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Financial Stability Oversight Council
Attn: Eric Froman
1500 Pennsylvania Avenue, NW
Room 2308
Washington, D.C. 20220
VIA ELECTRONIC PORTAL (www.regulations.gov)

Re: *Analytic Framework for Financial Stability Risk Identification, Assessment, and Response (RIN 4030-XXXX)*

Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (RIN 4030-XXXX)

Dear Members of the Council:

The Investment Company Institute[1] appreciates this opportunity to comment on two interrelated proposals (Proposals) concerning the Financial Stability Oversight Council's (FSOC or Council) exercise of its various authorities under the Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act): one proposal sets forth an analytic framework broadly outlining how the Council will identify, assess, and respond to potential risks to US financial stability; and the other proposal sets forth the procedures that the Council would apply in reviewing a nonbank financial company for potential designation as a systemically important financial institution (SIFI).[2] Each of the Proposals addresses aspects of the Council's existing

[1] The Investment Company Institute (ICI) is the leading association representing regulated investment funds. ICI's mission is to strengthen the foundation of the asset management industry for the ultimate benefit of the long-term individual investor. ICI's members include mutual funds, exchange-traded funds (ETFs), closed-end funds, and unit investment trusts (UITs) in the United States (collectively, registered funds), and UCITS and similar funds offered to investors in other jurisdictions. Its members manage $30.1 trillion invested in funds registered under the US Investment Company Act of 1940, serving more than 100 million investors. Members manage an additional $8.8 trillion in regulated fund assets managed outside the United States. ICI also represents its investment adviser members in their capacity as managers of certain collective Investment trusts (CITs) and retail separately managed accounts (SMAs). ICI has offices in Washington DC, Brussels, London, and Hong Kong and carries out its international work through ICI Global.

[2] FSOC, *Analytic Framework for Financial Stability Risk Identification, Assessment and Response*, 88 Fed. Reg. 26305 (Apr. 28, 2023) (Proposed Framework); FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 88 Fed. Reg. 26234 (Apr. 28, 2023) (Procedures Proposal). Section 113(a)(1) of the Dodd-Frank Act provides, in relevant part, that the Council "may determine that a US nonbank financial company

interpretive guidance on nonbank financial company determinations,[3] and so the Proposals must be analyzed together to have a full picture of the revisions that the Council is seeking to advance.

ICI's comments on the Proposals are informed by our deep engagement with policymakers and other interested parties on matters of systemic risk and financial stability, dating back to the immediate aftermath of the 2008 global financial crisis and development of the Dodd-Frank Act. It should come as no surprise that financial stability is a matter of 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 approaches that promote the robustness, diversity, and resiliency of financial markets and market participants. 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.

OVERVIEW

In this letter, we highlight serious concerns with the Council's approach. As compared with the Current Guidance, the Proposals take a step backward in terms of the rigor required of FSOC's analyses of perceived risks to financial stability and appear to lower the bar for Council action in response to such risks. Advancing the Proposed Framework and the Procedures Proposal separately obfuscates the full import of the proposed changes to the Current Guidance and circumvents 12 CFR 1310.3 (Process Rule), which requires FSOC to provide public notice and opportunity for comment prior to amending the Current Guidance.[4]

The Current Guidance is the product of careful development over several years. It is based on, and reflects the Council's experience with, the following:

- The Council's original interpretive guidance—issued in 2012 following three full rounds of public notice and comment—that focused *both* on how FSOC will analyze whether an

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shall be supervised by the Board of Governors and shall be subject to prudential standards…if the Council determines that material financial distress at the US nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the US nonbank financial company, could pose a threat to the financial stability of the United States."

[3] FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71740 (Dec. 30, 2019) (Current Guidance).

[4] *See* FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 84 Fed. Reg. 8958 (Mar. 13, 2019) (explaining that FSOC adopted the rule "in order to promote the Council's engagement with market participants and other interested parties.").

individual nonbank financial company could pose a threat to US financial stability and the procedural process to be followed in evaluating the company.[5]

- SIFI designations in 2013-14 of three insurance companies (AIG, MetLife, and Prudential) and one non-bank lender (GE Capital), following both the analysis and process set forth in the 2012 Guidance.
- Enhancements in 2015 to the procedural process for SIFI evaluations.[6]
- MetLife's lawsuit challenging its designation as a SIFI, and the 2016 district court decision overturning MetLife's designation.[7]
- The Council's 2017 decision to rescind AIG's designation following a more robust empirical analysis of incentives and disincentives for retail policyholders to surrender policies, including analysis of historical evidence of retail and institutional investor behavior.[8]
- Reform recommendations from the Treasury Department, which were developed with input from government entities, think tanks, academics, industry and trade groups, individual nonbank financial companies, and financial market utilities.[9]

We believe it is therefore important to scrutinize carefully how and why the Council is proposing to depart from the Current Guidance—and to consider what may be lost in the process.

Some features of the Current Guidance are appropriately reflected in the Proposals. The Procedures Proposal, for example, reflects many of the enhancements to the SIFI designation process that were adopted in 2015, at the urging of industry, members of Congress in both

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[5] FSOC, *Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies*, 77 Fed. Reg. 21637 (Apr. 11, 2012) (2012 Guidance). *See also* Letters from Paul Schott Stevens, President & CEO, Investment Company Institute, to the Financial Stability Oversight Council, dated Nov. 5, 2010 (2010 FSOC Letter); Feb. 25, 2011; and Dec. 19, 2011.

[6] FSOC, *Supplemental Procedures Relating to Nonbank Financial Company Determinations* (Feb. 4, 2015). In late 2014, ICI participated in a roundtable discussion on the SIFI designation process with Council staff and other stakeholders. *See also* Letter from Paul Schott Stevens, President & CEO, ICI, to the Financial Stability Oversight Council (dated Dec. 17, 2014) (recommending reforms in several areas).

[7] *MetLife, Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016), *appeal dismissed*, No. 16-5086, 2018 WL 1052618 (D.C. Cir. Jan. 23, 2018); *see also* Br. of *Amici Curiae* Chamber of Commerce of the United States of America and Investment Company Institute in Support of Appellee ("Chamber & ICI *Amici* Br."), *MetLife, Inc. v. Fin. Stability Oversight Council*, No. 16-5086, 2016 WL 4440273 (D.C. Cir. Aug. 22, 2016).

[8] FSOC, Notice and Explanation of the Basis for the Financial Stability Oversight Council's Recission of its Determination Regarding American International Group, Inc. (AIG) (Sept. 29, 2017). *See* In Wake of FSOC Decision on AIG, ICI Calls for Reform of the SIFI Designation Process (press release dated Sept. 29, 2017).

[9] US Treasury Department, Financial Stability Oversight Council Designations, Report to the President of the United States (Nov. 17, 2017).

parties, and other interested stakeholders. In contrast, we are concerned that the Proposed Framework is written so broadly and in such general terms that it will invite insufficient rigor in the Council's analyses. Moreover, the Proposed Framework signals an intention by FSOC to "turn back the clock" on certain features of the Current Guidance, such as the requirement to conduct an evaluation of costs and benefits when considering the potential designation of a nonbank financial company.

The Proposals signal something else—a more expansive view of the Council's role in responding to potential risks to financial stability. We are troubled by how FSOC is proposing to change its view of what constitutes a "threat to financial stability" and how that shift, together with other changes, would facilitate the Council's use of its SIFI designation authority without sufficient analysis of all relevant factors or sufficient consideration of alternatives to designation.

ICI fully supports the US government having the necessary capabilities and flexibility to respond to new or emerging risks to the stability of the financial system. We firmly believe, however, that the most effective means for identifying and addressing these risks is through leveraging the experience and expertise of primary financial regulators.

ICI also believes that the Council should provide sufficient public transparency into its analytical process, including when the Council is focused on entity-based designations versus other tools. This type of transparency and a framework that helps ensure analytical rigor would foster public confidence in the Council's decisions and methods. It also would empower market participants to make decisions about how to address or remediate the issues that FSOC believes may merit policy action (a form of market discipline, one of the Council's statutory goals).

SUMMARY OF COMMENTS

Our comments and recommendations include the following:

- Congress established FSOC as a council of existing regulators, able to bring together different perspectives and expertise from across the spectrum of financial services. The statutory provisions outlining the Council's purposes and duties make it clear that Congress intended FSOC to act in coordination with "front line" regulators to address potential risks to financial stability, even when the Council is utilizing its SIFI designation authority. **(Section 1.1)**
- The Current Guidance is a thoughtful and well-reasoned animation of the Council's congressionally mandated duties. It outlines an activities-based approach that makes the most of the existing authorities and expertise of Council member agencies and other federal and state regulators. The Current Guidance details how the Council will analyze potential risks to financial stability, ensuring sufficient analytical rigor and transparency

while also retaining necessary flexibility. It appropriately contemplates that risks to financial stability will be addressed on the broadest possible basis and that SIFI designation will be reserved for those instances where an activities-based approach would be inadequate. **(Section 1.2)**

- The Proposals would facilitate the Council's use of its SIFI designation authority without sufficient analysis of all relevant factors or sufficient consideration of alternatives to designation. The Proposals contemplate a greater focus on individual companies as potential sources of financial stability risk; less rigorous analysis of, and less engagement with, a company under review; and a lower standard for designation. ICI strongly opposes this outcome. We have consistently urged the Council to reserve SIFI designation for very specific and limited circumstances. **(Section 2.1)**
- The Proposals contemplate insufficient rigor in FSOC's analyses of potential risks to financial stability from financial activities, products, or practices. This, in turn, raises the prospect of policy outcomes that are unsupported by empirical data and actual experience. We point out that the Council's assertions about the risk of destabilizing redemptions from mutual funds are called into question by ICI data and analysis, which we outline in two appendices to this letter. **(Section 2.2)**
- The Council's decision to advance two separate proposals rather than modifying the Current Guidance in a single proposal makes it challenging and cumbersome to identify the precise changes the Council is seeking to make. While some of these changes are discussed in the preambles to the Proposals, others are insufficiently described or not acknowledged at all, as we illustrate with several examples. ICI recommends that the Council retain the Current Guidance in its entirety unless and until any changes are made in full compliance with the Process Rule. **(Section 3)**
- If the Council proceeds to finalize the Proposed Framework, we recommend that it make revisions in several areas to encourage thorough empirical analysis. Such analysis is key to an accurate understanding by the Council of the mechanism(s) by which adverse effects could be transmitted to other market participants and whether those effects are of a nature and magnitude sufficient to destabilize the financial system. That understanding, in turn, will enable the Council to distinguish between market risk and systemic risk, and to keep its focus squarely on the latter. **(Section 4)**
- Consistent with the Council's approach to asset management over several years, any monitoring of potential risks should focus on the activities in which asset managers and investment companies engage, and not on individual entities. **(Section 4.1)**
- More fulsome discussion of the various vulnerabilities identified by the Council would aid public understanding of how these vulnerabilities can contribute to risks to financial stability and bring needed discipline to the Council's analyses. **(Section 4.2.1)**

- A financial activity, product or practice, or even an individual company, cannot pose risk to the stability of the US financial system if there is no plausible mechanism for transmitting harms of a nature and magnitude sufficient to destabilize the system. Any final framework should include more detailed discussion of how the Council expects to analyze risk transmission through the identified channels. **(Section 4.2.2)**
- An evaluation of benefits and costs should be part of the Council's analysis when considering an individual company for potential SIFI designation. Such an evaluation also may be appropriate when the Council is considering potential action under its other authorities. **(Section 4.2.3)**
- Consideration of a company's vulnerability to financial distress should be part of the Council's analysis when considering the company for potential SIFI designation. **(Section 4.2.4)**
- The Council should provide some explanation as to how it may approach authorities that are identified in the final framework but have not been utilized to date (*e.g.*, designation of payment, clearing or settlement activity as systemically important). **(Section 4.3)**
- Engagement with industry stakeholders should be a regular feature of the Council's work. We offer suggestions on how FSOC can leverage their expertise, while noting that the Council would retain flexibility to structure the engagement in a way that is useful to the Council's purposes and would not delay its work. **(Section 4.4)**
- We likewise offer suggestions on how FSOC can provide greater transparency regarding its analysis of potential issues and its conclusions based on those analyses. **(Section 4.5)**

1. Current Guidance Animates the Council's Purposes and Duties

Exercise of any of the Council's authorities requires the involvement of, and action by, other financial regulators. We discuss how the Council's statutory purposes and duties are appropriately animated by the Current Guidance.

1.1 Purposes and duties of the Council

In the aftermath of the global financial crisis, Congress passed the Dodd-Frank Act, providing financial regulators with many new tools to address abuses and excessive risk taking by financial market participants, as well as to improve regulatory oversight for specific sectors. The Act also established FSOC as a council of financial regulators, able to bring together different perspectives and expertise from across the spectrum of financial services. Congress considered and rejected alternative options, including establishing a new agency as a systemic risk regulator and elevating an existing financial regulator above all others.[10] In ICI's view, this was the appropriate choice. The US financial system is complex, diverse, and rapidly changing. No single regulator can have a comprehensive frame of reference or the necessary expertise to assess and respond to those changes. The Council is positioned to enlist the expertise of the entire regulatory community in identifying and devising strategies to mitigate systemic risks. ICI believes that FSOC's ability to influence the oversight of risks to the financial system through its interactions with primary regulators is one of the Council's most significant roles.[11]

Section 112(a)(2) of the Dodd-Frank Act, which articulates the Council's duties, indicates that the Council is primarily intended to focus attention on, and coordinate efforts by others to address, potential risks to the stability of the financial system.[12] Of the 14 duties identified in the statute, 12 of them involve the Council acting to:

- Collect information from and facilitate information sharing and coordination across member agencies and other federal and state regulators, and request data and analysis from the Office of Financial Research [112(a)(2)(A), (B), (E)];
- Monitor the financial services marketplace and domestic and international financial regulatory proposals and developments [112(a)(2)(C), (D)];
- Make recommendations or submit comments to Congress, member agencies including the Federal Reserve Board and the Securities and Exchange Commission (SEC), other primary financial regulatory agencies, and standard-setting bodies [112(a)(2)(D), (F), (I), (K), (L)];
- Identify regulatory gaps [112(a)(2)(G)];

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[10] The initial discussion draft of the Restoring American Financial Stability Act, proposed by then-Senate Banking Chairman Christopher Dodd (D-CT) in November 2009, called for the creation of an independent systemic risk regulator. By the time that legislation was reported out of committee in April 2010, however, the independent agency concept had been replaced with language to create a council of financial regulators. Both versions of that Act are available at https://www.llsdc.org/dodd-frank-legislative-history.

[11] A former Council member has voiced similar views. *See* Timothy G. Massad, *It's Time to Strengthen the Regulation of Crypto-Assets*, Economic Studies at Brookings (March 2019) at 55, available at https://www.brookings.edu/wp-content/uploads/2019/03/Economis-Studies-Timothy-Massad-Cryptocurrency-Paper.pdf (stating that the Council's "utility is that it brings all financial regulators together and thus provides a forum for looking at issues that cut across regulatory jurisdictions."). *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.").

[12] *See* Procedures Proposal, *supra* note 2, at 26235 (stating that "[m]any of the Council's statutory duties relate to promoting interagency collaboration, monitoring financial market developments, facilitating information sharing, and recommending that existing regulators address risks.").

- Provide a forum for discussion and analysis of market developments and financial regulatory issues, and resolve jurisdictional disputes among member agencies [112(a)(2)(M)]; and
- Apprise Congress of significant market and regulatory developments, potential emerging threats to US financial stability, and the Council's activities [112(a)(2)(N)].

Only two of the 14 duties articulated in section 112(a)(2) envision some form of direct action by the Council. These are:

- Section 112(a)(2) (H), which calls for the Council to require supervision by the Federal Reserve Board for nonbank financial companies that may pose risks to the financial stability of the United States in the event of their material financial distress or failure, or because of their activities pursuant to section 113; and
- Section 112(a)(2)(J), which calls for the Council to identify systemically important financial market utilities and payment, clearing, and settlement activities (as that term is defined in section 803 of the Dodd-Frank Act).

Yet even these provisions contemplate the Council acting in coordination with other financial regulators to address potential risks to financial stability. The remedies to mitigate identified risks from a company, utility, or activity designated by the Council ultimately will be decided and executed by another agency—the Federal Reserve Board, the SEC, or the Commodity Futures Trading Commission (CFTC)—and not by the Council.[13]

This deference in the statute to the expertise of "front line" regulators likewise can be seen in section 112(a)(1) of the Dodd-Frank Act, which sets forth the purposes of the Council.[14] By its plain language, the statute contemplates a higher threshold for Council action—"emerging threats to financial stability"—than for Council monitoring—"risks [to financial stability] that could arise." This leaves room for regulators, using their existing authorities, to take action to

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[13] *See* Dodd-Frank Act section 165 (authorizing the Federal Reserve Board to establish prudential standards for the nonbank financial companies that it supervises); section 115 (permitting FSOC to make recommendations to the Federal Reserve Board regarding such standards); and section 805 (authorizing the Federal Reserve Board and, in certain situations, the SEC and/or the CFTC, to prescribe risk management standards, in consultation with the Council, for any payment, clearing or settlement activity designated by the Council under section 804).

