THE ANNUAL REPORT OF THE OFFICE OF FINANCIAL RESEARCH

HEARING

BEFORE THE

SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS

OF THE

COMMITTEE ON FINANCIAL SERVICES

U.S. HOUSE OF REPRESENTATIVES

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THE ANNUAL REPORT OF THE OFFICE OF FINANCIAL RESEARCH

Wednesday, February 5, 2014

U.S. HOUSE OF REPRESENTATIVES,
SUBCOMMITTEE ON OVERSIGHT
AND INVESTIGATIONS,
COMMITTEE ON FINANCIAL SERVICES,
Washington, D.C.

The subcommittee met, pursuant to notice, at 3:05 p.m., in room 2128, Rayburn House Office Building, Hon. Patrick T. McHenry [chairman of the subcommittee] presiding.

Members present: Representatives McHenry, Fitzpatrick, Duffy, Hultgren, Wagner, Barr, Rothfus; Green, Ellison, Maloney, Delaney, Sinema, and Beatty.

Chairman MCHENRY. This hearing of the Subcommittee on Oversight and Investigations will come to order. Today, we are pleased to welcome the Director of the Office of Financial Research for the annual report of the Office of Financial Research, a statutorily required element of the Dodd-Frank Act.

And without objection, the Chair is authorized to declare a recess of the subcommittee at any time.

I will now recognize myself for 5 minutes for an opening statement. As a creation of the Dodd-Frank Act, the Office of Financial Research (OFR) was established with the promise of being an independent, transparent, and apolitical agency that would be able to identify systemic risks to the economy and emerging threats to the financial stability of the United States; yet 3 years later, OFR has failed to provide useful information about the biggest risks facing our economy.

In the 2013 annual report, OFR delivers narrative descriptions of a variety of activities, policies, financial products, and financial institutions which it maintains pose a threat to the economy. However, it does not prioritize any of these risks, making it incredibly difficult for policymakers to determine which risks are considered the most pressing and demand immediate attention.

Just last week in The New York Times, Simon Johnson, the former chief economist of the International Monetary Fund, described the annual report as "not impressive," saying, "It read like some of the less informative systemic risk assessments that we saw prior to 2007."

This past September, the credibility of OFR's systemic risk analysis was called into question upon the release of the Asset Manager's Report, which critics panned as a study that reflected a fundamental lack of understanding of the asset management industry. I concur.

And the criticism did not come from industry trade associations and asset management firms alone. In fact, left-leaning financial advocate group, Better Markets, said through one of their leaders, Dennis Kelleher—in a comment letter to the SEC, he said, "Rather than focusing on the known systemic risks which materialized just 5 years ago, which inflicted widespread economic wreckage across the country, OFR chooses to take aim at the asset management buy side of the financial industry, which, by comparison, presents much lower risk and played no role or virtually no role in the most recent financial crash."

The former chairman of this committee, Barney Frank—whom I do not often quote—said about the asset management report, "It just seems to me a listing of possible horror stories with no indications that there was any significant likelihood of any of it happening."

Certainly, Barney said it with a little more flair than I just gave you and certainly a lot faster, but having said that, Dr. Berner, the OFR was sold to Congress and to the American people as an entity that would act as an early warning system. Through the promise of topnotch research, OFR was expected to help predict the next crisis. With an annual budget of roughly $86 million this last year, the OFR really needs to show it is a value to the American people, which to date you have failed to do.

So, I appreciate you being here.

And I yield the balance of my time to my colleague from Missouri, Ms. Wagner.

Mrs. WAGNER. Thank you, Mr. Chairman.

Out of all the regulatory creations in Dodd-Frank, I am not sure there is anything more troubling than the Office of Financial Research. As if Americans needed yet another agency collecting unlimited amounts of information from the American public for bureaucrats to pore over, there is tremendous concern that this agency will do nothing but misinform regulatory decisions and increase the risk of crippling cyber attacks.

Beyond these operational concerns, the OFR was created under a false premise that regulators did not possess enough information leading up to the financial crisis, but as any well-informed autopsy of the crisis will tell us, it was lack of will, not lack of information, which contributed to the regulatory failures of the past decade. Or as one witness put it to this committee at a 2011 hearing on OFR, "The risk of Fannie Mae could be seen on an abacus." It is therefore no surprise that the OFR's recent report on asset managers was greeted with criticism from all sides of the political spectrum. And when you unite the left and the right these days in opposition to what you are doing, it is fair to say something is more than amiss.

I believe this to be an unnecessary and potentially dangerous agency. And I think the question today should not be what reforms could improve a fundamentally flawed agency, but whether the OFR should be outright abolished.

I thank you, Mr. Chairman, and I yield back.

Chairman McHENRY. We will now recognize the ranking member of the subcommittee, the distinguished colleague of mine from Texas, Mr. Green, for 5 minutes.

Mr. GREEN. Thank you, Mr. Chairman.

And thank you, Dr. Berner, for your testimony today. I would also like to thank the staff for the exceedingly good job that has been done in helping with the preparation for this hearing.

Today's hearing is an opportunity to learn more about the Office of Financial Research's work last year as well as what we can expect from their 2014 agenda. By the end of 2007, the top 5 banks had assets of $6.8 trillion or 49 percent of GDP. Similarly, the top securities firms accounted for $3.8 trillion or about 27 percent of GDP.

In the years leading up to the financial crisis, our regulatory framework was simply unprepared to handle the growing risk and eventual collapse of a large interconnected financial institution. The financial crisis revealed deficiencies in our understanding of the financial system, including the extent of leverage, the migration of financial activities to underregulated or lightly regulated markets and entities, and the potential for disruptions to spread across interconnected companies and markets.

The crisis also revealed that the data available to monitor the financial system was too aggregated, too limited in scope, out of date, or otherwise incomplete. Accordingly, Wall Street reform created the Office of Financial Research (OFR) to support the Financial Stability Oversight Council (FSOC) and its member agencies.

The OFR's mandate includes standardizing financial data, performing essential research, and developing new tools to measure and monitor risk to the financial system. The OFR is designed to complement the work of FSOC member agencies by filling gaps in data and knowledge about the financial system. As such, the OFR's 2013 annual report highlights the progress we have made in reducing the risk in our financial system as well as identifies areas where further information is needed. OFR's report on asset management and financial stability is consistent with its mandate to support the Council in its efforts to identify and mitigate threats to financial stability. The report was produced at the FSOC's request, which asked OFR to examine how activities of the asset management industry could transmit risk through the financial system.

Admittedly, OFR itself identified significant data gaps in its report that limited a full evaluation of the industry. However, OFR has since assured us that it will continue to work with the Council member agencies to identify those gaps, prioritize them, and assist the Council as it continues to work to analyze the asset management industry.

We should be clear, Mr. Chairman, as to what this report is and what it is not. It is not a green light to designate actors in the industry as systemically important institutions. Rather, it is a first step towards better understanding a critical part of our financial markets.

The asset management industry provides important points of access into capital markets for commercial investors and can be an important piece of wealth building for the American middle class.

Mr. Chairman, the FSOC and the Office of Financial Research are central to the overarching objectives of Wall Street reform, and they must be given the opportunity to refine their research, rule-making, and deliberative process.

We understand from the financial crisis that there was a lack of collaboration and information sharing between the regulators. Both the FSOC and the OFR are important to ensure regulators are working together to monitor systemic risk. Similar Councils have been formed in Europe, and if given time, they should all work together effectively to ensure the global financial system is not threatened as it was in 2008.

I yield back the balance of my time, Mr. Chairman, and thank you for being generous.

Chairman MCHENRY. I certainly appreciate the ranking member.

Today, we will hear from the Director of the Office of Financial Research, Richard Berner. Prior to his confirmation as OFR Director, Dr. Berner served as a Counselor to the Secretary of the Treasury, with responsibility for standing up the OFR. Before joining Treasury in April of 2011, Director Berner was co-head of the global economics division of Morgan Stanley, and previously served in senior positions at Mellon Bank, Salomon Brothers, Morgan Guaranty Trust Company, and the Federal Reserve Board, all fairly well-known institutions. And Director Berner has won several economic forecasting awards as well. He received his bachelor's degree from Harvard College, and a Ph.D. from the University of Pennsylvania, again, other well-known institutions.

Dr. Berner, you are familiar with the process of testifying on the Hill. We have the lighting system, very simple for us Members of Congress: green means go; red means stop; and yellow means hurry up. So with that, we will give you 5 minutes to summarize your written statement.

STATEMENT OF THE HONORABLE RICHARD BERNER, DIRECTOR, OFFICE OF FINANCIAL RESEARCH (OFR), U.S. DEPARTMENT OF THE TREASURY

Mr. BERNER. Chairman McHenry, Ranking Member Green, and members of the subcommittee, thank you for the opportunity to testify this afternoon on behalf of the Office of Financial Research about our 2013 annual report. It is good to be back here.

Let me take this opportunity to reaffirm two commitments: first, to make the OFR a valued resource for Congress, the Financial Stability Oversight Council, and the American people; and second, to be transparent and accountable. Our annual report and my testimony here are two of the ways we honor those commitments.

Last March when I was here, I discussed our progress as a start-up organization. Today, we are not only standing on our own, but we are making significant contributions to promote U.S. financial stability.

This second annual report to Congress and our other work described in the report are evidence of that. In my written testimony, I discussed four key topics in our annual report: monitoring and analyzing potential threats to financial stability; data collection and analysis; data standards; and data security. I would like to give you some highlights from each of those.

Thanks to an array of policy measures and industry actions, the U.S. financial system has grown stronger and more stable since we issued our inaugural annual report in July of 2012, however, threats to U.S. financial stability remain, and we must remain vigilant.

To help identify and monitor those threats, we have developed a new tool, our prototype financial stability monitor. Our annual report discussed a first version, which we will refine and improve over time. Our report identified and analyzed eight threats to financial stability. Recent events have thrown one of them into sharp relief. Emerging markets have come under significant pressure and the stress has spilled over quickly into global markets for other assets. We are continuing to monitor these developments carefully.

Taking stock of existing data is necessary to fill data gaps and to avoid duplication in data collection. To that end, we recently published and will maintain an interagency data inventory of data held by all Council member agencies.

Our report outlines several initiatives to improve the scope and quality of financial data, including our work with the Federal Reserve Bank of New York on data related to short-term wholesale funding markets.

It is essential to analyze the data that we and others collect. For example, our first look at hedge fund leverage using aggregated data from foreign PF, which is collected by the SEC and the CFTC.

Data standards are critical to improve financial data quality. The OFR has led an initiative for a standard, called the Legal Entity Identifier (LEI). Like barcodes for financial transactions, LEI's benefit industry by helping to lower reporting costs, they benefit regulators with better data for policy decisions, and they benefit researchers with consistent data for analysis.

We have worked with others in the Council to highlight the need for another data standard, a single cradle-to-grave standard for mortgage data, called the Universal Mortgage Identifier. To be truly useful, data standards must be universally adopted, so I have called on regulators in the United States, and globally, to require use of the LEI and other standards through regulatory rulemaking.

No objective is more important to us than keeping data safe and secure. We have a multifaceted data security program that builds on the security infrastructure of the Treasury Department. We also have specific safeguards tailored to our unique mission, as well as securities standards and policies for acquiring, managing, and sharing data.

We want to be sure that you and the Congress are fully informed about our work. I look forward to opportunities like this hearing in the future. More broadly, we will engage with you and your staffs to assure that our dialogue is frequent, open, and informative.

Thank you again for inviting me here today, and I will be happy to respond to your questions.

[The prepared statement of Director Berner can be found on page 32 of the appendix.]

Chairman MCHENRY. Without objection, the witness' written statement will be made a part of the record.

Dr. Berner, I sent you a letter dated in—well, actually, in December of this year, and in my letter, I asked for information about the individuals who contributed to the asset management report and the relevant background and experience in the asset management industry, and you responded, but you did not answer that question. Furthermore, I also asked you to provide a list and description of all the meetings that the OFR held with representatives for the asset management industry in preparing this report. Again, you acknowledged that you and your staff met with folks from the asset management industry, but you did not provide the information we requested. I am now asking if you would be willing to provide that information.

Mr. BERNER. Mr. Chairman, I would be happy to provide that information, meet with you and your staff to provide that information. If you felt our letter was not responsive, we want to make sure that it is.

Chairman MCHENRY. I believe it was not responsive, unfortunately. And I certainly appreciate your willingness to have frequent conversations and dialogue. I just want to ensure that the folks who wrote the report have the sterling credentials or similar credentials that you do. And I know that is an important part to make sure that when we have analysis of data, that our government agencies provide sterling data and sterling insight to that data.

Now, as a part of this, can you explain how policymakers are supposed to act on the OFR's research if the OFR fails to prioritize all identified risks?

Mr. BERNER. Mr. Chairman, the annual report that we presented identifies eight risks to financial stability. We could probably enumerate some more, but those are the top eight. So in that sense, we did prioritize what we thought were the most important risks.

Chairman MCHENRY. So of those top eight, is there priority of those top eight?

Mr. BERNER. Mr. Chairman, when we think about threats to financial stability, sometimes those risks are interrelated. Indeed, when we looked at the top—the first three that we enumerated, those are—as I indicated in my written testimony, those three are related, and they are related to a fourth.

The basic theme there is that where market positioning is, markets may be vulnerable to a sharp unexpected rise in interest rates or in volatility.

Chairman MCHENRY. Sure.

Mr. BERNER. And that is—there is a—

Chairman MCHENRY. Bloomberg—for instance, anyone can pay the money to get a Bloomberg screen and know that level of information.

Now, the question is the magnitude of these risks. So if I were to ask you what is the single most significant risk to the U.S. economy, what would you say?

Mr. BERNER. That is a hard question, Mr. Chairman, because when we think about financial stability, risks to the financial stability, the reason we talk about threats is that many times they don't come in 1's or 2's, they may come in several flavors, and it is the combination of those threats when exposed to a shock which can expose vulnerabilities in our financial system that have an interplay among them, so it is really difficult to say what the top risk is right now.

I would say that there are remaining vulnerabilities in our financial system. One of the ones that we identify in the list of eight relates to short-term wholesale funding markets, which I alluded to in my comments a moment ago. That is a risk that has been partly addressed by policymakers, but not completely.

Chairman MCHENRY. Okay. But in terms of the difficulty of assigning a level of risk, I understand, but you have an $86 million budget and you are in—what you are supposed to do in standing up this agency is to lay out those risks and prioritize those risks, are you not? Aren't you a part of the process to identify the next financial crisis so we can avoid it?

Mr. BERNER. Actually, Mr. Chairman, I am not sure that we can identify when the next financial crisis will occur, nor can we prevent financial crises. What we can do is identify what the risks are to the financial system, where its vulnerabilities are in order to inform policymakers about strengthening those vulnerabilities and making our system more—

Chairman MCHENRY. And you said as much before the Senate Banking Committee a few weeks ago, a very similar quote, in fact, that you can't predict the next financial crisis. So why are we spending $86 million on an agency that can't do the thing it is supposed to do? It is a basic question.

Mr. BERNER. Mr. Chairman, the Dodd-Frank Act created the Office of Financial Research—

Chairman MCHENRY. I am familiar. Yes, sir.

Mr. BERNER. —to inform the Council and the American people. We think that is exactly what we are doing. We think that we are giving information to the Council and to the American people in order to strengthen the financial system.

We learned in the financial crisis that it was exactly those weaknesses that had not been immediately visible that contributed greatly to the financial crisis. Our job is to help strengthen those weaknesses.

Chairman MCHENRY. My time has expired, but I would say this, that when Simon Johnson says that your annual report is not impressive and it reads like some of the less informative systemic risk assessments that we saw prior to 2011, that should be deeply troubling to you, with your sterling academic credentials. And you should be willing to correct that and to improve that, and I hope you will.

With that, we will now recognize Mrs. Maloney from New York for 5 minutes.

Mrs. MALONEY. I thank the ranking member and the chairman for calling this important hearing.

And I thank our witness.

The purpose of the Office of Financial Research—and I was one of the contributors in authoring it—was based upon language set forth in Dodd-Frank to collect industry trade and transactional data for review and analysis to proactively prevent any future meltdowns like we saw in the Great Recession, and your Office was granted a sizeable budget to achieve this goal. And I am going to read from the law right now. It says your first duty was to collect data on behalf of the Council and provide that data back to the Council and member agencies; and secondly, to standardize the types and formats of data reported and collected.

Can you get us in writing what data elements you are collecting now? Are you sending that data back?

And also, one of the important parts of this bill, the Office of Research, was that the data should not come from the industry, because we had data from the industry that was collected, and no one could perceive what happened in 2008. So the data was supposed to be concrete actions, such as trades, where you could really see what was happening. And so my question is, what data have you collected and have you come out with a standardized form?

A problem with the LEI, when do you expect to see the LEI completed? What is the completion date? And as I understand it, foreign areas are part of this, and they are refusing to cooperate, so it seems to me it would be better to just collect the data so at least you have something.

I do want to put into the record two letters that I sent to the Office asking for responses in writing. I never received any responses. Chairman McHenry, may I place in the record the two letters that I sent? I would like you all to review them and see if you would like to send your own letter. Maybe it is because I am in the Minority, that I don't get an answer. Maybe the Majority could get an answer.

Chairman MCHENRY. I would be happy to review that, and we will include it in the record of this hearing.

Mrs. MALONEY. Thank you.

Chairman MCHENRY. Without objection, it is so ordered.

Mrs. MALONEY. So what data elements are you collecting now?

Mr. BERNER. Congresswoman Maloney, thank you very much for your question and thanks for your support for the Office.

We are actually in the process of collecting data through other agencies, through financial market utilities. And, as you know, the statute requires that we first make sure that the data that we want to collect, the data we need to do our analysis, that the Council needs to do its analysis are not available elsewhere. So in order to do that, we have constructed the data inventory, which I mentioned earlier, which catalogues all the data held by all the Council member agencies.

We are collecting in very granular form position and transaction data related to OTC derivative transactions. That is the first step. We are getting those data from a financial market utility. Those data are being—

Mrs. MALONEY. Have you made any contracts with anyone to collect this data? How do you collect this data?

