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Mr. Mark Schlegel
Office of the General Counsel
U.S. Department of the Treasury
1500 Pennsylvania Avenue, NW
Room 2208B
Washington, DC 20220

RE: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies – Notification of proposed interpretive guidance – 84 Fed. Reg. 9028 (March 13, 2019)

Dear Mr. Schlegel:

The Institute of International Finance (IIF)[1] welcomes the Administration's proposed interpretive guidance on the supervision and regulation of certain nonbank financial companies and offers in this letter some specific recommendations for enhancements to that guidance. The IIF appreciates the important role that the Financial Stability Oversight Council (FSOC) can play in identifying potential risks to the financial stability of the United States, responding to emerging threats to U.S. financial stability, and promoting market discipline. As we have emphasized in past submissions to the U.S. Department of the Treasury (Treasury), this work should naturally culminate in an assessment of whether systemic risk of a sufficiently high probability and magnitude to warrant a regulatory response could arise. This is a very challenging task which, if done correctly, can reinforce financial stability but otherwise may have unintended detrimental consequences on financial markets, those they serve, and economic growth. The IIF therefore appreciates the openness of Treasury and the FSOC to industry and stakeholder perspectives on this important interpretive guidance.

Overall, the proposed interpretive guidance is a very welcome development. It represents a significant positive step in the ongoing pivot from an entity-based approach (EBA) to an activity-based approach (ABA). This pivot shifts the FSOC from a narrow focus on an individual company and a single regulatory "solution" to systemic risk before it is even found to exist to a broader view of financial markets and the full range of available responses to any systemic risks that do arise. This pivot to the ABA is better aligned with the FSOC's statutory purposes and with current global policy approaches being developed to address systemic risk, including those underway at the International Organization of Securities Commissions (IOSCO) and the International Association of Insurance Supervisors (IAIS). The broader view of potential risks and policy responses under the ABA also serves to minimize the potential for competitive market distortions that can be amplified when firms operate globally. The prioritization of an ABA in addressing

[1] The IIF is the global association of the financial industry, with close to 450 members from 70 countries. Its mission is to support the financial industry in the prudent management of risks; to develop sound industry practices; and to advocate for regulatory, financial and economic policies that are in the broad interests of its members and foster global financial stability and sustainable economic growth. IIF members include commercial and investment banks, asset managers, insurance companies, sovereign wealth funds, hedge funds, central banks and development banks: www.iif.com.

systemic risk also would address the many acknowledged flaws of the EBA, some of which are highlighted below, and which warrant comprehensive and immediate reform.

Our comments on the proposed guidance are organized as follows. First, we offer some overarching conceptual comments on the ABA in order to frame the discussion. Second, we emphasize some of the key advantages of the ABA and key drawbacks of the EBA, focusing on the asset management and insurance industries. Finally, we offer some concrete recommendations for enhancements to or refinements of the proposed guidance.

We encourage the FSOC to revise and adopt the new guidance expeditiously. We recognize and commend the effort required to propose these comprehensive reforms. The principals and their staff involved in that effort should finalize the new guidance as soon as possible and thereby establish a sound framework for the FSOC to fulfill its statutory mandates. We respectfully submit that time is of the essence after seven years of delay.

Overarching Comments

The proposed interpretive guidance properly focuses the FSOC's analysis of potential systemic risk on a system-wide basis that considers the potential for systemic risk arising from the activities of a wide range of market participants. The FSOC proposal also compliments work that is underway internationally regarding systemic risk and the role of activities in asset management and in insurance. The Financial Stability Board (FSB) and IOSCO are currently working on operationalizing FSB recommendations to address structural vulnerabilities from asset management activities, whereas the IAIS is developing an activities-based approach to evaluating and mitigating systemic risk in the insurance sector. As such, the FSOC proposal can contribute to the international discussions around how systemic risk in the non-banking sector could be identified, assessed and addressed.

The ABA permits the consistent treatment of activities across sectors, reducing fragmentation, providing a level playing field for financial market participants, and promoting system-wide financial stability. An ABA also addresses the fact that systemically risky activities can be conducted by firms not subject to traditional financial services regulation and supervision or by smaller companies whose activities may not be as visible as those of their larger counterparts. An ABA also helps to eliminate the competitive distortions that arise under the EBA when a firm is singled out for enhanced regulation and supervision but its peers conducting similar activities are not. The ABA is also aligned with the FSOC's goal of utilizing market discipline as a mechanism for addressing potential financial stability risks.

