STATEMENT OF

PAUL SCHOTT STEVENS
PRESIDENT & CEO
INVESTMENT COMPANY INSTITUTE

BEFORE THE

U.S. SENATE
COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS

ON

FSOC ACCOUNTABILITY: NONBANK DESIGNATIONS

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EXECUTIVE SUMMARY

- Designation of systemically important nonbank financial companies is only one of several regulatory tools given the FSOC by the Dodd-Frank Act. Designation of a nonbank financial company as systemically important is intended to and should be used only as a last resort, when the FSOC has found, after thorough analysis based on all the criteria specified in the Act, that a firm poses significant, articulable risks to the stability of the financial system that cannot be remedied through other means.

- ICI supports U.S. and global efforts to address abuses and excessive risk in the financial system, but we are concerned that the FSOC is seeking to exercise its designation authority quite broadly and to the exclusion of other mandates. The opacity of the designation process only exacerbates this problem.

- The FSOC's recent informal changes to its designation process are welcome but fall well short. These changes should be codified in statute to provide greater certainty and predictability to the process. In addition, Congress must act to require the FSOC to give both primary regulators and companies under consideration for designation an opportunity to address identified systemic risks prior to designation. Such steps would support the FSOC's mission both by reducing risks in the financial system and by reserving SIFI designations and the exceptional remedies that flow therefrom only to those circumstances in which they are clearly necessary.

- In none of its nonbank designations thus far has the FSOC chosen to explain the basis for its decision with any particularity. Instead, it appears to have relied on a single metric (a firm's size) to the exclusion of the other factors cited in the Dodd-Frank Act. It also has theorized about risks instead of conducting the kind of thorough, objective, empirical analysis that should underlie its decisions. The FSOC should be explicit about the systemic risks it identifies arising from a firm's structure or activities, and the results of any analysis that might lead to designation should be made public. This would be beneficial on all sides – it would help market regulators and firms address such risks, and it would promote public understanding of and confidence in what the FSOC regards to be systemically risky and why.

- We support the FSOC's review of the asset management sector as the Council fulfills its mandate under the Dodd-Frank Act. We are hopeful it will conclude, as we believe it must, that SIFI designation is unnecessary and inappropriate in the case of funds and their managers. The history of the recent financial crisis demonstrates that, compared to other parts of the financial system, U.S. stock and bond funds exhibited extraordinary stability. Unlike banks, fund managers act solely as agents. This means that fund investors – not fund managers – bear

the risks and rewards of the fund. Funds use little or no leverage. Their structure, the way they are regulated and managed, and their overwhelmingly retail investor base – these and other factors all help explain why, in the 75-year history of the modern fund business, stock and bond funds have never posed risks to the financial system at large.

- We also support the role of the SEC as the regulatory body best equipped to address any concerns about financial stability with respect to funds and fund managers. While we believe there is no basis for designating them, recent proposals out of the FSB point to the prospect that the FSOC may soon consider designation for many large U.S. funds and their managers. If any of these entities was designated, the consequences would be highly adverse to investors and the capital markets. Application of the bank regulatory remedies set forth in the Dodd-Frank Act to designated stock and bond funds or their managers would raise costs on and jeopardize the interests of fund shareholders, greatly distort the fund marketplace, introduce a highly conflicted model of regulation, and compromise the important role that funds play as a source of financing in the economy.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute ("ICI" or "Institute"), and I am pleased to appear before the Committee today to discuss the transparency and accountability of the Financial Stability Oversight Council ("FSOC" or "Council") and particularly its processes for designating nonbank financial companies as systemically important financial institutions ("SIFIs").

ICI is the national association of U.S. registered investment companies, including U.S. mutual funds, closed-end funds, exchange-traded funds ("ETFs") and unit investment trusts. ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interests of funds, their investors, directors and managers. ICI members today manage approximately $17.5 trillion in assets and serve more than 90 million investors. These investors rely on stock and bond funds to help achieve their most important financial goals, such as saving for college, purchasing a home or providing for a secure retirement.

The Institute traces its origin back to 1940 and passage of the landmark Investment Company Act and Investment Advisers Act, statutes that the Securities and Exchange Commission ("SEC") has administered to great effect and that have provided a comprehensive framework of regulation for our industry. ICI members are both investors in the capital markets and issuers of securities. We understand the important role of appropriate regulation in protecting our investors, promoting confidence in our markets, and ensuring the resiliency and vibrancy of the financial system overall. For these reasons, ICI has been an active supporter of U.S. and global efforts to address issues highlighted by the global financial crisis. We also have been a strong proponent of improving the U.S. government's capability to monitor and mitigate risks across our nation's financial markets.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (the "Dodd-Frank Act"), by design, provides an array of tools, in addition to SIFI designation authority, to the FSOC and other regulators. For example, the FSOC has a risk monitoring role and has the authority to identify gaps in regulation and make recommendations to financial regulators.[1] The broad scope of these other authorities should allow the FSOC to reserve SIFI designation for those circumstances – thought to be quite rare when the Dodd-Frank Act was enacted[2] – in which

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[1] 12 U.S.C. § 5322(a)(2).

