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STATEMENT

OF

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BEFORE THE

US HOUSE OF REPRESENTATIVES

COMMITTEE ON FINANCIAL SERVICES

SUBCOMMITTEE ON
MONETARY POLICY AND TRADE

ON

THE FINANCIAL STABILITY BOARD'S IMPLICATIONS FOR US GROWTH AND COMPETITIVENESS

SEPTEMBER 23, 2016

EXECUTIVE SUMMARY

- ICI supports appropriate regulation to ensure the resiliency and vibrancy of the global financial system. We likewise believe it is appropriate for regulators to examine asset management to identify potential risks. Any such review, however, must be thorough, balanced, fact-based, and led by those with relevant expertise—*i.e.*, capital markets regulators.

- From the outset, the Financial Stability Board ("FSB"), whose membership consists largely of central bankers and finance ministers, has been predisposed to view virtually all financial activity conducted outside of banks as "shadow banking" and inadequately regulated because it is not subject to bank standards and supervision. As it relates to regulated funds and their managers, this orientation is deeply troubling in light of the FSB's ability to influence regulatory policy in its participating jurisdictions. US mutual funds and other regulated funds differ fundamentally from banks, and are among the most transparent and comprehensively regulated parts of the financial system.

- Over the last three years, the FSB has focused considerable attention on the asset management sector.

  - The FSB has proposed methodologies for identifying individual investment funds and asset managers for possible designation as global systemically important financial institutions ("G-SIFIs"). Broadly speaking, these methodologies have been advanced without due regard for empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posited by the FSB.

  - The FSB is engaged in a review to identify "structural vulnerabilities" in asset management activities raising concerns for global financial stability and to develop policy recommendations to address such risks. Regrettably, the justifications underlying the FSB's recommendations reflect the same sort of conjectures and assumptions that are apparent in the FSB's G-SIFI work on asset management.

- There are fundamental problems that pervade the FSB's work on asset management.

  - First, the FSB's proposed G-SIFI methodologies and its review of asset management activities are firmly rooted in concerns with "distress" and "disorderly failure" derived from the experience of banks and banking regulators. Only the occasional nod is given to fundamental distinctions between banking and asset management.

  - Second, the FSB affords an inadequate role to subject matter experts. Of particular concern to ICI, capital markets experts are leading neither of the FSB efforts highlighted above.

- Third, the FSB discounts empirical data and analysis that does not comport with the theories on which its work in asset management are based. Those theories include the potential for "fire sales" of investment fund assets, the transmission of risk from one or more investment funds to other market participants, and spillover effects to the global financial system. ICI believes the FSB has vastly overstated the potential for such effects. And, in the 76-year history of the modern US fund industry, there is no empirical basis for the FSB's concerns.

  In this regard, it is troubling that individual members of the FSB—including the Bank for International Settlements (which describes itself as "a bank for central banks") and the International Monetary Fund—are perpetuating the same conjectures about investment funds through other means. Our testimony offers several examples.

- Fourth, there is reason to question whether the FSB's work in asset management is simply results-oriented. There is an extensive public comment record that contradicts the FSB's conclusions to date in fundamental respects, yet it appears to have had little impact on the FSB's thinking to date.

- Fifth, as set forth in detail below, we have strong reservations about the transparency and fairness of the process that the FSB has followed in its work on asset management and the process it envisions for evaluating investment funds and asset managers under its proposed G-SIFI methodologies.

- In many of the five areas enumerated above, we see similar deficiencies in the Financial Stability Oversight Council's ("FSOC") SIFI designations and its review of asset management.

- We are troubled by the fact that a US Federal Reserve Board Governor leads the FSB committee overseeing the work on proposed G-SIFI methodologies for investment funds and asset managers. This arrangement raises the prospect that the process set in motion by the FSB ultimately could be used to exert multilateral influence on the FSOC to expand the reach of the Federal Reserve Board itself to regulated US funds and their managers and, by extension, US capital markets.

- SIFI or G-SIFI designation of regulated funds or their managers would have severe consequences. The requirements prescribed by the Dodd-Frank Act for SIFIs, such as capital and liquidity requirements, would—if applied to a regulated fund—result in higher costs and lower investment returns for individuals saving for retirement, education, and other life goals. Designation also could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd-Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. As I have explained in previous Congressional testimony, regulated funds and their managers could be subject to a highly conflicted form of regulation, pitting the interests of banks and the banking system against those of millions of investors.

- To address several of our concerns with the FSB, ICI recommends that Congress:
    - Continue to monitor closely US agencies' participation in the FSB's policy work and seek to ensure that their FSB participation does not conflict with the best interests of US investors and US capital markets.
    - Encourage US officials who participate in the FSB to support the delegation to the International Organization of Securities Commissions (that is, capital markets experts) of further work on asset management activities at the global level.
    - Use its influence to encourage the reconstitution of the FSB, with equal roles for capital markets, banking, and insurance, to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.
- With regard to the FSOC, Congress should enact legislation, such as H.R. 1550, the FSOC Improvement Act, to codify in statute important improvements to the SIFI designation process 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.

I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute ("ICI") and I am pleased to appear before the Subcommittee today to discuss the role of the Financial Stability Board ("FSB") and its impact on financial regulation and regulated funds. Thank you, Chairman Huizenga, Ranking Member Moore, and members of the Subcommittee for inviting me to testify.

ICI is a leading global association of regulated funds, including mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States, and similar funds offered to investors in jurisdictions worldwide.[1] 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's US fund members today manage total assets of $18.4 trillion and serve more than 90 million US investors.

For more than 75 years, the Investment Company Act and the Investment Advisers Act have governed the regulation of funds and their managers. As administered by the Securities and Exchange Commission ("SEC"), those statutes have supported the growth of the modern fund industry, which today helps American investors meet their most important financial goals, such as saving for college, purchasing a home or providing for a secure retirement.

ICI members, as both issuers of securities and investors in capital markets worldwide, understand the importance of sound, tailored regulation in maintaining a strong and resilient financial system. For this reason, ICI and its members seek to engage actively with policymakers and regulators and to provide meaningful input on financial policy matters that may have significant implications for funds and their investors. As financial policy continues to take on a greater global dimension, so too have ICI's efforts to monitor the work of, and engage with, policymakers and regulators outside the United States.[2]

In the years since the global financial crisis, the FSB has asserted an expanding role on the world stage. The FSB claims a broad mandate—nothing less than the entire global financial system—but it is dominated by central bankers and finance ministers. This membership is predisposed to viewing financial activity conducted outside of banks as "shadow banking" and to considering such activity to be

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[1] In this testimony, the term "regulated funds" includes "regulated US funds" (or "US mutual funds," where appropriate), which are comprehensively regulated under the Investment Company Act of 1940 ("Investment Company Act"). This testimony generally addresses regulated stock and bond funds and not money market funds, given the significant regulatory reforms that have been adopted for money market funds.

