Vanguard
P.O. Box 2600
Valley Forge, PA 19482-2600

Submitted via E-mail to:
fsb@bis.org

29 May 2015

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002
Basel
Switzerland

Re: Consultative Document (2nd)—Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions

Dear Sirs,

Vanguard[1] appreciates this opportunity to comment on the proposed high-level framework and specific methodologies for identifying non-bank, non-insurer global systemically important financial institutions ("NBNI G-SIFIs") set forth in the second consultative document ("Second Consultative Document" or "Consultation")[2] published by the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO").

Vanguard is an SEC-registered investment adviser to more than 150 U.S. mutual funds registered under the Investment Company Act of 1940 ("ICA"). Vanguard, together with its wholly owned affiliated investment advisers, operates in the United States, Europe, Asia, Australia, and Canada, where it provides investment advisory services to more than 280 mutual funds with approximately $3.3 USD trillion in assets under management ("AUM") worldwide.[3]

We provide these comments, informed by more than forty years of investment management experience, on behalf of the Vanguard family of investment advisers and mutual funds globally. Our comments, however, focus on the impact that the methodologies set forth in the Second Consultative Document will have on our U.S. investment adviser and U.S. mutual funds.

---

[1] The Vanguard Group, Inc. ("Vanguard") began operations in the U.S. in 1975, is headquartered in Valley Forge, Pennsylvania, U.S., and is registered with the U.S. Securities and Exchange Commission ("SEC") under the Investment Advisers Act of 1940 ("IAA").

[2] FSB and IOSCO, Consultative Document (2nd) – *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions*, March 4, 2015, available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

[3] As of April 30, 2015.

I. The entity-based designation approach set forth in the Consultation is significantly flawed.

A. Size is an imperfect and easily manipulated metric that should not be used as a proxy for systemic risk.

We are deeply disappointed by the approach adopted in the Consultation, which focuses on entity-based designations rather than addressing systemic risks through an activities-based approach. As we have posited in several forums, leverage coupled with interconnectedness, is the true indicator of systemic risk.[4] With the Consultation's continued focus on designating SEC-registered asset managers and mutual funds as NBNI G-SIFIs, we believe the criteria set forth in the Second Consultative Document are problematic for a number of reasons:

- First, the identification of asset managers and funds to be further evaluated based on size is at the same time both overinclusive and underinclusive. Size is not a proxy for risk and therefore should only be relevant after a systemic risk, such as leverage, has been identified. Size is also among the easiest metrics to manipulate. Entity-based designations that are driven by size will also never be capable of keeping up with potentially risky financial innovation in the markets, which can emerge from entities of any size, and will thereby miss the opportunity to accurately and adequately capture risk. We believe that the size-based designation methodology contained in the Second Consultative Document would be an ineffective tool that would not only fail to reduce systemic risk, but would likely be susceptible to manipulation and could result in regulatory arbitrage.

- Second, we also believe the Consultation's approach is problematic because the focus on size disproportionately captures U.S. mutual funds and U.S. investment advisers without addressing global systemic risk, and it also fails to acknowledge that primary regulators are continually strengthening the regulation of asset managers and investment funds.[5] If the

---

[4] *See* Vanguard White Paper, "The SIFI search: Some dangerous misconceptions about mutual funds." (Apr. 2014) ("SIFI White Paper"), p. 3; Vanguard Comment Letter to FSB re: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, April 7, 2014, ("Vanguard 2014 FSB Comment Letter"), p. 11.

[5] For example, the SEC recently held an Open Meeting on May 20, 2014 wherein it proposed new rules, forms, and amendments to modernize and enhance the reporting and disclosure of information by registered investment companies and investment advisers. *See* Investment Company Reporting Modernization, Securities Act Release No. 33-9776 (May 20, 2015), available at https://www.sec.gov/rules/proposed/2015/33-9776.pdf ("Reporting Modernization Proposal"). In Australia, recent reforms have required funds to disclose portfolio holdings publicly every six months with a 90-day lag and to disclose a product dashboard to investors each quarter containing information on the funds' average fees and costs, investment return target, investment risk and liquidity. *See* www.apra.gov.au; *see also* Letter dated 30 January 2015 re: "Further Superannuation Reform Guidance and Relief from ASIC." In Canada, regulators have also requested additional data from asset managers and investment funds to inform their regulatory activities. The Canadian Securities Administrators (CSA) has requested data to assist in the review of Canadian mutual fund fees. Similarly, the Compliance and Registrant Regulation Branch of the Ontario Securities Commission recently has been seeking data and information to inform possible future regulations. *See e.g.*, https://www.osc.gov.on.ca/en/About_advisory-committees_index.htm. We also believe that the approach adopted by the FSB in the Consultation is at odds with the European Union's Capital Markets

size-based criteria set forth in the Consultation were to be followed, almost all of the investment advisers and mutual funds captured by the criteria would be U.S. domiciled. Six of the mutual funds would be Vanguard U.S. mutual funds, all of which have no leverage and are invested in highly liquid assets.

In sum, we are unaware of any financial crisis that has been caused by an entity capitalized with 100% equity, no leverage, transparent holdings, and that is subject to daily pricing and valuation. We do not believe this is simply due to good fortune, but rather, attributable to the strength of the regulations that govern mutual fund activities, the long-term focus of most mutual fund investors, and the broad diversification of mutual fund ownership.

B. <u>The Consultation relies heavily on broad hypothetical scenarios and academic studies that are not grounded in complete and accurate industry data</u>.

We also believe that the approach outlined in the Second Consultative Document is deeply flawed because its reasoning relies heavily on broad hypothetical and academic statements that are not supported by complete empirical data sets. We are disappointed that systemic risk regulators would base their systemic risk concerns on this insufficient empirical record, and consequently appear willing to impose unnecessary and ineffective prudential regulations. Rather than rely on incomplete or inaccurate data, we believe systemic risk regulators would be wise to focus their efforts on efficient and effective ways to gather comprehensive and accurate information. In fact, the SEC has proposed to do just that, through its recent proposal to require mutual funds to provide more detailed and frequent portfolio holdings information.[6] Without further evaluation based on sound data that is made publicly available for review and comment, we believe that it would be wholly premature for the FSB and IOSCO to designate any asset manager or mutual fund as an NBNI G-SIFI.

C. <u>The Consultation fails to articulate and consider the consequences that the NBNI G-SIFI designation would have on investment advisers and mutual funds</u>.

The Consultation fails to identify and consider the consequences of the NBNI G-SIFI designation on the entities so designated. In the U.S., the only prudential regulations that have been drafted are those applicable to the systemically important banks. As detailed in prior comments, mutual funds have a fundamentally different risk profile than banks and insurers with fixed obligations.[7] Therefore, if bank-like prudential regulations were applied to mutual funds and investment advisers, they would not only be extremely ill-suited to limit systemic risk, but they would also threaten to disrupt the capital markets and drive up the costs of investing for millions of investors saving for college, retirement, and other long-term goals.[8] Under existing U.S. regulations, these negative consequences would be exacerbated

---

Union, which is seeking to make EU capital markets less bank-centric and more diverse by encouraging the participation by different types of capital markets vehicles, such as mutual funds. *See* http://ec.europa.eu/finance/capital-markets-union/index_en.htm.

