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**STATEMENT**

**OF**

**PAUL SCHOTT STEVENS  
PRESIDENT & CEO  
INVESTMENT COMPANY INSTITUTE**

**BEFORE THE**

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

**ON**

**THE ROLE OF THE FINANCIAL STABILITY BOARD IN THE  
U.S. REGULATORY FRAMEWORK**

**JULY 8, 2015**

## EXECUTIVE SUMMARY

- ICI supports appropriate regulation to ensure the resiliency and vibrancy of the global financial system. We likewise believe it is appropriate for regulators to examine asset management to identify potential risks. Any such review, however, must be thorough, balanced, fact-based and led by those with relevant expertise—i.e., capital markets regulators.
- From the outset, the Financial Stability Board (“FSB”), whose membership consists largely of central bankers and finance ministers, has been predisposed to view virtually all financial activity conducted outside of banks as “shadow banking” and inadequately regulated because it is not subject to bank standards and supervision. As it relates to regulated funds and their managers, this orientation is deeply troubling in light of the FSB’s ability to influence financial policy in its participating jurisdictions. U.S. mutual funds and other regulated funds differ fundamentally from banks, and are among the most transparent and comprehensively regulated parts of the financial system.
- The FSB has proposed methodologies for identifying and potentially designating global systemically important financial institutions (“G-SIFIs”) within the asset management sector. Broadly speaking, these methodologies have been advanced without due regard for empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posited by the FSB.
- There are fundamental problems that pervade the FSB’s work.
  - First, the FSB’s proposed methodologies conceptually derive from regulators’ experience with banking, not asset management. Thus, for example, the FSB posits risks of “distress” and “disorderly failure” derived from the experience of banks as a starting point for its G-SIFI methodologies for asset management. This is despite overwhelming public commentary to the FSB that these concepts have little relevance to investment funds and asset managers.
  - Second, the FSB affords an inadequate role to subject matter experts. Of particular concern to ICI, capital markets experts are leading neither the FSB’s work on asset management nor some other key projects focused on non-bank entities and activities.
  - Third, the FSB simply discounts empirical data and actual experience that do not comport with the conjecture and theories on which the proposed G-SIFI methodologies are based. Those theories include the potential for “fire sales” of investment fund assets, the transmission of risk from an investment fund to other market participants, and destabilizing effects to the global financial system. ICI believes the FSB has vastly overstated the potential for such effects. And, in the seventy-five year history of stock and bond funds in the U.S., there is no historical or empirical basis for the FSB’s concerns.

- Fourth, there is reason to question whether the FSB’s work on G-SIFI methodologies in asset management is simply results-oriented and based on little more than size as a criterion that would capture principally the largest U.S. funds and managers. The FSB has ignored public commentary on significant aspects of its proposed methodologies and offered no empirical basis for its criterion.
- Fifth, as set forth in detail below, we have strong reservations about the transparency and fairness of the process that the FSB has followed in developing its proposed methodologies and the process it envisions for evaluating investment funds and asset managers under these methodologies.
- In many of the five areas enumerated above, we see similar deficiencies in the FSOC’s SIFI designations and its review of asset management.
- The G-SIFI designation process set in motion by the FSB is intended to exert multilateral influence on “national authorities” with respect to the regulation of asset management. In the case of the U.S., this presumably may mean the FSOC and its designation authority under Title I of the Dodd-Frank Act. If adopted, the methodologies proposed by the FSB would have the effect of calling for an unprecedented expansion of the reach of the Federal Reserve Board to regulated U.S. funds and their managers and, by extension, U.S. capital markets. There is a clear prospect of harmful consequences for regulated U.S. funds, their investors and the capital markets. These include bank-like standards required by the Dodd-Frank Act that are ill-suited to funds, including capital requirements (possibly at the level of minimum bank capital standards, which is 8 percent), added fees and assessments, and prudential supervision by the Federal Reserve Board.
- Although there is movement, both in the U.S. and globally, toward an activity-based approach in asset management, there is much cause for continuing concern. Neither the FSB nor the FSOC has taken designation of individual regulated funds or their managers off the table. And if an activity-based approach is led not by capital markets experts but instead by central bankers, the same types of poor policy outcomes outlined above could result.
- To address several of our concerns with the FSB, ICI recommends that the Committee:
  - Continue to monitor closely U.S. agencies’ participation in the FSB’s policy work and seek to ensure that their FSB participation does not conflict with the best interests of U.S. investors and the capital markets.
  - Encourage the U.S. officials who participate in the FSB to support a full review of asset management activities and products, led by the International Organization of Securities Commissions (and the setting aside of further work on investment fund and asset manager G-SIFI assessment methodologies).

- Use its influence to encourage the reconstitution of the FSB, with equal roles for capital markets, banking and insurance, to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.
- With regard to the FSOC, Congress should enact legislation, such as Title III of S. 1484, to codify in statute important improvements to the SIFI designation process that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases.

## I. INTRODUCTION

My name is Paul Schott Stevens. I am President and CEO of the Investment Company Institute (“ICI”) and I am pleased to appear before the Committee today to discuss the role of the Financial Stability Board (“FSB”) and its impact on U.S. regulators and entities. Thank you, Chairman Shelby, Ranking Member Brown, and members of the Committee for inviting me to testify.

ICI is the national association of U.S. registered investment companies, including U.S. mutual funds, closed-end funds, exchange-traded funds and unit investment trusts.<sup>1</sup> ICI seeks to encourage adherence to high ethical standards, promote public understanding and otherwise advance the interests of funds, their investors, directors and managers. ICI members today manage approximately \$18.2 trillion in assets and serve more than 90 million U.S. investors.

This year marks the 75<sup>th</sup> anniversary of the enactment of the key statutes—the Investment Company Act and the Investment Advisers Act—that regulate and govern funds and their managers. As administered by the Securities and Exchange Commission (“SEC”), those statutes have supported the growth of the modern fund industry, which today helps American investors meet their most important financial goals, such as saving for college, purchasing a home or providing for a secure retirement.

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

In the years since the global financial crisis, the FSB has asserted an expanding role on the world stage. The FSB claims a broad mandate, nothing less than the entire global financial system, but it is dominated by central bankers and finance ministers. This membership is predisposed to viewing financial activity conducted outside of banks as “shadow banking” and to considering such activity to be inadequately regulated because it is not subject to bank standards and supervision. Not surprisingly, we

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<sup>1</sup> In this testimony, the term “regulated funds” includes “regulated U.S. funds” (or “U.S. mutual funds,” where appropriate), which are comprehensively regulated under the Investment Company Act of 1940 (“Investment Company Act”). This testimony generally addresses regulated stock and bond funds and not money market funds, given the significant regulatory reforms that have been adopted for money market funds.

<sup>2</sup> The international arm of the Investment Company Institute, ICI Global serves a fund membership that includes regulated funds publicly offered to investors in jurisdictions worldwide, with combined assets of US\$19.7 trillion. ICI Global seeks to advance the common interests and promote public understanding of regulated investment funds, their managers, and investors. Its policy agenda focuses on issues of significance to funds in the areas of financial stability, cross-border regulation, market structure, and pension provision. ICI Global has offices in London, Hong Kong, and Washington, DC.

strongly disagree with this portrayal and are deeply troubled by the FSB's ability to influence financial policy in its participating jurisdictions.