The Dodd-Frank Wall Street Reform and Consumer Protection Act, 12 U.S.C. 5321 (Dodd-Frank Act), gives the FSOC broad discretion to respond to threats to U.S. financial stability, including the ability to make recommendations to the primary financial regulatory agencies to apply new or heightened standards for financial activities or practices. The proposed guidance outlines a two-step process, in which the first step is focused on four framing questions designed to analyze (i) triggers of potential systemic risk, (ii) transmission channels for the adverse effects of the potential risk, (iii) possible adverse effects on the financial system, and (iv) the magnitude of those possible adverse effects. The second step is focused on working with the relevant financial regulatory agencies to address the identified potential risk. We recommend that the FSOC revise the framing questions to address the issue of likelihood – specifically, how likely it is that a risk would materialize, how likely it is that the risk would be transmitted to other financial system participants, and how likely it is that the risk would destabilize the U.S. financial system sufficiently to harm the U.S. economy. As currently proposed, the framing questions ask only whether events "could" happen. Evaluating the probability or likelihood of the event would help the FSOC avoid the pitfall of recommending regulation based on remote theoretical risks that are improbable or

insufficiently severe to justify substantial new regulation. We recommend that the FSOC revise the framing questions accordingly.

We agree that the application of targeted measures to the carefully defined and identified risks of a discrete activity is the most appropriate response to address potential systemic risks. We would emphasize, and encourage the FSOC to reflect clearly in its guidance, the importance of an empirical, fact-based connection between an identified risk and the targeted measures. The same type of empirical analysis should be conducted to answer the four framing questions and determine whether the identified risk is reasonably likely to occur and whether the manifestation of the risk would be of a magnitude that is reasonably likely to have material adverse effects on the U.S., the global financial system or the real economy.

In order to assess the effectiveness and efficiency of a proposed measure, we recommend that the primary regulator conduct an independently verifiable cost-benefit analysis of the measure and include in that analysis a consideration of other potentially less costly and less burdensome alternatives that could achieve the same objectives. Importantly, the impact of the prohibition or curtailment of an activity should be carefully assessed to avoid negative unintended consequences. The measurement should include the impact of the regulatory measure on economic growth and the ability of the sector to contribute to a well-functioning financial system.

The proposed guidance should also reflect the fundamental principle that there should be a high bar to warrant a policy or regulatory response that would curtail the conduct of financial markets activities and override the self-correcting market mechanism. Besides the costs, burdens and potential negative externalities of policy or regulatory intervention, the high bar for policy and regulatory intervention recognizes the continuing evolution of academics', regulators' and supervisors' understanding of financial markets and systemic risk, shortcomings in data and empirical evidence, the unproven nature of tools for addressing systemic risk, and the realization that the full effects of policy and regulatory measures often are only recognized after a long lag, which raises the risk of overshooting. Prior to assuming the Chair of the Federal Reserve Board, then-Governor Jerome Powell warned against supervisory interventions that "would almost surely interfere with the traditional function of capital markets in allocating capital to productive uses and dispersing risk to the investors who willingly choose to bear it" unless "the case for doing so is strong and the available tools can achieve the objective in a targeted manner and with a high degree of confidence."[2]

The guidance should make it clear that FSOC and the primary financial regulator bear the affirmative burden of establishing the existence of systemic risk and of demonstrating that the proposed response to the risk is optimal from an effectiveness and efficiency standpoint. The burden should shift from the industry being required to prove the negative – that an activity is not and could not become systemically risky – to the FSOC and the regulatory community being required to justify an intervention that overrides normal market functioning.

ABA versus EBA in the Asset Management and Insurance Sectors

The ABA advances the important principle of same activities/same regulation that has been consistently advocated by the IIF and avoids the inappropriate and irrational bias against larger financial firms that is characteristic of the EBA. By focusing on all firms engaged in the particular activity deemed to give rise to potential systemic risk, the ABA avoids a scenario in which activities that can contribute to systemic risk

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[2] See, e.g., Powell, Jerome: Financial Institutions, Financial Markets, and Financial Stability, Stern School of Management, February 18, 2015 (http://www.federalreserve.gov/newsevents/speech/powell20150218a.pdf).

migrate to smaller or unregulated firms. This migration risk is particularly high in the asset management and insurance sectors due to the highly substitutable nature of these industries.

