THE BROOKINGS INSTITUTION

SYSTEMIC RISK AND THE ASSET MANAGEMENT INDUSTRY

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Welcome:

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PANEL 1: FRAMING THE SYSTEMIC RISK ISSUE

Moderator:

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Panelists:

BRIAN REID
Chief Economist
Investment Company Institute

RICHARD BERNER
Director
Office of Financial Research

CRAIG M. LEWIS
Chief Economic and Director, Division of Risk and Economic Analysis
U.S. Securities and Exchange Commission

PANEL 2: WHAT SHOULD WE DO?

Moderator:

MARTIN NEIL BAILY
Senior Fellow and Director, Initiative on Business and Public Policy
The Brookings Institution

Panelists:

PAUL KUPIEC
Resident Scholar
American Enterprise Institute

MARCUS STANLEY
Policy Director
Americans for Financial Reform

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P R O C E E D I N G S

MR. ELLIOTT: Good afternoon, everyone. I'm Doug Elliott with the Economic Studies program here at Brookings. And thank you all for coming here today. Our topic is the asset management industry. And actually, there's enough stragglers here, I should vamp for a minute or so. Anybody want to hear me sing? Okay, so you have heard me sing. Fair enough.

As I was starting to say, our topic today is the asset management industry, and its potential contribution to financial instability. There's an ongoing debate on the extent to which asset managers can either create or amplify systemic financial risk, as opposed to simply being pass-through entities, reflecting the choices that their investors make. The Dodd-Frank Act created the Financial Stability Oversight Council, or FSOC, to bring together the nation's top financial regulators. A key part of its job is to monitor potential sources of financial instability, and to try to find ways to lower the level of risk. A specific task designated to FSOC, is to designate certain financial institutions as systemically important financial institutions or SIFI's. This basically is to look at non-bank financial institutions that have the capability to cause real systemic problems. The SIFI designation automatically substantially increases the regulator's authority over those designated financial institutions.

In addition, the FSOC is mandated to monitor systemically important financial activities, even if they don't take place within individual institutions that are SIFI's.

Dodd-Frank also created the Office of Financial Research, as a fairly autonomous unit within the Treasury Department. One of its key roles is to advise the FSOC in monitoring financial stability. And as part of this, the OFR recently released a report on the asset management industry and the financial stability issues, which was conducted at the request of the FSOC. We're fortunate to have here today, Dick Berner, the director of the OFR to talk about that report and about related issues. He'll be part of our first panel.

The asset management industry, as most of you know, is huge. In keeping with the vast size of the American financial markets. The OFR report puts its size at 53 trillion dollars in assets under management. It's also a highly varied industry. There are mutual funds and other registered investment companies, hedge funds, separate accounts that are managed by various types of investment advisors, private equity funds, venture capital funds, and other types of funds. Further, different managers focus on different financial markets, and/or use different approaches to investments. They also differ considerably in key-risk factors, such as the use of debt to leverage potential profits and losses. The key difference between asset managers as a type, and financial intermediaries, such as banks, is that asset managers primarily act as agents for others, while financial intermediaries put their own money at risk. So, a bank for example, borrows from depositors and from the capital markets, lends out money, or buys securities, and has the profits or losses that come from those activities. Now this differentiation between acting as an agent and acting as a principal, is not completely black and white, since financial intermediaries can sometimes act as agents, and asset managers may participate to some extent as principals. Nonetheless, this agency principal distinction is a key one.

Our event today is structured around two panels. The first will be moderated by me, and will provide an overview of the key analytical issues and facts related to asset managers and financial stability. The second panel will build on this by bringing a series of perspectives on whether, and to what extent, systemic risk exists in the asset management industry and its activities, and how it ought to best be handled by policymakers. My colleague, Martin Baily, who is head of our initiative on business and public policy, will be moderating that panel.

So let me now introduce the first panel. We'll start with Richard Berner, Director of the Office of Financial Research. His full bio is available to you. We have a pile outside if you didn't get one, but let me give you a few highlights. Dick is the first head of the OFR, which is only a year or two old, depending on how you count it. Prior to that, he was co-head of Global Economics at Morgan Stanley for many years. Going farther back, he worked for the Federal Reserve Board for seven years, in addition to holding other private sector positions.

Our second panelist on the first panel is Brian Reid, Chief Economist of the Investment Company Institute. He too worked at the Federal Reserve Board before, in his case, coming to the Investment Company Institute in 1996. His talk will focus on registered investment companies.

Craig Lewis, Chief Economist of the Securities and Exchange Commission, had to cancel at the last moment, unfortunately.

The panel will open with about 20 minutes of remarks from Dick, followed by remarks from Brian. I will then ask them both to come up here for a discussion among the three of us, followed by a question and answer period with the audience. With that, let's please welcome, Dick Berner. (Applause).

MR. BERNER: Thank you, Doug, for that kind introduction. It's really a pleasure to be here. I'm delighted to participate in this program, and I thank Doug and the other organizers for sponsoring it, and Martin. I am happy to have the opportunity also to be here with Brian, Paul, and others to explore the question using facts and analysis of whether certain asset management activities might create vulnerabilities in the financial system. In other words, could any such vulnerabilities, coupled with a financial shock, pose threats to financial stability? Could they transmit or amplify the impact of such shocks?

Now I framed the question in the way that I did because it reflects our mandate in understanding the research we did on asset management and financial stability. The mandate as you see here, has a couple of parts to it. First, the financial stability oversight Council asked the OFR to analyze activities and firms in the asset management industry to understand whether or not they might pose threats to financial stability. The council will assess specific threats and determine if any remedies are needed to mitigate those threats. Specifically, the council is solely responsible for the process of designating firms for prudential supervision by the Federal Reserve. The OFR supports the council's work with analysis and data, and when I emphasize that no decisions have been made regarding whether there are threats or whether any remedies for them should be used.

So let's start by talking about what we found in our work. The assets management industry, as Doug mentioned, by our estimates manages about 53 trillion dollars on behalf of global clients, about half of which are for U.S. domicile clients. As Doug also mentioned, asset management is clearly different from commercial banking and from insurance. Asset management is primarily an agency business, not a principal business. In fact, let me just take a moment to amplify on that point. Asset managers, also known as investment managers, are hired by clients to invest assets on their behalf. In this role, asset managers act as fiduciaries. Asset managers invest within the guidelines specified by their clients for a given mandate. This may include more or less risk taking, however the investment results, whether positive or negative, belong to the client. Importantly, the assets under management are owned by the clients. They are generally held by third party custodians, selected by and under contractual obligation to these clients. Typically, asset managers do not have physical control or direct access to client's assets. Consequently, asset managers have small balance sheets relative to those of other financial services firms. I read that because that actually is the description in a report put out by an asset manager. But it's one with which we completely agree. What we also found is the industry is diverse. The business mixes and business models in the asset management industry, again, as Doug mentioned, very significantly.

So, we, in our work, deliberately chose activities rather than firms as the basic analytical building block. Now it's important to recognize that in this work, we obviously need data to animate and to answer some of the questions that we want to ask. The data, however, are not as easy to come by as one might think. There are significant data gaps, particularly in what are called separate accounts. Doug referred to those in securities lending and in repo transactions. What you see is a slide that's reproduced here from our report. I know this is a little hard to read on the screen, but what it attempts to do is to indicate the sources of investable assets, the kinds of investment managers who are there, the kinds of funds they manage, and it indirectly gets at their activities which we're going to talk about. What the chart illustrates, I think in broad terms, is that the business mix is quite diverse. Estimates suggest that some firms consist primarily of funds registered under the Investment Company Act of 1940, those are mutual funds; otherwise known as the 40 act. Others are a mix of these and so-called separate accounts. Some manage a broad array of asset classes; others focus on equities or fixed income exclusively. Ancillary businesses are important and have important client synergies in asset management businesses. For example, some use and sell pricing models securities lending, and other types of businesses. The business models for each of these businesses is also diverse. Some funds may rely on short-term funding. Although 40 act firms are structured to have high levels of liquidity. Some firms use derivatives, others none. Some firms are funds engaged significantly in securities lending, others little. Some firms manage risk on a fund by fund basis, other centrally within the firm.

The point of all this is that this is a very diverse business which has many models and many mixes. That's also emphasized on this slide, which is also taken from the report. Again, it's hard to see, but if you go to the report, you can see it in detail there. This shows the diversity of business mix among asset managers. I'd make three points. Some firms consist largely of mutual funds, and others include separately managed accounts. A few of them, in fact, are predominantly involved in managing separately managed accounts. This diversity partly explains why, when you think about the narrative that we've seen from the industry, it's quite a bit different from our description. Because our description was designed to encompass the entire industry, not a particular part of it, but also to recognize the diversity in the industry. Now this slide does not show the diversity of business models. Our outreach to ten asset managers; however, confirmed that each asset manager's approach to the business model varies. In some cases, to a wide extent. So this is why we chose activities as the basic building block for analysis. First, that approach facilitates analysis of any sources of threats to financial stability, not just their symptoms. Second, it comprehends both asset managers, as well as their counterparties. After all, there are two sides to every financial transaction, and of the interconnectedness among them. For example, in securities lending, you also have securities borrowers. Third, it enables the aggregation from activities into firms. And last, we see that data -- there's a problem -- data are less widely available for activities, and are in many cases not available or adequate for analysis. So this approach that we took has many advantages, but obviously when we think about the gaps in data, that's something that we need to address. And those data gaps are significant. What you see in this table, also taken from the report, is that when we look at companies that are private, for example, not pubic companies, that is they don't, they're not publicly traded. So the data currently available are more limited than they are for other firms. Likewise, for separate accounts. It's hard to come by reliable estimates of separate accounts. Third, for securities lending. There are aggregate data on securities lending, but those data need improvement. In fact, there are work streams going on around the globe just to improve and focus on those data. Similarly for data involving repurchase transactions, or repurchase agreements, otherwise known as repo. Those are surprisingly somewhat limited as well. We, in the OFR, are making attempts to collaborate with our council member brethren to fill those gaps, and that work is underway.

Now, we examined several publicly available data sources. Data sources that were filed with the regulators and also from third parties. And we took a look at three in particular that are publicly filed that I wanted to share with you because I think it's important to recognize, while there are a lot of filings, as far as the analysis that we're doing, these data were not completely adequate for the work at hand. Form N-Q for example, filed with the SEC. It's a quarterly report of holdings and mutual funds, ETF's, closed-end funds, and other registered investment companies. Those data include significant fund-level detail, such as listings of all security holdings. However, they don't include any information on separate accounts. Form NCSR, another report filed with the SEC, these are annual and semi-annual reports for mutual funds, ETF's, money market funds, and other registered investment companies similar to a form 10K or 10Q, but for the individual fund. Again, this form and these reports do not include any information on separate accounts.

The third form is called ADV. This is an annual submission of basic firm profile information for all domestic registered asset managers. It does include information on separate accounts. But the data in this form and for separate accounts are of questionable validity because of double counting for sub advised funds and cross investing across registered investment advisors. So the double counting makes it really hard to figure out where the separate accounts really are, and where the other accounts are as well. Now we consulted several third party data sources. Those from DTCC of the Depository Trust and Clearing Corporation for derivative transaction information. We consulted Morning Star. The data from Morning Star are very similar to and derived from form N-Q. That's an aggregation of publicly available fund level data. And we consulted *Pensions and Investments*, which is a magazine that publishes survey-based data, so responses to their surveys indicate the size of the industry and other data. And we use those data in conjunction with the others to form the basis for our estimates for industry level activity.

There's a last form that's filed with the SEC, Form PF. Form PF is a form related to private funds, as its name suggests. And that outlines the risk profile of private fund activities and parallel separate accounts, and it's updated quarterly for large firms. The filers include hedge funds and private equity funds, as well as traditional asset managers with private funds. It includes detail and aggregate measures of fund risk. This is a new form. It's just begun to be analyzed, and we'll talk more about the data on that form in a little bit. But we did not consult those data or use those data in this report.

So more on what we found. We found that certain industry activities may create vulnerabilities. Among them, risk taking and separate accounts, and the reinvestment of cash collateral in securities lending transactions. Some specific factors that may make industry activities vulnerable to shocks are listed here. Among them, reaching for yield and herding behaviors, redemption risk, and collective investment vehicles, leverage, and potentially firms and sources of risk. Now it's important to note that all firms are registered and regulated, but the regulations vary widely as I indicate here.

Let me focus on some of the vulnerabilities. We think about reaching for yield and herding behaviors in today's low rate, low volatility world. Duration and fixed income portfolio allocations are still quite high. Thus, the vulnerability to a sharp rise in interest rates and/or volatility is similarly high. Redemption risk and collective investment vehicles -- the ability to redeem mutual funds at daily closing prices, is obviously a major benefit to investors. However, this redemption option, especially in funds that invest in less liquid fixed-income securities, creates a vulnerability that could amplify shocks. Leverage is limited, as I mentioned earlier in 40 act funds, but not so in separately managed accounts. The regulatory framework is something that does pertain, particular to 40 act accounts. It limits leverage. It limits the share of the portfolio that can be lent out and securities lending transactions, but does not apply to separately managed accounts. We estimate that separate accounts include about 40 percent of total assets under management at U.S. firms.