[2] *See* Testimony of Chairman Ben S. Bernanke, before the Committee on Financial Services, U.S. House of Representatives, July 24, 2009, *available at* http://www.federalreserve.gov/newsevents/testimony/bernanke20090724a.htm (stating that the "initial number of newly regulated firms [SIFIs] would probably be relatively limited").

the risks to the financial system as a whole are both large and quite plain, and nothing less than designation will suffice to address them.

The record of the Council's activities to date, however, suggests that the FSOC may be ignoring this statutory construct and, instead, seeking to exercise its designation authority quite broadly. The highly opaque process of the FSOC leading to designation has only exacerbated the problem, raising serious concerns about whether its determinations have adequate factual bases, take public comment into sufficient account, and can be subject to appropriate oversight. Without engaging more meaningfully with the public and with entities under review, the FSOC has appeared to be in headlong pursuit of designations based on foreordained conclusions rather than on rigorous and objective empirical analysis.

To truly advance financial stability, the FSOC's process must be open to the public, analytically based and grounded in the historical record. The history of the recent crisis demonstrates that America's stock and bond funds exhibited extraordinary stability. In particular, it is important for the FSOC to consider carefully how different stock and bond funds and their managers are from banks. Unlike banks, fund managers act solely as agents, which means fund investors – not fund managers – bear the risk of any loss, or the benefit of any gain, in a portfolio. Moreover, registered funds use little to no leverage. The structure of these funds, the ways in which they are comprehensively regulated and managed, and their overwhelmingly retail investor base – these and other factors all help explain why, in the 75-year history of the modern fund industry, stock and bond funds have never experienced a "run" of the sort to which banks are subject.

As discussed below, we hope the FSOC's recently announced changes to its SIFI designation process will increase communications and interaction with firms that are under review. More, however, needs to be done. These recent procedural changes were instituted informally and should be codified in statute. In addition, Congress should amend the Dodd-Frank Act to ensure that an institution targeted for designation and that institution's primary regulator have the opportunity to address and mitigate any "systemic risks" the institution may pose *prior* to final SIFI designation. Bipartisan legislation introduced in the 113th Congress by Reps. Dennis Ross (R-FL) and John Delaney (D-MD), and four cosponsors, the "FSOC Improvement Act of 2014," would codify these and other good government reforms to the SIFI designation process. Ultimately, this reasonable, bipartisan approach would enhance the ability of the FSOC to ameliorate systemic risk.

In addition, we believe it is imperative for Congress to revisit the remedies that follow upon SIFI designation in the asset management sector, and certainly so in the case of registered funds or their managers. The remedies currently provided for in the Dodd-Frank Act – i.e., imposition of bank-style capital requirements and prudential supervision by the Federal Reserve

– not only are unnecessary but are altogether inappropriate in the case of registered funds and their managers. They would inflict substantial harm on fund investors and retirement savers, distort the fund marketplace, and impede the important role that funds play as a vital source of funding in our capital markets. As noted, we do not believe that funds or fund managers merit SIFI designation. But, if a fund or fund manager were deemed to be systemically important, Congress should look to the SEC, and not the Federal Reserve, to conduct appropriately enhanced oversight of its activities.

In Section II below, we outline our concerns about the FSOC's SIFI designation process, explain the limitations of the recent changes to the process that have been adopted by the FSOC, and discuss why further action is necessary. In Section III, we explain why the lack of specifics in the FSOC's designations undermines the utility and fairness of the process. In Section IV, we set forth the basis for our concerns that the FSOC determinations be grounded in empirical data and historical experience, rather than the theory and conjecture as seems to be the Council's approach to stock and bond funds and their managers. In Section V, we discuss the ongoing FSOC process with regard to asset managers. Finally, in Section VI, we conclude with an explanation of the many worrisome consequences of inappropriately designating funds and asset managers, which would harm investors and financial markets.

II. THE FSOC'S SIFI DESIGNATION PROCESS SHOULD BE MORE TRANSPARENT AND ACCOUNTABLE

The FSOC's SIFI designation process has been the subject of widespread criticism. Members of Congress from both parties have submitted numerous letters and statements expressing their own concerns. In 2014, for example, a bipartisan group of five Senators stated that one of the greatest problems with the SIFI designation process "is a lack of transparency and accountability."[3] The Government Accountability Office ("GAO") likewise has urged the

[3] *See* Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mark Kirk (R-IL), Sen. Thomas Carper (D-DE), Sen. Patrick Toomey (R-PA), Sen. Claire McCaskill (D-MO), Sen. Jerry Moran (R-KS), dated Jan. 23, 2014 (stating that "we strongly urge the FSOC and other governing bodies not to base any policy or regulation actions grounded on the information in the OFR study . . . . The OFR study mischaracterizes the asset management industry and the risks asset managers pose, makes speculative assertions with little or no empirical evidence, and, in some places, predicates claims on misused or faulty information"). Senator Mark Warner has also noted that SIFI designation analysis "should follow a rigorous and transparent process, using reliable data, so that regulators and the marketplace can be armed with the best information possible." Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mark Warner (D-VA), dated May 9, 2014. House Financial Services Chairman Jeb Hensarling also noted that, with the exception of the national security agencies dealing in classified information, the "FSOC may very well be the nation's least transparent federal entity." Statement of Chairman Jeb Hensarling before House Financial Services Committee, Hearing on "The Annual Report of the Financial Stability Oversight Council" (June 24, 2014). *See also* Letter to The