[2] The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US$19.9 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

inadequately regulated because it is not subject to bank standards and supervision. Not surprisingly, we strongly disagree with this portrayal and are deeply troubled by the FSB's ability to perpetuate this view through its influence on financial policy in its participating jurisdictions.

Our particular concerns about the FSB arise in the context of its work on asset management and financial stability. In January 2014, the FSB issued the first of two consultations on the design of methodologies for identifying and potentially designating global systemically important financial institutions—or G-SIFIs—within the asset management sector. The proposals advanced by the FSB (one for investment funds, the other for asset managers) took little or no account of empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posited by the methodologies.[3] We thus were, and remain, concerned not only about the substance of the FSB's work but also by the processes by which this work is conducted.[4]

We likewise are concerned by the FSB's current review of potential "structural vulnerabilities" in asset management activities.[5] As discussed more fully below, we have few objections to the substance of the FSB's proposed policy recommendations. We strenuously object, however, to the way in which the FSB attempts to justify the need for those recommendations. Again we see the FSB resorting to conjecture over empirical evidence and actual experience.

Several of ICI's concerns with the FSB parallel those we have with the Financial Stability Oversight Council ("FSOC") here in the United States. For this reason, my testimony will highlight ICI's concerns with, and suggest some improvements relating to, both the FSB and the FSOC.

In Section II below, we discuss the composition and structure of the FSB, its "macroprudential" focus, and its pejorative view of capital markets and other nonbank activity as "shadow banking." In Section III, we discuss the FSB's actions to date with respect to the asset management sector. Section IV

[3] ICI has provided extensive data and analysis to demonstrate that regulated funds and their managers do not pose risks to financial stability. *See* Letters from Paul Schott Stevens, President & CEO, ICI to the Financial Stability Board, dated April 7, 2014 and May 29, 2015, available at https://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf and https://www.ici.org/pdf/15_ici_fsb_comment.pdf, respectively. These letters also make the case that SIFI or G-SIFI designation is not necessary or appropriate for regulated non-US funds (*i.e.*, funds organized or formed outside the United States and substantively regulated to make them eligible for sale to retail investors).

[4] We have expressed similar concerns to the heads of the US agencies that are members of the FSB. *See* Letter from Paul Schott Stevens, President & CEO, ICI to the Honorable Jacob J. Lew, Secretary, Department of the Treasury, The Honorable Mary Jo White, Chair, SEC, and The Honorable Janet Yellen, Chair, Federal Reserve Board of Governors, dated May 28, 2015 ("Lew/White/Yellen Letter"), available at https://www.ici.org/pdf/15_ici_fsb_lew_yellen_white.pdf.

[5] Financial Stability Board, Consultative Document, *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (22 June 2016) ("FSB Activities Consultation"), available at http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf. The FSB consultation has four areas of focus: (1) liquidity mismatch between fund investments and redemption terms and conditions for fund units; (2) leverage within investment funds; (3) operational risks and challenges in transferring investment mandates in a stressed condition; and (4) securities lending activities of asset managers and funds.

highlights the five reasons why the FSB's work on asset management has been deficient, and explains that some of these reasons apply equally to the FSOC's SIFI designation process and its own asset management review. In Section V, we briefly discuss the implications of the FSB's work for US regulated funds, their investors, and the capital markets. Finally, in Section VI, we provide our recommendations, including those regarding the involvement of US officials in FSB policymaking.

II. THE FSB: BACKGROUND INFORMATION FOR THE SUBCOMMITTEE

To provide important context for our concerns with the FSB and its work, below is brief background information about: (1) the FSB's composition, structure, and "macroprudential" focus; and (2) its pejorative views of the capital markets and nonbank activity more generally.

A. FSB Composition, Structure and "Macroprudential" Focus

Established by the Group of 20 in 2009 as the successor to the Financial Stability Forum, the FSB by its charter has two broad objectives. These are: (1) to coordinate at the international level the work of national financial authorities and international standard-setting bodies in order to develop and promote the implementation of effective regulatory, supervisory, and other financial sector policies; and (2) in collaboration with the international financial institutions, to address vulnerabilities affecting financial systems in the interest of global financial stability.[6] Although the FSB's decisions are not legally binding on its members, the FSB nevertheless is able to forge global recommendations regarding those activities perceived to pose systemic risk and to require international attention.

By any measure, the FSB is a bank-centric organization. Among the FSB's members, central bank officials, finance ministers, and representatives of banking-related bodies (e.g., the Bank for International Settlements ("BIS"), International Monetary Fund ("IMF"), and the Basel Committee on Banking Supervision) far outnumber capital markets regulators. And central bankers and finance ministers hold key leadership positions, chairing the FSB, its Steering Committee, its four standing committees,[7] and its six regional consultative groups.[8] Of particular relevance to today's hearing, the FSB's membership includes three US regulators: the Board of Governors of the Federal Reserve System

[6] *See* Charter of the Financial Stability Board (as amended and restated June 2012) ("FSB Charter"), available at http://www.financialstabilityboard.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf, at Section I, Article 1.

[7] The standing committees are: (1) Standing Committee on Assessment of Vulnerabilities; (2) Standing Committee on Supervisory and Regulatory Cooperation; (3) Standing Committee on Standards Implementation; and (4) Standing Committee on Budget and Resources.

[8] There are six regional consultative groups, one each for the Americas, Asia, Commonwealth of Independent States, Europe, Middle East and North Africa, and Sub-Saharan Africa. They are designed to expand upon and formalize the FSB's outreach activities beyond the membership of the G20 and to reflect the global nature of the financial system.

("Federal Reserve Board"), the SEC, and the Treasury Department.[9] And a Federal Reserve Board Governor chairs the FSB's Standing Committee on Supervisory and Regulatory Cooperation—the committee overseeing the FSB's current review of asset management activities.

While the FSB has its own legal identity and governance structure, the BIS hosts the FSB's Secretariat, which operates out of the BIS's head office in Basel, Switzerland. The BIS's mission is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas, and to act as a bank for central banks.[10] The BIS's website touts the fact that through this arrangement with BIS, the FSB receives "synergies of co-location; flexibility and openness in the exchange of information; and support from BIS expertise in the field of economics, banking and regulation."[11]

The FSB's charter further solidifies the organization's banking orientation. The charter specifies that as part of its mandate, the FSB will "assess vulnerabilities affecting the global financial system and identify and review on a timely and ongoing basis *within a macroprudential perspective*, the regulatory, supervisory and related actions needed to address them, and their outcomes."[12] Thus, incorporated into the FSB's organizational documents is a directive to approach its work on vulnerabilities to the global financial system "within a macroprudential perspective"—*i.e.*, from the perspective of central bankers.

