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Cooperative Capital Markets Regulatory System

Via Internet: commentonlegislation@ccmr-ocrmc.ca

Re: Consultation on the federal Capital Markets Stability Act and Provincial Capital Markets Act

Dear Sirs/Mesdames:

Fidelity Investments Canada ULC ("**Fidelity**", "**we**" or "**our**") appreciates the opportunity to comment on the Consultation drafts of the federal Capital Markets Stability Act ("**CMSA**" or "**Act**") and Provincial Capital Markets Act ("**PCMA**"). Fidelity believes that the creation of the Cooperative Capital Markets Regulatory System ("**CCMRS**") represents a substantial step forward in the evolution of Canada's regulatory regime, and that the purposes of the Act—promoting and protecting the stability of Canada's financial system and protecting the capital markets against the commission of financial crimes—are laudable. Moreover, we commend the mandate to the Capital Markets Regulatory Authority ("**CMRA**") to promote efficient capital markets and avoid imposing an undue regulatory burden. Given that significant details of the draft PCMA have not yet been released for public consultation, our comments in this submission are largely focused on the draft CMSA.

Fidelity is the 6th largest fund management company in Canada and part of the Fidelity Investments organization, which is headquartered in Boston. Fidelity Canada manages approximately $94.5 billion in mutual funds and institutional assets and offers approximately 200 mutual funds and pooled funds to Canadian investors.

Although we applaud the efforts of the participating jurisdictions to harmonize Canada's existing securities regulatory framework and to create a mechanism to address potential systemic risks, we recommend that the proposed legislation be modified in three important respects:

1. The Act should pursue a mandate that explicitly balances managing the systemic risks of the capital markets with preserving and enhancing both the economic and financial stability benefits created by the Canadian capital markets.

2. The Act should require a more objective and rigorous process for identifying systemic risk and selecting the most effective and efficient regulatory response.

3. The Act should abandon the notion of designating certain capital markets intermediaries as systemically important, when that approach would be unjustified, ineffective and inefficient. It should focus instead on regulating specific products and activities that give rise to systemic risks.

In addition to our comments herein, we have reviewed the response letter submitted on behalf of the members of the Investment Funds Institute of Canada and generally agree with their submissions.

I. The Act's Mandate Should be Broadened to Balance Both Managing Systemic Risks and Preserving and Enhancing the Benefits of the Canadian Capital Markets

The Act identifies its purposes as (a) promoting and protecting the stability and integrity of Canada's financial system through the management of systemic risk related to capital markets; and (b) protecting the capital markets against the commission of financial crimes. These are laudable goals. But the goal of managing the systemic risks related to capital markets should be balanced with the goal of preserving and enhancing the economic and financial stability benefits created by the Canadian capital markets and their individual participants.

Globally, regulators and leading policymakers have recognized the benefits that capital market financing can provide in comparison to financing through banks and other financial intermediaries. As recently explained by the International Monetary Fund, nonbank financial intermediaries (NBFIs) "complement traditional banking by expanding access to credit or supporting market liquidity, maturity transformation and risk sharing."[1] Such NBFIs "often enhance the efficiency of the financial sector by enabling better risk sharing and maturity transformation and by deepening market liquidity."[2] Given these benefits of nonbank financial intermediaries, the IMF observed that "[t]he challenge for policymakers is to maximize the benefits of [NBFIs] while minimizing systemic risks."[3]

The President-elect of the European Commission (Jean-Claude Juncker) echoed those sentiments in a recent mission letter to his new Commissioner for Financial Stability, Financial Services and Capital Markets Union. Mr. Juncker emphasized that the mission included "reduc[ing] the cost of raising capital," and "develop[ing] alternatives to our companies' dependence on bank funding."[4] That

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[1] *See* International Monetary Fund – Global Financial Stability Report: A Report by the Monetary and Capital Markets Department on Market Developments and Issues, at 66 (Oct. 8, 2014), available at https://www.imf.org/external/pubs/ft/gfsr/ (hereinafter, the "IMF GFSR").

[2] *Id.*

[3] *Id.* at 65.

[4] *See* Mission Letter from Jean-Claude Juncker to Jonathan Hill, at 4 (October 8, 2014), available

Cont'd.

mission is intended to be complete by 2019, "with a view to maximizing the benefits of capital markets and non-bank financial institutions for the real economy."[5]

Steven Maijoor, the Chair of the European Securities and Markets Authority voiced a similar view at the EFAMA Investment Management Forum 2014. He noted:

> Many policy makers and regulators have raised the desirability of moving in the EU from a bank-dominated financial system to a system with more diverse sources of funding. The thinking behind this shift is very attractive: as we all know in asset management, diversity should reduce risks. Also, in the non-banking sector there are more opportunities for equity funding which helps in increasing investments without necessarily increasing the indebtedness of our economy.[6]

Funding through capital markets—including through capital market intermediaries—creates numerous benefits, such as reducing the cost of financing Canadian businesses, increasing market liquidity and distributing market risks across diverse pools of equity investors. Therefore, encouraging the development of efficient and resilient capital market financing to promote Canadian economic growth should be a stated goal of the CMSA. Indeed, the Canadian Supreme Court has held that "[t]he preservation of capital markets to fuel Canada's economy and maintain Canada's financial stability" is a laudable national interest that goes beyond a specific industry and engages trade as a whole.[7]

As currently drafted, the Act places undue emphasis on managing the systemic risks related to capital markets. The purpose of the Act should be broadened to also promote the preservation and enhancement of the economic and financial stability benefits created by Canadian capital markets. The Act should make the CMRA responsible for pursuing this balanced mandate rather than focusing on systemic risk to the exclusion of systemic and economic benefits. By making such a balancing function explicit, the Act will help to provide additional structure to the decision-making of the Authority and ensure that the capital markets can continue to efficiently fuel Canada's economy.

