

“Why FSOC Should Not Designate Mutual Funds as SIFIs”

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Good morning. I am Paul Atkins, CEO of Patomak Global Partners. For six years ending in 2008, I served as a Commissioner of the Securities and Exchange Commission and was a member of the Congressional Oversight Panel for TARP. I am testifying this morning on my own behalf.

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As I am sure you know, under Dodd-Frank, the FSOC has statutory authority to label entities within the financial services industry “Systemically Important Financial Institutions,” abbreviated as S-I-F-I.¹ The other day, a former Chairman of this committee, Barney Frank, quipped that “SIFFY,” as some pronounce it, sounds like a disease. He’s right – but there’s more. SIFI designation is the statutory gateway to a new level – and for some entities, a whole new *world* – of regulation by the Federal Reserve. Those are the reasons why I insist that my pronunciation – Sci-Fi’s – is necessary and correct. FSOC’s “*Sci-Fi’s*” take us way out there to a world of unreality that exists only in the fertile imaginations of an unaccountable few.

This morning, I would like to focus on the problems inherent in using the FSOC’s authority under section 113 of Dodd-Frank to designate regulated investment funds – specifically, mutual funds – as SIFIs. Section 113 makes clear that the purpose of SIFI designation is to subject designated non-bank entities to prudential supervision by the Federal Reserve in the interest of promoting the safety and soundness of the U.S. financial system. Once under the Fed’s supervisory umbrella, the non-bank financial company will be subject to any “enhanced supervision and prudential standards” that the Federal Reserve may adopt at the FSOC’s recommendation.² Once under the Fed’s regulatory umbrella, SIFI-designated funds can expect to be subjected to bank-like capital requirements.³

Therein lies the problem: One simply cannot assume that an enhanced supervisory structure designed to stabilize very large banks is equally well suited to other financial entities with radically different structures and risk profiles. Indeed, given the considerable differences in how such institutions and funds are structured and operate, one should expect that applying the same regulatory standards would yield at least some unexpected and perhaps quite undesirable outcomes. I want to

¹ Dodd-Frank Act, sec. 113.

² Dodd-Frank Act, sec. 115.

³ Dodd-Frank Act, sec. 171(b)(7).

stress that that's just as true if you are a proponent of the various initiatives taken in the Dodd-Frank Act as if – like me – you are not. Let me explain.

To date, FSOC has designated three non-bank financial companies and eight financial market utilities as SIFIs, subjecting them to the Fed's prudential supervision.⁴ Implicit in these designations, as well as in the statutory authority from which they stem, is the belief that the largest banks and non-bank financial companies share characteristics that would make the Fed's prudential supervision and capital adequacy requirements an appropriate – that is, helpful and effective – regulatory approach. The trouble with that theory is that banks and managed investment funds like mutual funds are, in *fact*, fundamentally different. To regulate them as though they were the same would be a mistake with enormous implications. Moreover, the effect of a large bank's failure on the financial system would be massively and materially different from any risks that could be created by even the largest investment fund.

Start with this: Banks take deposits; the resulting obligations are bank indebtedness. Mutual funds take investments; the investor's equity in the fund is a contractual right to a pro rata participation in the investment fund's gains and losses. Investment fund managers are in an agency relationship to their investors. They have a fiduciary obligation to their funds – with the corollary that their judgment as fiduciaries could be at odds with what an outside prudential regulator might require. Banks, unburdened by fiduciary obligations to their depositors (they act as principals) face no such potential conflict of interest.

The differences do not end there. The largest – SIFI-designated – banks, are huge; the largest U.S. “systemically important bank” has assets of \$2.4 *trillion*, and the *average* “systemically important” U.S. bank has \$1.28 *trillion* in assets. The largest regulated investment funds – all of them in the United States – are orders of magnitude smaller, averaging a relatively modest \$159 *billion*.⁵ Moreover, while banks are deeply intertwined with other key participants in the financial system, investment funds are essentially freestanding. Whatever dangers the current batch of regulators see lurking in banks' “interconnectedness” – fears which I think are overblown – certainly do *not* exist with respect to mutual funds. The point, then, is that regardless of what measure we use, putting banks and mutual funds into the same regulatory basket is to embark on a fool's errand with half a map.

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Now, I would be the first to acknowledge from long and sometimes painful experience that not everything the SEC does is wise. Nor am I here to defend the

⁴ See <http://www.treasury.gov/initiatives/fsoc/designations/Pages/default.aspx>.