FSOC to make changes to its process, including "improv[ing] communications with the public."[4] Last year, several trade associations formally petitioned the FSOC to make changes to the SIFI designation process, including allowing entities undergoing review to receive more information and interact more extensively with the Council and its staff.[5]

In response to these repeated calls for change, the FSOC in November 2014 convened meetings with interested parties to discuss potential procedural reforms and thereafter, in February 2015, issued "supplemental procedures" to revise its SIFI designation process. The changes include, among other things, earlier notice to and opportunity to submit information by companies and their primary regulators under Stage 2 active review; meetings with the FSOC's Deputies Committee to allow companies in Stage 3 to present relevant information or arguments; a commitment to grant requests for oral hearings from companies in Stage 3; notices explaining a decision not to rescind a designation; and oral hearings for designated companies once every five years.[6]

Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Rep. Carolyn B. Maloney (D-NY), Ranking Member, Subcommittee on Capital Markets and Government Sponsored Enterprises, dated July 29, 2014. In a letter to federal regulators, Chairman Hensarling and others also commented that the "lack of transparency and due process injects needless uncertainty and instability into our financial markets." Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC; The Honorable Janet Yellen, Chair, The Federal Reserve System; and The Honorable Mary Jo White, Chair, SEC, from Rep. Jeb Hensarling (R-TX), Chairman, House Financial Services Committee, and the respective Subcommittee Chairmen, dated May 9, 2014.

[4] *See* GAO, *New Council and Research Office Should Strengthen the Accountability and Transparency of their Decisions* (Sept. 2012), *available at* http://www.gao.gov/assets/650/648064.pdf; GAO, *Continued Actions Needed to Strengthen New Council and Research Office* (Mar. 14, 2013), *available at* http://www.gao.gov/products/GAO-13-467T; GAO, *Further Actions Could Improve the Nonbank Designation Process* (Nov. 2014), *available at* http://www.gao.gov/assets/670/667096.pdf.

[5] The American Council of Life Insurers, the American Financial Services Association, the Association of Institutional Investors, the Financial Services Roundtable and the Asset Management Group of the Securities Industry and Financial Markets Association, *Petition for FSOC Rulemaking Regarding the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, (Aug. 19, 2014), *available at* http://fsroundtable.org/rulemaking-petition-fsoc/.

[6] FSOC, *Supplemental Procedures Relating to Nonbank Financial Company Determinations* (Feb. 4, 2015), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf.

ICI welcomes these changes, which were overdue, as an initial positive step towards providing greater fairness and clarity in the designation process. Nonetheless, more needs to be done to improve the FSOC's designation process. As it stands, the FSOC retains the absolute discretion to eliminate or change the new "supplemental procedures" at any time and without prior notice. Instead, the recent changes should be codified in law. This would provide a highly desirable predictability and certainty about FSOC's designation process.

In addition, we believe Congress must act to reform the FSOC's designation process[7] in ways that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases:

- First, the FSOC should allow a targeted firm's primary financial regulator an opportunity, prior to designation, to address any systemic risks identified by the FSOC. A company's primary regulator generally will have greater expertise and regulatory flexibility than the FSOC to address identified risks. By way of example, the SEC already has the necessary authority – and is taking steps – to strengthen oversight of asset managers and funds, including by expanding oversight of risk management in key areas and enhancing its collection of mutual fund data.[8]

- Second, an entity being reviewed for SIFI designation should have an opportunity to make changes to its structure or business practices to address identified systemic risks prior to designation. Allowing a firm the opportunity to change its business model or practices often may be the most effective way to address the identified risks.

These reforms would further the objectives of promoting market discipline and reducing systemic risk, all while reserving designation for the exceptional circumstances for which it was intended. It also would avoid undue imposition of the remedies outlined in the Dodd-Frank Act on nonbank institutions for which they are clearly inappropriate. As specified in the Act, those remedies include the following: a risk based capital requirement potentially as high as

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[7] As noted, bipartisan legislation introduced in the 113th Congress by Reps. Dennis Ross (R-FL) and John Delaney (D-MD), and four cosponsors, H.R. 5180, the FSOC Improvement Act, would codify these and other good government reforms to the SIFI designation process. Additional provisions in the bill include important annual and five-year reviews of prior SIFI designations in order to provide important information to firms and to the public about as to how previously designated SIFIs can take measures to ameliorate risks.

[8] *Remarks at the New York Times DealBook Opportunities for Tomorrow Conference*, Mary Jo White, Chair, SEC (Dec. 11, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VJMKZl4AKB .

eight percent;[9] "enhanced prudential supervision" by the Federal Reserve;[10] and susceptibility to paying into a resolution fund in the event of the failure of a bank SIFI.[11] We discuss the consequences of these statutory remedies for funds and their managers in Section VI below.