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at https://ec.europa.eu/about/juncker-commission/docs/hill_en.pdf.

[5] *Id.* at 5.

[6] *See* "Asset Management – The Regulatory Challenges Ahead," Speech by Steven Maijoor to the EFAMA Investment Management Forum 2014, at 3 (November 5, 2014), available at http://www.esma.europa.eu/system/files/2014-1333_steven_maijoor_keynote_speech_at_efama_5_nov_2014.pdf

[7] *See In Re a Reference by the Governor in Council pursuant to section 53 of the Supreme Court Act, R.S.C. 1985, c.S-26, as set out in Order in Council P.C. 2010-667, dated May 26, 2010, concerning the Proposed Canadian Securities Act*, (2011) 3 S.C.R. 837, 839, (Dec. 22, 2011).

II. The Draft Legislation Should Be Revised to More Objectively and Concretely Define The Risks to Be Addressed, the Mandate of the Authority, and the Procedural Protections for Potential Designees and Canadian Capital Markets.

Consistent with the balanced mandate proposed above, the Act should be revised to better define systemic risk and the process the CMRA must follow when identifying and deciding whether and how to regulate it. The Act should establish objective criteria and a rigorous process for measuring both the risks and benefits of capital markets, and should establish procedural protections to ensure that decisions are consistent, transparent and fair to the affected parties and increase the chances that the regulatory response selected will be effective and efficient.

As proposed, at every critical step—from the definition of systemic risk, to the process for evaluating whether a regulatory response is required, to the selection of the regulatory remedies—the Act provides only the vaguest of guidelines, and gives the CMRA the broadest of discretion. We are concerned that it is a recipe for regulatory failure rather than success. That level of uncertainty puts too much of a burden on the CMRA and the capital markets, with too little of the guidance necessary to direct the CMRA or inform and protect the individual regulatory targets, the capital markets, or the Canadian economy. As a result, the proposed approach risks confusing rather than clarifying the regulatory assessment of systemic risk and the capital markets' reaction to it. In turn, that confusion is more likely to undermine "public confidence" in market integrity, rather than enhance it.

A. The Statute Should More Specifically Define the Systemic Risk to Be Addressed

The Act needs to define systemic risk with greater specificity and rigor. Systemic risk is a foundational principal within the Act, but it is a shaky foundation because the term is effectively undefined. As proposed, the CMRA's authority to designate entities as systemically important depends solely on whether the CMRA is of the opinion that those entities pose a systemic risk. Products and practices can also be regulated by the CMRA if it opines that they are systemically risky. Indeed, because there is no objective standard established, the CMRA's authority to unilaterally determine that an entity or a practice is systemically risky is essentially unconstrained.

Given that the purpose of the Act is to manage systemic risk, one would expect the term to be carefully defined to guide regulatory action and constrain overreach. Yet, the definition of systemic risk lacks any degree of precision or objectivity. A systemic risk is defined to mean "a threat to the stability or integrity of Canada's financial system . . ." "that has the potential to have an adverse effect on the Canadian economy." There is no quantification of that "potential" or of how substantial or sustained a threat must be before it is deemed a systemic risk. Similarly, there is no definition of "Canada's financial system." As a result, neither the "numerator" (the threat) nor the "denominator" (the financial system) in the

systemic risk equation is defined, leaving the CMRA with no guidance as to what risks should be deemed systemically risky.

Further, the term "stability" is undefined, and the term "integrity" is defined vaguely and expansively to cover "the continuous and orderly operation" of any significant part of the system, the "cohesion and resilience" of any significant part of the system, and the "maintenance of public confidence" in the integrity of the system. Because of the expansive definition of integrity and the lack of definition of stability, the CMRA is given almost unfettered discretion to deem any conduct or entity systemically risky.

Such a broad and imprecise definition means that policymakers, the CMRA itself, market participants, and those that rely on Canadian capital markets will have no concrete guidance about the potential reach of the statute. For example, if an emerging market fund accounts for a significant portion of trading in emerging market bonds, could it pose a threat to the stability of the Canadian financial system? Would the answer depend on whether some portion of those bonds were traded or held by Canadian intermediaries? If so, would managers of Canadian funds be able to reduce their perceived systemic riskiness by purchasing securities that were not traded or held by Canadian intermediaries? Would the stability of the Canadian market for emerging market debt be deemed a significant part of the Canadian financial system such that it would have the potential to have an adverse effect on the Canadian economy? At what threshold do particular debt or equity markets become significant parts of the Canadian financial system? What specific harm to them should the CMRA seek to prevent?

As a second example, if a fund manager managed several funds that together held a significant amount of equity or debt in a Canadian company (such as BlackBerry), would such a fund manager pose a threat to the Canadian financial system that had the potential to adversely affect the Canadian economy? If so, should fund managers avoid equity or debt investments in Canadian companies to reduce any potential systemic risks they might be deemed to cause?