Mr. BERNER. In the case of those data, Congresswoman, we enter into a memorandum of understanding with the financial market utility to collect the data, to use them for our research purposes and to make sure that we keep them safe and secure.

Mrs. MALONEY. But the collection, if you are getting it—it was our intent to get it from open trades that you know are true as opposed to information that may be handed to you from somebody in the industry that may not be true.

Mr. BERNER. Right. And there are—

Mrs. MALONEY. And I would like to also go to the LEI. Nowhere in our legislation did we mention the LEI or did we require an LEI. We were after raw, factual, independent data. And I would like you to get back to me on what raw, factual, independent data you are collecting. It appears that the trades would be the best, that is what people in the industry tell me, because that is a factual data element that you can track.

Mr. BERNER. Congresswoman—

Mrs. MALONEY. And the LEI is problematic, I am told, because some people who don't have to comply are just not complying, but let me ask one question on the LEI. When do you intend to complete the LEI project and how much have you spent to date on the LEI project, which we did not even require?

Mr. BERNER. Congresswoman, the LEI is a great example of data standards, which we are required to promote and implement through the statute.

Mrs. MALONEY. No. The statute does not mention the LEI.

Mr. BERNER. It does not mention the LEI.

Mrs. MALONEY. I read it. I wrote it. I was part of the team who wrote it. We did not mention the LEI. We wanted independent data elements.

Mr. BERNER. Right. And when you talk about transaction data, raw data elements, a good example of that would be the data that we are working with the New York Fed to collect on repo transactions, positions, position date that will be very granular, as you describe it, true and accurate. We are working hard to start out collecting those data and will do so, and we will be happy to come back to you and report our progress on that for you.

Mrs. MALONEY. My time is up, but I would like to, in a handshake of bipartisanship, with the ranking member's permission, request that we come to your site. We would like to see what—it has been, what, 3 years, where over 150 million has been—what data elements are there? Can we come to your Office and see how you are collecting it, where is it? And are these bids, these contracts that are collecting it, are they competitively bid? You have said you are getting the information directly from the industry. We wanted it from independent sources.

So, Mr. McHenry, would you join me in going to the Office and seeing how they are collecting this data?

Chairman MCHENRY. Actually, if the gentlelady would yield, and I will ask unanimous consent that the gentlelady has an additional minute, if that is okay.

Mrs. MALONEY. Thank you.

Chairman MCHENRY. And if the gentlelady will yield, I would respectfully ask the Director, with the number of comments we have received on the asset management report, and the question the gentlelady has on this identifier, we have a number of questions as Members of Congress, but I think that would be a very helpful thing if the Director would be willing to sit down with us on his site to show us what he is doing.

Mrs. MALONEY. Thank you.

Mr. BERNER. I would be happy to have you come to my site or meet with you in your Offices or anywhere in between—

Chairman MCHENRY. Okay.

Mr. BERNER. —Congressman.

Chairman MCHENRY. Thank you. And as a corollary to that, would you be willing to have a public forum on the asset management report?

Mr. BERNER. We have been engaging publicly on the asset management industry. We engaged publicly back in December at a public forum on that. But I am always willing, always more than willing to engage and to have more public forums, more engagement with the industry, with you, and with the American people on any subject, not just asset management.

Chairman MCHENRY. So that would be a qualified yes, then?

Mr. BERNER. It would be a yes.

Chairman MCHENRY. Okay. Thank you.

Mrs. MALONEY. Thank you, I yield back.

Mr. MCHENRY. Okay. I thank the gentlelady. We are the Oversight Subcommittee. A note of bipartisanship is a very nice thing. I want to thank my colleague for that.

We will now recognize the vice chairman of the subcommittee, Mr. Fitzpatrick, for 5 minutes.

Mr. FITZPATRICK. I thank the chairman.

Director Berner, we all appreciate your testimony here today, not just required by the Act, but we all find it very helpful, both bodies, as we do our oversight, and where Mrs. Maloney asked a series of questions about what kind of data is being collected, provided to OFR, my questions have to do with once that data is collected. What actions is the Office of Financial Research taking to protect that data against unauthorized disclosure?

As you are aware, Dodd-Frank requires the Office's Director, and this is a quote from the Act, to ensure that the data collected and maintained by the Office of Financial Research's data center are kept secure and protected against unauthorized disclosure. However, the annual report, which has been provided to the committee, the 2013 report, provides really no indication that OFR has achieved this data-protection goal. For example, there is no detailed discussion on how OFR is protecting its data from data breaches and cyber attacks.

There is no accounting of the cyber attacks perhaps that OFR has experienced so far. The 2013 annual report does, however, state that you have certain priorities for 2014. They include collecting more data in a broad range of financial activities and institutions, including the repo market, securities lending, and asset management firms, as well as implementing systems that can analyze and process large data sets.

So, given these 20—first, I should ask, and I know that you did in your written testimony provide some information on data security, for instance, this is in the written testimony, you say that technology is necessary but insufficient alone to ensure security. So the systems we are building for data acquisition, management, and dissemination are accompanied by strict and clear rules for data security and data sharing.

It sounds like you are continuing to build the systems. Is that correct?

Mr. BERNER. Congressman, this is an ongoing process, building data security. But I think we start from a very strong foundation.

As I indicated in my written testimony that you just pointed to, we start with the governance from the Treasury Department and we use their standards as a starting point for our security systems. We build on that, using technology, using governance, using protocols for access to information, depending on the level of sensitivity of the information.

We have taken an active role. One of the aspects of keeping data secure is making sure that when they are appropriately shared, for example, with another Council member or agency on the Financial Stability Oversight Council, that they are kept just as secure by us and by the third party in the Council as they are by the original provider of the data.

So all of those things are being worked on. I am pleased to report to you that the process of engagement with the Council on getting agreement on those protocols is well under way and nearly complete, and that ensures that the controls which are applied to data that one agency has will be consistent with all the controls across the Council.

Limiting access to data, making sure that the right people have access to the data, only those who need to know, that is also important. The technology governs or controls that access to some extent. But we build in the human element just to make sure that there is a check and balance system so that nobody has access to data they shouldn't.

Mr. FITZPATRICK. Given the fact that, it is, I guess you could describe it as a work in progress, what kind of assurances can you give either this committee or the original owners of the data that supplied it were required to supply to OFR that it is protected today? I understand that going forward, there will be changes, there will be new protections. How do we know it is protected today?

And the second question would be, if there has been a cyber attack or if there has been an unauthorized disclosure of that information how would we be notified? How would the owner of the information be notified?

Mr. BERNER. Congressman, as I indicated, we build on the foundation laid by the Treasury Department. And the Treasury systems have proven over a long period of time to be secure, and so that is one example of that. I would be happy to sit down with you and your staff to talk about the particulars of these—

Mr. FITZPATRICK. Have there been incidents of unauthorized access?

Mr. BERNER. There have been no incidents of unauthorized access, to my knowledge. But that does not mean that we can take comfort that there would not be. We live in a world where that is an everyday occurrence. We live in a world where we need to safeguard—

Mr. FITZPATRICK. Right.

Mr. BERNER. —and protect our data and we are taking every step, every precaution to do that.

Mr. FITZPATRICK. If there was a cyber attack or an unauthorized disclosure, how would we be notified and how would the public be notified?

Mr. BERNER. We would make sure that we follow appropriate protocols to let the appropriate people know, including you in your right to know as Members of Congress.

Mr. FITZPATRICK. I yield back. Thank you.

Chairman MCHENRY. We will now recognize Mrs. Beatty for 5 minutes.

Mrs. BEATTY. Thank you, Chairman McHenry, and Ranking Member Green.

And thank you to our witness, Dr. Berner, for being here today. You have had a lot of questions about forms and data. So let me just add another thread to that. In both the annual report and in your written testimony, you talked about the new tool the OFR can use to track changes in stability in domestic financial markets, and that is the financial stability monitor. One of the things I noticed as I looked at the five areas that it also monitors, it is supposed to gauge the possible risks to the market stability based on the data collected by OFR. But, unfortunately, you mentioned that it only looks at the past and the current data that exists.

So I guess when you talk about these forward-thinking indicators, my question is, can you address to us or share with us if you anticipate from researchers in your Office what kind of future versions of this financial stability market do you have in mind for what those indicators are?

Mr. BERNER. Sure. Thanks for your question, Congresswoman.

It is a good question because it is very important that we have more forward-looking indicators in any summary statistic that looks at financial stability. So one of the ways to make the indicators that we use more forward looking is to try to incorporate the relationship between volatility in financial markets, how much they move up and down and at what frequency, and the leverage that financial market participants may use.

And there's theoretical work and empirical work which shows that there is a relationship between those, namely the lower the volatility, the more leverage that investors, market participants are encouraged to use.

That has future consequences; we know that from the financial crisis. That is one of the things we are trying to build in to make the financial stability monitor more forward looking in the future, and we are hard at work at that right now.

Mrs. BEATTY. And you mentioned the volatility. Do you have confidence or believe that this financial stability monitor will be able to accurately predict the instability based on the current information we have? And if so, why?

Mr. BERNER. It is a new tool. We are testing it. We are looking to assess what information can come out of it. I want to emphasize that no tool by itself is a failsafe indicator of where threats may lie.

Obviously, tools are used to inform judgment. And that is precisely the reason that we came up with this tool, because it does provide a comprehensive look across the financial system and across five key measures or buckets, if you will, of risk. Those are functional buckets of risk. We think that they are the right ones. Macroeconomic, funding and liquidity, market, credit risk, and contagion, which expresses the extent to which threats get transmitted across the financial system.

So we are working to improve it constantly. We are going to be testing it. We are going to try to assess its validity and its utility as a tool to inform our judgment.

Mrs. BEATTY. In my last minute, let me shift, you talked about risks, so let me ask you to address a different type of risk. Also in the annual report, the OFR speaks of several different currencies to the domestic financial market stability, ranging from the risks of risk in the repurchase market to exposure to duration risks. So we know we are now in the month of February, and we are approaching our whole debt ceiling date, and in your report you also talk a little bit about the one-upsmanship, the brinksmanship in how we are looking at this on our side of the aisle and on the other side of the aisle.

So as we are approaching the borrowing limit authorized under the deal to end the shutdown at the temporary raising the debt ceiling, I reflect back on what happened last year. And so I guess what I want to ask you is, as we approach this date, and maybe we are looking at that we are not really accepting the use of full faith credit of the United States as an unacceptable bargaining tool for a whole host of reasons, certainly by not anybody in this committee, but as we look in the broader sense.

Can you tell us or prognosticate if we have this fiscal policy brinksmanship and how it would disrupt the market or if we wait until we get to the nth hour of looking at how we are going to take care of our debt ceiling, where are we? We are in February. We are getting close.

Mr. BERNER. Congresswoman, thanks for your question. I am going to answer briefly because I see that the time is running out. But as you point out, the 2011 experience was instructive in that regard, and provided us maybe a taste of what could happen if we go down that road again. No two of these episodes are alike, but I think we can learn from that experience that markets don't like uncertainty and that the kind of developments surrounding that event were disruptive to markets, and indeed had some spillover into economic activity.

Mrs. BEATTY. Thank you.

Chairman MCHENRY. We will now recognize Mr. Duffy for 5 minutes. And if I may ask that gentlemen to yield?

Mr. DUFFY. Yes.

Chairman MCHENRY. Thank you.

Dr. Berner, have you been part of any Congress contingency planning within Treasury? Has Treasury asked you to do any research on this debt limit question?

Mr. BERNER. Mr. Chairman, no, they have not.

Chairman MCHENRY. Thank you. I will yield back.

Mr. DUFFY. So we are not speaking with data knowledge. And I guess I am not going to go into the $17.3 trillion of debt that we have and what happens to countries which experience a debt crisis and what that does to their markets. Sure, it is not very pleasant.

I want to go back to your collection of data and the systems that you have in place to secure that data. I believe that you testified earlier that the security portion is a work in progress; is that true?

Mr. BERNER. Congressman, I did say that. It is a work in progress. And—

Mr. DUFFY. And I guess, just quickly, I know that you are currently collecting data, right? You are not waiting until you have a great security system in place, you are actually collecting it currently, yes?

Mr. BERNER. Congressman—

Mr. DUFFY. Are you collecting data?

Mr. BERNER. We do have a very good security system in place—

Mr. DUFFY. My question is, are you collecting data right now?

Mr. BERNER. We are collecting data right—

Mr. DUFFY. And you are directing data. And you are coming in here and telling us that the security system isn't really ready, it is a work in progress. You don't leave us a lot of confidence in regard to the information which you are taking and that it is going to be secure.

I am going to follow up on the vice chairman's comments. Have there been any cyber attacks or data breaches on your system?

Mr. BERNER. Congressman, I prefer not to use those in a public forum. If there have been any, not to my knowledge, as I indicated, but I would be happy to come up and talk to you and your staff both about the steps we are taking to continually strengthen security, which is already strong, as well as the possible risks that may arise from any attacks.

Mr. DUFFY. I appreciate that. And I will take you up on the offer to meet with me privately. I know there could be some concerns about bringing things up publicly. But in this public forum, that also gives me concern that if there have been security breaches or cyber attacks, that necessarily hasn't been made public and hasn't been brought to our attention. And so if there has been data that has been compromised, it goes back to, I think, the chairman's earlier point. Is there a system in place to actually let people know that there are breaches and that there are cyber attacks that potentially have been successful?

And I know you have referenced, I believe, Treasury and their standards. You couldn't really articulate them for us, and we are going to ask you on a whole wide range of issues, and you can't be prepared on everything, I am sensitive to that. I wish you would be able to tell us about the security that you have in place. And the process you have that is available to notify individuals and Congress of those breaches.

Are you currently collecting information from firms and/or consumers?

Mr. BERNER. Congressman, we are not collecting information from firms, with one exception.

Mr. DUFFY. Okay.

Mr. BERNER. In serving the needs of the Financial Stability Oversight Council and in a ministerial role, as an agent role, for the Council's non-bank designation process, we have been asked to collect data to support that process from firms.

Mr. DUFFY. Do you have plans to collect consumer information in the future?

Mr. BERNER. Congressman, consumer data are not our focus in the Office—

Mr. DUFFY. That is not my question. Do you have plans to collect—

Mr. BERNER. We have no current plans to collect any consumer data.

Mr. DUFFY. And in regard to the universal mortgage identifier, are you going to be collecting mortgage information? I know you are working with the CFPB on this.

Mr. BERNER. Actually, Congressman, our role in the universal mortgage identifier was to provide conceptual information. We produced a concept paper, which is a paper on our Web site. And the purpose of that was to articulate the standards and the protocols that would be used in a universal mortgage identifier. Mortgage data would be collected by the primary regulator for housing finance, for example.

Mr. DUFFY. To be clear, you are just going to set the standards? You are not going to be involved in the collection of data?

Mr. BERNER. We have no current plans to collect any mortgage data.

Mr. DUFFY. Okay. But you are working on the universal mortgage identifier to be used by the CFPB. Is that your testimony?

Mr. BERNER. My testimony is that we are using—we are working on the universal mortgage identifier conceptually to assist the CFPB, to assist the FHFA, and the Council in general.

Mr. DUFFY. I just want to be clear—other agencies are collecting the consumer information, which we are aware of, we have talked to the CFPB about this.

Mr. BERNER. Right.

Mr. DUFFY. But not yours?

Mr. BERNER. That is correct.

Mr. DUFFY. Okay. I yield back.

Chairman MCHENRY. I thank my colleague.

And I will now recognize the ranking member for 5 minutes.

Mr. GREEN. Mr. Chairman, I ask unanimous consent to reserve my time.

Chairman MCHENRY. Without objection. The gentleman will reserve his time.

We will now go to my colleague from Missouri, Mrs. Wagner.

Mrs. WAGNER. Thank you, Mr. Chairman.

Director Berner, did the OFR originally plan on releasing its asset management report to the public?

Mr. BERNER. Congresswoman, when we got the request from the Council to prepare our report, it was actually to prepare to study the asset management industry. Subsequently, we believed in the interest of transparency and accountability.

Mrs. WAGNER. That is a yes-or-no question. Did you originally plan on releasing this report?

Mr. BERNER. We always want to be transparent and accountable and publishing the report on our Web site is one piece of evidence of that.

Mrs. WAGNER. The OFR spent about 18 months working on the asset management report; is that correct?

Mr. BERNER. Actually, Congresswoman, the Council, starting with a process in the interagency working group on the asset management industry, started working on looking at the asset management industry even before that. So, our work is a continuation of that work.

Mrs. WAGNER. During the time, did the OFR make it clear to asset managers that the report would be made available to the public?

Mr. BERNER. I'm sorry. Could you repeat the question?

Mrs. WAGNER. Did the OFR make it clear to asset managers that the report would be made available to the public?

Mr. BERNER. We said that decision was up to the Council. We presented our work to the Council, and we asked the Council if they would like to publish the report. They said yes, and we agreed.

Mrs. WAGNER. I am going to go back one more time. Did you originally plan on releasing the asset management report to the public?

Mr. BERNER. Congresswoman, the report was requested, the study was requested by the Council. So the—

Mrs. WAGNER. Yes-or-no answer.

Mr. BERNER. Any decision—

Mrs. WAGNER. Was it originally planned that you were going to release this management report? Asset management report?

Mr. BERNER. Congresswoman, any decision on that score was really, since this was something requested by the Council, was the Council's decision.

Mrs. WAGNER. Taking back my time, exactly when did OFR decide to make the asset management report publicly available? When?

Mr. BERNER. The OFR decided after we talked to the Council and the Council agreed to make the report public.

Mrs. WAGNER. Can you provide us with a date or at least a specific month when that decision was made?

Mr. BERNER. I believe it was in early September, about 3 weeks before the report was released.

Mrs. WAGNER. In early September, 3 weeks, is when the decision was made to make this public?

Mr. BERNER. The decision was made by the Council to release the report and make it public. The Council had to review the report before they made that decision. We presented the report to the Council. It was the Council's decision. And they made the decision to—

Mrs. WAGNER. One more time: Did asset managers know that this report would be made available to the public?