Our particular concerns about the FSB arise in the context of its work on asset management and financial stability. For some time, the FSB has been working on designing methodologies for identifying and potentially designating global systemically important financial institutions—or G-SIFIs—within the asset management sector. The proposed methodologies (one for investment funds, the other for asset managers) set forth in the FSB's two consultations have been advanced without sufficient weight to empirical evidence, historical experience, industry structure and practice, existing regulation, and other factors that might bear on the existence or severity of the risks posed by the methodologies.<sup>3</sup> We thus are concerned not only about the substance of the FSB's work—which appears to target the largest regulated U.S. funds and asset managers—but also by the processes giving rise to this work.<sup>4</sup>

Several of ICI's concerns with the FSB parallel those we have with the Financial Stability Oversight Council ("FSOC") here at home.<sup>5</sup> In March, I testified before this Committee regarding the FSOC's framework for assessing non-bank financial companies for possible SIFI designation and the FSOC's own review of asset management and financial stability.<sup>6</sup> There are, moreover, links between the FSB and FSOC efforts on asset management. For this reason, and given the Committee's interest in the activities of both policymaking bodies, my testimony will highlight ICI's concerns with, and suggest some improvements relating to, both the FSB and the FSOC.

In Section II below, we discuss the composition and structure of the FSB and provide background information on its efforts to develop methodologies by which to assess investment funds and asset managers for possible G-SIFI designation. Section III highlights the five reasons why the FSB's work on asset management has been woefully deficient, and explains that some of these reasons apply equally to the FSOC's SIFI designation process and its own asset management review. In Section IV, we discuss

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

<sup>4</sup> We expressed similar concerns in a recent letter to the heads of the U.S. agencies that are members of FSB. See Letter from Paul Schott Stevens, President & CEO, ICI to the Honorable Jacob J. Lew, Secretary, Department of the Treasury, The Honorable Mary Jo White, Chair, SEC, and The Honorable Janet Yellen, Chair, Federal Reserve Board of Governors, dated May 28, 2015 ("Lew/White/Yellen Letter"), available at [https://www.ici.org/pdf/15\\_ici\\_fsb\\_lew\\_yellen\\_white.pdf](https://www.ici.org/pdf/15_ici_fsb_lew_yellen_white.pdf).

<sup>5</sup> See Letter from Paul Schott Stevens, President & CEO, ICI to the Financial Stability Oversight Council, dated March 25, 2015, available at [https://www.ici.org/pdf/15\\_ici\\_fsoc\\_ltr.pdf](https://www.ici.org/pdf/15_ici_fsoc_ltr.pdf).

<sup>6</sup> See Statement of Paul Schott Stevens, President & CEO, ICI before the Committee on Banking, Housing and Urban Affairs, U.S. Senate, on FSOC Accountability: Nonbank Designations (March 25, 2015) ("Stevens Testimony"), available at [https://www.ici.org/pdf/15\\_senate\\_fsoc.pdf](https://www.ici.org/pdf/15_senate_fsoc.pdf).

the clear prospect of harmful consequences for U.S. regulated funds, their investors and the capital markets. Section V explains why the future direction of asset management work in the U.S. and globally is uncertain and continues to raise serious concerns. Finally, in Section VI, we provide our recommendations, including with regard to the involvement of U.S. officials in FSB policymaking.

## II. THE FSB: BACKGROUND INFORMATION FOR THE COMMITTEE

To provide important context for our concerns with the FSB and its work, below is brief background information about: (1) the FSB’s mission, organizational structure, and membership; (2) its focus on “shadow banking;” and (3) the proposed methodologies to identify G-SIFIs in the asset management sector.

### A. FSB Mission, Organizational Structure, and Membership

Established by the Group of 20 in 2009 as the successor to the Financial Stability Forum, the FSB by its charter has two broad objectives. These are: (1) to coordinate at the international level the work of national financial authorities and international standard setting bodies in order to develop and promote the implementation of effective regulatory, supervisory and other financial sector policies; and (2) in collaboration with the international financial institutions, to address vulnerabilities affecting financial systems in the interest of global financial stability.<sup>7</sup> Although the FSB’s decisions are not legally binding on its members, the FSB nevertheless is able to forge global recommendations regarding those activities perceived to pose systemic risk and to require international attention.

By any measure, the FSB is a bank-centric organization. Among the FSB’s members, central bank officials, finance ministers, and representatives of banking-related bodies (e.g., the Bank for International Settlements (“BIS”), International Monetary Fund (“IMF”), and the Basel Committee on Banking Supervision) far outnumber capital markets regulators. And central bankers hold key leadership positions, chairing the FSB, its Steering Committee, its four standing committees,<sup>8</sup> its six regional consultative groups,<sup>9</sup> and certain workstreams (including the “Workstream on Other Shadow Banking Entities”). In addition, of particular relevance to today’s hearing, the FSB’s membership

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<sup>7</sup> See Charter of the Financial Stability Board (as amended and restated June 2012) (“FSB Charter”), available at <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Charter-with-revised-Annex-FINAL.pdf>, at Section I, Article 1.

<sup>8</sup> The standing committees are: (1) Standing Committee on Assessment of Vulnerabilities; (2) Standing Committee on Supervisory and Regulatory Cooperation; (3) Standing Committee on Standards Implementation; and (4) Standing Committee on Budget and Resources.

<sup>9</sup> There are six regional consultative groups, one each for the Americas, Asia, Commonwealth of Independent States, Europe, Middle East and North Africa, and Sub-Saharan Africa region. They are designed to expand upon and formalize the FSB’s outreach activities beyond the membership of the G20 and to reflect the global nature of the financial system.

includes three U.S. regulators: the Board of Governors of the Federal Reserve System (“Federal Reserve Board”), the SEC, and the Treasury Department.<sup>10</sup>

The FSB’s “main mechanism for identifying and assessing risks and vulnerabilities in the financial system is its Standing Committee on Assessment of Vulnerabilities, or “SCAV.”<sup>11</sup> The SCAV has 32 members, at least 29 of which are central bankers or finance ministry representatives.<sup>12</sup> Four participants are U.S. regulators, but only one of these (the chief economist of the SEC) comes from the agency charged with oversight of the U.S. asset management industry and capital markets. The others are: the member of the Federal Reserve Board who leads the FSB workstream on proposed G-SIFI methodologies for investment funds and asset managers; a Treasury Department official; and the President of the Federal Reserve Bank of New York (acting in his capacity as a representative of the BIS).

While the FSB has its own legal identity and governance structure, the BIS hosts the FSB’s Secretariat, which operates out of the BIS’s head office in Basel, Switzerland.<sup>13</sup> The BIS’s website touts the fact that through this arrangement, the FSB receives “synergies of co-location; flexibility and openness in the exchange of information; and support from BIS expertise in the field of economics, banking and regulation.”<sup>14</sup>

The FSB’s charter further solidifies the organization’s banking orientation. The charter specifies that as part of its mandate, the FSB will “assess vulnerabilities affecting the global financial system and identify and review on a timely and ongoing basis *within a macroprudential perspective*, the regulatory, supervisory and related actions needed to address them, and their outcomes.”<sup>15</sup> Thus, incorporated into the FSB’s organizational documents is a directive to approach its work on vulnerabilities to the global financial system “within a macroprudential perspective”—i.e., the perspective of central bankers.