[14] Section 112(a)(1) states that the purposes of the Council are: (A) to identify risks to the financial stability of the United States that could arise from the material financial distress or failure, or ongoing activities, of large, interconnected bank holding companies or nonbank financial companies, or that could arise outside the financial services marketplace; (B) to promote market discipline, by eliminating expectations on the part of shareholders, creditors, and counterparties of such companies that the Government will shield them from losses in the event of failure; and (C) to respond to emerging threats to the stability of the United States financial system.

address potential risks to financial stability before those risks have a chance to develop into "emerging threats" to the financial system.

1.2 Current Guidance

Given the Council's statutory authorities, it is quite clear that the Council's success in mitigating risks or threats to financial stability will depend upon its ability to work in partnership with its member agencies and other federal and state regulators. The Current Guidance recognizes this by making the most of the existing authorities and expertise of those regulators.

Although its title refers to nonbank financial company determinations, the Current Guidance is broader in scope, outlining practices to address potential risks to financial stability that are "intended to comply with [the Council's] statutory purposes." Section II of the Current Guidance prioritizes a two-step process to identify, assess, and respond to potential risks presented by financial activities, products, and practices—labeled an "activities-based approach." In step one of the activities-based approach, the Council (in consultation with primary financial regulatory agencies) seeks to monitor financial markets and market developments to identify financial products, activities, or practices that could pose risks to financial stability. If a product, activity, or practice is so identified, the Council (in conjunction with relevant financial regulatory agencies) would evaluate the potential risk to determine whether it merits further review or action.

The Current Guidance contains a fulsome discussion of how the Council would conduct such an evaluation. It outlines various characteristics that could amplify potential risks to financial stability, and it provides commentary on the types of factors that could exacerbate or mitigate potential risks. While acknowledging the Council's need to tailor its evaluation to the particular risk at issue, the Current Guidance nonetheless outlines several "framing questions" expected to guide the Council's analyses:

- How could the potential risk be triggered?
- How could the adverse effects of the potential risk be transmitted to financial markets or market participants?
- What impact could the potential risk have on the financial system?
- Could the adverse effects of the potential risk impair the financial system in a manner that could harm the non-financial sector of the US economy?

The Current Guidance also affirms that in evaluating whether a potential risk merits further review or action, the Council will take into account existing laws and regulations that may mitigate that risk.

In step two of the activities-based approach, the Council will work with relevant financial regulatory agencies at the federal and state levels to seek implementation of measures to address an identified risk. The Current Guidance highlights that there may be different approaches existing regulators could take, based on their authorities and the urgency of the risk. It details the Council's authority to make formal recommendations to a primary financial regulatory agency, should the Council determine that the regulator's actions are inadequate to address the identified potential risk to financial stability.[15] The Current Guidance commits the Council to ascertaining whether that regulator would be expected to perform a cost-benefit analysis in responding to a recommendation from the Council and, if not, to conducting a cost-benefit analysis to inform the Council's decision as to whether or not to make such a recommendation.

The Current Guidance explains that the Council will consider a nonbank financial company for potential designation under section 113 only if a potential risk or threat to financial stability "cannot be adequately addressed through an activities-based approach." Section III of the Current Guidance provides a detailed description of the analysis that the Council intends to conduct during its reviews, including a discussion of channels through which risks from a company may be transmitted to other companies or markets, and the Council's assessment of the likelihood of the company's material financial distress and the benefits and costs of a determination.

In finalizing the Current Guidance just four years ago, the Council stated that the guidance

> reflect[ed] two priorities: (1) identifying and addressing, in consultation with regulatory agencies, potential risks and emerging threats on a system-wide basis and to reduce the potential for competitive distortions among financial companies and in markets that could arise from entity-specific determinations; and (2) allowing relevant financial regulatory agencies, which generally possess greater information and expertise with respect to company, product, and market risks, to address potential risks, rather than subjecting the companies to new regulatory authorities.[16]

ICI concurs with these priorities and strongly supports the Current Guidance as a thoughtful and well-reasoned animation of the Council's congressionally mandated duties. The Current Guidance recognizes the statutory limitations on the Council's ability to act and appropriately

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[15] Section 120 of the Dodd-Frank Act. This authority likewise is enumerated in the Council's list of duties in section 112(a)(2), providing that the Council shall "(K) make recommendations to primary financial regulatory agencies to apply new or heightened standards and safeguards for financial activities or practices that could create or increase risks of significant liquidity, credit, or other problems spreading among bank holding companies, nonbank financial companies, and United States financial markets."

[16] Current Guidance, *supra* note 3, at 71761.

leverages the authorities and expertise of individual regulators at the federal and state levels. Consistent with ICI's longstanding views, the Current Guidance prioritizes approaches that seek to address risks on the broadest possible basis and requires the Council to be mindful of market dynamics and regulatory costs and burdens as it determines the appropriate regulatory response in each instance. It does all of this while retaining necessary flexibility for the Council. Finally, the Current Guidance provides assurances to financial market participants and the broader public that the Council intends to approach its analyses with seriousness and rigor.

2. The Proposals

The preamble to the Procedures Proposal states that the Council is proposing three key changes to the Current Guidance: (i) the revised guidance would focus exclusively on the procedures applicable in any initial review of a nonbank financial company for potential designation and annual reevaluation of a designated company, and substantive analysis of the company would be governed by the new Proposed Framework; (ii) the revised guidance no longer would state that the Council will use an activities-based approach before considering the designation of a nonbank financial company; and (iii) the revised guidance no longer would commit FSOC to conducting a cost-benefit analysis or assessment of the likelihood of a nonbank financial company's material financial distress prior to making a determination under section 113.

In fact, there are other important ways in which the Proposals would depart from the Current Guidance. When viewed collectively, the changes portend two outcomes that ICI finds deeply troubling: facilitating the Council's use of its SIFI designation authority without sufficient analysis of all relevant factors or sufficient consideration of alternatives to designation, and insufficient rigor in Council analyses of financial activities, products, and practices. We discuss each of these expected outcomes below.

2.1 Use of SIFI designation authority

In the Proposed Framework, the Council states its expectation that "most potential risks to financial stability will continue to be addressed by existing regulators rather than by use of the Council's nonbank financial company designation authority." Yet the Proposals, if adopted in their current form, would facilitate the Council's ability to designate a nonbank financial company for heightened prudential regulation and supervision by the Federal Reserve Board without sufficient analysis of all relevant factors or sufficient consideration of alternatives to designation. The Proposals contemplate a greater focus on individual companies as potential sources of financial stability risk; less rigorous analysis of, and less engagement with, a company under review; and a lower standard for designation.

In the bullets that follow, we highlight the salient differences between the Current Guidance and the Proposals.

- ***Regular monitoring of financial entities.*** The Current Guidance contemplates Council monitoring of a broad range of financial activities, products and practices. The Proposed Framework would add regular monitoring of individual financial entities, including: banking organizations; broker-dealers; asset managers; investment companies; insurance companies; mortgage originators and servicers; and specialty finance companies.
- ***No commitment to consider other regulatory approaches***. The Current Guidance prioritizes an activities-based approach and states that the Council will only consider a nonbank financial company for designation if a potential risk or threat to financial stability "cannot be adequately addressed through an activities-based approach." The revised guidance no longer would commit the Council to using an activities-based approach first, "mak[ing] clear that the Council could consider using its section 113 designation authority…without first needing to consider other approaches."
- ***Staff review without notice to the company***. The Current Guidance requires notice to a company that it has been identified as potentially posing risks to US financial stability and will be subject to preliminary analysis. Although the revised guidance would retain that requirement, it also indicates that the Council's Nonbank Financial Companies Designations Committee would be free to conduct such an analysis without notifying the company.
- ***No vote by Council principals required to authorize a review of the company***. The Current Guidance requires that the Council, on a non-delegable basis, vote to commence a review of a nonbank financial company. According to the preamble to the Current Guidance, this requirement is meant to help ensure that sufficient consideration is given to alternative regulatory approaches before a potential designation is considered. The revised guidance does not contain this requirement.
- ***Potential for a less comprehensive analysis***. In an analysis undertaken pursuant to the Current Guidance, the Council would first consider the identified risk broadly, in an inquiry guided by the four framing questions and with an eye to whether the risk could be addressed through activity-based regulation. If the Council concludes that an activities-based approach is insufficient, it would then undertake a specific review of the company in accordance with the detailed approach set forth in Section III of the Current Guidance. Although echoing several aspects of the Current Guidance, the Proposed Framework provides far less specificity as to how FSOC would analyze potential risks to financial stability, particularly with respect to the "transmission channels" through which negative

effects would be spread to other markets or market participants.[17] For example, discussion of how the Council expects to analyze transmission of risks through the "exposures" channel comprises eight full paragraphs in the Current Guidance but a mere three sentences in the Proposed Framework. Of those three sentences, the first two appear to be more oriented to "normal order" risk than risks to financial stability.[18]

- ***No consideration of the company's vulnerability to material financial distress***. The Current Guidance states that, as part of any review of the company under the first designation standard in section 113, the Council will assess the likelihood of the company's material financial distress based on its vulnerability to a range of factors. The Proposals would drop this commitment.
- ***No cost-benefit analysis***. The Current Guidance provides that the Council will conduct an examination of benefits and costs of designation to inform its decision as to whether to make a determination under section 113. It specifies that the Council will make a determination only if the expected benefits to financial stability from Federal Reserve Board supervision and prudential standards justify the expected costs that the determination would impose. The Proposals would drop these requirements.
- ***Lower standard for designation***. Designation of a nonbank financial company pursuant to section 113 requires a finding that material financial distress at the company, or the nature, scope, size, scale, concentration, interconnectedness or mix of the activities of the company "could pose a threat to the financial stability of the United States." The Current Guidance states that the Council intends to interpret the term "threat to the financial stability of the United States" as meaning "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."[19] Under the Proposals, this definition would be rescinded, and in future analyses under Section 113, the Council will determine what constitutes a "threat to the financial stability of the United States" by looking to the

[17] For further discussion relating to transmission channels, see Section 4.2.2 of this letter.

[18] The Proposed Framework describes the exposures channel as follows: "Direct and indirect exposures of creditors, counterparties, investors, and other market participants can result in losses in the event of a default or decreases in asset valuations. In particular, market participants' exposures to a particular financial instrument or asset class could impair those market participants if there is a default or other reduction in the value of the instrument or assets. The potential threat to US financial stability will generally be greater if the amounts of exposures are larger; if transaction terms provide less protection for counterparties; if exposures are correlated, concentrated, or interconnected with other instruments or asset classes; or if significant counterparties include large financial institutions." Proposed Framework, *supra* note 2, at 26308.

[19] Current Guidance, *supra* note 3, at 71763.

description of financial stability included in the Proposed Framework.[20] That description states, in relevant part, that the Council seeks to respond to "risks to financial stability that could impair the financial system's ability to perform its functions to a degree that could harm the economy"—quite plainly, a more general and less rigorous restatement of the definition contained in the Current Guidance.[21]

- ***Potential designations of companies engaged in the same activity***. The Current Guidance states that if a potential risk identified by the Council relates to a financial product, activity, or practice arising at a limited number of individual financial companies, the Council would still prioritize a remedy that addresses the underlying risk across all companies engaged in the relevant activity. The Proposed Framework does not include this language. Instead, it states that an entity-based action may be appropriate "in cases where the financial system relies on the ongoing financial activities of a small number of entities, such that impairment of one of the entities could threaten financial stability."

ICI consistently has urged the Council to reserve SIFI designation—an extraordinarily potent, but blunt, legal authority—for those very limited circumstances when a specific company clearly poses significant risks to the financial system that cannot otherwise be adequately addressed through other means. Reasons to reserve SIFI designation as a tool of last resort include:

- 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.
- Uncertainty about the reaction of financial markets and market participants to a company's designation—which could result in a competitive advantage, or disadvantage, for the company.

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[20] The Council argues that the current definition of "threat to financial stability" inappropriately refers to "impairment that *would* be sufficient to cause severe damage to the broader economy" whereas Section 113 calls for consideration of whether a nonbank financial company "could pose a threat to the financial stability of the United States" (areas of emphasis added). But those two definitions are not in any tension and are perfectly compatible: Section 113 requires FSOC to consider whether a nonbank financial company could pose an impairment that would be sufficient to cause severe damage to the broader economy. In either case, the proper focus of the analysis should be on the likely outcome grounded in reality, not on speculative hypotheticals involving extreme and unlikely scenarios.

[21] The proposed formulation likewise is less rigorous than the standard originally adopted by the Council in 2012. *See* 2012 Guidance, *supra* note 5, at 21657 (Council will consider a "threat to the financial stability of the United States" to exist if there would be an impairment of financial intermediation or of financial market functioning that would be sufficiently severe to inflict significant damage on the broader economy.").

- 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.

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.

2.2 Analyses of financial activities, products, and practices

ICI is concerned that the Proposed Framework contemplates insufficient rigor in the Council's analyses relating to potential risks to financial stability posed by financial activities, products, and practices. This, in turn, raises the prospect of policy outcomes that are unsupported by empirical data and actual experience.

We are reminded of the Council's assertions about open-end mutual funds. For close to a decade, the Council has expressed concern that there may be a structural vulnerability arising from a liquidity mismatch in open-end mutual funds. In a 2016 statement, the Council asserted that this vulnerability could pose risks to the stability of the financial system.[22] In response, ICI economists prepared a bespoke analysis for the Council responding directly to its contentions about the prospect of destabilizing redemptions from mutual funds invested in less liquid assets. Years later, following the March 2020 market turmoil, the Council repeated the same concerns about mutual fund redemptions, without any indication that it had considered its assumptions in light of ICI's 2016 analysis.[23] ICI again has responded with empirical data and analysis examining bond mutual fund redemption activity during the tumultuous early weeks of the global Covid-19 pandemic.

Both the 2016 analysis and a summary of ICI's more recent work are included as appendices to this letter. The appendices reflect the sort of rigorous, data-driven analysis that we think the Council, with assistance from the Office of Financial Research, should conduct as part of its reviews of financial activities, products, and practices. Yet we see three ways in which that might not happen under the Proposed Framework as it is currently drafted.

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[22] FSOC, Update on Review of Asset Management Products and Activities (April 18, 2016). A press release on the statement is available here.

[23] Financial Stability Oversight Council Statement on Nonbank Financial Intermediation (Feb. 24, 2022).

First, the Proposed Framework does not incorporate the framing questions set forth in the Current Guidance. These questions—which call for the Council to focus initially on the triggering of the potential risk, transmission of adverse effects to markets or market participants, financial system impacts, and potential impairment to the non-financial sector—are designed to help the Council determine whether a particular risk truly has systemic implications and thus warrants further attention at the Council level. Having a common starting point brings consistency to the Council's inquiries from their earliest stage, and the answers to those questions should help the Council make well-reasoned choices about how to focus its attention and resources consistent with its broad statutory mandate.

Second, the Proposed Framework lacks sufficient detail as to how FSOC will analyze a perceived risk to financial stability from a financial activity, product, or practice. As noted in the preceding subsection, its discussion of the various transmission channels is quite cursory. In contrast, as can be seen in Section III of the Current Guidance, the Council has developed clear ideas about how to analyze the potential transmission, through the exposure and asset liquidation channels, of risks presented by a nonbank financial company. Given that those same channels have been cited by the Council in certain of its activity-focused reviews,[24] we can see no reason why the same high standards for analysis as set forth in the Current Guidance should not be extended to the Council's reviews of financial activities, products, or practices.

Finally, the Proposed Framework does not include a provision from the Current Guidance that calls for an assessment of the costs and benefits in connection with formal Council recommendations, made pursuant to section 120 of the Dodd-Frank Act, for heightened regulation of a financial activity, product, or practice. The Current Guidance provides that, before making such a recommendation, the Council will ascertain whether the regulator to which the recommendation will be directed would be expected to perform a cost-benefit analysis—and, if not, the Council would perform such an analysis before issuing its recommendation. According to the Current Guidance, this requirement is intended to promote analytical rigor and to avoid duplication. Committing to a cost-benefit analysis also helps to ensure that the recommended standards or safeguards "shall take costs to long-term economic growth into account," as required by section 120.

3. Replacing Current Guidance with the Proposals

The Council's decision to replace the Current Guidance with two separate Proposals makes it challenging and cumbersome to identify the precise changes that the Council proposes to make.

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[24] *See, e.g.,* FSOC, 2022 Annual Report (Dec. 2022) at 42 (citing exposure and asset liquidation channels in discussing potential risks associated with hedge funds) and 44 (citing asset liquidation channel in discussing potential risks associated with open-end funds).