As a third example, if a mutual fund manager happens to attract substantial investments by Canadian investors as a result of generating favorable returns or offering reduced fees, would the success of such a fund manager and the resulting size of its funds lead it to be deemed a threat to the stability of Canada's financial system such that it should close its funds to additional Canadian investors?

Although it may be tempting to provide a broad mandate and rely on the discretion of regulators to select those risks they deem systemic, such a "know it when you see it approach" creates uncertainty amongst market participants and sets the regulator up for failure rather than success. As the Nobel laureate Lars Peter Hansen observes when discussing systemic risk, the "know it when you see it approach" invites "a substantial amount of regulatory discretion," which can "lead to bad government policy, including the temptation to respond to political

pressures."[8] For example, in the event of a threatened downgrade in credit rating for Canadian government debt, the CMRA may face substantial political pressure to declare the credit rating agency systemically important in order to limit disclosure to the public or to modify the policies and procedures for the application of methodologies used for determining credit ratings.[9] Without any definition of systemic risk, regulators could neither justify to the public a decision to designate the credit rating agency, nor justify a decision to forgo such a designation.

The lack of specificity and objectivity in the term "systemic risk" also "undermine[s] the assessment of alternative policies."[10] If the CMRA were to determine that certain products or securities, such as derivatives, posed systemic risks and restricted trading of such products or securities, how if at all could the CMRA measure the risk-reducing benefits of such a policy compared to the costs it would pose to Canadian financial institutions and their clients? The adoption of rigorous empirical definitions, models and methods of measurement is critical both to advance the general understanding of these issues and to enable meaningful evaluation of the effectiveness of particular policies.

Even if the CMRA, in its discretion, chose not to designate any particular entities, products or activities as systemically important, that alone would not eliminate the regulatory uncertainty associated with the Act's use of the undefined term "systemic risk." Absent specific limitations and criteria set forth within the Act, market participants—including potential designees—will make strategic decisions based on assumptions about what the CMRA *might* do. Regulatory uncertainty created by the potential for an entity, its counterparties or competitors to be deemed systemically important may lead financial institutions to take actions to avoid their own designation or prepare to capitalize on the designation of others, which actions may ultimately be contrary to the goal of promoting efficient and resilient Canadian capital markets. On the other hand, given sufficient information and incentive, markets are inherently self-correcting. If the Act provided greater clarity about the specific activities and conduct considered systemically risky and the consequences of designation, market participants could take actions to eliminate the specific products or activities that posed a risk even without requiring designation by the CMRA.

In the United States, where a similar debate has surrounded the Financial Stability Oversight Council's ("FSOC") consideration of whether investment funds or their managers could be systemically important financial institutions (SIFIs), commentators have raised similar concerns about the risks of granting unchecked discretionary authority through the use of broad and undefined terms. For example, this summer, in testimony before the United States House Committee on Financial Services, Peter Wallison of the American Enterprise Institute testified that:

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[8] Lars Peter Hansen, "Challenges in Identifying and Measuring Systemic Risk," (Feb. 11, 2013), at 2, *available at http://www.nber.org/chapters/c12507.pdf.*

[9] *See* Act § 24 (1)

[10] *See* Hansen, *supra* n. 8, at 2.

> Key terms the FSOC must apply in order to take jurisdiction over any particular firm, 'financial distress' and 'market instability'—have no clear meaning, and because both involve predictions about the future, they amount to an enormous grant of discretionary power. Where judicial intervention is unlikely, as in this case, wide discretionary power can result in arbitrary, capricious and politically-based administrative decisions. An agency can rectify this problem by developing and applying standards that limit its own discretion, providing a roadmap for compliance by affected companies, and allowing the basis of its decisions to later be judged by Congress and the public.[11]

By setting forth in the Act itself a more precise definition of systemic risk, and (as discussed below) cabining the CMRA's discretion through the requirement that it develop and apply a consistent, objective, rigorous and transparent process, the Act can anticipate and proactively address such concerns prior to enactment rather than unfairly placing that burden on the newly created CMRA and offering it no meaningful guidance for meeting it.

B. Legislation Should Require the CMRA to Follow an Objective, Rigorous and Transparent Process when Evaluating and Balancing Systemic Risks and Benefits Associated with Entities and Activities.

For the same reasons that systemic risk must be more carefully defined, the Act should also require the CMRA to establish a consistent, objective, rigorous and transparent process to assess the potential economic and systemic risks and benefits associated with entities, products and practices. Such a process is necessary so that potential designees and other market participants will have confidence in, and can meaningfully contribute to, the CMRA's balancing of systemic risks and benefits, including any determination that an entity or activity presents systemic risks.

In the first instance, the CMRA's process should be a consistent one, applied to evaluate all decisions to designate entities or activities as systemically important or risky. That process should provide sufficient time for the CMRA to gather the necessary data, obtain input from the potential designees and other stakeholders, conduct rigorous analyses of the data, evaluate both the systemic risks and benefits associated with an entity or activity, and clearly articulate its conclusions. Timelines for assessment should be made known to potential designees and market participants so that meaningful input can be timely gathered.