## **B. Shadow Banking Focus**

From the perspective of central bankers, non-bank financial entities arouse skepticism based on the fact that they are not regulated in the same way as banks. Central bankers pejoratively refer to financial

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<sup>10</sup> Under the Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd-Frank Act”), the Treasury Secretary and the chairs of the Federal Reserve Board and SEC are members of the FSOC; the Treasury Secretary also serves as the FSOC’s chair.

<sup>11</sup> See <http://www.financialstabilityboard.org/what-we-do/vulnerabilities-assessment/>.

<sup>12</sup> The SCAV membership is listed at <http://www.financialstabilityboard.org/about/organisation-and-governance/members-of-standing-committee-on-assessment-of-vulnerabilities/>.

<sup>13</sup> The BIS’s mission is to serve central banks in their pursuit of monetary and financial stability, to foster international cooperation in those areas and to act as a bank for central banks. See <http://www.bis.org/about/index.htm>.

<sup>14</sup> See [http://www.bis.org/about/basel\\_process.htm](http://www.bis.org/about/basel_process.htm).

<sup>15</sup> FSB Charter, *supra* note 7, Section I, Article 2(1)(a) (emphasis added).

entities and activities outside of the banking system as “shadow banks” and “shadow banking”—without regard to how those entities and activities in fact are regulated.

In 2011, the FSB commenced its efforts to address “shadow banking” by instituting five workstreams to strengthen oversight and regulation of non-bank credit intermediation.<sup>16</sup> In a comment letter to the FSB at the commencement of this work, ICI agreed that it was appropriate for the FSB “to consider whether additional or different regulatory measures for non-bank financial entities may be important to strengthening the global financial system.”<sup>17</sup> But—in addition to taking the FSB to task for using inherently inaccurate and misleading terminology—our letter made a number of broader points that continue to be relevant, including:

- It is imperative for the FSB to acknowledge and respect the differences that exist between banking and securities and their respective regulatory frameworks.
- Banks and capital markets have existed alongside one another in the U.S. for centuries, with parallel bodies of regulation and oversight, and the U.S. financial system and our economy at large have thrived on the benefits that banks and capital markets provide.
- There are significant benefits and efficiencies to having the capital markets, in addition to banks, provide maturity and liquidity transformation services.
- Bank-like regulation is not appropriate, necessary or workable for funds registered under the Investment Company Act of 1940.

Unfortunately, the FSB’s work since 2011, including its work on G-SIFI assessment methodologies for the asset management sector, shows that our comments have gone unheeded.

### **C. Proposed Assessment Methodologies to Identify G-SIFIs in the Asset Management Sector**

During the global financial crisis, governments stepped in using public funds to prevent the distress or disorderly failure of certain large financial and other entities from having cascading effects throughout the financial system. In an effort to avoid the systemic and moral hazard risks associated with such bailouts in the future, a key priority on the FSB’s financial stability agenda has been “Ending ‘Too Big to Fail’ (TBTF).”<sup>18</sup> Starting with banks and then turning to insurance companies, the FSB’s approach

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<sup>16</sup> See, e.g., FSB Published Recommendations to Strengthen Oversight and Regulation of Shadow Banking (press release dated 27 Oct. 2011), available at <http://www.financialstabilityboard.org/2011/10/financial-stability-board-publishes-recommendations-to-strengthen-oversight-and-regulation-of-shadow-banking/>.

<sup>17</sup> Letter from Paul Schott Stevens, President and CEO, Investment Company Institute, to Secretariat of the Financial Stability Board, dated June 1, 2011 (responding to an FSB background note entitled “Shadow Banking: Scoping the Issues”), available at <http://www.ici.org/pdf/25258.pdf>, at 4. We expressed support for “the efforts of the FSB and the regulatory bodies it represents to study ways to monitor non-bank financial intermediaries, such as by improving and expanding data collection from these entities, as necessary, to help regulators identify and manage systemic risk.” *Id.*

<sup>18</sup> See, e.g., *Progress and Next Steps Towards Ending “Too-Big-To-Fail” (TBTF)*, Report of the Financial Stability Board to the G-20 (2 September 2013), available at [http://www.financialstabilityboard.org/wp-content/uploads/r\\_130902.pdf](http://www.financialstabilityboard.org/wp-content/uploads/r_130902.pdf).

has been to develop assessment methodologies for identifying financial entities “whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the global financial system and economic activity across jurisdictions.”<sup>19</sup>

Having already identified 30 banks and 9 insurance companies as G-SIFIs, the FSB more recently commenced work on developing assessment methodologies to identify non-bank, non-insurer (“NBNI”) G-SIFIs.<sup>20</sup> A January 2014 FSB consultation on this topic included a proposed methodology for identifying global systemically important investment funds.<sup>21</sup> On the basis of their size alone, the methodology singled out 14 highly regulated U.S. funds as the *only* funds that automatically would be subject to further review for possible G-SIFI designation. This was a curious and very troubling result, especially given that these funds belong to the part of the financial system that proved most stable during the global financial crisis.

After receiving extensive public comments, including from ICI, the FSB issued a second consultation in March 2015 that includes a revised methodology for investment funds and a new proposed methodology for asset managers.<sup>22</sup> The second consultation discounts key aspects of the public comment record on the initial consultation. The current proposals continue to place undue emphasis on size, thus continuing to single out large, highly regulated U.S. funds (and mostly U.S. asset managers) as candidates for potential designation.

As ICI’s comment letters explain in detail, even the largest regulated U.S. stock and bond funds do not pose risks to financial stability because:

- Regulated funds use little to no leverage.
- Regulated funds do not have disorderly failures and do not rely on government intervention.
- Regulated funds do not exhibit heavy redemptions leading to fire sales.
- Regulated funds’ structure and regulation limit risks and transmission of risks.

But the consequences of designating regulated funds or their managers would be highly adverse to investors and the capital markets. As we discuss in Section IV below, application of the bank-oriented “remedies” prescribed by the Dodd-Frank Act would increase costs and reduce returns for fund

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<sup>19</sup> See, e.g., *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (8 January 2014), available at [http://www.financialstabilityboard.org/publications/r\\_140108.pdf](http://www.financialstabilityboard.org/publications/r_140108.pdf), at 2.

<sup>20</sup> The FSB has stressed as an overarching goal consistency with the treatment of G-SIFI banks. We discuss the implications of this goal in Section III.A below.

<sup>21</sup> The consultation also included proposed methodologies for market intermediaries (securities broker-dealers) and finance companies.

<sup>22</sup> Consultative Document (2nd), *Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies* (4 March 2015) (“FSB Second Consultation”), available at <http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf>.

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

### **III. FUNDAMENTAL PROBLEMS PERVADE THE FSB’S WORK—AND THAT OF THE FSOC—RELATING TO ASSET MANAGEMENT**

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

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

#### **A. Misconception of the Business of Asset Management**

The FSB’s propensity to view the world through a banking lens is readily apparent in its work on asset management and financial stability. In designing methodologies for identifying and potentially designating global systemically important financial institutions—or G-SIFIs—within the asset management sector, the FSB has emphasized repeatedly that making those methodologies consistent with the methodology it uses to identify G-SIFI banks is an overarching goal.