[6] *See* Reporting Modernization Proposal.

[7] *See* Vanguard Comment Letter to the Financial Stability Oversight Council ("FSOC") re: Notice Seeking Comment on Asset Management Products and Activities, (FSOC – 2014-0001), March 25, 2015 ("Vanguard 2015 FSOC Comment Letter"), p. 3.

[8] *See* SIFI White Paper, p. 1 ("Designation as a SIFI would mark a destabilizing paradigm shift in the regulatory model that has governed the mutual fund industry for 75 years.").

by requiring, in effect, individual investors to risk their savings to bail out the highly leveraged banking industry.[9] The application of bank-like regulation is certain to cause unintended consequences that have not been fully vetted.[10]

D. The Consultation is internally inconsistent in that it exempts certain entities from the NBNI G-SIFI designation but does not apply the same logic to other entities that share the same characteristics.

The list of exclusions contained in the Second Consultative Document is problematic due to the arbitrary nature of the approach, which results in unexplained inconsistencies. The FSB and IOSCO exclude pensions[11] from this systemic risk evaluation due to the long-term nature of pension funds' investment horizons. Based on that reasoning, we believe that mutual funds with long-tenured accounts and low redemption ratios should also be excluded from the systemic risk designation. In addition, we note that the FSB and IOSCO have failed to list the long-term investment horizon in mutual funds as one of the basic impact factors,[12] even though that factor is clearly highly influential to regulators in light of the exclusion provided to pension funds.

Another example of the arbitrary nature of the approach is contained in the sovereign wealth fund exclusion. An argument could certainly be made that a sovereign wealth fund with many assets owned by and concentrated in a single decision maker could cause more market disruption and systemic risk than the millions of individuals who invest their savings for the long term, over multiple decades, in mutual funds. These two examples illustrate the issues underlying the rationale for the policy choices outlined in the Consultation and the weakness inherent in an entity-based designation approach.

II. Vanguard recommendations to improve the FSB and IOSCO Consultation.

In an effort to positively impact the systemic risk policy debate, we submit the following recommendations:

- **Data collection and public comment on such data should precede any regulatory action.** We urge the FSB and IOSCO to gather and analyze data and information to inform their decision-making. At the outset, the FSB and IOSCO should consider the data and comments

[9] *Id*., p. 2 (recalling historical context of systemic risk issues and, in particular, the financial crisis when taxpayers were required to bail out highly leveraged and interconnected enterprises). Under existing U.S. regulations, all entities designated as SIFIs could be required to provide capital support to another SIFI under certain circumstances.
[10] *See* Vanguard 2015 FSOC Comment Letter, p. 4. ("Adding another layer of regulation on mutual funds that is poorly matched to the normal functioning of funds in the capital markets, with uncertain benefit, threatens to have negative unintended consequences. These include disrupting the capital markets, impeding capital formation that fuels the U.S. economy, and harming the millions of Americans who use mutual funds to save for college, retirement, and other long-term goals.")
[11] We note the term "pensions" is not defined in the Second Consultative Document. We would argue that, at a minimum, individual retirement accounts and 401(k) accounts should be covered by the term "pensions" due to the similarly long-term nature and retirement objective of these instruments.
[12] *See* Second Consultative Document (listing five basic impact factors for assessing systemic importance: size, interconnectedness, substitutability, complexity, and global activities, that apply across all NBNI financial entities), p. 6.

provided to FSOC in response to its "Notice Seeking Comment on Asset Management Products and Activities".[13] All data gathered and relied upon to inform the regulatory approach for addressing systemic risk should be made publicly available for review and comment. In no event should an entity-level designation be the means through which regulators gather their data.

- **We encourage the FSB and IOSCO to change focus to an activities-based regulatory approach.** While we appreciate that the Consultation's criteria includes leverage and interconnectivity, we strongly believe that activities-based regulation offers the best form of protection against systemic risk.[14] We have repeatedly encouraged regulators to adopt an activities-based approach as the most effective way to address systemic risk.[15] In its recent proposal, FSOC illustrated its willingness to evaluate an activities-based regulatory approach to identify and curtail systemic risk. We believe the FSB and IOSCO should identify financial market activities that they believe may contribute to systemic risk and seek comments on such activities. An activities-based approach to identifying systemic risk will ensure that all participants in such activities will be subject to the same rules, regardless of an easily manipulated metric, like size.

- **To the extent the FSB and IOSCO are determined to pursue an entity-based designation approach, we urge the regulators to make consistent policy exemptions.** If pension funds do not raise systemic risk concerns due to the long-term nature of their assets, mutual funds with long-term accounts should also be exempted from designation. Based on industry data, approximately 56% of mutual fund assets consist of long-term retirement accounts.[16] We believe this fact provides a compelling policy reason to treat pension funds and mutual funds similarly.

The comments that follow focus on the Consultation's entity-based designation approach with respect to SEC-registered mutual funds and investment advisers and explain why neither type of entity imposes systemic risk.

III. Mutual funds do not impose systemic risk.

A. Mutual fund investors pose a low risk to financial stability due to their long-term investment perspective.

By excluding pension funds from consideration, the Second Consultative Document recognizes the market stabilizing nature of long-term investments.[17] We estimate that approximately 77% of our

[13] 79 FR 77488 (Dec. 24, 2014), available at https://federalregister.gov/a/2014-30255.
[14] *See* Vanguard 2014 FSB Comment Letter, p. 2.
[15] *See e.g*. Vanguard 2014 FSB Comment Letter; Vanguard 2015 FSOC Comment Letter.
[16] Investment Company Institute ("ICI"): The U.S. Retirement Market, Fourth Quarter 2014 (Mar. 25, 2015), available at http://www.ici.org/research/stats/retirement.
[17] *See* Second Consultative Document, p. 2.

AUM is held in long-tenured mutual fund accounts.[18] Should the FSB continue to exclude pension funds from its evaluation, it would only be logical to treat long-term retirement assets invested in mutual funds similarly.