One question I think that is important here is, do commingle investment vehicles engage in what's known in the finance and economics' profession as liquidity transformation? That means less liquid assets are transformed on the other side of the balance sheet, or transformed in some other way into more liquid assets or liabilities, depending on whose side of the trade you're on. The answer is yes. But clearly the extent depends on the market liquidity of the assets under management. In an S&P index fund, there is virtually no liquidity transformation. However, in a high yield or emerging market bond fund, there's somewhat more. No liquidity is obviously not an issue in normal times, and even less so today when ample funding liquidity from global central banks is boosting market liquidity. The issue of course is whether liquidity dries up in periods of stress. Gauging and quantifying market liquidity is challenging. At the OFR we're doing work on it. So I want to emphasize that we don't have definitive answers here. But as I mentioned earlier, today's exposure to a sudden unanticipated rise in interest rates, given still high duration and convexity risk and high fixed income portfolio allocations, in my view means that it's worth monitoring at the very least these issues. This slide shows liquidity and preferences by investors, and the trade-off between liquidity and stability of the investment.

Securities lending is an example of an activity that bears watching. Lenders mainly include institutional investors who lend portfolio securities to earn income. Direct borrowers include broker/dealers that most often relend the borrowed securities to hedge funds and to others for short selling and other permitted purposes. As you see in this slide, in a securities lending transaction, a security is temporarily transferred from a lender to a borrower in exchange for cash or another kind of collateral. In the U.S., securities lending cash collateral is typically invested in commingled funds. That is, for example, registered money market mutual funds, and unregistered short-tem funds, and in separate accounts. The cash collateral must be returned to the borrower upon the termination of the loan. Lenders often retain agents to manage the cash collateral. Many broker/dealers act as intermediaries for hedge funds or other borrowers. There is no single regulatory framework for this activity, but numerous regulatory requirements do apply to both lenders and to borrowers. Now securities' lenders generally consider these transactions low risk sources of income. But under stress, the reinvestment of the cash collateral may create vulnerabilities. If the securities' lender fears its reinvested cash collateral will lose value, or that the borrower will be unable to return the securities, the lender may recall the loaned securities. Or a borrower may seek to return securities, if it believes that its posted collateral is at risk. The unwinding as it's known of securities lending transactions contributed to market stress in the financial crisis. In some cases collateral was invested in illiquid assets, resulting in losses and forced asset sales, as firms sought to raise cash. These losses amplified fire sales and runs contributing to distress in money markets, and other short-term funding markets.

I mentioned form P-F earlier. The data from form P-F were not considered in this report because they were not yet ready for analysis. Some of that cleaning up work has been done. We worked very long and hard with the SEC in order to do that. So we now have some preliminary analysis of hedge funds using the data from form P-F. The form P-F data covers roughly 6,000 hedge funds. I want to emphasize that these results are preliminary, and based on analysis of quintiles funds, sometimes including a thousand in each quintile. Some including a hundred or so, so they must be interpreted with caution. So, in other words, the ones that include a hundred or so firms, are obviously from a greatly reduced set of the overall data.

We asked three questions. First, what's the relationship between a funds leverage and the fraction of its assets that are have to value, or so-called level 3 assets. The data suggests actually, that they are inversely related. Second, our highly leveraged funds carefully monitoring the risk exposure. The answer again on a preliminary basis, is that funds with higher leverage were somewhat more likely to calculate value at risk. Now this is a rough proxy that we use for monitoring risk exposure. It's certainly not the only proxy, but one that might prove useful. Last, what's the relationship between leverage and the level of value at risk? The answer is funds that report higher values of value at risk, also tend to report lower leverage.

Now, the interesting thing here is that, while these results are very preliminary, they seem to contradict the idea that hedge funds typically employ risky strategies. Again, I want to emphasize that these conclusions are very tentative. They're based on preliminary analysis of the data, and one should really take them as the starting point for their work. So I want to illustrate those three questions in these slides. This shows the quintiles that I referred to and shows the average leverage by each group, and shows that inverse relationship between the proportion of hard to value assets in the portfolio and leverage by quintilling. In this case, group one has zero average leverage. It's made up of about 2,600 or half the hedge funds in the overall sample. And the second, third, fourth, and fifth groups each have 665 hedge funds.

For the category of funds with the highest leverage, the mean ratio of debt to non-asset value of about 2.8, the corresponding, the fraction of hard-to-value assets in the portfolio was less than five percent. In contrast, hard-to-value assets represent about 20 percent or a little more of the assets of funds with no leverage. Again, this is a tentative conclusion, but one that probably bears further investigation.

Second question, are highly leveraged funds carefully monitoring their risk exposure? Again, as a rough way to look at that, we looked at whether or not the fund calculates value of risk. This is not a crystal clear relationship, but it is suggestive of the idea that funds with higher leverage were somewhat more likely to calculate value at risk. That's not surprising actually because the funds with higher leverage tend to be ones that were larger.

Finally, what's the relationship between leverage and the value, or the level of value of risk. We looked at 510 qualifying hedge funds that report a value of risk measure, after dividing them into five categories, based on reported value risk, so 87 of these funds reported a value of risk at zero. This illustrates the point that some of these data might need to be looked at more carefully in order to interpret what really was meant by reporting a value at risk of zero. We put those funds in their own category, and the remaining funds are put in quartiles, according to the reported value at risk. The data show that on average, funds that report higher values of VAR, also tend to report low leverage. For example, the group with the highest VAR have an average leverage ratio of about .8, about half that of the group with the next highest value at risk. We can't put too much weight on this result without alternative measures of portfolio risk to confirm it.

So, let me summarize. Asset management is primarily an agency business. In our view, we chose activities rather than firms to be the analytical building block of choice. We found, through our work, that certain activities may create vulnerabilities in the financial system. However, significant data gaps still hinder a comprehensive analysis. Now the council will decide whether or not the framework and the designation rules should apply to asset managers, if, in fact, it pursues this work. The council, not the office of financial research, must judge if and whether remedies under the current designations framework are relevant.

I just close by quoting Council Chair Lu. "We should keep an open mind on this work. Facts and analysis should drive any decisions that are made, and this report is aimed at providing those facts and that analysis." Thanks very much. (Applause).

MR. REID: Thank you very much, Doug. I really appreciate the opportunity to speak with you today, and also the Brookings Institution for inviting me here. I want to frame my remarks this afternoon around -- really a question that the OFR report doesn't explore very deeply, and that is, how with decades of experience the asset management industry has had with large fluctuations and financial markets and the like, there's really no evidence that asset managers are transmitting risks to the financial system. And I think some of the points that have been discussed so far, I think bear elucidating, and so I'm going to examine those.

So the three points that I want to focus on are first of all, that asset managers as both Dick and Doug have pointed out are agents and not principals. Secondly, much of my comments are focused on registered funds, that is mutual funds and ETF's, closed-in funds. And these funds are subject to key investor protections. But these key investor protections also create ways in which it separates the risks of the fund from the advisor, and they do so within the context of the law. The law sort of enshrines this agency relationship that provides a great deal of protection and separation.

The third point that I want to look at is really the empirical data, that we're really all called upon to examine. And that is, to focus on the core hypothesis within the OFR report, and that is that (inaudible) and fire sales could propagate systemic risks. And look to see why is it the case that the data do not support a sort of conclusion that registered funds are contributing to these sort of systemic risks. So what does it mean to be an agent? An agent, such as an asset manager, takes the money on behalf of its clients, be it institutions or individuals, and puts them into either a separate account or a commingled fund, such as a mutual fund, and invest it on their behalf into the market, so buying stocks, bonds, and other types of instruments. And as has been pointed out, really the key distinction here between the agency relationship and the principal relationship is that the investment risk remains with the investors, not the advisor. And this is quite important, and it comes about in a number of different ways that I'm going to explore. Principals, such as banks for instance put their own money at risk, and their capital there is there to absorb the losses on their assets to protect the depositors and ultimately the FDIC and the federal government from sort of taking in losses on that balance sheet. But ultimately, those losses do go to the bank itself. And the capital is there to absorb that. So for registered funds, this agency relationship really helps to limit the risks and the conveyance of risks between the funds and the advisor. The funds and other funds within the asset management industry, and in many ways also, funds to outside the asset management industry. So, what is key here? The advisor does not hold the assets of the funds that it manages. In fact, it is held by an independent separate custodian, and if the fund loses value, those losses do not go to the advisor. It may affect their income because the assets shrink, but it is not a loss to the advisor itself. And when I say that the assets belong to the fund or to, in the case of a separate account, the advisor has no right to access, borrow against, pledge, do anything else with those assets because they belong to the funds and to the investors. They're really separate entities. Even creditors cannot go after the assets in the funds. Either a credit of the custodial institution or the advisor. And if the advisor has financial difficulties, they can't use the assets in the funds to do it anyway to shore themselves up.

Each fund also, not only is there a wall between the funds and the advisor through this agency relationship, but also there are walls between each individual fund. And this is sometimes sort of forgotten. But losses in one fund, obviously cannot sort of affect the performance of another fund. The advisors cannot use assets in one fund to bolster another fund, so they can't borrow against those to support another fund. They can't pledge those securities in one fund to support another fund. There is, again, a wall between each individual fund and isolates that from everything else within the asset management firm.

In addition, it's been sort of alluded to, the asset managers are often investing in accordance to a mandate. A mandate either in a funds prospectus in terms of the client relationship. It may be a large pension fund that wants a small cap investment. And they will do that on their behalf according to that mandate. So, all of these features of this agency relationship that are imbedded in the federal regulations, help to create these various walls and separation. And there are a whole range of federal regulations that are surrounding registered investment companies. And as I said before, registered investment companies in many ways enshrine some of these agency relationships within the law. In addition to that, some funds are also overseen by the CFTC. There are self-regulatory organizations such as FINRA also, that oversee registered funds.

So what are some of the other features of registered funds that actually contribute to the reduction of overall risk, as well as protecting investors.

And one of the things that is really key here is lack of leverage. A mutual fund and ETF cannot create a senior security. It cannot issue a debt instrument. And so, therefore, the capital structure of a mutual fund is very simple. It issues shares. Those shares invest in a fund, and the fund invests in assets. If there is a future obligation on behalf of the fund, it must fully cover these with segregated and unencumbered assets, and those must be liquid assets. Now the fund may borrow through a bank, but for every dollar of borrowing that it engages in, it has to hold three dollars of assets. Again, sort of set aside to cover that loan.

The simple capital structure also prevents the pyramiding that you can find in other types of financial intermediaries. There are restrictions on funds' abilities to invest in other investment companies, investment advisors, broker/dealers and the like. Also, you can't have joint ventures, no off balance sheet financing. All of these are restricted by registered funds.

In addition to these various sort of walls that I've been talking about, there are also requirements upon the fund to help them manage the ability to take in orders from their investors on a daily basis -- this daily redeemability both to buy and sell shares. So there's diversification, liquidity and daily valuation. Diversification tests are mandated by, or encouraged by tax laws, as well as securities law, and while a fund doesn't have to be diversified, virtually all of them are.

Portfolio liquidity -- no more than 15 percent of registered funds assets can be held in a liquid security -- so 85 percent must be held in a liquid security. Again, going to this liquidity transformation, be it for a stock fund or a bond fund, the underlying assets must be tradable and are tradable in the markets.

The daily valuation also is really key here. That is, there's no investor when put in order and has an advantage over another investor because they're getting the same price at the end of the day. That price is struck when the markets are closed, and no-on knows with certainty what that price will be. And so as a result, diversification, liquidity, the daily valuation, all help for these registered funds to manage the liquidity that they're providing to their investors on a daily basis.

So the third sort of element of, why is it that we do not see historically over decades of financial cycles, asset managers (inaudible) to the types of systemic risk that we find in other types of financial intermediaries. And the third element of this is really investor behavior and funds behavior. And this really goes to a core theory within the OFR report in which they argue that in the face of large redemptions, you could have funds being forced to sell into the market. And those sales could then be transmitted to other types of entities out there. And I want to explore that for a few minutes. Looking again at investor and fund behavior. So I should note that all these data are available in the public domain. The SEC collects them. The ICI collects them. A number of third parties collect them, such as Morningstar, Lipper, Strategic Insight, and the market data are all available as well from a variety of sources including the stock exchanges and the New York fed as well.

So, the core issue that I want to focus on, is the sense that we find what's herding. Herding is a way of sort of framing the issue to sort of argue that investors are moving in as one, in a single direction, causing disruptions in the market, sort of like lemmings, and sort of moving in one way and then another. So what do we see in terms of evidence? Does that even happen? One of the things that we do know, and as you can see on this slide, the sold line here is return on stocks, and when stock returns are strong, we tend to find in-flows, which are the green lines. And when stock returns are weaker, we tend to find outflows. That's uncontestable.

The question is, is what is the extent of these flows that we're observing? So what we've done here -- again, these are all publicly available data. We used ours, but you could use any one of the other services out there. We look at the flows on a monthly basis, and divide by the previous month's assets, and ask, what are those outflows for a given fund? What share are they of the assets, and then look at the distribution. And one of the key takeaways here, is in 2013 for instance, while we are in net inflow into stock funds this year, we find a fairly wide distribution between sort of a minus 4 percent and a plus 4 percent in terms of the outflows. And these are again, if a fund is around for 12 months, or in this case 10 for 2013, they'll show up in 10 times, depending on what their flows were in any given month. The center of the mass though really kind of hovers right around zero very closely. And while there are funds that certainly have outflows or inflows even, that are more than four or five percent, those tend to be fairly small occurrences, but the funds are (inaudible) in the normal course of business.

