemption requests almost never rise to unmanageable levels for a mutual

fund, even during periods of severe financial stress. Second, even in those times of stress, investors are making new purchases of fund shares, and funds are continuously receiving dividend and interest income. A mutual fund can use these cash inflows to support redemptions, thus minimizing the fund's need to sell portfolio securities. For example, during September and October 2008—the height of the financial crisis—investors purchased \$274 billion of equity mutual fund shares and \$141 billion of bond mutual fund shares. In addition, during those two months stock funds reinvested \$7 billion in dividend payments and bond funds reinvested nearly \$11 billion. As a result, net outflows from stock funds (including reinvested dividends) amounted to only 2 percent of fund assets during September and October of 2008. For the same period, net outflows from bond funds amounted to only 1.8 percent of bond fund assets.

Another significant factor is the close correlation between investor activity in mutual fund shares and portfolio transactions by the fund manager. In the face of unexpected market events, fund managers generally are not selling portfolio assets into the market unless such sales are correlated to investor flows. This fact, taken together with the staying power of mutual fund investors as outlined above, means that even a large mutual fund is unlikely to face a situation in which it must liquidate its assets quickly.

Finally, we note that sales of portfolio assets by mutual funds do not impact overall market prices to any substantial degree. Even when portfolio managers do sell assets, these sales are small relative to the value of overall stock and bond market trading and place little, if any, additional downward pressure on securities prices. Importantly, during the financial crisis, domestic stock funds owned about 25 percent of U.S. stocks, but their gross stock sales—not offset by any purchases—represented less than 6 percent of market trading. If anything, funds had a dampening effect on market volatility during that period.

D. Fund Structure and Regulation Limit Risk and Risk Transmission

In addition to the agency capacity in which a fund manager acts, which was discussed above, structural features of funds have the effect of limiting risk and the transmission of risks. Most notably, each fund is a separate legal entity; its assets are separate and distinct from, and not available to claims by creditors of, other funds or the fund manager. Each fund has its own investment objectives, strategies, and policies. One fund's economic exposures will be different from another's and belong to it alone. Fund losses do not spread to other funds or to the manager.

Funds and their managers are comprehensively regulated under the Investment Company Act, other federal securities laws, and related SEC regulations. For mutual funds, these requirements are largely built around a defining feature of such funds—the ability of investors to redeem their shares daily at current value. Fund regulations also are designed to ensure that investors and other market participants have a clear understanding of a fund's investment strategy, holdings, and financial condition. In short, the regulatory regime for funds serves both to protect the interests of investors and to mitigate risk. The most salient of these requirements are as follows:

- **Daily mark-to-market valuation of the fund’s assets.** Mutual funds must value all of their portfolio holdings on a daily basis, based on readily available market values. These values are used to calculate the fund’s daily net asset value (NAV), which is the price used for all transactions in fund shares. This promotes market confidence, because investors, counterparties and others can understand easily the actual valuations of fund portfolios.
- **Liquidity to support redemptions.** At least 85 percent of a mutual fund’s portfolio must be held in liquid securities. The SEC has determined that this liquidity standard should satisfactorily ensure a fund’s ability to meet redemptions.
- **Leverage and borrowing limitations.** The Investment Company Act and related guidance limit the extent to which mutual funds can borrow or engage in other transactions involving leverage. As noted above, the maximum ratio of debt-to-assets allowed by law is 1-to-3, which translates into a maximum allowable leverage ratio of 1.5-to-1. A mutual fund must “cover” its future obligations by meeting enumerated asset coverage tests or, in certain cases, by segregating liquid assets on its books or maintaining offsetting positions.
- **Extensive disclosures.** Under the federal securities laws and applicable SEC regulations, mutual funds are subject to the most extensive disclosure requirements of any financial product. Mutual funds maintain an “evergreen” prospectus and provide robust public periodic reporting (including quarterly portfolio holdings) and audited financials. This high degree of transparency allows investors and other market participants a clear understanding of a fund’s investment strategy, holdings and financial condition.
- **Simple, transparent structure.** Mutual funds are prohibited from issuing debt or preferred stock. They do not engage in off-balance sheet financing.
- **Diversified portfolios.** All mutual funds are required by the federal tax laws to be diversified. Generally speaking, the minimum diversification a fund could have is 25% of its assets in each of two issuers, and 5% of its assets in each of 10 additional issuers. If a fund elects to be diversified for purposes of the Investment Company Act (and most do), the requirements are more stringent—with respect to 75% of its portfolio, no more than 5% may be invested in any one issuer.
- **Restrictions on affiliated transactions.** The Investment Company Act contains strong and detailed prohibitions on transactions between a fund and affiliates such as the fund manager, the manager’s corporate parent, or an entity under common control with the fund manager. These provisions are no less stringent than those contained in Sections 23A and B of the Federal Reserve Act. They also prevent most types of sponsor support, absent prior approval by the SEC on a case-by-case basis.