The Second Consultative Document also excludes sovereign wealth funds and public financial institutions, which are market participants in both short- and long-term credit and equity markets. A full government guarantee does not prevent these entities from being highly leveraged or impacting market prices. Sovereign wealth funds may be among the most likely to exit the markets to limit losses, while causing disruptions to the financial markets more broadly. These arbitrary exclusions are inconsistent with FSB's stated desire to ensure consistent international oversight.[19]

B. Existing comprehensive regulatory regimes effectively mitigate risks posed by large mutual funds.

We continue to believe that comprehensively regulated mutual funds should fall outside the scope of the systemic risk framework.[20] The objective of the proposed G-SIFI methodologies is "to identify NBNI financial institutions whose distress or disorderly failure, because of their size, complexity, and systemic interconnectedness, would cause significant disruption to the wider financial system **and** economic activity at the global level".[21] Mutual funds inherently fall out of this definition by virtue of risk-mitigating regulations that significantly limit their leverage, complexity and systemic interconnectedness, thereby eliminating their ability to transmit risks to other market participants even if large in size.

Among asset management vehicles, U.S. mutual funds are among the most comprehensively regulated. While we have previously provided summaries of regulatory controls that mitigate the risks mutual funds could introduce to the markets, given the FSB's reliance on academic studies that do not recognize these controls we believe it is important to restate key U.S. regulatory controls here, as well as cross reference our earlier submissions.[22] Risk-reducing features of U.S. regulatory controls include the following:

- Mutual fund assets must be valued daily at market value, thus ensuring clients invest or redeem only their pro rata share of the fund's market value.[23]

---

[18] Vanguard calculation based on accounts that were open as of 2004 and continued to hold balances through 2013. We observed similar longevity in both retail and institutional (includes defined contribution and other retirement plans) account types, with 67% and 88%, respectively, of AUM in accounts open for this period.
[19] *See* Second Consultative Document, p. 7.
[20] Vanguard 2014 FSB Comment Letter, p. 2. Our comments on the FSB and IOSCO's first consultative document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, January 8, 2014, available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf, also described the comprehensive risk-limiting provisions of the EU UCITS Directive.
[21] Second Consultative Document, p. 1.
[22] *See* Vanguard 2014 FSB Comment Letter and Vanguard 2015 FSOC Comment Letter.
[23] *See* Section 22 of the ICA and Rule 22c-1(a) thereunder.

- Mutual funds must invest at least 85% of their assets in liquid securities, which have been defined by the SEC to mean "securities that can be sold in the ordinary course of business within seven days at approximately the value at which the mutual fund has valued the investment."[24]

- Mutual funds have a simple capital structure and are limited in their ability to engage in leveraged transactions—short sales, the purchase of securities on margin, and derivative transactions.[25]

- Issuer concentration is limited and mutual funds are required to maintain diversified portfolios in order to qualify as investment companies under the Internal Revenue Code.[26]

- Mutual funds may suspend payment of redemption proceeds for up to seven days. Additionally, for any period during which an emergency exists, the SEC may grant a mutual fund the authority to suspend redemptions for more than seven days.[27]

For over 75 years, these restrictions have effectively neutralized the risk that U.S. mutual funds could impose on the global financial system. Notwithstanding the success of U.S. mutual fund regulations, the SEC's Division of Investment Management's 2015 regulatory agenda includes plans to further strengthen and improve the industry's resiliency through proposed liquidity management protocols and stress testing requirements.[28] Although we believe that liquidity and redemption risks are generally low for U.S. mutual funds, existing regulations, coupled with sound principles-based risk management practices, make these funds even less vulnerable to liquidity and redemption risks. Nevertheless, we look forward to engaging with the SEC to further strengthen fund resiliency for the benefit and protection of fund investors.

---

[24] *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612 (Mar. 12, 1992); SEC Division of Investment Management, IM Guidance Update No. 2014-1 at p. 6 (Jan. 2014), available at http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf.

[25] Funds are permitted to enter into leveraged transactions provided they maintain a continuous asset coverage ratio of at least 300% during the term of the transaction. The SEC does not require daily-calculated 300% asset coverage for a transaction if the fund (a) covers its exposure by entering into an offsetting transaction, or (b) segregates liquid assets equal in value to the fund's obligation under the transaction. The value of segregated assets is marked to market on a daily basis. As the Second Consultative Document acknowledges, publicly offered funds, such as U.S. mutual funds, currently have legal and regulatory limitations on their ability to use leverage and therefore have a limited systemic impact through the counterparty channel.

[26] *See* Subchapter M of the Internal Revenue Code.

[27] Section 22 (e) of the ICA defines emergencies as a period when 1) disposal of securities is not reasonably practicable or 2) it is not reasonably practicable for mutual funds to determine the value of their net assets. *See* Revisions of Guidelines to Form N-1A, SEC Release No. IC-18612, 57 Fed. Reg. 9828 (March 20, 1992) (stating that its standard was "designed to ensure that mutual funds will be ready at all times to meet even remote contingencies").

[28] White, Mary Jo, "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry," Speech at The New York Times DealBook Opportunities for Tomorrow Conference (Dec. 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VIoGhTHF884.

C. Market stability and systemic risk concerns are better addressed through market regulation and controls rather than a piecemeal entity-based approach.

1. A size threshold excludes funds engaged in risk-taking activities.

While a sized-based materiality threshold may be appealing to facilitate or simplify national systemic risk reviews, using size as the primary factor provides an arbitrary and misleading picture of risk. As detailed below in Figure 1, the only investment funds that meet the Option 2 criteria are domiciled in the U.S. and invest in the highly liquid U.S. equities market. In addition, all of the funds represented in this table employ little to no leverage.[29] As the Second Consultative Document recognizes, leverage is the key driver in posing risks to the global financial system.[30] Requesting that national systemic risk authorities conduct extensive reviews of funds with little to no leverage strikes us as an inefficient use of regulatory resources and taxpayer dollars. Furthermore, we do not believe the designation of one or more U.S. mutual funds will accomplish the goal of the Consultation, which is to evaluate global market risks.[31]

Figure 1. Morningstar Worldwide Fund Data[32]

	Name	Gross assets ($billions) (per 2014 annual report)	Global Broad Category Group	Morningstar Institutional Category	Domicile
	Vanguard Total Stock Market Index Fund	385.9	Equity	Large Core	United States
$200bn+	Vanguard Five Hundred Index Fund	199.4	Equity	S&P 500 Tracking	United States
	Vanguard Institutional Index Fund	189.0	Equity	S&P 500 Tracking	United States
	SPDR® S&P 500 ETF	180.8	Equity	S&P 500 Tracking	United States
	Vanguard Total Intl Stock Idx Fund	175.9	Equity	Foreign Large Core	United States
	American Funds Growth Fund of Amer	145.7	Equity	Large Core Growth	United States
	Vanguard Total Bond Market Index Fund	145.0	Fixed Income	Intermediate Investment Grade (4-6)	United States
$100bn+	Vanguard Prime Money Market Fund	131.4	Money Market	Money Market Taxable	United States
	American Funds Europacific Growth Fd	125.1	Equity	Foreign Large Growth	United States
	PIMCO Total Return Fund	259.7	Fixed Income	Intermediate Investment Grade (4-6)	United States
	Fidelity® Contrafund® Fund	111.7	Equity	Large Core Growth	United States
	JPMorgan Prime Money Mkt Fund	116.7	Money Market	Money Market Taxable	United States
	Fidelity® Cash Reserves	115.4	Money Market	Money Market Taxable	United States

2. The Consultation proposes flawed and arbitrary fund metrics to quantify risk, and it fails to account for investors' asset allocation decisions.