That process should also be based on objective criteria required by the Act

[11] *Testimony of Peter Wallison, American Enterprise Institute, before House Committee on Financial Services*, at 4, 5 (May 20, 2014).

and established by the CMRA in advance. To avoid the "know it when you see it" approach to the identification of systemic risks and benefits, and the uncertainty regarding the consequences of designation, the Act should require the CMRA to establish and publish the specific standards and metrics it will use to identify systemic risk, and to determine that new and different regulation is required prior to making any designation. For example, the Act requires that in determining whether a Capital Markets Intermediary is systemically important, the CMRA must consider the company's size, the volume and value of trading by it, the importance of the intermediary to particular market activities, as well as its leverage, liquidity and off-balance-sheet exposure.[12] Yet, the Act provides no meaningful objective criteria as to what threshold of size, leverage or liquidity will lead to potential designation, nor what metrics the CMRA will consider to determine the entity's importance to the Canadian financial system. Similarly, the Act does not require the CMRA to define the specific consequences of designating an entity or a product or activity as systemically important or risky. Nor does the Act require the CMRA to explain how designation will reduce systemic risk prior to making a designation determination. The Act should require the CMRA to establish those thresholds and metrics prior to evaluating potential designees, products and activities, and to define the specific consequences of a designation decision prior to making one.

The processes established by the CMRA should also be rigorous, based on the assessment of empirical data. The Act should make clear that decisions that are premised either on hypothetical concerns about market events that might happen in the future—particularly events that have no historical analogue—or on regulatory aspirations for unwritten and unapplied regulations would be an insufficient basis for CMRA decisions. Without a requirement that decisions are based on empirical data and trigger defined consequences, the objectivity of designation determinations would be lost, as most any imagined market scenario and potential regulation may be sufficient to justify designation; and opportunities to provide data, give input, or make meaningful cost-benefit determinations become illusory.

As part of a rigorous, objective evaluation, the CMRA should be required to balance the costs of designating an entity, product or activity as systemically important against the risk-reduction benefits of such a designation. Absent such a cost-benefit determination, it would not be possible for the CMRA to balance the goal of reducing systemic risks against the goal of enhancing the economic and financial stability benefits created by capital markets. Requiring a cost-benefit determination would ensure that the CMRA had adequately considered whether or not to act, and the full range of available regulatory actions for reducing risks. The CMRA necessarily would have to identify the potential regulatory remedies to be applied prior to designation, so that it could evaluate the costs and benefits associated with such remedies. If the remedies to be imposed following designation are unable to address the identified risk effectively and efficiently, the

[12] *See* CMSA § 27.

CMRA should conclude that designation would be counterproductive. Similarly, if the identified risk could only be addressed at great cost to the system (e.g., by substantially limiting the investment options available to Canadian investors or the capital available to Canadian businesses), the CMRA may conclude that designation would similarly be counterproductive.

The CMRA's decision-making process and rationale should also be transparent. Not only should the criteria and metrics for identifying and measuring systemic risk and the consequences of designation be defined in advance, but the designation decisions themselves should be issued in writing, and should clearly articulate the rationale and data relied upon to reach the decision and the specific consequences for the designees. Such transparency is a foundational basis for building trust in governmental decisions.[13] It is also important because it will provide insight to other market participants about how risks are evaluated and regulated so that they can make informed decisions about their own businesses. Further, the process of articulating the risks giving rise to designation, and the data reflecting that assessment, will help to sharpen the focus of regulators on the particular systemic risks to be addressed.

The Act should also provide a mechanism for review of CMRA designation decisions by a Court or other neutral body. That review should ensure, at a minimum, that designation decisions are consistent with the goals articulated in the Act, comply with the processes to be specified in the Act, and are based on a rigorous analysis of data rather than on arbitrary or unsupported conclusions. The opportunity for such review enhances the credibility of the designation process, giving market participants and designees greater confidence in the process and its results. It can also help to insulate the CMRA from political pressures. Absent such a review, there would be no teeth to the other procedural requirements.

Finally, the Act should also require the CMRA to create a framework for evaluating the effectiveness and efficiency of its designations on a periodic basis. The CMRA should be authorized to de-designate any entity, product or activity where these periodic evaluations reflect that the designation was either ineffective at reducing risk or not the most efficient means for addressing the risk posed. Such evaluations should be provided to the Council of Ministers or another appropriate authority at least annually, and should also be made available to investors and the public. By conducting such an annual evaluation, the CMRA

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[13] In the United States, similar concerns about a lack of transparency have substantially undermined confidence in the FSOC's processes. For example, in a January 23, 2014 letter to the Chairman of the FSOC, a bipartisan group of United States Senators noted that: "We follow a long line of Senators, industry groups and even a 2012 [Government Accountability Office] report in stating that one of the greatest problems with the [Office of Financial Research's (OFR)] activities and the FSOC's process for designation under Section 113 of [the Dodd-Frank Act] is a lack of transparency and accountability. . . . The absence of process, transparency, and accountability may help explain the alarming dearth of accurate data, information, modeling, and metrics to substantiate the OFR Study's sweeping conclusions and broad assumptions [about the asset management industry]." Letter from Sen. Mark Kirk, *et. al.* to Jacob Lew, Chairman, FSOC (Jan. 23, 2014).

can provide market participants greater direction concerning the risks being managed, and can help achieve the goal of building public confidence in the structural integrity of the Canadian capital markets.