In particular, the FSB conceptually bases its approach to asset management on concerns with “distress” and “disorderly failure” derived from the experience of banks and banking regulators. The FSB clings to these assumptions even though public commentary on the initial consultation clearly demonstrated that these concepts have little relevance to asset management. In fact, the FSB states frankly that “the NBNI G-SIFI assessment methodologies aim to measure the impact that an NBNI financial entity’s failure can have on the global financial system and the wider economy, rather than the *probability* that a failure could occur.”<sup>23</sup> We continue to question how the FSB can simply assume its way past such a fundamental question—that is, whether an investment fund or asset manager might actually experience such distress or disorderly failure.

As ICI repeatedly has advised, regulated funds and their managers are not banks. They do not “fail” like banks do. They are highly substitutable. Regulated funds generally use little to no leverage. Fund managers act as agents, not principals. They invest on behalf of their clients, leaving the risks—and rewards—to the end investors, who knowingly accept this tradeoff.

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<sup>23</sup> FSB Second Consultation, *supra* note 22, at 10 (emphasis in the original).

Although the FSB does acknowledge some of the defining characteristics of asset management, many of the FSB’s choices as reflected in its proposed methodologies for investment funds and asset managers remain stubbornly bank-focused. For example:

- Based on the misguided idea that the size of a fund alone can indicate the potential to pose risks to financial stability, the proposed methodologies would continue to single out large, highly regulated U.S. funds for possible designation.
- The proposed methodology for assessing asset managers would sweep large asset managers into the designation net, possibly based entirely on the amount of assets they manage, resulting in the identification of candidates for potential designation that are almost solely U.S. firms.
- The FSB continues to espouse an unsupported theory about the potential for destabilizing “fire sales” of investment fund assets that relies, in part, on conjecture by other banking-oriented regulators and discounts an extensive public record providing compelling evidence to the contrary. We discuss this below in greater detail.

In blindly striving for consistency with the treatment of banks, the FSB has persisted in pursuing an “entity-based” approach to identifying and addressing potential risks to global financial stability in the asset management sector—even though the characteristics that distinguish investment funds and asset managers from banks (e.g., substitutability) suggest that true mitigation of any risks identified in the asset management sector can only come from activity-based regulation.

## **B. Inadequate Role for Subject Matter Experts**

As discussed in Section II above, the FSB’s membership largely consists of central bankers, finance ministers and representatives of banking-related bodies. As a result, capital markets experts are not leading either the FSB’s work on asset management or some of its other projects focused on non-bank entities and activities.

For example, as discussed further in Section V below, the SCAV is heading up a new asset management workstream looking at potential industry-wide risks. In addition, in the case of the five “shadow banking” workstreams the FSB instituted in 2011, the FSB tapped the International Organization of Securities Commissions (“IOSCO”) to play a leading role for only two of those workstreams. In the workstream on “shadow banking” entities other than money market funds (also known as “workstream 3”), the bank-dominated FSB has the reins.

To its credit, the FSB has seen fit to involve IOSCO in its work on the G-SIFI assessment methodologies for investment funds and asset managers. It is our understanding, however, that rather

than establishing an equal partnership with IOSCO or deferring to IOSCO members' expertise in this area, the bank-dominated FSB has remained firmly in charge of the project.<sup>24</sup>

And why is this a problem? As ICI explained in its comment letter on the second NBNI G-SIFI consultation, since the global financial crisis, we have seen a continued propensity of banking-oriented regulators to view the asset management industry through the lens of banking—in particular, the “safety and soundness” goals of bank regulation, the inherent riskiness of the highly-leveraged bank model, the significant problems that banks experienced during the crisis, the unprecedented level of government intervention needed to safeguard the banking system, and the various regulatory tools that have been employed to strengthen individual banks and the overall banking sector. When applied to investment funds and asset managers, this ill-fitting lens has predictably led to the view that the largest funds and managers, in case they are not regulated like banks, may pose unaddressed and unacceptable risks to other market participants and the financial system as a whole.

Domestically, we have had similar concerns. For example, as I discussed in my March 2015 testimony before this Committee, the FSOC's review of asset management began most inauspiciously with a highly flawed 2013 report on asset management written by the FSOC's research arm, the Office of Financial Research (“OFR”). Among the range of sharp criticisms the report drew were that it reflected a deeply inaccurate understanding of the asset management industry.<sup>25</sup>

In addition, as with the FSB, the composition of the FSOC is weighted toward bank regulators. This would appear to give bank regulators the upper hand in designation decisions and other matters—even if they are not the experts with respect to the subject matter under consideration. We have seen this concern play out in the insurance industry, where the FSOC has designated firms as SIFIs despite the objections and misgivings of the presidentially appointed independent member of the FSOC with insurance expertise.

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

The FSB discounts empirical data and analysis that does not comport with the theories on which its proposed methodologies are based. Those theories include the potential for “fire sales” of investment fund assets, the transmission of risk from an investment fund to other market participants, and destabilizing effects to the global financial system. We believe the FSB has vastly overstated the potential for such effects. And, in the seventy-five year history of the modern U.S. fund industry, there is no historical or empirical basis for the FSB's concerns.

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<sup>24</sup> As discussed in Section V below, IOSCO's Board recently recommended that a full review of asset management activities and practices should take precedence over consideration of how to designate funds or asset managers as G-SIFIs. See IOSCO: Meeting the Challenges of a New Financial World (media release dated 17 June 2015) (“IOSCO media release”), available at <https://www.iosco.org/news/pdf/IOSCONEWS384.pdf>.

<sup>25</sup> Stevens testimony, *supra* note 6, at 13.

To the contrary, ICI's comment letter on the FSB's first consultation offered extensive data and analysis showing that regulated funds and their investors simply do not behave in the manner that the FSB envisions. Yet this data and analysis does not appear to have persuaded the FSB to re-examine its hypothesis that individual funds could, in certain circumstances, experience "fire sales" that could have negative spillover effects on other investment funds, fund counterparties, or particular markets.

Instead, in its second consultation, the FSB relies on the conjectures of other banking-oriented regulators or their representatives—including the FSOC—as support for its position. For example, the FSB appeared to endorse certain statements set forth in the FSOC's December 2014 notice seeking comment on asset management products and activities. The FSB repeated, without empirical or historical support, the FSOC's conjectures about a "first mover advantage" for investors in investment funds that offer redeemable interests, particularly funds investing in less liquid asset classes. This bank-regulatory "echo chamber," in which the FSB cites the mere speculations of the FSOC as evidence or authority supporting its proposed methodologies, is a matter of deep concern. It simply ignores the demonstrable, real-world experience of regulated funds. In fact, ICI's comment letter on the FSOC's notice provided detailed analysis and data to refute these purported risks in regulated U.S. stock and bond funds.