We are concerned about the seemingly flawed and arbitrary fund metrics and broad assumptions, including the homogenization of equity and fixed income asset classes, embedded in the Second Consultative Document. For example:

- Under the materiality threshold—Option 2, the substitutability ratio relies on fund trading volume, which is highly variable;

[29] According to each fund's annual report, leverage ratios (gross assets/net assets) ranged from 1.003 to 1.120. Funds may show higher gross assets than net assets for a multitude of reasons. For example, in equity index funds, the investment objective is to match the return of a reference index as closely as possible with minimal cost in the form of fund expenses, trading costs, and taxes. Vanguard uses equity futures to track a fund's index even more tightly and overcome marginal frictions due to cash balances or dividends that have not yet been received but are forecasted to be reinvested under the fund's index methodology.
[30] Second Consultative Document, p. 36.
[31] *Id.*, p. 6. *See also* p. 12 citing a difficulty in assessing global activity or cross-jurisdictional activities. The two funds captured by the materiality threshold hold U.S. domestic equities provide no data on global markets.
[32] Morningstar Worldwide data set includes data on open-ended, money market, and exchange-traded funds (excludes fund of funds and feeder funds) from funds domiciled in 73 countries that provide data to Morningstar.

- Under the materiality threshold—Option 2, the fire sale ratio assumes a one-size-fits-all for equity and fixed income securities;

- Indicator 4-4 (the investment fund liquidity profile) assumes an entire fund would have to be liquidated in one day at a reasonable price if investors have a right to daily redemption; and

- The cross-jurisdictional thresholds are fundamentally misaligned with the benefits of globalization. Unlike banks, mutual funds and fund managers do not have complex liabilities and intercompany funding arrangements that lead to confusion over claims from creditors in multiple jurisdictions. The benefits of globalization include:
    - The greater the diversification of a fund's investments around the globe, the less likely it is to be impacted materially by issues in any one region.
    - Having investors from multiple regions similarly reduces the impact actions taken by any one group of clients.
    - Similarly, having counterparties in different jurisdictions disperses counterparty risk.

Overall, the Second Consultative Document proposes metrics that are highly subjective and require significant data and analysis in order to assess the impact that an individual fund could have on the global markets. Absent that data and research, attempts to populate these metrics will likely cause systemic risk regulators to improperly default to AUM when evaluating risk. Such an arbitrary approach could be avoided by adopting an activities-based regulatory framework.

As the FSB looks to identify risks associated with dominant players in a particular asset class, we caution that large mutual fund cash flows are not synonymous with market liquidity disruptions or asset class price movements. Large-scale redemptions at individual asset management firms are idiosyncratic events, and investors often seek to reinvest their redemption proceeds with other asset managers who offer similar fund mandates. For example, a large bond fund recently experienced $81.7 billion in total outflows between September 2014 and December 2014, including $32.2 billion in outflows in October 2014 alone, the first full month after the sudden departure of a key portfolio manager. In the months before and after the news of the departure, in markets where the fund had large overweights, there was no sizable change in market valuation, volatility, or liquidity. Several concurrent global market events helped dictate market activity, and investors appeared to have taken the change in stride with no structural disruption in market dynamics. The key point made by this and other idiosyncratic risk events impacting large mutual funds and asset managers is that when investors redeem, they generally do not change their asset allocation and therefore impose no threat to financial stability.

3. <u>Simplistic metrics inaccurately capture the evolving multi-dimensional nature of market and fund liquidity</u>.

The Second Consultative Document cites to an international survey of academic literature that hypothesizes fund managers might sell more liquid assets to minimize the price impact of early redemptions. This is wholly inconsistent with our experience in managing liquidity, and we are unaware of historical data that substantiates this proposition. There is, however, a long track record demonstrating that asset managers have liquidity management practices that are consistent with the investment objective and strategies of a fund to ensure successful liquidity management through all types of market conditions, including those that may be extremely volatile. We acknowledge that it is difficult to predict when volatile market activity will occur. However, it is critically important for systemic risk regulators to understand that volatility does not equal instability. We are concerned that simplistic metrics fail to account for the principles-based nature of prudent liquidity management.

Mutual fund managers employ a variety of risk management practices to manage fund liquidity that are tailored to market conditions as well as individual fund mandates. A high-level overview of Vanguard's approach to liquidity risk management is summarized below.

Vanguard's Liquidity Management Practices:

- We carefully consider liquidity risk in managing portfolios, and we take an approach that is tailored to the portfolio and has multiple layers of protection.
- We comprehensively analyze each fund in terms of its holdings, the market liquidity of those holdings, past levels of peak redemption, composition of the fund's investors, as well as other factors that may be relevant for a particular fund. Based on this analysis, a liquidity policy for the fund is established and its portfolio is constructed and managed to align with the policy. Typically, the liquidity requirement for fixed income funds is fulfilled by holding highly liquid government securities or short-term, high-quality bonds that readily convert to cash.
- We first offset redemptions with other positive cash flows. When this is not possible, our objective is to maintain a fund's risk exposure by selling across the fund's holdings to meet redemptions, while also factoring in trading costs.[33]
- We work with larger clients to implement their redemptions in a manner that is least disruptive to the portfolio. The client might choose to redeem over a period of days or redeem in-kind with a cross section of the fund's holdings. Many larger clients prefer in-kind redemptions because the in-kind approach can minimize costs when moving assets to a new manager or strategy. We can also advance the settlement of market trades to match investor redemption payments (T+1 trade settlement), or delay settlement of an investor's transaction to match trade settlement within regulatory requirements.[34]
- Where appropriate, a fund may assess redemption fees to ensure that those clients transacting bear the cost of the transaction. Our funds have also adopted frequent trading policies that discourage abusive trading of fund shares by clients.

---

[33] We note that the Second Consultative Document references academic research and regulator statements that speculate whether competitive pressures create incentives to alter portfolios for competitive reasons (for instance, "herding" into less liquid asset classes). Mutual fund managers are not only subject to securities law requirements to adhere to the investment boundaries set forth in a fund's prospectus, but also face client scrutiny over whether the fund meets investors' anticipated asset allocation.

[34] The ICA also provides ability to suspend redemptions temporarily or postpone the payment of redemption proceeds beyond seven days under limited circumstances. *See* Section 22 (e)(2) of the ICA.

- We also maintain a committed line of credit with a syndicated group of banks and have secured an interfund lending exemptive order from the SEC to enhance our liquidity management options.

As discussed earlier in our comment letter, we encourage the FSB and IOSCO to gather industry data on liquidity management practices before determining that a systemic risk regulatory response is needed.