C. Proposed Legislation Should Provide Potential Designees with Opportunity for Meaningful Input into Designation Process

The Act should also be revised to provide potential designees with an opportunity for meaningful input into the designation process. Currently, the proposed Act provides the potential designee with only "an opportunity to make representations." The Act does not specify when that opportunity must be provided, to whom any representations would be made, what information those representations could contain, what consideration, if any, must be given to such representations, and the extent to which the designee is informed about the potential risks being evaluated or potential remedies being considered prior to making its representations.

Absent greater specification of the procedures for input by affected persons, the vague opportunity to "make representations" fails to provide the kind of procedural protections that would benefit both potential designees and the Authority. The designees, the CMRA, and the Canadian capital markets all benefit from ensuring that designation determinations and regulatory action are based on accurate data, evaluated against rigorous criteria, with the benefit of input from both designees and others knowledgeable about the potential risks being evaluated and the consequences of regulatory action.

At a minimum, the Act should ensure that potential designees are given timely notice that they are being considered for designation. The designee should be given access to the data and analyses intended to support a designation determination. The designees should have the opportunity to correct or supplement such data to provide the CMRA with accurate and complete information for evaluating any proposed determination, and the CMRA should be required to fully consider such information in making a final designation decision.

Further, the designees should be timely informed about the specific risks and conduct that designation is intended to address, so that the designee can fully inform the CMRA about any risk mitigants or other steps already taken to address those risks. The CMRA should also be required to identify the kinds of remedies that it would consider imposing to address those risks, so that the designee can help the CMRA identify the actual impacts, including the costs, of such remedies, the limits associated with any potential remedy, and alternative remedies that may better address the identified risk at lower cost.

Similar concerns have been raised about the designation process followed in the United States by the FSOC. Those concerns have prompted industry groups to petition the FSOC to revise its procedures in ways similar to those

identified above.[14] The FSOC recently met with those industry groups to discuss their concerns.[15] In Canada, we should take advantage of the opportunity to address those procedural concerns while the Act is still in the drafting stage.

III. Authority to Designate Capital Markets Intermediaries—Especially Mutual Funds and Their Managers—as Systemically Important Should Be Reconsidered.

The draft Act identifies as potential designees Capital Markets Intermediaries, defined to include investment funds and their managers. That category paints with too broad a brush, and incorrectly presumes that designating funds and their managers would be both justifiable and effective in spite of substantial evidence that neither is true. Mutual funds and their managers do not present the kind of systemic risk that the CMSA intends to address through designation of individual intermediaries and should therefore be excluded from the definition of Capital Markets Intermediaries.

Even if an individual investment fund or its manager were to present systemic risk at a level that required new additional regulation, designation would be the wrong approach to reducing that risk in the capital markets. Designating a single entity or a small group of entities within the asset management market would do little to address any perceived risks because of the ease by which investments flow from one fund to another, and from one manager to another. The high level of substitutability within the asset management industry and the capital markets broadly would preclude the CMRA from achieving its goal through designation.

A far more effective approach would be to focus on the specific activities giving rise to the alleged systemic risk and to regulate them as broadly as possible by applying the additional regulation to anyone who engages in them. Regulators from around the globe, including the FSB and the FSOC, after considerable study and debate in which Canadian policymakers, regulators and companies have played leading roles, have recognized that such activity-based regulation would be much more effective, and less counterproductive, than fund or manager designation.

Moreover, the kinds of regulatory intervention envisioned under the statute would interfere with the fiduciary obligations owed by mutual funds and their managers, and reduce the value those funds provide to investors. In so doing, the regulations have the potential to significantly harm the designated fund and its

[14] *See* Letter to Patrick Pinschmidt, Petition for Financial Stability Oversight Council Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, (August 19, 2014) available at http://www.sifma.org/issues/item.aspx?id=8589950444

[15] *See* Release by U.S. Treasury Department Office of Public Affairs, "Financial Stability Oversight Council Stakeholder Engagement Through November 12," (November 12, 2014) (identifying a number of meetings held with stakeholders to address potential changes to the FSOC designation process) available at http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/November%2012,%202014,%20Outreach%20Engagement.pdf

manager, undermine investor expectations and confidence in the capital markets, and even reduce the liquidity and efficiency of capital formation that mutual funds bring to capital markets that help fuel the Canadian economy.

Thus, the draft statute should be revised in order to better balance the benefits provided by funds, managers and the capital markets against any risks those funds may present and to promote the most effective and efficient regulatory response to any such risks. One potential revision—consistent with the evolution of the international approach to this issue—would be to focus only on regulation of specific activities and conduct, as opposed to the designation of specific capital market intermediaries as systemically important. A more modest revision would be to exclude from the category of capital markets intermediaries mutual funds and their managers.

A. Mutual Funds Do Not Pose the Kinds Of Systemic Risk That the Draft Legislation Is Intended to Address through Entity Designation

Mutual funds do not pose the kinds of systemic risk that the Act is intended to address through entity designation. The Act identifies Capital Markets Intermediaries as systemically important if their activities or "material financial distress" "could pose a systemic risk related to capital markets."[16] Yet mutual funds and their managers are not subject to material financial distress or insolvency of the sort that banks regularly experience, and any potential distress or insolvency would be insufficient to pose a systemic risk to capital markets and the Canadian economy.