Mr. BERNER. When we engaged with asset managers, we told them that all of our work would be transparent and open and made available to the public at an appropriate time.

Mrs. WAGNER. Dr. Berner, last week, before the Senate Banking Committee, you said of the asset management report, "We engaged the SEC almost from the start because they are the primary regulator for most of these companies and they had the expertise long acquired to look at these companies."

But as you know, the SEC took the absolutely unprecedented step of opening up the OFR report to public comment. Why shouldn't Congress interpret this as a sign that there was very little collaboration or agreement between the OFR and the SEC?

Mr. BERNER. Because, Congresswoman, there was robust and longstanding collaboration between the OFR and the SEC, indeed, between the OFR and all members of the Financial Stability Oversight Council.

Mrs. WAGNER. Why would the asset management industry and some financial reform advocates submit dozens of long comment letters to the SEC if they believed that their input was included in the asset management report?

Mr. BERNER. Congresswoman, I can't speak for them. I can only speak to the fact that we have every interest in being, as I indicated, transparent and accountable. That is precisely why we posted the report on our Web site for public review. Understand that the report was produced in the sense that we are a research and data organization. Our job is to inform the Council. We put the report on our Web site fully expecting—

Mrs. WAGNER. That is great. I appreciate that, and I really appreciate your trying to work towards transparency. And in that vein, will you commit to providing this committee, in writing, a record of all the meetings that you or OFR staff had with the SEC and who was present at those meetings, please?

Mr. BERNER. I am happy to sit down with you and provide that information.

Mrs. WAGNER. Will you provide that to the committee, please?

Mr. BERNER. Yes, I will.

Mrs. WAGNER. Thank you. I appreciate that.

One other thing, since I have a little bit of time left.

Looking at the report, the report has listed so many incorrect things, misrepresentations. It lists an incorrect for Fidelity's highest level asset manager and its entity and misreports the amount of its assets under management, improperly classified Vanguard's structure, and misreported the amount of assets under management for PIMCO. Thankfully, the Securities and Exchange Commission provided stakeholders with an opportunity to point out these careless mistakes. Director Berner, don't you agree that such carelessness is just indefensible?

Mr. BERNER. Congresswoman, there are no errors in our report, save for one chart that has been mislabeled, and we have examined every comment, every letter, every submission, and every claim of mistakes in our report and have found none.

Mrs. WAGNER. I believe I am out of time.

Chairman MCHENRY. I ask unanimous consent to submit for the record the comments of left-leaning financial activist group Better Markets, the quote by Dennis Kelleher that says, "Rather than focusing on the known systemic risks of the OFR report which materialized just 5 years ago, and which inflicted widespread economic wreckage across the country, OFR chooses to take aim at the asset management buy side of the financial industry which by comparison presents much lower risk and played no role or virtually no role in the most recent financial crash."

Without objection, that will be ordered.

And then, we have an additional comment from Vanguard that I would submit for the record, which refers to an incorrect classification of Vanguard as a non-deposit trust company member within the OFR report.

And without objection, we will submit that for the record.

We will now recognize Mr. Rothfus.

Mr. ROTHFUS. Thank you, Mr. Chairman. And welcome, Director. OFR is projecting a staff, including permanent, reimbursable, and detailed staff of 282 individuals in Fiscal Year 2015. Could you explain for us the process OFR used to determine that 282 was the right number of staff?

Mr. BERNER. Congressman, we try to outline our workforce plan, as we have done and are required to do under the statute for the first 5 years of our existence, in a report to Congress. By linking our plans for hiring to first our strategy, our strategic goals, we outlined those strategic goals first in our strategic framework for the first 2 years of our existence, or from 2012 to 2014. It is now 2014. We are taking a hard look at that because we anticipated that being a start-up organization, we would need to revisit that strategic plan and the goals that were contained in it.

We are in the process of doing that, so by 2015 I can report back to you and talk about how we have revised those and how they affect the way that we are hiring. The hiring is linked to the goals and the way we carry out our mission. And those two things are firmly connected.

Mr. ROTHFUS. OFR is outside the normal appropriations process and has a sole principal, yourself. If you or another OFR Director decided that OFR required, say, 1,000 or more staff, could Congress do anything to stop you?

Mr. BERNER. Congressman, we are subject to a number of checks and balances and substantial oversight. I am required as Director to consult with the Chairperson of the Council, who is also the Secretary of the Treasury, on matters of budget, and on hiring and compensation. So, there are checks and balances there. Second, our budget is published in the President's budget and so it is made public. I think that was referred to earlier today.

Mr. ROTHFUS. But there is nothing that Congress can do to limit the number of folks you would be hiring, or your budget, for that matter?

Mr. BERNER. We are also subject to oversight by the various Inspectors General and by the Government Accountability Office, which is an arm of Congress. And, in fact, when I was here 10 months ago, I testified on a report about transparency and accountability.

Mr. ROTHFUS. But does that give Congress the authority to set a limit on the amount of folks that you can hire?

Mr. BERNER. There is substantial oversight.

Mr. ROTHFUS. There is oversight, but there is no limit, is there?

Mr. BERNER. There is substantial oversight, but we are following the statute in the way that we proceed. And again, I have accountability to you as a Member of Congress to report back to you on exactly what we are doing and why we are doing it.

Mr. ROTHFUS. OFR funds itself with assessments on industry which are placed in its financial research fund. Dodd-Frank Section 155(a)(3) allows OFR to request the investment of the portion of the financial research fund that is not required to meet the needs of the Office. Do you know the current balance of OFR's investments?

Mr. BERNER. Congressman, the way that the financial research fund is set up, it funds actually not just the Office, but also the Secretary of the Financial Stability Oversight Council, certain activities of the FDIC to resolve large complex financial institutions, and some other institutions. We build into the process the idea in our assessment process which was the subject of a Treasury rule that we would collect. Every 6 months, we would collect 6 months of operating expenses for those entities and we would collect 12 months of capital expenditures projected, because capital expenditures, as you are well aware, can fluctuate, and are lumpy and hard to predict. And so, we do have a balance. I will get back to you with what is—

Mr. ROTHFUS. I appreciate that. We will follow up with you in writing on that.

Mr. BERNER. —in the fund currently. But that is the reason that any funds accumulate. Because when you assess every 6 months, you don't spend the money immediately.

Mr. ROTHFUS. It is widely acknowledged including by you in your annual report that U.S. Treasuries stand apart in terms of their creditworthiness in the highly liquid markets in which they trade, and that these attributes help tremendously in periods of market volatility.

You have indicated that you are focusing on activities in the asset management industry, and in doing so, what consideration is being given and what steps are you taking to preserve the deepest, most liquid market possible in Treasuries?

Mr. BERNER. Congressman, in our report on asset management, we didn't really address any aspects of any particular market. Rather, we focused on the activities of asset managers. The breadth, depth, and liquidity of the Treasury market are obviously a great asset to the United States. And you know—

Mr. ROTHFUS. Have you thought at all about the implications on the Treasuries market of your scrutiny of asset managers?

Mr. BERNER. We haven't linked those two things together directly, Congressman. But in our annual report, we do have a research study on financial market liquidity, particularly what is called market liquidity, or the ability to transact. And that study may inform some aspects of trading in the Treasury market.

Mr. ROTHFUS. I thank the chairman.

Chairman MCHENRY. We will now recognize my colleague from Kentucky, Mr. Barr, for 5 minutes.

Mr. BARR. Thank you, Mr. Chairman.

And thank you, Mr. Berner, for your testimony today. As you are well aware, the GAO in 2012 issued an audit of your agency. That audit outlined concerns both of your agency and of the Council. And one of those concerns was a lack of transparency.

I appreciate your testimony today and your commitment to enhancing or improving your reputation as an Office for better transparency. I do have a question related to that and the asset management report that was recently released. If your agency is committed to transparency, why did the Office not allow for public comment prior to releasing the asset management report?

Mr. BERNER. Congressman, when we do research, we want to make it available, and we look at a particular aspect of financial markets. We post as soon as it is ready to be posted, ready for public comment on our Web site. Seeking public comment is not something that is part of that process. I would tell you that when we do research, and when research is done generally in finance and economics or any other discipline, for that matter, it is common practice to make the research available, to welcome comment on it.

That is why, in fact, people call papers "discussion papers" or "working papers." We have 12 of those on our Web site. The whole purpose of doing that is to invite discussion, debate, and to further the state of our knowledge by having that discussion and debate.

Mr. BARR. If you are not incorporating the input from the asset managers themselves, how can you have confidence in the accuracy of the report? And as a followup, will you commit in the future to accepting comments and incorporating those into your reports?

Mr. BERNER. Congressman, because we didn't seek public comment the way that people do in rulemaking or the way that was done by another agency on this report does not mean we don't take seriously the comments that were made. We have looked at every single comment, and we have looked at every single issue that was raised in those comments.

We continue to look at those and we continue to welcome comments on our work and as we work forward, and we think about issues related to asset management and financial stability, we are taking into consideration those comments as we go forward.

Mr. BARR. The bottom line is in that case, you did not take into consideration those comments because you didn't make it available for public comment prior to putting it out. And according to the Treasury press release accompanying OFR's asset management report release, the Council requested the report in connection with the Council's review of non-bank financial companies, indicating that the report would have a direct bearing on future Section 113 non-bank SIFI designations.

Will the OFR asset management report that did not take into account the comments from the asset management industry be used for purposes of SIFI designations.

Mr. BERNER. Congressman, as you know, designation is a policy choice of the Council, and I can't predict—I am a non-voting member of the Council, but I can't predict what the Council will do. Our job is to present information to the Council for their information. We continue to do that, as I indicated earlier.

And the Council may ask us for additional research and data in the performance of their investigation into non-bank designation.

I would point out to you, Congressman, that designation is a firm-specific tool. We looked at the asset management industry and the activities in that industry. We did not look at particular firms. So we can't—you certainly could not use the report by itself as an input into the designation process.

Mr. BARR. Let me just follow up with a point that was made by Hester Peirce of the Mercatus Center related to this asset management report and the potential unintended consequences of applying bankcentric regulations for asset managers. She wrote, "Attempting to fit the asset management industry into a bank regulatory scheme might have the unintended consequence of further homogenizing the financial sector so that it is less able to meet investors' needs and more vulnerable to financial market shocks."

Are you concerned that your Office's asset management report may be used to support the case that asset managers should be subject to these bankcentric prudential regulation by the Federal Reserve?

Mr. BERNER. Congressman, we didn't indicate any preference for any remedy to any threat that might arise in asset management activities in our report, nor have we so indicated. Really, when you look at our report, it was designed, again, to inform the Council in its deliberations. What the Council chooses to do with that is really the Council's decision.

I would also add that we highlight on the first page of the report that asset managers and their businesses on their activities are significantly different in significant ways from those of other financial institutions, as we indicated.

So as I testified last week, we agree that asset management activities and businesses are quite different from traditional banking activities or, for that matter, other activities in the financial markets and in the industry.

Mr. BARR. Thank you.

I yield back.

Chairman MCHENRY. We will now recognize the ranking member, who is last at bat.

Mr. GREEN. Thank you, Mr. Chairman.

And I thank the witness again for appearing.

Mr. Director, do you report to FSOC? Is that correct?

Mr. BERNER. Congressman, I don't report to FSOC. I serve the needs of the FSOC. But I am accountable to, as dictated by the statute, the Chair of the Council, who is the Secretary of the Treasury.

Mr. GREEN. Thank you for that indication.

And is it true that you pass on your intelligence to FSOC?

Mr. BERNER. That is correct, Congressman.

Mr. GREEN. And is it true that you don't make policy?

Mr. BERNER. That is correct.

Mr. GREEN. You do get involved in some rulemaking for the entity that you work with, but you don't set policy for FSOC; FSOC determines what the policy is?

Mr. BERNER. The only rulemaking that we get involved with, and we haven't done that yet, will relate to data collection when and if we prosecute the need to collect data from financial firms. But so far we haven't done that. That is in the future. But that is the only rulemaking in which we are engaged. Other than that, you are absolutely correct, we don't make policy and we don't make rules.

Mr. GREEN. There was some concern about the number of employees as well as the budget. Is it true that you, meaning your agency, are a creature of Congress; Congress gave birth to you?

Mr. BERNER. That is correct, under the statute.

Mr. GREEN. And there was a gestation period?

Mr. BERNER. That is absolutely correct. We were, as I testified last March when I was here and I noted today, then a startup, still a start-up organization. Today, we are standing on our own. And, we are delivering on our promise and our mission.

Mr. GREEN. And is it true that in your world, what the Congress giveth, the Congress can take away, blessed be the Congress?

Mr. BERNER. Absolutely, Congressman.

Mr. GREEN. Meaning, if the Congress decides it wants you to have fewer employees, the same Congress that gave you life can also limit your existence?

Mr. BERNER. Congressman, if Congress decides to change the laws, which Congress obviously has the power to do—

Mr. GREEN. We can change the laws. If we choose to, we can eliminate your existence, your very existence. You are a creature of Congress, you exist because Congress decided that you should be there?

Mr. BERNER. That is correct.

Mr. GREEN. So if we want to limit the number of employees, we have that within our power?

Mr. BERNER. That is correct.

Mr. GREEN. That is, we have conferred upon you the authority to do what you are doing and that you cannot do more than we have accorded you. Is that a fair statement?

Mr. BERNER. That is true.

Mr. GREEN. Now, let's talk quickly about the LEI. Would you just give me a brief overview of what the LEI is contemplated to be and how you contemplate getting this up and running, please?

Mr. BERNER. The LEI is contemplated to be and in fact already is a unique identifier that helps us identify parties to financial transactions. So it assigns an identifier to the legal entities within a company around the world.

Currently, after only 2 years of existence, really 3 years since the LEI was simply a concept on the piece of paper, the LEI is up and running on a global basis: 27 countries have been involved; and 150,000 LEIs have already been issued, and more are coming at a rapid clip.

Nobody is compelled to use the LEI at present. These are all voluntary adherents, because this is so valuable to the industry in improving the quality of the data that they use that they report to us and to others, and to make it exactly clear, where their exposures are.

Back in the crisis, as you know, many people were exposed to particular counterparties, and they were not aware of that because the names did not indicate that they were exposed to A, B, or C; for example, Lehman Brothers. It turns out that had the LEI been in use at that time, then they would have known that exposure, they would have been better able to evaluate that exposure. Likewise, for regulators, as I indicated.

It gives us better quality data for researchers. It gives us better quality data. So earlier it was asked, when would the project be complete. It is like a process of surveillance. It is like a process of any other process that is ongoing, it is a journey, not a destination. We are already well in train. This process has not reached quite steady state yet, but the governance around it and the technology around it and the integrity of the process all are nearing completion.

Mr. GREEN. Thank you, Mr. Chairman.

And I will yield back.

Chairman McHENRY. I thank the ranking member.

And I misspoke. Mr. Green wasn't the last at bat. That would be Mr. Ellison from Minnesota, who is recognized for 5 minutes.

Mr. ELLISON. Yes, sir. Thank you, Mr. Chairman.

And thank you, Ranking Member Green.

I won't be long, just a few questions.

I just want to say that I was in Congress in 2008, and I will never forget the frantic calls we were receiving, the difficulty of managing the whole financial crisis.

And, in my opinion, one of the things that we did was we were responsive government. We passed the Dodd-Frank Reforming Consumer Protection Act, which created your Office, and I think that was a good thing.

I want to thank you for your public service, and I want to express my appreciation for the work you and your staff are doing. You are doing it in a difficult political environment.

Mr. BERNER. Thank you, Congressman.

Mr. ELLISON. You bet.

But I would like to just point out something that I think you are doing that I think makes some sense. And so, let me ask you about the Universal Mortgage Identifier.

Can you tell us about the idea behind it?

Mr. BERNER. Yes, I can.

The idea behind the Universal Mortgage Identifier is to fill a gap in our knowledge. We learned in the financial crisis that despite the great volume of mortgage data available, neither regulators nor market participants, nor, for that matter, sometimes the people who originated the loans could link first liens to second liens. So they couldn't assess where the problems might lie. If you want to think about the sum of those two things as representing the debt on a piece of property, you couldn't identify those things.

As you know, in the depths of the crisis, when people were trying to refinance their mortgages, they were not empowered to do so by virtue of the fact that some of the second lienholders were reluctant to let them do that to refinance their first lien. So there were efforts and steps taken to combine them, to refinance them as a package and so on. But the lack of information made that process much more difficult, much more complicated.

This proposal arose out of those difficulties, and it is designed to provide on a secure basis, without identifying personally identifiable information attached to the mortgage, either first or second lien or other characteristics, the loan from cradle to grave, as I indicated, and any other liens that may be linked to it so that regulators have better information. Mortgage originators, mortgage servicers, and investors who invest in securitized mortgages all will have much better information about the mortgages that are the underlying collateral in those investments.

Mr. ELLISON. It is a good idea. And in my own district—we have more than 35,000 foreclosures in Hennepin County, in the district I represent in Minnesota, and between 2007 and 2014, thousands more homes in delinquency, and finding out who owns the property can be a nightmare.

I think it is a good idea, and I applaud your recommendation, and I hope that you are staying in touch with us to help bring it into reality because I think it is an idea with a lot of merit.

I would like to ask you about a particular area of research that you might consider. So I am glad that the Office of Financial Research partnered with the National Science Foundation to sponsor research. It is important.

I have a question on your first grant, the one focused on the real threat from high-speed trading in the financial system. We have seen flash crashes. You might open the paper or look around and see these things happen from time to time and cause a lot of trouble.

Do you know if the research will include a comparison between the impact and risk of high-speed trading of nations with and without a financial transaction tax?

Because I am curious to know if these financial transaction taxes actually have the effect of slowing high-frequency trading?

And I am not asking you to opine an opinion. Of course, I would welcome it if you do. But, really, I am asking: Is this a research area that might be fruitful?

Mr. BERNER. Let me answer your specific question, Congressman.

The grant is funding research using U.S. domestic data.