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

First, the Chair of the SCAV (the FSB standing committee responsible for assessing risks and vulnerabilities in the financial system) is a Governor of the Reserve Bank of Australia, the staff of which recently issued a bulletin entitled *Recent Developments in Asset Management*.<sup>26</sup> The bulletin's discussion of asset management and systemic risk relies heavily on the FSB's two consultations and the widely-discredited 2013 report by the Office of Financial Research. It states baldly—without citation to any source, much less empirical or historical evidence—that "[o]pen-ended funds that offer daily redemptions are susceptible to bank-like runs." The bulletin concludes by stating that the asset management industry "poses potential risks to financial stability"—an observation that would appear to front-run the work by SCAV, which commenced this spring.<sup>27</sup>

Along the same lines, the BIS—which funds the FSB's work and houses the FSB Secretariat within its offices—included in its most recent annual report similar conjectures about the risks posed by the asset

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<sup>26</sup> See Fiona Price and Carl Schwartz, Reserve Bank of Australia, *Recent Developments in Asset Management*, Bulletin, June Quarter 2015, at 72. The bulletin's reference to open-ended funds appears to be targeted to stock and bond funds. *Id.* at 71-72 and Graph 4. The bulletin is available at <http://www.rba.gov.au/publications/bulletin/2015/jun/pdf/bu-0615-8.pdf>.

<sup>27</sup> Letter from Mark Carney, Chairman, FSB to G20 Finance Ministers and Central Bank Governors, dated 9 April 2015 ("Carney Letter"), available at <http://www.financialstabilityboard.org/wp-content/uploads/FSB-Chairs-letter-to-G20-April-2015.pdf>, at 3 (explaining that following the February meeting in Istanbul, the FSB developed a work programme to "understand and address vulnerabilities in capital market and asset management activities").

management industry.<sup>28</sup> The report states, for example, that “asset managers’ business models . . . incentivize short-sighted behaviour that can be destabilising in the face of adverse shocks” and that “[t]he decisions taken by a single large asset manager can potentially trigger fund flows with significant system-wide repercussions.”<sup>29</sup>

And in April, the IMF released its most recent Global Financial Stability Report (GFSR), including a chapter on “The Asset Management Industry and Financial Stability.”<sup>30</sup> It appears to be a robust analysis based on empirical data sufficient to support the IMF’s declaration that “even simple investment funds such as mutual funds can pose financial stability risks.”<sup>31</sup> Closer examination, however, reveals that the chapter contains numerous data errors, misinterpretations, and misleading charts.<sup>32</sup> By and large, these issues arise because the IMF lacks expertise in, and institutional knowledge of, regulated funds.

#### **D. Indications of Intended Results Driving Methodologies**

ICI has taken advantage of every available opportunity to participate in the public consultation process regarding the FSB’s proposed asset management methodologies.<sup>33</sup> Frankly, it is frustrating to see how little impact the extensive public comment record has had on the substance of the consultation.

Despite extensive public commentary that size alone does little to indicate the potential for systemic risk, the second consultation continues to place undue emphasis on the size of a fund, thus singling out many large regulated U.S. funds for potential designation. It also adds criteria to sweep large asset managers into the designation net, possibly based entirely on the amount of assets under management.

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<sup>28</sup> See Bank for International Settlements, *85<sup>th</sup> Annual Report, 1 April 2014–31 March 2015* (Basel, 28 June 2015) (“BIS Annual Report”), available at <http://www.bis.org/publ/arpdf/ar2015e.htm>.

<sup>29</sup> BIS Annual Report at 118, 119.

<sup>30</sup> IMF, *The Asset Management Industry and Financial Stability*, Chapter 3, Global Financial Stability Report: Navigating Monetary Policy Challenges and Managing Risks (April 2015) (“Asset Management Chapter”), available at <http://www.imf.org/external/pubs/ft/gfsr/2015/01/pdf/c3.pdf>.

<sup>31</sup> See *Plain Vanilla Investment Funds Can Pose Risks*, IMF Survey Magazine: Policy (April 8, 2015) (describing the IMF’s conclusions in the Asset Management Chapter), available at <http://www.imf.org/external/pubs/ft/survey/so/2015/POL040815B.htm>.

<sup>32</sup> ICI economists have written a series of blog posts explaining various problems in the IMF’s analysis of the asset management industry. See *The IMF Is Entitled to Its Opinion, but Not to Its Own Facts*, ICI Viewpoints (April 10, 2015); *The IMF Quietly Changes Its Data, but Not Its Views*, ICI Viewpoints (April 21, 2015); *The IMF on Asset Management: The Perils of Inexperience*, ICI Viewpoints (May 28, 2015); *The IMF on Asset Management: Which Herd to Follow?* ICI Viewpoints (June 1, 2015); *The IMF on Asset Management: Sorting the Retail and Institutional Investor “Herds,”* ICI Viewpoints (June 4, 2015). All of the blog posts in this series can be accessed at [https://www.ici.org/viewpoints/view\\_15\\_imf\\_gfsr](https://www.ici.org/viewpoints/view_15_imf_gfsr).

<sup>33</sup> We also have participated in numerous meetings with FSB officials and staff.

The approach, too, would result in identification of asset managers that are almost solely U.S. firms as candidates for potential designation.

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

What could account for this sharp reversal of views? It is possible that the FSB could have been influenced by the views of commenters whose identities, like their comments, have not been made publicly available.<sup>34</sup> An alternative, and equally unsettling, explanation is that the FSB could have been attempting to reverse-engineer the proposed methodologies to achieve a specific outcome.

The scope of the FSB's work to date on asset management also appears contrived. The second consultation proposes to exclude pension funds and sovereign wealth funds from any assessment for systemic risk. Some of these large pools of managed assets are many times the size of the U.S. stock and bond funds that the proposed G-SIFI methodology would target. We do not suggest that pension funds and sovereign wealth funds should be assessed for systemic risk based on their size alone. The FSB's justification for excluding them, however, lacks an empirical basis and is facially unconvincing. We question whether those investment vehicles are as comprehensively regulated or as transparent as the U.S. stock and bond funds that would be identified—solely on the basis of *their* size—for review.

Similarly, in the U.S., the way in which the FSOC has approached the question of non-bank SIFI designation has every feel of a results-oriented exercise as opposed to an objective analysis. In none of its non-bank designations thus far has the FSOC chosen to explain the basis for its decision with any particularity. Instead, it appears to have relied on a single metric (a company's size) to the exclusion of the other factors in the Dodd-Frank Act that are meant to be part of the FSOC's analysis. The FSOC also has theorized about risks instead of conducting the kind of thorough, objective, empirical analysis that should underlie its decisions. And by avoiding any meaningful discussion of the particular aspects or activities of the company that are thought to pose systemic risks, the FSOC not only forecloses the prospect of any reasoned justification for its decisions, but also frustrates Congressional intent.<sup>35</sup>

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<sup>34</sup> See FSB Second Consultation, *supra* note 22, at 3 (stating that all comments will be published “unless a commenter specifically requests confidential treatment.”).

<sup>35</sup> For further detail, see Stevens Testimony, *supra* note 6, at Section III.