Mutual funds pose no risk of financial distress or insolvency because they are funded almost entirely through equity capital. They carry little or no debt and reflect the fair values of their assets in their variable share prices.[17] Without debt, it is not possible for a fund to become insolvent, and large funds with floating net asset values that are comprised almost entirely of equity capital will not suffer financial distress. Even in the event of a catastrophic downturn in the capital markets, an unlevered mutual fund has no financial distress. While the assets of the fund may have declined in value, that loss is shared by all investors in the fund (in the same way that the loss is shared by all investors in the market). As Professor Andrew Metrick noted during a May 19, 2014 Conference on the asset management industry, "[b]anks fail all the time" because they are "levered," but "[i]n the absence of leverage," the "failure of a long-only manager" is "not something we need to worry about."[18]

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[16] *See* CMSA §27.

[17] *See* "The Age of Asset Management," a speech given by Andrew Haldane at the London Business School, at 12 (April 4, 2014), available at http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf (hereinafter "The Age of Asset Management") (noting that "asset managers are essentially unlevered").

[18] *See* Letter to Jacob Lew from Timothy Cameron and John Gidman regarding Comments Summarizing the Financial Stability Oversight Council's May 19, 2014 Conference on Asset Cont'd.

Mutual funds also face little vulnerability to financial distress from other factors, such as liquidity, off-balance-sheet exposure, or reliance on short-term funding.[19] Fiduciary and regulatory obligations, in addition to mutual fund policies, typically require mutual funds to maintain a substantial percentage (typically at least 85%) of assets in liquid securities. Further, funds typically have many tools for managing liquidity in response to redemption requests, including the option of taking up to three days to pay proceeds to redeeming investors, and the right to redeem investments in kind if authorized.

Even if a mutual fund could suffer financial distress, it would not pose a systemic risk to capital markets. This is true for several reasons. First, mutual fund losses would be distributed to (and absorbed by) fund investors—just as mutual fund gains are, thus avoiding the risk that losses would be concentrated within or passed on to particular entities in the financial markets. Because mutual funds consist principally of equity financing by many investors, "funds contain a [] 'shock absorber' feature," where "fund investors absorb the negative effects that might be caused by the distress or even default of a fund, thereby mitigating the eventual contagion effects in the broader financial system."[20] Second, because of fiduciary and regulatory diversification requirements, funds do not hold concentrated positions in any particular company or asset. Third, because funds are highly substitutable, even a fund closure would have no impact, as investors would simply move their investment to a different fund. As acknowledged by FSB/IOSCO, "funds close (and are launched) on a regular basis with negligible or no market impact."[21] The FSB/IOSCO reviewed data from US mutual funds from 2000 through 2012, which includes the market downturns in 2000-2002 and 2008-2009, and found that "no mutual fund liquidations led to a systemic market impact throughout the observation period."[22]

Mutual fund managers, like the funds they manage, also pose no risk of financial distress. As Bank of England's chief economist Andrew Haldane has explained, mutual fund managers play an agency role, in which they manage assets on behalf of end-investors, rather than for their own account.[23] "As an agency function, asset managers do not bear credit, market and liquidity risk on their portfolios. . . . Fluctuations in asset values do not threaten the insolvency of an asset manager as they would a bank. Asset managers are, to a large extent,

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Management, SEC File No. AM-1, available at http://www.sifma.org/comment-letters/2014/sifma-and-investors-group-submit-letter-to-us-treasury-summarizing-the-fsoc-s-conference-on-asset-management/.

[19] *See* CMSA § 27(2)(a).

[20] FSB/IOSCO Assessment Methodologies at 29.

[21] *See* FSB/IOSCO – Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions, at 30 (Jan. 8, 2014), available at http://www.financialstabilityboard.org/publications/r_140108.pdf (hereinafter "FSB/IOSCO Assessment Methodologies").

[22] *Id.*

[23] *See* The Age of Asset Management, *supra* n. 17, at 2.

insolvency-remote."[24]

Because mutual funds and their managers do not suffer material financial distress or insolvency, and because any hypothetical financial distress cannot pose a systemic risk to capital markets, mutual funds and their managers do not pose the kinds of risk that the Act is intended to address through the designation of individual intermediaries. Thus, the Act should exclude mutual funds and their managers from the category of Capital Market Intermediaries.

B. Designating Mutual Funds or Their Managers as Systemically Important Would Not Effectively Address Any Perceived Risks

Not only do mutual funds not pose the type of risk that the Act is intended to address through the designation of individual intermediaries, but designation of individual mutual funds as systemically important will have no effect in addressing any risks even if they were present. Designation of any one or several funds will lead investors to simply move their assets to other funds or investment alternatives that can provide the services and investment strategy they are seeking, taking any systemic risks with them. This movement of assets will become even more pronounced in the event that remedies of the sort envisioned by the Act are imposed.

As the FSB has noted, "the investment fund industry is highly competitive with numerous substitutes existing for most investment fund strategies."[25] Further, fund investors are highly sensitive to fees and performance, and can move their assets to other asset managers with the click of a mouse. If a fund were designated systemically important, its ability to pursue its investment strategy effectively and at competitive fee levels would be diminished, resulting in investors swiftly moving their assets to other funds.

In fact, even the threat of the remedial actions outlined in the Act would be sufficient to motivate investors to move their investments to other competing funds. The Act as drafted permits the CMRA to force or prevent the sale of securities (particularly during times of market dislocations), to impose additional liquidity requirements on mutual funds, and to require funds to terminate or restrict their activities. Faced with the potential added costs and restrictions that could be imposed on a designated fund, even the uncertainty created by designation would lead investors to move their assets to an undesignated fund employing a similar strategy. As a result, the assets giving rise to the perceived risks would simply move to different funds. The CMRA would be forced to chase—and never catch—those assets as they move among funds and managers.