While some of the changes are discussed in the preambles to the Proposals, others are insufficiently described or not acknowledged at all. The following selected examples illustrate this problem:

- To discern how the Council seeks to change the standard for designation under section 113, it is necessary to piece together parts of both Proposals: the explanation for why the Council is proposing to shift its view of what constitutes a "threat to financial stability" is set forth in the Procedures Proposal, but the revised concept of "financial stability" is set forth in the Proposed Framework. If the Council wants to change its interpretation of the standard by which it would impose its most consequential remedy, it should clearly indicate—in one place—how the standard would change and why the Council believes that such a change is appropriate.
- In the preamble to the Procedures Proposal, the Council states that it is making "only minor changes" to the procedures applicable in any initial review of a nonbank financial company for potential designation under section 113 and that those procedures afford "significant engagement and communication" between the Council and the company. The preamble then states that these "existing features" are supplemented with "further detail on how the Council would identify nonbank financial companies for preliminary evaluation." Only by reviewing the proposed text of the revised guidance is it apparent that the "further detail" would allow an initial review to occur before notice to the company, an outcome that it is at odds with the "existing features" touted by the Council. The revised guidance also would not contain a requirement that the Council, on a non-delegable basis, vote to initiate a review of the company, as is currently assured by Section IV in the Current Guidance. From the perspective of a company that could be put under the Council's microscope, these two departures from the Current Guidance are surely not "minor changes."
- As noted above, the Proposed Framework indicates that, in certain circumstances, section 113 designations may be appropriately applied to multiple companies engaged in the same financial activity. This is a different regulatory outcome than is contemplated by the Current Guidance, which states that the Council would prioritize a remedy that addresses the underlying risk across all companies engaged in the relevant activity. Neither preamble to the Proposals acknowledges this proposed change in position or explains the Council's reasoning for such a change.
- In the preamble to the Procedures Proposal, the Council states that it is "removing the prioritization" of an activities-based approach. It fails to mention, however, that the Proposed Framework would not include the detailed description, set forth in Section II of the Current Guidance, of how the Council would conduct an analysis of a financial activity, product, or practice.

- Although acknowledging the proposed rescission of Section III of the Current Guidance, the preamble to the Procedures Proposal does not mention the degree to which the Council is proposing to remove details about how it will conduct its analysis of any nonbank financial company for potential designation under section 113. For example, as mentioned above, much of the explanation regarding how the Council will analyze the transmission of a potential risk to other market participants and the financial system more broadly will be eliminated.

ICI is troubled by the Council's failure to highlight these and other proposed changes and to explain the rationale for them. We are concerned that many reviewers of the Proposals may not notice the full extent of the Council's changes or appreciate their significance. This could hamper the public's ability to provide meaningful input on the Proposals. It also does little to advance the Council's stated objective of providing "new public transparency" regarding its analyses.

Just four years ago, the Council voluntarily committed to more transparent practices by adopting the Process Rule. The rule states that the Council shall not amend or rescind the Current Guidance without providing the public with notice and an opportunity to comment in accordance with the Administrative Procedure Act. The Current Guidance further indicates that "[i]f the Council were to depart from [this guidance], it would need to provide a reasoned explanation for its action, which would ordinarily require acknowledging the change in position." In our May 2019 comment letter on what is now the Current Guidance, ICI observed that the Process Rule provides "helpful assurances to stakeholders and the public that FSOC will continue to be transparent about how it expects to employ its broad authorities."

We recommend, at the very least, that the Council retain the Current Guidance in its entirety unless and until the Council conducts a single notice and comment rulemaking that focuses squarely on proposed changes to the Current Guidance. The preamble to that proposal should highlight all material changes and explain the Council's rationale for advancing them.[25] In other words, the Council should follow its Process Rule.

4. Suggested Revisions to Proposed Framework

If the Council nevertheless chooses to proceed with finalizing the Proposed Framework, we urge that it be revised in several respects to encourage thorough empirical analysis of the sort envisaged by the Current Guidance. Robust analysis, based upon the best available data and reasonable assumptions, is key to the Council being able to distinguish, in the first instance, between acceptable levels of risk-taking by financial market participants and excessive risk

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[25] *See, e.g.*, *Encino Motorcars, LLC v. Navarro*, 579 US 211 221 (2016) (stating that an agency must "display awareness" of a change in position and "show that there are good reasons for the new policy").

taking with potential adverse effect.[26] Such analysis likewise is key to an accurate understanding of the mechanism(s) by which adverse effects could be transmitted to other market participants and whether those effects are of a nature and magnitude sufficient to destabilize the financial system.

There are two additional aspects that ICI would like to see reflected in any final framework: a greater degree of engagement with industry and other stakeholders in reviews relating to financial activities, products and practices; and assurances of greater transparency as to how the Council has analyzed potential areas of concern and its conclusions based on those analyses. In our view, these aspects are critical to fostering a more informed exchange of views, which would help deepen FSOC's understanding of particular issues and broaden its perspective.

In the subsections below, we outline our views on how the Proposed Framework should be revised. We discuss the importance of the Council engaging with, and meaningfully considering input from, industry stakeholders. Finally, we offer recommendations for how the Council can provide the public with greater insight into its analyses of potential risks.

4.1 Identifying potential risks to financial stability

This section of the Proposed Framework broadly envisions the areas to be monitored by the Council, in consultation with financial regulators both at home and outside the United States. This is appropriate, in our view, given the breadth of the Council's mandate and the inherent uncertainty of how future risks to financial stability may materialize.

Unlike the Current Guidance, however, the Proposed Framework contemplates regular monitoring of individual financial entities, including asset managers and investment companies. Monitoring individual asset managers and investment companies is at odds with the Council's own approach to asset management over several years, beginning with its consideration in 2012 of whether potential risks in asset management might be "better addressed" through regulatory measures other than designation,[27] its review of asset management products and activities in

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[26] *See, e.g.*, Deputy Treasury Secretary Neal S. Wolin, Remarks at McDonough School of Business, Georgetown University (Oct. 25, 2010) (articulating the broad principles guiding the Obama Administration's implementation of the Dodd-Frank Act, including to "…. protect the freedom for innovation that is absolutely necessary for growth. Our system allowed too much room for abuse and excessive risk. But as we put in place rules to correct for those mistakes, we have to achieve a careful balance and safeguard the freedom for competition and innovation that are essential for growth."); Ian Katz and Rebecca Christie, "Geithner's Oversight Council Seeks to Identify Firms Posing Systemic Risk," Bloomberg (Oct. 1, 2010) (quoting Treasury Secretary and FSOC Chairman Timothy Geithner as saying that FSOC wants "to preserve the right balance between the tough rules our system clearly requires, but we want rules that are still going to encourage innovation and competition.").

[27] 2012 Guidance, *supra* note 5, at 21644.

2015-16, and recent confirmation by Chair Yellen that an activities-based approach is appropriate in addressing potential risks in asset management.[28]

Highlighting an intention to monitor individual asset managers and investment companies, as opposed to monitoring the activities in which they engage, raises the specter of whether the Council might consider at some future time the designation of a registered fund or fund manager under section 113. We have long advised that such a course of action would be highly inappropriate but, as the Council has never taken this option off the table, we feel compelled to reiterate some of the reasons why:

- Registered funds don't fail like banks do—fund investors bear any investment losses.
- Unlike banks, fund managers act solely as agents, providing investment services to a fund by contract. Fund assets belong *pro rata* to the fund's investors and do not appear on the manager's balance sheet.
- The registered fund structure and comprehensive regulation of funds and their managers under the federal securities laws already limit risks and risk transmission.
- Funds and their managers are highly substitutable.
- The remedies that would accompany SIFI designation, which are designed to moderate bank-like risks, are ill-suited to registered funds and their managers.[29]
- A designated fund would face higher costs resulting in lower investment returns for individuals saving for retirement, education and other life goals.

It is almost ten years since the Office of Financial Research authored its *Asset Management and Financial Stability* report and the SEC issued it for public comment.[30] Publication of the study, which was produced for the Council, provided ICI and other interested parties with a first real glimpse into how an inadequate understanding of asset managers and investment companies—including their structure, operation, and regulation—could potentially pave the way for inapt regulatory policy. In its comment letter on the OFR Study, ICI spoke in detail about the key

[28] *See, e.g.*, Letter from Janet Yellen and other former Obama Administration officials to FSOC (May 13, 2019) ("Activity-based rules, guidance, and supervision will often be the best choice to reduce risks in the system. In our experience this was true when we examined a number of asset-management activities…").

[29] For a more complete discussion, *see, e.g.*, Testimony of Paul Schott Stevens, President & CEO, ICI, before the Committee on Banking, Housing and Urban Affairs, US Senate, on Financial Stability Oversight Council Nonbank Designations (March 14, 2019) at 8-9; Testimony of Paul Schott Stevens, President & CEO, ICI, before the Committee on Banking, Housing and Urban Affairs, US Senate, on FSOC Accountability: Nonbank Designations (March 25, 2015) at 15-18.

[30] OFR, *Asset Management and Financial Stability* (Sept. 2013); SEC, *Public Feedback on OFR Study on Asset Management Issues* (press release dated Sept. 30, 2013).

distinction between banks and asset management firms—the agency nature of an asset manager's business, which results in a vastly different risk profile. We also explained how the existing regulation of registered funds and their managers not only protects investors but also mitigates risk to the financial system. These points are as salient today as they were then.[31]

For all of these reasons, we urge the Council to clarify in any final framework that its monitoring of asset managers and investment companies would focus on the activities in which they engage and not on individual entities.

4.2 Assessing potential risks to financial stability

The Council explains that it will work with relevant regulators to "evaluate potential risks to financial stability to determine whether they merit further review or action." The Proposed Framework identifies various vulnerabilities that the Council believes commonly contribute to potential financial stability risks, as well as sample metrics commonly used to measure each vulnerability. It also describes various transmission channels through which the adverse effects of potential risks could be transmitted to financial markets or market participants.

4.2.1 Vulnerabilities and sample metrics

At present, the Proposed Framework provides little explanation regarding the various vulnerabilities identified by the Council. We believe a more fulsome discussion would aid public understanding of how these vulnerabilities can contribute to risks to the stability of the financial system. It likewise would bring needed discipline to the Council's analyses.

Regarding leverage, ICI fully concurs with the Council's observations about its potential amplifying effects, and we often have observed that highly leveraged companies pose greater potential risk to other financial market participants and perhaps the broader financial system. Yet ICI also has emphasized the importance of considering the context in which leverage is present. If a highly leveraged company's creditors also are highly leveraged, the company's losses and inability to fully repay its obligations could result in cascading losses among creditor firms. On the other hand, if the creditors are not highly leveraged, they would take a charge against their own capital, but further repercussions would be unlikely. The Council itself has expressed a more nuanced view of leverage in the asset management context. In its 2014 release requesting comment on various asset management products and activities, the Council differentiated between an investment vehicle's use of leverage "with appropriate controls and risk management," which FSOC acknowledged "can be a useful component of an investment

[31] Letter from Paul Schott Stevens, President & CEO, Investment Company Institute, to Elizabeth M. Murphy, Secretary, SEC, dated Nov. 1, 2013. We incorporate that letter in full into this response.

strategy," and high degrees of leverage, which "can present risks to investment vehicles by magnifying the impact of asset price or rate movements."[32] This is the type of balanced discussion that we recommend the Council incorporate into any final framework.

The discussion in the Proposed Framework regarding interconnections is particularly sparse. It merely notes that "[d]irect or indirect financial interconnections, such as exposures of creditors, counterparties, investors, and borrowers, can increase the potential negative effect of dislocations or financial distress." The entirety of finance is based upon interconnections, so it is important for the Council to provide more specificity as to how interconnections may become a "vulnerability."

Greater specificity likewise should be incorporated into the discussion of "destabilizing activities." As currently drafted, it states that "[c]ertain activities, by their nature…can destabilize markets … or impair financial institutions" and that destabilizing activities can be "intentional and permitted by law." This description provides no insight into the types of legally authorized activities that the Council would consider to be vulnerabilities. Without more, the "destabilizing activities" category amounts to a "we'll know it when we see it" catchall that is likely to frustrate, rather than aid, public understanding as to how the Council will evaluate financial activities.

The Proposed Framework identifies sample metrics commonly used to measure each vulnerability (except that no metrics are identified for "destabilizing activities"). While we welcome having insight into data points that might help shape the Council's analysis, we caution the Council against putting too much weight on any single metric. For example, the number of affiliates that a financial institution has offers only the roughest approximation of its complexity. We also wish to dissuade the Council from relying on metrics that are bank-centric (*e.g.*, amounts of capital and liquidity) when evaluating potential risks in the non-bank sector.

4.2.2 Transmission channels

This aspect of the Council's analysis is critically important. A financial activity, for example, cannot pose risk to the stability of the financial system if there is no plausible mechanism for transmitting harms from that activity of a nature and magnitude sufficient to destabilize the

[32] *See* FSOC, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77488, 77491 (Dec. 24, 2014) (2014 FSOC Notice). The Council also recognizes that "the Investment Company Act constrains the amount of leverage that may be employed by mutual funds and other registered funds." *Id.* at 77492. The SEC recently strengthened these provisions, adopting a new rule that provides a modernized and comprehensive approach to funds' use of derivatives and other investments that produce leverage. That rule, among other things, requires funds that are heavier users of derivatives to adopt a derivatives risk management program and to comply with a limit on the amount of leveraged-related risk the fund may obtain. *See Use of Derivatives by Registered Investment Companies and Business Development Companies*, Investment Company Act Release No. 34078 (Oct. 28, 2020).

financial system. It is therefore imperative that the Council evaluate the potential transmission of risk in a manner designed to maximize the accuracy and integrity of any results.

In our comment letter on the Current Guidance, ICI provided detailed observations about the transmission channels relating to exposures, asset liquidation, and critical functions or services. We highlighted helpful aspects of the Current Guidance and offered suggestions for further improvement. ICI believes those observations are still relevant and could be helpful to the Council as it reevaluates this part of the Proposed Framework. We accordingly incorporate those comments in full into this letter.[33]

ICI believes that it is particularly important for the Council to expand upon what is now a quite cursory discussion of the asset liquidation channel. This channel generally relates to the prospect that rapid liquidation of financial assets could have spillover effects, causing other holders of those assets to experience selling pressure that could lead to market disruptions. In our 2019 letter, we cautioned that this type of risk analysis is particularly challenging because it is heavily dependent upon the assumptions and models used.[34]

ICI also has advised the Council not to conflate market risk with systemic risk. Our 2019 letter observed that "asset sales could cause prices to fall, and some market participants might suffer losses as a result, but that would not necessarily raise financial stability concerns." The Current Guidance appropriately focuses the Council's inquiry on the magnitude of harm that could be transmitted, stating in relevant part that:

> the Council will consider whether a nonbank financial company holds assets that, if liquidated quickly, could pose a threat to US financial stability by, for example, causing a fall in asset prices that *significantly disrupts trading or funding* in key markets or causes *significant losses or funding problems* for other firms with similar holdings. (emphasis added).

The Proposed Framework articulates a slightly different, and seemingly lower, threshold for what would be considered a threat to financial stability:

> A rapid liquidation of financial assets can pose a threat to US financial stability when it causes a *significant fall in asset prices* that disrupts trading or funding in

[33] Letter from Paul Schott Stevens, President & CEO, ICI, to the Financial Stability Oversight Council, dated May 13, 2019 (2019 FSOC Letter), at 14-21.

[34] Concerns about rapid liquidation of financial assets, often referred to as asset "fire sales," motivates the Council's focus about redemptions by open-end funds, particularly those that invest in less liquid assets. We address this issue more directly in Sections 2.2 and 4.4 of this letter and in both appendices. *See also* Sean Collins, "Applying Evidence to Theories on Regulated Funds," ICI Viewpoints, Oct. 12, 2017 (discussing FSOC's analysis of the asset liquidation channel in rescinding AIG's SIFI designation).

> key markets or causes losses or funding problems for market participants holding those assets. (emphasis added).

We reiterate the importance of the Council carefully distinguishing between market risk and systemic risk—and focusing squarely on the latter. The Council's analysis cannot simply consider whether other market participants feel the effects of a fall in asset prices, even if that fall is significant – that is part and parcel of what it means to participate in the financial markets. Instead, the Council should focus its attention on whether and *how* that price drop could transmit adverse effects with sufficient magnitude to destabilize the financial system. This is a very high bar.

Finally, we note that the Proposed Framework articulates a new transmission channel—the "contagion" channel—without identifying it as new or providing much insight into how the Council proposes to analyze this type of risk transmission. In the Current Guidance, contagion is identified as one of the factors to be considered when evaluating the transmission of risk through exposures to counterparties or otherwise. The Current Guidance explains that the Council "will seek evidence regarding the potential for contagion, including relevant industry-specific historical examples" and that "[v]arious market-based or regulatory factors can strongly mitigate the risk of contagion." These statements in the Current Guidance suggest a measured approach in evaluating contagion, which ICI believes is necessary when evaluating a factor less likely to be quantifiable and arguably more susceptible to conjecture. No such assurances are provided in the Proposed Framework as currently drafted. We accordingly recommend that more specificity about expected analyses under the contagion channel be incorporated into any final framework.

