



1401 H Street, NW, Washington, DC 20005-2148, USA  
202/326-5800 [www.ici.org](http://www.ici.org)

**STATEMENT**  
**OF**  
**PAUL SCHOTT STEVENS**  
**PRESIDENT & CEO**  
**INVESTMENT COMPANY INSTITUTE**  
**BEFORE THE**  
**US SENATE**  
**COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS**  
**ON**  
**FINANCIAL STABILITY OVERSIGHT COUNCIL NONBANK DESIGNATIONS**

**MARCH 14, 2019**

## EXECUTIVE SUMMARY

- Financial stability is a matter of the utmost concern to ICI and its members. As major participants in US and global financial markets on behalf of over 100 million American investors, registered funds and their managers have every reason to support policy measures that promote the robustness and resiliency of those markets.
- Ten years after the financial crisis, the financial system clearly is more robust and resilient. ICI and its members believe that this is an appropriate time for policymakers to review post-crisis reforms and make tailored adjustments, informed by the experience of the past several years.
- Established under the Dodd-Frank Wall Street Reform and Consumer Protection Act, the Financial Stability Oversight Council (FSOC or Council) serves a valuable purpose in bringing together diverse perspectives and expertise from across the spectrum of financial regulators. This convening and coordinating power is the Council's greatest strength.
- FSOC also has the authority to designate nonbank financial companies as systemically important financial institutions (SIFIs). SIFI designation is a blunt regulatory tool, and there are numerous reasons why the Council should invoke it only in very limited circumstances—*i.e.*, when FSOC has determined that a specific company clearly poses significant risks to the financial system that cannot otherwise be adequately addressed through other means.
- ICI has supported improvements to the SIFI designation process to help avoid the risk of inappropriate designations—as would be the case if FSOC determined to proceed with the designation of a registered fund or fund manager. Such designation is unwarranted, because registered funds and their managers do not pose the risks that SIFI designation seeks to address. And it would be harmful to fund investors, because it would result in the application of ill-suited measures—such as capital requirements—designed to moderate bank-like risks. These measures would increase costs and lower returns for fund investors.
- There have been many calls for reforming FSOC and the SIFI designation process, including from members of Congress in both parties. Despite some progress, reforms are still needed in four key areas:
  - Greater engagement with a company being considered for possible designation;
  - A greater role in the process for the company's primary financial regulator;
  - More rigorous analysis of the company and its potential to pose risk to US financial system stability; and
  - Greater transparency to the financial markets and market participants.
- A November 2017 Treasury Department report took an important step in the right direction, making a series of recommendations that ICI strongly supports, including that FSOC:

- Prioritize an activities-based or industry-wide approach to addressing risks to US financial stability;
  - Increase the analytical rigor of its designation analyses;
  - Improve engagement and transparency in the designation process; and
  - Provide a clear “off ramp” for designated nonbank financial companies.
- If implemented appropriately, the Treasury recommendations will bolster substantially the effectiveness and integrity of FSOC’s work while minimizing the potential for unsound policy outcomes. Last week, FSOC released a proposal for public comment which—we were pleased to see—appears to hew closely to the Treasury recommendations. We are reviewing it carefully and look forward to submitting comments.
  - Notwithstanding the Council’s proposal, ICI continues to believe that Congress should confirm in statute that SIFI designation is intended to be a regulatory “tool of last resort.” Bipartisan legislation recently introduced by members of this Committee—Senators Mike Rounds (R-SD), Doug Jones (D-AL), Thom Tillis (R-NC) and Kyrsten Sinema (D-AZ)—would do just that.
  - S. 603, the “Financial Stability Oversight Council Improvement Act of 2019,” would add a modest but important step to the SIFI designation process. It would require that, before voting on a proposed designation, the Council must consider whether the potential threat posed by a nonbank financial company could be mitigated through other means—a different action of the Council; action by the company’s primary regulator; or action by the company itself. If the Council determines that such other means are impracticable or insufficient to mitigate the potential threat, the Council may proceed with a proposed designation.
  - ICI accordingly urges this Committee to consider S. 603 and report it favorably to the full Senate.

## I. INTRODUCTION

Financial stability is a matter of the utmost concern to ICI and its members. As major participants in US and global financial markets on behalf of over 100 million American investors, registered funds and their managers have every reason to support policy measures that promote the robustness and resiliency of those markets. Our investors are counting on their registered fund investments to help them achieve their most important financial goals, such as saving for college, purchasing a home or providing for a secure retirement.

Since the financial crisis, ICI and its members have engaged actively in US and global policy discussions concerning systemic designation of nonbank financial companies, particularly as they relate to asset management, and whether there are potential risks to financial stability from asset management products or activities. We have made detailed submissions to the Financial Stability Oversight Council (FSOC or Council), the Office of Financial Research (OFR), the Financial Stability Board (FSB) and numerous other bodies. ICI has testified before Congress on several occasions; we have engaged in extensive public commentary; and we have sought to inform the policymaking process by providing empirical research about registered funds and their investors.<sup>1</sup>

Ten years after the financial crisis, the financial system clearly is more robust and resilient. ICI and its members believe that this is an appropriate time for policymakers to review post-crisis reforms and make tailored adjustments where needed to fix unintended consequences and achieve balanced regulation. Let me underscore that point—we advocate for using the experience of the past several years to inform tailored adjustments that increase regulatory efficiency and effectiveness, not measures that would undermine the progress that has been made toward a more resilient financial system.

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), by design, provides FSOC and its member agencies with an array of regulatory tools, including SIFI designation authority. The Council, for example, has a risk monitoring mandate and the authority to identify gaps in regulation and make recommendations to financial regulators. As the Council observed in its proposal just last week on the SIFI designation process, the Dodd-Frank Act provided FSOC with broad discretion as to how to employ its range of authorities.

This Committee held a hearing four years ago to examine the SIFI designation process and consider ways to improve transparency and accountability. Testifying at that hearing, I advised that, to truly advance financial stability, that process must be open to the public, analytically based, and grounded in the historical record. I reiterate that message in my testimony today. Indeed, these principles should apply not just to SIFI determinations but across the whole of FSOC's work.

---

<sup>1</sup> A compendium of selected ICI work on financial stability (with links to comment letters, speeches, research papers, Congressional testimony and other commentary) is available at [https://www.ici.org/pdf/misc\\_18\\_financial\\_stability\\_compendium.pdf](https://www.ici.org/pdf/misc_18_financial_stability_compendium.pdf).

In 2017, the Treasury Department issued a thoughtful and thorough report that included specific recommendations on how to recalibrate the SIFI designation process. The report also considered—appropriately, in my view—how the SIFI designation process should fit into the broader context of the Council’s authorities and recommended in effect that SIFI designation be a regulatory tool of last resort. FSOC has now issued a proposal to implement the Treasury recommendations. Based on our preliminary review, there is much to commend in the proposal. ICI will evaluate the proposal closely in consultation with our members, and we look forward to commenting on behalf of the registered fund industry.

Even if FSOC adopts such reforms, as we hope it will, ICI firmly believes that legislation is necessary to provide a more durable solution. We believe Congress should confirm that SIFI designation of nonbank financial companies should be used by the Council only in rare circumstances, where no other regulatory action suffices to address the potential risk to financial system stability. So long as FSOC’s statutory authority remains unchanged, nonbank financial companies (including regulated funds and their managers) will continue to face the risk, even if remote, of inappropriate SIFI designation.

In Section II, we discuss the limitations of SIFI designation and why its use should be reserved for extraordinary circumstances. We note our continuing concern that FSOC at some future time might proceed with the designation of a registered fund or fund manager, and we describe why this course of action would be unwarranted and harmful to fund investors. In Section III, we explain that reform of the SIFI designation process is necessary in several key areas: greater engagement with a company being considered for possible designation; a greater role in the process for the company’s primary financial regulator; more rigorous analysis of the company and its potential to pose risk to US financial system stability; and greater transparency to the financial markets and market participants. In Section IV, we discuss the Treasury Department’s 2017 recommendations for improving the SIFI designation process and FSOC’s proposal, issued just last week, to implement those recommendations. We also observe that the global Financial Stability Board likewise is considering improvements in how it conducts its work, following a review of its processes and transparency. In Section V, we urge the Committee’s support for legislation to confirm that SIFI designation is intended to be a regulatory “tool of last resort.” Finally, Section VI briefly outlines our recommendations for Congress.

## **II. SIFI DESIGNATION IS A BLUNT REGULATORY TOOL, AND ITS USE SHOULD BE RESERVED FOR EXTRAORDINARY CIRCUMSTANCES**

ICI’s support for improving the US government’s capability to monitor and mitigate risks across the financial system—including by creating a new council of financial regulators—dates from the beginning of the legislative debate over financial services regulatory reform in the wake of the financial crisis.<sup>2</sup> Then, as now, we saw the value of bringing together diverse perspectives and expertise from across the spectrum of financial services to consider emerging risks. The

---

<sup>2</sup> See, e.g., Testimony of Paul Schott Stevens, President and CEO, ICI, Before the Committee on Banking, Housing, and Urban Affairs, United States Senate, on Establishing a Framework for Systemic Risk Regulation (July 23, 2009).

coordination of regulatory policies is altogether important in light of the size and complexity of the financial system and the sheer number of government entities involved in overseeing it. Ever since Congress created FSOC as part of Title I of the Dodd-Frank Act, we have continued to believe that the convening and coordinating power of the Council is its greatest strength.