## E. Insufficient Transparency and Accountability in Consultation and Designation Process

ICI is concerned by the process the FSB envisions for evaluating investment funds and asset managers under the proposed methodologies. Among the serious shortcomings of the process are the following:

- Because the FSB has agreed to hold comments in confidence, the entire process may be heavily influenced by submissions that are kept from public view and scrutiny. In addition, there is no public information about what position U.S. regulators participating in the process have taken with respect to the proposed methodologies. This is a matter of particular concern because the FSB's work in this area is being led by a Federal Reserve Board Governor, and that work seems bent on producing recommendations to the FSOC calculated to expand the Federal Reserve Board's own authority over U.S. asset management and capital markets.
- Investment funds or asset managers being considered for G-SIFI designation may have little or no information as to the basis upon which specific decisions are being or will be made.
- There is no required notice that an investment fund is being evaluated (*i.e.*, for funds that do not meet the materiality threshold but are considered by national authorities to be "potentially globally systemic") or that a fund will *not* be designated (for funds that do meet the materiality threshold).
- There is no assurance that an investment fund or asset manager will be permitted to provide information that they believe is relevant to a designation determination (or that any such information would be considered by the FSB and the relevant national authority).
- There is no requirement to consider the relative costs and benefits of a potential designation.
- There is no formal (or informal) mechanism for an investment fund or asset manager to challenge a G-SIFI determination.

In our recent comment letter to the FSB, we recommended various procedural reforms that, in our view, would help address concerns that the FSB process has a predetermined outcome in mind—*i.e.*, naming the largest investment funds and asset managers as G-SIFIs—rather than seeking to identify demonstrable risks to global financial stability and to pursue the most effective and efficient means of mitigating them. Our recommendations included three important reforms:

- First, the FSB should provide an entity under review with sufficiently detailed information about the potential risks of concern to the FSB.
- Second, the process should include greater reliance on an entity's primary regulator, including consideration of whether potential risks posed by the entity are better addressed through regulation targeted to the relevant activity, rather than through G-SIFI designation.

- Third, the entity should have the opportunity to propose changes to its business, structure or operations to address the risks identified by the FSB, and should receive a response from the FSB to these proposed changes.

The FSOC SIFI designation process likewise would benefit from these types of common-sense improvements.<sup>36</sup> As the Committee is aware, ICI and many other stakeholders, including members of this Committee, have expressed concerns with the FSOC’s SIFI designation process.<sup>37</sup> In a December 2014 letter to the FSOC, for example, ICI highlighted the following areas for potential reform: greater engagement with companies under evaluation; greater involvement by a company’s primary financial regulator; allowing a company to propose a “de-risking” plan as an alternative to SIFI designation; greater transparency, which would give other companies and the broader public more insight into the FSOC’s concerns about systemic risk and the business activities or practices giving rise to such risks; and periodic comprehensive review of designated companies.<sup>38</sup>

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

In this regard, the Committee should be aware of a related issue. In issuing the above-noted supplemental procedures, the FSOC indicated that it would publish “further details explaining how the Stage 1 thresholds are calculated.”<sup>39</sup> The so-called Stage 1 thresholds are the six quantitative metrics that the FSOC and its staff use to identify those companies that will be subject to comprehensive

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<sup>36</sup> We discuss our specific recommendations in greater detail in Section VI, below.

<sup>37</sup> See, e.g., Letter from Rep. Carolyn B. Maloney (D-NY), Ranking Member, Subcommittee on Capital Markets and Government Sponsored Enterprises to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated July 29, 2014; Statement of Chairman Jeb Hensarling before Committee on Financial Services, Hearing on “The Annual Report of the Financial Stability Oversight Council” (June 24, 2014) (stating that, with the exception of the national security agencies dealing in classified information, the “FSOC may very well be the nation’s least transparent federal entity”); Letter from Jeb Hensarling (R-TX), Chair, Committee on Financial Services, et. al. to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, et al., dated May 14, 2014 (raising concerns about the SIFI and G-SIFI designation process); Letter from Sen. Mark Warner (D-VA) to The Honorable Jacob J. Lew, Secretary, Department of the Treasury, Chairman of the FSOC, dated May 9, 2014 (noting that SIFI designation analysis “should follow a rigorous and transparent process, using reliable data, so that regulators and the marketplace can be armed with the best information possible”).

<sup>38</sup> See Letter from Paul Schott Stevens, President & CEO, ICI to Patrick Pinschmidt, Executive Director, FSOC, dated Dec. 17, 2014.

<sup>39</sup> FSOC, Supplemental Procedures Relating to Nonbank Financial Company Determinations (Feb. 4, 2015), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/Supplemental%20Procedures%20Related%20to%20Nonbank%20Financial%20Company%20Determinations%20-%20February%202015.pdf>, at 5.

review for possible SIFI designation.<sup>40</sup> The FSOC and its staff maintain that these metrics “are designed to be uniform, transparent, and readily calculable by the Council, non-bank financial companies, market participants, and other members of the public.”<sup>41</sup> Even with the further details the FSOC staff issued in early June, however, the metrics fall well short of this standard. With respect to the metric focused on derivatives liabilities, for example, the new guidance provides *no* additional details—despite specific industry requests for clarification<sup>42</sup>—and merely restates information from the FSOC’s 2012 release adopting these metrics. In our view, if the FSOC and its staff are not willing to provide the information needed to make the Stage 1 thresholds “transparent and readily calculable,” they should refrain from mischaracterizing this part of the SIFI designation process.

#### **IV. THERE IS A CLEAR PROSPECT OF HARMFUL CONSEQUENCES FOR REGULATED U.S. FUNDS, THEIR INVESTORS AND THE CAPITAL MARKETS**

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

##### **A. Effect of the FSB’s Work on U.S. Entities**

As mentioned earlier, three U.S. government agencies represented on the FSOC—the Federal Reserve Board, the Treasury Department, and the SEC—also are members of the FSB. The lack of transparency and accountability around the FSB’s NBNI G-SIFI consultation process makes it impossible to know precisely what role these agencies have played in this project and what their views are on it.<sup>43</sup> Efforts by members of Congress to gain greater insight into these matters have been largely unavailing.<sup>44</sup>

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<sup>40</sup> We note, however, that FSOC reserves the right to evaluate a company even if it does not meet the Stage 1 metrics.

<sup>41</sup> FSOC Staff Guidance, Methodologies Related to Stage 1 Thresholds (June 8, 2015), available at <http://www.treasury.gov/initiatives/fsoc/designations/Documents/FSOC%20Staff%20Guidance%20-%20Stage%201%20Thresholds.pdf>, at 1.

<sup>42</sup> See, e.g., Letter from Gus Sauter, Managing Director and Chief Investment Officer, and John Hollyer, Principal and Head of Risk Management and Strategy Analysis, Vanguard, dated Dec. 19, 2011 (recommending that, in calculating net derivative liability under its “Stage 1” analysis, FSOC take into account not just cash collateral but also collateral consisting of cash-equivalents, such as Treasuries and other U.S. government agency securities).

<sup>43</sup> Chair Yellen’s recent response to the Lew/White/Yellen Letter (*supra* note 4) shed no additional light. Chair Yellen stated that “as the FSB is made up of participants from many jurisdictions, the particular statements and documents produced by the FSB do not necessarily reflect my views or those of the Federal Reserve.” Letter from Janet L. Yellen, Chair, Board of Governors of the Federal Reserve System, to Paul Schott Stevens, President and Chief Executive Officer, Investment Company Institute, dated June 11, 2015 (“Yellen Response”).

<sup>44</sup> See, e.g., Hearing Transcript, *The Annual Testimony of the Secretary of the Treasury on the State of the International Financial System*, Committee on Financial Services, House of Representatives (May 8, 2014) (exchange between The Honorable Jacob Lew, Secretary, Department of the Treasury, and Chairman Jeb Hensarling (R-TX) *et al.* regarding the FSOC’s interaction with the FSB and the FSB’s designation of three U.S. insurance companies as G-SIFIs).