4.2.3 Evaluation of benefits and costs

One of the Proposals' "key changes" is to eliminate the requirement that the Council conduct a cost-benefit analysis prior to making a determination under section 113. ICI strongly objects to this proposed approach, under which the Council would designate a nonbank financial company without ever analyzing whether the expected benefits to financial stability from Federal Reserve supervision and prudential regulation of that company justify the expected costs that the determination would impose.

The Council contends that, by its terms, section 113 does not require the Council to conduct a cost-benefit analysis. This same line of argument was advanced by FSOC in the MetLife litigation, and it was carefully considered—and rejected—by the district court. The court explained that the Council's statutory interpretation was inconsistent with Supreme Court precedent and longstanding principles of agency decision making, noting for example that:

> Agencies have long treated cost as a centrally relevant factor when deciding whether to regulate. Consideration of cost reflects the understanding that

> reasonable regulation ordinarily requires paying attention to the advantages and disadvantages of agency decisions.[35]

The court determined that FSOC's "refus[al] to consider cost as part of its calculus" made it "impossible to know whether [MetLife's] designation 'does significantly more harm than good,'" and thus rendered the Council's decision to designate MetLife arbitrary and capricious.[36]

In the Proposals, the Council acknowledges that "there may be costs associated with a designation or the resulting Federal Reserve supervision" but nevertheless argues that having to conduct a cost-benefit analysis prior to a section 113 determination would not be "useful or appropriate" and would be unlikely to "yield a balanced result." In support of its contentions, the Council states that it is not feasible to estimate with any certainty the likelihood, magnitude or timing of a future financial crisis and, in turn, costs associated with potential failure of a particular company. It further asserts that benefits of designation are "potentially enormous" and "the costs of any particular future financial crisis, and the benefits of its prevention through designation or other measures, cannot be predicted."

The Council seems to be saying that a cost-benefit analysis in the section 113 context cannot be done with precision and, therefore, should not need to be done at all. In fact, we think the Council has it backward. Precisely because there is some degree of uncertainty with respect to both the costs and the benefits associated with a designation, it is *imperative* that the Council conduct a cost-benefit analysis, to the best of its ability, before proceeding to use its most consequential authority.

The Current Guidance details how the Council can do just that. It provides insight into what the Council should consider to be a "benefit" or a "cost" of designation, as well as some of the factors and metrics that may be relevant to evaluating benefits and costs. The Current Guidance envisions that the Council would consider both quantitative and qualitative inputs, but it is careful to point out that benefits to financial stability "may be difficult to quantify" and "some of the costs may be difficult to forecast with precision." Limitations as to what the Council can analyze likewise are acknowledged. The Current Guidance states, for example, that "reasonably estimable benefits and costs" will be quantified "when possible" based on "empirical data when available" and that the Council "will attempt" to consider the relative importance of qualitative inputs but only "[t]o the extent feasible." Even with these qualifications, the type of analysis contemplated by the Current Guidance will help to ensure that the Council's decision whether or

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[35] *Metlife, Inc.*, 177 F. Supp. 3d at 240 (quoting *Michigan v. EPA*, 576 U.S. 743, 752–53 (2015)).

[36] *Id.* at 241 (quoting *Michigan*, 576 U.S. at 752); *see also* Chamber & ICI *Amici* Br. 15–19, *supra* n.7 (explaining why *MetLife* decision was correct). ICI hereby incorporates these legal arguments contained in the Chamber & ICI *Amici* Brief.

not to designate a nonbank financial company "rests 'on a consideration of the relevant factors.'"[37]

Cost-benefit analysis likewise is important when the Council is considering potential action under its other authorities (*e.g.,* potential recommendation, pursuant to section 120, that a regulator adopt heightened standards applicable to a financial activity). Indeed, one central function of agency cost-benefit analysis is to help assess whether there may be a preferable alternative to the agency's proposed course—such as, in this context, taking an activities-based approach rather than relying on company-specific designation. The Proposed Framework, however, would abandon both of these well-established, companion elements of reasoned agency decision-making—consideration of costs and benefits, and consideration of alternatives. We accordingly urge the Council to incorporate cost-benefit analysis into any final framework.

4.2.4 Likelihood of material financial distress

For reasons similar to those outlined in the preceding subsection, ICI objects to eliminating language in the Current Guidance stating that the Council will assess the likelihood of a company's material financial distress prior to making a determination under section 113. The statute simply does not, as the Council contends, allow it to "presuppose a company's material financial distress, and then evaluate[] what consequences could follow for US financial stability."

Multiple factors in section 113 contemplate that the Council will consider the company's vulnerability to material financial distress. These include the extent of the company's leverage [(a)(2)(A)], the degree to which the company is already regulated by one or more primary financial regulatory agencies [(a)(2)(H)], and the amount and types of liabilities of the company, including the degree of reliance on short-term funding [(a)(2)(J)]. Each of these statutory factors contemplates an analysis as to whether something about the existing operations of the company makes it vulnerable to financial distress. Other factors specifically reference potential impacts on third parties (*e.g.*, the extent and nature of the transactions and relationships of the company with other significant nonbank financial companies and significant bank holding companies [(a)(2)(C)]). The contrasting language among factors makes clear that Congress contemplated a consideration of *both* parts of the problem—*i.e.*, whether the company was vulnerable to material financial distress and, if so, whether that distress could pose a threat to US financial stability.[38]

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[37] *See, e.g., Michigan v. EPA*, 135 S. Ct. 2699, 2706 (2015) (citing *Motor Vehicle Mfrs. Ass'n of US, Inc. vs. State Farm Mut. Auto. Ins. Co.*, 463 US 29, 43 (1983)). *See also* Cass R. Sunstein, *Cost-Benefit Analysis and the Environment*, 115 Ethics 351, 354 (2005) ("Without some sense of both costs and benefits—both nonmonetized and monetized—regulators will be making a stab in the dark.").

[38] *See* Chamber & ICI *Amici* Br. 5–10, *supra* n.7. ICI hereby incorporates these legal arguments contained in the Chamber & ICI Amici Brief.

In fact, this is precisely how the Council originally interpreted the statute. In January 2011, the Council proposed a six-factor analytical framework to govern its analyses under section 113. The Council's framework mapped each of the specific criteria in section 113 to one of six broad categories—size, lack of substitutes, interconnectedness, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny—that, in the Council's view, reflected different dimensions of a company's potential to pose risk to the financial system. The 2012 Guidance went on to indicate that the six categories would be further divided into two groups: (i) those that seek to assess the potential for spillovers from the firm's distress to the broader financial system or real economy (size, lack of substitutes, and interconnectedness); and (ii) those that *seek to assess the vulnerability of a nonbank financial company to financial distress* (leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny).[39]

The Current Guidance describes how the Council should analyze a company's vulnerability to material financial distress. We urge the Council to incorporate this description into any final framework, as a way to help ensure that FSOC finds a realistic, rather than speculative, threat to the financial system before subjecting a nonbank company to a SIFI designation.

4.3 Addressing potential risks to financial stability

The Proposed Framework appropriately identifies the many tools that may be used by the Council, in conjunction with financial regulators at the federal and state levels, to address potential risks to financial stability. We note that the Proposed Framework highlights two authorities which have not yet been utilized by the Council. The first is designation of a nonbank financial company based on the second standard articulated in section 113—that is, whether the nature, scope, size, scale, concentration, interconnectedness or mix of the company's activities could pose a threat to US financial stability. The second is a designation (pursuant to Title VIII of the Dodd-Frank Act) of a payment, clearing or settlement activity as, or likely to become, systemically important. ICI urges the Council to consider incorporating into any final framework some explanation of how the Council may utilize these authorities.[40]

4.4 Engagement with industry stakeholders

The Proposed Framework says that the Council relies on data, research and analysis from a range of sources, including industry participants. It also states that the Council may engage with market participants and other members of the public as it assesses potential risks to financial stability.

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[39] 2012 Guidance, *supra* note 5, at 21658 (emphasis added).

[40] *See also* 2019 FSOC Letter, *supra* note 33, at 43 (advising that, should the Council determine in the future to analyze a nonbank financial company under the second standard, it must first consider whether a different analytic framework may be needed).

ICI firmly believes that such engagement should be a regular feature of the Council's work. Input from industry stakeholders may be helpful, for example, as the Council considers factors that may amplify or mitigate a particular risk arising from a financial product, activity, or practice—a line of inquiry that is important yet also may be amorphous and more susceptible to eliciting theoretical (rather than actual) concerns. A "real world" perspective likewise could prove valuable to any evaluation involving new products or technologies.

The Council should welcome a frank exchange of views on the issues that is causing it concern, as input from industry and other stakeholders can help foster greater understanding of where risks do—or do not—threaten the financial system. In our 2019 letter, we outlined several possible ways for the Council to engage with industry stakeholders, and we reiterate them briefly here.

- The Council could begin exploring a broad topic or area with a public conference and then use the information learned to narrow the Council's focus. As appropriate, the Council could follow up with a request for public comment.
- Similar steps could be employed in reverse order: the Council could issue a request for public comment on a broad topic and then use the feedback it receives to identify areas for a "deeper dive" (through, *e.g.,* roundtables or meetings with various stakeholders).
- For some issues, the Council may wish to conduct more extensive outreach to solicit a broader range of public input. It could do so by holding a series of public hearings or roundtables in different parts of the country, an approach that other regulators have used.

The Council and its staff are experienced enough to know how to "kick the tires" on information provided by industry stakeholders. Moreover, the Council would retain flexibility to determine how to structure its engagement with stakeholders, including the extent and timing of such engagement, depending upon the specifics of the particular inquiry. This should help to ensure that the engagement is useful to the Council's purposes and does not delay its work.

A necessary corollary to this, of course, is a willingness on the part of the Council to consider the data and analysis contributed by industry and, if necessary, to modify its assumptions or conclusions accordingly. In this vein, we request that the Council re-examine its assertions about destabilizing effects from mutual fund redemptions in light of the data and analysis summarized in the two appendices to this letter and ICI's more detailed work cited therein.

4.5 Greater transparency

The Proposed Framework indicates that annual reports describe FSOC's work in implementing its responsibilities. We strongly believe there is a need for further elaboration, particularly on *how* FSOC has analyzed potential issues and its conclusions based on those analyses.

We reiterate a recommendation we made to FSOC in 2019: Consistent with statutory requirements and FSOC's transparency policy,[41] we recommend that the Council commit to report publicly on its reviews of financial activities, products, and practices. Such reporting should be a regular part of each annual report issued by the Council. FSOC should report on, for example: the status of its reviews; any empirical work that has been or will be conducted; how FSOC is interpreting relevant data; and any conclusions that a particular product, activity, or practice does not presently pose financial stability risks. If circumstances warrant, the Council also could issue one or more interim updates.[42] This might be appropriate, for example, to allay market concerns about a particular review or if the review involves issues that are time sensitive.

There are other steps the Council could take to provide greater transparency regarding its observations and concerns. While FSOC does issue prompt "readouts" after its closed-door meetings, those readouts and subsequent minutes provide the public with little insight. We believe the Council should release detailed minutes shortly after its closed meetings, as is the practice of the Federal Reserve Board's Federal Open Market Committee.

ICI recognizes that there is a time and place for regulators to meet behind closed doors to encourage and allow for candid discussion of potentially sensitive topics. In addition, there can be valid reasons to avoid releasing information too early in the course of an analysis. But in our view, providing as much public transparency as possible into this work is essential to serve the Council's stated goal of promoting market discipline as a mechanism for addressing potential risks to US financial stability.

Finally, and as a matter of good government, the Council should inform the public about which staff members at the different agencies are involved in FSOC work. This information, which is not readily 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 at agencies that do not otherwise possess expertise with respect to a particular financial industry sector.

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[41] Transparency Policy for the Financial Stability Oversight Council.

[42] *See, e.g.*, 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) (video for day 2, panel 6 at 40:28 to 40:54) ("we need to be more in the moment of looking at systemic risk and I think reports that come out annually that are identifying risks are very useful but they are necessarily somewhat backward looking and I think I'd like to see us push toward a more dynamic reporting out").

Conclusion

We appreciate your consideration of ICI's comments. If you have questions or would like to discuss our comments further, please contact either one of us at (202) 326-5800.

Sincerely,

/s/ Eric J. Pan	/s/ Rachel H. Graham
Eric J. Pan President & CEO	Rachel H. Graham Associate General Counsel & Corporate Secretary

Appendices (2)

Appendix A
Experience in the High-Yield Bond Market: 2014–2016
(prepared for FSOC – July 2016)

Regulators and academics have advanced a variety of hypotheses for why there could be financial stability risks associated with redemptions from mutual funds, particularly funds investing in less liquid asset classes. One hypothesis attributes these risks to a "first-mover advantage"—the idea that fund investors may have unique incentives to redeem ahead of other investors to avoid possible future transaction costs[43] or a possible future decrease in portfolio liquidity.[44] Another hypothesis anticipates that funds may need to sell assets more quickly than expected in a stressed market, putting additional downward pressure on asset prices and leading to additional outflows.[45] Yet another hypothesis envisions increased, possibly panic-driven, selling by fund investors in response to a triggering event (*e.g.*, sudden or unexpected closure of a single fund) that then transmits stress to additional funds and the broader market.[46]

These hypotheses share four testable predictions:

- **Prediction 1:** Mutual fund investors will redeem heavily across most funds within the affected asset class.
- **Prediction 2:** During this period of heavy redemptions, investors will refrain from purchasing new shares of funds within the asset class, creating a one-way market of sellers of fund shares.
- **Prediction 3:** Fund managers as a group will be forced by the heavy redemptions to sell portfolio assets and will not be in a position to buy assets, with the result that managers will be on one side of the trade in a down market.
- **Prediction 4:** Other investors will not enter the market to buy the portfolio assets that fund managers are trying to sell. [47]

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[43] *See, e.g.*, FSOC, Update on Review of Asset Management Products and Activities (April 18, 2016) ("FSOC Statement") at note 12 and accompanying text (citing Qi Chen, Itay Goldstein, and Wei Jiang, *Payoff Complementarities and Financial Fragility: Evidence from Mutual Fund Outflows*, Journal of Financial Economics 97(2), pp. 239-262 (2010)).

[44] *Id.* at note 13 and accompanying text (citing Paul Hanouna, Jon Novak, Tim Riley and Christof Stahel, *Liquidity and Flows of U.S. Mutual Funds*, SEC DERA white paper (Sept. 2015)).

[45] *Id.* at 5.

[46] *Id.* at 8.

[47] *Id.* at 9 (citing Fang Cai, Song Han, Dan Li, and Yi Li, *Institutional Herding and Its Price Impact: Evidence from the Corporate Bond Market*, Federal Reserve Working Paper (Mar. 1, 2016)).

In this appendix, we test these four predictions using publicly available data. We begin with some brief background on the U.S. high-yield bond market and a description of the state of that market prior to November 2015. Then, to test the predictions, we look at the experience of high-yield bond mutual funds from early 2014 to early 2016, with particular attention to the period from November 2015 to February 2016, a time of significant stress in the high-yield bond market.[48] This period included the December 2015 announcement by Third Avenue Focused Credit Fund (FCF), a high-yield bond mutual fund, that it had suspended investor redemption rights.[49] We provide empirical data regarding the behavior of investors in high-yield bond funds, the managers of those funds, and other participants in the high-yield market.

Contrary to these predictions, the data show that investors were purchasing (as well as selling) shares in high-yield bond funds during this period of market stress. Similarly, fund managers and other investors not only sold but also purchased high-yield bonds. The net result was that trading volumes of high-yield bonds actually *rose* during December 2015—when the high-yield bond market was under the greatest degree of stress.[50] We conclude by urging regulators and academics to reexamine their hypotheses, in accordance with these findings.

An Initial Word on the U.S. High-Yield Bond Market

The U.S. high-yield bond market is generally considered less liquid than U.S. Treasury and agency bond markets.[51] Companies that issue below investment grade bonds have weaker balance sheets and, during periods of slower economic growth, are more likely to default on their bonds than are investment grade issuers. For example, more than 10 percent of high-yield debt in the United States is issued by oil and gas producers and distributors, firms that are vulnerable to fluctuations in oil and gas prices. As a result, yields on below–investment grade bonds are

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[48] ICI data on high-yield bond funds includes two types of bond funds: (1) funds that primarily invest in high-yield fixed-rate bonds, and (2) high-yield floating-rate funds that largely invest in high-yield floating-rate loans and other floating-rate debt securities. In May 2014, for example, $293 billion was held in funds that primarily invest in high-yield fixed-rate bonds, and $147 billion was held in high-yield floating rate funds (for a total of $440 billion in high-yield bond funds).