The use of an EBA can heighten migration risk. For example, the designation of an investment fund as systemically important and the application of limits and costly policy measures to a particular fund but not to its competitors would likely render the fund unattractive and prompt investors to transfer a substantial portion of its assets to a competitor that offers the same product or service without the regulatory burden. This result is almost certain in an industry that is so competitive that performance and fees are measured in single basis points.[3] A similar result could occur in the insurance industry if a designated company incurs higher underwriting costs and finds it necessary to raise premium rates; policyholders would simply migrate their business to a competitor with more favorable rates due to a more favorable cost structure at the non-designated company.

The migration risk under the EBA could actually cause an increase in systemic risk in an industry or market if activities migrate quickly to firms that are not as well equipped to manage and mitigate the risks of the activities. This concern is heightened if activities migrate to unregulated firms or to firms that are not subject to market discipline. The EBA may also have unintended consequences for markets and consumers if firms change their business models in response to designation or the fear of designation and products become unavailable or only available at a significantly heightened cost. This is particularly a concern for products that serve important social purposes, such as retirement and long-term savings products. The very act of designating a company as systemic could have immediate ripple effects throughout the market, making products unavailable or cost-prohibitive.

The ABA facilitates a proportionate policy or regulatory response targeted to the source of systemic risk exposures and the relevant transmission channel, if a review of existing policies or regulatory/supervisory measures indicates that gaps exist. Policy measures or regulations that are targeted and linked to the sources and transmission channels of systemic risk are much more likely to be effective and cost efficient and less likely to give rise to negative unintended consequences. Any policy or regulatory response should be based upon a quantitative and qualitative gap analysis that considers existing policy, regulatory and supervisory measures, as well as industry standards for mitigating and managing the risks of the activity in question.

The ABA is the correct approach to address potential systemic risk in the asset management industry. Asset management is portfolio management and the trading of securities to achieve a specific investment objective for the benefit of investors such as pension funds, insurance companies, corporations, charities, educational establishments and individuals. In the United States alone, regulated funds (mutual funds, exchange-traded funds (ETFs) and institutional funds) totaled over USD 22 trillion in net assets as of end-2017 and these regulated funds included more than 8,000 mutual funds[4], representing significant diversity of investment thought processes and execution strategies. Worldwide, there were more than 114,000 regulated funds with total net assets of more than USD 49 trillion as of year-end 2017 providing a wide array of investment choices for investors.[5]

An asset manager is a fiduciary to its clients and acts as an agent on behalf of its clients, that is, the asset manager transacts for its investor clients, not for itself and, as such, does not have a sizeable balance

[3] See, e.g., https://www.thebalance.com/cheapest-index-funds-to-buy-4067421; https://www.cnbc.com/2018/09/04/fidelity-offers-first-ever-free-index-funds-and-1-billion-follows.html

[4] 2018 Investment Company Fact Book, Investment Company Institute, https://www.ici.org/pdf/2018_factbook.pdf. at 23.

[5] Id. at 13.

sheet business. The asset manager is hired by institutional investors directly or by the trustees of collective investment vehicles such as mutual funds and ETFs, in each case entering into an investment management agreement that establishes the relationship between the asset manager and the client. The investment strategy and the investment guidelines to be followed by the asset manager are set out in the investment management agreement or are established by the offering or constituent documents that establish the fund. Importantly, the client makes the asset allocation decision and, as the FSOC has noted, the exposure of the client is to the issuers of the managed assets. The clients' assets are held by a custodian, not the asset manager, and, as such, are not at risk in the event of a manager's financial distress or bankruptcy. Asset management is a highly substitutable business; if a manager experiences distress or failure, other managers stand ready to assume the business.

Asset managers are subject to comprehensive regulation that requires managers to establish and maintain substantial risk management and compliance policies and procedures regarding the management of client accounts, and to keep and make available to regulators extensive records regarding their operations and transactions on behalf of clients. Comprehensive regulation of asset managers and investment funds effectively reduces the risk footprint of the industry.