III. THE ABSENCE OF PARTICULARITY IN SIFI DETERMINATIONS IMPEDES INTERESTED PARTIES FROM UNDERSTANDING AND BENEFITTING FROM THE FSOC'S ANALYSES

Providing a company and its primary financial regulator an opportunity to mitigate identified systemic risks prior to designation would have the added benefit of requiring the FSOC to explain the bases for its designation decisions with some particularity. As discussed below, this is not something the FSOC has done in *any* of its nonbank SIFI designations thus far. Requiring an appropriate degree of specificity would enable the firm under consideration, the firm's principal regulator, other market participants, Congress and the public at large to understand the specific reasons for the FSOC's actions, thus enhancing both the transparency and accountability of the Council and its actions.

The Dodd-Frank Act permits the FSOC to designate a nonbank financial institution as "systemically important" in one of two situations. The FSOC may designate a firm if either (1) the company's material financial distress (the "First Determination Standard") or (2) the nature, scope, size, scale, concentration, interconnectedness or mix of the company's activities (the "Second Determination Standard"), could pose a threat to the financial stability of the United States.[12] To date, the FSOC has predicated *all* of its nonbank SIFI determinations on the basis of the First Determination Standard and has not addressed whether the *activities* of the company could pose a threat to the financial stability of the United States. In its 2014

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[9] 12 U.S.C. § 5371. An unresolved inconsistency between two provisions in the Dodd-Frank Act calls into serious question just how much flexibility the Federal Reserve would have to limit the application of capital requirements to any U.S. mutual fund designated as a SIFI or G-SIFI. Although one provision of the Dodd-Frank Act gives the Federal Reserve discretion in applying capital standards to nonbank SIFIs (Section 165(b)(1)(A)(i) of the Dodd-Frank Act (providing the Federal Reserve authority to determine that capital standards are inappropriate for a particular SIFI and to substitute "other similarly stringent risk controls.")), another provision — known as the "Collins Amendment"—may not (see Section 171 of the Dodd-Frank Act, which requires the imposition of minimum leverage capital and risk-based capital standards on any SIFI.).

[10] 12 U.S.C. § 5365.

[11] 12 U.S.C. § 5390(o)(1)(D)(ii)(I).

[12] 12 U.S.C. § 5323(a)(1).

report on improving the FSOC designation process, the GAO noted the FSOC's exclusive reliance on the First Determination Standard, and expressed concern that the approach was flawed and would lead the FSOC to ignore certain risks.[13]

In effect, the approach taken by the FSOC has led to designations that appear to be based on a firm's size, rather than on the basis of the more complete and detailed analysis of a firm's activities and the risks they present, as the Dodd-Frank Act envisioned.[14] The FSOC's state insurance commissioner representative stated, in response to the MetLife, Inc. ("MetLife") designation, that "the [FSOC] has failed to address the criticism that it did not conduct a robust analysis of characteristics of MetLife beyond its size," and that without more specific details on the bases for determination, "any large company could meet the statutory standard applied by the [FSOC]."[15] In fact, Congress expressly required in the Dodd-Frank Act that the FSOC consider at least ten statutory factors, only two of which directly relate to an institution's size.[16] By avoiding any discussion of the particular aspects or activities of an institution that are thought to pose systemic risks, the FSOC not only forecloses the prospect of any meaningful, reasoned justification for its decisions, but also frustrates congressional intent.

In addition, and equally troubling, the FSOC's exclusive reliance on the First Determination Standard does nothing to inform a designated nonbank firm, other market participants, Congress or the general public about the primary drivers (if any, other than size) of the Council's designation decision. It therefore offers the firm *no* insight into how it might "de-risk" and thereby no longer merit SIFI designation or require application of the exceptional remedies specified in the Dodd-Frank Act. This is an odd result indeed if the object of the

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13 *See* GAO, *Further Actions Could Improve the Nonbank Designation Process* (Nov. 2014), *available at* http://www.gao.gov/assets/670/667096.pdf.

14 The Financial Stability Board ("FSB") has proposed to take a similarly flawed approach, focusing in its second consultation on the size of firms to the exclusion of other factors. *See* FSB, *Second Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions* (Mar. 4, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

15 Adam Hamm, *View of the State Insurance Commissioner Representative* (Dec. 2014), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.

16 *See* 12 U.S.C. § 5323(a)(2). The two considerations are 12 U.S.C. §§ 5323(a)(2)(I) and (J), which require the FSOC to consider "the amount and nature of the financial assets of the company" and "the amount and types of the liabilities of the company, including the degree of reliance on short-term funding," respectively.

exercise is to eliminate or minimize what are thought to be out-sized risks to the financial system at large.