B. Views of Capital Markets and Other Nonbank Activity

From the perspective of central bankers, non-bank financial entities arouse skepticism based on the fact that they are not regulated in the same way as banks. Central bankers routinely refer to financial entities and activities outside of the banking system as "shadow banks" and "shadow banking"—an epithet regularly and deliberately used to suggest that entities like mutual funds present unacceptable risks because they are not regulated like banks.

In 2011, the FSB commenced its efforts to address "shadow banking" by instituting five workstreams to strengthen oversight and regulation of non-bank credit intermediation.[13] In a comment letter to the FSB at the commencement of this work, ICI agreed that it was appropriate for the FSB "to consider whether additional or different regulatory measures for non-bank financial entities may be important to

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[9] Under the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act"), the Treasury Secretary and the chairs of the Federal Reserve Board and SEC are members of FSOC; the Treasury Secretary also serves as FSOC's chair.

[10] *See* http://www.bis.org/about/index.htm.

[11] *See* http://www.bis.org/about/basel_process.htm.

[12] FSB Charter, *supra* note 6, Section I, Article 2(1)(a) (emphasis added).

[13] *See, e.g.*, FSB Published Recommendations to Strengthen Oversight and Regulation of Shadow Banking (press release dated 27 Oct. 2011), available at http://www.financialstabilityboard.org/2011/10/financial-stability-board-publishes-recommendations-to-strengthen-oversight-and-regulation-of-shadow-banking/.

strengthening the global financial system."[14] But—in addition to pointing out that the FSB uses inherently inaccurate and misleading terminology—our letter made a number of broader points that continue to be relevant, including:

- It is imperative for the FSB to acknowledge and respect the differences that exist between banking and securities and their respective regulatory frameworks.

- Banks and capital markets have existed alongside one another in the United States for centuries, with parallel bodies of regulation and oversight.

- The US financial system and our economy at large have thrived on the benefits that both banks and capital markets provide.

- Bank-like regulation is not appropriate, necessary or workable for funds registered under the Investment Company Act of 1940.

According to the FSB's annual report issued this August, "transforming shadow banking into resilient market-based finance" continues to be one of the core areas of the FSB's regulatory reform program.[15] As applied to regulated funds and their managers, this characterization suggests a level of disregard both for the way in which such funds and their managers long have operated and been regulated, *and* for the contributions they already make today as sources of long-term capital to finance economic growth. In Sections III and IV below, we discuss in detail how this orientation has affected the FSB's work on asset management.

III. THE FSB's WORK TO DATE ON ASSET MANAGEMENT

A. Proposed Assessment Methodologies to Identify G-SIFIs in the Asset Management Sector

During the global financial crisis, governments stepped in using public funds to prevent the distress or disorderly failure of certain large financial institutions from having cascading effects throughout the financial system. In an effort to avoid the systemic and moral hazard risks associated with such bailouts in the future, a key priority on the FSB's financial stability agenda has been "Ending 'Too Big to Fail'

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[14] Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Secretariat of the Financial Stability Board, dated June 1, 2011 (responding to an FSB background note entitled "Shadow Banking: Scoping the Issues"), available at http://www.ici.org/pdf/25258.pdf, at 4. We expressed support for "the efforts of the FSB and the regulatory bodies it represents to study ways to monitor non-bank financial intermediaries, such as by improving and expanding data collection from these entities, as necessary, to help regulators identify and manage systemic risk." *Id.*

[15] FSB, Implementation and Effects of the G20 Financial Regulatory Reforms, 2nd Annual Report (31 August 2016) ("FSB Report on Reform Implementation"), available at http://www.fsb.org/wp-content/uploads/Report-on-implementation-and-effects-of-reforms.pdf.

(TBTF)."[16] Starting with banks and then turning to insurance companies, the FSB's approach has been to develop assessment methodologies for identifying financial entities "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions."[17]

Having already identified 30 banks and 9 insurance companies as G-SIFIs, the FSB intends to adopt assessment methodologies to identify non-bank, non-insurer ("NBNI") G-SIFIs.[18] The FSB's initial consultation in January 2014 proposed a methodology for identifying global systemically important investment funds.[19] On the basis of their size alone, the methodology singled out 14 highly regulated US funds as the *only* funds that automatically would be subject to further review for possible G-SIFI designation. This was a curious and very troubling result, especially given that these funds belong to the part of the financial system that proved most stable during the global financial crisis.

After receiving extensive public comments, including from ICI, the FSB issued a second consultation in March 2015 that included a revised methodology for investment funds and a new proposed methodology for asset managers.[20] The second consultation discounted key aspects of the public comment record on the initial consultation. And the methodologies it proposed again placed undue emphasis on size, thus continuing to single out large, highly regulated US funds (and mostly US asset managers) as candidates for potential G-SIFI designation.

This is particularly troublesome as the consequences of designating regulated US funds or their managers would be highly adverse to investors and the capital markets. Application of the bank-oriented "remedies" prescribed by the Dodd-Frank Act would increase costs and reduce returns for

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[16] *Id. See also Progress and Next Steps Towards Ending "Too-Big-To-Fail" (TBTF), Report of the Financial Stability Board to the G-20* (2 September 2013), available at http://www.financialstabilityboard.org/wp-content/uploads/r_130902.pdf.

[17] *See, e.g., Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (8 January 2014), available at http://www.financialstabilityboard.org/publications/r_140108.pdf, at 2.

[18] *See, e.g.,* Consultative Document, *Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* (22 June 2016) at 2, available at http://www.fsb.org/wp-content/uploads/FSB-Asset-Management-Consultative-Document.pdf.

[19] The consultation also included proposed methodologies for market intermediaries (securities broker-dealers) and finance companies.

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

fund investors, distort the fund marketplace, introduce a conflicted model of regulation, and compromise the important role that funds play as a source of financing in the economy.[21]

B. Review of "Structural Vulnerabilities" from Asset Management Activities

In responding to each of the FSB's consultations on NBNI G-SIFI methodologies, ICI pointed out a series of fundamental problems with FSB's approach to asset management. We strongly urged the FSB to pursue an activity-based approach as a better way to address any identified risks to global financial stability posed by the asset management sector, given the agency nature of the business and the high degree of substitutability of investment funds and asset managers.

ICI therefore welcomed the FSB's July 2015 announcement that it had set aside the NBNI G-SIFI project while conducting a review of asset management activities. Eleven months later, in June 2016, the FSB requested public comment on proposed policy recommendations to address potential financial stability risks in four areas: liquidity and redemptions in investment funds offering daily redeemability ("open-end funds"); leverage within investment funds; operational risk and the transfer of investment mandates; and securities lending. The consultation discusses the posited "structural vulnerability" in each area, describes in broad terms the way in which existing regulation and practices already address the vulnerability, and proposes policy recommendations to address any "residual risk" in that area.