In the U.S., the Securities and Exchange Commission (SEC) is the primary regulator of asset managers that are registered as investment advisers. Asset managers that operate as trust banks or through bank trust departments are overseen by federal or state banking authorities. In the U.S., many asset managers are also subject to regulation by the Department of Labor under the Employee Retirement Income Security Act of 1974, if providing services to or managing assets for certain pension plans, and by the Commodity Futures Trading Commission if they invest client funds in commodities or certain derivative instruments. Additionally, the Dodd-Frank Act introduced a host of new rules that provide for enhanced reporting, oversight and transparency for trading in financial instruments and for financial institutions, including asset managers. U.S. registered mutual funds are required to maintain 300 percent asset coverage for all borrowings, a coverage ratio that is higher than comparable standards in the banking industry. In practice, mutual funds are funded primarily with the equity capital of retail investors for long-term goals, which enhances financial stability. Many of these funds are held in tax advantaged accounts (like 401(k) plans) that encourage regular contributions via payroll deductions and discourage redemptions, both of which further enhance financial stability. Moreover, a minimum of 85 percent of the assets of a U.S. registered mutual fund must be liquid in order to support redemptions.

In the European Union (E.U.), the management of separate accounts is comprehensively regulated under the E.U. Markets in Financial Instruments Directive, and the management of pooled funds is regulated under the Undertakings for the Collective Investment in Transferable Securities Directive, which governs retail mutual funds, the Insurance Distribution Directive, which covers funds structured as unit-linked insurance vehicles, and the Alternative Investment Fund Managers Directive, which covers all other investment funds managed by E.U. asset managers. In some cases, E.U. legislation may be supplemented by additional national requirements. Supervision of consistent implementation of E.U. legislation by national member states is undertaken by the European Securities and Markets Authority, which has power to issue binding technical standards as well as additional guidelines.

Similar regulatory regimes exist in other regions and jurisdictions. For example, in the Asia-Pacific region, regulatory agencies overseeing asset managers include the Financial Services Agency in Japan, the Securities and Futures Commission in Hong Kong, and the Australian Prudential Regulatory Authority and the Australian Securities and Investments Commission in Australia.

The ABA is also the correct approach to address potential systemic risk in the insurance industry. Traditional insurance risk is largely uncorrelated with the economic cycle and, thus, traditional insurance

activities have a negligible systemic risk footprint. Moreover, insurers are a major source of long-term capital to the real economy that enables them to act as a shock absorber in financial markets and as a stabilizing force in economic downturns. Insurers' investment portfolios generally are high quality, closely matched to their liability profile, held for the long-term as opposed to actively traded, and well diversified. Traditional insurers benefit from diversified and idiosyncratic risk and risk pooling, as well as a steady stream of cash inflows from upfront premium payments (i.e. the inverted production cycle). The level of leverage in the insurance sector is low, compared to other financial services sectors.

Insurers are subject to comprehensive regulation that focuses on risk-based solvency, comprehensive asset/liability and risk management, market, rate and product regulation, and consumer protection. In the U.S., insurers are subject to state-based regulation that is coordinated and supported through the National Association of Insurance Commissioners (NAIC), an organization that consists of the chief insurance regulatory officials of the 50 states, the District of Columbia and the U.S. territories. The NAIC provides a forum for collective development of model legislation, rules, regulations and white papers. State supervisors conduct on- and off-site examinations of insurers on a regular basis.

To protect policyholders, each U.S. state has a non-profit guaranty fund that can step in, if needed, to pay policyholder claims in the event of an insurer's failure. Insurers are required to be members of the guaranty fund as a condition of licensing. Like the asset management industry, insurance is a highly substitutable business.

In the E.U., insurers are subject to the Solvency II Directive, which provides a framework for risk-based solvency standards, a comprehensive supervisory regime for insurance groups, and requirements for governance, risk management, key functions (e.g. risk management, compliance, audit and actuarial functions), internal control systems, supervisory reporting and public disclosure. The Solvency II delegated regulation sets forth detailed requirements for applying the Solvency II Framework, including the valuation of assets and liabilities, eligibility of insurers' own funds to cover capital requirements, the treatment of certain investments for capital purposes, rules on the use of internal models to calculate required capital, and further details on governance and management requirements. E.U. insurers are also subject to the Insurance Distribution Directive, which is designed to enhance consumer protection in the sales of general and life insurance and insurance-based investment products. E.U. insurers are also subject to regular on- and off-site examination and oversight.