Title I also gave FSOC the authority to designate nonbank financial companies as SIFIs, and our early views concerning the use of this power likewise remain unchanged.<sup>3</sup> It is fundamentally important to view SIFI designation authority in context—recognizing that it is just one regulatory tool among many afforded to financial regulators under the Dodd-Frank Act to address abuses and excessive risk taking by financial market participants, and that in many cases such designation is merely an addition to other pre-existing powers. We continue to emphasize to the Committee that there are numerous reasons why the Council should invoke this extraordinarily potent, but blunt, legal authority only in very limited circumstances. As we indicated previously, these reasons include:

- The inherent difficulty of trying to predict *in advance* whether a given nonbank financial company is, or may prove to be, systemically significant
- The potential mismatch between the remedies that the Dodd-Frank Act prescribes for designated companies (*i.e.*, consolidated supervision by the Federal Reserve Board and enhanced prudential standards, such as capital requirements, that largely reflect banking regulation concepts) and the risks that FSOC has identified as the basis for designation<sup>4</sup>
- Uncertainty about the reaction of markets and market participants to a company's designation—which could result in a competitive advantage, or disadvantage, for the company
- Increased moral hazard, if market participants succumb to the temptation to relax their own due diligence with respect to a designated company based on the expectation that the government is monitoring and preventing risks
- Reduced competition and consumer choice—for example, if companies exit certain businesses, or reduce their participation in those businesses, to avoid designation by FSOC

To the preceding list, we would add that SIFI designation authority necessarily requires FSOC to single out individual companies—even though other companies may have similar structures or engage in similar activities. As all this suggests, there is and should be a very high bar for determining that a single company has the potential to threaten the stability of the US financial system.

---

<sup>3</sup> See, e.g., Letter from Paul Schott Stevens, President & CEO, ICI, to FSOC, dated Nov. 5, 2010, available at <https://www.ici.org/pdf/24696.pdf>.

<sup>4</sup> We elaborate on this point later in this section of the testimony.

These challenges, potential negative consequences, and shortcomings of the SIFI designation tool are why we repeatedly have advised that the use of this tool should be reserved for extraordinary circumstances. By this, we mean those (presumably quite limited) circumstances when FSOC has determined that a specific company clearly poses significant risks to the financial system that cannot otherwise be adequately addressed through other means. Moreover, use of the tool should reflect FSOC’s determination that the regulatory regime presented by Title I of the Dodd-Frank Act is the appropriate response to address the identified risks.

Our long-standing position is in line with views expressed by senior government officials directly involved in the formation of FSOC and its early years of operation. With foresight, as we have noted previously, former Federal Reserve Board Chairman Ben Bernanke expressed his expectation that use of the SIFI designation tool would be limited.<sup>5</sup> And in hindsight, former Treasury Under Secretary for Domestic Finance Mary Miller recently lamented that she now believes that during the time she was involved, FSOC spent too much time on designations and not enough on regulatory coordination.<sup>6</sup>

Underpinning our views about limiting the use of SIFI designation is the simple notion that FSOC’s primary goal should be to reduce systemic risk, and that there can be more effective, less burdensome, and/or more expedient ways to do so. Even those who argue for broader use of SIFI designation as a regulatory tool acknowledge that it is not a panacea.<sup>7</sup>

---

<sup>5</sup> During a Congressional hearing in connection with the development of the Dodd-Frank Act, Chairman Bernanke was asked expressly for his views on the number of firms that might be considered to be “systemically significant, too big to fail, too interconnected to fail.” He responded: “A very rough guess would be about 25. But I would like to point out that virtually all of those firms are organized as bank holding companies or financial holding companies, which means the Federal Reserve already has umbrella supervision. So, I would not envision the Fed’s oversight extending to any significant number of additional firms.” See Regulatory Perspectives on the Obama Administration’s Financial Regulatory Reform Proposals, Part II: Hearing before the House Committee on Financial Services (Serial No. 111-68), 111th Congress (2009), p. 47 (question by Rep. Campbell).

<sup>6</sup> Remarks by Mary Miller at *Functions and Firms: Using Activity and Entity-based Regulation to Strengthen the Financial System*, conference co-sponsored by the Office of Financial Research and the University of Michigan Center on Finance, Law and Policy (Nov. 15-16, 2018, Washington DC) (Functions and Firms Conference) (“...with the hindsight of now four years out of the government and back in the real economy and Main Street, I would say that we probably spent too much time on the designation work and not enough time on another very important role that FSOC can play, which is regulatory coordination. And I think if we could have done that differently we would have moved some things through the pipeline sooner, we might have gotten more buy-in on some very important concepts that followed the financial crisis that we should have jumped on....”), available at <http://financelawpolicy.umich.edu/conferences/functions-and-firms-using-activity-and-entity-based>, video for day 2, panel 6 at approximately 12:35 to 13:10. See also *Is Dodd-Frank oversight council still relevant?* by John Heltman, *American Banker* (March 5, 2019) (noting the observation by former Treasury official David Portilla that FSOC’s success “will be in the power of convening the body and ensuring the regulators talk to each other and are sharing information and... not leaving [risks] unaddressed.”).

<sup>7</sup> A key “takeaway” from the discussion at the Functions and Firms Conference was that several of the participants view activities-based and entity-based approaches as complementary—as even the full name of the conference suggests. See conference video, *supra* note 6.

## **Designation of a registered fund/fund manager would be unwarranted and harmful to fund investors**

ICI and its members consistently have called for improvements to the SIFI designation process that will help avoid the risk of inappropriate designations. We remain concerned that FSOC at some future time might proceed with the designation of a registered fund or fund manager. Why would such a designation be inappropriate? Because registered funds don't fail like banks do—fund investors bear any investment losses, so there's no need for a government bailout.<sup>8</sup> Unlike banks, fund managers act solely as agents, providing investment services to a fund by contract. The registered fund structure and comprehensive regulation of funds and their managers under the federal securities laws already limit risks and risk transmission. And, as more than seven decades of historical experience demonstrates, registered fund investors do not panic or redeem heavily in the face of market downturns or turmoil.<sup>9</sup>

Testifying in the House of Representatives five years ago, William McNabb, then ICI Chairman and Chairman & CEO of the Vanguard Group, pointed to press reports that FSOC was evaluating two large asset management firms for possible designation. He warned:

If the FSOC continues down this path, it could result in extension of the Federal Reserve's supervisory authority to companies whose business is rooted in the capital markets and which the Federal Reserve does not have the expertise to regulate. And it could mean the application of bank regulatory standards that are entirely out of keeping with the way in which [registered] funds and their managers are structured, operated and currently regulated and with the expectations of investors and the capital markets.<sup>10</sup>

It is important for the Committee to bear in mind what is at stake. Of greatest concern are the harms that SIFI designation would bring to fund investors by applying measures that are designed to moderate bank-like risks and are ill-suited to registered funds and their managers. These measures include capital and liquidity requirements, along with prudential supervision by the Federal Reserve Board. Designated funds or managers also would have to pay additional fees or assessments to defray Federal Reserve supervisory costs and FSOC and OFR expenses. And a designated fund could be assessed to cover costs associated with the resolution of a distressed financial institution deemed systemically important. Stated more plainly, this means that fund investors could have to help bail out a distressed, “too big to fail” financial institution—even

---

<sup>8</sup> See, e.g., Investment Company Institute, “Orderly Resolution” of Mutual Funds and Their Managers July 15, 2014), available at [https://www.ici.org/pdf/14\\_ici\\_orderly\\_resolution.pdf](https://www.ici.org/pdf/14_ici_orderly_resolution.pdf).

<sup>9</sup> For more detail on this experience, see *Regulated Fund Shareholders' Reaction to Market Turmoil, 1944-January 2019*, at Appendix A to this testimony.

<sup>10</sup> See Statement of F. William McNabb III, Chairman and CEO, The Vanguard Group, and Chairman, ICI, on Examining the Dangers of the FSOC's Designation Process and Its Impact on the US Financial System ((May 20, 2014) at 2, available at [https://www.ici.org/pdf/14\\_house\\_fsoc.pdf](https://www.ici.org/pdf/14_house_fsoc.pdf). The testimony highlights several ways in which registered funds and their managers are fundamentally different from banks. It explains why SIFI designation of a fund manager is unwarranted and why even the very largest registered funds likewise are not SIFIs. And it discusses the investor harm and market distortion that would stem from such a SIFI designation.

though a major goal of the Dodd-Frank Act was to prevent “Main Street” from having to bail out “Wall Street.”