D. Mutual funds provide liquidity to the markets during times of market stress.

Implicit in the Second Consultative Document's proposed transmission channel methodology and related metrics are presumptions that mutual fund investors redeem at a disproportionately higher rate during times of market stress than do other market participants, and consequently, mutual funds sell assets at a disproportionally high rate. However, no data supporting this conclusion has been provided. We would welcome the opportunity to review and comment on the data used by FSB and IOSCO to make such conclusions.

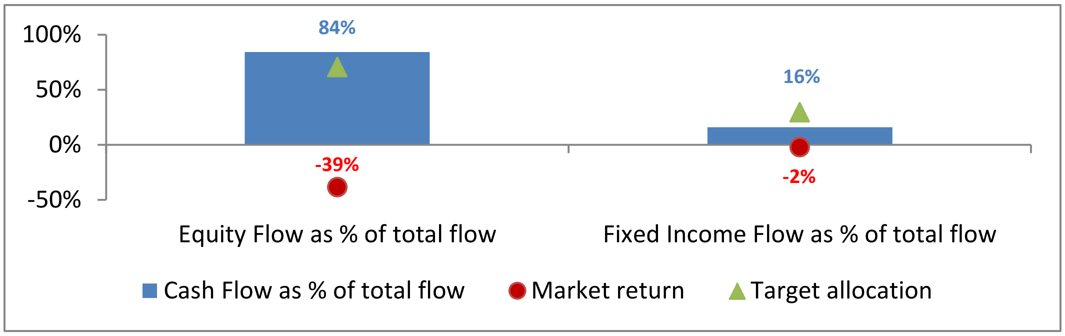
In our experience, mutual fund mandates can provide market stabilizing cash flows. For instance, target date mutual funds[35] create countercyclical investment flows that are beneficial to markets from a systemic risk perspective. As the market fluctuates, a target date fund's manager has to invest new cash flows to meet the target asset allocation and/or rebalance the fund. This phenomenon is more pronounced in times of market stress as reflected in Figures 2 and 3 below.

From January 2008 through January 2009, equities depreciated 39% while fixed income was only down roughly 2%; however, during this period the Vanguard Target Retirement 2020 Fund invested 84% of its cash flow into equities.[36] At Vanguard, our target date funds achieve this asset allocation mandate by investing in other Vanguard index funds. Therefore, target date cash flows into equities created in flows for Vanguard Target Retirement 2020 Fund's underlying equity index funds.

[35] These funds may also be called "target retirement funds." Target date funds are characterized by a changing investment mix or asset allocation among different asset categories over time and are typically designed to help investors invest for long-term goals such as retirement. The year in a target date fund name typically refers to the approximate year (the target date) when an investor in the fund would retire and leave the workforce. Target date funds are generally designed to gradually shift their portfolios from more aggressive investments (stocks) to more conservative ones (bonds and short-term reserves) over time.

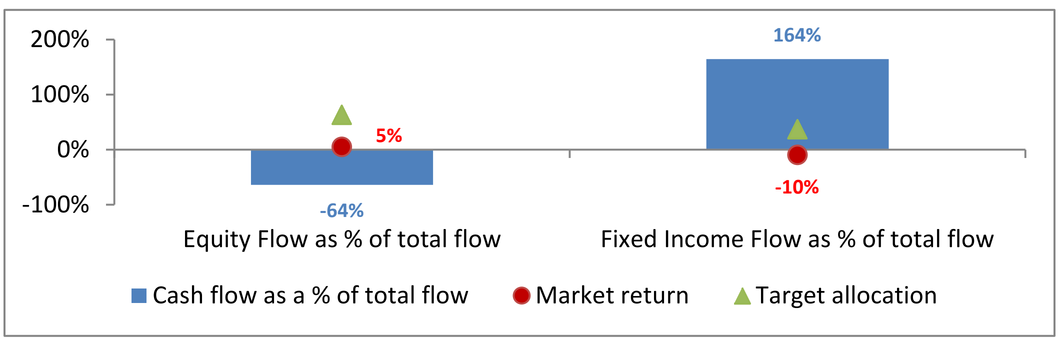
[36] Source: Market data from MSCI and Barclays from Jan. 31, 2008 to Jan. 31, 2009.

Figure 2. Vanguard Target Retirement 2020 Fund's cash flow to fixed income and equities during the financial crisis (January 2008 to January 2009).



In the summer of 2013, when investors were cautious about investing in bonds as the Federal Reserve was preparing to end its bond buying program ("Taper Tantrum"), fixed income had a return of -10% while equities had a return of 5%.[37] During this time, the Vanguard Target Retirement 2020 Fund actually sold equities to purchase bond exposures in addition to investing 100% of its cash flow into bond exposures. This cash resulted in in-flows for the underlying bond index funds.[38] It is worth noting that this countercyclical rebalancing approach is not unique to Vanguard—over $1 trillion in assets is invested in target date mutual funds that follow this approach.[39]

Figure 3. Vanguard Target Retirement 2020 Fund's cash flow to fixed income and equities during the "Taper Tantrum" (March 2013 to September 2013)



E. <u>Redemption activity in mutual funds does not pose systemic risks</u>.

Fund redemptions are controlled by the behavior of the investor, not the asset manager. An investor's decision to reallocate assets or raise cash would occur whether he or she held assets in a mutual fund or held stocks and bonds directly. Although the Second Consultative Document speculates about the possibility of mass redemptions, the reality is that mutual funds are ultimately owned by tens of millions of individual investors, each with their own time horizons, risk preferences, and investment goals. Even under the most stressful market conditions, our experience is wholly inconsistent with the

---

[37] Source: Market data from MSCI and Barclays from May 31, 2013 to Sept. 30, 2013.
[38] We note that U.S. bond market exposure is achieved by investments in an index fund that is available only to Vanguard funds of funds or similar products.
[39] ICI data as of Dec. 31, 2014.

conjecture that mutual funds are susceptible to mass redemptions. Mutual fund investors simply are not inclined to redeem during times of market stress. By way of illustration, Vanguard examined 401(k) participant behavior from September 2007 to December 2009 in Vanguard-administered retirement plans. Over the course of that period, about three-quarters of participants made no investment changes to their accounts whatsoever, and only 3% eliminated all exposure to stocks.[40]

In our experience, investors invest in mutual funds as an efficient way to gain exposure across different asset classes and to save for long-term goals. Investors may redeem their shares for any number of reasons, including:

- To switch mutual fund managers (because of a manager's deteriorating reputation or performance, a desire for lower fees, or a need for better services);
- To change their asset allocation (for example, to switch from stocks to bonds); and/or
- To obtain cash (for example, to make a down payment on a house).