Mr. ELLISON. Okay.

Mr. BERNER. It may and should yield insights into market stability, working with large data sets in the area of computing that needs to be undertaken, but tax policy is not one of the factors that the researchers on this grant are considering.

Mr. ELLISON. Okay.

Mr. BERNER. You raise a good question, though, and it is something that perhaps we could sit down with you and your staff and discuss.

Mr. ELLISON. We would be more than happy to do that.

So, that yellow light means I have to hurry up, but I just want to say that I am glad the report addressed the swaps market. These $400 trillion markets were unregulated until Dodd-Frank. Swaps markets contributed to the collapse of AIG and others, which worsened the financial crisis.

I am out of time, but I just want to know as I wrap up—and I will get your answer perhaps in writing—

Chairman MCHENRY. Yes. That would be great.

Mr. ELLISON. Okay. Thank you.

So, we would like to talk to you about swaps at a better time when there is more time.

Mr. BERNER. I would be happy to sit down and talk to you about the work that we are doing in collaboration with the CFTC and, by extension, with the SEC on making sure that the data we collect from swap data repositories and trade repositories has the highest integrity and can be used for policy purposes, monitoring purposes and research purposes.

Mr. ELLISON. Thank you, sir.

Chairman MCHENRY. I am not too familiar with the rules of baseball or the practice of baseball, but last at bat, then last at bat, and now I might actually mean it with our colleague from Maryland who just arrived.

Mr. Delaney is recognized for 5 minutes. Perhaps that means that—what is the batting order where you are batting cleanup?

That actually might be you, Mr. Green, with the order of things. But Mr. Delaney is recognized for 5 minutes.

Mr. DELANEY. Thank you, Mr. Chairman.

And thank you, Director Berner, for joining us here today. I apologize for being late.

But I did have one question about asset managers. And before I ask my question, I think it is fair for me to share with you my views on the issue, which is I don't believe asset managers should be deemed systemically important for a whole variety of reasons.

And I understand that you are here in your capacity as heading up the research component of this analysis; so, I want to make sure my question is narrowly framed in that regard.

But I noticed in the report you identified certain vulnerabilities with the asset management industry, or potential vulnerabilities that the asset management industry poses, and I was wondering—because, in my experience, asset managers, particularly the large ones, have hundreds and, in many cases, potentially thousands of different funds that they manage either on a discretionary basis or in different kind of structures with their investors, and the investors are different in profile. Some are long term in their orientation; some are short term in their orientation. Some have significant limits of redemptions; some have very little limits of redemptions. Some employ leverage; some don't. Some are designed to be long in the market; some are designed to be short in the market. Some are designed to be distressed in orientation, et cetera.

And it seems to me, when you think about the asset management industry, you have to almost disaggregate each one of those funds individually and almost make a determination if a fund itself is systemically important as opposed to the firm's—firmwide, because my sense is the underlying activities of all these funds at a minimum probably cancel each other out, or in many ways the funds are—asset managers are inherently hedged because they have all kinds of funds doing different things with different types of investors.

And it just—to say that the asset management industry presents vulnerabilities, it is almost like saying the market presents vulnerabilities; in other words, it is a little circular, because, in fact, these big firms represent the whole of the market. And to observe that they—markets do panic. That is a vulnerability, a psychological vulnerability, and that just is human nature, and it is still reflected in markets. And so to almost deem asset managers systemically important is almost like saying the market is systemically important, which is not a very productive statement.

And so, I am curious as to how you think about them when you come to this conclusion that they have vulnerabilities. Did you, in fact, disaggregate them, or did you take into consideration the fact that they are structured the way they are as opposed to with one balance sheet and one or two sources of liquidity, which is typically what you find in banks, being most the obvious example, or other balance sheet-oriented lenders?

Mr. BERNER. Congressman Delaney, I am really glad you asked that question because it highlights something that is very important about our study, namely, that instead of focusing on firms, our analysis focused on activities as the basic building block for the work that we did, and, as a consequence, we don't focus so much on firms as specific activities, which actually is very close to what you were just talking about in terms of different funds have different objectives, employ different degrees of leverage and other characteristics that are different.

In fact, a basic conclusion of our report is that the industry and activities in which it engages are diverse, the business models of asset managers are diverse, the business mix of asset managers is diverse.

And so, that is one of the reasons that we went to visit 10 asset managers who themselves represented a spectrum of diversity across the industry to learn more about their business mix and their business models, how they manage their risk, for example, and all those things.

Our report concluded that activities was the best way to focus on the industry, to look at the risks that might be found in those activities rather than in firms. And, consequently, we focused on some activities in particular, some where we lacked information before we could come up with a more complete judgment; for example, activities in separately managed accounts—

Mr. DELANEY. Right.

Mr. BERNER. —second, in securities lending, and, in particular, in the reinvestment of cash collateral in securities lending, which is very close to a repo transaction, and the unwind from which could look very much like the unwind of a repo transaction; repurchase agreements used by asset managers themselves in certain respects. And so those are some of the things that we identified.

Mr. DELANEY. I appreciate it. I just want to make one comment before you—because we are running out of time here. And I appreciate the response.

I would just make one suggestion as we think about asset managers. Definitely if you have concentrated banks, and the markets behave a certain way, and several banks dominate the banking industry, their behavior will clearly result in different outcomes in the market.

But it would seem to me that it would be interesting just to think about asset managers, think about the asset management industry and you—in one case there were several big ones, and, in another case, there were no big ones, just small ones. My suspicion is that, if you were to model that, the outcomes would be no different in terms of how the markets would behave because, in fact, again, they kind of reflect the market.

But I appreciate your answer. Thank you, sir.

Mr. BERNER. That is an interesting question, Congressman. I welcome the opportunity to talk to you about it further.

Mr. DELANEY. Great. Thank you.

Mr. BERNER. Thank you.

Chairman MCHENRY. I want to thank my colleagues for the questions.

We will now have an additional round of questions. But by prior agreement, I would ask unanimous consent that we have 5 minutes for the Majority side and 5 minutes for the Minority side, at which point the hearing will end. So for our witness to be aware of that is only right and just. Right?

I will now recognize Mr. Barr of Kentucky for 5 minutes.

Mr. BARR. Mr. Berner, I appreciate your indulgence for just a quick second set of questions here.

The Dodd-Frank Act, as you are very familiar with this provision, requires you, as the Director of the OFR, to report and testify before the Senate Banking Committee and this committee annually, which is what you are doing here today, but statutorily to provide an assessment of the Office of significant financial market developments and potential emerging threats to the financial stability of the United States.

In your annual testimony to the Senate Banking Committee, Subcommittee on Economic Policy, I believe last week, you testified that, "when we think about the financial system, it is very hard to predict financial crises. In fact, I am not sure we can really predict crises."

I am not suggesting that you are a fortune teller or that your staff or the people who work with you can foretell all emerging threats, but isn't this the statutory obligation and responsibility with which your Office is charged? Aren't you supposed to be able to do the best you can to identify these emerging threats and predict financial crises?

Mr. BERNER. Congressman, I am not a lawyer, so I am not going to interpret the statute. But my read of my responsibilities is that our job is to identify vulnerabilities in the financial system that might give rise to, at some point in the future, maybe the immediate future, threats that could create risks of financial stability.

And so, by identifying those threats, those vulnerabilities and the shocks that could expose them, without being able to predict them, nonetheless, if we see that the vulnerabilities are there, our job to you and our responsibility to you is to identify those, to point those out, to point them out as weak spots in the financial system that need to be strengthened. Because if we have a stronger financial system, then whenever the shock comes, if it does—and, again, I don't think we can predict when that happens—that we will be more able to withstand those shocks.

Mr. BARR. I appreciate that response.

But I suppose that, as an oversight subcommittee, our responsibility is to make sure that—on behalf of the taxpayer, that your Office, that your agency, is adding value, that you all are actually contributing to the financial stability of the United States by notifying the public, warning the public, warning the Congress about emerging threats.

And so, in fulfilling your statutory responsibility here today, please specifically identify the emerging threats that you see which could potentially lead to a financial crisis.

Mr. BERNER. Last week, I talked about three such threats. I talked about the impact of a—perhaps a sharp and unanticipated increase in interest rates or in volatility, given the current market setting, given the environment in which we live, where positioning in financial markets is not positioned for that. In fact, what we have seen lately is a sharp decline over the past few weeks in interest rates, given what is going on in emerging markets.

But if there is a sharp increase in volatility or in rates, that is one threat that we identified both at that hearing last week and, also, in our annual report.

Second, I talked about the vulnerabilities that still remain in short-term wholesale funding markets. Those are issues that have been partly addressed. Particularly the Federal Reserve and others have addressed some of those vulnerabilities in the so-called triparty repo market, but we really don't think that we have addressed all those vulnerabilities.

That market in particular is still vulnerable to shocks that could produce runs in fire sales, which were elements in the recent financial crisis, which could play a role in any future financial crisis. So, we need to strengthen that market. Other aspects of short-term wholesale funding are important as well.

And I identified a third risk among the many; that is, vulnerabilities that come to us from outside our financial markets, but which may exist in the global financial markets. And I think we have seen play out in markets—not that I am saying that this is currently a real threat to financial stability—the tremors that have recently occurred in the emerging markets that—

Mr. BARR. If I may reclaim my time, I hear your three identified potential threats, and what I didn't hear in those three threats was the failure to make certain SIFI designations and that not being a potential threat.

Let me ask you one kind of final question about the role of the OFR relative to FSOC.

In your written testimony, you say: The OFR report—the annual report provides an independent assessment of the state of the U.S. financial system, although we solicit impact—solicit and incorporate feedback from the Council member agencies and other subject matter experts. And then you all are obviously providing information to the Council.

It appears to me that is a bit circular. And my question to you is: What is it that you all do that cannot be performed by the Council?

Mr. BERNER. As you indicated, Congressman, we do provide an independent view. We are interested in getting feedback not just from Council member agencies, but from others in performing that analysis and making that assessment.

We, for example, have a financial research advisory committee, an independent group whom we don't pay, but who comes to us because they are interested in providing us with advice.

So we are interested in making sure that, when we make our judgments about where the threats to financial stability are, that they are based on facts, that they are based on solid analysis. That is the counsel that we seek from outside, but the judgments are ours.

Mr. BARR. Thank you for your testimony.

I yield back.

Chairman MCHENRY. We will now recognize the ranking member for the final word.

Mr. GREEN. Thank you, Mr. Chairman.

And, again, I thank you, Mr. Director.

With reference to a statement from your report indicating that the financial system is stronger today, yet there are still some concerns that have to be addressed, the strength of which you speak, is that, in part, related to Dodd-Frank? And, if so, can you give some indication as to how Dodd-Frank has had a positive impact on the financial system with reference to its stability?

Mr. BERNER. Congressman, yes, absolutely it is related to some of the things that were mandated in Dodd-Frank. I would point to the regulation of the derivatives markets which were previously not subject to the kind of regulation that they are today.

Transparency in those markets is essential, and Dodd-Frank mandated several things that had to be done, such as clearing of derivatives through a variety of mechanisms that would make those markets more transparent, that would improve what is called price discovery in those markets.

So the oversight in the derivatives markets, which amplified the effects of the financial crisis when they occurred, is a major accomplishment.

More fundamentally, I think that Dodd-Frank obviously is consistent with the kinds of increases in capital requirements, the proposed increases in liquidity requirements for a financial institution, and last, but not least, the creation of the Financial Stability Oversight Council so that regulators across the financial system could share their insights, could collaborate on implementing the things that were mandated by Dodd-Frank, so that they can come together in a coherent way to make sure that all those rules that came out of the implementation were consistent with each other.

Mr. GREEN. I thank you for your testimony.

And, Mr. Chairman, I will yield back my time such that the witness may be excused.

Chairman MCHENRY. I thank the ranking member. And I want to thank my colleagues on the panel for their bipartisan note.

Director Berner, I want to thank you for your responsiveness, and that is noted and appreciated.

I certainly appreciate your willingness to have the open forum on the asset manager report, to respond to the inadequacies that I outlined in your response to my letter, as well as your response to Carolyn Maloney and Ann Wagner's requests as well. I certainly appreciate that, and I thank you so much for your testimony.

The Chair notes that some Members may have additional questions for this witness, which they may wish to submit in writing. Without objection, the hearing record will remain open for 5 legislative days for Members to submit written questions to this witness and to place his responses in the record. Also, without objection, Members will have 5 legislative days to submit extraneous materials to the Chair for inclusion in the record.

And without objection, this hearing is adjourned.

[Whereupon, at 4:39 p.m., the hearing was adjourned.]

A P P E N D I X

February 5, 2014

Testimony of Richard Berner, Director of the Office of Financial Research, U.S. Department of the Treasury
House Financial Services Subcommittee on Oversight and Investigations
Hearing on "The Annual Report of the Office of Financial Research"

February 5, 2014

The views expressed in this testimony are those of Richard Berner, Director of the Office of Financial Research, and do not necessarily represent the views of the President.

Introduction

Chairman McHenry, Ranking Member Green, and members of the subcommittee, thank you for the opportunity to testify today on behalf of the Office of Financial Research about our *2013 Annual Report*.

This is my second appearance before the Subcommittee as Director of the OFR and I am pleased to return. Let me take this opportunity to reaffirm my commitment to make the OFR a valued resource for Congress, the Financial Stability Oversight Council, and the American people. Equally important, I want to reaffirm that we are fully committed to transparency and accountability.

Our annual report and my testimony here are two of the ways we honor that commitment and make our work known to our stakeholders. This is our second report to Congress, fulfilling an annual requirement to assess the state of the United States financial system and analyze threats to U.S. financial stability.

In my testimony, I will summarize four key topics addressed in the report:

1) monitoring and analyzing potential threats to financial stability,
2) data collection and analysis,
3) data standards, and
4) data security.

We pursue all four to fulfill our mandate to support the Financial Stability Oversight Council (FSOC or the Council). I will also describe other ways we support the Council.

Before I discuss those topics, I want to review the mission of the Office and update you on the status of our efforts to meet it.

OFR Mission and Status

The financial crisis revealed serious deficiencies in our understanding of vulnerabilities in the financial system and in the financial data needed to measure them. A core part of the OFR's mission is to fill those critical gaps in analysis and data for the benefit of the Council and, ultimately, the public. Our mandate is to complement, not duplicate, the work of other Council member agencies — to provide the connective tissue that will help us look across the financial system to discover vulnerabilities and risks.

The OFR is an office within the Treasury Department, but is unique among Treasury offices. The objectivity and independence of the Office's work is protected by statute. To ensure OFR objectivity, our Congressional testimony and, by extension, our research, must be independent. Under the statute, no officer or agency of the United States can require the OFR Director to submit Congressional testimony for approval, comment, or review prior to delivery to Congress.

In creating the OFR, the Dodd-Frank Act prescribed that the OFR is funded by assessments on certain financial companies. OFR employees' pay and benefits are comparable to those of other federal financial regulators. At the same time, the law requires the Director to consult with the Council Chair, who is the Secretary of the Treasury, on the OFR budget, hiring, employee compensation, and other matters.

This autonomy is critical to doing our job right and goes hand-in-hand with a fundamental responsibility to be transparent and accountable to Congress and the American people.

To assure this transparency and accountability, we regularly engage in many ways with our stakeholders and those with responsibility for oversight of the Office. Our staff regularly briefs members of Congress and their staffs. We publish our studies through our Working Paper Series and our annual reports, and make them available on our website. We have also developed our website to be user-friendly and a growing source of content. When we post significant content to the website, we send out an alert to website subscribers. Since I testified here last March, the number of subscribers who signed up to receive these e-mail alerts to flag new website content has more than doubled from about 2,000 to more than 4,500.

We routinely make public presentations to industry, academia, government, and public interest groups to share our research insights and receive feedback from the broader community. We also invite outside experts to seminars to share and debate their findings, and sponsor conferences to engage with the public. In the past year, we jointly sponsored three such meetings with the Council and the federal reserve banks of Cleveland and New York.

The OFR has developed rapidly during the 18 months since we released our first annual report. In addition to our headquarters here in Washington, D.C., we have a satellite office in New York City to engage closely with market participants. Our workforce now stands at more than 190 employees, up from only 30 in fiscal 2011. By fiscal 2015, we plan to reach a full staff of about 280.

As we have grown, we have refined our management structure and our policies and procedures to help us carry out our mission. For example, we established an office of External Affairs, led by a member of our senior management team, to coordinate engagement with external stakeholders and partners in government. Building on the strategic framework that we released in March 2012 to cover FY 2012-14, we are working on a new, five-year strategic plan to take effect in FY 2015. The strategic goals in those plans are tied to objectives, outcomes, and performance measures that keep us accountable.

When I was here in March, I discussed our progress in standing up the OFR. Today, the OFR is not only standing on its own, but is making important contributions to promote the stability of the U.S. financial system.

OFR Annual Report

The OFR and the Council produce annual reports at six-month intervals. Although the reports cover similar ground, they take different approaches. The Council report is signed by all Council members. It takes a comprehensive view of vulnerabilities and recommends ways to strengthen the financial system. The OFR report, in contrast, provides an independent assessment of the state of the U.S. financial system, although we solicit and incorporate feedback from Council member agencies and other subject matter experts. In addition, the OFR report dives more deeply into specific vulnerabilities in the financial system.

The OFR's *2013 Annual Report* analyzes threats to financial stability, evaluates macroprudential policies, presents findings of OFR research on financial stability (specifically, financial contagion, market liquidity, and interconnections among financial institutions and markets), addresses data gaps and OFR's efforts to fill them, and discusses our work to promote data standards, such as the Legal Entity Identifier. The report also discusses the status of the Office in achieving its mission, and concludes with our future research and data plans.

Monitoring and Analyzing Potential Threats to Financial Stability

Thanks to an array of policy measures and industry actions, the U.S. financial system has grown stronger and more stable since we issued our inaugural annual report in July 2012. However, the financial crisis taught us never to be complacent about a potential buildup of risks that might damage the financial system and the economy. Threats to U.S. financial stability remain and we must stay vigilant.