As explained in our letter responding to the consultation, we generally have few objections to the substance of the FSB's proposed policy recommendations.[22] They generally envision that the International Organization of Securities Commissions ("IOSCO")[23] and authorities in each jurisdiction will review existing regulation and make enhancements where appropriate. This approach properly directs these responsibilities to the regulators with deep experience in asset management and the capital markets.

But ICI strenuously objects to the justifications offered by the FSB in this consultation, particularly with regard to "liquidity mismatch" in open-end funds. In conclusory terms, the FSB describes the potential mismatch between the liquidity of individual fund portfolio holdings and daily redeemability of fund shares as a "key structural vulnerability" raising concerns for global financial stability. In

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[21] *See, e.g.*, Statement of Paul Schott Stevens, President & CEO, ICI before the Committee on Banking, Housing, and Urban Affairs, US Senate, on FSOC Accountability: Nonbank Designations (March 25, 2015) ("Stevens Testimony"), available at https://www.ici.org/pdf/15_senate_fsoc.pdf.

[22] *See* Letter to the FSB from Paul Schott Stevens, President & CEO, ICI, dated Sept. 21, 2016 ("ICI Letter on FSB Activities Consultation").

[23] The International Organization of Securities Commissions (IOSCO) is the international body that brings together the world's securities regulators and is recognized as the global standard setter for the securities sector. IOSCO develops, implements and promotes adherence to internationally recognized standards for securities regulation. For more information, *see* https://www.iosco.org/about/?subsection=about_iosco.

support of its contention, however, the FSB resorts to conjecture and assumptions about the potential for destabilizing impacts from fund redemptions, while discounting empirical evidence and the actual experience of open-end funds and their investors. This is a recurring problem in the FSB's work, and one that we discuss more fully below.

IV. FUNDAMENTAL PROBLEMS PERVADE THE FSB'S WORK—AND THAT OF THE FSOC—RELATING TO ASSET MANAGEMENT

ICI supports appropriate regulation to ensure the resiliency and vibrancy of the global financial system. As a related matter, we believe that regulators can—and should—examine different sectors of the financial system, including asset management, to identify potential risks to financial stability. But reviews of this nature must be thorough, balanced, and fact-based—and, to those ends, led by policymakers with requisite expertise. For asset management, this means capital markets regulators. Clearly, these regulators are best positioned to determine whether regulated funds and their managers do or do not pose potential risks to financial stability.

The FSB's work relating to asset management falls far short of these basic standards. We highlight five specific areas of concern below. In many of those areas, unfortunately, we see similar deficiencies in the FSOC's SIFI designations and its review of asset management.

A. Misconception of the Business of Asset Management

The FSB's propensity to view the world through a banking lens is readily apparent in its work on asset management and financial stability. Although giving the occasional nod to fundamental distinctions between banking and asset management, the FSB's work on asset management is firmly rooted in concerns with "distress" and "disorderly failure" derived from the experience of banks and banking regulators.

In its G-SIFI work, for example, the FSB states frankly that the proposed methodologies for investment funds and asset managers "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."[24] We continue to question how the FSB can simply assume its way past such a fundamental

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[24] FSB Second Consultation, *supra* note 20, at 10 (emphasis in the original). With regard to the SIFI designation process in the United States, the question of whether FSOC is required (by statute or its own interpretive guidance) to assess the likelihood that a company will experience material financial distress is currently being litigated. *See, e.g., MetLife, Inc. v. Financial Stability Oversight Council*, C.A. No. 15-0045 (D.D.C. Mar. 30, 2016). In *MetLife*, the court rescinded FSOC's designation of MetLife, Inc. (identified by the FSB, in consultation with the International Association of Insurance Supervisors and national authorities, as a global systemically important insurer in July 2013) as a SIFI under US law. The court found that FSOC violated its own analytical framework for assessing nonbank financial companies for possible SIFI designation by (1) failing to assess MetLife's vulnerability to material financial distress, and (2) assuming that MetLife's material financial distress would inflict significant damage on the US economy. The court also found that FSOC failed to consider the costs of designation to MetLife, in violation of recent US Supreme Court precedent. FSOC is appealing the court's decision..

question—that is, whether an investment fund or asset manager might actually experience such distress or disorderly failure.

This same propensity remains present in the FSB's asset management activities consultation, where the FSB bases its operational risk concerns on the notion of distress befalling a large asset manager. For example, the FSB states "operational difficulties could potentially become a financial stability concern if they were to materialise during stressed market conditions, particularly if they affect an asset manager (or managers) of sufficient scale or complexity." The FSB contends that such difficulties could lead to redemptions in the manager's funds and that "[r]edemptions at a large manager[s] or manager[s] that plays a significant role in certain markets can potentially affect the market prices of investment assets . . . particularly during a period of market stress." And the FSB focuses its policy recommendations to address "residual risks" associated with transferring investment mandates or client accounts solely on asset managers that are "large, complex, and/or provide critical services."

As ICI repeatedly has advised, regulated funds and their managers should not be viewed through a banking lens. They do not "fail" like banks do. They are highly substitutable. Regulated funds generally use little to no leverage. Fund managers act as agents, not principals. They invest on behalf of their clients, leaving the risks—and rewards—to the end investors, who knowingly accept this tradeoff. And regulated funds and their managers routinely exit the business in an orderly way, with no systemic impact, even during periods of severe market stress.

B. Inadequate Deference to Capital Markets Experts

As discussed in Section II above, the FSB's membership largely consists of central bankers, finance ministers, and representatives of banking-related bodies. As a result, capital markets experts are not leading the FSB's work on asset management.

To its credit, the FSB has seen fit to involve IOSCO in its work on the G-SIFI assessment methodologies for investment funds and asset managers. It is our understanding, however, that rather than establishing an equal partnership with IOSCO or deferring to IOSCO members' expertise in this area, the bank-dominated FSB has remained firmly in charge of the project. And it was not until after the IOSCO Board publicly recommended that a full review of asset management activities take precedence over consideration of how to designate funds or asset managers as G-SIFIs[25] that the FSB changed the course of its work. While we are pleased that the FSB set aside its work on G-SIFI methodologies to conduct an activities-based review, we note that the review likewise is under the FSB's control.

Why is this a problem? The central bankers who dominate the FSB are experts in banking, and they come to their FSB duties with that expertise and experience in mind—in particular, the "safety and

[25] *See* IOSCO: Meeting the Challenges of a New Financial World (media release dated 17 June 2015), available at https://www.iosco.org/news/pdf/IOSCONEWS384.pdf.

soundness" goals of bank regulation, the inherent riskiness of the highly-leveraged bank model and its propensity for "runs," the significant problems that banks experienced during the crisis, the unprecedented level of government intervention needed to safeguard the banking system, and the various regulatory tools that have been employed to strengthen individual banks and the overall banking sector. It is not surprising, therefore, that this banking expertise colors the FSB's views of investment funds and asset managers, leading them to believe that the largest funds and managers may pose unaddressed and unacceptable risks to other market participants and the financial system as a whole.