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 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.<sup>11</sup>

While the prospect of such an ill-suited designation does not currently loom as large as it did in 2014, there are improvements that can be made to the SIFI designation process and to the Council’s designation authority that would help avoid such an outcome in the future. I discuss those areas for improvement in the remainder of my testimony.

### **III. THE SIFI DESIGNATION PROCESS SHOULD BE REDESIGNED IN LIGHT OF “LESSONS LEARNED”**

Calls for reform of the SIFI designation process are not new. And these calls have not come just from industry stakeholders. They have come from the Government Accountability Office, in reports dating back to 2012.<sup>12</sup> They have come from Republican and Democratic members of Congress in letters to FSOC.<sup>13</sup> And they have come most emphatically from members of the House of Representatives from both parties, with the April 2018 passage of H.R. 4061, the FSOC Improvement Act, by a bipartisan vote of 297 to 121.

The Council itself has recognized shortcomings in its own process. By this, I do not mean just the current FSOC, but also the Council as constituted under the prior Administration. In November 2014, just two and a half years after adopting its rule and guidance outlining the designation process, FSOC staff convened roundtable discussions including academics and various stakeholders, including ICI. In early 2015, FSOC principals endorsed a set of

---

<sup>11</sup> See Statement of Paul Schott Stevens, President & CEO, ICI, on FSOC Accountability: Nonbank Designations (March 25, 2015) (“2015 FSOC Testimony”), available at [https://www.ici.org/pdf/15\\_senate\\_fsoc.pdf](https://www.ici.org/pdf/15_senate_fsoc.pdf), 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](https://www.ici.org/viewpoints/view_15_designation).

<sup>12</sup> See, e.g., 2015 FSOC Testimony at note 4.

<sup>13</sup> *Id.* at note 3.

“supplemental procedures” designed to improve the Council’s engagement with companies and other regulators and increase transparency to the public.<sup>14</sup>

In my 2015 FSOC Testimony, I explained that ICI welcomed those changes as an initial positive first step toward providing greater fairness and clarity in the designation process. But I also advised that more needed to be done to achieve that goal.

My message today, four years later, is much the same. The SIFI designation process is still in need of reforms in several key areas:

- greater engagement with a company being considered for possible designation;
- a greater role in the process for the company’s primary financial regulator;
- more rigorous analysis of the company and its potential to pose risk to US financial system stability; and
- greater transparency to the financial markets and market participants.

I discuss each of these areas briefly below.

### **Greater engagement with a company being considered for possible designation**

Meaningful dialogue between a company being considered for SIFI designation and FSOC and its staff is of utmost importance. To be meaningful, such a dialogue needs to begin as early as possible in the process. If a company is given an early indication as to why FSOC has selected it for review, the company is in a position to provide pertinent information about its business, structure and operations. With a more complete picture of the company and its risk profile, the Council and its staff can engage in a more informed review of the company or determine that no further investigation is necessary. This benefits FSOC by allowing it to make smart use of its limited resources, and it provides a fairer process for the company.

To its credit, FSOC recognized early on the value of more robust engagement with companies under review. Its 2015 supplemental procedures include several measures designed to increase communications with the company at various stages of the designation process. But these are not guaranteed protections, because FSOC issued them informally. Unless and until FSOC incorporates these procedures into its interpretive guidance through a public notice and comment

---

<sup>14</sup> See FSOC, Supplemental Procedures Relating to Nonbank Financial Company Determinations (Feb. 4, 2015), available at <https://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf>.

process, they will remain “supplemental” and thus subject to amendment or rescission at the Council’s discretion.<sup>15</sup>

### **Greater role for the company’s primary financial regulator**

The current process calls for consultation with a company’s primary financial regulator prior to any final designation of the company. This is merely a recitation of the requirement in Section 113(g) of the Dodd-Frank Act. The supplemental procedures contemplate that the Council will notify and consult with the primary regulator at an earlier stage of the process but, as mentioned above, those procedures are not currently incorporated into the existing guidance and thus are subject to amendment or rescission at the Council’s discretion.

ICI strongly believes that the designation process should expressly require early and robust involvement by the primary regulator. A company’s primary financial regulator has its own regulatory tools, some of which may provide another, possibly better avenue to address identified risks than SIFI designation. In addition, a primary financial regulator can evaluate whether an identified risk at one company exists more broadly and therefore would be more effectively handled on an industry-wide or cross-industry basis.

Working with a primary financial regulator in this manner gives FSOC more flexibility to address identified risks. Importantly, FSOC would retain control of the designation process and would still be able to make systemic designations when necessary.

### **More analytical rigor & attention to actual experience**

It has long been ICI’s view that such an important and consequential regulatory decision as SIFI designation must be based on a robust, empirical analysis that considers all of the factors that Congress enumerated in Section 113 of the Dodd-Frank Act, including the degree to which a firm is already regulated and the prospects of using that pre-existing regulatory structure to address perceived risks. In my 2015 FSOC Testimony, I called for this analysis to be thorough and objective, and to include consideration of the company’s structure, activities and historical experience. I also observed that requiring a consideration of the costs and benefits of designation would put the Council’s decision making on par with the Administrative Procedure Act’s requirements for significant rulemakings and the Obama Administration’s executive orders regarding rulemaking processes.<sup>16</sup>

---

<sup>15</sup> Last week, FSOC adopted a rule stating that the Council shall not amend or rescind its interpretive guidance on nonbank financial company determinations, which appears in Appendix A to 12 CFR part 1310, without providing the public with notice and an opportunity to comment consistent with the Administrative Procedure Act. FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, RIN 4030-AA03 (March 6, 2019), available at <https://home.treasury.gov/system/files/261/Final-Rule-Regarding-Notice-and-Comment.pdf>. The 2015 supplemental procedures are not part of Appendix A to 12 CFR part 1310.

<sup>16</sup> Exec. Order No. 13563, 76 Fed. Reg. 3821 (Jan. 21, 2011) (requiring certain agencies to engage in cost-benefit analysis before rulemaking); Exec. Order 13579, 76 Fed. Reg. 41585 (July 14, 2011) (encouraging independent regulatory agencies to engage in cost-benefit analysis before rulemaking).

Regrettably, the Council’s analysis in many instances has fallen well short of these standards. This was seen, for example, in the Council’s stated basis for designating Prudential Financial, Inc. as a SIFI in 2014. The independent member with insurance expertise on the Council at the time, Roy Woodall, dissented from that decision, observing that FSOC’s “underlying analysis utilizes scenarios that are antithetical to a fundamental and seasoned understanding of the business of insurance, the regulatory environment, and the state of insurance company resolution and guaranty fund systems.”<sup>17</sup>

The same has been true outside the SIFI context. Following a lengthy review of asset management products and activities, the Council released an April 2016 public update discussing what it found to be financial stability risks stemming from liquidity and redemption risks in mutual funds, particularly in funds invested in less liquid assets. ICI was disappointed by the Council’s findings, because they largely ignored the extensive data and analysis that ICI and other commenters had provided to the Council in early 2015 on these very questions. ICI’s letter highlighted the tremendous growth in both stock and bond funds since the mid-1940s, the several episodes of severe market stress occurring over the same seven decades—and the lack of any empirical evidence of destabilizing redemptions by stock and bond funds during those episodes. ICI’s 2015 letter also explained *why* the historical data paint a consistent picture—*i.e.*, because mutual funds’ historical experience is grounded in their comprehensive regulatory framework, the nature of their investor base, and the realities of fund portfolio management.<sup>18</sup> In announcing its findings of potential financial stability risks, however, the Council cited *no* evidence that long-established, historical patterns of mutual fund investor behavior have changed or are likely to do so. In effect, its observations about “the potential for outflows [from mutual funds] to cause fund distress, and hence broader stress” amounted to mere conjecture.

To underscore the importance of rigorous empirical analysis as a basis for sound policymaking, ICI undertook a case study of the scenario that seemed to concern FSOC the most—the prospect of destabilizing redemptions from mutual funds invested in less liquid assets. Using publicly available data about high-yield bond funds and their experience from early 2014 to early 2016 (a period that included significant stress in the high-yield bond market), ICI’s chief economist tested the predictions about destabilizing redemptions that had been suggested by the Council and by other policymakers and academics. The result? Contrary to those predictions, the data show that investors were purchasing (as well as selling) shares in high-yield bond funds, and in the underlying bonds, during this period of market stress. And, on a net basis, trading volumes of high-yield bonds actually *rose* when the high-yield bond market was under the greatest degree of

---

<sup>17</sup> See “Views of the Council’s Independent Member Having Insurance Expertise” (Sept. 19, 2013), available at <https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf>.