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[24] *Id.* at 6.
[25] FSB/IOSCO Assessment Methodologies, *supra* n. 21, at 30.

C. *Designating Mutual Funds or Their Managers as Systemically Important Would Burden Funds and Their Managers, Interfere with Investor Expectations, and Risk the Market Benefits That Mutual Funds Provide*

Not only would the designation process fail to achieve its desired objectives, but designation would be destructive to designated funds and their investors, and would likely distort the markets.

As noted above, the Act authorizes the CMRA to take a number of actions that could significantly impact investors in a designated fund. For example, the CMRA can require a fund to maintain minimum liquidity levels, alter its organizational orcapital structure, or to otherwise prescribe or restrict its capital or financial resources.[26] In the event the CMRA deems something to be a serious and imminent systemic risk, the CMRA can also require the disposition of a security, the termination or restriction of the fund's activities, or "anything else that is necessary to address the risk."[27]

Such actions would impose substantial costs on fund investors. Recently, for example, a study was done to estimate the potential cost to investors of a supplemental capital requirement in the largest mutual funds. That study concluded that if regulators imposed an 8% capital set-aside on the largest mutual funds, the resulting loss to investors who kept their assets invested in those funds over a 50-year period could be up to 25% of their total returns.[28] Of course, even if there were no capital set-aside imposed on an unlevered mutual fund (because such a fund is essentially 100% equity capital already), investors in a mutual fund could lose 25% of their investments (or significantly more) if that fund were prohibited from disposing of securities at a time of a serious and imminent financial market event.

Such CMRA regulatory actions would necessarily interfere with the fiduciary obligations that fund managers owe to their investors. Even the threat of such interventions would communicate to investors that designated mutual funds and their managers, particularly in times of market turmoil when it matters most, would be required to place market protection before investor protection. Assuming investors even continued to invest their assets in such designated funds, in the event of a market downturn, investors would have an incentive to redeem their shares from the fund before the CMRA regulatory restrictions were put in place. Thus, designation and the risk of regulation could cause the very redemptions of fund shares and sales of underlying assets that designation and the accompanying restrictions are presumably intended to prevent.

[26] *See* CMSA § 28.
[27] *See* CMSA § 29.
[28] See Douglas Holtz-Eakin, Satya Thallam, The Investor Cost of Designating Investment Funds as Systemically Important Financial Institutions, American Action Forum, May 15, 2014.

In the more likely scenario, however, investors would not wait until a market downturn to move their assets out of designated funds. Substantial fund movements would occur upon designation. Not only would those fund movements make the designation process ineffective (as discussed above), they would also result in the closure, or significant downsizing, of the designated funds. Investors would be the ultimate losers in this process. Those investors presumably chose to invest in the designated funds due to the cost, diversification or performance advantages those funds held over other available investment options. By forcing investors into less desirable investment options, designation would make capital formation less efficient and could potentially reduce market liquidity, thereby hindering economic growth.

D. Perceived Risks Should Be Managed Through Activity-Based Regulation

The systemic risk reduction that the Act targets could more effectively and efficiently be achieved through a different means, by focusing on the activities and products that give rise to systemic risks rather than designating as systemically important individual funds or their managers. Those identified activities and products could then be addressed through targeted regulations that apply to all entities that engage in those activities or to a class of products. Such an approach would more effectively address risks wherever they lie within the capital markets without creating the market distortions or adverse incentives that accompanies disparate treatment of similar entities.

For example, if the CMRA identified a risk related to the leverage employed by capital markets intermediaries, it could propose a regulation to limit the amount of leverage that such intermediaries (and other capital market participants) might employ. Presumably, if high leverage levels at an investment fund with $10 billion in assets under management created the potential for systemic risk, those same risks would exist if similarly high leverage levels were employed at 10 other funds, each with $1 billion in AUM. An across-the-board regulation could far more effectively address that risk.

Such activity-based regulation has several advantages over entity-specific regulation. In the first instance, activity-based regulation addresses the identified risk wherever it occurs within the market, whether at larger entities or collectively across a number of smaller entities. Regulators also avoid the need to chase assets from one fund to the next, and avoid the creation of an uneven playing field and resultant market distortions. Further, activity-based regulations provide far more explicit guidance to all market participants about the risks being targeted.

Activity-based regulation is not only consistent with how regulators have operated historically, but it is also in line with the global trend of policy-makers currently addressing systemic risk issues. For example, the FSB and IOSCO suggested in January 2014 that a systemic risk management approach that considers "possible financial stability risks that could arise out of certain asset management-related activities" may be preferable to an approach based on entity

designations.[29] Comments on that proposal favored an activities-based approach, and after reviewing those comments, the FSB approved a second consultation on the subject, which will be published near the end of 2014.[30]