⁵ See figures in App. B to ICI's April 7, 2014 letter to the Secretariat of the Financial Stability Board, at pp. B-3 - B-4 (based on 2013 data from the FDIC and Lipper), reprinted at: http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

SEC's jurisdiction. If this were some sort of "turf war," you wouldn't be hearing from me about it. Even so, there can be no question about whether the SEC is expert at regulating capital markets – *risk* markets. It *is* expert, and it has no close competition – certainly not the Fed. That's simply *not* what the Fed does – much less the FSOC. Let me take a minute to explore that with you.

The Fed, as our central bank and the nation's lender of last resort, is concerned with overall maintenance of a stable banking system. It is a *prudential* regulator concerned with the safety and soundness of the banking system and, by extension, our larger financial system. Accordingly, the Fed's core concern is with capital adequacy – whether the banking system, in which leverage is inherent, is adequately capitalized and sufficiently liquid to meet its obligations as they come due.

The SEC, by contrast, functions more like an umpire of the U.S. capital markets, with a professed goal of using both its rulemaking and enforcement authority to keep those markets free and fair. The Fed, then, is in the capital assurance business, while the SEC is overwhelmingly focused on the actions and activities of participants in U.S. capital markets. For the SEC, the liquidity of risk-taking entities is generally the issue, rather than their capitalization.

Contrast the Fed, which regulates to preferred outcomes – after all, central bankers are central *planners*. The SEC tends to train its regulatory focus on activities, setting outer limits on what capital markets participants may do and enforcing those limits as necessary – again, the capital markets' umpire at work. The point is simple: Not only is there a big difference between the Fed's objectives and expertise and that of the SEC, but the implications stemming from that difference are enormous when it comes to regulating non-bank financial entities, particularly investment funds.

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When you or I invest in a mutual fund, we buy shares in that fund; as a result, we participate in the fund's gains and losses. We can redeem our shares for whatever they happen to be worth when we elect to redeem them. But we are not assured of making a profit – or even of getting our money back. We made an investment and to that extent have put our invested funds at risk. We may – and certainly hope to – do far better than we would by putting that money into, say, a savings account. Our investment risk, in other words, correlates to our desired returns.

That's a classic, if simple, description of what happens in capital markets – investment risk correlated to potential reward. It stands in contrast to the deposit and lending model banks employ. The SEC's entire experience and focus is on maintaining free and fair capital markets, while the Fed exists to ensure the safety and soundness – the continued viability – of the banking system, although it appears

increasingly to be expanding to include *non*-banking entities. Borrowing the very apt observation Representative Garrett made in a recent speech:

“In the securities markets ... the Fed’s safety and soundness, or ‘no risk’ mandate, simply doesn’t fit. After all, investors in the securities markets can only make worthwhile returns to the extent they are willing to risk their money on companies that may or may not succeed.”⁶

There is nothing in the Fed’s 100-year history that even begins to suggest that applying prudential standards to capital markets participants would be a benefit – *or* that the Fed would in any sense be an effective capital markets regulator. It’s just not what the Fed does.

Let me pause here to acknowledge, with Commissioner Dan Gallagher of the SEC, that it doesn’t take an SEC Commissioner to explain the difference between deposits and investments. Still, he has noted, “when it comes to setting capital requirements, bank regulators seem increasingly determined to seek a one-size-fits-all regulatory construct for financial institutions.”⁷ But again, and as many have stressed, banks and investment funds are fundamentally different.

So, whatever the wisdom of designating any *bank* a SIFI and subjecting it to whatever additional capital standards or other constraints the Fed may devise in the exercise of its prudential regulation mandate, the question is why would *anyone* do the same for investment funds – *or*, for that matter, insurance companies? Let me hazard some possible answers.

First, section 113 of Dodd-Frank sets that out as the prescribed solution, thereby *making* it a good idea. And, to the extent that Dodd-Frank has been pre-sold as having solved the 2008-2009 financial crisis, its supporters have stressed the importance of implementing it fully and uncritically. There is a sort of book club mentality at work here – a sense that those in the charmed circle have figured out what was wrong and that all the benighted others should get out of the way of the prescribed solution – regardless of whether those others are independent expert agencies. Indeed, it is fair to say that Secretary Geithner’s new book carries hints of that perspective.⁸

Second, one can identify a longstanding Fed and Treasury desire to bring mutual funds under the Fed’s prudential regulation umbrella. Perhaps this is due to

⁶ Rep. Scott Garrett, Chairman, Capital Markets Subcommittee, House Committee on Financial Services, Keynote address, AEI Lunch Conference on the Designation of SIFIs by FSOC (May 6, 2014).