<sup>18</sup> See, *e.g.*, Letter to FSOC from Paul Schott Stevens, President & CEO, ICI, dated March 25, 2015 (“March 2015 Letter”), available at [https://www.ici.org/pdf/15\\_ici\\_fsoc\\_ltr.pdf](https://www.ici.org/pdf/15_ici_fsoc_ltr.pdf). As explained in detail on pages 14-36 of the letter, the “realities” of registered fund portfolio management include the following: funds have sources of cash to meet redemptions, other than through sales of portfolio assets; funds typically have multi-faceted liquidity management practices; portfolio rebalancing in accordance with stated investment strategies helps keep funds’ cash ratios relatively stable, irrespective of market events; and funds can vary their purchases and sales of portfolio securities to accommodate redemptions.

stress. We submitted this analysis to the Council and urged it to reexamine its hypotheses about mutual funds in accordance with ICI's findings.<sup>19</sup>

Fortunately, recent analyses by the Council appear to be putting greater weight on evidence and less on conjecture. In its 2017 decision to rescind the designation of American Insurance Group (AIG), for example, the Council made clear that it had re-examined one of its key theories. When FSOC designated AIG as a SIFI, one of the arguments it used was that if AIG ever came under financial distress, "there could be a forced, rapid liquidation of a significant portion of AIG's assets as a result of [insurance] policyholder surrenders or withdrawals that could cause significant disruptions to key markets, including corporate debt and asset-backed securities markets." In other words, the Council postulated that if AIG experienced financial distress, its policyholders *could* behave like depositors at a bank, causing a "run" on AIG that would cascade through the financial markets. But in determining to rescind AIG's designation, the Council reconsidered that view. Based upon "additional consideration of incentives and disincentives for retail policyholders to surrender policies, including analysis of historical evidence of retail and institutional investor behavior," the Council determined that there was "not a significant risk that asset liquidation by AIG would disrupt trading in key markets or cause significant losses or funding problems for other firms with similar holdings."<sup>20</sup> ICI welcomes this development, because more precise and accurate analysis is essential to sound policy outcomes.

### **Greater transparency to financial markets and market participants**

In the four cases in which FSOC voted to designate a nonbank financial company as a SIFI, the company received a lengthy, detailed report discussing FSOC's findings and conclusions, and only a very abbreviated summary was made available to the public. These summaries did not give other companies and the broader public sufficient insight into FSOC's concerns about systemic risk or the business practices giving rise to those risks. ICI has long believed that a more detailed public report—perhaps a redacted version of FSOC's report to the company—could offer these insights while still maintaining the confidentiality of sensitive, proprietary information about the designated company.

Greater transparency from FSOC also would be helpful in areas other than SIFI designation, and we have two suggestions to offer in that regard. First, while we welcome FSOC's practice of issuing prompt "readouts" after closed-door meetings, the readouts and subsequent minutes from those meetings provide the public with little insight into FSOC's observations and areas of focus or concern. ICI recommends that FSOC release detailed minutes shortly after its closed meetings, as is the practice of the Federal Reserve Board's Federal Open Market Committee.

---

<sup>19</sup> For further detail, see Letter from Paul Schott Stevens, President & CEO, ICI, to FSOC, dated July 18, 2016 (commenting on FSOC Update on Review of Asset Management Products and Activities), and accompanying analysis in Appendix B to the letter, available at [https://www.ici.org/pdf/16\\_ici\\_fsoc\\_ltr.pdf](https://www.ici.org/pdf/16_ici_fsoc_ltr.pdf).

<sup>20</sup> For further detail, see Sean Collins, *Applying Evidence to Theories on Regulated Funds*, ICI Viewpoints (Oct. 12, 2017), available at [https://www.ici.org/viewpoints/view\\_17\\_fsoc\\_aig](https://www.ici.org/viewpoints/view_17_fsoc_aig).

Second, as a matter of good government, FSOC should inform the public about which staff members at the different agencies are involved in FSOC work. This information, which is not currently available, would promote engagement by stakeholders and other interested parties with the appropriate staff members on issues relevant to the FSOC agenda. Among other benefits, such engagement can provide educational opportunities and information resources to staff of agencies that do not otherwise possess expertise with respect to a particular financial industry sector.

#### **IV. PROPOSED REFORMS WOULD PROMOTE FSOC’S PURSUIT OF ITS MISSION**

As we have established, there has been growing recognition of the continuing need for reforms to address the areas highlighted above. Recent developments in this regard are significant and promising. Most notably, in November 2017, the US Treasury Department published a report making recommendations for improving FSOC’s nonbank SIFI designation process (FSOC Report).<sup>21</sup> And at an open meeting just last week, FSOC voted to issue for public comment a proposal to implement those recommendations and other changes.<sup>22</sup> There also are encouraging signs in the global financial stability policy realm—a related area of interest to the Committee.<sup>23</sup> We discuss these developments below.

##### **FSOC Report**

ICI welcomed the release of the FSOC Report as an important step in the right direction.<sup>24</sup> This thorough and thoughtful report reviews the purposes, composition, and authorities of the Council and articulates five policy goals—in our view, laudable and appropriate ones—that Treasury believes FSOC’s processes should be designed to achieve:

- Leverage the expertise of primary financial regulatory agencies;
- Promote market discipline;
- Maintain a level playing field among firms;

---

<sup>21</sup> Department of the Treasury, Financial Stability Oversight Council Designations (Nov. 2017), available at <https://www.treasury.gov/press-center/press-releases/Documents/PM-FSOC-Designations-Memo-11-17.pdf>. The report came in response to a Presidential Memorandum that is available at <https://www.whitehouse.gov/the-press-office/2017/04/21/presidential-memorandum-secretary-treasury>.

<sup>22</sup> FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, RIN 4030-ZA00 (March 6, 2019) (FSOC Proposal), available at <https://home.treasury.gov/system/files/261/Notice-of-Proposed-Interpretive-Guidance.pdf>.

<sup>23</sup> For example, in July 2015, the Committee held a hearing on “The Role of the Financial Stability Board in the US Regulatory Framework” at which I testified. See <https://www.banking.senate.gov/hearings/the-role-of-the-financial-stability-board-in-the-us-regulatory-framework>.

<sup>24</sup> See ICI News Release, *ICI Applauds FSOC Reforms of SIFI Designation Process* (March 6, 2019), available at [https://www.ici.org/pressroom/news/19\\_news\\_sifi](https://www.ici.org/pressroom/news/19_news_sifi).

- Appropriately tailor regulations to minimize burdens; and
- Ensure the Council’s designation analyses are rigorous, clear, and transparent.

The report discusses the effects and efficacy of nonbank financial company designations in achieving the Council’s purposes. It acknowledges many of the concerns ICI and others have been raising for almost a decade and offers a series of constructive recommendations for improvements. The recommendations and related discussion in the report reflect a solid understanding of the lessons learned from experience to date and seek to address the areas highlighted in the previous section of this testimony.

The FSOC Report followed on the heels of another Treasury Department report—one that reviewed the US regulatory structure for asset management and insurance (Asset Management Report).<sup>25</sup> Consistent with ICI’s long-held views, the Asset Management Report acknowledged that entity-based systemic risk evaluations generally are not the best approach for mitigating risks arising from asset management. Presaging aspects of the FSOC Report, Treasury recommended that federal regulators focus on risks arising from asset management products and activities and on implementing regulations that strengthen the asset management industry as a whole.

For its part, the FSOC Report recommends that FSOC:

- ***Prioritize an activities-based or industry-wide approach to addressing risks to US financial stability.*** The report indicates that prioritizing an activities-based approach would have many benefits. It would: (a) enable FSOC to “identify the underlying sources of risks to financial stability, rather than addressing risks only at a particular nonbank financial company”; (b) “address some of the potential limitations that could arise from designations” (e.g., competitive disadvantages and unnecessarily burdensome regulatory requirements); and (c) “preserve the option to consider designation in the rare instance, such as the historical case of Fannie Mae and Freddie Mac, where it was clear that individual institutions could pose a threat to financial stability, but a primary regulator has not taken or cannot take adequate steps to address the risk.”<sup>26</sup>
- ***Increase the analytical rigor of designations analyses.*** The report recognizes the “considerable and continuing uncertainty among market participants about how the Council makes its decisions, which factors the Council views as most relevant in identifying a company that could pose risks to financial stability, and how a company can

---

<sup>25</sup> Department of the Treasury, A Financial System That Creates Economic Opportunities: Asset Management and Insurance (Oct. 2017), available at [https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset\\_Management-Insurance.pdf](https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf). The report made recommendations—including with respect to asset management and systemic risk—to better align the current regulatory structure with the Administration’s “Core Principles” for regulation of the US financial system. Exec. Order No. 13772 (Feb. 3, 2017).

<sup>26</sup> FSOC Report at 19.

take action to avoid designation.”<sup>27</sup> According to the report, increased analytical rigor would promote certainty in FSOC’s conclusions and increase transparency to firms and the public. The report makes several specific recommendations in this regard, including that FSOC evaluate the likelihood of the company’s material financial distress as a threshold question and conduct a cost-benefit analysis.

