The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
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Comment Letter on Second FSB Consultation Regarding Assessment Methodologies for Identifying Investment Funds or Asset Managers as Global SIFIs

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TO: SECURITIES OPERATIONS ADVISORY COMMITTEE
INTERNATIONAL OPERATIONS ADVISORY COMMITTEE No. 17-15 RE: COMMENT LETTER ON SECOND FSB CONSULTATION REGARDING ASSESSMENT METHODOLOGIES FOR IDENTIFYING INVESTMENT FUNDS OR ASSET MANAGERS AS GLOBAL SIFIS

As you may know, in early March, the Financial Stability Board ("FSB") published its second consultation on methodologies to identify non-bank, non-insurer financial institutions for possible designation as global systemically important financial institutions ("G-SIFIs" and, where appropriate, "NBNI G-SIFIs"). [1] The second consultation notes that after considering responses to FSB's initial consultation in January 2014, [2] the FSB decided to take a more inclusive approach that focuses on "the two categories of actors involved in the asset management industry: (i) investment funds and (ii) asset managers." The dual approach consists of (1) a "refined" methodology for investment funds with an increased focus on leverage; and (2) a methodology focusing on activities that, if conducted by a particular asset manager, may have the potential to generate systemic risk and warrant consideration.

ICI, on behalf of ICI and ICI Global members, has filed a comment letter on the second consultation highlighting several fundamental problems in the FSB's proposed methodologies. [3] The comment letter expresses regret that the FSB has discounted key aspects of the extensive public commentary received on its first consultation, and that the FSB persists in pursuing "materiality thresholds" based almost solely on size that would single out large regulated funds or asset managers for potential designation. It offers detailed analysis of the FSB's assertions and recommends that the FSB move away from entity-based designation to focus instead on a market-wide evaluation of any risks it may perceive as arising from asset management. In a second letter, ICI wrote to the U.S.

representatives to the FSB and urged them to use their influence to redirect the FSB's efforts along those lines. [4]

Set forth below is an excerpt from ICI's comment letter to the FSB, which highlights our concerns with the FSB's approach and summarizes our comments. [5]

FSB Comment Letter: Introductory Observations and Summary of Comments

I. Concerns with the FSB's Approach to Asset Management

Since the global financial crisis, ICI has become increasingly concerned about the continued propensity of banking-oriented regulators, in various jurisdictions and on the global stage, 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. From the outset, we have strenuously objected to the characterization of all portions of the financial system other than banks as mere "shadow banks"—a term that describes this FSB work stream and that betrays the kind of bank regulatory "group think" that pervades the current consultation. This distorted "shadow-banking" perspective, when applied to investment funds and asset managers, has predictably led to the view that the largest participants in asset management, 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.

This propensity is on display in the Second Consultation. Although the FSB does acknowledge some of the defining characteristics of asset management—characteristics that highlight the vastly different risk profile of investment funds and asset managers, as compared to those of banks—these acknowledgements do not appear to have "moved the dial" in terms of the FSB's thinking. Indeed, many of the FSB's choices as reflected in the proposed methodologies for investment funds and asset managers remain stubbornly rooted in the banking mindset. This leads to certain fundamental flaws in the Second Consultation.

First, the FSB has determined to persist with a methodology for investment funds, and to add a methodology for asset managers. And it has continued to insist that the proposed methodologies for asset management be fashioned to achieve "broad consistency with the existing assessment methodologies for global systemically important banks (G-SIBs) and insurers (G-SIIs)." This goal, too, does not appear to stem from directions from the G20 Leaders but rather is a choice made by the FSB that utterly discounts the fundamental distinctions between the agency business of asset management and the principal businesses of banking and insurance.

Second, the FSB provides no data or analysis to support the proposed materiality thresholds for investment funds or asset managers—thresholds that have no nexus to the global financial system or its stability. Under either threshold proposed for "traditional" investment funds, the effect is the same: the FSB would continue to zero in on the most highly regulated, transparent and unleveraged funds for possible G-SIFI designation. In other words, the FSB has ignored the substantial body of evidence, brought to its attention in response to the Initial Consultation, showing that these funds have not been and are not expected to be sources of risk to global financial stability. In fact, as demonstrated by the data in our 2014 comment letter ("2014 ICI Letter"), the largest regulated US funds belong to the part of the financial system that proved most stable during the global financial crisis.