⁷ Commissioner Daniel M. Gallagher, Remarks given at the Institute of International Bankers 25th Annual Washington Conference, March 3, 2014, available at: <http://www.sec.gov/News/Speech/Detail/Speech/1370540869879#.U3TKMl6VgI>.

⁸ Timothy F. Geithner, *Stress Test – Reflections on Financial Crises* (2014).

their being fairly straightforward cash investments so, in that one, very limited sense, comparable to bank deposits. Imposing capital requirements and fees would raise funds for other regulatory purposes – for example, to help bail out financial institutions that are not viable. Forget the moral hazard.

Third, to the extent that implementing Dodd-Frank quickly and fully is seen as a *political* imperative, putting a dent in the fender of the largest mutual funds would, arguably, be a small thing. After all, the thinking goes, they can afford it (never mind that it's really the *investors* who will pay). And, in any event, under this rationale, whatever money is raised from whomever could perhaps be used to promote the stability of the financial system as a whole. But there's more: It would serve to vindicate the otherwise useless and sophomoric Office of Financial Research report of September 2013.⁹ Well, if *that's* your motivation – if even ill-informed change is inherently good – then no amount of data or common sense need change your mind.

Fourth, the Financial Stability Board is well on its way to promulgating an international methodology for designating “Global-SIFIs” – a completely non-transparent effort that has prompted a torrent of concerned expert commentary.¹⁰ Once final, FSB member states are, as a practical matter, very likely to see it as their obligation to implement the FSB standards. In the United States, that will involve, at a minimum, action by the SEC and perhaps other independent agencies – conceivably the CFTC, but certainly the Fed itself. And while the FSOC's ability to compel independent agencies to ratify its prefabricated policy outcomes is still very much in doubt, there can be little doubt that the current FSOC would, in fact, designate non-bank SIFIs in a manner consistent with the FSB's new methodology, whatever it may turn out to be.¹¹ This would, of course, call into question the integrity of the FSOC's own designation methodology and process, to the extent that they are ostensibly different from those of the FSB.

⁹ See, Office of Financial Research report, “Asset Management and Financial Stability,” reprinted at: http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf. This is in no sense a partisan criticism. See, e.g., singeing assessments of the OFR Report in letter to The Hon. Jacob Lew from Senators Kirk, Toomey, Moran, Carper, and McCaskill (Jan. 23, 2014), reprinted at: <http://www.sec.gov/comments/am-1/am1-36.pdf>. See also SEC Commissioner Aguilar's recent speech, “Taking an Informed Approach to Issues Facing the Mutual Fund Industry” (April 2, 2014), reprinted at: <http://www.sec.gov/News/Speech/Detail/Speech/1370541390232#.U20iEV6ViCc>, and Senator Mark Warner's recent letter to The Hon. Jacob Lew (May 9, 2014) (“report issued by OFR last September ... has come under considerable scrutiny”).

¹⁰ See comments on FSB's draft designation methodology reprinted at: https://www.financialstabilityboard.org/publications/r_140423.htm.

¹¹ These and related concerns are the subject of a May 9, 2014 letter from the Chairman and each Subcommittee Chairman of the House Financial Services Committee objecting to the non-transparency of the FSB and FSOC designation processes and requesting relevant documents from the Department of the Treasury, The Federal Reserve, and the SEC; see: http://financialservices.house.gov/uploadedfiles/05-09-14_jh-letter.pdf.

Finally, under section 113 of Dodd-Frank, SIFI designation is the height of the FSOC's mission, notwithstanding that it is easy to argue that FSOC designation of investment funds as SIFIs stems from a fundamental misunderstanding of their nature. To the proverbial policy hammer, after all, everything is a nail.

So why *not*? Well, it all comes down to this. Investment funds and banks are engaged in very different businesses that pose vastly divergent risks both to themselves and to the financial system as a whole. Apples are *not*, in *fact*, oranges, regardless of how they are described. Treating them the same is misguided. As to investment funds, it would be to impose costs without corresponding benefits. It would penalize efficiency by imposing arbitrary new costs disproportionately on the most efficient, low-cost funds – which correlate closely to the largest funds. The effect would be to introduce a wholly arbitrary and ill-founded *disincentive* to cost-minimization *throughout* the industry – with the assured result that investors in funds both large and small would, for different reasons, surely bear higher costs and suffer correspondingly lower returns on their fund investments in the future.¹²

Indeed, homogenized prudential regulation of large, albeit dissimilar, institutions in the financial services industry could have the effect of increasing, rather than reducing, aggregate systemic risk. Those similarly regulated institutions would then be susceptible to the same shocks and more likely to behave similarly in the face of the same market events and behaviors. Is that not one of the lessons of 2007-2008? Heterogeneity in the financial services industry, as in genetics, is a systemically healthy feature.