- ***Improve engagement and transparency in the designation process.*** The report recommends enhancements to FSOC’s engagement with companies under review, engagement with primary regulators, and public transparency.
  - *Engagement with Companies Under Review.* The report recommends that FSOC explain to a company at an earlier stage the key risks that have been identified. The report notes: “[i]f a company is aware of the potential risks the Council has identified during its preliminary review, the company can take action to mitigate those risks” prior to designation, thus helping achieve the goal of addressing potential risks to US financial stability.<sup>28</sup>
  - *Engagement with primary regulators.* The report describes several benefits of deep engagement with a nonbank financial company’s primary financial regulator and recommends that FSOC (i) actively solicit the regulator’s views regarding risks at the company and potential mitigants, (ii) share its preliminary views regarding potential risks at the company, and request that the regulator provide information regarding those risks and whether they are adequately mitigated, e.g., by existing regulation or the company’s business practices, and (iii) during the designation process, continue to encourage the regulator to use its existing authorities to address any risks to US financial stability.
  - *Public transparency.* The report recommends that FSOC release publicly the full explanation of its basis for any future nonbank financial company designations or rescissions of designations (redacting confidential information), to give the public the greatest possible understanding of FSOC’s reasons for its actions.
- ***Provide a clear “off ramp” for designated nonbank financial companies.*** The report recommends, for example, that FSOC’s explanation of the final basis for any designation highlight the key risks that led to the designation and the factors that were most important, which would make clear to the company the steps it could take to address the Council’s concerns.

ICI strongly supports the Treasury recommendations. If implemented appropriately, they will bolster substantially the effectiveness and integrity of FSOC’s work while minimizing the potential for unsound policy outcomes.

---

<sup>27</sup> FSOC Report at 23.

<sup>28</sup> *Id.* at 30.

## **FSOC Proposal**

Since the release of the Treasury FSOC Report, ICI and its members have been urging prompt action to implement the recommendations. At the same time, we recognize that the subject matter is complex and determining how to implement the recommendations effectively and appropriately—and to the satisfaction of the range of FSOC members—involves challenges. Further, we commend FSOC for making known early on its intent to handle this matter through a notice and comment process. Given the important themes underlying many of the recommendations, FSOC should proceed in a transparent and accountable manner.

Consistent with its plan, FSOC last week proposed for public comment revised guidance to govern the nonbank SIFI designation process.<sup>29</sup> ICI is reviewing the proposal carefully and looks forward to submitting comments. Our preliminary reaction is very positive, as it appears that FSOC has hewed closely to the recommendations in the Treasury report. Under the proposal:

- FSOC has firmly committed to addressing risks through an activities-based approach and would only consider designating entities as SIFIs as a last resort—as we have long urged.
- If FSOC did decide to pursue designation, that process would be more transparent, accountable, and rigorous.
- The proposed changes seek to facilitate more constructive—and appropriate—engagement between nonbank financial companies and the Council.
- The proposed changes would elevate the crucial role of primary regulators, who are best suited to work with the company under review to mitigate potential risks before imposing the costly burden of SIFI designation.

For the benefit of the Committee, we include a more detailed summary of the FSOC proposal in Appendix B.

## **Similar recalibration at FSB**

In testimony before this Committee in July 2015, I discussed the role of the FSB in the US regulatory framework.<sup>30</sup> Like FSOC, as part of its post-crisis agenda, the FSB trained its focus on the asset management sector and on large registered US funds and fund managers. At first, the FSB set out to develop methodologies to identify global systemically important funds or fund managers, closely following a pattern it had established in the banking and insurance sectors. It later put this work on pause while conducting a review of potential “structural vulnerabilities” in asset management. My testimony illustrated that the work of the FSB related to asset management exhibited many of the same fundamental problems that have pervaded FSOC’s

---

<sup>29</sup> FSOC Proposal, *supra* note 22. FSOC also adopted a rule requiring that any future changes to the guidance be subject to a notice and comment process. *See supra* note 15.

<sup>30</sup> *See* Statement of Paul Schott Stevens, President & CEO, ICI on The Role of the Financial Stability Board in the US Regulatory Framework (July 8, 2015), available at [https://www.ici.org/pdf/15\\_senate\\_banking\\_fsb.pdf](https://www.ici.org/pdf/15_senate_banking_fsb.pdf).

work.<sup>31</sup> These problems included: a tendency to view the asset management sector through a banking lens; an inadequate role for subject matter experts; reliance on conjecture and theory rather than empirical data and actual experience; indications that desired results, rather than the public record, might be driving the FSB’s work; and insufficient transparency and accountability in the FSB’s consultation and designation process.

I am pleased to report some signs of progress on the FSB front. For example, consistent with ICI’s urging, the FSB properly entrusted the implementation of several of the policy recommendations that emerged from its asset management review to the International Organization of Securities Commissions (IOSCO)—a body with a deep well of relevant subject matter expertise.

More generally, late last year, after conducting a review of its processes and transparency, the FSB agreed to take certain actions—including actions to improve communication and engagement with external stakeholders along the lines ICI has recommended.<sup>32</sup> In addition, the FSB has turned some of its focus to evaluating the effectiveness and efficiency of reforms that have been implemented and considering whether any adjustments are needed.

Some of these changes appear to reflect the direction in which the new FSB chairman, Federal Reserve Board Vice Chairman for Supervision Randal Quarles, is seeking to steer the organization. Based on his recent inaugural speech as FSB chairman, there is reason to be encouraged.<sup>33</sup> His remarks focused on the core principles he believes should guide the FSB’s future work: engagement, including improved outreach and transparency with a broad range of constituencies; rigor, so that assessment of financial sector vulnerabilities is based on “cutting edge thinking and a disciplined methodology”; and analysis, including critical analysis of the effects of reforms to determine if there are improvements that can be made—for example, to achieve resiliency in less burdensome and more efficient ways.

I believe Chairman Quarles’s leadership and policy approach will serve the interests of all who participate in and benefit from a robust financial system, including millions of Americans who invest in registered funds to meet their most important financial goals.

---

<sup>31</sup> For details, *see id.* *See also* Statement of Paul Schott Stevens, President & CEO, ICI, 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 (Sept. 27, 2016), available at [https://www.ici.org/pdf/16\\_house\\_fsc\\_fsb.pdf](https://www.ici.org/pdf/16_house_fsc_fsb.pdf).

<sup>32</sup> *See* Letter from Paul Schott Stevens, President & CEO, ICI, to the Secretariat of the FSB, dated Sept. 21, 2016 (responding to Consultative Document; Proposed Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities), available at [https://www.ici.org/pdf/16\\_ici\\_fsb\\_ltr.pdf](https://www.ici.org/pdf/16_ici_fsb_ltr.pdf), at 40.

<sup>33</sup> *See* Ideas of Order: Charting a Course for the Financial Stability Board, Remarks by Randal K. Quarles, Vice Chairman for Supervision, Board of Governors of the Federal Reserve System, Chair, Financial Stability Board, at Bank for International Settlements Special Governors Meeting, Hong Kong (Feb. 10, 2019), available at <http://www.fsb.org/wp-content/uploads/Quarles-Ideas-of-order-Charting-a-course-for-the-Financial-Stability-Board.pdf>.

## **V. A LEGISLATIVE SOLUTION IS STILL APPROPRIATE AND NECESSARY**

In the release explaining its proposal, the Council emphasizes that the Dodd-Frank Act gives it broad discretion to determine how to respond to potential threats to financial stability. As we indicate above, our initial analysis of the proposal is quite positive. ICI believes that the Council has outlined a sound approach to using its range of authorities, from information sharing to SIFI designation. Nevertheless, we continue to believe that Congress should confirm in statute that SIFI designation is intended to be a regulatory “tool of last resort.”

Bipartisan legislation recently introduced by members of this Committee—Senators Mike Rounds (R-SD), Doug Jones (D-AL), Thom Tillis (R-NC) and Kyrsten Sinema (D-AZ)—would do just that. S. 603, the “Financial Stability Oversight Council Improvement Act of 2019,” would add a modest but important step to the SIFI designation process. It would require that, before voting on a proposed designation, the Council must consider whether the potential threat posed by a nonbank financial company could be mitigated through other means—a different action of the Council; action by the company’s primary regulator (which could include implementing standards/safeguards pursuant to Council recommendations under Section 120); or action by the company itself, as detailed in a written plan submitted promptly to the Council. If the Council determines that such other means are impracticable or insufficient to mitigate the potential threat, the Council may proceed with a proposed designation.

The bill preserves maximum flexibility for the Council. While it requires the Council to consult with the primary regulator and the company, it does not dictate how the Council should do so. Nor does the bill preclude the Council from proceeding expeditiously. What it does do is help to ensure that the Council consider the range of options available and make an informed decision about how to address the potential threat to financial stability.

S. 603 comports well with the current requirements of the Dodd-Frank Act. Section 113(g) of the Act already requires FSOC to consult with the primary regulator for a company that is being evaluated for possible designation. The bill simply would specify that this consultation must happen at an early stage of the process—that is, before FSOC votes on a proposed designation. And, importantly, S. 603 affirmatively preserves the Council’s emergency powers as outlined in Section 113(f).

ICI accordingly urges this Committee to consider S. 603 and report it favorably to the full Senate.