Domestically, we have had similar concerns. FSOC's review of asset management began most inauspiciously with a highly flawed 2013 report on asset management written by the FSOC's research arm, the Office of Financial Research ("OFR"). Among the range of sharp criticisms the report drew was that it reflected deep misunderstandings of the asset management industry.[26]

As with the FSB, the composition of the FSOC is weighted toward bank regulators. This would appear to give bank regulators the upper hand in designation decisions and other matters—even if they are not the experts with respect to the subject matter under consideration. It is unclear, for example, why FSOC felt compelled to offer recommendations relating to issues of mutual fund liquidity during an open SEC rulemaking on that very topic.[27] We have seen this concern play out in the insurance industry, where the FSOC has designated firms as SIFIs despite the objections and misgivings of the presidentially appointed independent member of the FSOC with insurance expertise.

C. Reliance on Conjecture and Theory Rather than Empirical Data and Actual Experience

The FSB discounts empirical data and analysis that does not comport with the theories on which its work in asset management are based. Those theories include the potential for "fire sales" of investment fund assets, the transmission of risk from one or more investment funds to other market participants, and spillover effects to the global financial system.

We believe the FSB has vastly overstated the potential for such effects. And, in the 76-year history of the modern US fund industry, there is no empirical basis for the FSB's concerns. ICI's submissions to the FSB have offered extensive data and analysis showing that regulated stock and bond funds—particularly US mutual funds—and their investors simply do not behave in the manner that the FSB envisions. Yet all this data and analysis does not appear to have prompted the FSB to re-examine its hypotheses, or seek to understand (and, in their models, account for) *why* the experience of regulated funds has been so consistent, across even the most severe periods of market stress.

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[26] Stevens Testimony, *supra* note 21, at 13.

[27] *See* FSOC, Update on Review of Asset Management Products and Activities (April 18, 2016), available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf.

The FSB also has relied on the conjectures of other banking-oriented regulators or their representatives—including the FSOC—as support for its positions. For example, in its second G-SIFI consultation, issued in March 2015, the FSB appeared to endorse certain statements set forth in the FSOC's December 2014 notice seeking comment on asset management products and activities. The FSB repeated, without empirical or historical support, the FSOC's conjectures about possible financial stability effects from a "first mover advantage" for investors in investment funds that offer redeemable interests, particularly funds investing in less liquid asset classes. This bank-regulatory "echo chamber," in which the FSB cites the mere speculations of the FSOC as evidence or authority, is a matter of deep concern.

Also troubling is the fact that individual members of the FSB are perpetuating these conjectures through other means. We offer several examples.

- A representative from the Reserve Bank of Australia sits on the FSB's Steering Committee. Last year, staff at the Bank issued a bulletin entitled *Recent Developments in Asset Management*.[28] The bulletin's discussion of asset management and systemic risk relies heavily on the FSB's two G-SIFI consultations and the widely-discredited 2013 report by the Office of Financial Research. The bulletin states baldly—without citation to any source, much less empirical or historical evidence—that "[o]pen-ended funds that offer daily redemptions are susceptible to bank-like runs." The bulletin concludes by stating that the asset management industry "poses potential risks to financial stability."[29]

- The BIS—which funds the FSB's work and houses the FSB Secretariat within its offices—has included similar conjectures about the risks posed by the asset management industry in each of last two annual reports. The BIS annual report for 2015 states, for example, that "asset managers' business models . . . incentivize short-sighted behaviour that can be destabilising in the face of adverse shocks" and that "[t]he decisions taken by a single large asset manager can potentially trigger fund flows with significant system-wide repercussions."[30] In a chapter devoted to "the challenges the financial sector is facing," the BIS annual report for 2016 points to the growth in assets under management, the "increasing presence" of open-end mutual funds in corporate bond markets, and concerns about market liquidity.[31] The BIS then suggests that

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[28] *See* Fiona Price and Carl Schwartz, Reserve Bank of Australia, *Recent Developments in Asset Management*, Bulletin, June Quarter 2015, at 72. The bulletin's reference to open-ended funds appears to be targeted to stock and bond funds. *Id.* at 71-72 and Graph 4. The bulletin is available at http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-8.pdf.

[29] *Id.*

[30] *See* Bank for International Settlements, *85th Annual Report, 1 April 2014–31 March 2015* (Basel, 28 June 2015) at 118, 119. The report is available at http://www.bis.org/publ/arpdf/ar2015e.htm.

[31] *See* Bank for International Settlements, *86th Annual Report, 1 April 2015—31 March 2016* (Basel, 26 June 2016) at 103, 120-21. The report, which is available at https://www.bis.org/publ/arpdf/ar2016e.htm?m=5%7C24, claims that in the United States, open-end mutual funds "now hold some 22% of corporate debt according to financial accounts data—up

"it is investors, not market-makers, who need to internalise the risk that liquidity will evaporate when everybody heads for the exits."[32] This is a stark example of banking experts projecting the bank experience onto regulated funds. Anyone familiar with the basic workings of the capital markets can confirm that "everybody" can't "head for the exits" at the same time—because trades require both a seller *and* a buyer.

- In April 2015, the IMF Global Financial Stability Report included a chapter on "The Asset Management Industry and Financial Stability."[33] On its face, the chapter appears to present a robust analysis based on empirical data sufficient to support the IMF's declaration that "even simple investment funds such as mutual funds can pose financial stability risks."[34] Closer examination, however, reveals that the chapter contains numerous data errors, misinterpretations, and misleading charts.[35] By and large, these issues arise because the IMF lacks expertise in, and institutional knowledge of, regulated funds.[36]

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from about 8% in 2005." In fact, according to revised Federal Reserve Board data, US mutual funds have only a 15 percent share of the corporate bond market, essentially unchanged since 2012. ICI applauds the Federal Reserve Board for improving the quality of these data. The revised data show that FSB concerns about mutual funds (at least those that invest in corporate bonds)—which the BIS perpetuates—relied upon the faulty predicate that US mutual funds' share of the corporate bond market is large and growing rapidly. Thus, it is incumbent on these and other policy bodies to step back and reexamine their conjectures concerning bond funds and systemic risk.

[32] *Id.*

[33] IMF, *The Asset Management Industry and Financial Stability*, Chapter 3, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks (April 2015) ("Asset Management Chapter"), available at http://www.imf.org/external/pubs/ft/gfsr/2015/01/pdf/c3.pdf.

[34] *See Plain Vanilla Investment Funds Can Pose Risks*, IMF Survey Magazine: Policy (April 8, 2015) (describing the IMF's conclusions in the Asset Management Chapter), available at http://www.imf.org/external/pubs/ft/survey/so/2015/POL040815B.htm.