Even in periods of profound financial stress, it is incomprehensible that this diverse group of investors would act in unison. In fact, in the history of the mutual fund industry, a run on equity and bond funds has never materialized. Even if an unprecedented redemption out of stock and bond funds were to occur, fund investors would expect to receive current market values for their securities. Consequently, there would be no need for taxpayers to support these values.

Furthermore, as shown in Figure 4 below, mutual funds own only a modest share of the assets in the global equity and fixed income markets. Worldwide, equity mutual fund assets account for approximately 25% of global stock market capitalization (with U.S. mutual funds accounting for approximately 13%). Bond mutual fund assets account for an even smaller percentage of the global debt capital markets, with worldwide bond mutual funds accounting for approximately 10% (and U.S. mutual funds accounting for approximately 4%).[41] Consequently, the liquidity needs of mutual funds represent a relatively small portion of the overall liquidity needs of the market.

---

[40] *See* Vanguard Research, "Resilience in Volatile Markets: 401(k) Participant Behavior" (Mar. 2010), available at https://pressroom.vanguard.com/content/nonindexed/Resilience_in_volatile_markets_401k_participant_behavior.pdf.

[41] Source: International Investment Funds Association and the International Monetary Fund ("IMF"), as of Dec. 31, 2013, Global Financial Stability Report (Oct. 2014) available at https://www.imf.org/external/pubs/cat/longres.aspx?sk=41631.0.

Figure 4.

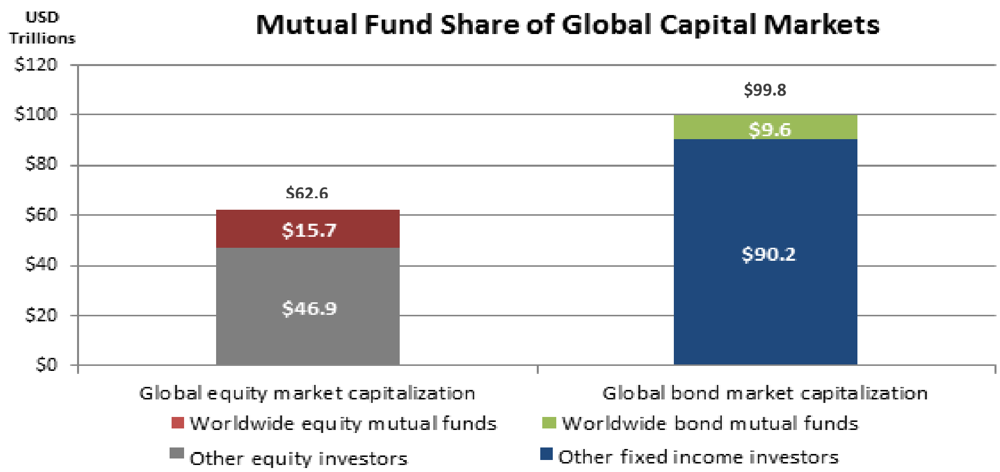
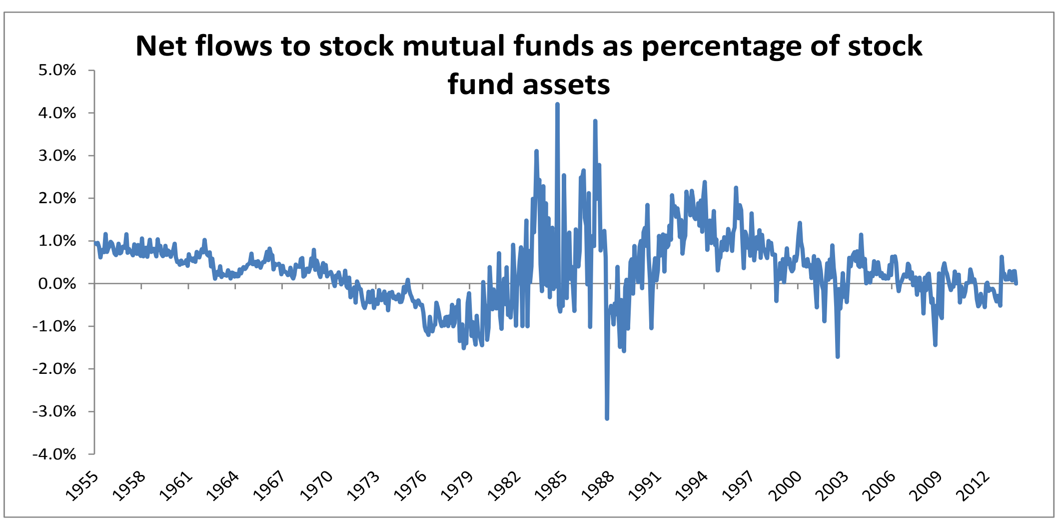


Figure 5 below shows the history of redemptions from equity mutual funds as a percentage of mutual fund assets. For example, during October 1987, when the S&P 500 Index returned –21.5%, stock fund investors made net redemptions totaling about 3% of stock fund assets. From October 31, 2007, to February 27, 2009, the S&P 500 Index returned –50.9%, the worst stock market decline since the Great Depression. Over this same period, investors redeemed a net $281 billion from equity mutual funds, which represented a mere 4.1% of equity assets under management measured from the start of the period.

Figure 5. No Evidence of a Run on Stock Funds[42]

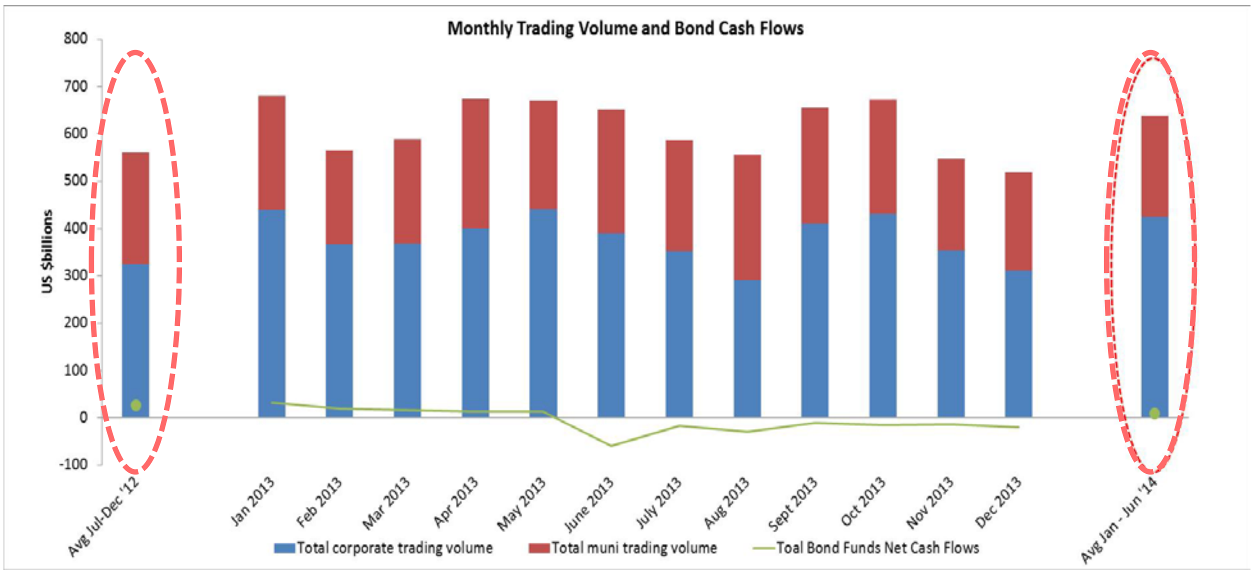


In June 2013, in response to indications from the Federal Reserve that the extraordinary level of monetary stimulus might soon reverse, the 10-year Treasury note yield rose by almost 50 bps. Bond