## **VI. RECOMMENDATIONS**

ICI is pleased to offer its recommendations for addressing the matters we discuss above.

- Congress should encourage FSOC’s current effort to implement the Treasury Department’s FSOC reform recommendations through the pending proposal and a public notice and comment process.

- Congress should enact legislation, such as S. 603, to codify in statute that FSOC's nonbank SIFI designation authority is intended to be used only in extraordinary circumstances, as a regulatory tool of last resort.
- Congress should continue to monitor US involvement in the FSB. It also should support Chairman Quarles in his reform efforts which, if successful, will benefit US investors.

\* \* \* \*

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

## Appendix A

# Regulated Fund Shareholders' Reactions to Market Turmoil, 1944–January 2019

The notion that investors in regulated funds are flighty, prone to panic, and likely to trigger “runs” and “fire sales” of assets—events that would propagate and exacerbate turmoil in financial markets—is not new.

- In the 1930s, US Supreme Court Justice Louis Brandeis and others pushed the idea that investment companies helped cause the crash of 1929 by dumping stocks.
- In 1940, an official at the then-new US Securities and Exchange Commission testified that a “run” on a mutual fund could trigger “an undesirable effect upon the stock market.”
- In 1959, *Time* magazine claimed that “in a falling market, millions of panicky, inexperienced investors would redeem their shares, forcing [mutual] funds to liquidate huge blocks of stock and collapse the market.”
- In 1994, famed economist Henry Kaufman warned that “the technology is in place for a cascade of selling by investors in mutual funds,” creating “an economic shock.”
- And since the global financial crisis, a host of academics and US and global regulatory bodies have promoted theories about fund investor runs, first-mover advantages, asset-sale “waterfalls,” and other speculative phenomena that could pose severe risks to the financial system at large.

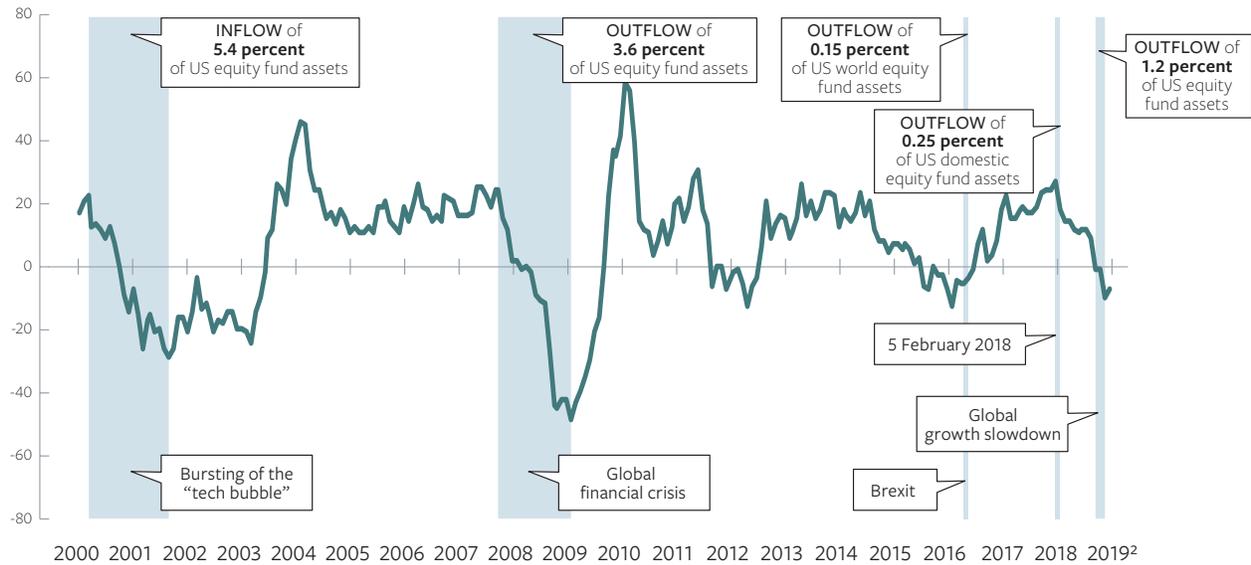
These theories, however, find little support in history, data, or empirical analysis. Since the mid-1990s, the Investment Company Institute has conducted extensive research on market cycles affecting US equity and bond funds, as well as US funds investing in emerging markets. In the past decade, that work has been extended to funds based in Europe and Canada.

In episode after episode, the message is the same: shareholders in regulated funds do not panic or redeem heavily in the face of market downturns or turmoil. In fact, funds often have inflows during falling markets. When funds do have net outflows, they do not occur precipitously. And even when funds are in net outflow, they frequently are buyers of securities in the market. In the pages that follow, we detail the reactions of regulated fund investors to market episodes, from January 2019 back to the early days of the US regulated fund industry.

Since the financial crisis, ICI has amassed a considerable body of work—comment letters, research papers, speeches, and *ICI Viewpoints* commentaries—on these and other issues related to regulated funds and financial stability. That work can be found at [https://www.ici.org/ICI\\_Work\\_On\\_Financial\\_Stability](https://www.ici.org/ICI_Work_On_Financial_Stability).

## US Equity Mutual Funds: Net Flows Are Modest During Market Events

Total return on equities, percent;<sup>1</sup> 2000–2019<sup>2</sup>



<sup>1</sup> The total return on equities is measured as the year-over-year percent change in the MSCI All Country World Daily Gross Total Return Index.

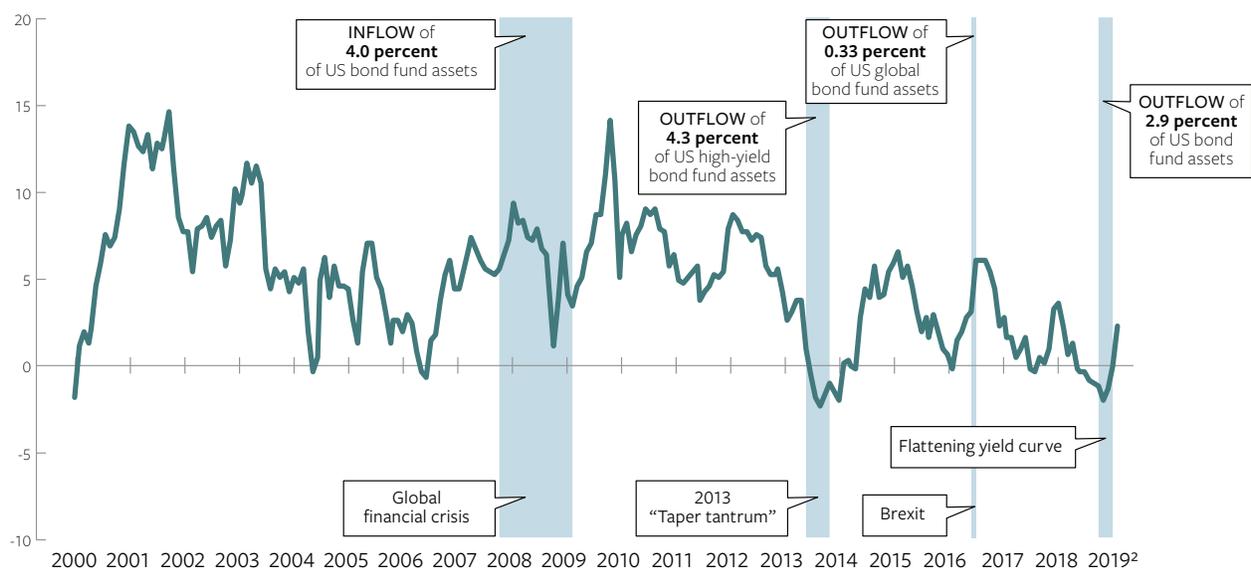
<sup>2</sup> Data are through January 31, 2019.

Note: Net new cash flow data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, MSCI, and Bloomberg

## US Bond Mutual Funds: Net Flows Are Modest During Market Events

Total return on bonds, percent;<sup>1</sup> 2000–2019<sup>2</sup>



<sup>1</sup> The total return on bonds is measured as the year-over-year percent change in the FTSE US Broad Investment Grade Bond Index.

<sup>2</sup> Data are through January 31, 2019.

Note: Net new cash flow data exclude mutual funds that invest primarily in other mutual funds.

Sources: Investment Company Institute, FTSE Russell, and Bloomberg

# Market Events and Investor Reactions

## Since the Global Financial Crisis (2010–Present)

### GLOBAL GROWTH SLOWDOWN, OCTOBER–DECEMBER 2018 | US equity and bond funds; European equity and bond funds

*Fear of a severe slowdown in global economic growth—stemming in part from lower-than-expected GDP growth in China and deteriorating trade relations between China and the United States—contributed to a dip in stock markets around the world in the fourth quarter of 2018.*

Between October 3 and December 24, 2018, the S&P 500 fell 19.6 percent, wiping out all of its gains in the first three quarters of the year. During the same period, returns on stocks elsewhere around the world fell 11.9 percent.<sup>1</sup> Despite this decline in worldwide stock markets, cumulative outflows from US equity funds amounted to only 0.5 percent of total net assets from October through December.

