

**MEMO# 35385**

July 28, 2023

# **ICI Files Letter with FSOC Relating to Nonbank SIFI Designation Process and Analytic Framework for Financial Stability Risks**

[35385]

July 28, 2023

TO: ICI Members

Investment Company Directors

SEC Rules Committee SUBJECTS: Financial Stability

Investment Advisers

Money Market Funds RE: ICI Files Letter with FSOC Relating to Nonbank SIFI Designation Process and Analytic Framework for Financial Stability Risks

ICI has filed comments<sup>[1]</sup> with the Financial Stability Oversight Council (FSOC or Council) on two proposals: (i) revised guidance on the Council's process for potential designation of a nonbank financial company as a systemically important financial institution (SIFI);<sup>[2]</sup> and (ii) a new analytic framework outlining how the Council expects to identify, assess, and address potential risks to financial stability.<sup>[3]</sup> This memorandum provides brief background on the two proposals<sup>[4]</sup> and summarizes ICI's comments.

## **Background on FSOC Proposals**

The Council's current interpretive guidance on SIFI designation (Current Guidance) addresses both how the Council will analyze whether an individual nonbank financial company could pose a threat to US financial stability and the procedural process to be followed in evaluating the company. The Current Guidance: (i) outlines a two-step process, or "activities-based approach," by which FSOC would monitor markets and work with primary regulators, such as the Securities and Exchange Commission, to address potential risks to financial stability; (ii) provides that the Council will consider a company for possible SIFI designation only if the potential risks posed by the company cannot be adequately addressed through the activities-based approach; and (iii) requires FSOC to consider the possible designation of any such company under a robust procedural process.

The Council states that it is proposing three "key changes" to the Current Guidance: (i) the revised guidance would focus exclusively on the procedures that FSOC would apply in any

initial review of a nonbank financial company for potential designation and any annual reevaluation of a designated company, and the Council's substantive analysis would be governed by a new analytic framework; (ii) the Council no longer would prioritize an activities-based approach before considering the designation of a nonbank financial company; and (iii) the revised guidance would not commit FSOC to conducting a cost-benefit analysis or assessing the vulnerability of a company to financial distress prior to making a SIFI designation.

FSOC also proposes a new analytic framework outlining how it expects to identify, assess, and address potential risks to financial stability—regardless of whether those risks arise from activities, individual firms, or otherwise—using its range of authorities granted in the Dodd-Frank Act. The preamble to the proposal indicates that the framework "is intended to help market participants, stakeholders, and other members of the public better understand how the Council expects to perform certain of its duties."

## **Summary: ICI Comments**

- Congress established FSOC as a council of existing regulators, able to bring together different perspectives and expertise from across the spectrum of financial services. The statutory provisions outlining the Council's purposes and duties make it clear that Congress intended FSOC to act in coordination with "front line" regulators to address potential risks to financial stability, even when the Council is utilizing its SIFI designation authority.
- The Current Guidance is a thoughtful and well-reasoned animation of the Council's congressionally mandated duties. It outlines an activities-based approach that makes the most of the existing authorities and expertise of Council member agencies and other federal and state regulators. The Current Guidance details how the Council will analyze potential risks to financial stability, ensuring sufficient analytical rigor and transparency while also retaining necessary flexibility. It appropriately contemplates that risks to financial stability will be addressed on the broadest possible basis and that SIFI designation will be reserved for those instances where an activities-based approach would be inadequate.
- The proposals would facilitate the Council's use of its SIFI designation authority without sufficient analysis of all relevant factors or sufficient consideration of alternatives to designation. The Proposals contemplate a greater focus on individual companies as potential sources of financial stability risk; less rigorous analysis of, and less engagement with, a company under review; and a lower standard for designation. ICI strongly opposes this outcome. We have consistently has urged the Council to reserve SIFI designation for very specific and limited circumstances.
- The Proposals contemplate insufficient rigor in FSOC's analyses of potential risks to financial stability from financial activities, products, or practices. This, in turn, raises the prospect of policy outcomes that are unsupported by empirical data and actual experience. We point out that the Council's assertions about the risk of destabilizing redemptions from mutual funds are called into question by ICI data and analysis, which we outline in two appendices to this letter.
- The Council's decision to advance two separate proposals rather than modifying the Current Guidance in a single proposal makes it challenging and cumbersome to identify the precise changes the Council is seeking to make. While some of these changes are discussed in the preambles to the proposals, others are insufficiently described or not acknowledged at all, as we illustrate with several examples. ICI recommends that the Council retain the Current Guidance in its entirety unless and

until any changes are made in full compliance with 12 CFR 1310.3, a rule requiring FSOC to provide public notice and comment prior to amending the Current Guidance.

- If the Council proceeds to finalize the proposed analytic framework, ICI recommends that it make revisions in several areas to encourage thorough empirical analysis. Such analysis is key to an accurate understanding by the Council of the mechanism(s) by which adverse effects could be transmitted to other market participants and whether those effects are of a nature and magnitude sufficient to destabilize the financial system. That understanding, in turn, will enable the Council to distinguish between market risk and systemic risk, and to keep its focus squarely on the latter.
- Consistent with the Council's approach to asset management over several years, any monitoring of potential risks should focus on the activities in which asset managers and investment companies engage, and not on individual entities.
- More fulsome discussion of the various vulnerabilities identified by the Council would aid public understanding of how these vulnerabilities can contribute to risks to financial stability and bring needed discipline to the Council's analyses.
- A financial activity, product or practice, or even an individual company, cannot pose risk to the stability of the US financial system if there is no plausible mechanism for transmitting harms of a nature and magnitude sufficient to destabilize the system. Any final framework should include more detailed discussion of how the Council expects to analyze risk transmission through the identified channels.
- An evaluation of benefits and costs should be part of the Council's analysis when considering an individual company for potential SIFI designation. Such an evaluation also may be appropriate when the Council is considering potential action under its other authorities.
- Consideration of a company's vulnerability to financial distress should be part of the Council's analysis when considering the company for potential SIFI designation.
- The Council should provide some explanation as to how it may approach authorities that are identified in the final framework but have not been utilized to date (e.g., designation of payment, clearing or settlement activity as systemically important).
- Engagement with industry stakeholders should be a regular feature of the Council's work. ICI offers suggestions on how FSOC can leverage their expertise, while noting that the Council would retain flexibility to structure the engagement in a way that is useful to the Council's purposes and would not delay its work.
- ICI also offers suggestions on how FSOC can provide greater transparency regarding its analysis of potential issues and its conclusions based on those analyses.

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#### Notes

[1] The letter is available [here](#).

[2] FSOC, [Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies](#), 88 Fed. Reg. 26234 (April 28, 2023).

[3] FSOC, [Analytic Framework for Financial Stability Risk Identification, Assessment and Response](#), 88 Fed. Reg. 26305 (April 28, 2023).

[4] For a more detailed summary, see [ICI Memorandum 35265](#) (April 28, 2023).

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