INVESTMENT COMPANY INSTITUTE

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FSOC Approves Revised Guidance Relating to Nonbank SIFI Designation Process and Analytic Framework for Financial Stability Risks

[35509]

November 14, 2023

TO: Investment Company Directors
SEC Rules Committee SUBJECTS: Financial Stability
Investment Advisers
Money Market Funds RE: FSOC Approves Revised Guidance Relating to Nonbank SIFI Designation Process and Analytic Framework for Financial Stability Risks

On November 3, the Financial Stability Oversight Council (FSOC or Council) unanimously approved: (i) revised guidance on the Council's process for potential designation of a nonbank financial company as a systemically important financial institution (SIFI);[1] and (ii) an analytic framework outlining how the Council expects to identify, assess, and address potential risks to financial stability.[2] The approved measures are substantively similar to the proposals issued by the Council last April, which we detailed previously.[3] This memorandum briefly comments on the approved measures and discusses how the Council addressed some of the issues covered in ICI's July comment letter.[4]

Revised Guidance on SIFI Designation Process

The Revised Guidance differs in three key respects from the Council's prior interpretive guidance on SIFI designation, which was adopted in 2019 (2019 Guidance). The Revised Guidance: (i) focuses exclusively on the procedures that the Council would apply in any initial review of a nonbank financial company for potential designation and any annual reevaluation of a designated company; (ii) does not prioritize an activities-based approach before the Council considers the possible designation of a nonbank financial company; and (iii) does not require FSOC to conduct a cost-benefit analysis or assessing the vulnerability of a company to financial distress prior to making a SIFI designation. The preamble to the Revised Guidance outlines the Council's responses to many of the issues raised by ICI and other stakeholders who commented on both proposals.

Analytic Framework for Financial Stability Risk Identification, Assessment and Response

The Framework outlines how the Council 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 states 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" and further specifies that the Framework "is not a binding rule and does not establish rights or obligations applicable to any person or entity."

How the Council Addressed Certain Issues Raised in ICI Comment Letter

- The Council acknowledged concerns voiced by many commenters as to the suitability of SIFI designation, generally and as applied to certain sectors or types of entities. For example, the ICI letter outlined the reasons why SIFI designation would be highly inappropriate for regulated funds. The Council stated, however, that it "will not reject in advance the use of its statutory authority" and that "assessing the suitability of designation of any class of nonbank financial companies would be premature."

- ICI's letter recommended that, consistent with the Council's approach to asset management over several years, any monitoring by FSOC of potential risks should focus on the activities in which asset managers and investment companies engage, and not on individual entities. The Framework adopted by the Council continues to envision monitoring of asset managers and investment companies. It further identifies private funds as entities that will be subject to such monitoring.

- ICI's letter expressed strong support for the activities-based approach outlined in the 2019 Guidance, explaining that such an approach makes the most of the existing authorities and expertise of Council member agencies and other federal and state regulators. The letter observed that prioritizing an activities-based approach 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 Framework as adopted does not prioritize an activities-based approach. The preamble to the Framework states that the Dodd-Frank Act "does not contemplate that one of the Council's authorities takes precedence over others, or that the Council must make recommendations to existing regulators before commencing a review of a company for potential designation," and it further states that "rescinding the prioritization of an activities-based approach will better enable the Council to respond to threats to financial stability irrespective of their source." The preamble also highlights the Council's intention to "maintain its previous commitment to engaging extensively with existing regulators."

- ICI's letter noted that the Council appeared to be proposing a more general and less rigorous statement of what would constitute a "threat to financial stability"—the standard for designation set forth in Section 113 of the Dodd-Frank Act—than the 2019 Guidance. The Council responded by strengthening its interpretation and stating plainly in the Framework that it would interpret "threat to financial stability" to mean events or conditions that could "substantially impair" the financial system's ability to support economic activity.

- ICI's letter called for more fulsome discussion of the various vulnerabilities identified by the Council, noting that such discussion would aid public understanding of how these vulnerabilities can contribute to risks to financial stability and bring needed discipline to the Council's analyses. As adopted, the Framework includes further details on several vulnerabilities that may factor into any analysis by the Council. In particular, the discussion of the "liquidity risk and maturity mismatch" vulnerability identifies two additional sample metrics that the Council may consider: the scale of financial obligations that are short-term or can become due in a short period; and amounts of transactions that may require the posting of additional margin or collateral.

- ICI's letter asserted that 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. It further asserted that any final framework should include more detailed discussion of how the Council expects to analyze risk transmission through the identified channels. As adopted, the Framework includes expanded discussion "regarding the Council's consideration of how the adverse effects of potential risks could be transmitted to financial markets or market participants and what impact the potential risks could have on the financial system." In response to commenters, the Council added language to indicate that risks arising from exposures to assets managed by a company on behalf of third parties are distinct from exposures to assets owned by, or liabilities issued by, the company itself. The preamble notes that the Framework's discussion of the "asset liquidation" transmission channel "now provides greater detail on the features of certain assets, liabilities, and market behavior that could affect the Council's analysis and further describes how actions by market participants or financial regulators may influence the transmission of risks through asset liquidation."

- ICI's letter asserted that an evaluation of benefits and costs should be part of the Council's analysis when considering an individual company for potential SIFI designation. The preamble to the Revised Guidance contains a lengthy discussion as to why the Council "does not believe that a cost-benefit analysis of individual designation determinations is legally required or reasonably estimable, useful, or appropriate in this context."

- ICI's letter stated that 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 preamble to the Revised Guidance explains the reasons for the Council's disagreement, including by stating that "[a]ssessing a nonbank financial company's likelihood of material financial distress is not among the tasks Congress set for the Council and could undermine financial stability by spurring a run on a company that is designated or under review for potential designation."

- ICI's letter objected to the Council's characterization of its proposals as affording significant engagement and communication with a nonbank financial company under review, while failing to be forthright about the fact that Council staff would be permitted to conduct a preliminary analysis of the company before providing notice that the company has been identified as potentially posing risks to US financial stability. The Revised Guidance preserves the ability of Council staff to conduct such analysis without providing notice to the company.

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Notes

[1] FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (Nov. 3, 2023) (Revised Guidance).

[2] FSOC, Analytic Framework for Financial Stability Risk Identification, Assessment and Response (Nov. 3, 2023) (Framework).

[3] A summary of the proposals and relevant background is provided in ICI Memorandum 35265 (April 28, 2023).

[4] The letter is available here.