This persistent focus on large, unleveraged investment funds in fact undermines the FSB's goal of "broad consistency" with the G-SIB methodology. As we already explained to the FSB, looking simply at the size of an investment fund as compared to a bank is not an "apples to apples" comparison. All banks are leveraged to one degree or another, because the size of a bank's balance sheet and the amount of its debt go hand-in-hand. The same is not true for regulated funds. For this reason, a materiality threshold effectively based on size would impose a unique and more sweeping standard on regulated funds, without any justification for this difference in treatment.

Equally unsupported by data or analysis are two additional aspects of the proposed scope of the FSB's methodologies for asset management. With respect to asset managers, the FSB is considering a materiality threshold based on a manager's level of assets under management. This proposed approach conflicts sharply with the FSB's recognition that asset managers act as agents and it is their clients, and not the managers themselves, who bear the risks of investing. In addition, the FSB in this Second Consultation proposes to exclude from consideration a large swath of funds and investment pools, including pension funds and sovereign wealth funds. In addition to lacking an empirical basis, the reasons offered for these exclusions are facially unconvincing.

Third, the investment fund and asset manager methodologies are based on flawed assumptions of "distress" and "disorderly failure" derived from the experience of banks and have little relevance to asset management. The comment record on the Initial Consultation amply explains these flaws, yet the Second Consultation insists on starting from the premise that investment funds and asset managers do experience the sort of distress or disorderly failure that would roil the global financial markets. It states:

> The overarching objective in developing the methodologies is to identify NBNI 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.

Further evidence of the FSB's intransigence in departing from its flawed assumptions in the Initial Consultation can be found in its footnote to the above-quoted passage, which states: "Therefore, the methodologies' emphasis is on identifying indicators that point to systemic impact on failure, rather than an institution's likelihood of failure." We continue to question how the FSB can simply assume its way past such a fundamental question—that is, whether an institution might actually ever experience such distress or disorderly failure.

Fourth, we believe the FSB has vastly overstated 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. With respect to regulated funds, we are aware of no historical or empirical basis for those concerns. Our 2014 ICI Letter offered extensive data and analysis to show that, over the course of the 75-year history of the US regulated fund industry, there is compelling evidence to the contrary—that is, regulated US funds and their investors simply do not behave in the manner that the FSB envisions. The FSB discounts this and other commentary on the Initial Consultation, and continues to advance its hypothesis that individual investment funds could, in certain circumstances, experience "fire sales" that could have negative spillover effects on other investment funds, fund counterparties, or particular markets.

The FSB does so, in part, by reference to similar conjectural statements by other banking-oriented regulators. The Second Consultation seems to endorse statements in a recent notice by the US Financial Stability Oversight Council ("FSOC") concerning investment funds that offer redeemable interests. The Second Consultation repeats, without empirical or historical support, the conjectural statements in the FSOC notice suggesting a "first mover advantage" for investors in such funds, particularly funds investing in less liquid asset classes. Nor did the FSOC notice provide any empirical or historical support for this suggestion. In a recent comment letter to FSOC (the "2015 ICI FSOC Letter"), ICI provided detailed analysis and data to refute these purported risks in regulated US stock and bond funds. The Second Consultation likewise appears to endorse similar statements in a 2014 speech by Andrew Haldane of the Bank of England. Those statements by Haldane also suggest that "fire sales" of investment fund assets "could aggravate frictions in financial markets or in market liquidity" that could result in asset prices falling "possibly to well below their long-term or fundamental value." The Second Consultation conveniently ignores, however, subsequent statements later in the Haldane speech acknowledging that this line of inquiry "still leaves some big questions begging" and that "[a]t present, we do not have good empirical answers to any of those questions." We are puzzled as to why the FSB would give far more weight to the conjectures of other banking-oriented regulators (or their representatives) than to the demonstrable, real-world experience of regulated funds.

Fifth, the repeated dismissal or discounting of empirical data, historical experience, industry structure and practice, existing regulation, and other highly pertinent factors raises the question of whether the FSB may be attempting to reverse-engineer the proposed methodologies to achieve a specific outcome. How else to explain developments such as the addition of the substitutability channel for investment funds, and a new proposed methodology for asset managers? Far from reflecting a better understanding of asset management, both changes run contrary to the FSB's conclusions on these topics in the Initial Consultation and input from commenters affirming the FSB's original decisions.