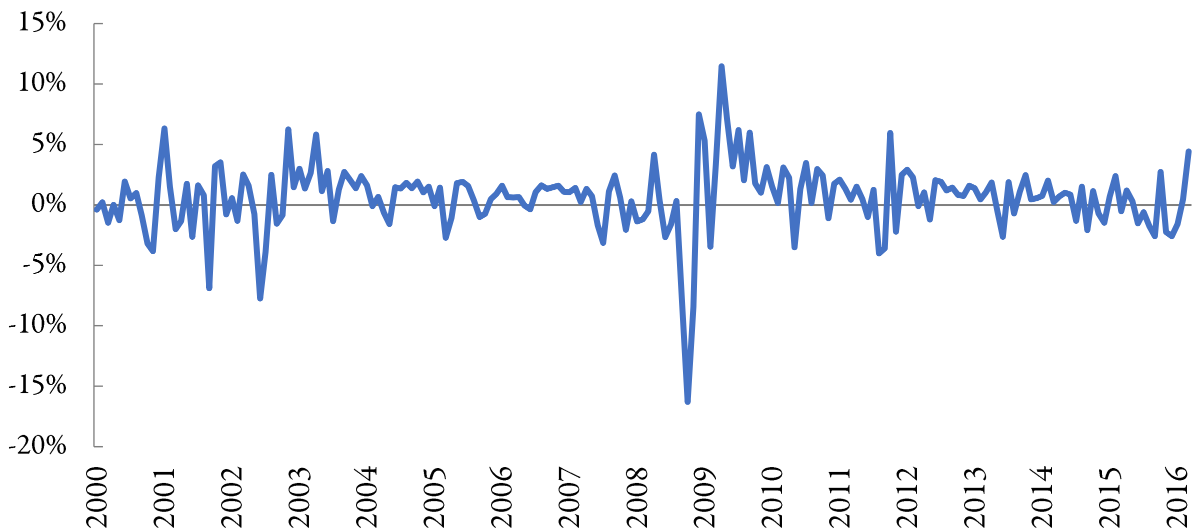
[49] *See* FSOC Statement, *supra* note 43, at 7 (pointing to FCF's suspension of redemptions as a "useful example" to illustrate "the potential for outflows to cause fund distress, and hence broader distress").

[50] Some may find it counterintuitive that trading volumes in the high-yield bond market rose during a time of severe market stress, expecting instead that trading would freeze up. Mortgage-backed bonds, for example, often are identified as an instrument that ceased to trade during the financial crisis. In the case of mortgage-backed bonds, however, investors were unable to value the pool of mortgages backing many of these bonds. The opacity of the bonds obscured their risk features and even the nature of bondholders' claims on the underlying pool of loans. In contrast, a high-yield bond is issued by a single company, which makes it easier for investors or analysts to evaluate the likelihood of default.

[51] *See e.g.*, FSOC Statement, *supra* note 43, at note 21 (citing Barclays, Liquidity Cost Scores Report (Mar. 2016)).

more volatile, creating larger potential capital gains and losses for investors relative to investment grade bonds. For this reason, investors in high-yield bonds, including those who invest through funds, can and do experience sizeable monthly fluctuations in total returns (Figure 1).

Figure 1
Monthly Total Returns of U.S. High-Yield Bonds* Are Volatile
Percent; monthly, January 2000–March 2016



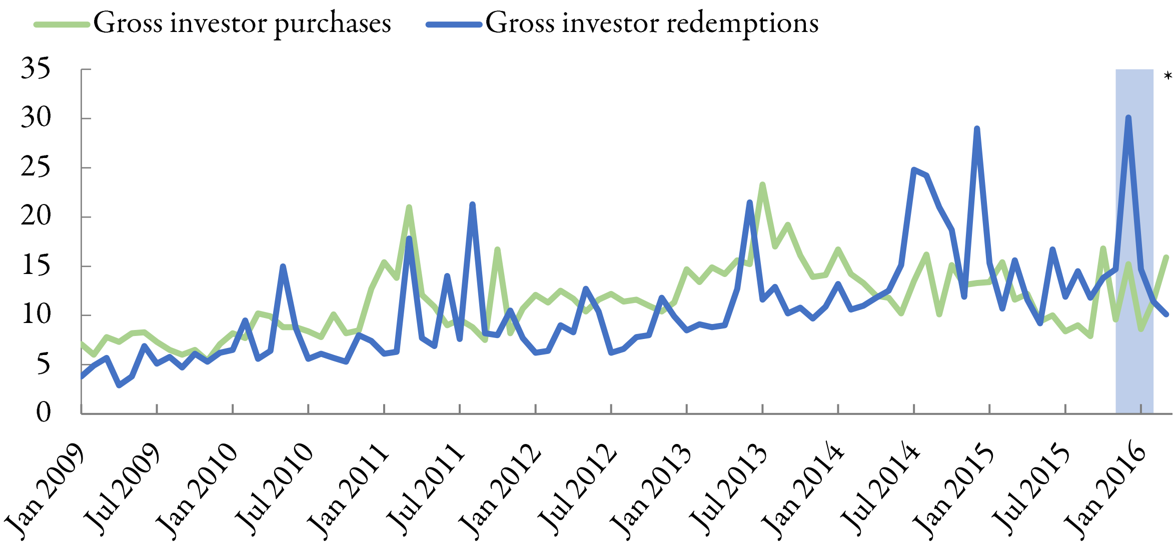
*Index represents the BofA Merrill Lynch US High Yield Total Return Index Value©, retrieved from FRED, Federal Reserve Bank of St. Louis.
Note: The variation (standard deviation) in monthly returns for U.S. high-yield bonds was 2.81 percent over the given period. Investment-grade bonds experienced less volatility, with a variation of 1.51 percent over the same period.
Source: Investment Company Institute tabulations of Federal Reserve Bank of St. Louis data

State of the U.S. High-Yield Bond Market Prior to November 2015

Corporate revenues and profits rose in the aftermath of the global financial crisis. As expected, default rates on below–investment grade bonds declined, bond prices rose, and yields fell sharply. By the end of June 2014, effective yields on high-yield bonds had fallen to 5.28 percent, nearly an 18 percentage point drop from their peak in late 2008.[52] Yields on debt rated CCC or below had declined 37 percentage points to 8.0 percent.[53]

The falling yields and rising prices of bonds produced substantial capital gains for investors and attracted investors to high-yield bond funds. Beginning in early 2009, high-yield bond funds began to experience net inflows as investor purchases outpaced investor redemptions (Figure 2). From January 2009 through May 2014, high-yield bond funds received $162 billion in net inflows, and assets in these funds reached a record $440 billion by the end of May 2014.[54]

Figure 2
Investor Purchases and Redemptions of High-Yield Bond Funds
Billions of dollars; monthly, January 2009–March 2016



*The shaded region represents November 2015 through February 2016.
Source: Investment Company Institute

[52] BofA Merrill Lynch, *BofA Merrill Lynch US High Yield Effective Yield©*, retrieved from FRED, Federal Reserve Bank of St. Louis, at https://research.stlouisfed.org/fred2/series/BAMLH0A0HYM2EY.

[53] BofA Merrill Lynch, *BofA Merrill Lynch US High Yield CCC or Below Effective Yield©*, retrieved from FRED, Federal Reserve Bank of St. Louis, at https://research.stlouisfed.org/fred2/series/BAMLH0A3HYCEY.

[54] Out of concern about the volume of these flows, some in the policy community flagged the growth of high-yield bond funds as a potential source of risk for the economy, based on fears that when yields rose and these funds suffered losses, investors would react by quickly redeeming their fund shares. *See, e.g.*, International Monetary Fund, *Global Financial Stability Report*, Ch. 1: Improving the Balance Between Financial and Economic Risk Taking (Oct. 2014).

Beginning in mid-2014, yields on high-yield bonds began to rise on expectations that falling oil prices, slower global growth, and a rising dollar would slow issuers' revenue and profit growth and increase the default rate on these bonds. Effective yields on high-yield debt rose more than 2 percentage points during the second half of 2014, reaching 7.28 percent by mid-December. Bond yields declined in the first part of 2015, but resumed their rise during the summer and early fall as investors became increasingly concerned that slower global economic growth could lead to higher default rates.

From June 2014 through October 2015, high-yield bond funds in the aggregate fluctuated between modest net outflows (i.e., redemptions exceeded purchases) and weak net inflows (i.e., purchases exceeded redemptions).[55] Averaged over the period, high-yield bond funds had net outflows of about 1 percent of assets per month. The share of outstanding high-yield bonds held by high-yield bond funds declined slightly, from 21.3 percent in June 2014 to 19.9 percent in October 2015.[56]

Test of Predictions 1 and 2: Fund Investor Behavior from November 2015 to February 2016

All of the hypotheses of investor behavior that regulators and academics have put forth predict that fund investors will redeem heavily from an asset class during a period of market stress affecting those assets (Prediction 1). According to these hypotheses, fund investors may redeem to avoid losses or transaction costs or because they fear a contagion. Similarly, during this period of heavy redemptions, investors will refrain from purchasing new shares of funds within the asset class (Prediction 2).

The fourth quarter of 2015 provided an opportunity to test these predictions. Sentiment among investors in the high-yield bond market had turned noticeably more negative in November 2015. Declining oil and commodity prices along with further signs of slower growth in Brazil, China, and other emerging market economies increased investor concerns about corporate profits and revenues. Yields on below–investment grade debt rose sharply. In early November, average yields on high-yield bonds were about 7.5 percent.[57] Yields increased to 8 percent by the

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[55] We note that net outflows were elevated in December 2014. One explanation for this may be that investors were redeeming shares to realize tax losses.

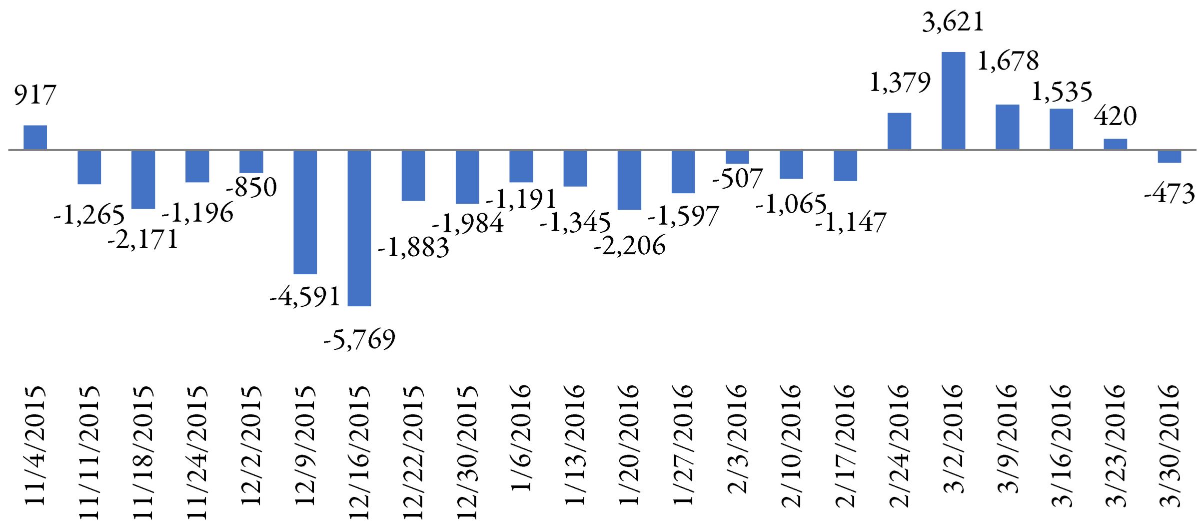
[56] We use as the measure of outstanding high-yield bonds the market value of the bonds in the BofA Merrill Lynch US High Yield Index. Our calculation of high-yield bond funds' market share excludes high-yield floating-rate funds. These funds predominantly hold bank loans and are not included in the BofA Merrill Lynch US High Yield Index.

[57] *See supra* note 10.

beginning of December, and to nearly 8.5 percent by December 9. For bonds rated CCC or below, yields rose from 14 percent in early November to 17 percent by December 9. [58]

Net outflows rose in early December. For the week ending December 2, 2015, outflows totaled $850 million, or about 0.2 percent of these funds' assets. The next week, ending December 9, net outflows increased to $4.6 billion, or 1.3 percent of fund assets (see Figure 3).

Figure 3
U.S. High-Yield Bond Fund Net Outflows Deepened, but Quickly Tapered Off In December 2015
Millions of dollars; weekly, November 4, 2015–March 30, 2016



Source: Investment Company Institute

Late on December 9 came the announcement that FCF, a high-yield bond fund, had suspended investor redemption rights and would liquidate.[59] News services carried the story on December

[58] *See supra* note 11.

[59] Mutual funds routinely liquidate for a variety of reasons (*e.g.*, investment strategy no longer in favor, insufficient interest from investors, departure of portfolio manager), but they very rarely suspend redemptions. Rather, consistent with their obligations under the Investment Company Act of 1940 and applicable state law, a fund announces its plan to liquidate on a certain date, and investors are able to redeem some or all of their shares in the fund at any time before the liquidation date.

10,[60] and it made the front page in some major newspapers on December 11.[61] Some market commentators anticipated significant fallout from the fund's closure during a period of heightened pressure in the high-yield bond market.[62]

FCF's problems did not arise suddenly. Over the prior 18 months, the fund's cumulative return was *minus 34 percent*, and the fund experienced outflows, according to Morningstar, during much of this period. In four of those months, the fund had outflows exceeding 10 percent of fund assets. By November 2015, FCF's assets were $942 million, down from $3.5 billion at its peak (a decrease in assets of 73 percent).[63]

Certainly, all the elements for the type of fund investor-driven contagion that academics and regulators have hypothesized were in place:

- The high-yield bond market was under stress;
- High-yield bond funds were experiencing moderate outflows even prior to FCF's announcement;
- FCF suspended investor redemptions—a rare occurrence for a mutual fund;[64] and
- News reports were predicting further fallout in the high-yield bond market.

According to Predictions 1 and 2, net outflows from high-yield bond funds should have grown, amplifying pressure in the high-yield bond market. In the week ending December 16, net

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[60] *See e.g.*, A Junk Bond Fund Will Liquidate, and Reimburse Investors Slowly http://www.nytimes.com/2015/12/11/business/dealbook/high-yield-fund-blocks-investor-withdrawals.html?_r=0 and Junk Fund's Demise Fuels Concern Over Bond Rout http://www.wsj.com/articles/as-high-yield-debt-reels-mutual-fund-blocks-holders-from-redeeming-1449767526.

[61] *See e.g.*, Junk Fund's Demise Fuels Concern Over Bond Rout http://www.wsj.com/articles/as-high-yield-debt-reels-mutual-fund-blocks-holders-from-redeeming-1449767526, which appeared on A1 of the *Wall Street Journal* print edition.

[62] *See e.g.*, "A Junk Bond Fund Freezes Out Investors, and the Chills Spread" http://www.nytimes.com/2015/12/12/business/dealbook/a-junk-bond-fund-freezes-out-investors-and-the-chills-spread.html and "Third Avenue Fund's Eerie Financial-Crisis Echo" http://www.wsj.com/articles/third-avenue-funds-eerie-financial-crisis-echo-1449785807.

[63] Morningstar Direct.

[64] *See, e.g.*, SEC, *Open-End Fund Liquidity Risk Management Programs*, 80 Fed. Reg. 62274, 62283 at n.82 (Oct. 15, 2015) ("The Commission has rarely issued orders permitting the suspension of redemptions for periods of restricted trading or emergency circumstances but has done so on a few occasions."); Letter to Brent J. Fields, Secretary, SEC, from David W. Blass, General Counsel, ICI, dated Jan. 13, 2016, at 46 and Appendix B (identifying six instances since 1940 in which the SEC has granted such orders to one or more stock or bond mutual funds, and describing the limited and unusual circumstances in each instance). Likewise, the Council acknowledges on page 86 of its 2016 annual report that suspensions of redemption rights "have been rare."

outflows picked up a bit as investors redeemed, on net, $5.8 billion or 1.7 percent of high-yield bond fund assets. But despite continued pressures in the high-yield market, net outflows from high-yield bond funds quickly tapered off in the second half of the month, totaling $4.2 billion or 1.2 percent of fund assets over this two-week period (see Figure 3).