Today's environment of persistently low interest rates and low volatility might seem benign, but this environment can breed complacency. It can encourage market participants to take more risks and employ more leverage to achieve desired returns. Those, in turn, increase potential vulnerabilities to future shocks, such as sharp increases in interest rates and jumps in volatility.

The weaknesses in the financial system are often hidden — becoming obvious only when shocks expose them. We cannot predict or prevent financial crises. Instead, our job at the OFR is to try to identify and assess the vulnerabilities before those shocks hit, and to inform policymakers about tools needed to strengthen the weaknesses. I am confident that such monitoring and analysis can help reduce the severity, and hopefully, the frequency of future financial crises.

A new tool for monitoring threats. We are developing a new tool — our prototype Financial Stability Monitor — to identify and monitor these threats and to assess the interplay among them. This new monitor, a heat map, tracks five functional areas of risk: macroeconomic, market, credit, funding and liquidity, and contagion. We consider this breakdown best for looking at risks across the financial system and identifying causes rather than just symptoms. We quantify risks through a mix of economic indicators, market indexes, and measurements that we calculate.

This monitor is the first version of a tool that we will refine and improve over time. One limitation of Version 1.0 is that our current set of metrics largely tells us where we are, not where we are going. To address that, we are working to incorporate new, forward-looking indicators into our framework.

Principal threats to financial stability; monitoring tools and policy analysis. Informed by this monitor, we have identified a range of potential threats to financial stability. The first four are closely related and often occur together.

1. Disruptions in wholesale funding markets, such as repurchase agreements, or repo.
2. Exposure to a sudden, unanticipated rise in interest rates.
3. Exposure to shocks from greater risk-taking in a low-volatility environment.
4. Exposure to a sudden shock to market liquidity.
5. Excessive credit risk-taking and lax underwriting standards.
6. Operational risk from automated trading systems, such as high-frequency trading.

One additional risk is worth discussing in light of the events of the past month. Emerging-market currency and asset markets have recently come under significant pressure, and such stress has spilled over quickly into global markets for other assets. In our *2013 Annual Report*, we highlighted emerging-market vulnerabilities, including those that have played out in financial markets in the last three weeks. We are monitoring these developments carefully.

In Chapter 4 of our annual report, we summarize OFR research projects on new tools for measuring and monitoring market liquidity (examining the measurement of liquidity shocks across asset classes) and network analysis to improve our understanding of contagion among financial firms exposed to each other.

Macroprudential policies are those aimed at reducing contagion and other vulnerabilities that span the entire financial system. They address threats that cut across financial institutions and markets, and are designed to reduce the likelihood and severity of financial crises.

The Dodd-Frank Act requires us to evaluate macroprudential policies. In Chapter 3 of the report, we outline a framework for evaluating such policies. Since the financial crisis, U.S. regulators have expanded the macroprudential toolkit, for example, through supervisory stress tests. Further improvement to stress tests would incorporate funding risks, potential spillovers, and feedback effects to increase value for financial stability assessments.

Conducting and sponsoring research. We do not conduct our research and analysis in a vacuum. On the contrary, we engage with the broader research community to conduct, promote, and sponsor world-class research by exchanging and testing ideas.

The OFR has conducted and sponsored a wide range of studies in support of its mission. For example, our Working Paper Series is designed to inform the process of assessing, measuring, monitoring, and mitigating threats to financial stability.

We now have a dozen Working Papers published on our website, and several more in the works. Subjects of recent working papers include contagion in financial networks and several papers on the theory and practice of stress testing. Our most recent paper calls for the establishment of a single, cradle-to-grave, universal mortgage identifier that protects the privacy of the borrowers. These papers, usually written in collaboration with outside experts, advance the state of knowledge on financial stability topics by engaging the broader financial economics research community in developing and testing economic thinking and theory.

We have also established a program for sponsoring research through grants. In May 2013, we announced our partnership with the National Science Foundation to sponsor novel research related to financial stability. The first grant was awarded in September 2013 for a project to examine the impact of high-speed trading on the financial system. This research promises to yield additional insights into working with extremely large financial datasets in a supercomputing environment. Researchers at the University of Illinois at Urbana-Champaign and the San Diego Supercomputing Center are conducting the research.

In addition, the conferences, workshops, seminars, and public appearances that I mentioned earlier serve as incubators for generating new ideas about promoting financial stability and making our financial system safer.

Our Financial Research Advisory Committee also helps us evaluate our analysis. The committee consists of 30 distinguished professionals in economics, data management, risk management, information technology, and other fields who provide expert advice to the OFR and bring diverse perspectives to help the OFR fulfill its mission. In August 2013, the committee submitted its first set of recommendations to the OFR; these recommendations and the proceedings of the Committee are posted on our website. We will soon be webcasting another meeting of the Committee when we will have the opportunity to provide updates on our progress against those recommendations.

Data Collection and Analysis

A key mandate for the OFR is to improve the scope and quality of financial data. To better measure financial activity and thus better understand how the financial system works — its interconnections, its vulnerabilities, and its risks — we are engaged in several projects to fill data gaps.

A critical step in filling data gaps involves taking stock of existing data. To that end, we have produced and recently published the public portion of an Interagency Data Inventory on the OFR website. The OFR produced the inventory in collaboration with the FSOC Data Committee.

The inventory is a catalog of the data that FSOC-member agencies collect from industry. We will update it regularly. The inventory contains a listing of datasets, or "metadata," not the data themselves. The public portion posted on our website excludes information about nonpublic data, including those derived from other data.

The inventory is essential for identifying gaps in data, avoiding duplication in future requests for data from industry, and improving research and analysis to understand threats and vulnerabilities in the financial system. It is thus a key building block in the OFR data analysis and reporting architecture.

Chapter 5 of our annual report discusses data gaps in detail. It assesses gaps related to short-term funding markets and related financial activities, explains why filling gaps in data related to these markets is a top priority, and describes ways we will fill them. We are currently working with the Federal Reserve Bank of New York to improve and expand data that measure activity in such markets, like repo and securities-lending activities. We are also engaged in Financial Stability Board initiatives supported by the G20 to fill data gaps in these areas, and in other aspects of shadow banking activity. In addition, we are collaborating with the Securities and Exchange Commission on cleaning and analyzing detailed data from Form PF, which is submitted by hedge funds and other private funds.

Regarding data analysis, our annual report contains preliminary results of OFR research using newly available, highly granular data. For example, our analysis of money market fund investments enables us to assess the factors triggering the large decline in U.S. money fund holdings of European bank liabilities during the European sovereign debt crisis. An analysis of the sovereign credit default swap market enables us to identify the sellers, market makers, and buyers of credit protection, and thus to locate sources of risk. We also analyzed hedge fund leverage using aggregated data from Form PF. These aggregated data suggest that hedge fund use of leverage is inversely related to the liquidity of, and the risks in, assets in the funds' portfolios.

Data Standards

High-quality data are critical for good decisionmaking. Data standards are essential to assure data quality, and thus for comparing, aggregating, linking, and analyzing data. Their adoption will improve data quality and reduce collection costs and duplication.

What are data standards? They are rules that help precisely identify parties to financial transactions, precisely define financial instruments and how they relate to one another, and precisely specify how data should be collected. Just as standards were necessary 150 years ago to make sure all of our trains could fit on all of our rails, standards are critical today to the functioning of the global financial system's infrastructure. In the same way that templates are used to collect address information with separate fields for street, city, state, and zip code, the use of standards improves data management and the quality of analysis.

We are making needed investments in the development and implementation of data standards. Chapter 6 of our annual report describes the framework we have developed for creating and promoting data standards. Not surprisingly, a key conclusion is that to be effective, standards should be adopted universally. We all need to use the same standards, or alternatively to be able to translate one set of standards smoothly into another. More work is needed, and I ask for your support to promote their use.

The report also describes progress on implementing the Legal Entity Identifier (LEI), a global standard like a bar code for uniquely identifying parties to financial transactions. OFR leadership in the initiative to establish and promote the use of the LEI includes serving as Chair of the LEI's Regulatory Oversight Committee, made up of almost 60 central bankers, treasurers, and markets regulators from around the globe.

The LEI's benefits are huge. Precise identification of counterparties would give firms a clearer picture of their exposures in the marketplace. Estimates from financial industry sources suggest that use of the LEI will save billions of dollars that the industry now spends on cleaning and aggregating disparate data and on reporting data to regulators.

For financial regulators, the LEI would assist in data aggregation and comparisons, thus help in identifying vulnerabilities in the financial system and providing insight into ways shocks can spread across financial markets.

Given those benefits, the case for universal adoption of the LEI system is strong. Almost 150,000 entities are already identified using the LEI. Regulators already require using the LEI for certain swaps, insurance, and banking reporting in the U.S., Canada, Europe, and parts of Asia. I call on regulators in the U.S. and around the world to require use of the LEI in regulatory reporting.

The need for data standards also extends to financial products. As I mentioned earlier, a universal mortgage identifier (UMI) is clearly needed. Mortgage debt represents 70 percent of U.S. household liabilities. The mortgage finance system is complex and the data produced by this system are fragmented. A single UMI that protects personal privacy would bring coherence to these data and would significantly benefit households, industry, regulators, and researchers.

Substantial input from several agencies was essential in developing the OFR working paper we recently published on the characteristics that a UMI should have and criteria for implementation.

Many industry participants favor the LEI and the UMI to help make their internal data and their reporting activities coherent and efficient.

Some initiatives require identifiers for both entities and products. As a case in point, the OFR and the Commodity Futures Trading Commission (CFTC) contribute to a Financial Stability

Board initiative to design data standards and criteria for aggregating data across trade and swap data repositories. We are also collaborating with the CFTC to design and implement standards to improve the quality of data collected from trade and swap data repositories.

Data Security

No OFR goal is more important than safely and securely collecting data and safeguarding the data we hold.

OFR information security standards are governed by those of the Treasury, and our Chief Information Security Officer works closely with his Treasury counterpart to assure that our policies and procedures meet or exceed the standards of the Treasury Department, as well as the standards of Council member organizations.

To support OFR staff research and to clean, manage, and store large-scale datasets, we have made substantial progress in building our technological infrastructure and the analytical environment that will house our data and give our researchers the advanced tools they need to conduct innovative research.

Our information security standards are fundamental to this new technology infrastructure, verifying access permissions at the most granular level. Technology is necessary but insufficient alone to assure security, so the systems we are building for data acquisition, management, and dissemination are accompanied by strict and clear rules for data security and data sharing.

As required by the Federal Information Security Management Act, the Office has established an information security program policy and data handling procedures for proper safekeeping of information at the highest level of the Federal Information Processing Standards. Our program also includes post-employment restrictions for employees who handle sensitive information.

In addition, we are expanding security controls for sharing information among Council member agencies, collaborating to forge bilateral data-sharing agreements to assure all participants that shared data will be protected, secured, and treated consistently. The agreements are consistent with the analysis of Council data sharing by the Council of Inspectors General for Financial Oversight.

For data-sharing agreements to work, agencies must agree on information security classifications and how to apply them. For example, different agencies may have had different policies for handling data defined as "restricted" or "high security."

The Office led an initiative in the Council Data Committee to "crosswalk" security classification categories. An interagency working group established a common framework for information security practices, processes, and compliance requirements. All Council member agencies but one have signed off on that framework; when they do, data sharing will be far simpler and more secure than it is today. The National Institute of Standards and Technology assisted the working group in aligning the framework with the Federal Information Security Management Act of 2002 and the Federal Information Protection Standards. These federal standards represent the common base to which all federal agency classifications are mapped.

FSOC Support

A key element of the OFR mission is to support the work of the Council. However, the OFR and the Council are separate. The OFR provides data and analysis to the Council, and our missions to assess and monitor threats to financial stability are complementary. But it is incorrect to say that the Office is the research arm of the Council.

As OFR Director, I serve on the Council, but as a non-voting member.

Under the Dodd-Frank Act, the OFR evaluates policies related to financial stability, but the OFR does not make policy. The Council does. That role puts us in an objective position to analyze threats to financial stability and to evaluate policies to mitigate them.

The OFR has also conducted analysis for the last two FSOC annual reports. In addition, we have facilitated analysis for the Council, such as evaluating the risks of money market funds and providing data and analysis related to the first-stage process of designating nonbanks for supervision by the Federal Reserve.

Interagency coordination is part of the OFR's every day routine in engaging with FSOC member agencies and others. Examples include our extensive coordination with relevant agencies on our asset management report, on data sharing, in seeking input from agencies on other research-related publications, and in providing subject-matter expertise to them.

The OFR leads the FSOC's Data Committee, which handles issues related to data collection, gaps, and standards. We are also supplying data and analysis to the FSOC Systemic Risk Committee and the Nonbank Designation Committee, and we lead the U.S. delegation on the global LEI initiative.

Before publishing a research working paper or annual report, we solicit feedback from subject matter experts in academia and at FSOC member agencies and other financial regulators, such as the Federal Reserve Bank of New York.

At the request of the Council, we conducted a study to inform the Council's consideration of what threats in asset management activities exist and what remedies, if any, might be appropriate for the Council to consider to mitigate any such threats.

In September 2013, we released the results of that study in a report, *Asset Management and Financial Stability*.

The report had three key findings:

- Asset management activities and firms differ from banking activities and banks. To quote the first page of the report, asset management activities "differ in important ways from commercial banking and insurance activities. Asset managers act primarily as agents: managing assets on behalf of clients as opposed to investing on the managers' behalf. Losses are borne by — and gains accrue to — clients rather than asset management firms. In contrast, commercial banks and insurance companies typically act as principals: accepting deposits with a liability of redemption at par and on demand, or assuming specified liabilities with respect to policy holders."
- Vulnerabilities in some activities could give rise to threats to financial stability, in particular, risk-taking in separately managed accounts and the reinvestment of cash collateral in securities lending transactions.
- Significant data gaps hamper analysis. Filling them would be essential to verifying our findings.

It is also important to note what the report did not do:

- It did not evaluate individual firms. Any designation process by the FSOC would involve evaluation of individual firms. The OFR report did not focus on individual firms, but instead on asset management activities. As a result, the OFR report alone could not be used as the basis for designating any particular firm. This is why firm-specific, non-public information was not needed for the report.
- It did not substitute for the Council's work. The goal of the report was to provide information. The Dodd-Frank Act established the OFR as a research and data organization with the mandate to support the Council and its member agencies in their efforts to identify and mitigate threats to financial stability. Responding to the Council's request for this analysis is part of fulfilling that mandate. However, the OFR's responsibilities do not extend to deciding on policy actions. The OFR Director is a non-voting member of the Council; only the voting members of the Council decide on the specific threats posed by any activity and whether any remedies are necessary to mitigate such threats.

Finally, it is important to note that the OFR followed an open and transparent process in gathering information for the report:

- The OFR research team met with representatives from the asset management industry on numerous occasions. Not only did we grant every request from the industry to meet, but we actively sought meetings with industry representatives to learn as much as possible about industry business models and practices.
- The OFR research team engaged with experts from FSOC member agencies throughout the entire course of the process, including extensive interaction with experts from the Securities and Exchange Commission. Many important contributions from those experts appear verbatim in the report.

Conclusion

Let me conclude where I began — with our commitment to transparency and accountability. Fulfilling our mission requires that we collaborate with our stakeholders and be accountable to them, including the Council, other regulators, industry, and the American people.

In that regard, we want to be sure that you in Congress are fully informed about our work to help promote U.S. financial stability. Hearings like this are critical venues for that information exchange, and I look forward to such opportunities in the future to keep you informed. More broadly, we invite engagement with you and your staffs to assure that the dialogue is frequent, open, and informative.

Thank you again for inviting me here today. I would be happy to respond to your questions.

BETTER MARKETS
TRANSPARENCY · ACCOUNTABILITY · OVERSIGHT

November 1, 2013

Ms. Elizabeth M. Murphy
Secretary
Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549-1090

Re: Public Feedback on OFR Study on Asset Management

Dear Ms. Murphy:

On September 30, 2013, the Office of Financial Research ("OFR") issued a report entitled "Asset Management and Financial Stability" ("Report"), which is purportedly an overview of the asset management industry. That same day, the Securities and Exchange Commission ("SEC") posted the Report on its website and announced that it would accept feedback from members of the public interested in providing input on it. Better Markets, Inc.[1] ("Better Markets") appreciates the opportunity to submit its views.

OFR was designed to be a highly regarded crown jewel in the country's financial reform architecture. The legislative and executive branches created and structured OFR to be a very powerful, independent resource and support structure for financial reform generally and the fight against systemic risk in particular. Independent funding, subpoena power, and virtually unlimited jurisdiction were the pillars to enable OFR to produce superior, high quality, and robust data, research, and analysis.

OFR was intended to be a transformative, game-changing organization. It was supposed to be the all-source financial fusion center as well as the heart of the policy-making circulatory system that nourished the other parts of the government. Its work was not just to improve the quality of financial data to policy makers; it was expected to set the gold standard for independent, rigorous, unimpeachable, and sophisticated analysis of the financial system.

Regrettably, OFR has thus far fallen short of the goals set for it and short of the standards that it was expected to meet and that the American people need it to meet. The glaring deficiencies of this Report are, unfortunately, evidence of these shortcomings.

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1 Better Markets, Inc. is a nonprofit organization that promotes the public interest in the capital and commodity markets, including in particular the rulemaking process associated with the Dodd-Frank Act.

The first and most obvious problem is the inexcusable lack of transparency and disclosure regarding how and why the Report came about as well as how its analysis (such as it is) was conducted and with who's input and direction. Most troubling, it appears to confirm some of the worst suspicions that OFR is influenced by and biased toward the too-big-to-fail sell-side banks that dominate Wall Street. After all, rather than focusing on the known systemic risks that they pose, which materialized just five years ago and which inflicted widespread economic wreckage across the country, OFR chooses to take aim at the asset management buy-side of the financial industry, which, by comparison, presents much lower risk and played no role or virtually no role in the most recent financial crash.