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

The FSOC maintains that the FSB's decisions do not determine those of the FSOC.<sup>45</sup> And Federal Reserve Board Chair Yellen recently echoed this view in response to ICI's letter. Chair Yellen indicated that "any recommendations by the FSB with respect to the asset management industry would not be binding on the United States. That responsibility remains with the appropriate domestic regulatory authorities and the Financial Stability Oversight Council."<sup>46</sup> But these assertions provide little comfort as regards the potential for the FSB's decisions to influence the FSOC's. While the FSB's recommendations may not be "binding," they seem certain to have some import for the FSOC. One need only consider the experience of the insurance industry. Surely it is more than just a coincidence that the FSOC has designated for enhanced prudential regulation and Federal Reserve Board supervision all the U.S.-based insurance firms the FSB named as global systemically important insurers.

Indeed, the FSB's proposed process for identifying NBNI G-SIFIs expressly calls for involvement by "national authorities" in each member jurisdiction. Thus, if the FSB were to adopt its current proposal, regulators in the U.S. would be called upon to analyze U.S. funds and asset managers under the applicable assessment methodology and to develop a preliminary list of NBNI G-SIFIs. In addition, under the proposal, national authorities would be permitted to add to their preliminary lists "other NBNI financial entities that are below the materiality thresholds but which they determine should still be added for more detailed assessment."<sup>47</sup> Subsequently, U.S. regulators, together with the FSB, would determine the final list.

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<sup>45</sup> See, e.g., FSOC Nonbank Designations – FAQs (FAQ #11), available at <http://www.treasury.gov/initiatives/fsoc/designations/Pages/nonbank-faq.aspx>. FAQ #11 states:

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

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

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

<sup>46</sup> Yellen Response, *supra* note 43.

<sup>47</sup> Second FSB Consultation, *supra* note 22, at 14.

Moreover, participation as a member of the FSB carries with it the expectation that member jurisdictions will implement any agreed upon standards and policy measures.<sup>48</sup> Consistent with this expectation, FSB Chairman Mark Carney recently stated that “full, consistent and prompt implementation” of the standards developed under the FSB “remains essential in order to maintain an open and resilient global financial system.”<sup>49</sup> Notwithstanding this instruction, as we advised in the Lew/White/Yellen Letter, we believe that the FSB’s proposed asset management methodologies cannot serve as a predicate for any regulatory action in the United States.<sup>50</sup>

## **B. What is At Stake? The Consequences of Designation**

As ICI has cautioned previously, SIFI or G-SIFI designation of regulated funds or their managers would have severe consequences. In both cases (i.e., SIFI and G-SIFI), U.S. law already has established the measures that would apply to any fund or manager designated as systemically important. As prescribed by the Dodd-Frank Act, these measures are designed to moderate bank-like risks and are ill-suited to regulated funds and their managers. Most notably, the requirements include:

- Capital requirements – possibly at the level of the minimum bank capital requirement, which is 8 percent<sup>51</sup>
- Fees/assessments – to defray the Federal Reserve’s supervisory costs and to cover the expenses of the FSOC and the U.S. Treasury Department’s Office of Financial Research
- Possible resolution assessments – to cover costs associated with the resolution of a distressed financial institution deemed systemically important—for example, fund investors could have to help bail out a “too-big-to-fail” financial institution
- Possible highly prescriptive liquidity requirements – such as a requirement to hold a specified level of cash or cash equivalents
- Federal Reserve prudential supervision – described as “prudential market regulation” of funds and asset managers in accord with banking “system demands” determined by the Federal

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<sup>48</sup> See, e.g., Carney Letter, *supra* note 27.

<sup>49</sup> Carney Letter, *supra* note 27, at 1.

<sup>50</sup> Lew/White/Yellen Letter, *supra* note 4, at 3-4.

<sup>51</sup> An unresolved inconsistency between two provisions in the Dodd-Frank Act calls into serious question just how much flexibility the Federal Reserve Board would have to limit the application of capital requirements to any regulated fund designated as a SIFI or G-SIFI. One provision (Section 165(b)(1)(A)(i)) gives the Federal Reserve Board discretion in applying capital standards to nonbank SIFIs, while another (Section 171, also known as the “Collins Amendment”) may not. Specifically, the Collins Amendment requires the imposition of minimum leverage capital and risk-based capital standards on any SIFI. The Federal Reserve Board accordingly may be compelled to hold a regulated fund SIFI to the bank minimum capital requirement of 8 percent, although it is unclear whether that precise standard would be applied. See 12 C.F.R. 217.10(a)(3) (the capital adequacy rule for U.S. bank holding companies).

Reserve Board, in contrast to the fiduciary obligations of fund managers and fund boards of directors to act in funds' best interests

Based on these requirements, designated funds would face higher costs resulting in lower investment returns for individuals saving for retirement, education and other life goals. The resulting competitive imbalances would distort the fund marketplace, potentially reducing investor choice. Designation also could have far-reaching implications for how a fund's portfolio is managed, depending on how the Federal Reserve exercises its supervisory charge under the Dodd-Frank Act to "prevent or mitigate" the risks presented by large, interconnected financial institutions. As I have previously testified, regulated funds and their managers could be subject to a highly conflicted form of regulation, pitting the interests of banks and the banking system against those of millions of investors.<sup>52</sup>

## **V. THE FUTURE DIRECTION OF ASSET MANAGEMENT WORK IS UNCERTAIN AND CONTINUES TO RAISE SERIOUS CONCERNS**

To mitigate any risks to financial stability that may arise in asset management, ICI has called for regulators to address those risks through industry-wide or activity-based regulation. Likewise, we have said repeatedly that a sector-wide appraisal of activities and practices is the appropriate way in which to evaluate any potential out-sized risks in asset management.

It is encouraging, therefore, to see some movement in this direction both domestically and abroad.

- The FSOC is conducting an activity-based review of the asset management sector, of which its December 2014 notice seeking public comment is a part.
- The SEC—which already has the necessary authority and expertise to oversee the asset management sector—is taking steps to strengthen its oversight of regulated funds and asset managers. Work is underway on a set of targeted reforms in areas including risk management and enhanced collection of fund data.
- The FSB recently inaugurated a separate workstream to review asset management activities on an industry-wide basis.
- Just last month, IOSCO's Board recommended that a review of asset management activities "take precedence" over consideration of the designation of individual funds or asset managers as systemically important.<sup>53</sup> In a subsequent speech, IOSCO Chairman Greg Medcraft said: "I'm not convinced . . . that there is evidence that asset managers put financial stability at risk simply

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<sup>52</sup> Stevens Testimony, *supra* note 6, at 15-18 (discussing in greater detail the highly adverse consequences of inappropriate designations to investors and the capital markets). See also Paul Schott Stevens, *Designation's Vast Reach into Investor Portfolios*, ICI Viewpoints (March 24, 2015), available at [https://www.ici.org/viewpoints/view\\_15\\_designation](https://www.ici.org/viewpoints/view_15_designation).