One reason for the slowdown in net outflows is that, while some high-yield bond fund investors were redeeming their shares in December, other investors were purchasing shares of high-yield bond funds to such an extent that the total dollar volume of investor purchases of high-yield bond funds increased (see Figure 2). Some of these purchases may be attributable to investor flows from defined contribution plans. But such plans account for only a small percentage of the assets in high-yield funds, and accordingly other investors were an important source of fund share purchases.[65]

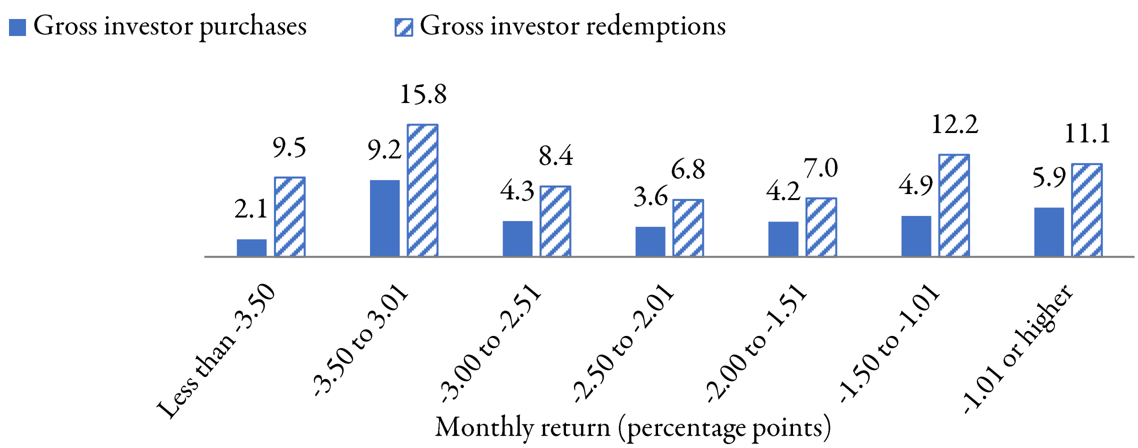
Investors weren't just buying shares of a few high-performing funds. In December 2015, 98 percent of high-yield bond funds received new investor purchases. As Figure 4 shows, the purchases (solid blue bars), measured as a percentage of assets, were significant, even for those funds with the most negative returns (the horizontal axis).

Why is it that, contrary to Prediction 2, some investors were buying shares of high-yield bond funds—even as prices were falling and other investors were selling? One reason is that when bond prices fall, yields rise—compensating investors for the possibility of higher bond default rates.[66] A related point is that if some investors sell into a down market—and help to drive bond prices below their fundamental value—investors who step in can reap the rewards when bond prices recover. Thus, investors may be attracted by depressed bond prices because of higher yields or the prospect of rising bond prices.

[65] Investors hold about 15 percent of taxable bond fund assets through defined contribution plans. The share of high-yield bond fund assets held through such plans is even less. Hence, flows from defined contribution plans typically account for a small share of high-yield bond fund flows and assets.

[66] This is a factor that the first-mover hypothesis overlooks when seeking to explain investor redemptions during periods of market stress. If investors redeem out of funds to avoid future mutualized trading costs, they also forego future interest income. Sitting out of the market in December 2015 alone would have cost investors 60 to 80 basis points in interest income, based on prevailing yields on high-yield bond funds. Such lost income would have exceeded the trading costs, even for the funds that had significant outflows.

Figure 4
U.S. High-Yield Bond Funds Had Investor Purchases and Redemptions in December Regardless of Performance
Gross purchases and redemptions as a percentage of assets, by fund return, December 2015



Number of funds:	12	15	42	40	39	30	35
Assets* Billions of dollars:	$17.4	$10.2	$91.6	$40.8	$69.1	$71.8	$34.3

*Assets are as of November 30, 2015.
Sources: Investment Company Institute and Morningstar

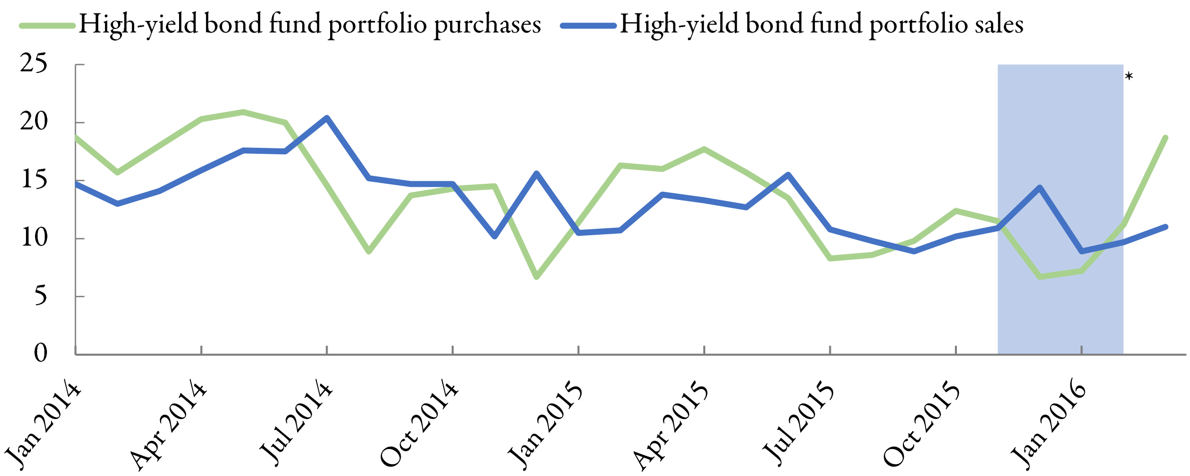
Irrespective of the reason, these facts—that investors increased their purchases of shares of high-yield bond funds during December 2015 and that net outflows tapered off—provide evidence that the hypotheses advanced by academics and regulators do not take into account an important component of investor behavior: that some investors step in to purchase fund shares even for funds investing in less liquid securities, and even in a highly stressed market. In effect, this two-way trading in fund shares disrupts the destabilizing spiral that the hypotheses predict.

Test of Prediction 3: Fund Portfolio Manager Trading From November 2015 to February 2016

According to the hypotheses advanced by regulators and academics, not only will fund investors make one-sided trades to get out of their funds, but fund managers will be forced into one side of the market, only *selling* portfolio assets (Prediction 3). These sales would then cause a negative feedback loop, pushing the prices of those assets lower, sparking further redemptions by fund investors, and prompting further sales of portfolio assets by fund managers.[67]

The data tell a different story. Contrary to Prediction 3, fund trading activity provides evidence that fund managers were both selling and *buying* portfolio assets—primarily corporate bonds—during December 2015 (Figure 5). Some funds had new cash to invest. About one-quarter of high-yield bond funds were in net *inflow*—meaning investors were buying more shares of these funds than they were selling (Figure 6). Even funds with modest net outflows would have had proceeds from maturing bonds and interest income to put to work in the market. As a result, 85 percent of high-yield bond fund managers were buying corporate bonds, including managers of funds that had some of the weakest performance in December 2015 (Figure 7).

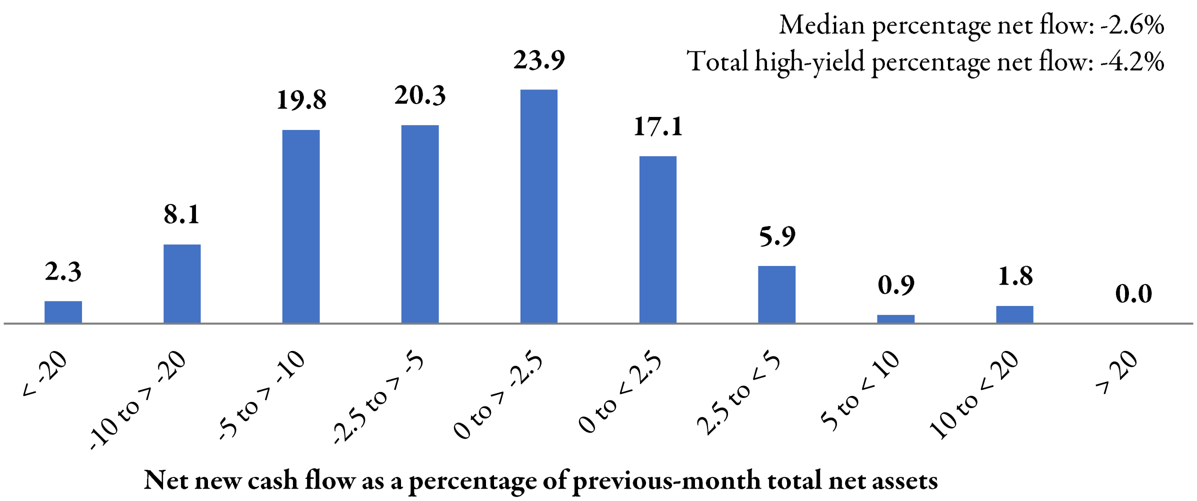
Figure 5
U.S. High-Yield Bond Fund Managers Continued to Buy Corporate Bonds Even During the 2015 Sell-Off
Billions of U.S. dollars; monthly, January 2014–March 2016



*The shaded region represents November 2015 through February 2016.
Source: Investment Company Institute

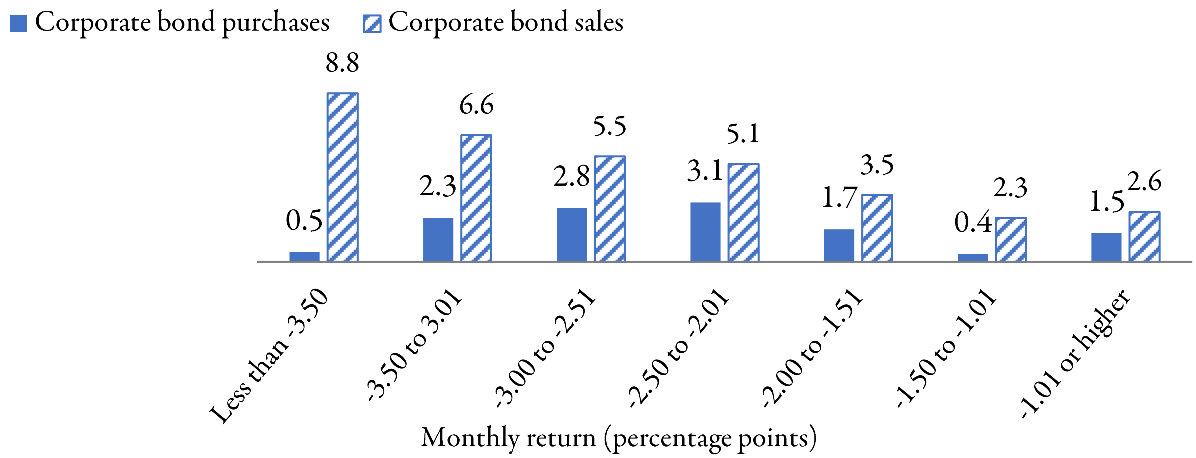
[67] The FSOC Statement acknowledges that "the extent to which fund redemptions might contribute to financial stability risks also depends on the behavior of various types of investors…[F]orced asset sales may not create a feedback loop if other investors step in to buy the assets." FSOC Statement, *supra* note 43, at 8.

Figure 6
Most U.S. High-Yield Bond Mutual Funds Had Modest Net Outflows; More than One-Quarter Had Net Inflows in December 2015
Distribution of net flows as a percentage of total number of funds, December 2015



Note: Data exclude mutual funds that invest in other mutual funds, funds specifically designed for frequent trading, funds without a full year of history, and any fund with a merger between November 1, 2015 and December 31, 2015.
Source: Investment Company Institute

Figure 7
U.S. High-Yield Bond Funds Both Purchased and Sold Corporate Bonds in December 2015 Regardless of Performance
Purchases and sales of corporate bonds as a percentage of fund assets, by fund return, December 2015



Number of funds:	12	15	42	40	39	30	35
Assets* Billions of dollars:	$17.4	$10.2	$91.6	$40.8	$69.1	$71.8	$34.3

*Assets are as of November 30, 2015.
Sources: Investment Company Institute and Morningstar

Test of Prediction 4: Other Investors Trading Behavior from November 2015 to February 2016

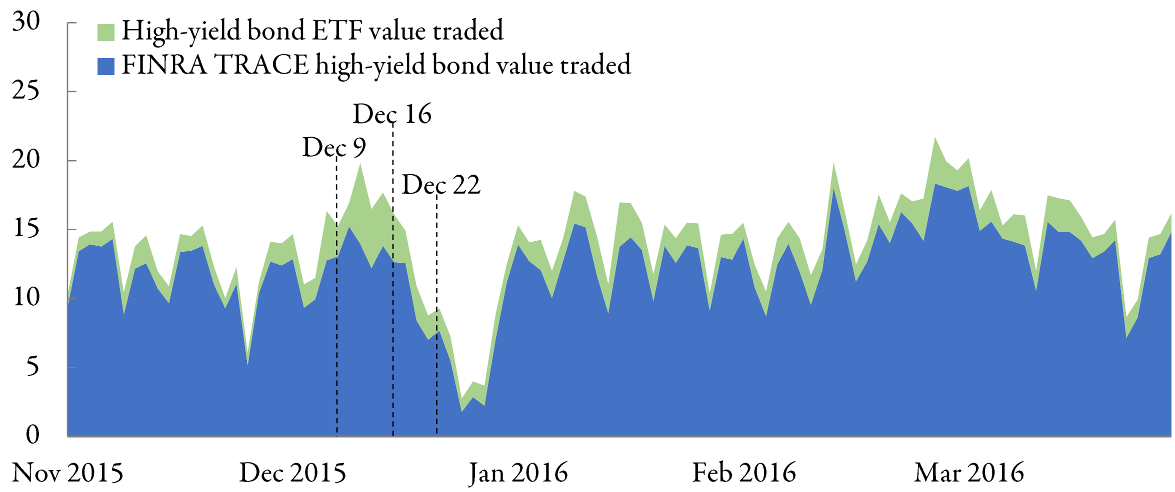
According to Prediction 4, other investors, including institutional investors, would not enter the market to buy the portfolio assets that fund managers were trying to sell. [68] This prediction would suggest that overall trading volumes would decline as buyers failed to step into these markets during periods of stress and that bond funds' share of the overall trading in the high-yield market would rise. Neither occurred.

As shown in Figure 8, high-yield bond trading volumes held up well in December 2015 (until the normal seasonal decline over the year-end holidays), particularly during the most stressed period in the first half of December when investors' expectations of higher default rates were changing quickly and bond yields were rising. Trading of high-yield bonds actually rose slightly during the second week of December. In addition, during the period of greatest market pressure,

[68] *See supra* note 47.

secondary market trading of shares in high-yield bond exchange-traded funds (ETFs) rose, providing an additional means for market participants to buy and sell exposure to the high-yield bond market.

Figure 8
U.S. High-Yield Bond Trading Volume Rose in Mid-December 2015; ETFs Added Market Liquidity
Billions of U.S. dollars; daily, November 2, 2015–March 31, 2016

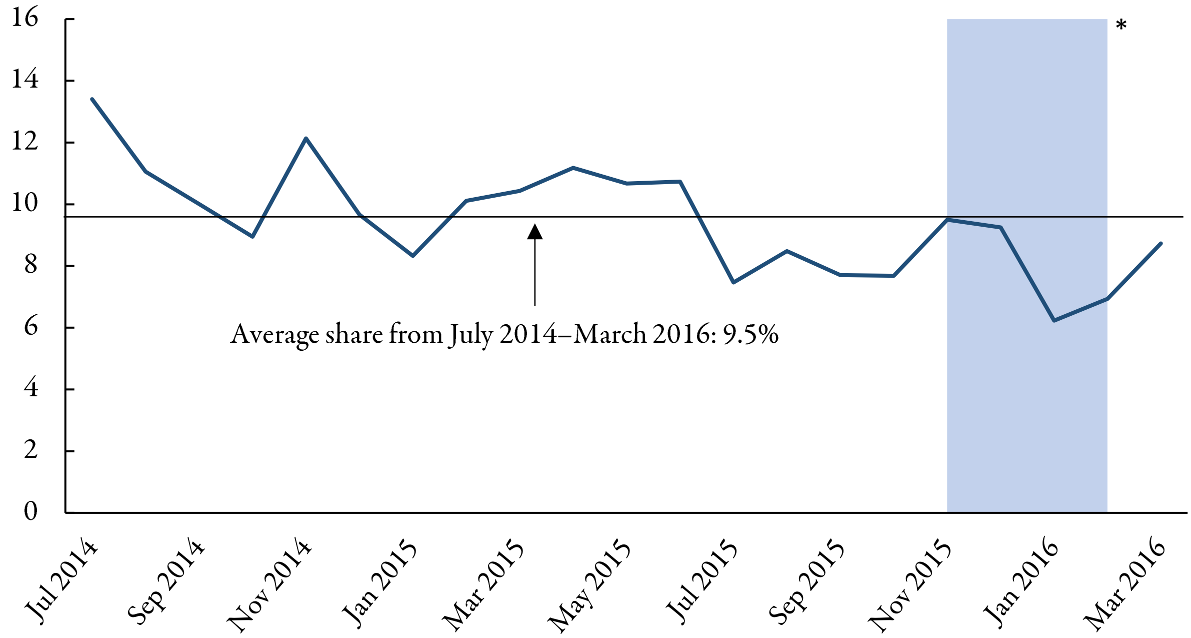


Note: Data exclude high-yield bond ETFs designated as floating-rate. Data also exclude Veteran's Day, the Friday after Thanksgiving, Christmas Eve, and New Year's Eve.
Sources: FINRA TRACE and Bloomberg

The share of trading volume in the high-yield bond market attributable to high-yield bond funds also did not spike (Figure 9). In December, bond funds' buying and selling of corporate bonds accounted for 9.2 percent of the trading volume in the high-yield bond market, *less than* funds' average share from July 2014 through March 2016.