Now, the question is, what happened in 2008? We had outflows from stock funds, and the question is, do we see a very significant leftward shift in this distribution? The answer is no. It is during the stock market decline of 2008, which the stock market had its largest annual decline -- second largest annual decline since 1825, we saw only a marginal shift to the left in the distribution in terms of flows. We still had funds within flows. We still had some funds with very large inflows. The number of funds that had outflows didn't widen. The tails did not widen in this distribution, and in fact, the outflows generally occur because of a -- basically a 1 or 2 percentage point shift in this distribution. So thinking about then this herding, sort of framing of investors and funds all moving in one direction, we actually find evidence of just the opposite. There's quite a diverse range of activity even in periods where there are outflows or consistent inflows as in aggregate for the industry.

So the next question that we ask is, well, what is the extent of these? How large are they? How large are they relative, and how volatile are they? And this chart takes data back to 1955. I'm happy to provide these data to anybody who would like them. And what you can find is that on a month to month basis outflows aggregated for the industry amount to somewhere between a plus 4 or a minus 4 percentage points of assets. And actually in recent years -- in the last quarter century, we found much less volatility and this range is really much more in the range of a plus 2 or a minus 2 percent of overall fund assets.

So then the next way to think about this is -- is then, well how much of these outflows are relative to the size of the capital markets? So again, we looked at the net flows into stock mutual funds as a percentage of the overall size of the U.S. stock market, both the NYSE AND NASDAQ, and look to the capitalization, and again, you can see that the fluctuations and flows, whether they are positive or negative, usually are less than a half a percent of the overall size of the capital market. And in 2008 and 9, when we had the largest outflows, they amounted to about a minus .5 percent of the size of the capital market.

Thinking about the overall trading then that mutual funds were contributing of the overall capital market, again, examining this very core issue of herding that the OFR report focuses on and potential for destabilizing runs, we asked, well what share of the overall trading of the NYSE, and stock mutual funds accounted for on average, about 8 percent of the overall trading over the last decade.

During the financial crisis it actually fell because the trading volumes jumped in the markets, and the overall share fell closer to about 5 percent. That is 95 percent of the trading in the stock markets was occurring outside of mutual funds.

Same thing for bond funds. Let’s examine that very quickly here. And we can see the same positive relationship. We do tend to see inflows when returns are up, but outflows when returns are down. But again, they’re usually somewhere in the order of 1 or 2 percent, even the most severe months of outflows in terms of assets. Again, the distribution, the same patterns that we saw for stock funds. They tend to be concentrated around zero, a couple of percentage points above or below. Flow is a percentage of previous month assets. We do find very thin tails, and in 2013, we were in net outflow. 2008 we were as well, but those patterns of distribution look pretty much identical.

And then finally, the last point that I would like to make here, is about the overall volume of trading of bond funds. We've heard about the duration risk and the potential for destabilizing flows. How may this feed into the market? And what we have found is, you know, we had a fairly sizeable run up in interest rates this summer, as the fed began to signal that it would begin to taper its bond-buying program. And what we found was, was the actual amount of trading, and this is the amount of sales and purchases of mutual funds, of fixed income securities as a share. The primary dealer's trading, and this excluding the intra-dealer market, we found that it actually fell during this period of time, even though there were outflows because overall trading volumes jumped, and they amounted to about five percent of the trading volume.

So the takeaway from all of this is to re-examine and really step back and say, okay, we've experienced decades of financial volatility. The academic literature has not found that asset managers are contributing to the systemic risk. And why is that? So this is an examination of facts and the laws and the structure. To get a better understanding of that, and to think about this going forward is that we think about designation and identifying risks in the system. Thank you. (Applause).

MR. ELLIOTT: Again, thank you both. For the next 15 minutes or so, what I'd like to do is have a three-way discussion here. And then we'll give all of you a chance. We have a lot of people crowded here in the room, so we definitely want to give you a little time. First, are there any responses you'd like to make, based on Brian's comments, Dick, before we go to other --

MR. BERNER: You know, I think Brian's comments are pretty much consistent with our comments. Namely that, asset management is an agency business. We all agree on that. That, you know we look at activities of asset managers that they might be engaged in that might cause threats to financial stability. Normal trading of registered mutual funds was not really the focus of our activity in the report. We focused on, as we mentioned, reinvestment of cash collateral, and securities lending. And we focused on risks and separately managed accounts. So, that's, you know, since Brian's comments were mostly restricted to registered funds, you know the data show what the data show. Whether or not that transmits or amplifies risks to financial stability, I might add, may or may not be illustrated in the data that he showed. He was showing with flows, and the flows may tell a part of the story. Price action may tell a part of the story as well, but that's a different part of the story.

MR. ELLIOTT: Okay, thank you. One suggestion I would make on your future work in this area, and I'll give you a chance to comment on it because it seems to be a fairly central point. As I was reading through the report, it seemed to me sometimes, at least in terms of explanation, there was a mixing of things that happened because we have markets and people are people, and things that happen because of the existence of asset managers. For instance, the search for yield. I would have thought that the great bulk of the search for yield comes because of the desires of the end investors, not because of the way asset managers operate. Well first, do you think that's a useful distinction? If you don't, why not? If you do, what implications might that have?

MR. REID: Well, what I say is there's no question that asset managers are responding to the next of their clients. Asset managers are typically operating under an investment mandate where they are trying to fulfill the needs of their clients, and that typically involves the best possible return for a given amount of risk. So I don't think that the two are inconsistent. Again, what we're talking about is activities rather than firms, and I think it's the activities that we focused on rather than looking at particular firms.

MR. ELLIOTT: And I guess, again, it's a little bit muddy, but it seems to me when you look at the activities, it wasn't always clear whether you were looking at the incremental risk created by the existence of asset managers or the way they operate, and to what extent you were talking about -- in addition to that, risk that simply flowed through.

MR. BERNER: So as we indicated, Doug, you can have certain activities that might be the sources of risk. You might have others that might amplify risks. You might have others that could transmit risks. All those are important to us as we think about financial stability. And our report was designed to shed light on what the activities of asset managers were, and where we saw the risks might occur. Not to try at this point to precisely identify. In order to more precisely identify, I'm not sure we ever really can precisely identify. But in order to do more precise identification, I think one needs better data. And since we lacked a lot of the data as I indicated, particularly for separate accounts, it's not clear to me that any precision is something that we could really do.

MR. ELLIOTT: Okay, let me ask you what may be a slightly unfair question. We'll give you a chance to respond. There's been a pretty negative reaction to the OFR report. You presumably think that's not justified. First of all, am I correct you think that's not justified, and secondly, what do you think is the cause of the misunderstandings. What do you think the misunderstandings are?

MR. BERNER: Well, you know, I can't speak for other's behavior. All I can do is say that, as far as we're concerned, we stand behind the report. The report was designed to be a piece of research. It shouldn't be confused with something that was aimed at or to be used at -- in a particular set of remedies, particularly designation. As I made clear, I think that's something that's up to the council. The OFR is a research and analytical organization. I can't speak for other's behavior or other's reaction to the report. I'm simply saying that as far as we're concerned, the report accurately describes what we see out there, in asset management activities and in the industry.

MR. ELLIOTT: And Brian, obviously your own organization has responded fairly negatively through the report. Do you think that there are valid lessons that could be taken or points from the report where you believe that it would make sense for the industry and the regulators to try to tackle some of the risks that were catalogued.

MR. REID: I think the real challenge is trying to understand what are the risks that are being catalogued, actually. Certainly, the core thesis again, from my perspective, was the herding, redemption, fire sale, thesis. That largely is based on some empirical literature that does use a lot of information from mutual funds and other types of pool products. But what the real challenge was, was that while these studies sometimes, and I emphasize sometimes, find that there may be an incremental affect on the prices that would potentially move a price away from its fundamental value. And of course, there's a joint hypothesis there to use the term. First of all, you can identify the fundamental value. And the action then on the part of the fund or the asset manager has moved it away from there. The real logical leap then is that this is creating a systemic problem. And I think that's really where the burden lies. While there may be a marginal impact on prices, this academic research has not found that this has created systemic problems for the financial sector as a whole. And I think that logical leap has to really be sort of addressed. It's alluded to, and so I think that's where our first level of concern was.

The second level of concern is, is that while a lot of the focus does tend to be, to be honest, on the registered investment side of the business, registered investment funds. That's where the most information is currently. And so as a result, it does lead by implication then that's where potentially the risks lie, just by the fact that it does tend to focus on there. It's sort of the dollar bill underneath the lamppost.

MR. ELLIOTT: On herding, one thing that wasn't clear to me, are you going so far as to say that it's not true that markets tend to overreact, that markets tend to go into one sector (inaudible) the stock market, or are you saying that it doesn't show up in the registered investment company world, what is it intuitively that you're saying about the markets when you make this herding point?

MR. REID: Right, so the herding point is -- one is left with the impression that trillions of dollars are moving in that direction. I think even in the OFR report they point to money flowing into bond funds for instance. Now, what we have been pointing out for some time is that the money that's going into bond funds, first of all is dwarfed by the amount of money that is going into -- that central banks globally have poured into the bond market, particularly, you know, of (inaudible). Secondly, I mean 10 to 1, so it's hard to argue, and that was very sort of intentional on the part of Central Bank's globally to drive down interest rates and bond prices up.

The second point is that while there may be sort of a shift that may occur during a period of time where sort of in the late nineties more money was going into tech funds or the tech sector than in prior years. It certainly wasn't the case that investors or funds themselves were sort of moving in one direction as one, towards that. I think the term of herding tends to indicate or suggest that. So I think it's more the characterization of this sort of massively moving trillions of dollars into one area or another that are driving the markets, and could potentially, when pulled out, drive them again. We've seen, as I said, probably the second or third largest run up of interest rates in a five, six month period this last summer, and it all flows from bond funds was very modest and easily accommodated. While the flows don't tell you what the price impact was, I can look at the daily flows and see that those flows actually occurred after every single run up in interest rates, not during or before. So I know they do not cause the interest rates to go up. In fact, it was caused by Central Banks, Chairman Bernanke discussing future potential monetary policy. That's very clear from the data.

MR. ELLIOTT: Dick, anything you want.

MR. BERNER: Well, I think there may be a confusion here because the way that -- we're not arguing that flows into or out of a particular asset class moved prices. We're arguing that positioning within an asset class when positions are being taken, they may be subject to certain risks, and that's the basic point that we're trying to make. So, in today's world, where interest rates have been driven down by economic fundamentals, where central banks have been aggressively both using short-term interest rates and purchases of longer term securities to drive down interest rates. Because Brian said raise prices, lower rates. It's the positioning that is of concern because when that unwinds, those positions may be exposed to both duration risk and volatility risk, and those are risks for the future. We're not arguing at all in this report, nor did we ever conceive of the idea that it's what flows into the funds themselves that drive the prices. In fact, it's the prospect of returns that drive the flows, and it's a sudden reversal in the price action, and that could create the risk, given those positions. So I think that's the fundamental difference here in the way we would characterize it. I think also there is a misconstruing of the analytical evidence or the academic literature out there because while in general the academic literature found that in many cases they couldn't detect on average evidence of herding. The problem with saying on average is that sometimes the averages cover a wide spectrum of results and so what some of the literature did find is that, particularly in small cap stocks, there was evidence of herding, although not necessarily found in the broad stock market. And as I indicated in my comments, you know what we see when we look at equities, there isn't a lot of liquidity transformation in the equity mutual funds. What is perhaps of a little more concern is that there is liquidity transformation that goes on in fixed income funds, particularly those that invest in less liquid securities. Now, the last point I think is also important. When we look at aggregate flows or aggregate positions, we're looking across the spectrum of risk in the financial markets. That may hide particular pockets of risk. And so it's pretty clear that when we're looking for risk, far from looking at risk with the dollar bill under the spotlight, it's our job to look where the light is not shining, and to shine some light on where that risk might be that other people may not have anticipated. So we don't focus on registered funds primarily as the source of risk. On the contrary. We focus on the fact that there is a scarcity of data in separate accounts. Those are gaps that one ought to fill if you're going to do more looking into the question, and those are the kinds of things that I think need to be looked at, rather than continuing to focus on whether there's herding in the stock market mutual funds.

MR. REID: Could I just raise one other point though. And this is, it's unclear -- and I understand that the OFR isn't the one that makes the designation of the SIFI designation, but we clearly see that the report goes in the direction of identifying that the investment actions on the part of either funds, the asset managers, or as directed by the clients, could be driving investment decisions. I mean that's how markets operate. And so I guess I struggle with trying to understand what the conclusion is to draw away from that. Clearly if interest rates would rise sharply, because there's going to be an anticipated change in Federal Reserve policy, some sectors, some asset classes will respond more dramatically. That's been the case for decades, and that's not a transmission mechanism in and of itself. Even in the activity of investing. I think that's where the challenge is. It's not clear from the report how the activity of investing, which seems to be part of the herding. I mean you're herding in terms of flows, you're herding in terms of asset classes, and then you're herding in terms of pulling back from that asset class. That's a flow story, fundamentally.

MR. ELLIOTT: Okay, why don't we go to audience questions then. So I just have a few requests. One, please make it an actual question. Ideally make it a question, and please identify yourself and any affiliation that you have. Sir.