<sup>53</sup> See IOSCO media release, *supra* note 24.

because they're large. As yet we do not have concrete evidence that this has been or might be the case."<sup>54</sup>

- Recent press reports indicate that Federal Reserve Board Governor Daniel Tarullo, who leads the FSB workstream on proposed G-SIFI methodologies for investment funds and asset managers, has expressed support for an activities-based approach to the asset management industry.<sup>55</sup>

But despite these positive developments, there is much cause for continuing concern. Notably, neither the FSOC nor the FSB has taken designation of individual regulated funds or their managers off the table. We also are not aware of any FSB response to the IOSCO Board's recent recommendation or Chairman Medcraft's subsequent remarks. Instead, the last official FSB communication touching on the FSB's future course of action was Chairman Carney's April letter. In addition to emphasizing the need for "full, consistent and prompt implementation" of FSB standards, the letter lays out the FSB's work plan for the remainder of 2015, which includes "taking further steps this year to end too-big-to-fail for financial entities other than banks."<sup>56</sup>

Even if policymakers shift their approach from the consideration of individual fund or manager designations to a review of asset management practices and activities, this is not a panacea. For example, we understand that the FSB's SCAV has been tasked with the new asset management workstream mentioned above. Having now looked more closely at that committee's composition (as discussed in Section II above), we are highly skeptical about its ability to conduct a rigorous and balanced review of the asset management sector. We understand that the SCAV's work is internal to the FSB, and thus likely will be conducted without a public consultation.

An activity-based approach to asset management, if led by central bankers, could result in the same poor policy outcomes as designation of individual regulated funds or their managers. The regulatory model that central bankers seem intent on bringing to asset management is a set of highly prescriptive regulations that are straight out of the bank regulators' playbook.<sup>57</sup> This model, we believe, is the "prudential market regulation" that Federal Reserve Board Governor Tarullo envisions as the way to

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<sup>54</sup> *IOSCO and the international reform agenda for financial markets*, Speech by Greg Medcraft, Chairman, IOSCO, to the National Press Club, Washington, DC (22 June 2015) ("Medcraft Speech"), available at <http://download.asic.gov.au/media/3273669/speech-to-the-national-press-club-washington-dc-greg-medcraft-published-22-june-2015.pdf> at 6.

<sup>55</sup> John Heltman, *Shift Toward Activities-Based Regulation Continues to Make Headway*, American Banker (June 26, 2015) ("Tarullo said earlier this month that he favored an activities-based approach to the asset management industry, but his Thursday comments expanded on those thoughts.").

<sup>56</sup> Carney Letter, *supra* note 27, at 2.

<sup>57</sup> See, e.g., BIS Annual Report, *supra* note 28. See also Medcraft Speech, *supra* note 54 (asserting that refinements to existing tools of capital markets regulators, and not banking tools, should be considered to address any risks in asset management).

address perceived risks posed by asset management activities.<sup>58</sup> Just like the Dodd-Frank policy measures discussed above, such requirements would pit the interests of banks and the banking system against those of fund investors. Ironically, if applied to regulated U.S. funds, these types of prescriptive measures would fundamentally change a highly successful investment product upon which tens of millions of Americans rely to meet their financial goals.

## VI. RECOMMENDATIONS

ICI is pleased to offer its recommendations for addressing several of the concerns we discuss above. We believe that this Committee and Congress as a whole have important roles to play.

- On an ongoing basis, the Committee should continue to monitor closely U.S. agencies' participation in the FSB's policy work, particularly as it relates to asset management. As part of its oversight of these agencies, the Committee should seek to ensure that their FSB participation does not conflict with the best interests of U.S. investors and the capital markets.
- In the near term, the Committee should encourage the U.S. officials who participate in the FSB to support the IOSCO Board's recommendation to conduct a full review of asset management activities and products, and urge the FSB to set aside further work on G-SIFI assessment methodologies for investment funds and asset managers. Of utmost importance, IOSCO should lead this review.
- The Committee should use its influence to encourage the reconstitution of the FSB. This reformed FSB should give major sectors of the global financial system—capital markets, banking and insurance—an equal role. In addition, in pursuit of global financial health, the organization's mission should be to advance the dual objectives of mitigating risk to the financial system, while promoting vibrant markets and economic growth.
- With regard to the FSOC, Congress should enact legislation, such as Title III of S.1484, to codify in statute important improvements to the SIFI designation process. In particular, ICI strongly believes that Congress must reform the FSOC's designation process in ways that will advance the Dodd-Frank Act's dual goals of reducing systemic risk while reserving SIFI designation as a tool to be used only in truly exceptional cases. We suggest focusing such reforms on three critical areas:
  - First, the FSOC should provide notice sufficient to inform a company as to the financial stability risks that the FSOC believes the company presents.

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<sup>58</sup> See *Speech at the Office of Financial Research and Financial Stability Oversight Council's 4<sup>th</sup> Annual Conference on Evaluating Macroprudential Tools: Complementarities and Conflicts*, Daniel K. Tarullo, Governor, Board of Governors of the Federal Reserve System, available at <http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm>.

- Second, the primary financial regulator of a company under evaluation should have a meaningful opportunity, prior to designation, to address any risks the FSOC identifies as systemic. The primary regulator generally will have greater expertise and regulatory flexibility than the FSOC to address such risks.
- Third, a company under evaluation should have an opportunity, prior to designation, to propose changes to its structure or business practices that would address the risks the FSOC has identified. This “de-risking” option, which would require the FSOC’s consent, could prove to be a more direct and effective way to achieve the FSOC’s goal of risk mitigation.

As for our recommendations concerning the FSOC, ICI is pleased that Chairman Shelby has included reforms of this nature in S. 1484, the Financial Regulatory Improvement Act.<sup>59</sup> If adopted, these types of measures—which have garnered bipartisan support<sup>60</sup>—would give the FSOC additional tools and *more* flexibility to ameliorate systemic risks. We emphasize that, if the FSOC determines that neither action by the primary regulator nor the company’s de-risking proposal is sufficient, the FSOC retains the authority to move forward with a SIFI designation. Neither of those two options, moreover, interferes with the FSOC’s emergency authority to designate.

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

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<sup>59</sup> Similar legislation has been introduced on a bipartisan basis in the House by Reps. Dennis Ross (R-FL) and John Delaney (D-MD). H.R. 1550, the Financial Stability Oversight Council Improvement Act of 2015, has 10 additional cosponsors.

<sup>60</sup> *See, e.g.*, Remarks by Senator Robert Menendez (D-NJ) at *FSOC Accountability: Nonbank Designations*, Hearing before the Committee on Banking, Housing and Urban Affairs, U.S. Senate (March 25, 2015) (“what is the use of engaging with a company if it is not to both come to a conclusion as to whether it is systemically risky, what activities are systemically risky, and if it wished to avoid the designation because of the consequences that flow from that, give it the opportunity to do so? To me, that is not theoretical. It just makes common sense.”); Remarks by Chairman Ander Crenshaw (R-FL) at *Budget Hearing – Department of Treasury*, Hearing before the Subcommittee on Financial Services and General Government, Committee on Appropriations, U.S. House of Representatives (March 4, 2015) (“I question why FSOC would not create a process to allow companies, or primary regulators, to address identified risks before designation. It seems to me this would save a lot of time and resources for the Council as well as ensure stability within our financial system.”).