Equally troubling is the inexplicably and indefensibly poor quality of the work presented in the Report. As explained in detail below, the Report adopts an arbitrary analytical framework; it provides little empirical support; it ignores or minimizes the significance of relevant factors; and it conveys its findings in such vague and amorphous terms that it proves to be of little value and is in fact misleading. The Report suggests that the asset management industry poses a threat to the stability of our financial system, but the information set forth in the Report, skeletal though it is, actually suggests the opposite.

The Report will also have a negative, if not pernicious, impact. First and foremost, it risks discrediting OFR, its independence, its mission, and its work. It may also lead to the imposition of prudential supervision in the asset management sector, where such enhanced oversight appears to be unwarranted. In addition, it represents a costly distraction from more important challenges facing the Financial Stability Oversight Council ("FSOC") and other regulators: addressing the already-known and still-unresolved systemic risks inherent in our overleveraged, undercapitalized, fragile, and too often unregulated too-big-to-fail bank and non-bank system. Indeed, the most telling aspect of the Report is not what it says about the asset management industry, but what it confirms by comparison about the egregious shortcomings in the current state of the systemically significant part of the banking industry.

Finally, and of greatest concern to Better Markets, the Report may undermine confidence in the quality of the research and analysis that the OFR can and should produce. This is a major failure and a gross disservice to the American people because OFR has such a critical role to play in identifying, analyzing, and controlling systemic risk in our financial system. Ultimately, the protection of the American people, our financial system, and our standard of living is at stake. OFR can and must do better. It must withdraw this Report and focus on the much larger, imminent, and known threats to systemic stability. Only after those threats are eliminated, and only after a thorough re-evaluation of priorities, should OFR direct its attention to other possible threats.

SUMMARY OF THE REPORT

The Report states that it is a "brief overview of the asset management industry."[2] However, the origins of the Report are unclear and undisclosed. The FSOC apparently asked the OFR to provide data and analysis to assist the FSOC in determining "whether—and how—to consider asset management firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Act."[3]

In response, the OFR did not apply the template of statutory factors that governs the FSOC's designation of financial institutions under Section 113. Nor did the OFR apply the three-stage protocol adopted by the FSOC to identify candidates for further scrutiny under Section 113. Inexplicably, the OFR responded by generically "analyzing industry activities, describing the factors that make the industry and individual firms vulnerable to financial shocks, and considering the channels through which the industry could transmit risks across financial markets."[4]

The findings of the Report are couched in exceptionally tentative and vague terms, and without significant empirical support. Indeed, the Report does not include some basic, publicly available information that one would expect, much less the information and data that OFR was specifically authorized to collect and analyze. And some of the Report is inaccurate.

The Report essentially makes the following observations:

- The asset management industry is a diverse mix of businesses, highly concentrated, offering a broad variety of funds, and overseeing a large amount of financial assets, estimated at $53 trillion.[5]

- The asset management industry **may** be vulnerable to financial shocks by virtue of (1) reaching for yield; (2) redemption risk; (3) leverage; and (4) the distress or failure of a large asset management firm.[6]

- Asset managers **could** transmit risk across the financial system through (1) exposure of creditors, counterparties, and other market participants to asset manager activity, and (2) disruption to financial markets caused by fire sales.[7]

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2 OFR, ASSET MANAGEMENT AND FINANCIAL STABILITY, at 1 (Sept. 2013), *available at* http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.
3 *Id.*
4 *Id.*
5 *Id.* at 3.
6 *Id.* at 9.
7 *Id.* at 21.

- There is a shortage of available data with respect to separate accounts, securities lending, the repo market, and private asset managers that do not issue public financial statements.[8]

While the Report describes a number of "possible" risks associated with asset managers, it ignores or sets aside evidence suggesting that asset managers, by virtue of their structure, activities, and role in the last crisis (or lack thereof), do **not** pose significant levels of systemic risk.[9] And the Report provides no judgments about the weight of the points listed above, or the likelihood that the asset management industry will in fact incubate and propagate systemic risk in our financial system. Perhaps the most shocking omission is the lack of any context or prioritization of the "possible" risks from asset managers relative to the many other known and clear systemic risks that remain unaddressed, unabated, and unregulated in our financial system. It is to those risks that the time, resources, and attention of the FSOC and the OFR should be devoted.[10]

COMMENTS

I. The Report is not transparent, as it does not reveal important information about the basis for the FSOC's decision to focus on asset managers as potential sources of systemic risk.

The Report is remarkably uninformative about exactly why or how the FSOC chose to focus its time, efforts, and resources, as well as those of the OFR, on asset managers. The OFR simply states in the Report that "[t]he FSOC **decided** to study the activities of asset management firms to better inform its analysis of whether—and how—to consider such firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Act."[11] But the Report provides no information regarding the basis for that decision.[12]

Elsewhere, the Report offers this observation about the origins of the study: "The diversity of [asset management] activities and the vulnerabilities they may create, either

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8 *Id.* at 24.

9 The point is not that asset management funds could never transmit systemic risk or contribute to a fall in market confidence by virtue of runs or fire sales. Rather, the point is that asset management typically limits that risk to the maximum possible extent by placing it on investors rather than creditors and U.S. taxpayers, and by relying principally on equity funding rather than leverage. These enormously important distinctions are not recognized, analyzed, or weighted accordingly in the OFR Report.

10 The Report notes that it does **not** focus on either money market funds or private funds such as hedge funds and private equity funds. Report at 2.

11 Report at 1 (emphasis added).

12 When the OFR posted the Report on its website, it was similarly terse in describing its origins: "The OFR studied the activities of asset management firms and funds at the request of the Council." U.S. Dept. of the Treas., OFR, Asset Management and Financial Stability, http://www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx. The SEC simply posted the Report and invited comment, without any discussion or analysis of its own views.

separately or in combination, **has attracted attention** to the potential implications of these activities for financial stability."[13] But here too the Report raises more questions than it answers—attracted whose "attention" and why?—and it provides no insight into the FSOC's decision to focus on asset managers. These decisions are all the more important given the many other well-known and clearly observable systemic risks that persist,[14] many of which materialized just five years ago at great cost to the country.[15]

Previously, the FSOC disclosed that it was analyzing asset management companies as a potential threat to financial stability. On April 11, 2012, the FSOC issued a rule regarding the manner in which FSOC intends to apply the statutory designation authority granted in Section 113 of the Dodd-Frank Act ("FSOC Release").[16] In the FSOC Release, the FSOC noted that:

> [T]he Council, its member agencies, and the OFR are analyzing the extent to which there are potential threats to U.S. financial stability arising from asset management companies. This analysis is considering what threats exist, if any, and whether such threats can be mitigated by subjecting such companies to Board of Governors supervision and prudential standards, or whether they are better addressed through other regulatory measures."[17]

Yet again, this statement was unaccompanied by any information regarding the reasons for the FSOC's decision to "analyze" asset management companies.

This is unacceptable, and the American people deserve better. The FSOC and the OFR must do more to promote transparency as they discharge their duties under Section 113. Certainly, the designation authority is one of the most important measures that Congress adopted in the Dodd-Frank Act. Designation has profound consequences for financial companies, their competitors, the economy more widely, and the American people.[18] All of these constituents are entitled to an understanding of how the FSOC is using its formidable power, even in the preliminary stages of the process.

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[13] Report at 1 (emphasis added).

[14] Because the OFR and the FSOC face such important challenges with limited time and resources, prioritization and a clear ranking of systemic risks is essential.

[15] *See* BETTER MARKETS, THE COST OF THE WALL STREET-CAUSED FINANCIAL COLLAPSE AND ONGOING ECONOMIC CRISIS IS MORE THAN $12.8 TRILLION, at 36-39 (Sept. 15, 2012), *available at* http://bettermarkets.com/sites/default/files/Cost%20Of%20The%20Crisis_0.pdf.

[16] Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637 (Apr. 11, 2013) ("FSOC Release").

[17] FSOC Release at 21,644.

[18] The GAO Report, discussed *infra*, cites a number of positive and negative consequences that can flow from a Section 113 designation, including fees and compliance costs and competitive advantages accruing from the perception that the institution is too big to fail. GAO, FINANCIAL STABILITY: NEW COUNCIL AND RESEARCH OFFICE SHOULD STRENGTHEN THE ACCOUNTABILITY AND TRANSPARENCY OF THEIR DECISIONS, GAO-12-886, at 44-45 (Sept. 2012), *available at* http://www.gao.gov/products/GAO-12-886 ("GAO Report").

Certainly, for example, the extent to which representatives from competing industries, or any other interested parties, may have communicated with (or more directly lobbied) the FSOC in hopes of influencing the process should be disclosed. In addition, an understanding of how the FSOC prioritizes its activities is key. Those priorities affect the allocation of the FSOC's resources, and may ultimately determine how quickly and effectively other types of nonbank financial companies are assessed for possible designation—including companies that pose far more acute systemic risks. And the public, along with Congress, needs insight into the workings of the FSOC, as well as the OFR, to gauge their effectiveness.

In fact, the FSOC itself has acknowledged the importance of transparency in the designation process. Furthermore, it has stated that it intends to "foster" that transparency through the publication of guidance containing profiles of firms likely to be evaluated for potential designation, and the factors the FSOC intends to use to make its determinations.[19] Thus, providing greater openness in connection with the evaluation of asset managers for potential Section 113 designation is what the FSOC has already promised, yet failed to do here.

The GAO has confirmed the lack of transparency in the FSOC's operations. In its September 2012 report on the FSOC ("GAO Report"),[20] the GAO concluded that—

> Public information on FSOC's and OFR's decision-making and activities is limited, which makes assessing their progress in carrying out their missions difficult. . . . Appropriate accountability and transparency mechanisms also need to be established to determine whether FSOC and OFR are effective and to ensure that the public and Congress have sufficient information to hold the entities accountable for results.[21]

The OFR Report proves that GAO's concerns were not only valid, but remain unaddressed.

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[19] FSOC Release at 21,639.
[20] GAO Report.
[21] GAO Report, at Introduction and 50-51.

II. The Report indicates that the FSOC and the OFR either did not follow, or do not have, meaningful protocols for early-stage evaluation of potential systemic risks.

The Report is especially striking because it ignores the specific methodology that the FSOC adopted as a guide for deciding which financial companies should be candidates for Section 113 designation. In the Section 113 Release, the FSOC set forth a three-stage process that it intends to use for that purpose. A "Stage 1" analysis is "designed to narrow the universe of nonbank financial companies to a smaller set," and ultimately "to identify nonbank financial companies that should be subject to further evaluation in subsequent stages of review."[22]

The FSOC further explained that in Stage 1, "the Council intends to evaluate nonbank financial companies by applying **uniform quantitative thresholds** that are broadly applicable across the financial sector."[23] Those thresholds include size, interconnectedness, leverage, liquidity risk, and maturity mismatch.[24] Moreover, the release states that "the Council will apply the Stage 1 thresholds to **all** types of nonbank financial companies, including . . . asset management companies."[25]

However, the Report contains no indication that the FSOC did in fact conduct a Stage 1 analysis as the basis for asking the OFR to further study asset managers. Nor does it set forth any other standard the FSOC might have used as a kind of "pre-Stage 1" test for deciding how and where to direct its resources and those of OFR.[26] Thus, either the FSOC and OFR are operating without processes and standards that guide their early-stage identification of potential systemic risks, or they have ignored the methodologies that they have established. Either way, they have failed to disclose which path they chose and both alternatives are unacceptable.

This problem has also drawn criticism from the GAO. In its September 2012 report, the GAO made this finding:

> FSOC has not developed a systematic forward-looking process for identifying potential emerging threats in its mandated annual reporting

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22 FSOC Release at 21,642.
23 *Id.* (emphasis added).
24 *Id.*
25 *Id.* at 21,643 (emphasis added).
26 The only reference to OFR's **methodology** is this uninformative statement that appeared on the website upon release of the Report: "In developing the report, the OFR staff reviewed existing research, analyzed industry data, interviewed market participants, and consulted extensively with Council member agencies." U.S. Dept. of the Treas., OFR, Asset Management and Financial Stability, http://www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx. Given the glaring deficiencies in the Report, OFR owes it to the American people to disclose the details of all the information reviewed, people consulted, and other activities undertaken in preparation of the Report.

> process. In particular, FSOC does not have processes for consistently identifying such threats, separating them from more current threats, or prioritizing them.[27]

The FSOC should promptly correct this situation. It must either establish new objective protocols for early-stage evaluation of financial companies that may warrant Section 113 designation, or apply the ones that exist in a transparent manner.

III. The Report adopts a weak analytical framework.

Even if the FSOC has not yet developed a methodology for preliminary evaluation of nonbank financial companies under Section 113, the OFR could have and should have adopted and disclosed a more useful analytical framework in the Report. An obvious choice would have been to consider asset management in terms of the statutory factors for designation set forth in Section 113. However, the Report does not follow any of the statutory or regulatory templates that have been established to guide the implementation of Section 113. For example, the Report does not track or mention the ten statutory factors that the FSOC must apply when making a Section 113 designation determination. Nor does the Report track or mention the six-factor test that the FSOC has developed for implementing the statutory standards.[28]

Furthermore, as discussed above, the Report omits any reference to the three-stage test adopted by FSOC for triaging the universe of nonbank financial companies that may be appropriate subjects of further scrutiny under Section 113. Finally, the Report makes no mention of the framework that the FSOC developed for identifying the channels that are most likely to transmit the "negative effects of a nonbank financial company's material financial distress or activities to other firms and markets."[29]

The Report offers no explanation for the seemingly ad hoc selection of issues that the OFR chose to address. As a result, it is difficult to derive helpful information from the Report **in terms of** the statutory and regulatory factors that ultimately determine whether a nonbank financial company should be subjected to enhanced supervision under Section 113.

IV. The Report is so hypothetical and conditional that it lacks value, and even misleads by exaggerating the potential threats posed by asset managers.

The Report draws very few helpful judgments or conclusions. Many observations are couched in such vague terms that they provide little useful information. As a result, by simply listing a range of possible ways in which asset managers might theoretically create

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27 GAO Report, second page of Introduction.
28 FSOC Release at 21,641.
29 *Id.*

systemic risk, the Report implies that the threat is far more serious than the OFR Report establishes or than it actually is.

For example, the Report includes some basic facts about asset management, but fails to provide meaningful assessments regarding the implications of those facts. It is certainly true that investors in managed funds can lose money; that managers may be tempted to reach for yield; that funds can experience flight and fire sales; that a small subset of funds employ leverage; and that funds might transmit risk to some degree via counterparties, creditors, and fire sales. But the Report fails to offer insights into how significant these facts are, or how likely they are in reality to contribute to systemic instability in our financial markets.

The observations in the Report are not only hypothetical, but also conditional. For example, the Report states that "Some activities highlighted in this report that **could** create vulnerabilities—**if** improperly managed or accompanied by use of leverage, liquidity transformation, or funding mismatches—include risk-taking in separate accounts and reinvestment of cash collateral from securities lending."[30] Elsewhere the Report states that "The failure of a large asset management firm **could** be a source of risk, **depending** on its size, complexity, and the interaction among its various investment management strategies and activities."[31] Such hypothetical and conditional statements provide little meaningful information. Yet the Report is replete with them, and it thereby fosters the unsupported impression that asset managers pose significant threats of systemic instability.

V. <u>The Report offers little concrete support, and it ignores or minimizes relevant factors.</u>

The Report lacks robust empirical support. It includes a number of snapshots aimed primarily at conveying rudimentary information about the asset management sector, including the leading firms and their size. However, it does not include much in the way of specific information that could provide a detailed and dynamic profile, reflecting money flows, interconnections, and the actual track record of asset management firms during the 2008 crisis and other periods of market instability.

In addition, while the Report acknowledges a number of important features of the asset management industry, it fails to assess their significance. For example, the Report notes a fundamental distinction between the asset management industry and banks. Asset managers are predominantly agents for clients, and it is client funds that are risk. In contrast, banks and insurance companies are principals, and in the event of failure, they put shareholder, creditor, and ultimately taxpayer money at risk.[32] This distinction strongly suggests that while investors may lose money through asset management, those activities

[30] Report at 1.
[31] Report at 18.
[32] Report at 1.

do not threaten wide spread contagion. However, the significance of these distinctions is not analyzed in the Report.

The Report observes that economic conditions may induce portfolio managers to reach for yield by purchasing riskier assets.[33] At the same time, the Report points out that "The asset management industry has many practices and regulatory restrictions that can mitigate such risks."[34] The Report furthers observes that this problem is also addressed through investor disclosure requirements regarding a fund's risks, holdings, and investment strategies.[35] Yet, nowhere does the Report assess the effectiveness of these mitigants or net out all of the relevant concerns and factors.

The Report's discussion of leverage is among the most uninformative and is, in fact, misleading. It essentially notes that leverage may be used in funds themselves or at the firm level.[36] It also cites anecdotal information that during the financial crisis, leverage caused "significant losses for some registered funds."[37]

But, inexcusably, the Report does not quantify the amount of leverage currently deployed in the asset management industry, which is in fact relatively low. Indeed, while hedge funds employ leverage strategies, they appear to be used in less than 5% of the asset management industry,[38] and the leverage ratio that hedge funds use averages less than 3 to 1.[39] To the extent the Report suggests that such use of leverage poses unacceptable threats to systemic stability, then it speaks volumes about the need for much greater leverage limits in the banking sector: Under Basel III, banks can assume risks funded with 3% equity and 97% debt, equating with a leverage ratio of 33 to 1.[40]

The Report fails to provide this important context for assessing leverage used by asset managers. Moreover, it again raises the fundamental question of why the FSOC and OFR focused on merely "possible" risks arising from a low-leverage activity with a largely stable asset base, when so many high-leverage, fragile, short-term, hot-money systemic

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33 *Id.* at 9.
34 *Id.*
35 *Id.*
36 *Id.* at 17.
37 *Id.* at 18.
38 *See* Managed Funds Association, Hedge Fund Basics, Industry Size, http://www.managedfunds.org/hedge-fund-investors/industry-fact-sheets/industry-size/ (last visited Nov. 1, 2013) (noting hedge funds comprise $2.51 trillion); Boston Consulting Group, *Press Releases* (July 9, 2013), *available at* http://www.bcg.com/media/PressReleaseDetails.aspx?id=tcm:12-139274 (citing the $62.4 trillion global asset management industry as of 2012).
39 Citiprime Finance, *Hedge Fund Industry Snapshot*, at 1 (Aug. 2013), *available at* http://www.citibank.com/icg/global_markets/prime_finance/docs/hf_monthly_sep13.pdf (calculating gross leverage on a mean basis as 1.96x).
40 KPMG, *Basel III Issues and Implications*, at 10 (2011), *available at* http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/basell-III-issues-implications.pdf (noting bank leverage limit is 3%).

risks remain. These agencies can and must be expected to make better judgments and establish better priorities.