[35] ICI economists have written a series of blog posts explaining various problems in the IMF's analysis of the asset management industry. *See The IMF Is Entitled to Its Opinion, but Not to Its Own Facts*, ICI Viewpoints (April 10, 2015); *The IMF Quietly Changes Its Data, but Not Its Views*, ICI Viewpoints (April 21, 2015); *The IMF on Asset Management: The Perils of Inexperience*, ICI Viewpoints (May 28, 2015); *The IMF on Asset Management: Which Herd to Follow?* ICI Viewpoints (June 1, 2015); *The IMF on Asset Management: Sorting the Retail and Institutional Investor "Herds,"* ICI Viewpoints (June 4, 2015). All of the blog posts in this series can be accessed at https://www.ici.org/viewpoints/view_15_imf_gfsr.

[36] Nevertheless, the FSB continues to cite to this report. *See* FSB Activities Consultation, *supra* note 5, at 10 n.29 (cited as support for the FSB's contention that "[t]here may also be cases in which open-ended funds could create incentives for investors to redeem ahead of others (*i.e.*, create a 'first-mover advantage')."

D. Indications That Desired Results May Drive the FSB's Work Product

ICI has taken advantage of every available opportunity to participate in the public consultation process regarding the FSB's work on asset management.[37] Frankly, it is frustrating to see how precious little impact the extensive public comment record appears to have had on the FSB's thinking to date.

Despite extensive public commentary on the initial G-SIFI consultation that size alone does little to indicate the potential for systemic risk, the FSB's second G-SIFI consultation continued to place undue emphasis on the size of a fund, thus singling out many large regulated US funds for potential designation. It also added criteria to sweep large asset managers into the designation net, possibly based entirely on the amount of assets under management. The approach, too, would result in identification of large US asset managers for potential designation.

This is not the only example of the FSB ignoring public commentary on a significant aspect of its proposed G-SIFI methodologies. Virtually all commenters agreed with the FSB's reasoned decision in the initial consultation not to focus on individual asset managers because of the agency nature of their business. In other words, the FSB recognized that fund investors and other clients of an asset manager, rather than the manager itself, are the bearers of investment risk. Nevertheless, in the second consultation, the FSB chose to ignore public comments *and* its own counsel by adding a separate assessment methodology for asset managers.

What could account for this sharp reversal of views? It is possible that the FSB could have been influenced by the views of commenters whose identities, like their comments, have not been made publicly available.[38] An alternative, and equally unsettling, explanation is that the FSB could have been attempting to reverse-engineer the proposed methodologies to achieve a specific outcome.

Similarly, in the United States, the way in which the FSOC has approached the question of nonbank SIFI designation suggests a results-oriented exercise as opposed to an objective analysis. In none of its nonbank designations thus far has the FSOC chosen to explain the basis for its decision with any particularity. The FSOC also has theorized about risks instead of conducting the kind of thorough, balanced, empirical analysis that should underlie its decisions. And by avoiding any meaningful discussion of the particular aspects or activities of the company that are thought to pose systemic risks, the FSOC not only forecloses the prospect of any reasoned justification for its decisions, but also frustrates Congressional intent.[39]

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[37] We also have participated in numerous meetings with FSB officials and staff.

[38] *See* FSB Second Consultation, *supra* note 20, at 3 (stating that all comments will be published "unless a commenter specifically requests confidential treatment.").

[39] Roy Woodall, the independent member of FSOC having insurance expertise, made a similar observation in dissenting from FSOC's decision to designate MetLife Inc. as a SIFI. *See* Views of the Council's Independent Member Having Insurance Expertise at 2 ("It is important to identify particular activities in order to encourage appropriate and further action that could lessen any company-specific threat to U.S. financial stability. Paraphrasing what one insurance thought

E. Insufficient Transparency and Accountability in Consultation and Designation Processes

In the course of our ongoing engagement with the FSB on asset management issues, ICI has highlighted significant concerns with how the FSB conducts its work. In so doing, we have contrasted the FSB's flawed processes with the requirements to which US regulators must adhere in developing new regulations. Under the Administrative Procedure Act, US regulators must examine relevant data and articulate a satisfactory basis for their actions, including a rational connection between the facts found and regulatory choices made. Conclusory statements and unsupported conjectures are not sufficient, nor may regulators ignore contradictory evidence in the record before them. Regulators may not impose substantial new burdens on regulated entities to guard against illusory or wholly improbable risks.

We have urged the FSB to consider adopting similar requirements to guide its work. We also have suggested that the FSB consider more robust rules designed to bring greater transparency to the input that shapes its initiatives and related deliberations, some of which now escapes public scrutiny.[40]

Similarly, ICI is concerned by the process that the FSB has proposed for evaluating investment funds and asset managers for possible G-SIFI designation.[41] Among the serious shortcomings of that process are the following:

- Investment funds or asset managers being considered for G-SIFI designation may have little or no information as to the basis upon which specific decisions are being or will be made.
- There is no required notice that an investment fund is being evaluated (*i.e.,* for funds that do not meet the specified threshold but are considered by national authorities to be "potentially globally systemic") or that a fund will *not* be designated (for funds that do meet the threshold).
- There is no assurance that an investment fund or asset manager will be permitted to provide information that they believe is relevant to a designation determination (or that any such information would be considered by the FSB and the relevant national authority).
- There is no requirement to consider the relative costs and benefits of a potential designation.
- There is no formal (or informal) mechanism for an investment fund or asset manager to challenge a G-SIFI determination.

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leader once told me: 'We should not tolerate any insurance company posing a threat to our financial system – pinpoint what makes them systemically risky and let's fix them.'") (citation omitted). Mr. Woodall's dissent is available at https://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.

[40] *See* ICI Letter on FSB Activities Consultation, *supra* note 22.

[41] *See* FSB Second Consultation, *supra* note 20, at 12-15.

We have recommended various reforms to the proposed process that, in our view, would help address concerns that the FSB has a predetermined outcome in mind—*i.e.*, naming the largest investment funds and asset managers as G-SIFIs. The most significant of those reforms are:

- First, the FSB should provide an entity under review with sufficiently detailed information about the potential risks of concern to the FSB.
- Second, the process should include greater reliance on an entity's primary regulator, including consideration of whether potential risks posed by the entity are better addressed through regulation targeted to the relevant activity, rather than through G-SIFI designation.
- Third, the entity should have the opportunity to propose changes to its business, structure or operations to address the risks identified by the FSB, and should receive a response from the FSB to these proposed changes.