MR. CRAWLEY: I'm Dan Crawley with the law firm K & L Gates. The regulatory agency with the most expertise on regulation of asset managers is the SEC, so it's unfortunate that they're absent from today's debate. Quite frankly it raises a question in my mind about what role they've had in this whole process. To what extent was the SEC involved in the discussions with OFR. Were their thoughts, suggestions, recommendations accepted by OFR, and do you have any thoughts on why the SEC felt compelled to put the OFR asset manager study out for public comment.

MR. BERNER: So did we engage with and work with the SEC on this report? Absolutely. We engaged frequently with the SEC on all aspects of the report. Every single one from beginning to end. The SEC made numerous suggestions. We accepted numerous suggestions from the SEC. We worked hand in glove with the SEC on producing this report. No pun intended, but their fingerprints are on the report as well. So I would say the engagement was frequent, the engagement was strong, and the engagement was complete from start to finish. You know, as far as what the SEC thinks it's concerned about why they put out the comment on the report, I think you have to ask the SEC. We don't typically follow a process that involves asking for comments on the research that we do at the OFR.

MR. ELLIOTT: Okay, in the back there.

MR. LINDNER: Peter Lindner, IMF, to Dick's point about the activities, isn't there maybe another way of looking at it that conforms to some of your points, namely, the use of leverage. Leverage probably has played a big role, particularly in the last crisis. Banking is highly leveraged. Hedge funds are -- housing is highly leveraged in this country. And both banking and housing were at the center of the crisis. Now when you go to seek lending, that's pure leverage. During the crisis and before, leverage was built up through structures, CMO's that had been around and using time trenching for decades, but then they used credit trenching (inaudible). You know, when I look at mutual funds, the SEC, but if it hasn't changed in the last few years, it doesn't even tell people what the real risk in the fund is. You have to put the ten biggest positions out there. If you put up one third of all your assets or whatever in the form of futures, and the futures haven't experienced any change in value it's (inaudible). The retail client can't even see what's going on. So what do you think about looking at it from the more "dangerous" activities, rather than looking at the whole industry and one gets into discussions of (inaudible) focus regulation and observation on these things. I mean there are other things in the asset management industry that may deserve supervision or more research. Thank you.

MR. BERNER: How about if I take a crack at that? So, you're absolutely right. That's why we focused on activities as the basic building block. In order to try to isolate those things which we saw that might contribute the most threats to financial stability to create vulnerabilities that might create threats to financial stability. And you mentioned securities lending. That's one activity.

Here's where I agree with Brian on one point, however. In funds that are registered under the 40 act, there are pretty specific disclosure rules. There are pretty specific liquidity rules. There's specific limitations on securities lending in a portfolio, and there are specific limitations on the leverage that they can use all in the context of 40 Act Funds. Which is precisely why we tried to shine a spotlight on the areas where there aren't such rules. Where there's opacity. Where there's a lack of transparency, namely in the separate accounts. And as I mentioned, we estimate there's something like 40 percent of assets under management by U.S. firms, U.S. domiciled firms on behalf of global clients, it's in separately managed accounts.

MR. REID: I guess the point I'd like to make is that the industry has always supported and looked for ways to work with the regulators when more data has been wanted. The SEC is looking at the use of derivatives and other types of (inaudible) instruments, and we will comment and work with them on that. The focus here is -- the concern is not that regulators find potential areas of concern and want to think about revise and regulations or updating them or gathering more information. It's about sort of trying to address that with a very general, and in many ways potentially damaging SIFI designation. It is not clear how -- again, designating an asset management firm as a SIFI deals with any of these specific issues, and by sort of the example of banks if it means increasing capital and liquidity for the asset manager, that begins to really break down the walls between the asset manager and the funds that clearly exist both in rules and with the standard of agency. And so if really the issue is here, are there potential ways in which the SEC could increase oversight, provide additional direction, whatever, the industry is always willing to participate in that and engage in that conversation.

MR. BERNER: So it sounds like there is some agreement between Brian and me. It sounds like specific activities might give rise to threats to financial stability. It sounds like you would agree that our report really is not designed to address the question of designation as I mentioned. The council is solely responsible for the process of designating firms for prudential supervision, by the Federal Reserve. That's one thing I stated right at the outset.

MR. REID: I think we remain concerned that this report could be used for SIFI designation. And I realize that isn't up to the OFR itself, but to use this report for that would be very deeply troubling, and should not be used for that. For identifying specific risks again, these may be ways in which, you know, finding ways in which the investment company and others need to have further clarification on the activities of funds or the (inaudible). But I wouldn't acknowledge that these are necessarily systemic risks, but ways in which perhaps guidance or whatever needs to be updated or clarified or additional information gathered. I think there is a nuance there that's important.

MR. STEVENS: Mr. Berner, thank you very much for being here today. And I appreciate your comments very much. I'm Paul Stevens of the ICI.

MR. BERNER: Nice to see you, Paul.

MR. STEVENS: I was one of those people who commented on the report.

MR. ELLIOTT: And you weren't always nice about it.

MR. STEVENS: I tried to be.

MR. BERNER: Paul, let me just say that we welcome your comments. We welcome comments from any quarter on the work that we do.

MR. STEVENS: Thank you very much. You can depend upon us. You have repeated several times that the conclusion of the report is at certain agency activities may create vulnerabilities, and I respect your point of view, but you're not the only one who has been looking at activities lately. We've had five regulatory agencies developing the (Inaudible) rule, who has spent years looking at activities of banks. And of the things they determined is that principal activities with banks could create risk to the bank's safety and soundness and to the banking system and presumably to the financial system. But they expressly exclude agency activities of banks, that is to say, investing activities as an agent and fiduciary activities. So my question to you is, after all this process, when five regulators have determined that agency activities do not create vulnerabilities, even for too big to fail banks, why is it when those activities are conducted outside of a bank, they create vulnerabilities for the whole financial system.

MR. BERNER: You know, Mr. Stevens, I can't really address what your interpretation of the way you just characterized the rule. I was not involved with the rule, and that rule is something that's up to the regulators, not to the office of financial research. But what I would say is that when we look at securities lending activities, for example, on the reinvestment of cash collateral, I don't think that's covered by any rules. As I mentioned, that's not something that's the subject of any comprehensive rule or regulatory purview, and it's something that regulators now on a global basis are taking a look at, both with respect to filling gaps in the data and to finding out more about the behavior of, as I put it the reinvestment of cash collateral in the event of an unwind of the securities either because the borrower wants to put the securities back or because the lender asked for the securities to be put back in the case of an unwind. That's just one example of that. And as you're aware, I mentioned another set of activities. As you're aware, there are many other activities that regulators are looking at. For example, the risks in short-term wholesale funding markets. That has nothing to do with the rule you just cited, and which in many cases are agency activities. That does not mean that those activities are without risk, it just means that the risks arise of a different sort.

MR. REID: I just want to clarify one point. That is, actually the investment company act is quite specific about how to invest the cash collateral. So there are rules around that.

MR. BERNER: For 40 act firms.

MR. REID: For 40 act firms. But you said you weren't aware. I just wanted to clarify that there are rules for 40 act firms.

MR. BERNER: There are for 40 act firms, but I said there's no comprehensive system of regulation that looks at the activity as a whole. And by the way, it's also important, as I mentioned in my remarks, it's really important not just to look at the lender of the securities, it's also important to look at the borrower of the securities, and to look at the activity as a whole. That's really important. And I think that focus on activities and to look at the activity across the financial system, that's what we're really about.

MR. ELLIOTT: I tend to neglect the back so all the way at the back.

MR. KYLE: Hi, I'm Pete Kyle, Professor at the University of Maryland where I teach a course on asset management. When you look at the last 30 years in the financial crises that have occurred, there are three of them that jump out as being triggered by asset managers. The 1987 stock market crash with the portfolio insurers. The 1998 collapse of LTCM, where it was hedge fund managers who played an interesting role as both principals and agents in their hedge funds, and then the role of mutual funds in 2008. What did we learn from the earlier stock market crash of 1987 and the 1998 collapse of LTCM about the systemic importance of asset managers.

MR. REID: Pete, it seems to me, and thanks for your question. It seems to me that one of the things that we learned. In each of those instances we learned that a focus on activities, rather than a focus on who might be involved and engaged in those activities. There may be many parties engaged in those activities. But the focus on the activity itself, you mentioned portfolio insurance, that was an activity in which many kinds of institutions engaged, but if that was the root of the problem, I'm not saying necessarily that it was with all due respect, I'm simply saying that's something that regulators then focused on as a source of amplification at the very least of the dynamics of markets as they unfolded during that period.

MR. REID: I guess the premise that asset managers were key to those three financial crises, I guess I would take issue with that. I mean fundamentally the 2008 crisis was one of leverage in banking. It started there. It continued and metastasized and continued to increase, and eventually as one market after another began to collapse, that then spread to other markets. And fundamentally that was not an asset management driven process. That was about leverage. It was about poor quality mortgage backed securities that were issued and then bundled together and sold off. And again, for the long-term capital management, again, it was particular hedge funds that had borrowed, borrowed from banks that potentially couldn't then repay those banks engaging in leverage there as well. So again, if there are activities that we want to look at that require further discussion and focus, I think, again, that's perfectly fine. This report does really to me seem to go beyond that though. Maybe that's not the intent. Maybe that's not where it's going now, but from a plain reading of it, when it came out, that seemed to be the direction.

SPEAKER: Thanks so much for coming today. I want to pick up on the last two things, pick upon the last set of charts your discussed, a complete analysis of Form PF, and (inaudible) leverage, because there's this inverse correlation between leverage and risk assessment. And in my mind as investor, one of the most risky things to do is not assess risk. So maybe if you'd just spend a little bit more time talking about the types of firms that that covered, and the lessons learned from that, in particular, I mean even the great sage of Omaha uses leverage, right? That's what we found out. What do we learn from that? Maybe (inaudible) on those charts a little bit more please.

MR. BERNER: Sure, thanks, Chris. You know, first of all, financial activity involves risk taking and the pricing of risk and the management of risk. And all three of those things are really important. Otherwise, there may be no return. Sometimes they go hand in hand. So, I would quite agree that it's not the question of whether or not leverage is being used. It's a question of how it's being used, how it's being managed, how people are aware of it on both sides of the transaction. That's really the key. The purpose of the analysis that we did in Form PF, was really to show that a preliminary investigation of the facts in Form PF, and it's a preliminary investigation, actually turns out some results that are contrary to the usual perception about leverage and hedge funds in particular. So, typically people expect that hedge funds employ a lot of leverage, and that that's associated with certain characteristics of hedge funds. And the purpose of this analysis to say, look a preliminary analysis of these data shows that actually the opposite is true. So it's not that risk isn't being taken. It's not that leverage isn't being used. It's just that it doesn't accord with people's priors. And the point there is to shine a light on the fact that if you look at data and you look at analysis, you may find that the results may contradict your preconceived notions of how things work. All we're saying is be open to the idea that we should look at the data. We should look at the analysis. We should be willing to shine a light on activities as we see them. That's really the point.

MR. ELLIOTT: I do want to say -- and maybe it's because I was in the markets for too long, but I was a little puzzled by the amount of time you spend on those slides, in that it seems to me someone who's working with dynamite will be more careful. Someone who's working with nuclear energy will be even more careful, but that doesn't tell us much about whether they're being careful enough for the risks there taking.

MR. BERNER: Well, that's a very good point, Doug. And I think that goes to my point which is, you know, that sometimes your style has preconceived notions, just maybe out of kilter with the risks. Somebody who's working with dynamite is likely to be careful, particularly if they've had some experience with it. Somebody's working with dynamite may not be so careful if they don't understand what they're doing.

MR. ELLIOTT: No, it's certainly true, and I do find, I did find it interesting, so I applaud you for putting that up there, but anyway -- Sir.

SPEAKER: Thank you. I wanted to ask you, Dr. Berner, at the last FSOC meeting you spoke about completing a heat map tool which will allow you basically to analyze different types of data gaps, macroeconomic risk, credit risk, funding risk, et cetera. I was wondering if you could talk a little bit more about that, and how it relates into your general conclusions and whether that's asset manager based or activity based.

MR. BERNER: So that's a great question. What's very interesting about your question is that it points out that this discussion we had, and this was at the last meeting of the council which was open to the public. We talked about a heat map that we were putting together, and I mentioned specifically that it focused on some of the kinds of risks that you mentioned -- market, macro, contagion risk and so on. Those are functional -- that's a functional analysis of risk. It intentionally does not focus on who's engaged in taking either side of the transaction there. It focuses on the risks themselves. In other words, it tries to focus on the causes of, or sources of risk, rather than on the symptoms. So it's deliberate in its focus away from institutions and towards the behavior itself, or the source of risk itself.

MS. DELHOY: My name is Monica Delhoy, and I worked for a long time in the World Bank. And now I work with (inaudible). I used to teach at Georgetown. And my question -- I worked on the intervention, and this morning I was writing to Hank Paulsen, and here's my question to you. The number one issue we had in 2008 when we were trying to intervene and stop the collapse was number one, funds and how you replenish them or they were not ready. Or the governance of the fund did not allow you to enter in the crisis and intervene. So the issue is replenishment and the second is what the issue we have is, whether it is IMF or World Bank. It's a private comment, and I worked on this also at the (inaudible) on how we intervene if it's a private versus a public, and how and what's your take when there's a blend between the two? So I tried to explain as plain as I can. Thank you very much.