VI. The Report will have a predominantly negative impact, far outweighing the modest benefits that it provides, and it should be withdrawn.

The Report will have several deleterious effects, which outweigh its limited value. The Report is useful in that it provides some basic information about the asset management industry. Furthermore, it reflects a generally laudable impulse by the FSOC to search diligently for possible systemic risks in our financial system. And it highlights several subsectors in the asset management industry where more data should be available to regulators.

However, the drawbacks of the Report are far more significant. Obviously, the weaknesses in the Report will only undermine confidence in the ability of the FSOC to apply transparent, objective metrics or to make sound and informed judgments about potential systemic risks. The Report also casts doubt about the ability of the OFR to support the FSOC's mission with useful and independent data, research, and analysis.

More importantly, the Report does not in fact support the notion that asset management funds or firms should be subjected to enhanced supervision under Section 113. Yet because of the many flaws and deficiencies described above, it may lead to such an eventuality. That outcome would impose undeserved, adverse, and unwarranted consequences on the asset management industry, without affording the benefits that Section 113 was intended to confer.

Finally, the Report represents a potentially costly distraction from more important challenges facing the FSOC and other regulators. As the GAO report found, the FSOC has struggled to prioritize the emerging systemic risks that it perceives in our financial system. This failure creates its own unique hazards, and the Report unfortunately illustrates the point. By drawing attention to asset managers, the Report diverts attention from more pressing regulatory challenges. And among those noteworthy challenges is addressing the persistent systemic risks created by our too-big-to fail banks.

In light of the foregoing, the FSOC and the OFR must withdraw this Report and focus on the serious, known systemic risks that pose grave threats to the American people today. If, after those risks have been addressed, the agencies decide that attention to the possible threats from the asset management industry is still warranted—based upon a publicly disclosed and robust ordering of priorities—then they must rectify the defects described above in any further report.

Ms. Elizabeth M. Murphy
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CONCLUSION

We hope that our comments are helpful.

Sincerely,

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CHAMBER OF COMMERCE
OF THE
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February 4, 2014

The Honorable Patrick McHenry
Chairman
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

The Honorable Al Green
Ranking Member
Subcommittee on Oversight and Investigations
Committee on Financial Services
U.S. House of Representatives
Washington, DC 20515

Dear Chairman McHenry and Ranking Member Green:

The U.S. Chamber of Commerce, the world's largest business federation representing the interest of more than three million businesses of all sizes, sectors, and regions, as well as state and local chambers and industry associations, and dedicated to promoting, protecting, and defending America's free enterprise system, believes that effective systemic risk monitoring and analysis are important responses to the 2008 financial crisis. As the Subcommittee on Oversight and Investigations holds a hearing entitled "The Annual Report of the Office of Financial Research," we would like to bring several issues to your attention.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) established the Office of Financial Research (OFR) to act as the data gathering and research arm of the Financial Stability Oversight Council (FSOC). Congress bestowed upon OFR the overarching mission to gather and streamline data from amongst financial regulators and directly from financial institutions, and to analyze this data, and other factors, to help identify potential threats to the U.S. financial system. The Chamber supports the goal to monitor and mitigate systemic risk; however, we believe OFR has fallen short of its mission, which could result in the unwarranted designation of nonbank financial companies as systemically important financial institutions, leaving the system more vulnerable. Such actions would have the unintended consequence of limiting broad and diverse sources of capital that American businesses can access and the disincentive to engage in the reasonable risk-taking needed for a free enterprise system to work.

The release of OFR's "Report on Asset Management and Financial Stability" last autumn is a microcosm of these concerns and demonstrates a number of reforms that are necessary to ensure a credible, properly functioning agency. OFR failed to provide adequate transparency on the asset management report project that resulted in serious defects in the report. These include serious flaws in its methodology, its unsupported and unwarranted assertions, and its highly speculative conclusions. OFR worked on the report for well over a year before it was released publicly, yet, to our knowledge, only contacted a handful of asset managers for meetings prior to the finalization of the report. This left hundreds of other asset managers unaware that financial stability analysis was being conducted on the industry, depriving them of the opportunity to contribute accurate and meaningful input. Moreover, the asset managers who met with OFR walked away with a very limited understanding of the purpose of the report – despite asking that question.

Additionally, the process and extent by which OFR coordinated with the primary regulator, the Securities and Exchange Commission (SEC), is questionable. While the asset management report is ultimately an OFR report, the comments and edits from SEC should have been incorporated in full. The Chamber was encouraged that SEC put the report out for public comment after the report was released by OFR suggesting, as indicated by press reports, that SEC was not satisfied with the final report. We hope OFR can avoid these process fouls in the future. In December, the Chamber released the FSOC Reform Agenda, which recommends a handful of reforms designed to strengthen evidence-based analysis including:

- Improving OFR's empirical and analytical reports;
- OFR should coordinate data collections amongst multiple agencies; and
- Increase OFR oversight.

These reforms would have significantly strengthened the quality of the report while avoiding the many flaws in the report that numerous commenters have identified to SEC.

Among the important purposes of OFR, streamlining data amongst agencies remains one of the more critical functions it needs to accomplish. Streamlining data is crucial, as businesses face several requests from one agency and often from multiple agencies asking for similar data in different formats. These duplicative data requests are costly and growing as the Dodd-Frank Act continues to come online. To date, these streamlining functions, which are an example of smart regulation and promotion of efficient government, have not been exercised by OFR.

The Chamber is also concerned about the use of proprietary business data by OFR and the security of such data. The Government Accountability Office has raised similar concerns and criticisms of the cyber security of financial regulators. On November 8, 2011, the Chamber wrote to OFR regarding these concerns in a comment letter concerning the interim final rule entitled "Post Employment Restrictions for Employees of the Department of the Treasury, Office of Financial Research." The Chamber also raised these issues in a meeting with OFR in 2012.

Many of these issues arise out of structural flaws embedded in the Dodd-Frank Act. OFR suffers from a lack of checks and balances, similar to the Consumer Financial Protection Bureau. This is occurring while other issues arise because of the growing pains as the Dodd-Frank Act is implemented. Some issues continue to linger because they were left unaddressed in the underlying legislation.

The Chamber believes that these and other issues must be addressed in order to have effective systemic risk monitoring and for the United States to have a financial regulatory system designed for the diverse capital needs of a competitive 21st century economy. We thank the

Subcommittee for holding this hearing, and we look forward to working with Congress to achieve these goals.

Sincerely,

R. Bruce Josten

cc: Members of the Subcommittee on Oversight and Investigations

Vanguard

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November 26, 2013

Ms. Elizabeth M. Murphy
Secretary
U.S. Securities and Exchange Commission
100 F Street, NE
Washington, DC 20549

Via Electronic Submission

Re: Comments on the Office of Financial Research's ("OFR") Report "Asset Management and Financial Stability"

Dear Ms. Murphy:

We greatly appreciate the invitation from the Securities and Exchange Commission ("SEC" or "Commission") to comment on the OFR report entitled "Asset Management and Financial Stability," dated September 2013 (the "Report"). As the primary regulator of asset managers and asset management activities, we believe it is appropriate for the Commission to seek public comment on the Report's findings. We strongly believe that the public comment process adds significant value to the regulatory process, and should be actively solicited by the Financial Stability Oversight Council ("FSOC") and the OFR to make well-informed decisions. Having now received a significant number of comment letters in response to the Report from industry participants and others, we call upon the Commission to publish a compilation of the comments for the benefit of the public and the other agency members of FSOC. The SEC, as the regulator with the most experienced and tenured staff addressing investment adviser and asset management activities, is uniquely positioned to compile such a report.

As one of the largest U.S. asset managers, whose core purpose is "to take a stand for all investors, to treat them fairly, and to give them the best chance for investment success," Vanguard[1] has advocated for responsible asset management regulations for more than 30 years. We welcome the opportunity to address systemic risk concerns about regulated asset management activity, and to inform our systemic risk regulators about the risk-limiting measures prescribed by the Investment Company Act of 1940

[1] "Vanguard" refers to The Vanguard Group, Inc., an SEC-registered investment adviser for more than three decades. We note that the Report incorrectly classifies Vanguard as a "non-deposit trust company-member." *See* Report at 6. As of October 31, 2013, Vanguard manages, as agent, approximately $2.4 trillion in long-only U.S. mutual fund assets on behalf of fund investors.

("ICA") and the Investment Advisers Act of 1940 ("IAA"), including the SEC rules and regulations promulgated thereunder.[2] We also welcome the opportunity to discuss how recent rules and regulations drafted in response to the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") adequately address the concerns expressed in the Report.

We have some fundamental questions about the purposes and potential uses of the Report. The Report purports to identify certain asset management activities that could create financial shocks. Given the significant variations among asset managers, asset management activities, and risk mitigation practices, any study of the asset management industry requires careful differentiation between the various activities of regulated mutual funds, the activities of unregulated funds, and the business practices of asset managers. While the Report does make such helpful distinctions in a few instances,[3] we believe that it suffers from several significant shortcomings, namely, incomplete and inaccurate facts, generalizations that lack empirical support, and omissions about existing regulatory safeguards that mitigate the very risks identified in the Report. In addition, the Report suggests that it excludes concerns stemming from money market mutual funds, but nevertheless discusses many of the issues that are most relevant to these funds,[4] and presumes that the same issues equally apply to equity and bond funds.

More troubling, however, is that the authors of the Report contend that it is nothing more than a "brief overview of the asset management industry"[5] but was produced in response to an FSOC request for assistance in determining "whether—and how—to consider asset management firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Act."[6] We are deeply concerned that such a brief overview would or could be used by FSOC as a foundation for such a significant determination. We are equally concerned that the OFR, charged with providing the member agencies of FSOC independent, complete and accurate reports, could submit a report with such shortcomings. We believe that the member agencies of FSOC have a responsibility to ensure that the information provided to them is accurate, balanced and complete, and derived from knowledgeable sources. If the Report serves no other purpose, at a minimum it should serve to demonstrate the need for such reports to be subject to public comment.[7]

The Report identifies that securities lending and repurchase ("repo") agreement activities lack transparency and consistency in application.[8] We agree that the risks stemming from the reinvestment of

[2] Unless noted otherwise, all references to "investment advisers," "asset managers," and "asset management activity" refers to those managers and activities that are regulated by the SEC pursuant to the ICA and IAA.
[3] *See* Report at 1 (stating that asset managers act primarily as agents for their clients, while banks and insurance companies invest on their own behalf); *Id.* at 3 (stating asset managers have a diverse mix of businesses and business models, and offer a broad variety of funds); *Id.* at 4 (Figure 1, providing an asset management industry overview); *Id.* at 9 (stating that mutual funds have regulatory restrictions that can mitigate the risks of reaching for yield); and *Id.* at 27(Appendix providing asset management firm types and types of collective investment vehicles).
[4] *See* Report at 1 ("asset managers may create funds that can be close substitutes for the money-like liabilities created by banks . . ."); *Id.* at 12 (discussing redemption risk and the first-mover advantage); and at 23 (discussing funding mismatches). We also note that several of the research papers cited in the Report apply specifically to money market funds.
[5] *Id.* at 1.
[6] *Id.*
[7] *See* Vanguard Comment Letter to FSOC, dated December 19, 2011, at 3 (stating that upon completion of its study of asset managers, FSOC "should share its findings with the public and provide for an adequate comment period.")
[8] Although Vanguard funds engage in both securities lending and repurchase transactions, our involvement in these markets is limited by our risk management protocols. With respect to securities lending, all net lending revenues are

cash collateral, in certain instances, can present significant challenges if not managed appropriately. Although Vanguard does not participate in the repo market to the same extent as other asset managers, we support the ongoing efforts of regulators to reform repo transactions.[9] As history has demonstrated, the repo market is particularly sensitive to counterparty credit deterioration, which can result in the prompt disposal of securities and exacerbate financial shock.

We summarize our key points below:

- Regulated asset management activity that is conducted on an agency basis does not generate system risk. The prescribed risk-limiting measures of the ICA and IAA adequately protect investors and the broader financial markets from the types of risk-producing activities that are more common among other market participants. These risk-producing activities include investments in highly illiquid assets, the use of significant amounts of leverage, and a lack of transparency in holdings and valuation. These risk-producing activities are simply not conducted by mutual fund investment advisers.

- The Report suffers from several significant shortcomings, including inaccurate and incomplete data, generalizations that do not differentiate, in many cases, between regulated mutual fund activity, unregulated fund activity and the various business and risk management practices of asset managers, and omissions about the ICA, IAA and other regulatory safeguards that have been, or are in the process of being, implemented. As such, we question the utility of the Report as a foundation for the systemically important non-bank financial institution ("SIFI") designation of any asset manager or recommendations for regulatory changes to the SEC.

- The Report fails to identify how several of the asset management behaviors identified in the Report have produced, or could produce, systemic risk.

- The SEC, as the primary regulator of asset managers and asset management activity, should compile a summary of the comments it has received in response to the Report. The Report, together with the SEC's summary of public comments, will provide the members of FSOC with a more accurate and complete assessment of the asset management industry. If, upon further research and analysis, FSOC determines there are gaps or weaknesses in asset management regulations, the SEC is the functional regulator with the appropriate expertise to develop and implement any regulatory changes.

Part I of this letter addresses the four categories of asset management risks identified in the Report. Part II of this letter describes the risk-mitigating provisions of the ICA and IAA. Part III of this letter concludes that the Report is an inadequate basis upon which FSOC may make any determination pursuant to Section 113 or 120 of the Dodd-Frank Act.

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credited to the funds, and we only lend a small portion of any fund's portfolio. We take minimal risk in our collateral reinvestment by seeking to earn the cash rate. With respect to repurchase transactions, we limit collateral to Treasury and government securities.

[9] We note that the Federal Reserve Bank of New York held a workshop as recently as last month to discuss the risk of fire sales in the triparty repo market. *See* "The Fire-Sales Problem and Securities Financing Transactions," remarks by Jeremy C. Stein, Board of Governors of the Federal Reserve System (New York, NY, October 4, 2013).

I. Asset Management Risks Identified in the Report

According to the Report, there are four categories of risks that could produce some level of disruption, although the Report does not clarify when or which behaviors would necessarily result in systemic risk. These behaviors include: (i) reaching for yield and so-called herding behavior; (ii) redemption risk and liquidity management; (iii) use of leverage; and (iv) asset managers as a source of risk. We address each of these items in greater detail below.

A. Reaching for Yield and Herding Behavior

The Report claims that portfolio managers may seek higher yielding securities in riskier assets than otherwise would be expected for a particular mandate. The Report offers that competition from other asset managers may incentivize a portfolio manager to seek yield in order to attract assets. The Report asserts that this phenomenon can feed on itself, producing so-called "herding" behaviors where asset managers crowd into the same assets or asset classes. Although the Report mentions two instances where bond fund investments proved to be riskier than originally anticipated, these references illustrate idiosyncratic—not systemic—risk. The Report does not identify any example of where "reaching for yield" or so-called "herding" behavior produced systemic risk.

We see no evidence that asset managers "herd" into assets. "Herding" is an investor behavior, regardless of whether investors buy assets directly or through a mutual fund. Asset managers do not serve as principals, but rather as agents, when purchasing securities for a fund. Mutual fund asset managers are required, by existing securities rules and regulations, to invest in assets that are consistent with a fund's disclosed risk factors and in a manner consistent with a fund's investment strategy. Such disclosure may take the form of a summary prospectus or statutory prospectus, including the fund's Statement of Additional Information.[10] The Report does not address the effectiveness that existing disclosure requirements have on any investment adviser's ability to chase yield. For example, mutual funds are required to have policies and procedures governing the disclosure of portfolio holdings. Funds are required to submit their portfolio holdings to the SEC on a quarterly basis.[11] Many advisers, however, have policies that provide for monthly disclosure of fund holdings. In addition, fund advisers are required to produce semi-annual and annual shareholder reports to provide investors with detailed information about fund performance, portfolio characteristics, and a discussion by the fund's adviser discussing factors that have affected the fund's performance. Likewise, the Report does not address the significant liability that arises when a fund's risks are not accurately described and disclosed in its prospectus. Liability associated with inadequate disclosure creates a powerful incentive for the investment adviser and the fund's board of trustees to ensure that the fund is being managed in accordance with the prospectus guidelines. We note that the securities rules and regulations governing disclosure and fraud are enforced by regulators, including the SEC, FINRA and, in some instances, state attorneys general. For example, during the 2008 financial crisis, some investment advisers faced regulatory fines and lawsuits by one or more of these regulators for failure to adequately disclose the risks associated with particular fund investments, and for marketing certain funds as cash-like vehicles, when in fact the funds had substantially more risk. We believe the authors of the Report do not fully appreciate the deterrent and disinfectant effect that disclosure has for mutual funds and their advisers.

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[10] *See* SEC Form N-1A.
[11] *See* SEC Form N-Q and Form N-CSR.