- **Custody protections.** All funds must maintain custody of fund assets (including any collateral posted by the fund) with eligible custodians, in order to safeguard fund assets from theft or misappropriation. Nearly all funds use a bank custodian for domestic securities, and the custody agreement is typically far more elaborate than the arrangements used for other bank clients. The benefits of this approach were highlighted following the collapse of Lehman Brothers, as mutual funds with such custody arrangements were able to take control of both their own collateral and the collateral posted by Lehman with far less difficulty than market participants with different custody arrangements.
- **Independent board oversight.** Funds are unique among investment products in that they are required by statute to have a board of directors with oversight responsibility for the fund’s investment program, risk management and compliance, portfolio valuation and investment performance. In practice, more than four out of five fund boards have a significant majority of independent directors, who serve as “watchdogs” for the interests of fund investors. All fund directors are fiduciaries who must act in the best interest of the fund.

IV. SIFI DESIGNATION OF FUNDS WOULD HARM FUND INVESTORS AND DISTORT COMPETITION

Under the Dodd-Frank Act, nonbank SIFIs are subject to: (1) enhanced prudential standards, including capital and liquidity requirements; (2) assorted fees and assessments; and (3) Federal Reserve supervision. Exactly how some of these measures will be applied to any specific nonbank SIFI is not yet known. But it is indisputable that applying requirements designed to moderate bank-like risks to funds would be highly problematic for funds and harmful to their investors. Designated funds and their investors would bear higher, unnecessary costs and could be put on the hook to bail out failing institutions in the next financial crisis. Designation also could adversely affect the management of funds’ portfolio investments and funds’ ability to serve investors.

- **Capital requirements.** The Dodd-Frank Act subjects nonbank SIFIs to certain mandatory enhanced prudential standards and authorizes heightened standards in other areas. Most troubling is the prospect of capital requirements. One provision of the Dodd-Frank Act gives the Federal Reserve discretion in applying capital standards to nonbank SIFIs but senior Federal Reserve officials have indicated that another—known as the “Collins Amendment”—does not. As a result, the Federal Reserve would be compelled to hold a designated fund to the bank minimum capital requirement of 8 percent. Funds have neither the need for capital nor the ability to meet capital requirements. Their “capital” comes from investors who own fund shares and who fully accept that *they* will absorb the investment gains and losses experienced by the fund. Any mechanism for “loss absorption” would be inconsistent with funds’ basic nature and purpose.
- **Liquidity requirements.** Depending on how the Federal Reserve implements liquidity requirements for nonbank SIFIs, a designated fund could be required to hold more cash or

cash-equivalent securities than the manager projected when establishing the fund's investment objectives and policies. This could impede the fund's ability to deliver returns its investors expect and render it less competitive.

- **Fees and assessments.** Nonbank SIFIs are subject to fees to defray the Federal Reserve's increased supervisory costs and to assessments to cover the expenses of the FSOC and the OFR. The Dodd-Frank Act also authorizes assessments if needed to reimburse the U.S. government for costs of resolving a distressed financial institution determined to be systemically important, such as a large bank holding company. As applied to funds, these fees and assessments are tantamount to taxes on fund investors. Particularly disturbing and ironic is the possibility that fund investors, many of whom are using funds to save for retirement, might be required to help shoulder the costs of a "bailout" of a large financial institution—under a provision that Congress enacted specifically for the purpose of *avoiding* burdening taxpayers with these costs.
- **Prudential supervision.** The Federal Reserve's prudential supervision could conflict with a fund's investment objectives and policies as described in the fund's prospectus and with the fiduciary duties of a fund's manager and board of directors to act in the best interests of the fund. In the interest of mitigating risks to the financial system, the Federal Reserve could impel a fund's manager to manage the fund's portfolio in a manner that the manager otherwise would not do, and that the manager may believe to be contrary to the best interests of fund investors and to its own fiduciary duties. For example, the Federal Reserve could pressure the fund to continue financing certain counterparties or not sell particular securities, avoid exposure to certain issuers, or maintain excess levels of cash or cash equivalents.