Sixth, we presume that the starting point for the FSB's development of incremental policy measures for NBNI G-SIFIs will be the types of measures already established for G-SIBs and G-SIIs. Those policy measures are bank-like in nature, consisting of: (1) "loss absorption" capacity (i.e., capital) requirements; (2) enhanced prudential supervision requirements; and (3) resolution planning requirements. Given the FSB's heavy emphasis on consistency, we are concerned that such measures may be adopted with little consideration of whether they make sense outside the banking context. Moreover, the consequences of NBNI G-SIFI designation for regulated US funds—which are in the cross-hairs under the proposed investment funds methodology—already are established under US law. Similarly bank-oriented, the prescribed US "remedies" are altogether inappropriate and will be harmful if applied to regulated US funds.

Finally, despite every cogent reason to focus on sector-wide activities and practices, the FSB seems blindly determined to pursue an "entity-based" approach that will culminate in labelling individual investment funds, and possibly asset management firms, as NBNI G-SIFIs—again, without a specific mandate to do so. It seems that part of what is driving this effort is the stated desire to strive for consistency with the treatment of banks. But that truly is "a foolish consistency," in our view, because it leads down an unproductive path. The substitutable nature of investment funds (and asset managers) distinguishes them from banks and suggests that true mitigation of identified risks in the asset management sector can only come from activity-based regulation.

II. Summary of Comments

A. Investment Funds Methodology

1. The proposed methodology for analyzing investment funds has not materially changed from that set forth in the Initial Consultation. The FSB has kept highly regulated “traditional” funds (regulated funds) within the scope of its assessment of individual entities, relying on a flawed size-based approach to identifying funds for review.
2. The Initial Consultation proposed applying a wholly arbitrary materiality threshold of $100 billion in AUM to determine which “traditional” investment funds automatically would be subject to further analysis. ICI and other commenters urged the FSB to modify the threshold to include balance sheet leverage. Despite the FSB’s assertion of an increased focus on leverage, the two materiality thresholds proposed in the Second Consultation are, in effect, still based on size alone. As a result, both options continue to focus attention disproportionately on regulated US funds.
3. The proposed materiality thresholds contrast sharply with the robust public record demonstrating why—unlike in the case of banks—asset size by itself reveals very little about whether an investment fund could pose risk to the global financial system.
4. There is simply no historical or empirical basis for the FSB’s concerns that a regulated fund’s investment losses, fully borne by its shareholders, could be transmitted to other market participants in such a manner and magnitude as to destabilize the global financial system. Nor has the FSB provided any empirical data or reasoned analysis for concluding that these concerns will materialize in the future when, for example, the US Federal Reserve Board raises interest rates after years of keeping them at historically low levels.
5. Regulated funds, as the Second Consultation acknowledges, “currently have legal and regulatory limitations on their ability to use leverage (either balance-sheet leverage or synthetic leverage).” For this reason, they are highly unlikely to transmit risk to their counterparties, an effect that the FSB describes as occurring through the “exposures/counterparty channel.” In fact, regulated funds are typically providers of capital to public and private sector entities—as such, they are more likely to be the bearers of counterparty exposure from banks and other entities, rather than transmitters of risk to those counterparties.
6. The FSB’s concerns about forced asset sales by individual investment funds (so-called “fire sales”) and their negative spillover effects on other investment funds, fund counterparties or particular markets—effects that the FSB describes as occurring through the “asset liquidation/market channel”—are not relevant for regulated funds generally and US mutual funds in particular.
7. Regulated funds are able to meet redemptions—including during exceptional market conditions—and employ a variety of means to reduce the impact of such redemptions on remaining shareholders. When a regulated fund does need to liquidate, it follows an established and orderly

process, and does not occasion systemic disorder. The FSB acknowledged as much in the Initial Consultation, citing to data for 2000-2012 (a period that includes the global financial crisis). Our empirical data and analysis show that the actual experience of US mutual funds contradicts the FSB's "asset liquidation/market channel."

8. The Initial Consultation correctly recognized the high level of substitutability of investment funds and therefore concluded that funds would not transmit risk to other market participants through the so-called "critical function or services/substitutability channel." The FSB has reversed course in the Second Consultation, in a manner that is contrary to the comment record and does not appear to have any empirical basis. Our views, however, remain the same. The regulated US funds that exceed the proposed materiality thresholds have highly diversified portfolios and invest in deep and liquid markets. They compete against large numbers of other regulated funds, and none is a "dominant player" in its market segment.
9. In contrast to other jurisdictions, the US already has established by statute the measures that will apply to any nonbank financial company designated as systemically important under US law. These include certain mandatory enhanced prudential standards and consolidated (prudential) supervision by the US Federal Reserve. These bank-oriented "remedies" are altogether inappropriate and would be harmful if applied to regulated US funds.
10. The FSB proposes to exclude from consideration a large swath of funds and investment pools, including sovereign wealth funds and pension funds, many of which are far larger than the largest regulated fund and less comprehensively regulated or transparent. The reasons that the FSB proffers for doing so lack empirical bases and are facially lacking in credibility.