In the United States, although the FSOC has designated three entities (two insurers and GE Capital) as systemically important and recently proposed the designation of another insurer (MetLife), it has moved away from that approach with respect to investment funds and their managers. Following an initial report by the Office of Financial Research, the FSOC received overwhelming commentary calling into question the wisdom of designating funds or their managers as systemically important. The FSOC convened a conference on May 19, 2014 of leading academics, regulators and members of industry to discuss the risks posed by the asset management industry. A summary of that conference reflects that three themes emerged: (1) fundamental attributes of the asset management business significantly reduce the potential to create systemic risk; (2) asset management often affirmatively reduces systemic risk and enhances financial stability; and (3) even with respect to those activities that may pose hypothetical risks, those risks are not yet proven to exist and further analysis of those activities is needed in order to determine whether they create risks at a level that requires a regulatory response.[31] There was consensus, however, regarding the appropriate structure of capital markets regulation. As Professor Kim Schoenholtz of NYU helpfully summed up: "as pragmatists[,] we probably agree that activities are a better way to regulate our capital markets."[32] As a result of that feedback, the FSOC announced on July 31, 2014 that it had directed its staff to focus its analysis on industry-wide products and activities in the asset management industry that potentially pose risks.[33]

Such alignment with global trends is consistent with the Act's direction that the CMRA "coordinate, to the extent practicable, its regulatory activities with those of . . . foreign financial authorities."[34] Indeed, the Act already provides a mechanism for the CMRA to regulate those products and practices that the CMRA believes pose a systemic risk.[35] Thus, the adoption of such an activity-based

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[29] FSB/IOSCO Assessment Methodologies, *supra* n. 21, at 32.

[30] *See* Press Release: FSB Plenary meets in Cairns, Australia, 18 September 2014, (FSB, jointly with IOSCO, will publish a second consultative document around the end of 2014."), available at http://www.financialstabilityboard.org/2014/09/pr_140918/.

[31] *See* Letter to Jacob Lew from Timothy Cameron and John Gidman regarding Comments Summarizing the Financial Stability Oversight Council's May 19, 2014 Conference on Asset Management, SEC File No. AM-1, at 2, available at http://www.sifma.org/comment-letters/2014/sifma-and-investors-group-submit-letter-to-us-treasury-summarizing-the-fsoc-s-conference-on-asset-management/.

[32] *Id.* at 3.

[33] *See* Release by U.S. Treasury Department Office of Public Affairs, Financial Stability Oversight Council Meeting July 31, 2014, (July 31, 2014) (announcing that the FSOC was "directing its staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry.") available at http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/July%2031%202014.pdf

[34] *See* CMSA § 6(2).

[35] *See* CMSA § 30-32.

approach is quite consistent with the goals and structure of the Act as already drafted.

E. Proposed Legislation Should Be Modified to Eliminate the Potential Designation of Capital Market Intermediaries, or to Reduce the Scope of Entities That Could Be Designated.

To address the points above, the Act should be modified to eliminate the potential designation of capital markets intermediaries as outlined in sections 27 through 29 of the Act. Sections 30 through 32 already provide the CMRA with ample authority to review the activities and products of capital markets companies and to regulate any such activities and products, which aligns more closely with the approach followed by other regulators.

In the alternative, if the designation authority with respect to capital markets intermediaries is not removed in its entirety, the Act should be amended to specifically exclude mutual funds and investment managers from the definition of capital markets intermediaries. Because those entities do not pose the kinds of risks that would warrant individual designation, and designation of those entities as systemically important would be ineffective and counterproductive, the Act should make clear that the CMRA has no authority to designate mutual funds or their managers as systemically important.

General Comments on the Draft PCMA

We appreciate the opportunity to comment on the draft provisions of the PCMA as they relate to investment funds and fund managers. Many of the key legislative provisions in the PCMA have been delegated to the regulations, which were not issued with the PCMA for stakeholder consultation. Therefore, it is unclear whether the draft initial regulations will include significant changes to, among other things, prospectus requirements, recission rights, investments in related parties, conflicts of interest and the definition of and registration requirements for investment fund managers. Accordingly, we are unable to provide meaningful comments without having the opportunity to review the relevant draft regulations alongside the PCMA.

With respect to conflicts of interest for investment funds, section 57 of the draft PCMA appears to extend National Instrument 81-107 *Independent Review Committee for Investment Funds* ("**NI 81-107**") to require an investment fund to identify, disclose and manage conflicts of interest ("**COIs**"). We believe that the reference to an "investment fund" is confusing and does not reflect the actual legal relationships that are contemplated under existing rules, including NI 81-107. Investment funds are not typically self-managed and are therefore unable to identify, disclose and manage COIs, which is true for the vast majority of funds in Canada. This is the job of the fund manager—to identify, disclose and manage COIs between a fund manager's own business interests and its fiduciary duty to manage its funds in the best interests of those funds. The current conflicts framework under NI 81-107 should remain untouched as it continues to work well

for investors and fund managers. However, if the Canadian government decides to make material changes to NI 81-107, including extending it to cover investment funds, it should only do so after meaningful public consultation and debate.

Finally, with respect to the review of the draft initial regulations when they are released for comment, we recognize the resources and time that would need to be afforded in order to accurately review these materials. We encourage the Canadian government to include a description of all significant and material changes from existing rules and national policy statements. Accordingly, we recommend a minimum of a 150-day comment period.

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Again, we commend the effort to create the Cooperative Capital Markets Regulatory System, and believe that this represents a substantial step forward in the evolution of Canada's regulatory regime. We believe that the revisions and comments proposed in this letter can help ensure that those reforms both manage the systemic risks and enhance the benefits of the Canadian capital markets. We look forward to reviewing revised draft versions of the CMSA and PCMA and to working with you as this initiative proceeds.

Yours truly,

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