MR. BERNER: Maybe I could just respond to that. You know, when we think about threats to financial stability, I think that the point is that we recognize when we look across the financial system we see how threats can spread across the financial system. It's clear that if there's a possibility that there are losses, we want to build more resiliency into the financial system in two ways. One is, and this is built into the council's mandate. One is to make sure that firms have more loss absorbing capacity, if they're going to be subject to losses. Now in the case of asset managers, just to bring it back to the topic at hand, the firms themselves don't experience the losses as both of us have said. It's the investors who experience the losses. But the important point there is that doesn't mean that there aren't losses. So that leads us to the second aspect, or one of the other aspects of the way that policymakers and the council are thinking about, and everywhere about financial stability, and that is to restore market discipline and to create the right incentives for people to engage in liquidity transformation, maturity transformation, risk-taking, use of leverage, all the things that go on in the financial system, but with an understanding of where the risks lie and what the trade-offs are. So if we create incentives or put in place guard rails to make sure the people understand those risks, that they take action to manage those risks, that's likely to build a stronger and safer financial system.

MR. REID: I just think one point here is that the way the investment advisors act, the investment company act is structured. It's applied to public or private firms. Those guard rails that Dick is referring to, that are already there. Are there for either type of asset manager or fund or the like. If ultimately the discussion here is about ways in which to refine those guardrails or find where there may be vulnerabilities, that's a very different discussion than one about whether or not we should begin to designate asset managers as systemically important financial institutions.

MR. ELLIOTT: In the back, I think this will probably have to be the last one.

MR. DELFIN: Rick Delfin with the systemic risk council. I had a quick question for Dick in particular, as to whether or not you thought about other products, activities and operations of asset managers that might pose a systemic risk. For example, the products you talk about are dealing with separate accounts. Clearly, that's one product, but other products might be money market mutual funds, or (inaudible) and those products are not really discussed in your report. I know money market funds are a separate issue, but that seems like other kinds of products. In addition, there are other activities, you talk about (inaudible) lending as an activity that might have a systemic risk, and repo, but I wonder about order cancellation, and high-frequency trading. Those are activities of asset managers that might have a systemic risk on the amount of liquidity in the system with the market volatility. And finally, operationally there was Waddell and Reed and their flash crash and the impact that that asset manager had just on putting a wrong order into the system. So I wondered if you looked at those issues as well, or if you just focused on the particular activities you talked about.

MR. BERNER: Rick, thanks for your question. It's good to see you. We miss you, where we used to see you frequently. So I think the answer to the question is, we wanted to focus in this report on the activities that typically asset managers engage in. The things that you're talking about are clearly subjects that both the council and we and other prudential authorities around the world are looking at. It's not that they're unimportant; it's just that we need to define the scope and breadth of what we're doing here. You know, those are potentially important issues, and work is being done on those issues, but they were not in the scope of this work.

MR. ELLIOTT: Brian, you have anything you want to add?

MR. REID: No, I think some of those very issues that you pointed out, the SEC is already looking at. You know, in terms of market structure, market structure reform and the like. And so they seem to be proceeding at the agency that has the primary regulatory authority here.

MR. ELLIOTT: Okay, well let's thank Dick and Brian, and then we'll turn it over to Martin Bailey for the second panel.

MR. BAILY: Well, thank you. I think we've had a terrific first panel, and

I hope we'll be able to match that in the second panel. We certainly have a good group of folks to discuss some of these issues.

So, we have three people who are speaking on the panel. The first is Paul Kupiec, who is a Resident Scholar at the AEI and was previously Associate Director at FDIC where he oversaw research on bank risk measurements and regulatory policy such as Basel III. He's also worked at the IMF, at J.P. Morgan, and at the Federal Reserve and has a PhD from the University of Pennsylvania.

So, welcome.

Our second panelist is Marcus Stanley, who's the Policy Director of Americans for Financial Reform and has been a frequent contributor to panels here.

So, we're very grateful to you, Marcus, for coming again and speaking with us.

He has a PhD in public policy from Harvard and has been the economic and political advisor to Senator Barbara Boxer.

Our third panel member doesn't probably need any introduction. After all, he was moderating the first panel, and that's Doug Elliott, who's a Fellow here at the Brookings Institution and has written a lot on financial regulation. He was a former investment banker at J.P. Morgan and a founder of Coffee, his own think tank in an OEI incarnation.

So, welcome to all three of you and to everyone here. We're going to start with Paul. You're going to make remarks.

I don't know if he needs help pulling up the presentation or --

Do you have slides to come up here?

MR. KUPIEC: Well, thank you very much for inviting me here. It's a pleasure to be here.

When I got the topic of this session that's called "What should we do?" my first question is sort of three questions: What should we do about what? -- all right? What should we do about the OFR study? And what should we do about the asset management industry? Or maybe what should we do about the FSOC SIFI designation process?

So, first I'm going to move and talk a little bit about the OFR study. The OFR study came out in September, and it was sort of this very unusual process whereby the Securities Exchange Commission asked for comments on an OFR report in 60 days -- actually, 30 days maybe -- and a number of people commented on the report. And, by and large, the report did not get sort of a very favorable rating. It's sort of been widely criticized as viewing asset managers as if they were banks. It's been criticized that there's no actual original research in the report. The report itself is sort of a very nuanced interpretation of the existing literature.

One of the particular things that people found problematic was while the report was asked for by the FSOC Committee, it doesn't really produce a framework for assessing whether an individual asset manager poses systemic risk. There's no framework in the paper. As I think you heard Director Berner say earlier, they focused on activities that are done industrywide and by banks and management firms, so it's not clear how this fits into the actual helping the SIFI designation process.

The report sort of focuses on things like herding and stretch per yield, which applies to all investors. It's not a particular problem just for -- or even if it is a problem -- I'm going to come back to that in a minute. It also mentions things like fees and conflicts of interest, which really are not the case for regular mutual funds that we think about where performance fees are regulated. It's more about hedge funds and maybe private equity and funds that are specifically set aside for sophisticated investors who are supposed to understand how fees work to incent people. And it talks about redemption risk, even though it's not talking about money market mutual funds or claims. I'm going to come back to the redemption risk arguments in a second.

It mentions a lot of issues with exchange-traded funds, although this is a relatively small class of funds compared to the whole entire industry, some of which do have leverage. It sort of deals with it as if the whole thing is a systemic problem.

It brings up issues with securities lending where lots of financial institutions do securities lending, and, again, this should be maybe a focus on the rules of conduct and not in a SIFI designation report.

So, if I had to summarize it sort of in one, I like to get a few pictures in every now or a cartoon. Ed Cain sort of taught me that. I was thinking, how would I summarize this, and one of my favorite movies, *Men in Black 2*, I just remember the scene when Kay is put back in the Post Office and somebody brings in this horribly wrapped package, and he says, "This is a case of go home and do it again," Mrs. whoever it was, and I just thought that that was maybe the reaction to the report, at least for me.

So, what should we do about the asset management industry? Here's my little -- that's the asset management industry. There's Michael Douglas with his big cigar. That's what guys do in asset management, I guess, I don't know.

Anyway, the asset management industry -- what about concentration in the industry? You know, why is it a problem? Well, first of all, asset managers are not banks. They've said that a bunch of times, people have today. Asset management firms themselves have very little leverage. The assets are owned by the fund participants. And outside of money market mutual funds, there's no guaranteed redemption value. The shareholders in these funds expect to gain in the profit and loss. And if we actually go to concentration in the industry -- I'm borrowing some slides from the Investment Company Institutes, so thank you in advance for allowing me to use those even though you didn't know I was going to do this. -- the concentration in the asset management industry, it's concentrated. The largest 10 complexes have about 53 percent of the assets, according to ICI in 2012, and that's increased since 1995 from about 47 percent. So, the growth in concentration, it's concentrated. The growth isn't all that extreme, and in the bottom panel you'll see I borrowed a panel from a New York Federal Reserve Bank article on bank holding companies, and you can see the dark line there is the concentration level -- and it's on the left scale -- of the top

10 bank holding company assets under management, and it starts well below, it saved 21 percent in 1991 and grossed to something like 65 percent and this ends in 2011, so maybe it's even grown since then. So, the growth in concentration and holding company assets in the banking system is sort of much more of an issue probably than it has been in the mutual fund industry.

So, industry concentration has increased over time, but one of the interesting things about the mutual fund industry -- I'm going to borrow from the ICI's report -- is that mutual funds enter and exit the industry all the time. In fact, mutual fund liquidations -- liquidations of actual -- liquidations of funds are not particularly uncommon, right? There's a lot a year, almost, you know, one a business day in many years, and there were two a business day in 2009, and it's not a very big deal, unless a money market mutual fund breaks the buck, which occasionally happens -- you know, actually not that often. But there's entry and exit, and mutual funds merging or liquidating are sort of not front-page news all the time, which makes me not worry so much about it.

You've already seen these two slides. Brian put them up and spent a lot of time on them, but I want to talk a little bit about herding and this notion that there could be redemption and fire sales. Now, the OFR report pulls its information from mutual fund studies that are already in the literature, and if you go to the references and you look at the studies in the literature, the studies in the literature do say that when mutual funds -- equity mutual funds mainly -- experience big outflows, they have to sell assets and asset prices fall. Not a surprise.

What they also say in another part of these same studies is when these mutual funds have big inflows they have to go out and buy assets, and that raises the price of assets. Well, the OFR study I have a particular issue through, because it focuses only on the negative side of these graphs, and it calls those fire sales, because that's a very cool phrase in banking right now. So, when they sell assets, it causes fire sales. But what about when asset prices go up when people buy mutual fund assets? There's obviously price pressure there. Is that a systemic risk? Or is it we just can't have losses, I guess. I don't know. To me this is supply and demand, though, and it's really an issue about supply and demand, and the fire sale critique that's put on these particular studies is really not appropriate.

So, another issue that we need to think about is that the designating the largest asset management shop as SIFIs would impose costs on investors. Investor cost and fund size are very much linked, and I'm again borrowing from the ICI fact book. Investors reward asset managers that are efficient, because they tend to put most of their money in asset managers where the fees are small. So, if you look at these charts, these are different asset fund categories, and the green is for the percentage of funds that have fees in the lowest 25th percentile. So, the cheapest funds have the most assets under management -- 72 percent, 69 percent, 80 percent -- whereas the most expensive funds don't have many assets under management. So, investors seem to be pretty rational this way, and they reward funds that are cheap, right? They do what they want them to do in an inexpensive, efficient manner.

I would remark that this is unlike large bank holding companies where the evidence the depositors pay higher fees and get lower interest rates in the too-big-to-fail banks.

So, anyway, I think investment companies have something going for them here, and investors pick it out.

So, what about the FSOC designation process? And if I had to think about that -- that's my slide there, and that's an old clip from the *Son of Frankenstein* (laughter), and if you look in the clip of this thing, there's actually an existential debate that goes on behind the scenes here, and it's really highbrow, and it says, "Was Frankenstein born evil, or did somehow his environment make him evil? So, if you think about Dodd-Frank and the designation process, you can think whatever you want about that.

But anyway -- I have some words, actually. I didn't want to go thank you yet.

So, the SIFI designation process in my view is a mess, right? There's a little science involved and a whole lot of politics. And designation leads to what when –it's a non-bank SIFI.

Bank capital and liquidity rules? How does this make any sense? These are not banks most of them. How will this reduce financial sector risk? This is what we were looking for in the FSOC report. T–he OFR should have been producing for the FSOC, and it just wasn't in there.

So, the politics. If you look at who they've designated, you have GE Capital-AIG; these are big tarp rescue recipients. They were big users of the

FDIC's TLGP program, so both of these, politically, we're very much a must from the FSOC SIFI designees. How was the FSOC not going to designate these guys.

You look at Prudential, Prudential applied for TARP, and it was approved for TARP money but it turned TARP money down. As far as I can tell in the FDIC records, it did not use the temporary liquidity guarantee program to issue any debt, and maybe you might not be shocked that what Prudential was designated it was pretty unhappy about, and it's the only firm that I'm aware of so far that's appealed the ruling. And who do you appeal to? You appeal to the FSOC, and of course the FSOC said, well, we'll think about it again and, oh, no, you're a SIFI. So, they lost. They didn't get it.

So, MetLife also did not take -- MetLife, to my understanding, is still under consideration -- it did not take TARP, but it did use the FDIC's TLGP to the tune of about 14 billion. So, in my view, probably they're toast, but they haven't been decided upon yet.

Prudential was designated, appealed, and lost; MetLife is still under consideration. One of the interesting things about the Prudential case is -- and you go out and read it, the FSOC dissenting opinions on Prudential -- the three agencies or the three FSCO players that dissented were the FHFA, the state insurance commissioner FSOC representative, and the FSOC independent member with insurance experience. And all of these opinions, if you read them, are very thoughtful, and they raise a lot of concerns about the basic FSOC case made for the SIFI designation in Prudential. All of these dissenting opinions criticized the FSOC designation process. They say there's a pervasive banking buy in the way the FSOC thinks about these things. It treats every investor claim like it's a bank deposit that will run even when there's no evidence to support these assumptions.

The FSOC ignored contracts and regulatory features that prevent runs in insurance products. The FSOC report even criticized the fact that in state insurance companies or (inaudible) by state regulation to prevent contagion, so you can kind of control risk in the funds. And it said this could inhibit a resolution process. So, it's kind of strange.