Moreover, because the largest investment funds are all U.S.-based, any added capital charges and fees the Fed might elect to impose in the name of safeguarding those funds and ensuring the financial system's safety and soundness would, in fact, amount to a competitive disadvantage to the competitiveness of U.S. funds abroad. That would be a classic "own-goal," even if it assuaged the geo-commercial consciences of those who find it awkward that the 14 largest mutual funds are all American.

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And what could the individual investor saving for retirement reap from this situation? First, higher costs and lower returns. Mutual funds don't hold or, generally, raise capital. Were the Fed to impose capital requirements on SIFI-designated funds, investors – ordinary individual investors who are saving for retirement through their 401(k) plan or for a down payment – would have to pony up. The same would be true as to any fees imposed, just as it would were funds to

¹² For a recent attempt at calculating these costs to investors, see D. Holtz-Eakin & S. Thallam, "The Investor Cost of Designating Investment Funds as Systemically Important Financial Institutions" (May 15, 2014), at: <http://americanactionforum.org/research/the-investor-cost-of-designating-investment-funds-as-systemically-important>.

seek to raise capital some other way. Likewise, if capital requirements were imposed on fund advisers, investors would ultimately pay in the form of higher fees or decreased choice. The higher fees could cause investors to withdraw their money from funds managed by SIFI-designated advisers, which could lead to the advisers dropping below the threshold that caused them to be designated in the first place. Talk about circularity.

Second, even non-SIFI investment funds would operate in a less cost-competitive environment. Higher costs for the largest U.S. funds, whose costs tend to be lower per dollar invested than smaller funds, would reduce the incentive to smaller, relatively higher cost funds to minimize their costs. Once again, investors would lose – again with no demonstrable advantage either to fund or financial system.

Third, the Federal Reserve could constrain investors' ability to redeem their shares on demand. The Fed could impose a delay on the effectiveness of an investor's redemption decision or elect to require fund managers to remain in positions they would otherwise have elected to exit. Regardless of fund or investor interests, SIFI-fund managers could be forced to finance banks or other counterparties; remain exposed to particular markets; avoid exposure to specified issuers; and to hold cash or cash equivalents. What would this do to risk management or even to liquidity in the market? How would market participants price in this uncertainty regarding the potential disposition of securities? If anything, this uncertainty would make markets *more* unstable and much more unfair for the average investor in troublesome times.

All of this would be novel and none of it would provide any advantage to the fund's investors. Indeed, such Fed impositions would likely force a conflict with the fund manager's fiduciary duties to the fund in question. Because investors in mutual funds, in particular, tend to hold their shares for the long-term and to purchase additional shares through all phases of market cycles, a fund is very unlikely to be subject to a general run and, short of that, would be highly likely to be able to meet redemption requests as usual. That was, in any event, true during the 2008-09 financial crisis – the most recent serious test to the system.

Fourth, investors in sound funds could find their funds subject to demands to support failing banks – an entirely new and unnecessary phenomenon – think of it as an investor-funded “TARPs-are-us.” So sure, one could argue that U.S. taxpayers were off the hook for bailouts, but it would be the unfortunate investors in SIFI funds – taxpayers all – whose returns would be subjected to the risk of supporting too-big-to-fail financial institutions.

That would be more tolerable were it not for the fact that investment funds are wound up and leave the business regularly, with *no* systemic consequences and *no* FDIC resolution process. During 2012 alone, 296 U.S. mutual funds were liquidated, following an orderly process involving fund manager and board decision,

approval of a plan of liquidation, payment of the fund's debts and obligations, conversion of portfolio securities to cash and payment of the proceeds to the fund's investors, followed by filing terminal financial reports and deregistration.¹³ Because of the nature of the investor's agreement with his or her fund, there is simply no need for a "bail out," nor are such funds "interconnected" with other financial institutions in any way that would impose an unsustainable burden on them. Once again, we see new costs without corresponding benefits.

It is worth stressing also that investment funds are, overwhelmingly *providers* of capital. Mutual funds, in particular, tend to carry little or no leverage. Instead, regulated investment funds generally hold long equity and debt positions through which they help capitalize companies, governments, and central banks. In sum, a mutual fund does not transmit, but *bears* counterparty risk. To that extent, at least, mutual funds are the very opposite of the sort of entity enhanced Fed supervision was designed to support pursuant to a SIFI designation.