Cumulative estimated outflows from equity UCITS totaled only 0.5 percent of total net assets from October through December.

*Investors closely monitored the continued tightening of US monetary policy along with broader issues concerning geopolitical risk. The US Treasury yield curve flattened substantially in the fourth quarter of 2018, as the difference in rates between 10-year and 3-month US Treasuries fell from 100 basis points in early October to just 24 basis points by year-end. Additionally, in June, the ECB signaled its intent to end its quantitative easing scheme at the end of 2018, creating uncertainty in the European corporate debt market.*

US bond funds experienced cumulative outflows of 1.9 percent of total net assets from October through December.

Fixed income UCITS experienced cumulative estimated outflows of 1.8 percent of total net assets from October through December.

### FEBRUARY 5, 2018 | US equity funds

*On February 5, 2018, the Dow Jones Industrial Average suffered its largest single-day point drop ever—down 1,175 points.*

US domestic equity exchange-traded funds (ETFs) had net redemptions in February, but domestic equity mutual funds had net purchases of \$8.6 billion in stocks. Net fund

---

<sup>1</sup> As measured by the MSCI All Country World Daily ex-US Total Return Index.

redemptions accounted for just 0.25 percent of trading.<sup>2</sup> Federal Reserve Board Chairman Jerome Powell testified, “I don’t think [ETFs] were particularly at the heart of what went on, on those days.”<sup>3</sup>

### BREXIT, JUNE 2016 | US global equity and bond funds; European equity and bond funds

*On June 23, 2016, British voters shocked markets by voting to leave the European Union. In the first two trading days after the vote, stocks lost \$3 trillion in value worldwide.*

In the week ended June 29, US funds invested in world equities had outflows of 0.15 percent of assets; US global bond funds had outflows of 0.33 percent.<sup>4</sup>

Bond UCITS had estimated inflows totaling 0.1 percent of assets during the Brexit period.<sup>5</sup> Equity UCITS had estimated outflows of 1.2 percent of assets.<sup>6</sup>

### OIL PRICES, 2015–2016 | Canadian equity and bond funds

*From April 2015 to January 2016, Canadian stock prices fell more than 20 percent as global oil prices tumbled.*

Investor purchases of Canadian-domiciled equity funds exceeded redemptions for most of the period, with net inflows of 0.8 percent of assets. Canadian-domiciled bond funds saw net inflows of 2.5 percent during the period, and global and high-yield bond funds domiciled in Canada saw strong inflows.<sup>7</sup>

---

<sup>2</sup> William F. Truscott, Chairman’s Address: 60th General Membership Meeting, available at [https://www.ici.org/pressroom/speeches/18\\_gmm\\_truscott](https://www.ici.org/pressroom/speeches/18_gmm_truscott).

<sup>3</sup> Monetary Policy and the State of the Economy, Hearing Before the Committee on Financial Services, House of Representatives, February 27, 2018, Serial No. 115-76, page 29, available at <https://financialservices.house.gov/uploadedfiles/115-76.pdf>.

<sup>4</sup> “Matching Models to Reality: Doomsayers Are Disappointed—Again—as Funds Weather Brexit Shock,” *ICI Viewpoints*, July 13, 2016, available at [https://www.ici.org/viewpoints/view\\_16\\_bond\\_fund\\_series\\_01](https://www.ici.org/viewpoints/view_16_bond_fund_series_01) (“Brexit Viewpoints”).

<sup>5</sup> Letter from Paul Schott Stevens, President and CEO, ICI, to Secretariat, Financial Stability Board, dated September 21, 2016, available at [https://www.ici.org/pdf/16\\_ici\\_fsb\\_ltr.pdf](https://www.ici.org/pdf/16_ici_fsb_ltr.pdf) (“FSB Letter”).

<sup>6</sup> FSB Letter.

<sup>7</sup> FSB Letter.

## DECEMBER 2015 | US high-yield bond funds

*The US high-yield bond market—generally considered less liquid than the market for Treasury or investment grade corporate bonds—was under considerable stress due to falling oil prices and signs of slowing growth in emerging economies. Yields on below-investment grade bonds rose 100 basis points from early November to December 9. On December 9, Third Avenue Focused Credit Fund, a US high-yield bond fund, announced that it had suspended investor redemptions and would liquidate.*

US high-yield bond funds saw outflows of 1.2 percent of fund assets over a two-week period. But US mutual funds remained buyers of high-yield bonds, and outflows quickly tapered off and remained subdued.<sup>8</sup> US high-yield bond ETFs added liquidity to the market.<sup>9</sup>

## AUGUST 24, 2015 | US equity exchange-traded funds

*After a disorderly opening in US stock markets, many ETFs experienced multiple trading halts amid rapidly fluctuating prices. Some ETFs traded at substantial discounts to their underlying value.*

Investigations by securities regulators and exchanges showed that conflicting rules on trading halts and re-openings exacerbated selling pressures and led to multiple trading halts. Exchanges revised many market structure rules.<sup>10</sup>

## GERMAN BUND SELL-OFF, 2015 | European bond and equity funds

*In spring 2015, the market for the German 10-year bund sold off rapidly, driving the yield up 75 basis points in two months.*

Bond UCITS had estimated inflows of 0.4 percent of assets during the sell-off. Equity UCITS had estimated inflows of 1.5 percent of assets.<sup>11</sup>

---

<sup>8</sup> FSB Letter.

<sup>9</sup> “High-Yield Bond ETFs: A Source of Liquidity,” *ICI Viewpoints*, December 22, 2015, available at [https://www.ici.org/viewpoints/view\\_15\\_hybf\\_etf](https://www.ici.org/viewpoints/view_15_hybf_etf).

<sup>10</sup> “Research Note: Equity Market Volatility on August 24, 2015,” Staff of the Office of Analytics and Research, Division of Trading and Markets, US Securities and Exchange Commission, December 2015, available at [https://www.sec.gov/marketstructure/research/equity\\_market\\_volatility.pdf](https://www.sec.gov/marketstructure/research/equity_market_volatility.pdf).

<sup>11</sup> FSB Letter.

## “TAPER TANTRUM,” 2013 | US high-yield bond funds; European bond funds; Canadian bond funds; emerging market bond funds

*US Federal Reserve Board officials indicated that they were planning to “taper” purchases of US Treasury bonds. US interest rates rose about 100 basis points from late spring through the fall of 2013—the sharpest four-month rise in interest rates since 1994—with spillover to European and Canadian bonds. Yields on emerging market debt denominated in US dollars widened by 94 basis points relative to Treasury yields.*

US high-yield bond mutual funds experienced cumulative outflows of 4.3 percent of assets from May through October.<sup>12</sup>

Bond UCITS had estimated outflows of 2.2 percent of assets.<sup>13</sup>

Canadian-domiciled bond mutual funds had outflows of 1.7 percent of assets.<sup>14</sup>

Detailed analysis of bond trading in emerging markets shows no destabilizing effects from fund flows during this episode.<sup>15</sup>

## EUROZONE DEBT CRISIS, 2011 | European bond and equity funds

*Several member states in the eurozone experienced difficulties refinancing their debts in 2011. Bond yields rose sharply, and some banks with heavy exposure to these debts faced higher funding costs.*

Bond UCITS had estimated outflows of 1.8 percent of assets during the eurozone debt crisis.<sup>16</sup> Equity UCITS experienced estimated outflows of 4.1 percent of assets.<sup>17</sup>

---

<sup>12</sup> Rochelle Antoniewicz, “What Happens When Rates Rise? A Forecast of Bond Mutual Fund Flows Under a 2013 Taper Tantrum Interest Rate Scenario,” *ICI Research Report* (December 2016), available at [https://www.ici.org/pdf/rpt\\_16\\_bmff\\_forecast.pdf](https://www.ici.org/pdf/rpt_16_bmff_forecast.pdf).

<sup>13</sup> FSB Letter.

<sup>14</sup> FSB Letter.

<sup>15</sup> “Taper Tantrum” Paper.

<sup>16</sup> FSB Letter.

<sup>17</sup> FSB Letter.