The increased costs associated with SIFI designation clearly would lead to higher expenses for fund investors—a cohort that has shown itself to be quite sensitive to costs. Consider the 14 funds with assets that exceed the FSB's proposed \$100 billion threshold. They are highly efficient, relatively low-cost funds within their asset classes. Their expense ratios range from 76 basis points down to 3 basis points, with an asset-weighted average of 31 basis points. On that base, it would not take much in added fees, assessments, and capital costs to increase quite significantly the expenses borne by investors in these funds.

The costs and fund management implications of SIFI designation would make any designated fund less competitive and less attractive to investors. This, in turn, would distort competition in the fund marketplace and could limit investor choice.

Key financial regulatory officials have acknowledged the limitations of prudential regulation. For example, Federal Reserve Board Governor Daniel Tarullo has observed that "prudential standards

designed for regulation of bank-affiliated firms may not be as useful in mitigating risks posed by different forms of financial institutions.”⁷ Similarly, SEC Chair Mary Jo White recently stated:

We also will continue to engage with other domestic and international regulators to ensure that the systemic risks to our interconnected financial systems are identified and addressed – but addressed in a way that takes into account the differences between prudential risks and those that are not. We want to avoid a rigidly uniform regulatory approach solely defined by the safety and soundness standard that may be more appropriate for banking institutions.⁸

We agree with these statements. Applying bank-oriented prudential regulation to funds is unwarranted and could severely impair the single best tool for individual investors saving for such financial goals as retirement or education.

V. ACTIVITY-BASED REGULATION IS A BETTER APPROACH TO ADDRESSING IDENTIFIED RISKS

As discussed above, funds and their managers simply do not pose the concerns that would warrant SIFI designation. Moreover, forcing certain individual funds into a bank regulatory mold through the imposition of prudential standards and Federal Reserve supervision would be wholly inappropriate and have harmful consequences for these funds and their investors. Instead, if regulators believe specific activities or practices pose risks to the market or to the financial system, ICI recommends that regulators use their considerable rulemaking authority to address those risks through activity-based regulation.

An activity-based approach offers several advantages. First, it starts with identified activities and practices that pose demonstrable risks. Second, it would follow regular rulemaking procedures such as open meetings, public notice and opportunities for comment. Third, targeting activities and practices will engage primary regulators who have deep experience and expertise with specific industries and markets. In the case of activities or practices involving the capital markets, the SEC should drive the process for identifying issues and considering appropriate solutions.

Indeed, the SEC is doing just that with respect to asset management. According to Chair White’s recent comments before this Committee, the SEC already has the necessary authority to adequately regulate the industry. But it is taking additional steps to strengthen its oversight of asset managers and funds. The SEC’s Division of Investment Management is working to expand its asset

⁷ *Regulating Systemic Risk*, Remarks by Daniel K. Tarullo, Member, Board of Governors of the Federal Reserve System, at the 2011 Credit Markets Symposium, Charlotte, N.C. (March 31, 2011), available at <http://www.federalreserve.gov/newsevents/speech/tarullo20110331a.pdf>

⁸ *Remarks to the 2014 SEC Speaks Conference*, Mary Jo White, Chair, SEC (Feb. 21, 2014), available at <http://www.sec.gov/News/Speech/Detail/Speech/1370540822127>.

manager risk management oversight program, which includes developing a proposal for enhancing its collection of mutual fund data. The latter initiative is designed to provide the SEC with more timely and useful information about fund operations and portfolio holdings. ICI and its members are providing the SEC staff with industry expertise and practical information that we hope will help lead to requirements that measurably improve the SEC's ability to identify and monitor risks without imposing undue costs and burdens on funds and their investors.

In other areas, regulators have taken and are continuing to take actions to mitigate risk in the financial system or to make markets and market participants more resilient to future shocks. For example, securities lending and repurchase agreement transactions are currently the subject of specific regulatory efforts, with additional efforts on the horizon. Under Title VII of the Dodd-Frank Act, regulators have promulgated rules governing, among other things, initial and variation margin requirements for cleared and uncleared swaps and other terms central to counterparty and clearinghouse relationships. Once fully implemented, the Title VII regime will dramatically change the way swaps are traded, cleared and settled, to the benefit of both individual counterparties and the financial system generally.

In addition to these regulatory developments, ICI's Board of Governors has endorsed a voluntary initiative led by the Depository Trust & Clearing Corporation to shorten settlement cycles for a range of securities from trade date plus three days (T+3) to T+2. The voluntary move to a T+2 settlement cycle would reduce systemic, liquidity, and operational risks, promote better use of capital, and create significant process efficiencies for market participants—all changes that would benefit investors.

VI. CONCLUSION

I appreciate the opportunity to share these views with the Committee. ICI looks forward to continued engagement with Congress and regulators on issues relating to the fund industry and broader questions relating to U.S. financial stability.