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Much the same objections could be made to FSOC designation of large insurance companies as SIFIs. In case you missed them, I note with great concern the pointed comments that FSOC's two insurance experts made in dissenting from the FSOC's designation of Prudential Financial as a SIFI. The FSOC's non-voting State Insurance Commissioner Representative, John Huff, stressed that "[i]nsurance is not the same as a banking product" and that FSOC's designation decision "inappropriately applies bank-like concepts to insurance products and their regulation, rendering the rationale for designation flawed, insufficient, and unsupportable."¹⁴ Similarly, the FSOC's independent insurance expert, Roy Woodall, noted that the grounds for FSOC's determination "are simply not reasonable or defensible." He continued:

"No empirical evidence is presented; no data is reviewed; no models are put forward. There is simply no support to link Prudential's material financial distress to *severe* consequences to markets leading to *significant* economic damage."¹⁵

¹³ See figures in App. E to ICI's April 7, 2014 letter to the Secretariat of the Financial Stability Board, at pp. E-1 - E-2 (ICI data), reprinted at: http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

¹⁴ View of Director John Huff, FSOC State Insurance Commissioner Representative (Sept. 19, 2013), reprinted at: <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>.

¹⁵ Dissent of Roy Woodall, the FSOC's "Independent Member having Insurance Expertise" (Sept. 19, 2013), reprinted at: <http://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>.

If FSOC's cavalier treatment of the insurance industry is any precedent, we should all be extremely concerned that equally misguided and uninformed treatment of regulated investment funds – notably, mutual funds – is soon to follow.

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I cannot but conclude that the FSOC's moves to designate regulated investment funds as SIFIs are similarly without analytic foundation. Certainly, there is nothing in last September's self-serving OFR report¹⁶ to suggest otherwise. Mr. Woodall added a further point that heightens my concerns, noting that FSOC had failed to make any recommendation to the primary financial regulatory agencies¹⁷ or to the Federal Reserve under the FSOC's own Interpretive Guidance.¹⁸

Meanwhile, investment funds are thoroughly regulated by the SEC. Chair White, in fact, recently made that point while acknowledging, in response to your questions, Mr. Chairman, that the SEC has all the tools it needs to regulate investment funds.¹⁹ That certainly was my view while an SEC Commissioner. Further, I – and a large number of other former bank and capital markets regulators who signed an open letter to the *Wall Street Journal* in December²⁰ – endorse a caveat Chair White made earlier this year; she pointed out that:

“We want to avoid a rigidly uniform regulatory approach solely defined by the safety and soundness standard that may be more appropriate for banking institutions.”²¹

True. FSOC's apparent disregard for the congressionally established expert independent regulator of the mutual fund industry in favor of its own Star Chamber of politically unaccountable agency heads and Administration appointees is, in my view, exceedingly unwise.

So my bottom line this morning is two-tiered: First, I strongly question whether it is even possible to make any sense of subjecting regulated investment funds to the Fed's prudential supervision, complete with capital requirements. Second, I would like to join – if I may, Mr. Chairman – in the plea you made to

¹⁶ Office of Financial Research report, “*Asset Management and Financial Stability*,” reprinted at: http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf.

¹⁷ Citing Dodd-Frank sec. 112(k).

¹⁸ 12 C.F.R. pt. 1310, app. A (2013).

¹⁹ See transcription of Hensarling-White exchange at April 29, 2014 hearing of the House Financial Services Committee (“*Oversight of the SEC's Agenda, Operations, and FY 2015 Budget Request*”), at: http://www.ici.org/viewpoints/view_14_house_sec_hearing.

²⁰ Letter to the Editor, “*Don't Regulate Asset Managers as if They Were Banks*,” *The Wall Street Journal*, Dec. 17, 2013 (sixteen signatories), reprinted at: <http://online.wsj.com/news/articles/SB10001424052702303932504579256681029347954>.

²¹ Chair Mary Jo White, *Chairman's Address at SEC Speaks 2014* (Feb. 21, 2014), reprinted at: <http://www.sec.gov/News/Speech/Detail/Speech/1370540822127#.U20ZrV6ViCc>.

Secretary Lew at the Committee’s hearing earlier this month – that the FSOC “cease and desist” from making further SIFI designations until the Committee has had an opportunity to study the matter further.²² That, surely, is an eminently reasonable request – indeed, the very least one could ask given the major issues and enormous potential consequences entailed by proceeding further with non-bank SIFI designations.

Thank you – and I look forward to any questions the Committee may have.

²² See House Committee on Financial Services video recording of Hearing, *“The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System”* (May 8, 2014), at: https://www.youtube.com/watch?v=aju2Uz_ZNbY; see also related Committee Press Release, at: <http://financialservices.house.gov/news/documentsingle.aspx?DocumentID=379369>.