The FSOC SIFI designation process likewise would benefit from these types of common-sense improvements. ICI and many other stakeholders, including Financial Services Committee Chairman Jeb Hensarling, have expressed concerns with this process.[42] In a December 2014 letter to the FSOC, for example, ICI highlighted the following areas for potential reform: greater engagement with companies under evaluation; greater involvement by a company's primary financial regulator; allowing a company to propose a "de-risking" plan as an alternative to SIFI designation; greater transparency, which would give other companies and the broader public more insight into the FSOC's concerns about systemic risk and the business activities or practices giving rise to such risks; and periodic comprehensive review of designated companies.[43]

In February 2015, in response to those calls for change, the FSOC voted to approve "supplemental procedures" to revise its SIFI designation process. The new procedures call for earlier engagement with companies under review, more transparency to the public on the designation process and reasons for designating companies, and a more robust process for annual reviews. While a helpful first step, these new procedures do not go far enough and can be changed at any time without prior notice. ICI believes

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[42] *See, e.g.*, Letter from Rep. Carolyn B. Maloney (D-NY), Ranking Member, Subcommittee on Capital Markets and Government Sponsored Enterprises to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated July 29, 2014; Statement of Chairman Jeb Hensarling before Committee on Financial Services, Hearing on "The Annual Report of the Financial Stability Oversight Council" (June 24, 2014) (stating 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"); Letter from Jeb Hensarling (R-TX), Chair, Committee on Financial Services, et. al. to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, et al., dated May 14, 2014 (raising concerns about the SIFI and G-SIFI designation process); Letter from Sen. Mark Warner (D-VA) to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated May 9, 2014 (noting 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").

[43] *See* Letter from Paul Schott Stevens, President & CEO, ICI to Patrick Pinschmidt, Executive Director, FSOC, dated Dec. 17, 2014.

the changes should be codified in statute to provide greater certainty and predictability to the SIFI designation process.

In this regard, the Subcommittee should be aware of a related issue. In issuing the above-noted supplemental procedures, the FSOC indicated that it would publish "further details explaining how the Stage 1 thresholds are calculated."[44] The so-called Stage 1 thresholds are the six quantitative metrics that the FSOC and its staff use to identify those companies that will be subject to comprehensive review for possible SIFI designation.[45] The FSOC and its staff maintain that these metrics "are designed to be uniform, transparent, and readily calculable by the Council, nonbank financial companies, market participants, and other members of the public."[46] Even with the further details the FSOC staff issued in early June, however, the metrics fall well short of this standard. With respect to the metric focused on derivatives liabilities, for example, the new guidance provides *no* additional details—despite specific industry requests for clarification[47]—and merely restates information from the FSOC's 2012 release adopting these metrics. At a minimum, if the FSOC and its staff are not willing to provide the information needed to make the Stage 1 thresholds "transparent and readily calculable," they should refrain from mischaracterizing this part of the SIFI designation process.

V. THERE IS A CLEAR PROSPECT OF HARMFUL CONSEQUENCES FOR REGULATED US FUNDS, THEIR INVESTORS AND THE CAPITAL MARKETS

ICI is greatly concerned about the deficiencies discussed in Section III above because of the potential for the FSB's work to have serious negative consequences for regulated US funds, fund investors, and the capital markets. In this section, we highlight how the FSB's work is able to affect US entities and reiterate what the consequences of designation would be for US funds or their managers.

A. Effect of the FSB's Work on US Entities

As mentioned earlier, three US government agencies represented on the FSOC—the Federal Reserve Board, the Treasury Department, and the SEC—also are members of the FSB. The lack of transparency and accountability around the FSB's NBNI G-SIFI consultation process makes it impossible to know precisely what role these agencies have played in this project and what their views

[44] 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, at 5.

[45] We note, however, that FSOC reserves the right to evaluate a company even if it does not meet the Stage 1 metrics.

[46] FSOC Staff Guidance, Methodologies Related to Stage 1 Thresholds (June 8, 2015), available at http://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf, at 1.

[47] *See, e.g.*, Letter from Gus Sauter, Managing Director and Chief Investment Officer, and John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard, dated Dec. 19, 2011 (recommending that, in calculating net derivative liability under its "Stage 1" analysis, FSOC take into account not just cash collateral but also collateral consisting of cash-equivalents, such as Treasuries and other U.S. government agency securities).

are on it.[48] Efforts by members of Congress to gain greater insight into these matters have been largely unavailing.[49]

It also is troubling that, as mentioned above, a Federal Reserve Board Governor leads the FSB committee overseeing the work on proposed G-SIFI assessment methodologies for investment funds and asset managers. This arrangement raises the prospect that the process set in motion by the FSB ultimately could be used to exert multilateral influence on the FSOC to expand the reach of the Federal Reserve itself to regulated US funds and their managers and, by extension, US capital markets.

The FSOC maintains that the FSB's decisions do not determine those of the FSOC.[50] Federal Reserve Board Chair Yellen echoed this view in her June 2015 response to ICI's letter. Chair Yellen indicated that "any recommendations by the FSB with respect to the asset management industry would not be binding on the United States. That responsibility remains with the appropriate domestic regulatory authorities and the Financial Stability Oversight Council."[51] But these assertions provide little comfort insofar as the FSB's decisions may front-run the FSOC process. While the FSB's recommendations may not be "binding," they seem certain to have some import for the FSOC. One need only consider the experience of the insurance industry. Surely it is more than just a coincidence that the FSOC has designated for enhanced prudential regulation and Federal Reserve Board supervision *all* of the US-based insurance firms the FSB named as global systemically important insurers.

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[48] Chair Yellen's response to the Lew/White/Yellen Letter (*supra* note 4) shed no additional light. Chair Yellen stated that "as the FSB is made up of participants from many jurisdictions, the particular statements and documents produced by the FSB do not necessarily reflect my views or those of the Federal Reserve." Letter from Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, to Paul Schott Stevens, President and Chief Executive Officer, Investment Company Institute, dated June 11, 2015 ("Yellen Response").

[49] *See, e.g.*, Hearing Transcript, *The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System*, Committee on Financial Services, House of Representatives (May 8, 2014) (exchange between The Honorable Jacob Lew, Secretary, Department of the Treasury, and Chairman Jeb Hensarling (R-TX) *et al.* regarding the FSOC's interaction with the FSB and the FSB's designation of three U.S. insurance companies as G-SIFIs).

[50] *See, e.g.,* FSOC Nonbank Designations – FAQs (FAQ #11), available at http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx. FAQ #11 states:

"11. If international entities such as the Financial Stability Board (FSB) identify a U.S. firm as systemically important, does that mean that the FSOC will do the same?

No. While the FSB and the FSOC are both focused on strengthening financial stability, their processes are distinct. Decisions reached in the FSB do not determine decisions made by the FSOC. In fact, the FSOC is under no obligation to even consider a firm identified by the FSB for designation.

The FSB's identification of a firm as a global systemically important financial institution does not have legal effect in the United States or any other country. In the United States, the FSOC is the only entity that can designate nonbank financial companies for enhanced prudential standards and Federal Reserve supervision. FSOC designations can be made only pursuant to a super-majority vote of its 10 voting members based solely on the standards and processes set forth in U.S. federal law, after a robust analysis that reflects extensive interaction with the company."