The GAO's 2014 study makes a similar point. The GAO found that even nonpublic documentation of Stage 3 evaluations – the final stage of the FSOC's multi-staged analytic process – did not include sufficient detail on the bases for the FSOC's determinations.[17] In dissenting from MetLife's SIFI designation, S. Roy Woodall, the presidentially appointed independent member of the FSOC with insurance expertise, noted that basing determinations solely on the First Designation Standard "does little else to promote real financial system reform" because it does not provide "constructive guidance for the primary financial regulatory authorities, the [Federal Reserve] Board of Governors, international supervisors, other insurance market participants and, of course, MetLife itself, to address any [systemic] threats posed by the company."[18]

The FSOC should be explicit about the systemic risks it identifies arising from a firm's structure or activities. It should provide enough detail to enable both a company and its primary regulator to respond substantively with proposals to mitigate the risk. This is beneficial on all sides – systemic risk would be curbed, the public and market might gain insight on what activities or structures the FSOC considers to be systemically risky and why, and the firm could avoid unnecessary and potentially inappropriate regulation and supervision.

IV. THE FSOC'S APPROACH TO DESIGNATION IS PREDICATED ON CONJECTURE, AS OPPOSED TO EMPIRICAL DATA

If the FSOC were required to provide greater specificity about the bases for its designation decisions, as the Dodd-Frank Act anticipates, it would be more likely to engage in the kind of robust, empirically based, data-driven, "bottom up" analysis that one would reasonably expect in connection with such a significant regulatory determination. Such an approach would take fully into account all of the factors that Congress enumerated in Section 113 of the Dodd-Frank Act, including the degree to which a firm already is regulated and the prospects of using that pre-existing regulatory structure to address perceived risks. It would help ensure that designations are not made on the basis of pre-judgment or conjecture or on "implausible,

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17 *See* GAO, *Further Actions Could Improve the Nonbank Designation Process*, at 35 (Nov. 2014), *available at* http://www.gao.gov/assets/670/667096.pdf (stating that the FSOC's nonpublic documentation "could have benefitted from inclusion of additional detail about some aspects of its designation decisions").

18 S. Roy Woodall, *Views of the Council's Independent Member Having Insurance Expertise* (Dec. 2014), *available at* http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf .

contrived scenarios"; it also would make the FSOC far less susceptible to criticism, from within its own ranks, for "failures to appreciate fundamental aspects" of a potential designee's business, products and services.[19] Remarkably, in dissenting to Prudential Financial, Inc.'s ("Prudential") designation as a SIFI, Mr. Woodall observed the following:

> Key aspects of [the FSOC's] analysis are not supported by the record or actual experience; and, therefore, are not persuasive. The underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the insurance regulatory environment, and the state insurance company resolution and guaranty fund systems . . . . [T]he grounds for the Final Determination are simply not reasonable or defensible, and provide no basis for me to concur.[20]

The state insurance representative on the FSOC, John Huff, agreed; he found the FSOC's analysis of Prudential to be "flawed, insufficient, and unsupportable."[21]

Moreover, this highly theoretical approach is not unique to the FSOC. The Financial Stability Board ("FSB") recently issued a second consultation on evaluation criteria for nonbank, non-insurer global SIFIs ("NBNI G-SIFIs").[22] In this second consultation, the FSB frankly states that "the NBNI G-SIFI assessment methodologies aim to measure the impact that an NBNI financial entity's failure can have on the global financial system and the wider economy, rather than the *probability* that a failure could occur."[23] Apparently, if bank regulators meeting in Switzerland can conjure up some "systemic" concern, then their conjecture can serve as a basis for global policymaking – even if it has no historical, factual or even rational predicate. When we have argued for a process informed by facts, we often have been invited to prove a negative – that is, to demonstrate that the hypothetical risks so articulated *cannot* arise.

In sum, the way in which the FSOC has approached the question of nonbank SIFI designation has every feel of a result-oriented exercise as opposed to an objective analysis – where a single

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19 *Id.*

20 S. Roy Woodall, "Views of the Council's Independent Member Having Insurance Expertise" (Sept. 19, 2013), *available at* www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf .

21 John Huff, *View of Director John Huff, the State Insurance Commissioner Representative* (Sep. 2013), *available at* http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf .

22 FSB, *supra* note 14.

23 *Id.* at 10, emphasis in the original.

blunt metric (size) dwarfs the other statutory factors and mere hypotheses are used to compel a seemingly predetermined outcome – i.e., that designation is required.

We believe Congress expected, and it should demand, something more of the FSOC. SIFI designation should be predicated on a thorough, objective analysis of a specific institution, its structure and activities, its historical experience, the ways in which it is regulated currently and other empirical information, including all the factors set out in the Dodd-Frank Act – and the results of this analysis should be made available to the public. Relatedly, if it determines to consider asset managers and their funds for SIFI designation, the FSOC should subject the metrics and thresholds used to evaluate such entities to notice and comment.[24] With such a focus on facts, the FSOC also would do well to consider whether using one of the other tools that the Dodd-Frank Act makes available to it would be more appropriate than SIFI designation. Indeed, requiring a consideration of the costs and benefits of designation would put the FSOC's decision making on par with the Administrative Procedure Act's requirements for significant rulemakings and the Obama Administration's executive orders regarding rulemaking processes.[25]