[42] Source: ICI monthly net flows as a percentage of stock fund assets at the start of the month.

fund prices declined, and these funds collectively experienced net outflows of $68 billion (approximately 1.8% of aggregate assets) during the month.[43] Although larger than usual, this redemption activity was still a small fraction of the asset base (and the overall trading volume of the bond market) and did not cascade into a financial calamity requiring taxpayer support (see Figure 6 below). Trading volumes were sustained at normal levels and there was no evidence of insufficient levels of market liquidity. This held true within all segments of the bond market, including less liquid asset classes such as high yield bonds and municipal securities.

Figure 6. No Evidence of a Run on Bond Funds[44]



We believe these examples of actual market events experienced by mutual funds illustrate not only that stock and bond funds have no track record of unsustainable shareholder redemption activity, but that redemptions result from investor asset decisions, not perceptions of redemption incentives. While the historical track record shows no evidence of large-scale redemptions from mutual funds, we are not content to blindly rely on the past in assessing potential future risks. Our confidence in the resiliency of stock and bond mutual funds to meet redemptions is based on the sound regulation of their activities and structure, effective liquidity risk management, and a highly diversified client base.

F. <u>Inconsistency in methodologies with those developed by national systemic risk authorities creates disparity among market participants without mitigating systemic risks</u>.

The Second Consultative Document fails to recognize FSOC's recent focus on products and activities in the asset management industry. The Second Consultative Document also fails to propose materiality thresholds that are consistent with those already adopted by national regulators. For example, the Consultation proposes a leverage materiality threshold (3 times NAV) that diverges from

---

[43] IM Guidance Update No. 2014-1 at 2 (Jan. 2014), http://www.sec.gov/divisions/investment/guidance/im-guidance-2014-1.pdf, citing ICI data.
[44] Sources: Securities Industry and Financial Markets Association (SIFMA), Barclays, and ICI.

the limitations placed on bank leverage under current global banking regulations, and the non-bank SIFI leverage indicator applied by FSOC (15:1). This approach contradicts the FSB's stated principle to create a framework that is broadly consistent with the criteria used to identify G-SIBs and G-SIIs.[45]

IV. Asset managers do not impose systemic risk.

A. AUM of an investment adviser is not indicative of systemic risk.

The Consultation proposes two possible thresholds for identifying systemically risky asset managers. The first threshold is a balance sheet test. As stated in the Consultation, very few asset managers have large balance sheets, given that they do not act as principals on behalf of the funds that they advise. The second threshold is triggered off of AUM. But the Consultation itself recognizes that "AUM may not always be the most effective threshold measure."[46] Nonetheless, the Consultation concludes that AUM is an "appropriate indicator" simply because "an asset manager's global AUM generally is readily available."[47] We believe systemic risk regulators' focus is best placed on identifying and reducing systemic risks, not identifying and designating entities whose data is generally available. The AUM threshold demonstrates why the approach being advanced by this Consultation is inferior to an activities-based assessment of systemic risk.

B. Unlike other economic actors, the operational risks that may arise at any one investment adviser would be idiosyncratic and would not introduce systemic risk to the financial markets.

1. The Consultation's focus on asset managers as producers of systemic risk is misplaced.

As we have stated in previous comment letters,[48] investment advisers that are registered with the SEC are effectively regulated to minimize the risk that they might pose to the stability of the financial markets. Mutual fund advisers do not present systemic risk for the following reasons:

- Fund advisers serve as agents, not principals, when conducting financial market activities for the funds they advise;
- Fund advisers do not own fund assets;
- Fund assets are custodied with third-party custodians;
- Fund assets are recorded on the fund's balance sheet, not the adviser's balance sheet;
- Fund assets cannot be used to satisfy the obligations of the adviser or other funds managed by the adviser;
- Each fund is its own corporate entity, separate and distinct from its adviser and all other mutual funds; and
- Investment activity of mutual fund advisers is limited by each fund's distinct objective and strategy.

---

[45] Second Consultative Document, p.3.
[46] *Id*., p. 51.
[47] *Id*., p. 52.
[48] *See* Vanguard 2015 FSOC Comment Letter.

The Consultation recognizes many of these facts and correctly summarizes that asset managers tend to have small balance sheets, employ little to no leverage, and the forced liquidation of their own assets would not generally create market disruptions.[49] In other words, the FSB and IOSCO appear to agree that asset managers are not likely to cause systemic risk. Nonetheless, the Consultation contends that a manager's failure or distress "may still create or amplify potential market distress through its off-balance sheet activities (e.g., provision of indemnification and guarantees) or through its reputational/operational risks."[50] We believe this statement deserves closer analysis.

First, if it is off-balance sheet activities that concern systemic risk regulators, regulators should propose to regulate such activities in a manner that effectively addresses their systemic risk concerns. We strongly believe that entity-level designations should not be used as a proxy for data gathering of off-balance sheet activities, or for activities-based regulation.

Second, the Consultation (i) fails to provide evidence of how an investment adviser's reputational/operational risks could produce the widespread market failure that would call for government intervention, and (ii) fails to demonstrate why an entity-based designation is the appropriate regulatory tool to address such risks. In fact, the Consultation suggests that the NBNI G-SIFI assessment methodology may want to consider whether such risks "could cause, for example, substantial redemptions from any investment funds that [an adviser] manages…in a way that could adversely affect the global financial system."[51] We find this statement troubling. On the one hand, the Consultation is proposing a methodology to designate certain asset managers as NBNI G-SIFIs because of the reputational/operational risks that such managers may transmit to the global financial markets. On the other hand, the Consultation is uncertain as to whether or not the very reputational/operational risks it cites could, in fact, cause those asset managers to be systemically important. If systemic risk regulators are not convinced that these risks could have systemic impacts on the global financial system, we believe it is premature to be proposing a methodology to designate asset managers as NBNI G-SIFIs.