And the independent insurance members too issue with this. You know, something that's worked so well for so long, why is this a risk? Why is this a problem? None of the FSOC members that wrote these dissenting opinions found the case compelling, and one of them (inaudible) asked, well, what exactly does the Prudential designation fix? There's no designation in the FSOC ruling what Prudential could do to de-SIFI-fy, right? It doesn't really say why Prudential's a SIFI or what features make it for SIFI. It's just bit, and it could be a problem. And there are no specifics that would allow Prudential sort of to get of this designation. And that's the dissenting issue.

So, what does it look like for asset managers? If you look at the existing decisions so far, I would say the picture is not very pretty. I think the FSOC seems inclined to take asset size alone as a pretty compelling factor. And one of the interesting things is if you think about what Dick was talking about and some of things brought up about hedge funds and leverage and ETFs, the largest asset management complexes are not the guys doing this mainly, right? This is not really a debate, unless it's changed a lot, about designating hedge funds; it's really a debate about designating the biggest players it seems to me, unless something's changed.

So, I expect that the reports on the FSOC asset manager will assume that their assets run just like a bank deposit and will treat it like a fire sale externality and that sort of thing. And one of the telling features is -- and the OFR report mentions it -- is the money market mutual funds at the bank holding companies are already subject to stress testing under the Federal Reserve stress testing account, because they're in a holding company, and maybe the peeling on the outside (inaudible). Maybe we should get them all under it, I don't know. I'm not privy to that.

But, again, what framework is in place to reduce the risk? Bank holding company rules -- why do these make sense for these kinds of firms. Why does more capital in the management firm (inaudible)? Are shareholders going to expect then to bail out funds when they break the buck and other things? This just doesn't -- the framework is not in place, and the issues have not been clearly identified.

So, I will now say thank you and see you at questions.

MR. STANLEY: So, I thought there was a rather surprising amount of agreement underneath the disagreement in the first panel, and I think there's going to be a certain amount of surprising agreement in this panel as well, although I think our emphasis is going to be very different. My emphasis is going to be on the first part of this, that there shouldn't be any question about the systemic risk posed by the set of activities that we put under the label of "asset management," and it's very important to address those systemic risks. But I also think there really is a very open question about how best to regulate it, and that question circulates around the question of what are we doing with designation, which is what Paul raised here. What is designation for, and what does designation imply?

Now, I think FSOC was kind of caught in the middle of that, because, really -- and the third point there is I think what we're looking at in this whole situation is some really disturbing and troubling problems with the fragmentation of our regulatory system, because, really, that question about what designation is for and what implies -- you really need the participation of the Federal Reserve to answer that. They're the people who are going to write the rules for designated entities.

So, we're really seeing the regulators approaching a really critical question: how to regulate the systemic risks involved with asset management. But we're seeing a very sort of disturbing process that seems to be highlighted by turf wars and public squabbles between the regulators where instead it requires very tight cooperation. And I'm going to suggest that's because of the fragmentation of our regulatory system, which is really constructed for a Glass-Steagall world of functional divisions that doesn't really exist anymore.

Now, some of what I'm going to say in here -- I sort of figured that this would happen -- was covered in a lot of detail in the first panel, which I thought was very good, but the argument on asset managers is always that asset managers just deploy other people's money, you know, what's the problem? Well, most of what goes on in financial systems is, in some sense or other, deploying other people's money, and there are lots of problems that can occur.

We've heard a lot of talk about pro-cyclical hot money and how this can create bubbles. Well, it's been raised isn't this just the financial market, isn't this what people do? They pursue yields in financial markets. Well, guess what. Asset bubbles are something that is inherently a part of financial markets, too. You can do an experimental asset financial market in a classroom with full information on the underlying value of an asset -- you'll still get a bubble. And, guess what, bubbles are a macroeconomic problem. I mean, how many speeches and how much discussion do we have to see from the Federal Reserve about how to asset address asset inflation, how to address asset bubbles. It's the only way to do it through the blunt tool of interest rates, or can we use financial regulation to do it? Well, this is what we're talking about here: How can we use financial regulation to potentially address asset bubbles?

Also, the second and things here should really kind of just be slid together under "liquidity and maturity transformation." Obviously I don't mean just promises of short-term liquidity. You can redeem anytime from a fund. But the promise of a short-term stable value and then the use of money given to a fund under a promise of some kind of short-term, stable value or at least low volatility and the use of that money to invest in longer-term assets or longer-term credit, and that's liquidity and maturity transformation. And the reach for yield is particularly a problem in this context, I think, because there's a have-your-cake-and-eat-it-too element of what people selling products in the financial markets try to do. The try to say, hey, this is really safe; it's going to have a reasonably stable value over the short term; but, on the other hand, it's got a bigger return for you than anything else that's safe -- right? As I said, that's having your cake and eating it, too, and, not surprisingly, that's the kind of promise that blows up in peoples' faces, and that's the kind of problem that you can see from asset managers.

The use of implicit and explicit leverage and a potentially expanded role post-Dodd-Frank that hasn't gotten much attention yet that I want to about. But the thing we hear when these things are raised is these don't count. You know, it's don't regulate me, regulate the guy behind the tree. This is somehow outside the space that we're supposed to be talking about with asset managers. In the case of liquidity and maturity transformation, oh, well, that's money market funds and that's happening in that rule over there. Well, asset managers are the sponsors of money market funds, and money market funds have kept their stable value over the decades by hundreds and hundreds of sponsor interventions over the years. This has been well documented. Where are these sponsor interventions coming from? Well, they're coming from asset managers. That's actually -- in most cases, not all, but in many cases -- and that's actually one of the cases where asset managers do look a little like banks.

So, say we did do a good regulation of money market funds that addresses the issues in money market funds implicitly making it harder for the managers of money market funds to make that have-your-cake-and-eat-it-too promise to people, that I'm going to give you a high return for a short-term stable value. Well, we could expect to see other kinds of funds making that same kind of promise. And we're already seeing those kinds of funds -- short-term liquidity funds -- that aren't necessarily money market funds.

And, likewise, in terms of the use of leverage, we had this compelling and powerful -- Brian gave this compelling and powerful and eloquent defense of the Forty Act in the first presentation, and I loved that, because the Forty Act is significantly tougher than Dodd-Frank. If we could go out there and put the protections of the Forty Act out there for everybody in the financial markets, that would be awesome, and AFR I think would support a lot of that.

But of course there are many, many entities out there that are run by asset managers that are forms of funds that take advantage of various exemptions from the Forty Act. So, when you focus on the Forty Act, you're not getting the whole universe of funds.

And in terms of run risk -- this is the run on money market funds that occurred during the crisis -- you see in a period of one month 25 percent of prime funds run. They mostly run to government funds. You lose $500 billion. This is why the United States government had to get behind and bail out the entire sector. That's a run leading to a government bailout. It doesn't get much clearer than that. And this is what happened in the securities lending market -- well, not just the securities lending market but the overnight repo in the commercial paper markets. That financial commercial paper -- when people were running from the prime funds, the prime funds were the customers for that commercial paper. That commercial paper was the mechanism that let them fund these longer-term assets that created the maturity in the liquidity transformation I was talking about, and you see a complete collapse, you see a collapse of over 50 percent in both of these markets -- securities lending and the commercial paper markets -- and that's where you see M2. The normal money supply doesn't do very much, but the supply of financial-sector-generated money just collapses catastrophically. And the asset manager industry, as a major sort of customer in the repo markets and as a major purchaser of financial commercial paper -- had something to do with that.

And I think looking back at the financial crisis, looking back at 2008, the securities lending market is really the mechanism through which a lot of this happens. When you look at the systemic impact and implications of fund behavior in 2008, some of it I think did occur through the exit of -- through sort of herding behavior. But, really, the securities lending market is the epicenter and funds were incredibly important participants in that in all kinds of ways.

But now we look at what's going to happen in post-Dodd-Frank. If you just look around, you can see numerous observers of the market saying that funds -- it's mostly hedge funds -- that funds are going to get more involved in the direct lending sector, that as we see things like the Volcker Rule and capital provisions changing the equations for the big banks on liquidity provision and the corporate bond market on things like prime brokerage, you could see asset managers stepping in. You know fidelity is already the tenth largest prime broker in the financial system.

I think that this relates to something Rick Delfin said in his question regarding electronic trading. I think one of the directions in Dodd-Frank, both through the Volcker Rule and through the standardization of derivatives, is more movement to trading of standardized instruments in electronic markets. Well, depending on how an electric market is designed, you can get a very wide range of liquidity providers. Basically, the person with the biggest securities inventory potentially has the power to end up being one of the most significant liquidity providers, especially in all-to-all markets where anyone can interact with anyone else on an anonymous basis. You can very easily slide into being a market maker, and that may already be happening.

I think one thing I didn't put up here that I think is quite important is the Jobs Act and general solicitation for hedge funds. You know, you're going to be able to do -- we haven't really seen exactly the protections that are going to be on this, but potentially you're going to be able to call grandma's nursing home and advertise a purchase of a hedge fund to her. That's going to create some really interesting bubble dynamics. And then we just have all the interconnections with the banks. I mean, you can see it's just visible that about half of the top U.S. asset managers are owned by global SIFIs, and then there are all kinds of other connections, I think, going on behind the scenes. This is not a hard-to-see connection; it's just one I was ignorant of. But how many people knew that PNC Bank owns a fifth of Black Rock. I actually didn't know that. It was probably my ignorance. But I think there are a lot of connections buried away in there. And I think that the OFR report -- which is coming for so much abuse -- mostly is sort of a preemptive strike on designation and was simply, in my perspective, raising these issues for a discussion, a discussion that's long overdue.

But I think that the reaction to this report has really been disturbing. We've seen kind of a turf protection and a turf war reaction in which the industry has been enlisted kind of by one regulatory agency to criticize another regulatory agency, and to me that's a very disturbing thing to be seen when what we need is cooperation by the regulatory agencies. And as I said at the beginning here, the U.S., unlike Britain and some other countries, is living in sort of a Glass-Steagall regulatory system that assumes functional divisions so that our regulatory system actually sort of is built around this assumption that only certain kinds of entities can do certain kinds of activities, whereas the reality now is that these activities are spreading across all kinds of entities, and if you regulate one entity in one way, the activity can very easily migrate. The purpose of the FSOC was to make our regulatory system, I think, flexible and cooperative enough to handle this situation, and so far the reaction to this report and money market funds -- the preliminary returns on that are not very encouraging.

I think the dynamics here -- the Federal Reserve doesn't trust the SEC as a prudential or systemic risk regulator. I've attended speeches where the hot prominent people of the Fed basically said the financial crisis was, to a significant degree, the SEC's fault. The SEC likes its regulatory focus and its traditional relationship with asset managers and sees the Fed is potentially intruding on that, and the FSOC is kind of stuck in the middle, and the OFR, not even being a regulator, is even more stuck.

So, what role does -- I know I'm running a little long, but I'm getting right close to the end here. I think this question we have to answer is what role does designation play? And this has been a very economist-heavy couple of presentations, but to me this is a legal question as much or maybe more than an economic question, but the issue to me is: Say that I've decided that such and such an activity, say something to do with securities lending, is something that needs to be regulated wherever it occurs in the financial system. And then I as a regular go and say, aha, you over there, this fund or this investment or whatever, are doing this activity and I'm going to say that you have to reduce your leverage somehow when you're performing this activity. And then they sue you, because you don't have the sort of prudential jurisdiction over them as an entity. I mean, what do you then? You go search throughout the regulatory system and you go to the other regulator and you say, okay, well, you should regulate this activity the way I think that it should be regulated. And that regulator may or may not agree with you, and by the time you've hashed it out, you know, it's a couple years later, potentially, and who knows what's happened to that activity.

And legitimately there lots of ways to regulate the systemic risks associated with asset management. You can go all the way to the security level, which you could do in securities lending, and think about the haircut attachment individual security. You could go to the security level, the fund level, the asset manager level, the subsidiary level, the subsidiary of the overall entity that is the asset manager, or you could do it up at the asset management level. And I think you need to know something about what you're doing and why you're doing it to figure out what's best.

But I think there's sort of a temptation to say if we want to make sure, under the American regulatory system, that we have the legal jurisdiction to what needs to be done, and if we want the Fed to be our lead systemic regulator, then maybe we have to do this sort of catchall designation of big entities just to make sure that when push comes to shove the Fed has the legal jurisdiction.

I mean, if you look at the Federal Reserve plan to regulate short-term funding markets, which I think is going in the right direction and is very important. They talk about controlling haircuts at the security level, and they talk about capital add-ons for important players in securities lending markets. Does this require designation? And who does it require designation of? I asked the Fed this question, and they said, well, you know -- tellingly they didn't directly address it -- they said, we think we have legal authority under margin lending, under our old depression year ability to regulate margin for securities purchases. So, the Fed has the ability to say how much margin you can use in a securities purchase. Well, I can imagine the lawsuit there. You know repo isn't a purchase, and you have no prudential authority over us, so how do you do this? Could the Fed pull this off just by regulating particular utilities that are central in the short-term funding markets. I'm not sure. This is sort of a question for lawyers as well.

So, what's so disturbing to me is that it seems very clear that asset management is linked to financial stability. It was linked in 2008. Even if we get a good money market fund rule, there's plenty of capacity to sort of morph the sector, so some of the same dangers could arise, it seems to me, though I bet Brian will disagree. And we really need to cooperate and think hard about exactly how to do this, and so far the situation here has looked more like a turf war, even though, as I think we saw in the initial panel, there's actually a lot of underlying agreement about potential risks.