Nor did trading volumes collapse, as the hypotheses would predict, in January or Feburary 2016. Bond prices continued to fall until late February, but there is nothing to suggest that this was anything more than normal market dynamics, in which buyers and sellers were repricing the default risk of these securities. High-yield bond trading volumes were in line with their levels a year earlier. Bond funds were buying and selling roughly equal volumes of bonds (Figure 5), and their share of market trading fell somewhat.

Figure 9
U.S. High-Yield Bond Mutual Funds' Share of High-Yield Bond Market Trading Remained Steady in 2015
Percentage; monthly, July 2014–March 2016



*The shaded region represents November 2015 through February 2016. The simple average cumulative total return was negative 8 percent for U.S. high-yield bond funds between mid-September and mid-January.
Note: Data exclude high-yield bond funds designated as floating rate funds. Aggregate data for high-yield 144A transactions are only publicly available starting in July 2014.
Sources: Investment Company Institute and FINRA TRACE

Conclusion

The empirical evidence presented in this appendix raises serious doubts about the validity of the current hypotheses underpinning FSOC's perception of the behavior of mutual fund investors, mutual fund managers, and other investors. The Council acknowledges that the extent to which fund redemptions might contribute to potential financial stability risks depends on the behavior of various types of investors, and if other investors step in, a negative feedback loop will not materialize.[69] This is an important observation, and one that the Council and others have not sufficiently explored.

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[69] FSOC Statement, *supra* note 43, at 8.

This case study provides just one example of the dozens of times that the hypotheses that the FSOC relies on have been tested for stock and bond funds in the past 75 years. In the past decade alone, other tests of these hypotheses and their predictions include the 2007–2009 financial crisis, the European debt crisis of 2011, the so-called Taper Tantrum of 2013, the 2015–2016 sell-off in the U.S. high-yield bond market, and, most recently, in the market turmoil following the United Kingdom's surprising vote on June 23 to leave the European Union ("Brexit"). Economists seldom have the opportunity to repeatedly test the predictions of their hypotheses. In each case, the hypotheses set forth by the Council failed to predict actual investor behavior.

We therefore urge the Council—as well as other regulators and academics—to step back and reexamine these hypotheses based on empirical evidence. Failure to do so could result in the development of regulatory policies that are misguided or even harmful to investors and the broader markets.

Appendix B
Summary of Recent ICI Research on First-Mover, Dilution, and Systemic Risk in Mutual Funds

B.1 Introduction

For close to a decade, the Financial Stability Oversight Council (Council) has expressed concern that there may be a structural vulnerability arising from a liquidity mismatch in open-end mutual funds ("funds") that could become a systemic risk.[70] This concern is primarily based on the theory that there is a *first-mover advantage* in funds which may cause investors to redeem heavily during a crisis to avoid dilution,[71] and, in turn, could lead funds to fire-sell securities thereby potentially amplifying stress throughout the financial system.

In this appendix we provide a synopsis of recent ICI research on topics directly related to first-mover advantage and financial stability in mutual funds. Our analytical work:

- Sizes the first-mover effect by estimating dilution in mutual funds,
- Explores whether a first-mover advantage is unique to the mutual fund structure,
- Assesses the impact on the bond markets from bond mutual funds' net sales of bonds in March 2020, and
- Provides an accurate estimate of bond mutual funds net sales of Treasury securities in March 2020.

The results of ICI's research provide evidence that hypotheses regarding first-mover advantage, dilution, and asset market stress amplification in mutual funds are not significant enough to warrant such intense focus by policymakers. Our results show that:

- Estimated dilution is far too small to motivate heavy redemptions,
- First-mover advantage is not unique to the mutual fund structure,

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[70] *See, e.g.*, FSOC, Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77488 (Dec. 24, 2014) (2014 FSOC Notice) (requesting comment on liquidity and redemption risk in registered funds); FSOC, Update on Review of Asset Management Products and Activities (April 18, 2016) (asserting that there are financial stability concerns that may arise from liquidity and redemption risks in mutual funds, particularly funds investing in less liquid asset classes).

[71] Dilution occurs when fund investors buy or sell fund shares and the transaction costs of meeting those purchases or redemptions—such as bid-ask spreads or market impact costs from the fund having to buy or sell portfolio securities—are borne by non-transacting fund investors as a reduction in the fund's return.

- There is no evidence that mutual funds amplified bond market stresses in March 2020, and
- Mutual funds sold far less Treasuries in March 2020 than claimed by policymakers.

B.2 Estimated Dilution Is Far Too Small to Motivate Heavy Redemptions from Mutual Funds

ICI has long disputed the first-mover hypothesis for two reasons. First, the theoretical models that produce this result do not consider real world factors such as taxes, reinvestment risk, long investment horizons and other factors, that undoubtedly influence investor behavior and can make redeeming less appealing.[72] Second, for the first-mover hypothesis to be credible, dilution must be both highly predictable and so substantive that it incentivizes investors to redeem heavily to try to avoid dilution. If dilution is economically small, there is little cost to investors staying put in funds, and indeed the costs to investors of redeeming could far exceed anticipated dilution.[73]

To provide evidence on this, we estimate average dilution for various types of mutual funds using two prominent approaches from the academic literature, one by Zitzewitz (2003) and the other by Choi et al. (2022).[74]

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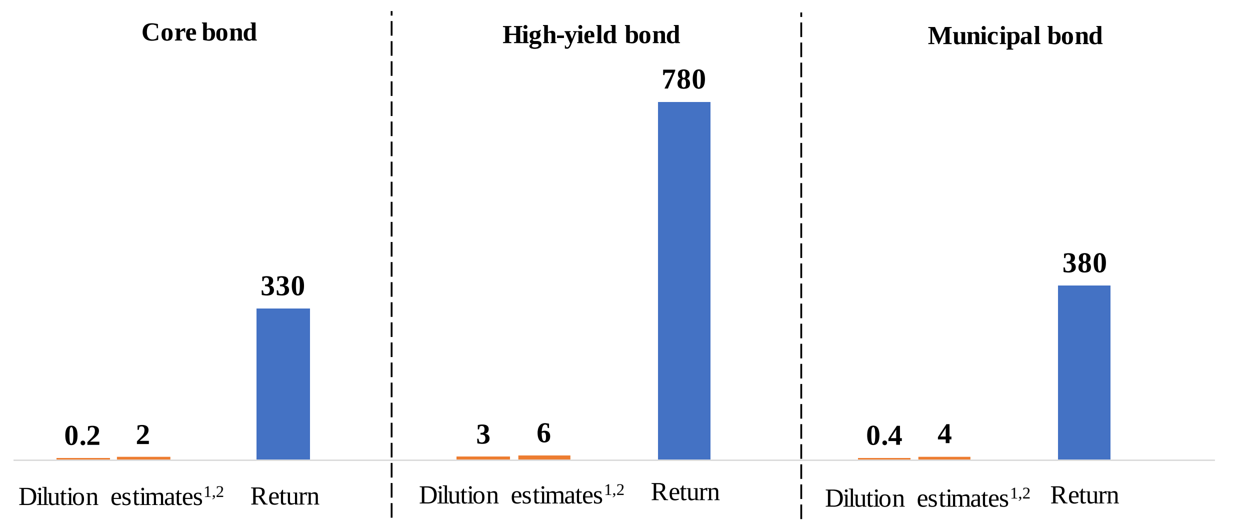
[72] *See* Sean Collins, "First-Mover Advantage: The Theory Is Only as Good as its Assumptions," *ICI Viewpoints*, June 7, 2023.

[73] Direct evidence of a first-mover effect in the general academic literature is lacking. Rather studies tend to provide evidence that mutual fund flows track market returns (or fund returns). One study which is highly cited and frequently noted as documenting a first-mover mover effect is Goldstein, Jiang, and Ng (2017), "Investor flows and fragility in corporate bond funds," *Journal of Financial Economics*, 126(3):592–613. The paper examines the relationship between monthly fund flows and performance and argues that they have found evidence that bond fund "outflows are sensitive to bad performance more than their inflows are sensitive to good performance," a so-called "concave performance-to-flow relationship." But Goldstein et al. (2017) does not claim to have found evidence of a first-mover advantage. Instead, as the paper's abstract states, its findings "*may* [emphasis added] generate a first-mover advantage among investors in corporate bond funds," leaving open the possibility that their results also may not imply a first-mover advantage. Another study by Feroli, Kashyap, Schoenholtz, and Shin (2014), "Market Tantrums and Monetary Policy," Chicago Booth Research Paper no.14-09, argues that they have found evidence of a first-mover advantage in bond mutual funds. Research by Collins and Plantier (2014), "Are Bond Mutual Fund Flows Destabilizing? Examining the Evidence from the Taper Tantrum," however, challenges the findings in Feroli et al (2014). Collins and Plantier (2014) discuss the econometric identification problems in Feroli et al (2017) and show that the posited evidence of a first-mover advantage in their results vanishes once variables proxying for changes in monetary policy are introduced into the analysis.

[74] *See* Zitzewitz (2003), "Who Cares about Shareholders? Arbitrage-Proofing Mutual Funds," Journal of Law and Economics, October, 19(2), 245-280; Choi, Kronlund, and Oh (2022), "Sitting bucks: Stale pricing in fixed income funds," Journal of Financial Economics, 145, 296–317.

We estimate that daily dilution for US mutual funds is on average too small to motivate the heavy redemptions that the first-mover hypothesis envisions. Estimated dilution is typically on the order of tenths or hundredths of a basis point and perhaps a few basis points per day during periods of stress for certain types of funds.[75] To be sure, small daily dilution estimates can accumulate over time. For high-yield bond mutual funds—which some regulators and academics have characterized as "illiquid"— our estimates indicate that dilution averaged just 3 to 6 basis points annually (Figure 1). Although dilution estimates can vary across individual funds and day-to-day for a given fund, any potential dilution must be set in context. ICI's analysis indicates that investors' concerns about dilution generally will be far outweighed by concerns about daily variability in market returns and likely are outweighed manyfold by the long-term returns that investors earn in mutual funds.

Figure 1
Hard to See That Dilution Is a Motivating Factor for Investors to Redeem from Bond Mutual Funds
Annual average in basis points, 2009 to 2022

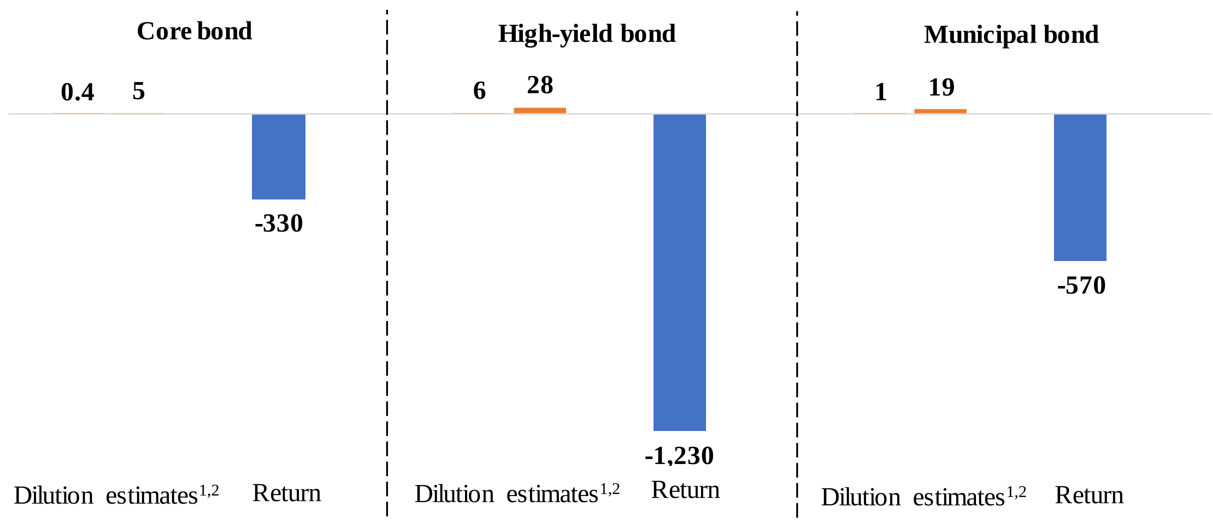


[1] Left orange bar represents ICI estimate based on model from Zitzewitz (2003).
[2] Right orange bar represents ICI estimate based on model from Choi, Kronlund, and Oh (2022).
Source: ICI calculations of Morningstar and Refinitiv data

[75] *See* Figure 2.3 of "ICI Comment Letter on Open-End Fund Liquidity Risk Management Programs and Swing Pricing" at www.ici.org/system/files/2023-02/23-cl-sec-liquidity-proposal.pdf. We emphasize that these are estimates of fund dilution. In our analysis, a positive number for estimated dilution suggests redeeming investors may be gaining at the expense of non-redeeming investors. Negative dilution estimates indicate that redeeming investors would have been better off not redeeming today because the fund's net asset value rose in coming days.

Of course, investors might be concerned about dilution during periods of market stress. To assess this, ICI estimated dilution for the entire month of March 2020—a period of broad market stress stemming from pandemic-related developments.[76] Even for high-yield bond mutual funds, estimated dilution—which ranged from 6 basis points to 28 basis points depending on the model—remained negligible (Figure 2). Was dilution of a magnitude to really factor into fund investors' decisions to redeem during that time? More likely investors were intensely focused on the steep losses on bonds and the spikes in bond return volatility stemming from a rapid deterioration in global macroeconomic conditions.[77]

Figure 2
Even in March 2020, Was Dilution Really a Consideration for Bond Mutual Fund Investors?
Total estimated in basis points, March 2020



[1] Left orange bar represents ICI estimate based on model from Zitzewitz (2003).
[2] Right orange bar represents ICI estimate based on model from Choi, Kronlund, and Oh (2022).
Source: ICI calculations of Morningstar and Refinitiv data

[76] *See* Shelly Antoniewicz, Sean Collins, and Hammad Qureshi, "Setting the Record Straight on Dilution, First-Mover Advantage, and Financial Stability Risk," *ICI Viewpoints*, June 5, 2023.

[77] *See* "The Impact of COVID-19 on Economies and Financial Markets," Investment Company Institute, October 2020.

B.3 First Mover Advantage Is Not Unique to the Mutual Fund Structure

In addition, new research challenges the theory that there is something about the structure of mutual funds that generates a unique and strong incentive for fund investors to redeem heavily when asset prices are tumbling.

Academic theory implies that investors in mutual funds and direct investors in stocks and bonds should behave differently during market downturns.[78] The first-mover hypothesis asserts that the shared liquidity of investors in mutual funds creates an incentive for fund investors to redeem heavily during market downturns because liquidity costs are absorbed by the remaining fund investors. It also posits that direct investors have no such incentive because they bear the full liquidity cost of selling securities. Thus, if the first-mover hypothesis as applied to mutual funds is correct, mutual fund investors should react much more strongly to changes in market conditions than do direct investors.

New evidence by Stahel (2022), however, suggests that mutual fund investors and direct owners react similarly to changes in market conditions.[79] Stahel (2022) reports that the so-called "concave performance-flow" relationship that academics have argued is evidence of a first-mover advantage in bond mutual funds is also found in performance and flow data for fixed income separately managed accounts (SMAs). SMAs are accounts in which investors directly own portfolios of securities. As one striking example, we estimate that percentage outflows from taxable bond mutual funds and fixed income SMAs were nearly identical in March 2020 (Figure 3), 4.9 percent versus 4.5 percent, respectively.[80]

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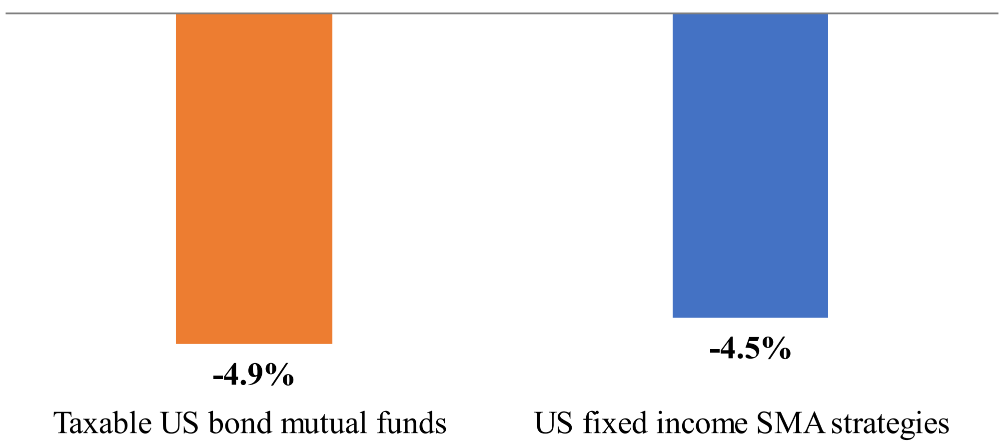
[78] *See also* 2014 FSOC Notice, *supra* note 70, at 77490 (stating that the Council "is interested in exploring the ways in which investors in some pooled investment vehicles could have greater incentives to redeem than if they were to sell a direct investment in the financial assets comprising the vehicle's portfolio. Investors in pooled investment vehicles that offer near-term access to redemptions could face increased redemption incentives, especially during periods of financial market stress, because the costs associated with redemptions are shared and, as a result, partially borne by remaining shareholders" and that "[i]n contrast, because [separately managed accounts (SMAs)] impose the full cost of asset sales on the redeeming investor, SMAs are unlikely to create the same incentives for the investor to redeem.").