2. Investment advisers are effectively regulated by the SEC for operational risks.

Because the SEC effectively regulates idiosyncratic operational risks, prudential regulation of investment advisers is unnecessary to address any such risks. SEC-registered investment advisers are required to adopt and implement a written compliance program that must include a business continuity plan.[52] The purpose of business continuity plans is to develop alternative ways to carry out normal business functions without access to facilities, systems, and/or key third-party providers of goods or services to the funds or its adviser. Within an investment adviser, business continuity planning is an ongoing process—compliance, audit, and enterprise risk professionals are dedicated to constantly troubleshooting possible contingency scenarios and engaging with business leaders to prioritize business continuity initiatives, update business continuity plans, and engage in business continuity drills.

---

[49] Second Consultative Document, p.48.
[50] *Id*., p. 48-49.
[51] *Id*., p. 49.
[52] Rule 206(4)-7 under the IAA. *See also* Final Rule: "Compliance Programs of Investment Companies and Investment Advisers," IAA Release No. 2204 (Dec. 17, 2003) (discussing the need for advisers to establish a reasonable process for responding to emergencies, contingencies, and disasters, and that an adviser's contingency planning process should be appropriately scaled, and reasonable in light of the facts and circumstances surrounding the adviser's business operations and the commitments it has made to its clients).

Prudential regulation of the same internal planning process would be highly duplicative and unnecessary given the absence of any impact to systemic risk.

3. The transfer of client accounts from one investment adviser to another is a routine and well-managed process.

The Consultation cites the operational risks that may arise when transferring client accounts from one investment adviser to another.[53] History has shown, however, that clients routinely move their accounts between investment advisers without significant impact, both in times of stressed and non-stressed market conditions, without evidence of the concerns cited by systemic risk regulators. For example, global merger and acquisition volume across the asset management industry totaled $4 trillion in 2009, double the $2 trillion in 2008.[54] Despite that merger volume and the environment in which it occurred, we are not aware of any client/asset transfers during this period that presented systemic risk.

C. The resolution of an investment adviser is a straightforward process that does not raise operational risks of a systemic nature and therefore does not require the prudential oversight of a special resolution regime.

In the years following the 2008 financial crisis, much focus has been placed on the need for highly complex, leveraged financial institutions to be subject to orderly liquidation regimes. The purpose of these regimes is to ensure the unwinding of an insolvent financial institution is performed in a controlled, measured manner to reduce the systemic impact that the insolvency might otherwise have on other financial institutions or the markets generally. Unlike the resolution of institutions with high leverage ratios and commitments to repay billions of dollars in fixed obligations (i.e., loans, notes, bonds, and other borrowings), the resolution of investment advisers and/or the funds they manage does not present risks to global financial stability. When investment advisers exit the business, they do so in an orderly fashion because they lack these hallmarks of complexity. In short, advisers do not "fail." Even in periods of severe market stress, investment adviser dissolutions do not create disruptive conditions impacting the investing public, market participants, or financial markets—and there remains a healthy market of interested acquirers for funds and fund management firms.

If a mutual fund's investment adviser were to go bankrupt, the investment adviser would have no access to the fund's assets or the assets of other funds managed by the same adviser. The investment adviser's own assets would typically be limited to, for example, real estate, and telecommunication, computer and office equipment, and possibly some proprietary equity investments that would rank *pari passu* with investments held by other shareholders. Liabilities would typically be limited to, for example, leases and contracts for services used in the investment advisory business (e.g.,

[53] Second Consultative Document, p. 49.

[54] ICI, "'Orderly Resolution' of Mutual Funds and Their Managers" (July 15, 2014) ("Orderly Resolution"), at p. 5, fn. 3, available at http://www.ici.org/pdf/14_ici_orderly_resolution.pdf; Frances Stadler and Rachel Graham, "Living Wills and an Orderly Resolution Mechanism? A Poor Fit for Mutual Funds and Their Managers" (Aug. 12, 2014), available at http://www.ici.org/viewpoints/view_14_orderly_resolution, (summarizing Orderly Resolution).

investment research), modest amounts of indebtedness to meet working capital requirements, and routine liabilities tied to personnel.[55]

If a fund's investment adviser were to go bankrupt or experience significant reputational harm, the board of trustees of a fund managed by that investment adviser would simply hire another investment adviser to manage the fund. In 2004, when Strong Financial, a mutual fund investment advisory firm, withered in a trading scandal, the funds' board of trustees hired another investment adviser to manage the Strong Funds. As with any change in adviser, the transition required no government or regulatory intervention.[56]

We also note that the investment adviser subsidiaries of two U.S. non-bank financial companies that have been designated "systemically important" by FSOC are included in the resolution plans of these entities. The plans indicate that the routine U.S. Chapter 11 bankruptcy proceedings are capable of resolving these investment advisers.[57] It appears, therefore, that some systemic risk regulators have already conceded that investment advisers require no special resolution regime. Finally, we believe it is important to note that the SEC has recently announced its plans to focus on transition planning requirements for asset managers, above and beyond the business continuity plans that such advisers must maintain.[58] We believe this activities-based regulatory approach is the most appropriate and effective way to address any lingering concerns about operational risks at U.S. investment advisers.

****

We appreciate the opportunity to provide the FSB and IOSCO with our thoughts and perspectives on these important issues. If you have any questions about Vanguard's comments or would like any additional information, please contact James M. Delaplane, Jr., Principal, at (610) 669-9321, or Laura Merianos, Principal, at (610) 669-2627.

Sincerely,

/s/ Tim Buckley

Managing Director
and Chief Investment Officer
Vanguard

/s/ John Hollyer

Principal
and Head of Risk Management Group
Vanguard

[55] *See* Orderly Resolution, p. 9.
[56] Diamond, Randy, "One-time powerhouse Strong Financial down to a staff of 1" (Aug. 6, 2012), available at http://www.pionline.com/article/20120806/PRINT/308069980/one-time-powerhouse-strong-financial-down-to-a-staff-of-1#.
[57] *See* Prudential Financial Inc., 2014 Resolution Plan, Public Section (June 30, 2014) available at http://www.federalreserve.gov/bankinforeg/resolution-plans/prudential-fin-1g-20140701.pdf; American International Group, Inc. Resolution Plan, Section I; Public Section (July 1, 2014) available at http://www.federalreserve.gov/bankinforeg/resolution-plans/aig-1g-20140701.pdf. Similarly, it is worth noting that Neuberger Berman, an investment advisory subsidiary of Lehman Brothers, required no special resolution process, and, if fact, successfully navigated Lehman's bankruptcy.
[58] *See e.g.*, White, Mary Jo, Speech at The New York Times DealBook Opportunities for Tomorrow Conference, New York, N.Y., (Dec. 11, 2014).

cc: The Honorable Jacob J. Lew
Secretary
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Washington, D.C. 20220

The Honorable Mary Jo White
Chair
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

The Honorable Janet Yellen
Chair
The Federal Reserve System
20th Street and Constitution Ave, NW
Washington, DC 20551