## During the Global Financial Crisis (2007–2009)

### GLOBAL FINANCIAL CRISIS, 2007–2009 | US equity and bond funds; European equity and bond funds; Canadian equity and bond funds

*During the global financial crisis, stock and bond markets globally suffered intense pressure and heavy losses. In the United States, the S&P 500 fell 53 percent—losing more than half of its value—from October 31, 2007, to February 27, 2009. From August to December of 2008, spreads between yields on lower-rated bonds and Treasury securities widened by nearly 300 basis points.*

US equity mutual fund outflows totaled 4.1 percent of assets from November 2007 to February 2009. US bond mutual funds experienced inflows totaling 4.0 percent of assets for the entire crisis period. From September to December 2008, however, US bond mutual funds had outflows totaling 3.6 percent of assets.<sup>18</sup>

Equity UCITS had estimated outflows of 2.5 percent of assets. Bond UCITS had estimated outflows of 12.9 percent of assets, exacerbated by German officials' decision to guarantee all bank deposits, drawing assets out of bond funds.<sup>19</sup>

Canadian equity funds had outflows of 2.4 percent of assets during the crisis. Canadian bond funds had outflows of 5.5 percent of assets.<sup>20</sup>

## 1996–2006

### BURSTING OF THE “TECH BUBBLE,” 2000–2001 | US equity funds

*The dot-com bubble began to burst in mid-March 2000. From February 29, 2000, to September 28, 2001, the NASDAQ and S&P 500 indexes declined by 68 percent and 24 percent, respectively.*

Over this same period, US equity mutual funds received net inflows totaling \$227 billion, or 5.4 percent of assets. Equity mutual funds did experience outflows in five separate months, but none were precipitous: the largest monthly outflow was 0.9 percent of assets in September 2001.<sup>21</sup>

---

<sup>18</sup> Letter from Paul Schott Stevens, President and CEO, ICI, to Elizabeth M. Murphy, Secretary, US Securities and Exchange Commission, dated November 1, 2013, available at [https://www.ici.org/pdf/13\\_ici\\_ofr\\_asset\\_mgmt.pdf](https://www.ici.org/pdf/13_ici_ofr_asset_mgmt.pdf) (“SEC-OFR Letter”).

<sup>19</sup> FSB Letter.

<sup>20</sup> FSB Letter.

<sup>21</sup> SEC-OFR Letter.

## ASIAN FINANCIAL CRISIS, 1997 | US emerging market equity funds

*Rapid appreciation of the US dollar and economic problems in Southeast Asia caused stock markets in Thailand, Malaysia, Indonesia, and the Philippines to fall by more than 40 percent from July to September. In a second round of turmoil between September and year-end, the stock markets of Asian emerging economies plummeted an average of 31 percent. Latin American stocks were also affected.*

US global emerging market equity mutual funds, which held 1.2 percent of the market capitalization of emerging markets at year-end 1996, experienced net inflows throughout 1997, except for December.

Mutual funds focused on Asian and Latin American emerging markets experienced moderate outflows. US emerging market mutual funds were net buyers of Asian stocks throughout most of 1997.<sup>22</sup>

## The First 50 Years (1944–1995)

### THE BOND MELTDOWN, 1994–1995 | US bond funds

*The Federal Reserve sharply tightened monetary policy, boosting its target for the federal funds rate from 3 percent to 6 percent. The yield on the 10-year Treasury note rose 1.85 percentage points, sending bond returns into negative territory for months.*

During this time, US bond mutual funds experienced net outflows totaling 11.3 percent of their assets. These net outflows, though, occurred smoothly rather than precipitously. In no month during the 12-month period from February 1994 to January 1995 did net outflows exceed 2 percent of bond mutual funds' assets.<sup>23</sup>

### BLACK MONDAY, OCTOBER 1987 | US equity funds

*On Monday, October 19, 1987, the Dow Jones Industrial Average fell by a then-record 508 points. From October to December 1987, the stock market declined by 23 percent.*

Over these three months, net outflows from US equity mutual funds totaled 4.2 percent of their assets. The largest one-month net outflow from equity mutual funds during this period was 3.2 percent in October 1987, when the S&P 500 declined by 22 percent in a single month.<sup>24</sup>

---

<sup>22</sup> Mitchell A. Post and Kimberlee Miller, "US Emerging Market Equity Funds and the 1997 Crisis in Asian Financial Markets," *ICI Perspective* 4, no. 2 (June 1998), available at <https://www.ici.org/pdf/per04-02.pdf>.

<sup>23</sup> SEC-OFI Letter.

<sup>24</sup> SEC-OFI Letter.

## BEAR MARKET, 1973–1974 | US equity funds

*Global tensions and a sharp spike in oil prices triggered a deep and long-lasting recession in the United States and elsewhere. From January 1973 to December 1974, the S&P 500 declined 42 percent.*

Outflows from US equity mutual funds over this period were modest, cumulating to \$3.2 billion, or 5.8 percent of fund assets. During this period, the maximum one-month net outflow from US equity mutual funds was 0.6 percent of assets.<sup>25</sup>

## STOCK MARKET CYCLES, 1945–1990 | US equity funds

*From 1945 to 1990, there were 12 additional major US stock market cycles (as identified by peaks and troughs in the S&P 500 index) of varying magnitudes and lengths (in addition to the 1973–1974 bear market and 1987's Black Monday).*

In eight of these 12 cycles, US equity mutual funds experienced inflows even during the contraction phase of the cycle. In the four cycles with outflows during the contraction, the largest monthly outflow was 1.1 percent of assets.<sup>26</sup>

---

<sup>25</sup> SEC-OFR Letter.

<sup>26</sup> John Rea and Richard Marcis, “Mutual Fund Shareholder Activity During US Stock Market Cycles, 1944–95,” *ICI Perspective* 2, no. 2 (March 1996), available at <https://www.ici.org/pdf/per02-02.pdf>.

## Summary: FSOC Proposal to Reform the SIFI Designation Process\*

- Activities-Based Approach. The proposed activities-based approach includes a two-step process.
  - *First*, FSOC would monitor financial markets and market developments, in consultation with relevant financial regulatory agencies, to identify products, activities, or practices that could present risks to financial stability. This step to a large degree imports into the guidance the role of FSOC’s Systemic Risk Committee. See Charter of the Systemic Risk Committee of the FSOC, section 2 (available at <https://www.treasury.gov/initiatives/fsoc/governance-documents/Documents/The%20Council%27s%20Committee%20Charters.pdf>.)
    - In determining whether an activity presents risks to U.S. financial stability, FSOC will consider, among other factors, whether the activity is complex or opaque, conducted without effective risk-management practices, significantly correlated with other financial products, or either highly concentrated or significant and widespread.
  - *Second*, FSOC will work with the “relevant financial regulatory agencies” (a term that FSOC indicates will be interpreted more broadly than the “primary federal regulatory agency” that is responsible for overseeing a market or practice) to seek to implement actions to address any identified potential risk. The goal of this step would be for the existing regulators to take actions to mitigate the identified risks. This step would typically result in “relatively informal actions,” but could include FSOC making a recommendation under section 120 of the Dodd-Frank Act for an agency to apply new or heightened standards. As an illustration of the limits of an activities-based approach, the proposal notes that FSOC only will use section 120 “to the extent that its recommendations are consistent with the statutory mandate of the relevant primary financial regulatory agency.”
- Reforms to Designation Process. The proposal also would reform the designation process. Notable changes include the following:
  - *Analytic framework*. FSOC’s evaluation of a nonbank financial company for potential designation would focus on how the negative effects of the company’s material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness or mix of the company’s activities, could be transmitted to or affect other firms or markets, thereby causing a broader impairment of financial intermediation or of financial market functioning.
    - To complete such an analysis, FSOC will focus on three transmission channels: (1) the exposure transmission channel; (2) the asset liquidation transmission channel; and (3) the critical function or service transmission channel.

---

\* FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, RIN 4030-ZA00 (March 6, 2019), available at <https://home.treasury.gov/system/files/261/Notice-of-Proposed-Interpretive-Guidance.pdf>.

- The proposal would eliminate the six-category framework included in the current guidance FSOC uses for evaluating companies for a potential designation. This framework had been regarded in various quarters as difficult to apply in practice, and its analytic benefit was unclear. The proposed elimination should provide greater ex-ante transparency around how FSOC analyzes companies for potential designation.
- *Definition of key terms.* The proposal would define key terms, including “material financial distress” and “threat to the financial stability of the United States,” as outlined below.
  - “Material financial distress” would be defined as “being in imminent danger of insolvency or defaulting on financial obligations.”
  - “Threat to the financial stability of the United States” would be defined as “the threat of an impairment of financial intermediation or of financial market functioning that would be sufficient to inflict severe damage on the broader economy.”
- *Cost-benefit analysis.* The proposal contemplates that FSOC would perform a cost-benefit analysis prior to making a designation. Then, FSOC only would make a designation if the expected benefits justify the expected costs. FSOC would consider ranges of quantified benefits and costs, as well as non-quantified benefits and costs.
- *Likelihood of material financial distress.* FSOC would assess the likelihood of a company’s material financial distress, applying qualitative and quantitative factors.
- *Two-stage process.* The proposal would condense the current three-stage designation process set out in the existing guidance into two stages, by eliminating the current stage 1. The proposal also would codify certain aspects of FSOC’s 2015 supplemental procedures, which provide opportunities for engagement with the company under consideration for designation.
- *Off-ramps.* Under the “new” stage 1, the company would be able to provide information to FSOC, allowing an opportunity for a “pre-designation ‘off-ramp.’” The proposal also would clarify the “off-ramp” process for a designated company, so that the company could identify changes it could consider making to address the concerns that motivated FSOC’s original designation decision. The proposal states that the process is designed to encourage companies to address the key factors that led to designation.