V. THE FSOC'S REVIEW OF ASSET MANAGEMENT APPEARS SIMILARLY FLAWED

A 2013 report on asset management written by the Office of Financial Research ("OFR"), the research arm of the FSOC, heightened our concerns with the FSOC's SIFI review process and demonstrated the need for increased public input. The report was the subject of withering criticism – for reflecting a deeply inaccurate understanding of the asset management industry, for rendering sweeping conclusions unsupported by data or analysis and for lacking clarity, precision and consistency in its scope, focus and use of data.[26]

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[24] The FSOC has warned that it may use other methods to assess the asset management industry, but, as a bipartisan group of Congressmen has pointed out, "the FSOC should . . . publicly disclose the economic models, data and analysis that support its approach *before* taking any steps to identify particular asset management entities for SIFI designation." Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Reps. Dennis Ross (R-FL) and John Delaney (D-MD) and 39 other members of the House Financial Services Committee (May 9, 2014). Publicizing the metrics will ensure the FSOC is not relying on inaccurate data and false assumptions, such as those in the Office of Financial Research's Asset Management Study.

[25] Exec. Order No. 13,563, 76 Fed. Reg. 3821 (Jan. 21, 2011) (requiring certain agencies to engage in cost-benefit analysis before rulemaking); Exec. Order 13,579, 76 Fed. Reg. 41585 (July 14, 2011) (encouraging independent regulatory agencies to engage in cost-benefit analysis before rulemaking).

[26] *See, e.g.*, Letter to The Honorable J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mark Kirk (R-IL), Sen. Thomas Carper (D-DE), Sen. Patrick Toomey (R-PA), Sen. Claire McCaskill (D-MO), Sen. Jerry Moran (R-KS), dated Jan. 23, 2014 (stating that the report "mischaracterizes

Regrettably, the FSOC appears to be persisting in this pattern of reliance on conjecture and hypothesis in its consideration of liquidity and redemption risks associated with investment vehicles that are offered by asset managers. Its recent Notice Seeking Comment on Asset Management Products and Activities (the "Notice")[27] simply *assumes* a variety of potential threats to the financial system arising from asset management, much as the OFR report did in 2013. For example, the Notice hypothesizes that shared trading costs for stock and bond funds create a unique and powerful incentive for fund investors to redeem *en masse* in the face of a market decline, potentially leading to severe additional downward pressure on markets. The Notice points to no historical experience nor any empirical data to support this hypothesis. In fact, there is none: the hypothesis is based on a series of assumptions that simply do not reflect how stock and bond funds and their managers operate nor how their investors behave, as the Institute discusses in detail in its comment letter to the FSOC to be filed on March 25, 2015. Even if this hypothesis were at all plausible, there is nothing to suggest it would in fact pose a risk to financial stability.

While we are concerned with the highly theoretical nature of some of the questions presented in the Notice, ICI commends the FSOC for seeking public comment on this occasion. We hope and expect that Council members will thoroughly review and give due consideration to all the public comments they receive, including the extensive research and commentary submitted by ICI and its members. A transparent, fact-based and fair FSOC process with respect to funds and their managers – one that takes full account of the structure and characteristics of these entities, the ways in which they operate, the 75-year history of the industry, and the highly effective framework of regulation under which it currently operates – will, we believe, allay any

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the asset management industry and the risks asset managers pose, makes speculative assertions with little or no empirical evidence, and in some places, predicates claims on misused or faulty information"); Letter to The Honorable Jacob J. Lew, Secretary, U.S. Department of the Treasury, Chairman of the FSOC, from Sen. Mike Crapo (R-ID), dated Jan. 27, 2014 (stating that "OFR's failures to take into account the perspectives of and data from market participants will result in flawed evaluation of the asset management industry by FSOC and, worse, a move towards designation of asset management firms as SIFIs without an accurate understanding of the rule they play in the financial system"); Daniel M. Gallagher, Commissioner, SEC, *Public Feedback on OFR Study on Asset Management Issues* (May 14, 2014), *available at* http://www.sec.gov/comments/am-1/am1-52.pdf (citing multiple critics of the asset management report and calling the report "a botched analysis that grossly overstates – indeed, in many cases simply invents without supporting data – the potential risks to the stability of our financial markets posed by asset management firms").

[27] 80 Fed. Reg. 7595 (Feb. 5, 2015), *available at* http://www.gpo.gov/fdsys/pkg/FR-2015-02-11/pdf/2015-02813.pdf .

concerns that funds or their managers pose risks to the financial system meriting SIFI designation.

VI. THE CONSEQUENCES OF INAPPROPRIATE DESIGNATIONS WOULD BE SEVERE

Ensuring that the FSOC meets high standards of transparency and accountability as it exercises its authority under the Dodd-Frank Act is vitally important: its designations carry with them exceptional consequences. In the case of funds and their managers, we submit that there is no basis for designation – and, if they were designated, the consequences would be highly adverse to investors and the capital markets.

As noted above, if a fund or its manager were to be designated a SIFI, the Dodd-Frank Act could require it to meet bank-level capital requirements. The fund or manager would have to cover the costs of its "enhanced prudential supervision" by the Federal Reserve. It would bear a share of the costs of the FSOC and OFR annually. It would even be subject to assessments to cover the cost of bailing out another SIFI if one were to fail, thus exposing fund investors (likely retirement savers) to having to foot the bill.