Similar to the U.S., E.U. member jurisdictions generally have guaranty funds to protect consumers in the event of an insurer's failure. Solvency II sets forth rules for the winding up or reorganization of an insurance company.

Recommendations for Enhancements to the Proposed Guidance

Overall, the proposed interpretive guidance is a very welcome development that represents a significant positive step in the ongoing pivot from an EBA to an ABA. We welcome the emphasis on the ABA as the optimal method for addressing systemic risk, the consideration of the source, effects and impact of potential systemic risk, and the FSOC's commitment to transparency in its processes and decision-making, and an analysis of costs and benefits prior to an FSOC designation of a firm. We would, however, like to offer for your consideration the following recommendations for enhancements to the proposed guidance.

1. **The FSOC should add to the four framing questions an explicit consideration of the likelihood of the adverse impact and adverse effects on the financial system.**

The FSOC's four framing questions are: (i) how could the potential risk be triggered; (ii) how could the adverse effects of the potential risk be transmitted to financial markets or market participants; (iii) what

impact could the potential risk have on the financial system; and (iv) could the adverse effects of the potential risk impair the financial system in a manner that could harm the non-financial sector of the U.S. economy. We recommend that FSOC revise the framing questions to address the issues of likelihood – specifically, how likely is it that a risk would materialize, how likely is it that the risk would be transmitted to other financial system participants, and how likely is it that the risk would destabilize the U.S. financial system sufficiently to harm the U.S. economy. Without a consideration of the likelihood of the risk and the likelihood of the risk having a negative effect or impact, the FSOC potentially could recommend policy or regulatory action based only on a theoretical risk that is not likely to materialize or based on a risk that is not likely to have systemic adverse effects or impacts. We appreciate that the FSOC has included an assessment of the likelihood of a firm's material financial distress in the cost-benefit analysis of a potential FSOC designation under the EBA, but we believe that this consideration should extend as well to the ABA and should form part of the FSOC's analysis at an earlier stage of its deliberations.

2. **The FSOC should establish an empirical connection between the identified systemic risk of an activity and the targeted measures applied to address and mitigate that risk.**

We agree that the application of targeted measures to the carefully defined and identified risks of a discrete activity is the most appropriate response to address potential systemic risks. We would emphasize, and encourage the FSOC to reflect clearly in its guidance, the importance of an empirical connection between an identified risk and the targeted measures. Specifically, empirical data capable of independent analysis and validation should support the conclusion that a systemic risk exists and that the proposed targeted measure would address the risk effectively and efficiently. The same type of empirical analysis should be conducted to determine whether the identified risk is a systemic risk of a magnitude that could have material adverse effects on the U.S., the global financial system or the real economy. In addition to empirical analysis, the FSOC should consider, to the extent feasible, a forward-looking analysis, as analysis based on historical data can be instructive but incomplete. Consistent with recommendations 3, 11 and 16-18 below, we recommend that the FSOC subject its analyses to review by third-party experts and stakeholders to test their validity and refine them as necessary before basing policy decisions on them.

3. **The guidance should further articulate how the significance and magnitude of an activity would be measured, should call for an empirical measurement of significance or magnitude that is capable of independent verification and validation, and the FSOC should clearly relate the significance or magnitude of the activity to the likelihood of systemic risk arising from that activity.**

We strongly believe that the FSOC's determination that an activity could have systemic risk implications would be strengthened considerably by an empirical analysis of the significance of that activity to the financial markets and the real economy and the magnitude of that activity. This analysis should be based on empirical data that is capable of, and published for, independent verification and validation. The FSOC should establish a clear linkage between the significance and magnitude of the activity and the likelihood of systemic risk arising from that activity.

4. **The preamble to the guidance should explain the drawbacks of the FSOC's current and historic reliance on EBA and highlight the need for a pivot to the ABA.**

We believe that a further explanation of the drawbacks of the EBA and the need to pivot to the ABA will place the shift in focus from the EBA to the ABA in its proper context. A detailed explanation will also contribute greatly to the domestic and global discussions of systemic risk and establish the FSOC's and Treasury's thought leadership on these issues.

We appreciate that the FSOC has taken some steps to acknowledge and document the flaws of the 2012 guidance, including by recognizing that key terms in the 2012 guidance were not defined (most notably, "threat to the financial stability of the United States") and by acknowledging that designation should be supported by a robust cost-benefit analysis. However, we urge the FSOC to acknowledge expressly the flaws of the prior guidance in order to provide a clear written record of "lessons learned" from prior approaches.