MR. ELLIOTT: Hello, again. No presentation, but I do have some thoughts about what the others have said so far. I don't want to get sidetracked, but I do want to comment on what Paul was saying. I do actually think that we need the authority to designate nonbanks systemically financial important institutions. There can well be such. I think there are some, and if we don't have the ability to make that designation, then we're not going to have the authority to deal with some institutions that can have a big effect on financial stability. So, I don't have a problem with the idea of this or of having the FSOC be the one to do it.

I also think that asset managers are clearly important for our markets and therefore forced in financial stability. I don't happen to think it's likely that any of them at this point in their existence are truly systematically important financial institutions. I'd need more information than I have to be absolutely sure of that conclusion, but based on what I know and my intuition it seems unlikely.

I do, though, think, based on what I was saying about the sheer importance of this sector, it clearly needs to be better understood by FSOC, the OFR, and regulators; and it needs to be monitored. So, I am glad that the OFR is doing a report, that the FSOC is looking at this. I think it would be a mistake if the fears of the industry came true and it turned out that this was just a prelude to designation by editing.

Now, several points there. One is I really haven't looked enough into the money market fund issue. Like most of us here, I'm just going to put that to one side. That does look a lot more like banking than many other things. But putting that aside, I'll stick with what I said.

In addition, it is possible, as Marcus was talking about that changes in what asset managers do over time as a regulatory arbitrage pushes activities toward them, they could develop to where one or more of them did deserve to be designated as a SIFI. I just don't think we're there now, and it makes sense to keep watching.

A big reason I don't think we're there now is something I was sort of foreshadowing in my question to Dick earlier. It seems to me that while it's true that asset managers touch many things that create systemic risk, when you do a catalogue of everything that they are in any way associated with that could wrong, it can look pretty scary. I think they actually create or amplify very few systemic risks. Not none. There's definitely some associated with the industry. I'd just be surprised if it crosses the threshold at any given firm. And in most activities I don't think it crosses the threshold.

For example, again as I was kind of foreshadowing with Dick, I was bothered a bit in the OFR report by the way in which there was emphasis on reach for yield and herding. To the extent it exists, I think it exists because we have financial markets and we have humans making decisions in those financial markets. And I know Marcus was touching on those issues, too. He came to a little conclusion than I do. But I don't see where -- I mean, you could take -- this is an extreme way of putting it, but you could take a sort of Stalinist approach and say this stuff flows through the asset managers, so they're the place where I can do something about it. But I'm a little leery of trying to regulate normal human market behavior in terms of basic decisions about what do I want to own and what don't I want to own. Trying to regulate that by taking one class of financial players where the money flows through and gets pulled together and say, I'm going to keep them from doing these things in hopes that this will improve financial stability overall. It might even work in the short run. But I think what it will mostly do by limitations on the abilities of asset managers to operate is it will push the business towards people where there aren't those restrictions who are likely to operate more I the shadows anyway and probably to the extent to they're contributing risk will contribute more risk. Same sort of thing with redemption risk. To the extent their redemption risk is just about people deciding they don't want to own this thing anymore and it happens to be owned by them indirectly through the asset manager, again I see that as a market-based risk, not one that is created or even, in most cases, amplified by the existence of asset managers.

I don't want to carry this too far, but there's even an argument on the leverage side. To the extent that the buyers of these funds that have leverage wanted the leverage, there are other ways for them to achieve it. You might argue that individuals, less wealthy individuals in particular, might not have access to the ability to do that, so maybe it would somewhere reduce leverage by putting restrictions on it or at least watching it carefully. But much of it could be achieved anyway.

Another key point, and I think there's been a lot of emphasis on this. It's really important that we don't talk about asset managers as one large category. They're very different. There are many different subcategories. The types of risks that exist are very different in those subcategories. And I can see as a first cut why the OFR took the approach they did. But I think we should very quickly towards looking at a more detailed analysis.

So, having said all that, I do think there are some legitimate areas of potential concern that we ought to be watching. One is leverage. I'm sort of two minds about leverage, but certainly leverage significantly increases the possibility that a thing that goes wrong goes really wrong. And so we just need to pay attention to where it exists and how it influences the markets. I do have a concern, and think it was Paul maybe who was saying he thought the concern was overstated in the OFR report. I do have a concern about fire sales. The reason I have the concern about fire sales -- again, I want to separate out what would happen just because of normal human behavior from what might be added effect because of the existence of asset managers. But fire sales are a key mechanism that we saw in this last crisis by which the core financial system can be affected by more peripheral parts and where the larger economy can be impacted.

I have concerns about exchange-traded funds. Now, this literally may be because I don't understand exchange-traded funds. I would need to look at this more. But nobody has yet shown me why I shouldn't be worried and it is something I should learn more about, because I think it's an example of what Marcus and some of the others, Dick, were talking about was liquidity transformation. Now, liquidity transformation is not automatically a bad thing at all. In fact, on the whole I think it's a good thing for society if properly done. But if you get a sort of hidden or false liquidity transformation, and it's something I worry maybe be happening with some of the ETFs where people buy them thinking they've got hourly liquidity without capability of losing very much if they do pull out. And in a crisis they just not have that. That would be a concern to me. That may be more of an issue of how these things are sold and understood, but even if it's just that, it's important.

Securities lending clearly has systemic implications, and we need to look at the rules of the asset managers in that and understand that. And of course money markets I'm just going to punt on again.

I think the OFR, though, is taking the right approach in the sense of reading between the lines a little bit. I think they're kind of saying you might not want to designate any of the asset managers as SIFIs. That may not be the right way to go. But you may want to do things about some of these activities that concern us, at the very least monitor them closely.

If that's what they're actually thinking, and it's difficult to say, it's probably not that different from my view. I do think a number of these activities we need to understand better. Some of them -- I think there doubtless are ways that we can improve how they're regulated. But it doesn't seem likely that these things add up in individual institutions to create systemically important financial institutions.

Thank you.

MR. BAILY: So, thanks to all of you.

I thought that was a really interesting discussion, and I thought we did have some lively disagreements actually, Marcus, which (inaudible) to see. (Inaudible) life more interesting in this discussion. I don't have particular a horse in this race, but I want to sort of see if we can bring out the issues a little more clearly, a little more forcefully, although you were pretty forceful. There was no need to press you in that direction. Now, what the report says -- you were pretty dismissive of the report. "Go home and do it again" was, I think, your summary conclusion.

Now, what Dick said they were trying to do was identify some ways in which there could be systemic risk in the asset management industry: reaching for yield; herding; redemptions leverage; behavior within the firms, risky behavior; and also data gaps that they mentioned. And that was something that Dick drew attention to, that you don't know a lot about some of these assets or where they are, whose they are, and so on.

Now, your criticism was, well, they should be focused on SIFI designation, but weren't they trying to identify some of these risks and therefore give the FSOC the tools it needed to decide whether a particular institution should be a SIFI or not. How much did it have in these potential risks.

MR. STANLEY: Well, it did speak a lot to activities. What it did not do was tie these activities to any particular firm. It spends a whole lot of time in introduction, detailing who the largest firms in the industry are and how many assets they have under and focuses a lot on separate accounts, which are co-mingled accounts. Their accounts were, you know, hire an asset manager to invest your money, and they're not subject to reporting, because, well, they're not supposed to be. So, it tees all that up, then it sort of tries to create lots of concern about these generic risks that arise in all kinds of places in financial markets. They're not just in investment. It did not serve the purpose of linking the activities to any particular firm in any particular way. Now if it had concluded that why we think these activities are perhaps or systemic risk would arise and here's what we need to link them to particular firms, which is missing, but it didn't -- when I read it, it didn't really come across to me that way at all. It wasn't directed in that direction I don't think.

MR. BAILY: Well, let me press you again a little bit in the sense that one of the things that there's been a lot of discussion about with Dodd-Frank, in Dodd-Frank, and then post-Dodd-Frank is we need to go beyond just the banks that are regulated regularly by the OCC or the FDIC. We need to know something about shadow banking and where all this other stuff lies that could create risks or that maybe to some extent did create risks in the crisis. So, you say, well, they describe these risks, but these risks are all over the place. But so what. They're trying to whether these risks exist in asset managers, aren't they? And that was there task.

MR. KUPIEC: There are many studies and other studies that speak to money market mutual fund risks, to ETF risks. The report actually cites some of these in the references, but it doesn't actually mention that these kinds of things have already been covered. It sort of treats it as new ground, and these are financial firms and they have risks. These are some of the risks that might arise. I did not find it a constructive framework to go forth and assess any particular firm as one that would have the Dodd-Frank requirements to require a SIFI designation. Most of these activities are activities where conduct rules or other kinds of SEC rules. The FSOC could ask the SEC to strike the rules on certain kinds of activities, but that's not a SIFI designation. And the report, the way I read the preamble and the news, was that this report was done to help inform the FSOC how to make a SIFI designation in SM management industry. So, to me that's why I send them back home.

MR. BAILY: Okay, Marcus, I don't know if you want to comment specifically on that, on the SIFI designation, but you spent quite a bit of time talking about money market funds that clearly got into trouble in the crisis, and there was excess, and you showed the chart with the excess mostly I think the wholesale funds, the prime funds that got into trouble. But my sense is from the other responses is that there's a sort of a line between money markets, which, yes, we had to have some new rules and we have had some new rules about money rules versus asset managers that are handling people's retirements or rich people and their wealth. So, you're kind of lumping those two together, and my sense is that the criticism is that they're not the same. We've got new rules about money market funds, so why are you putting up stuff about money market funds when we're really talking about a different animal?

MR. STANLEY: Well, I would say a couple of thing, first of all that the new rules don't really do the trick. I don't think that a floating NAV -- particular a floating NAV is somewhat limited under the SEC proposal -- is necessarily going to prevent runs in these kinds of funds. I think historically the stability of money market funds in normal times has frequently been maintained through sponsor intervention. Those sponsors are often asset managers. You know, it's kind of complicated who within the whole loose network -- an asset management is almost a brand name, and there's an overarching -- there's an ultimate parent entity maybe, which used to be a phrase in antitrust. But then there are these different subsidiaries under it. But those sponsors have usually been somebody in the asset manager family.

And the third point that I was making is that this promise of short-term liquidity at a reasonable stable value, along with returns that beta the market, is just a super attractive promise, and if you regulate money market funds and you take away a couple of the tools they use to make that promise more tangible to people, I think there are other kinds of funds that are going to come along and make similar sorts of promises to people, and they're going to be vulnerable to some of the same dynamics. So, I don't think that this problem of liquidity and maturity transformation and wanting to sell this have-your-cake-and-eat-it-too promise goes away, certainly not based on the SEC's proposed rule.

MR. BAILY: Well, if we were, hypothetically, to separate money market funds from the rest of the asset management industry, is there any evidence in this crisis or in previous crises that the asset management industry itself, aside from money market funds, which are a bit of a funny animal -- they were sort of an arbitra created in response to arbitrage -- but is there any evidence that they caused any problems in the crisis or that they've caused problems in previous crises?

MR. STANLEY: I mean, I thought Pete gave some pretty good examples. There is some literature showing that the behavior of mutual funds -- specifically, that they rapidly shifted their country waiting in response to the beginnings of the crisis -- did really impact the international spread of the crisis. And that's a tricky thing, from the U.S. perspective, because one of the things that happens when you have these global crises is people run to the U.S. So, it's a little bit the international transmission is a complicated thing. It can actually stabilize U.S. financial markets sometimes. But there's been a lot of discussion, I think, in the financial crisis about the ways that the fund flows, you know, kind of serve as this channel for hot money.

And I think another thing that wasn't discussed -- we saw a lot of discussion from Brian of the equity funds in the first panel, but the commodity boom of the last couple of years -- which I think did play a role in 2008 through the oil bubble -- the commodity boom I think was related to asset managers figuring out how to turn commodities into a tradable asset that they could sell as liquid and giving you reliable exposure to something that diversified you from the stock market. And funds are a part of the business of inventing these new forms of assets we see with the exchange-traded funds, and as that happens, lots of stuff can occur. I could go on.

MR. KUPIEC: I'd like to pick up on a point you mentioned that funds can transfer risk and things like that. In fact, the FSOC I think, when the European crisis first came on, was very instrumental in encouraging U.S. money market mutual funds and bank funds to get out of European bank paper, so I don't know if it was the funds that ran from Europe, or maybe it was a little of advice, but it was a little indigeneity problem in how that went on, because I think if you read the FSOC reports and what was going on behind the scenes, they basically told them, yeah, get out of that, get out of that European bank paper, so we chuck that one up to the asset managers herding and funding or we chuck up to the supervisors. I don't know.

MR. STANLEY: I think in 2011 it definitely happened In 2008 I'm not so sure about that. And the literature I was talking about was '08, but I take your point.

MR. BAILY: Doug, can you comment on some of these issues?

MR. ELLIOTT: Sure. Let me step back and make a really perhaps overly simplistic point, but I think it's worth making. You know, when I've talked about the life insurers and the ones that have been designated, I suspect that was probably the right choice. But what I've said about the life insurers is it's clear to me they have significantly less systemic risk per dollar of assets. It's just some of them have a hell of a lot of dollars of assets. When you multiply the two, they plausibly still cross the line.

My point with the asset managers is I can see a number of ways in which they might create some systemic risk or the amount by which they amplify systemic risk could be noticeable. But I just think for every dollar of assets they own, it's a pretty small percentage. So, I do think we ought to be looking at these activities to see if there are ways to regulate those so that wherever they're being done they're being done more safety. It's just fairly implausible to me that the total amount at any one firm is enough to make them a SIFI.