All of these costs would be unique to the designated fund or manager, and thus uniquely borne by that fund complex. The fund marketplace in the U.S. is highly competitive. There are many substitutable funds and providers from which to choose, and our investors and their financial advisers are properly focused on the impact of fees and expenses on long-term investment results. It is not apparent that a stock and bond fund or manager saddled with the additional costs of being a SIFI can remain fully competitive under these circumstances. Its shareholders may have very strong incentives to invest elsewhere. SIFI designation for some funds or fund managers thus stands to greatly distort the fund marketplace.

Of still more fundamental concern are the implications of "enhanced prudential supervision" of a stock or bond fund or its manager by the Federal Reserve. The bank model of regulation seeks first and foremost to preserve the safety and soundness of banks and the banking system. It contrasts strongly with the model of regulation enshrined in the Investment Company Act and Investment Advisers Act as administered by the SEC. Under that model, the adviser to a fund owes the fund's shareholders an exclusive duty of loyalty and care – and one of the SEC's primary missions is to protect the fund investors' interests.

An overlay of bank regulation thus would introduce a new and troubling dynamic of conflicted regulation. For example, a SIFI-designated stock and bond fund or its manager would be expected to comply with the Federal Reserve's directions about how to manage its investment portfolio, irrespective of the fund adviser's or independent directors' fiduciary duties or the best interests of the fund's shareholders. This is not a theoretical concern. In the aftermath of the

financial crisis, some bank regulators vocally criticized fund managers for acting to protect their investors from financial losses by not maintaining short-term investments with banking institutions that were at risk of failure.[28] The priority of the bank regulators, of course, was not protecting the interests of the fund investors, but propping up failing banks and thereby the banking system.

Just this kind of approach to regulating asset managers is something that Federal Reserve Governor Daniel K. Tarullo explicitly called for in a recent speech – terming it "prudential market regulation," something needed to provide a "system-wide perspective" that would trump traditional investor protections and market regulation and respond to "system-wide demands."[29] Presumably, any fund or manager designated a SIFI henceforward would be put to the service of two masters – the Federal Reserve in the interests of the "system," and secondarily the fund's shareholders.

Moreover, a SIFI regime for funds or their managers likely will result in highly prescriptive regulations and a common set of "approved" investments within portfolio structures – just as the Basel standards pushed banks toward a standard portfolio of "lower-risk" assets, and thus helped usher in the financial crisis of 2008. This is the model that the Federal Reserve would bring to asset management. With it would come decreasing diversification, increasing correlation, great volatility, and more – not less – risk. Such requirements would ultimately compromise and diminish the exceptional role that funds play as a source of financing to the economy.

That the remedies in the Dodd-Frank Act seem altogether inappropriate when applied to stock and bond funds and their managers is perhaps not surprising: during consideration of the Dodd-Frank Act, there was no thought that these remedies would be applied to a part of the financial system that had remained comparatively so resilient even in the midst of the crisis.

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28 *Remarks at the Federal Reserve Bank of New York Workshop on Fire Sales as a Driver of Systemic Risk in Triparty Repo and other Secured Funding Markets*, Jeremy C. Stein, Member, Board of Governors of the Federal Reserve System (Oct. 4, 2013), *available at* http://www.federalreserve.gov/newsevents/speech/stein20131004a.htm ; *Remarks at the Global Research Forum on International Macroeconomics and Finance on Dollar Funding and Global Banks*, Jeremy C. Stein, Member, Board of Governors of the Federal Reserve System (Dec. 17, 2012), *available at* http://www.bis.org/review/r121218c.pdf.

29 *Remarks at the Office of Financial Research and Financial Stability Oversight Council's 4th Annual Conference on Evaluating Macroprudential Tools: Complementarities and Conflicts*, Daniel K. Tarullo, Member of the Federal Reserve System (Jan. 30, 2015), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.pdf.

This underscores the need for Congress to craft, with respect to asset management, a very different set of remedies that would flow from any SIFI designation. If the FSOC does identify systemic risks in the asset management sector, we believe enhanced oversight by the SEC, and *not* by the Federal Reserve, is appropriate.

The figure on page 18 illustrates just how consequential allowing the FSOC and the Federal Reserve to proceed down the current path is likely to be. In connection with its "Workstream on Other Shadow Banking Entities,"[30] led personally by Governor Tarullo, the FSB recently released for public comment proposed thresholds for identifying the pool of asset managers and individual funds that automatically would be evaluated for potential designation as G-SIFIs. The FSB proposes alternative thresholds for funds and for asset managers. The below chart applies the broader FSB threshold for funds – any fund with assets of more than $100 billion in assets. For asset managers the below chart applies the FSB's $1 trillion under management threshold.

The vast majority of the funds and asset managers that automatically would be evaluated under these criteria are U.S. firms. Applying these thresholds to our industry – something that seems to be highly likely if the FSB adopts them[31] – we estimate that *more than half* of the $6.3 trillion in assets in defined contribution plans would fall either directly or indirectly under the "enhanced prudential supervision" and thus the "prudential market regulation" of the Federal Reserve, assuming that the funds and managers meeting the thresholds are designated. More broadly, we estimate that *well over half* – nearly $10 trillion - of the $18 trillion in assets that U.S. households have invested in mutual funds, ETFs or other registered investment companies would fall under such supervision by the Federal Reserve.