B. Asset Manager Methodology

1. The Second Consultation proposes a separate assessment methodology for asset managers. The decision to do so conflicts with the Initial Consultation and the public comment record.
2. The Second Consultation suggests that an asset manager facing "distress or forced failure could . . . potentially cause or amplify significant disruption to the global financial system . . . ." We know of no instances of this occurring in the case of managers of regulated funds. In fact, there are compelling reasons why these concerns should not arise—reasons that the FSB acknowledges in the Second Consultation.
3. The FSB seeks to justify its focus on asset managers by emphasizing activities other than "traditional" asset management—namely, securities lending agent services, provision of risk management platforms or pricing services to clients, and consulting/advisory services that rely on an asset manager's breadth of expertise. If these activities in fact are the cause of the FSB's concern, it should be looking at these activities broadly across financial institutions, and not through an entity-based methodology focused only on the largest asset managers.
4. The Second Consultation suggests that a large asset manager experiencing distress or failure due to reputational or operational risks could transfer those risks through the assets it manages, with adverse effects for global

financial stability. There has been no instance in which redemptions from a manager's regulated funds destabilized the broader fund industry, much less the global financial system. And there are several reasons why there is virtually no chance of such an instance occurring in the future.

5. More broadly, managers of regulated funds—like all financial firms and other organizations—face reputational and operational risks. Effectively managing and mitigating these risks is part and parcel of running a successful business which, presumably, describes any asset manager managing at least $1 trillion in assets for a range of clients. Moreover, as fiduciaries to comprehensively regulated funds, these managers are required to have robust policies, procedures and systems covering not only their own operations but also those of their significant service providers.
6. It is not apparent how G-SIFI designation of an asset manager would mitigate in any way either reputational issues that may arise in the future or operational risks that are beyond currently applicable regulations and standards. And we question how it would be possible to identify in advance—and on that basis designate—the specific manager or managers that would be expected to experience either reputational or operational problems of the sort that the FSB would consider to have the potential to pose risks to global financial stability.

C. Assessment Process

1. ICI strongly believes that application of the proposed methodologies to regulated funds and their managers would be misplaced, counterproductive, and harmful to investors. If regulators identify risks involving regulated funds and their managers—or indeed the asset management industry more broadly—that need to be addressed, industry-wide or activity-based regulation would be a better approach.
2. The FSB's discussion in the Second Consultation of the assessment process and outcome remains largely unchanged from that in the Initial Consultation. Our letter therefore reiterates ICI's serious concerns about many aspects of the proposed process. These include the tremendous discretion to regulators to engage in highly subjective deliberations, the fact that funds or managers may receive little to no information as to the basis upon which specific decisions are made, and the lack of transparency or "due process" requirements.

3. We believe that the experience in the United States—the only jurisdiction to have adopted a process for SIFI designation—should serve as a cautionary tale. Moreover, we firmly believe that the process for G-SIFI designation of an NBNI financial entity should be no less robust than that applicable to a US "domestic" designation.

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endnotes

[1] 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), available at http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

[2] The first consultation, published in January 2014, proposed a high level framework plus sector-specific indicators to be applied to investment funds, finance companies, and market intermediaries (securities broker-dealers). The first consultation is available at http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf. ICI filed a detailed comment letter in April 2014 explaining why designation of regulated funds is unnecessary and would be harmful. The letter is available at http://www.ici.org/pdf/14_ici_fsb_gsifi_ltr.pdf.

[3] Letter from Paul Schott Stevens, President & CEO, ICI, to Secretariat of the Financial Stability Board, dated May 29, 2015, available at http://www.ici.org/pdf/15_ici_fsb_comment.pdf.

[4] Letter from Paul Schott Stevens, President & CEO, ICI, to The Honorable Jacob Lew, Secretary, U.S. Department of the Treasury, et al., dated May 28, 2015, available at http://www.ici.org/pdf/15_ici_fsb_lew_yellen_white.pdf.

[5] The excerpt provided in this memorandum does not include relevant footnotes. To view those footnotes, please see the text of the letter at http://www.ici.org/pdf/15_ici_fsb_comment.pdf.