So, I want to clarify something you picked up on. I am not saying that asset management firms can't generate systemic risk. I believe they probably could in many ways or that one couldn't rise to the occasion that it should be a SIFI. What I'm saying is we don't have a framework yet that identifies that. Moreover, we don't have policies and procedures that are in place to understand what would happen if we did designate it as a SIFI and what it would fix. More capital at the management company top level? I don't know how that fixes any of these things below. So, we don't have the framework yet. We're ahead of ourselves. And we're not really even sure what systemic risk is and how to measure it, so when we cross the line, the line's pretty fuzzy still, and that's the part I'm reacting to. It's not that it couldn't be. We're not there yet.

MR. STANLEY: Can I make a --

MR. BAILY: Sure.

MR. STANLEY: One is, I think the OFR is in an incredible verging out impossible position with respect to this, and I think, first of all, that they deliberately did not set up a framework aimed at the individual asset managers, because they -- what I heard is that they didn't want to get the report to get attacked as making argument for designation of firms before they felt they had enough evidence to do it. But, of course, damned if you do and damned if you don't. Now, they're getting attacked for not being specific enough. But the OFR is actually not tasked, really, with coming up with that framework and I think would get in some trouble if they sort of went out there and set up the framework for what the Fed is supposed to do when they designate beyond the very general stuff that's in Dodd Frank.

So, this is why I said there's really a requirement for very sort of close detail behind-the-scenes cooperation between the regulators, and instead you have in-front-of-the-scenes squabbles. I can't ever remember an agency putting out for comment another agency's report. That was pretty striking.

And just the last thing that I sort of have to say, because I represent an organization and we have positions, but I believe it -- I wasn't meaning to say that the designation authority -- I just want to agree with Doug -- the designation authority is really valuable. There are lots of things that entities out there do where they make guarantees, they make liabilities, they have liabilities that could be called on, on a very short-term basis, and they need some kind of reserve money to back that up. Insurance companies frequently do that, and they do that for financial guarantee products that are deeply correlated with the rest of the financial system and are quite similar to things that banks do. So, I think it's important to have that ability for designation.

MR. BAILY: Let me throw it open to the audience and see if get some questions.

Yes, here on the end and then --

SPEAKER: Hi, Ed (inaudible). I'm an analyst with (inaudible) Analytics.

I guess a lot of this keeps coming back to securities lending and how do we find the demon in securities lending, and I guess when I look at securities lending it seems like the actual institutions that are doing lending on the prime brokerage firms or the custodian, and when we peel back the onion on that, I mean, it's going to wind up -- we're going to be back at the banks again. It's not the asset manager that's physically lending out the securities, but those go into a custodial arrangement and there's agreement with the custodian whether they can lend out those assets or not.

That really -- if it's a fidelity managing the account for a pension fund, it's not fidelity's decision to lend those out. It's the pension fund's decision, specifically in a separate account, to lend those out, and then it's the custodian bank that actually physically lends those out on behalf of that client.

So, I guess I'm kind of confused on where we're going with securities lending and how we're going to address that risk via the asset management industry. What are the vehicles there? When it seems like it's really held outside and when you come down to it, it J.P. Morgan, Deutsche Bank. It's bank in New York, Mellon, right? It's State Street. Those are where the issues are going to come in with securities lending.

MR. BAILY: So, your question specifically is?

SPEAKER: How do we address systemic risk with securities lending be the asset managers when they're not really the driver of the decisions to win those assets?

MR. STANLEY: Well, I'm the one who made the big fuss about securities lending, or one of the ones. I mean, I think this is why you need -- you know, this is as much a matter for lawyers as it is for comment. The issue is where the ultimate decision comes as to -- you know, I mean, a lot of people use securities lending to (inaudible) their returns for their final -- for the final investor. I'm sure asset managers are involved with that at some point. Exactly who has the legal authority to make the final decision and also to direct that in terms of selecting the counterparty and how that works -- you know, I've got to admit that I don't understand every detail of that, and I would bet that it varies by fund and by the type of fund and maybe even by the type of contract. But it's the kind of thing that we have to understand in setting up regulation of these activities, because each and every time you can face a situation because of the way the U.S. regulatory systems is set up as regulation of entities where you have an entity who has control over that activity who's going to make a legal claim that you don't have the authority to force it to do something. So, this is -- it's very much a legal question, and maybe we're going to find someone here who know all the answers.

MR. BAILY: Are you going to comment on securities lending or not.

MR. KUPIEC: I wouldn't hold myself out as an expert on securities lending, the minutia of it. I think there are some rules in Dodd-Frank that potentially put limits on some of the bank holding companies to engage in securities lending. They have to -- they're counted as counterparty credit risk, whereas in the asset management firm, if you're designated as a SIFI you would not be subject to those limits. So, there might be lurking underneath somewhere some competitive issue or level playing field issue. I'm not sure. But the rules probably don't apply equally to bank holding companies versus a fidelity or whether that causes systemic risk or source of it and hasn't been identified in the report. And I'm not aware that people are worried about that specifically.

MR. BAILY: Yes.

MR. CROWLEY: Dan Crowley with K&L Gates.

Dodd-Frank is a very comprehensive piece of legislation. It revisited every financial services law from the 1864 National Bank Act through Sarbanes-Oxley and addressed some really significant, risky issues -- regulation of Swaps, Title VII, a whole new regulatory regimen regulation of mortgaged-backed securities, and so forth and so on. And yet the OFR asset management report was silent about the impact of any of these reforms on the marketplace. I don't know whether asset managers were the perpetrators of systemic risk or whether they're the victims of it. But it seems to me at this point don't we need to assess the implications of all these forms and whether at this point this attempt to impose bank-like regulation on non-banks might actually be a solution in search of a problem.

MR. BAILY: Well, I agree with you. No one's really looking at the overall framework of Dodd-Frank and what all the separate pieces are doing fitting together. I don't know if any of you together have comment on that.

MR. ELLIOTT: One comment I would make is that I actually take the OFR at its work that effectively what they were doing was creating a giant catalog of all the ways in which the asset management industry touches systemic risk. And if you view it that way rather than they were trying to lay out the case for SIFI designation, then it may be disappointing they weren't able to go further, but it's at least a consistent first step, and you'd want to do that first step before you then said, oh, by the way, moving on from history to now, how are the new rules changing the way in which systemic risk might come out of these activities.

MR. STANLEY: and I agree completely with Doug, by the way. I thought that this report got a bum rap from the people looking to it to be something that it wasn't. But I said, actually in another presentation right here, that Dodd-Frank took kind of a Chinese menu approach to financial reform. It's going to take one from column A and B, one from ever column, and it's going to do a little bit on each of them. It really -- I think Dodd-Frank, even in Title VII, which is maybe the most comprehensive part -- it still permits the over the counter (inaudible) as market to continue and pushes the market in the direction it was already going in some cases. And we've seen a lot of these rules. You know, more than half the rules aren't even finished. So the question of whether Dodd-Frank has really fully transformed the risks that certainly it spoke to, there are words in Dodd-Frank that speak to everything that was involved. But whether it's really succeeded in transforming these risks and controlling all these risks in different areas, to me the answer to that would be no, so you still really have to ask some of these tough questions.

MR. BAILY: Yes, (inaudible).

MR. KUPIEC: I'm going to weigh in on this, too. I take issue with this on the OFR report. If you're going to write a report that catalogs the ways in which certain activities may or may not cause systemic risk, you would want to explain both sides of the issue. Here's an activity, it's alleged that it could cause it. Here's the mechanism. But there's other evidence that this same sort of activity has other effects that aren't externalities and don't need to be regulated. The OFR report is silent on any of these things that are positive and only emphasizes the negatives. That does not sound to me like a fair and balanced report that is trying to inform the FSOC and guide the FSOC through a process. It is very negative. It's very negative. And mutual fund flows cause asset prices to rise just as often as -- more often, actually, if you look at the charts, than they cause them to fall. Why are we calling one thing a fire sale a fire sale and the other thing not?

MR. ELLIOTT: Because you don't care about that part.

MR. KUPIEC: No, we do, we want them to rise. I care very much.

I want the upside.

MR. ELLIOTT: No, no, the OFR and the FSOC are supposed to be looking at financial stability issues.

MR. KUPIEC: We can't outlaw losses in financial markets. You can't do it.

MR. ELLIOTT: I'm not --

MR. KUPIEC: (Inaudible) on that.

MR. ELLIOTT: I'm not suggesting that as you well know from what I was saying earlier. But all I'm saying is I do think an emphasis on the systemic risk -- that is, what can go wrong when things really blow up -- is appropriate for them. And in that, you're not very much worried about the fact that sometimes things will be pushed up except to the extent you're thinking about, well, maybe they'll come back down later, in which case, that, too, would actually be (inaudible).

MR. KUPIEC: Right, bubbles can -- you know, when we built this financial system where we made liquidity -- this is the importance of thinking about securities lending markets I think -- we made liquidity depend very, very directly on asset prices in a way that when we had a more under-the-New-Deal system, I think we had a more comprehensive set of backstops, of liquidity backstops, and we also had more entities, you know, more credit intermediation through entities instead of the money market. So, you know, like it or not, we've created this situation where our liquidity flows are dependent on asset prices, and this has created, frankly, this broader societal and government interest in asset prices. You may not like it, but it's the world we've created for ourselves. And we saw that world growing in the '90s through the Greenspan put and through lots of other ways that the Federal Reserve was implicitly -- you know, various kinds of interventions on international financial crises, you know, where the Federal Reserve, the Committee to Save the World, where the Federal Reserve and Treasury were intervening behind asset prices. And we've got to look clearly. I'm not saying that this should lead to a particular regulation of asset management firms, but we've got to look clearly at what we've created here and how to address it. And it's a world where asset price bubbles create a risk for our economy.

MR. STANLEY: And we still have the Committee to Save the World that's going to regulate it after the (inaudible).

MR. BAILY: I think probably this is our last question, because we're running out of time.

SPEAKER: Yeah, I'm going to really resist asking the question about whether it's simply a time for (inaudible) experience if the Fed will save us from bubbles. But my question is this. There seems to have been a constant theme on these panels. Mr. Berner started with it by saying that so many people have commented on their report, it was just a big misunderstanding. The OFR, he actually commented, is not accustomed to putting its research out for public comment. You observed that isn't it odd that the SEC put this report out, and frankly it's the only reason I believe that any of us knew what the report said. I think that it might be -- and I'd love your reaction, so put this as a question --

would it not be helpful to this whole process and instructive were the FSOC, including the OFR, to follow a path of far greater transparency and accountability in their development of these extraordinarily important regulatory positions than has been the case to date or as required by Dodd-Frank.

MR. BAILY: Okay, let me start at the far end. Do you agree with that, Doug? More transparency?

MR. ELLIOTT: I'd like to see more transparency there. It would be possible to make the hurdle so high that it would become very hard to actually operate. But directionally I certainly agree with you. They've not been as transparent as I'd like them to be.

I mean, the FSOC put their report out on the Worldwide Web as soon as it was released. Anyone could read it, and anyone could write them a letter, you know, so it's not a formal notice and comment process, but I think when you put out a report -- I've never had a problem calling up Treasury and asking for a meeting, and I'm sure if I don't have a problem --

MR. BAILY: You seem to be complaining about the fact that the SEC put this out for comment.

MR. ELLIOTT: Well, right, because I think it was somewhat of a hit job, frankly. I mean, it was an invitation to criticize it on the part of the entities regulated by the SEC, because the SEC didn't want to see the Fed stepping into its turf on these issues. But I think anybody could have written a letter to the Treasury, ask for a meeting with the OFR. You know, I don't think -- you know, to me it's transparent that they put it out publicly to start with.

SPEAKER: The SEC did. No other agency put this report out for comment.

MR. ELLIOTT: Wait. The report was up on the Web the moment that the OFR put it out, unlike other stuff that they do. I mean, I found it there. Are you saying that they somehow kept it -- that the OFR kept it secret?

SPEAKER: The SEC published the report. It was not put out by any other FSOC regulatory agency.

MR. ELLIOTT: What I'm talking about is it was posted on the OFR website, and anybody who wanted to write a letter to Treasury about it or get a meeting with Treasury about it could so. I mean, I'm not sure what the for-comment adds to that, really.

But the other thing about it is that the FSOC designation process includes many, many opportunities for the firms under consideration to weigh in on that process through multiple stages of the process. And actually the public doesn't really have nearly the opportunity that the firms under consideration do during the process. So, I would kind of like to see the public having more of an opportunity during the process to weigh in. But I think the firms, when they move toward a designation, I think there are many opportunities for the firm being considered to weigh in and to sue afterward, as we've seen with prudential.

MR. BAILY: Paul, any last comments here?

MR. KUPIEC: Well, the FSOC designated cases are posted on the website, and they're interesting to read. There's very little concrete smoking gun to systemic risk. Systemic risk is a fairly hazy concept anyway, and few of these reports have any direct lines in terms of many of these designations. They're very general. I think that pattern is what we'll see going forward, and it's disappointing that the framework isn't evolving in a more exact scientific way and that the designation is linked to things that make sense for the new prudential standards. Right now that process has totally fallen apart, and it makes moving forward that much more problematic I think.

MR. BAILY: Thank you very much to the panel and to the audience. I hope this has encouraged discussion on this issue, and thank you all for coming. Terrific, thank you.

(Applause)

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