[79] *See* Christof W. Stahel (2022), "Strategic Complementarity among Investors With Overlapping Portfolios," working paper, Investment Company Institute.

[80] Although some might be tempted to argue that the larger outflows from bond mutual funds compared to fixed income SMAs in March 2020 are evidence of a stronger first-mover incentive in mutual funds, this would be incorrect. Stahel (2022) formally tests whether investors in mutual funds behave differently during market downturns (i.e., have a larger redemptions) than investors in comparable SMAs, who are the direct owners of their portfolio assets. Stahel's results show there is no statistical difference between mutual fund investors' responses and those of SMA investors. In other words, mutual funds do not exhibit further accelerated outflows over SMAs. This implies that any difference in aggregated outflows shown in Figure 3 can be attributable to other factors, such as sampling error arising from variations in data sources, data definitions, breadth of data coverage, and other data related issues, rather than fund investor behavior.

Figure 3
If the First-Mover Hypothesis Is Correct, Bond Mutual Fund Investors Should React Much More Strongly to Market Changes than Do Direct Investors in Bonds—But that Doesn't Appear to Be True
Outflows as a percentage of net assets, March 2020



Source: ICI calculations of ICI and Morningstar Direct data

B.4 No Evidence That Mutual Funds Amplified Bond Market Stresses in March 2020

The Council has repeatedly voiced concerns that during a market downturn a first-mover advantage might cause mutual funds to fire-sell assets, amplifying the downturn. However, the Council offers no hard evidence of this. ICI has provided hard evidence that should allay this concern.[81] We collected from bond mutual funds their actual daily portfolio purchases and sales during March 2020[82] and found no evidence that bond mutual funds significantly amplified market stresses during that tumultuous month.

Policymakers frequently cite certain academic studies as suggesting that mutual funds' sales of portfolio securities amplify stresses in financial markets. These studies typically provide evidence that selling by mutual funds has a *statistically* significant effect on market prices (or

[81] *See* Shelly Antoniewicz and Sean Collins, "Setting the Record Straight on Bond Mutual Funds' Sales of Treasuries," *ICI Viewpoints*, February 24, 2022; Shelly Antoniewicz and Sean Collins, "Policymakers Say Bond Mutual Funds Contributed Significantly to Treasury Market Stress but…," *ICI Viewpoints*, March 24, 2022; Sean Collins and Shelly Antoniewicz, "Policymakers Need to Focus on Economic Fundamentals and Not Blame Bond Mutual Funds: Examining the Evidence of Investment Grade Corporate Bond Yield Spreads in March 2020," *ICI Viewpoints*, July 6, 2022; Sean Collins and Shelly Antoniewicz, "Core Bond Mutual Funds Had Little Impact on the Investment Grade Corporate Bond Market," ICI Viewpoints, August 4, 2022.

[82] *See* Shelly Antoniewicz and Sean Collins, "ICI Bond Mutual Fund Survey Brings Facts to the Debate," *ICI Viewpoints*, February 24, 2022.

yields), but upon closer examination those effects are not *economically* meaningful.[83] In addition, these studies do not have data on funds' actual sales of bonds. Instead, the authors attempt to infer it from funds' month- or quarter-end holdings, fund returns, and estimated fund flows—all of which could introduce errors into their analyses.

To more precisely analyze whether bond mutual funds had a significant impact on the bond markets during March 2020, we estimated the contribution of their *actual* daily net sales of bonds on the increase in high-yield and investment-grade corporate credit spreads and the increase in the yield on the 10-year Treasury bond.

We find that, while there is a statistically significant effect of mutual funds' net sales of high-yield bonds on their yield spreads to Treasuries,[84] the economic effect in March 2020 was very small. The $11 billion in high-yield bonds that bond mutual funds sold on net from February 28 to March 23, 2020, accounted for only an estimated 19 basis points or 3.4% of the 557-basis point increase in the high-yield credit spread over the same period (Figure 4).

In our model, the effect of mutual funds' sales of investment grade corporate bonds is also statistically significant. But because bond mutual funds sold only $10 billion on net in investment grade bonds from February 28 to March 23, 2020, the impact was economically immaterial—accounting for an estimated 5 basis points or 1.6% of the 313-basis point increase in the yield spread. For Treasury bonds, we find no statistically significant effect from mutual funds' sales of Treasury bonds on Treasury yields (the 15-basis point effect shown in Figure 4 is based on a statistically insignificant regression coefficient).

In each case, other factors (such as uncertainty as represented by stock or bond market volatility, general market sentiment, and general bond market liquidity), or other unexplained factors (e.g., sales by other market participants) account for nearly all of the increase in yield spreads (or yields in the case of Treasury bonds).

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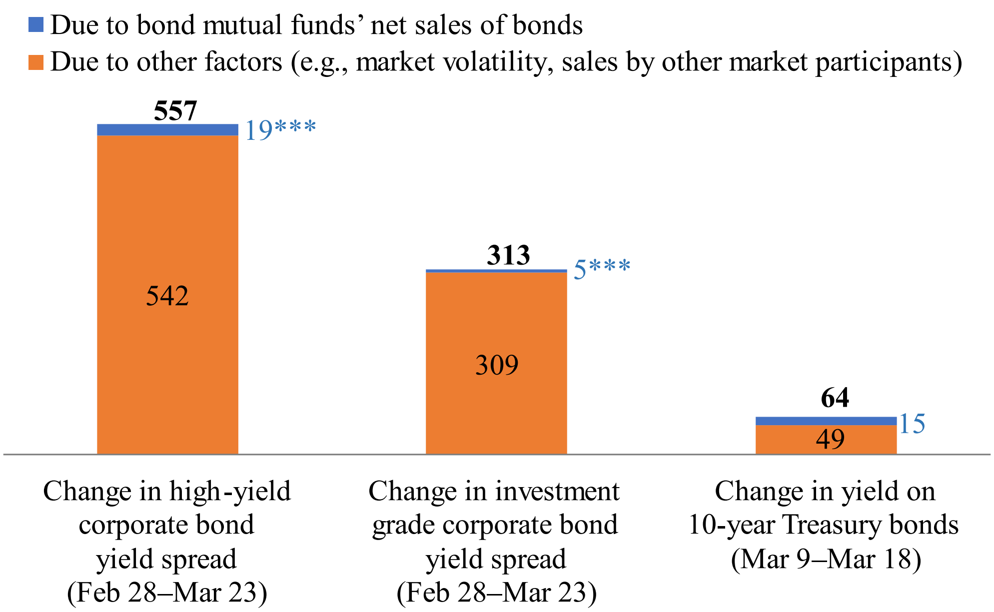
[83] *See* ICI Comment Letter on Open-End Fund Liquidity Risk Management Programs and Swing Pricing, Appendix A at pages 33 to 35 for a detailed discussion on the lack of economic significance in the results reported in several research papers recently cited by the Securities and Exchange Commission. These papers include Coval and Stafford (2007), "Asset fire sales and purchases) in equity markets," *Journal of Financial Economics*, 86, 479–512; Yiming Ma, Kairong Xiao, and Yao Zeng (2022), "Mutual fund liquidity transformation and reverse flight to liquidity," *The Review of Financial Studies*; and Haddad, Moreira, and Muir (2021) "When Selling Becomes Viral: Disruptions in Debt Markets in the COVID-19 Crisis and the Fed's Response," *The Review of Financial Studies*, 34, 5309–5351.

[84] *See* ICI Comment Letter on Open-End Fund Liquidity Risk Management Programs and Swing Pricing, Supplemental Appendix on Asset Market Stress Amplification, Figure A3.1 for the detailed results of the regression models estimating the relationship between the change in high-yield and investment grade credit spreads/Treasury yields and mutual funds' net purchases/sales of these securities.

Figure 4

Mutual Funds' Net Sales of Bonds in March 2020 Had Little Effect on Bond Markets

Change in yield spread (high-yield and investment grade) or change in yield (Treasuries)
Basis points, March 2020



*** indicates that the regression coefficients used to estimate the influences of bond funds' net sales of high-yield and investment grade corporate bonds are statistically significant at the 1 percent level. In the regression for the 10-year Treasury bond, the coefficient used to estimate the influence of bond funds' net sales of Treasury bonds is not statistically significant.

Note: In the figure, the heights of the bars for high-yield and investment grade bonds are changes in yield spread. For high-yield bonds, the yield spread is the difference between the ICE BofA US High-Yield Index yield and the yield on 7-year Treasury bonds from February 28, 2020, to March 23, 2020. Bond mutual funds sold $11 billion on net in high-yield bonds over the period. For investment grade corporate bonds, the yield spread is the difference between the yield on the ICE BofA BBB US Corporate Index and the yield on 10-year Treasury bonds from February 28, 2020, to March 23, 2020. Bond mutual funds sold $10 billion on net in investment grade corporate bonds over the period. For Treasury bonds, the height of the bar is the change in the yield on US Treasury securities at 10-year constant maturity from March 9, 2020, to March 18, 2020—the period when the Treasury market was dislocated. Bond mutual funds sold $62 billion in Treasury notes and bonds over the period.

Sources: ICI calculations of ICI bond mutual fund survey, Refinitiv, TRACE, and Federal Reserve Bank of St. Louis FRED data

B.5 Mutual Funds Sold Far Less Treasuries in March 2020 Than Claimed by Policymakers

Some policymakers and analysts have thrown out some very large numbers when making claims about mutual funds' sales of Treasuries in the first quarter of 2020.[85] In these statements, they appear to have drawn on the same official source for data for these statements, and infer that mutual funds sold, on net, $260 billion in Treasuries during 2020:Q1.[86] Policymakers have treated this $260 billion figure as fact, and have focused intensely on bond mutual funds as the predominant, if not entire, source of the net sales in March 2020.

ICI has provided evidence from its own monthly statistical collection and its special survey on bond mutual funds' daily security transactions in March 2020 that this $260 billion estimate published by the Federal Reserve's Flow of Funds Accounts (Flow of Funds) was far too high.[87] Using ICI's survey data, we estimate that in March 2020 mutual funds altogether sold $130 billion on net in Treasury notes and bonds—of which $101 billion was from bond mutual funds, the focus of policymakers' concerns.

There is a conceptual difference between the Flow of Funds estimate and ICI's estimate. Specifically, the Flow of Funds' estimate is a broader "net acquisition" concept reflecting purchases less sales of bonds less the amount of any bonds that matured off the books of mutual funds. In contrast, ICI's estimate is a "net transaction" concept—purchases less sales. To the extent mutual funds had Treasury bonds mature off their portfolios in 2020:Q1, the Flow of Funds estimate will overstate net sales of Treasuries by mutual funds.

Even after taking into consideration this conceptual difference, we suspect much of the gap between the two figures is due to the methodology used by Flow of Funds to create its estimates. Flow of Funds does not use as inputs *any* data on mutual funds' purchases, sales, or matured bonds. Rather, mutual funds' net acquisitions of Treasuries are estimated by taking the quarterly difference in the estimated market value of mutual funds' Treasury holdings and adjusting this difference by estimated capital gains on Treasury securities in the quarter. This methodology leaves room for error particularly when there are large swings in Treasury prices, and so it is an open question as to whether the figures published by Flow of Funds are plausible estimates of

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[85] See Board of Governors of the Federal Reserve System, *Financial Stability Report* (November 2021); Annette Vissing-Jorgensen, "The Treasury Market in Spring 2020 and the Response of the Federal Reserve," National Bureau of Economic Research Working Paper 29128 (August 2021).

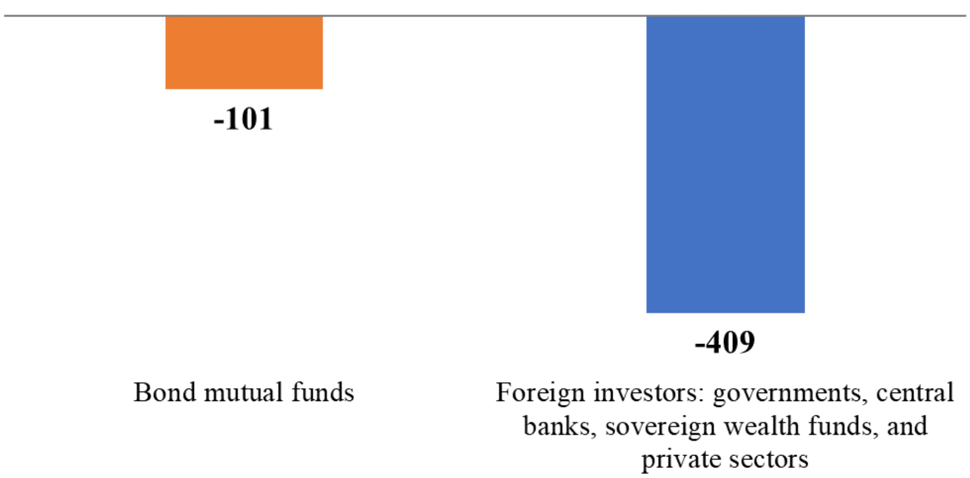
[86] The $260 billion was reported in *Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2021*, Z.1 Release (December 9, 2021), US Federal Reserve Board.

[87] *See* Shelly Antoniewicz and Sean Collins, "*Setting the Record Straight on Bond Mutual Funds' Sales of Treasuries*," ICI Viewpoints, February 24, 2022.

mutual funds' net acquisitions of Treasury bonds. Indeed, Flow of Funds has since revised their 2020:Q1 estimate of net acquisitions of Treasuries by mutual funds from -$260 billion to -$208 billion.[88] Although closer to ICI's estimate, we would contend that this revised Flow of Funds estimate is still too high.

The Council—likely using the Flow of Funds as a point of reference—has claimed that US mutual funds were among the largest recorded sellers of Treasuries during March 2020.[89] Our survey data, which show significantly lower net sales of Treasuries, provide a far different perspective. Foreign investors—which include non-US banks, foreign central banks, sovereign wealth funds, and others—sold far more Treasury notes and bond (an estimated $409 billion) than bond mutual funds. Foreign investors sold heavily despite having no first-mover incentive because they generally held the securities directly and would have borne their own liquidity costs.

Figure 5
Foreign Investors Sold Four Times More Treasuries Than Bond Mutual Funds
Net sales of Treasury notes and bonds, billions of dollars, March 2020



Sources: Investment Company Institute and Weiss (2022)[90]

[88] *See Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Third Quarter 2021*, Z.1 Release (June 8, 2023), US Federal Reserve Board code FU653061125.Q (mutual funds; other Treasury securities, excluding Treasury bills, not seasonally adjusted).

[89] Financial Stability Oversight Council Statement on Nonbank Financial Intermediation (February 4, 2022).

[90] *See* Colin R. Weiss, "Foreign Demand for US Treasury Securities During the Pandemic," FEDS Notes, Federal Reserve Board (January 28, 2022).

B .6 Conclusion

The empirical evidence presented in this appendix raises serious doubts about the validity of the first-mover advantage and stress amplification hypotheses underpinning the Council's perception of the behavior of mutual fund investors.

ICI's work on estimating dilution in mutual funds—which shows that even during stressed markets dilution is economically too small to credibly motivate investors to redeem ahead of others—seriously calls into question the cogency of the first-mover theory. Other research by ICI—which shows that investors who hold fixed income securities directly through SMAs respond virtually the same as bond mutual fund investors when there is a downturn in the market—legitimately contests the theory that mutual funds' pooled structure creates a unique first-mover incentive. ICI's analysis showing that bond mutual's net sales during March 2020 had a negligible impact on the corporate bond and Treasury markets disproves the theory that mutual funds are a source of asset market stress amplification.

ICI calls on the Council and other interested parties to evaluate the solid empirical evidence we have presented and reassess the soundness of these hypotheses. Otherwise, policies based on inaccurate data or inapt narratives could harm fund investors.