[51] Yellen Response, *supra* note 48.

Indeed, the FSB's proposed process for identifying NBNI G-SIFIs expressly calls for involvement by "national authorities" in each member jurisdiction. Thus, if the FSB were to adopt the process outlined in its second consultation, regulators in the United States would be called upon to analyze US funds and asset managers under the applicable assessment methodology and to develop a preliminary list of NBNI G-SIFIs. In addition, under the proposal, national authorities would be permitted to add to their preliminary lists "other NBNI financial entities that are below the materiality thresholds but which they determine should still be added for more detailed assessment."[52] Subsequently, US regulators, together with the FSB, would determine the final list.

Moreover, participation as a member of the FSB carries with it the expectation that member jurisdictions will implement any agreed upon standards and policy measures.[53] Consistent with this expectation, FSB Chairman Mark Carney has stated that "*full, consistent and prompt implementation*" of the standards developed under the FSB "remains *essential* in order to maintain an open and resilient global financial system."[54] Notwithstanding this stern injunction, we believe that the deeply flawed way in which the FSB has developed its proposed asset management methodologies means that they simply cannot serve as any predicate for regulatory action in the United States.[55]

B. What is At Stake? The Consequences of Designation

As ICI has cautioned previously, SIFI or G-SIFI designation of regulated funds or their managers would have severe consequences. In both cases (*i.e.*, SIFI and G-SIFI), US law already has established the measures that would apply to any fund or manager designated as systemically important. As prescribed by the Dodd-Frank Act, these measures include capital and liquidity requirements and prudential supervision by the Federal Reserve.[56] These measures are designed to moderate bank-like risks and are ill-suited to regulated funds and their managers.

Based on these requirements, designated funds would face higher costs resulting in lower investment returns for individuals saving for retirement, education, and other life goals. The resulting competitive imbalances would distort the fund marketplace, potentially reducing investor choice. Designation also

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[52] Second FSB Consultation, *supra* note 20, at 14.

[53] *See, e.g.,* Letter from Mark Carney, Chairman, FSB to G20 Finance Ministers and Central Bank Governors, dated 9 April 2015 (emphasis added).

[54] *Id. See also* FSB Report on Reform Implementation, *supra* note 15, at 2 ("G20 Leaders' continued support is needed to address identified gaps and inconsistencies in . . . core reform areas, and to overcome legal and operational obstacles to implementation by . . . ensuring that legal, data and capacity constraints do not hamper implementation efforts.")

[55] Lew/White/Yellen Letter, *supra* note 4, at 3-4.

[56] In May 2014, ICI's Chairman testified in greater detail about the consequences of SIFI or G-SIFI designation of regulated funds or their managers. *See* Statement of F. William McNabb III, Chairman and Chief Executive Officer, The Vanguard Group, Inc., on behalf of the Investment Company Institute, before the Committee on Financial Services, US House of Representatives, on Examining the Dangers of the FSOC's Designation Process and Its Impact on the US Financial System (May 20, 2014).

could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd-Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. As I have explained in previous Congressional testimony, regulated funds and their managers could be subject to a highly conflicted form of regulation, pitting the interests of banks and the banking system against those of millions of investors.[57]

VI. RECOMMENDATIONS

ICI is pleased to offer its recommendations for addressing several of the concerns we discuss above.

- On an ongoing basis, Congress should continue to monitor closely US agencies' participation in the FSB's policy work, particularly as it relates to asset management. As part of its oversight of these agencies, Congress should seek to ensure that their FSB participation does not conflict with the best interests of US investors and US capital markets.

- In the near term, Congress should encourage US officials who participate in the FSB to support the delegation to IOSCO of further work on asset management activities at the global level. This would mean having the FSB delegate to IOSCO responsibility for final consideration of the policy recommendations set forth in the current consultation (as appropriate after IOSCO gives due consideration to public comments) and monitoring progress as the recommendations are implemented.

- Congress should use its influence to encourage the reconstitution of the FSB. This reformed FSB should give all major sectors of the global financial system—capital markets, banking, and insurance—an equal role. In addition, in pursuit of global financial health, the organization's mission should be to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.

- With regard to the FSOC, Congress should enact legislation, such as H.R. 1550, the FSOC Improvement Act, to codify in statute important improvements to the SIFI designation process. In particular, ICI strongly believes that Congress must reform the FSOC's designation process 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. We suggest focusing such reforms on three critical areas:

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[57] Stevens Testimony, *supra* note 21, at 15-18 (discussing in greater detail the highly adverse consequences of inappropriate designations to investors and the capital markets). *See also* Paul Schott Stevens, *Designation's Vast Reach into Investor Portfolios,* ICI Viewpoints (March 24, 2015), available at https://www.ici.org/viewpoints/view_15_designation.

- First, the FSOC should provide notice sufficient to inform a company as to the financial stability risks that the FSOC believes the company presents.

- Second, the primary financial regulator of a company under evaluation should have a meaningful opportunity, prior to designation, to address any risks the FSOC identifies as systemic. The primary regulator generally will have greater expertise and regulatory flexibility than the FSOC to address such risks.

- Third, a company under evaluation should have an opportunity, prior to designation, to propose changes to its structure or business practices that would address the risks the FSOC has identified. This "de-risking" option, which would require the FSOC's consent, could prove to be a more direct and effective way to achieve the FSOC's goal of risk mitigation.

ICI is pleased that the House Financial Services Committee approved H.R. 1550 with a strong bipartisan vote.[58] If adopted, these measures would give the FSOC additional tools and *more* flexibility to ameliorate systemic risks. We emphasize that, if the FSOC determines that neither action by the primary regulator nor the company's de-risking proposal is sufficient, the FSOC retains the authority to move forward with a SIFI designation. Neither of those two options, moreover, interferes with the FSOC's emergency authority to designate.

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I appreciate the opportunity to share these views with the Committee. ICI looks forward to continued engagement with Congress on these important matters.

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[58] Similar provisions have been included in the Senate as part of S. 1484, the Financial Regulatory Improvement Act, and these policies have garnered bipartisan support. *See, e.g.*, Remarks by Senator Mike Crapo (R-ID) at *Oversight of the Financial Stability Oversight Council Designation Process*, Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (July 22, 2015) ("If at that point when the decision apparently has been made and the risks have been identified, the activities have been identified, shouldn't the company at that point have an opportunity to evaluate its business model and structure and determine whether to adjust it?"); Remarks by Senator Robert Menendez (D-NJ) at *FSOC Accountability: Nonbank Designations*, Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (March 25, 2015) ("what is the use of engaging with a company if it is not to both come to a conclusion as to whether it is systemically risky, what activities are systemically risky, and if it wished to avoid the designation because of the consequences that flow from that, give it the opportunity to do so? To me, that is not theoretical. It just makes common sense.").