B. Redemption Risk and Liquidity Management

The Report discusses the risk that collective investment vehicles (a category that is quite broad and includes mutual funds) could experience disruptive redemptions during times of market stress. The articulated concern is that redemption activity could put stress on a fund's ability to produce adequate liquidity to accommodate shareholder redemptions. The Report recognizes that equity and bond funds price their shares using market values, where investors expect and accept fluctuations in a fund's share price, but states that investors still have an incentive to redeem early in order to avoid experiencing further losses.[12] Over the past three decades, there have been several periods of heightened market volatility where mutual fund advisers have accommodated significant redemption activity. The Report fails to discuss this history, the data available from these events, the resiliency of the markets, and the successful management of liquidity by mutual fund advisers during these market disruptions. The Report also fails to acknowledge that during these periods of market turbulence, advisers have rarely needed to use the contingency measures provided by the ICA to delay redemption payments. We note that when employed, such contingency measures did not generate systemic risk. Although both equity and bond funds have experienced significant outflows in the past, severe systemic illiquidity has never, to the best of our knowledge, been created by any single asset manager, or through the collective activities of equity or bond fund managers.

C. Use of Leverage

The Report mentions that common asset management activity, such as borrowing and the use of derivatives and repurchase agreements, can subject firms to "margin calls and liquidity constraints that increase the risk of fire sales."[13] Here the Report fails to distinguish that such exposures would occur at the fund level, and would not amount to a liability of the investment advisor. The Report does correctly state that the ICA limits borrowing and leverage for mutual funds to no more than 33% of a fund's assets, and that mutual funds are required to cover their derivatives positions with liquid assets equal to the exposure created by the derivatives contract.[14] The Report also correctly highlights that the ICA requires mutual funds to maintain 85% of their assets in liquid securities. The Report, however, fails to mention the significant improvements that have been made, and are in the process of being implemented, with respect to derivatives and repurchase agreements. We believe these developments are significant, in that they address perceived risks presented by asset managers and by the existing derivatives and repurchase market structure (including risks presented during the 2008 financial crisis).

An assessment of market risk must recognize the profound market enhancements brought about by the Group of Twenty Finance Ministers and Central Bank Governors' ("G20") directive for the

[12] We believe this argument is misplaced. Redemption risk and liquidity management are issues relevant to money market funds, which are not intended to be covered by the Report, and are two of the concerns being addressed by the SEC in its most recent money market reform proposal. In addition, the argument that investors have an incentive to redeem early in a variable NAV fund contradicts the rationale provided by FSOC for proposing the floating NAV for money market funds. *See* 77 Fed. Reg. 69455 (Nov. 19, 2012); Financial Stability Oversight Council, "Proposed Recommendations Regarding Money Market Mutual Fund Reform" (2012), available at http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf (proposing a floating NAV for money market funds because it would desensitize investors to losses and prevent runs).
[13] *See* Report at 17.
[14] *Id.*

reporting, margining, clearing and exchange trading of derivatives as implemented in the United States through Title VII of the Dodd-Frank Act. New swap data reporting and recordkeeping requirements provide both the Commodity Futures Trading Commission ("CFTC") and SEC with a clear window into the market to monitor trading and identify abuses and risk concentrations.[15] The uniform requirement for both initial and variation margin for cleared and uncleared swaps serves to mitigate counterparty risk, and limit leverage.[16] Central clearing of the most standardized swaps further limits counterparty risk while mandatory exchange trading is intended to enhance liquidity and improve pricing through greater market transparency and competition.[17] Increased capital requirements serve to reduce the likelihood of a swap dealer's insolvency.[18] As these changes are fully implemented in the United States and abroad, we believe that the derivatives markets will operate on a much more stable, controlled platform and will present significantly less systemic risk than the Report suggests.

The efforts of the Treasury Market Practices Group ("TPMG") of the Federal Reserve Bank of New York ("FRBNY") have likewise targeted risks identified during the 2008 financial crisis. Through the implementation of revised settlement guidelines and requirements for more timely trade confirmations, the efforts of FRBNY have served to mitigate credit exposures, enhance transparency and address the risk of defaulted securities in the repurchase market.[19] TPMG's directives will result in a fundamental change to the market for forward-settling mortgage-backed securities by requiring trades to be subject to close-out netting and bilateral collateralization through the execution of market standard documentation. Credit risk will be mitigated and leverage will be reduced as collateral is required to secure the performance of these trades.

It is also important to point out that reforms implemented by each of the SEC and CFTC have further enhanced the reporting regimes to which asset managers are subject. While the Report suggests gaps in available information, it ignores SEC requirements for both SEC-registered investment advisers and advisers to private funds to report on a long list of business activities and investment profiles. The Report also ignored the changes to CFTC rules applicable to commodity pool operators ("CPOs") and commodity trading advisers ("CTAs") that require operators of both SEC-registered and private funds to also register with the CFTC if they advise funds that trade in more than a *de minimis* amount of commodity interests. These changes mean that in addition to the reporting already required by the SEC, the CFTC will receive detailed schedules of investments and other information.

We believe that any firm's use of leverage on behalf of its funds,[20] coupled with its interconnectedness with other systemically important companies resulting from its leverage, should concern the systemic risk regulators, if such leverage is not offset by the segregation of liquid assets to cover future or contingent payments. However, any asset manager that, on behalf of its funds, segregates liquid assets to cover future or contingent payments is not likely to present systemic risk.[21] To the extent

[15] *See* Sections 728, 763(i) and 766 of the Dodd-Frank Act.
[16] *See* Sections 731 and 764(a) of the Dodd-Frank Act.
[17] *See* Sections 723 and 763(a) and (c) of the Dodd-Frank Act.
[18] *See* Sections 731 and 764(a) of the Dodd-Frank Act.
[19] TPMG, "TPMG Announces Market Practice Recommendations to Support More Timely Trade Confirmation in the Tri-Party Repo Market" (May 23, 2013).
[20] By "leverage" we mean (a) borrowing money to gain a return greater than the borrowing costs or (b) initiating or holding financial positions with little or no capital to gain exposure to potentially large risks and rewards.
[21] Virtually all of the funds advised by Vanguard are long-only unleveraged mutual funds.

that any one fund is connected with other important financial companies through its use of leverage, the risk posed by such a fund to the financial markets is mitigated by the fact that it has earmarked assets to satisfy any future payments, and the value of those assets is marked to market on a daily basis.

D. Asset Managers as a Source of Risk

The Report asserts that the "failure of a large asset management firm could be a source of risk, depending on its size, complexity, and the interaction among its various investment management strategies and activities."[22] The Report notes that asset managers sometimes act in dual roles, acting as agents to perform portfolio management duties, and other times serving as principals when investing their own funds.[23] The Report then concludes, "[c]oncentration of risks among funds or activities within a firm may pose a threat to financial stability. Instability at a single asset manager could increase risks across the funds that it manages or across markets through its combined activities."[24] This conclusion is overly broad. Concentration of risks among mutual funds does not pose a risk to the asset manager itself because the manager serves in an agency capacity when managing such funds. Even where an asset manager serves in a principal capacity, for example, by managing a proprietary account, the losses that the asset manager may suffer would not increase risk across the other mutual funds it advises. As noted in Part II of this letter, the ICA and IAA provide protections against this contagion risk. For example, one fund's assets are prohibited from being commingled with another fund's assets. Fund assets and liabilities are also prohibited from being commingled with the assets and liabilities of the asset manager. While contagion risk can be common among firms acting in a principal capacity, contagion risk is not prevalent among asset managers who serve as agents.

Our experience managing mutual fund assets indicates that when investors flee asset managers for fear of a firm failure, investors take their assets and seek a similar mandate with another asset manager. Fears about an asset manager's solvency do not prompt market activity that produces systemic risk. The Report correctly notes that material distress of an asset manager could increase the likelihood of redemptions from the funds it advises. This happened, in fact, when certain asset managers were under scrutiny for accommodating market timing activity. Those advisers who permitted their mutual funds to be used by market timers did experience widespread redemptions across many of their mutual funds. We note, however, that the redemption activity did not generate systemic risk. The Report, however, infers that mutual fund redemptions prompted by concerns about the asset manager have produced systemic risk. The Report references the increased redemption activity experienced by the asset management divisions of Bear Stearns, Wachovia, and Lehman as evidence that the mutual fund redemption activity contributed to the demise of the firms, and somehow contributed to broader market dislocations. This is simply not true. At the time that Bear Stearns, Wachovia, and Lehman were under duress during the financial crisis of 2008, the markets were already dysfunctional due to fears about subprime exposures. The Report offers no evidence that the mutual fund redemption activity resulted in the failure of each firm, or that there was a net loss of investments in equity and bond funds, generally.[25]

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[22] *See* Report at 18.
[23] *Id.*
[24] *Id.*
[25] We note that mutual funds hold a relatively modest share of the overall equity and fixed income markets. For example, based on estimates from 2012 year-end figures, U.S. mutual funds hold approximately 28% of all U.S. corporate equity, 28% of all U.S. municipal securities and 12% of all U.S. government securities. Given the number

The Report correctly notes that firms with extensive repo and securities lending businesses could have an elevated risk of experiencing a firm failure that also produces broader financial market dislocations. The Report, however, fails to note that, through the efforts currently underway to reform the repo market, coupled with prudent risk management and collateral reinvestment practices, the concerns of the systemic risk regulators would be addressed. The Report's failure to provide a balanced view of this issue produces a misleading impression that any firm with a repo or securities lending business could be vulnerable to failure, and such failure would inevitably lead to systemic disruptions. We believe it is imperative that the systemic risk regulators have a fully informed record on this matter.

II. Existing Risk-Mitigating Statutes, Rules and Regulations

As stated in a previous comment letter that Vanguard has submitted to FSOC,[26] we believe the ICA and IAA provide key protections to mitigate the risks that any asset manager can generate.[27] Specifically, we believe mutual fund advisers do not present systemic risk for the following reasons:

- Fund advisers do not own fund assets;
- Fund assets are owned, *pro rata*, by the fund's shareholders;
- The assets of one fund are prohibited from being intermingled with the assets of another fund;
- Each fund is its own legal entity, separate and distinct from its adviser and all other mutual funds;
- Each fund has its own board of trustees, which has a fiduciary duty to act in the best interests of fund shareholders;
- Fund assets and liabilities are recorded on the fund's balance sheet, not the adviser's balance sheet, using GAAP accounting methodologies;
- Fund advisers perform daily valuation of fund assets, on a marked-to-market basis, making it difficult to mask risk;
- Fund assets are subject to strict custody requirements;
- Fund assets cannot be used to satisfy the obligations of the adviser or other funds managed by the adviser;
- Fund advisers manage assets as fiduciaries;
- Investment activity of mutual fund advisers is limited by each fund's distinct objective and strategy, and the risks of each fund are disclosed to investors;
- Mutual fund advisers do not put taxpayer dollars at risk, as the advisers are not entitled to any government insurance or guaranty;
- Fund advisers have limits on fund holdings of illiquid securities;
- Fund advisers provide regular transparency into fund holdings; and
- Fund advisers have conservative limits on the amount of leverage they may create in a fund.

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of mutual funds and mutual fund advisers, it is not plausible that systemic risk would be generated by the redemption activity occurring in the funds of any single asset manager.

[26] *See* Vanguard Comment Letter to FSOC, dated November 5, 2010 (enumerating the protections under the ICA and IAA that mitigate any one adviser's ability to cause systemic risk).

[27] We note that in addition to the ICA and IAA, asset managers and asset management activities are also regulated by the Securities Act of 1933 and the SEC's regulations thereunder; ERISA and the Department of Labor's regulations thereunder; and the Internal Revenue Code and IRS regulations thereunder. We note that the Report did not explore the impact that any of these laws and regulations have on asset managers and asset management activity.

We note that the Report does not enumerate these protections, nor does the Report discuss the effectiveness of these measures. We believe this is a significant gap in the Report's analysis of asset managers and asset management activities. Importantly, financial companies that trade as principals do not share these characteristics, and historically have had incentives to assume risks—typically involving some combination of leverage, complexity, interconnectedness, and lack of transparency—for short-term rewards. The same opportunities are simply not available to asset managers who manage mutual funds as agents.

III. Conclusion

Based upon its content, the Report cannot provide a foundation for specific action with respect to asset managers. The Report is incomplete[28] and inaccurate in several respects and omits relevant information about key statutes, rules and regulations that address or mitigate several of the concerns articulated therein. It would be highly beneficial for the SEC to compile the comments it receives and produce a summary of the input provided by industry experts. At a minimum, the Report together with the SEC's compilation will provide the members of FSOC with a more accurate and complete assessment of the asset management industry. If upon further research and analysis FSOC determines there are gaps or weaknesses in asset management regulations, FSOC should not seek to address such measures through a SIFI designation of one or more firms.[29] Instead, we believe the appropriate regulatory response would be for FSOC to refer its recommendations to the SEC, with an appropriate opportunity for notice and comment.

In closing, we believe the Report fails to present a true picture of the asset management industry, the level of data currently available to regulators and the actual risk generated by both the industry and financial markets. As the details of the Report receive further consideration, we urge regulators to keep in mind the Report's deficiencies and the degree of risk mischaracterization caused thereby. We believe the wholesale revolution in market regulation and participant oversight presents a future with significantly less systemic risk for the financial markets globally.

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[28] We note that the Report highlights several gaps in data. *See* Report at 24-26.
[29] We caution systemic risk regulators from adopting any regulatory approach that could convert an agency-based management model into a structure that requires capital. We believe such actions would have a significant impact on the financial markets, and would not necessarily serve the best interest of investors.

We thank the Commission for providing us with the opportunity to share our thoughts on the Report. If you have any questions about Vanguard's comments or would like any additional information, please contact Laura Merianos, Principal, at (610) 669-2627.

Sincerely,

/s/ Tim Buckley

Managing Director
and Chief Investment Officer
Vanguard

/s/ John Hollyer

Principal
and Head of Risk Management Group
Vanguard

cc: *Securities and Exchange Commission:*
The Honorable Mary Jo White, Chair
The Honorable Luis A. Aguilar, Commissioner
The Honorable Daniel M. Gallagher, Commissioner
The Honorable Kara M. Stein, Commissioner
The Honorable Michael S. Piwowar, Commissioner
Norm Champ, Director, Division of Investment Management

Financial Stability Oversight Council:
Chairman Jacob J. Lew, Secretary of the Treasury
Ben S. Bernanke, Chairman of the Board of Governors of the Federal Reserve System
Richard Cordray, Director of the Consumer Financial Protection Bureau
Thomas J. Curry, Comptroller of the Currency
Edward DeMarco, Acting Director of the Federal Housing Finance Agency
Gary Gensler, Chairman of the Commodity Futures Trading Commission
Martin J. Gruenberg, Chairman of the Federal Deposit Insurance Corporation
Debbie Matz, Chairman of the National Credit Union Administration
S. Roy Woodall, Jr., Independent Insurance Expert

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August 18, 2011

Richard Berner
Counselor to the Secretary
Office of Financial Research
United States Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Dear Mr. Berner,

Thank you for testifying before the House Financial Services Oversight and Investigations sub-committee in July. As a proud conferee of the Dodd-Frank Act, I am extremely interested in the progress related to the implementation of the Act. In this regard, I would like to follow-up on a few issues that emerged from the hearing.

First, with respect to staffing, I understand OFR has hired 24 employees at this point and it appears that efforts to "ramp up" staffing are slow. I know you are doing everything you can to attract qualified staff for the OFR and I hope that process will continue.

Second, as you know, Dodd-Frank contains extensive language to eliminate conflicts of interest and ensure that the OFR maintain a credible arms length distance from the Financial Services community as it collects, analyzes data and determines systemic risk in the U.S. and world financial markets. To that end, I would like to know what steps are being taken by the OFR to comply with the spirit and intent of the legislation to eliminate potential conflicts and to maintain complete independence as you create the structures necessary to advise FSOC with a relevant and real time picture of financial markets.

Third, I would like to request a progress report for implementation and a projected timeline for developing the data collection and analysis process. Specifically, I am interested whether the job of creating a centralized warehouse of transactional data that can be accessed by all of the members of the FSOC is receiving the same priority as the Legal Entity Identifier (LEI) standardization process. It is my strong belief that development of the data collection process can and should begin immediately while existing methods can be used to achieve the LEI standardization process.

I would like to set up a meeting with you and your senior staff to discuss these issues when Congress resumes in September. I appreciate your attention to this matter and to ensuring that the Office of Financial Research is up and running as Dodd-Frank intended.

Sincerely,

Carolyn B. Maloney

CAROLYN B. MALONEY
Member of Congress

Congress of the United States
Washington, DC 20515

August 23, 2013

The Honorable Gene Dodaro
Comptroller General
U.S. Government Accountability Office
441 G Street NW
Washington, DC 20548

Dear Comptroller Dodaro:

We write today concerning the data collection practices of the federal financial regulators, including the Consumer Financial Protection Bureau (CFPB), the Federal Reserve (Fed), the Federal Deposit Insurance Corporation (FDIC), and the Office of the Comptroller of the Currency (OCC).

These agencies, in their capacity as independent regulators, are authorized to gather information which may include Personally Identifiable Information (PII) in the course of their supervisory activities. In addition to the data that these agencies request directly from supervised institutions, they may also subscribe to data aggregation services.

While we understand that data collection is part of each agency's mission of promoting financial stability and enforcing regulation, it is important that those goals are balanced against the agencies' obligations to minimize the burden of data collection requests on supervised institutions and to closely guard the privacy of PII.

We are therefore requesting that the Government Accountability Office (GAO) review the policies and procedures in place at the Fed, CFPB, FDIC, and OCC to protect the confidentiality and privacy of PII, including information technology standards, policies with regard to staff access and third parties to information, and data sharing agreements with other covered entities.

We also request that the GAO study the potential for overlapping or duplicative data requests that the financial regulators make of regulated financial institutions, as well as the data sharing practices among the agencies. We request that GAO provide recommendations for areas of improvement for information sharing between agencies. Finally, we request that the GAO review how the agencies use the data that they collect from financial institutions, as well as the data that they obtain from third party vendors.

We appreciate your attention to this request. Please contact Aaron Sporck (Capito) at (202) 225-7502 or Ben Harney (Maloney) at (202) 225-7944 if you have further questions.

Sincerely,

Shelley Moore Capito

Shelley Moore Capito, M.C.
Chairman
Subcommittee on Financial Institutions and Consumer Credit

Carolyn B. Maloney, M.C.
Ranking Member
Subcommittee on Capital Markets and Government Sponsored Enterprises

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