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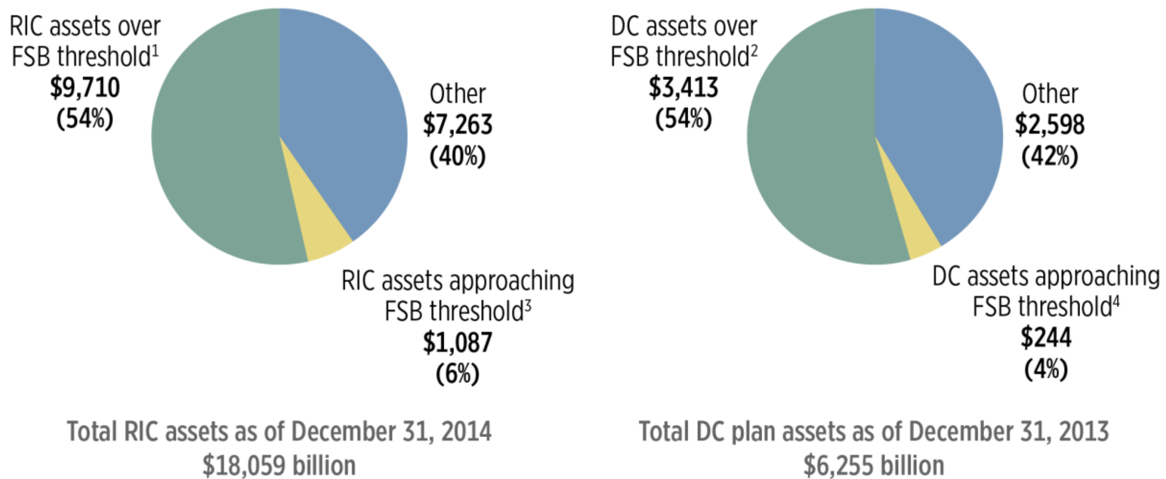
[30] FSB, *supra* note 14.

[31] We note that all insurance companies that have been designated as SIFIs were first designated by the FSB as global systemically important insurers (G-SIIs).

Under FSB Proposal, Federal Reserve Would Be "Prudential Market Regulator" for More Than Half of U.S. Regulated Fund and Defined Contribution (DC) Plan Market

Billions of dollars



[1] Represents registered investment company (RIC) assets managed by asset managers with over $1 trillion in AUM globally or RIC assets managed by asset managers with at least one regulated fund whose net assets exceed $100 billion.

[2] Represents defined contribution (DC) assets managed by asset managers with over $1 trillion in AUM globally or DC assets managed by asset managers with at least one regulated fund whose net assets exceed $100 billion.

[3] Represents registered investment company (RIC) assets managed by asset managers with over $750 billion in AUM globally.

[4] Represents DC assets managed by asset managers with over $750 billion in AUM globally.

Note: Components may not add to the total because of rounding.

Sources: Investment Company Institute and Pensions and Investments

We do not believe that any Member of Congress had any conceivable notion of the prospect that this extraordinary expansion of Federal Reserve authority could result from the Dodd-Frank Act. Surely, however, important participants today in the FSOC and FSB are well aware of it. And, ironically, there are voices in the bank regulatory community urging that the real problem with the FSOC is not that it has too little accountability, but that it has too much – and should be able to exercise all these extraordinary new regulatory powers with a very high degree of independence from Congress and the executive branch.[32]

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[32] *See, e.g.,* Donald Kohn, *Institutions for Macroprudential Regulation: The U.K. and the U.S.* (Apr. 17, 2014), *available at* http://www.brookings.edu/research/speeches/2014/04/17-institutions-macroprudential-regulation-kohn (advocating for a change in the FSOC's structure "to enhance its independence").

* * *

In conclusion, let me say that ICI and all its members have deep concerns about the transparency, accountability and fairness of the FSOC process. We by no means object to the Council's examination of asset management as it weighs possible out-sized risks to the financial system. What we do ask is simple, and nothing more than common sense and good governance would seem to require:

- The FSOC should consider all the tools available to it to mitigate risks, not simply SIFI designation;
- SIFI designations should have a clear and compelling empirical basis and take into account all the factors Congress enumerated in statute;
- The FSOC should communicate with particularity the bases for its designations;
- Congress should ensure that there is an opportunity for "de-risking" by a primary regulator and by the institution concerned in advance of final SIFI designation; and
- In the event that the FSOC does not heed the volume of data to the contrary and designates a stock or bond fund or asset manager as a SIFI, Congress should ensure that the remedies to which the designated fund or manager is subject are appropriate ones, for those currently contained in the Dodd-Frank Act clearly are not.

We appreciate the opportunity to share these views with the Committee. ICI looks forward to working with Congress on reforming the FSOC's SIFI designation process to ensure that it works as Congress intended.