Specifically, the FSOC should acknowledge and document the issues that arose under the 2012 guidance. Under the 2012 guidance, the expertise of the primary financial regulators of nonbanks, as well as the knowledge of FSOC members with sector-specific (insurance) experience, were not leveraged[6], with the result that the decisions of the FSOC were based on incomplete or flawed analyses; in one case, that decision was overturned by the U.S. courts. Similarly, the Office of Financial Research, Treasury's primary research bureau and an FSOC member, overrode the concerns of the SEC in publishing a report on "Asset Management and Financial Stability," leading to significant criticisms from one of the SEC Commissioners.[7]

The FSOC should also explicitly acknowledge that the designation of a company under the EBA would result in the company becoming subject to bank-like enhanced prudential standards under the Dodd-Frank Act, notwithstanding the fact that its risks are likely to be inapposite to a nonbank financial company that does not engage in banking activities. Following on this acknowledgement, the FSOC should state clearly that designation of a nonbank company as systemically important will be a last resort to be utilized only to address threats to U.S. financial stability for which such bank-like regulation would be effective.

5. **The focus of the ABA should be on new or substantially changed activities, rather than on well-established activities with an existing regulatory framework.**

The guidance should recognize the ability of existing regulatory frameworks to adapt to address emerging risks that may not have been apparent when the regulation was first promulgated. The focus of the ABA should be on activities for which a regulatory framework has not yet been established or for new activities where existing regulatory frameworks clearly are inadequate. For example, as noted by Randal Quarles, Vice Chair for Supervision for the U.S. Federal Reserve Board of Governors and Chairman of the FSB, the activities of large technology companies and new technologies that could decentralize financial transactions may raise financial stability implications.[8] An ABA could be an important tool to ensure that the benefits of technology are gained without harming financial stability. In addition, the FSOC should consider activities where regulatory or supervisory authority may be limited by jurisdictional or political considerations, that is, where existing frameworks may be inadequate.

6. **The Treasury and FSOC should call upon the Federal Reserve Board to fulfill its statutory obligation under Section 170 of the Dodd-Frank Act to establish criteria for exempting certain classes of nonbanks from Federal Reserve supervision.**

Section 170 of the Dodd-Frank Act provides that the Federal Reserve Board shall promulgate regulations on behalf of, and in consultation with, the FSOC setting forth the criteria for exempting certain types or classes of U.S. nonbank financial companies or foreign nonbank financial companies from supervision by

[6] See www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf (MetLife) and www.treasury.gov/initiatives/fsoc/council-meetings/Documents/September%2019%202013%20Notational%20Vote.pdf (Prudential).

[7] See www.sec.gov/comments/am-1/am1-52.pdf.

[8] See http://www.fsb.org/wp-content/uploads/S280319.pdf. In the same vein, Moody's recently warned that blockchain could create systemic risk in structured finance - https://www.fnlondon.com/articles/moodys-warns-blockchain-may-pose-systemic-risk-to-structured-finance-20190426.

the Board of Governors. These regulations are required to be written but have not been promulgated to date.

The fulfillment of this statutory obligation would help to sharpen the focus of the EBA by excluding types or classes of companies that would not be considered for designation because they lack some or all of the characteristics required for designation under Section 113 of the Dodd-Frank Act or because they have inherent qualities that prevent them from presenting systemic risk or qualities that render an EBA an inferior option to available alternatives. For example, establishing criteria to exempt certain classes of nonbanks could be based on a finding that bank-like supervision is not optimal for those nonbank financial firms and, that, if there is a need for heightened supervision of these firms, the primary federal or state regulator, applying sector-appropriate measures, is best suited to the role. In this way, identifying such companies would also help define the scope of the ABA.

7. **The criteria for, and process of moving from, the ABA to an EBA should include a specific attestation from the primary regulator and an affirmative vote of FSOC members.**

The criteria for, and process of moving from, the ABA to an EBA needs to be set forth with greater specificity in the guidance. In particular, it is not clear that the primary regulator has a key role in making the decision that an EBA is necessary to address potential systemic risk. We believe it is critical that the primary regulator have a key role in the decision to move from the ABA to an EBA, as the primary regulator will have the 'birds-eye view' of the sector and the market and could best alert the FSOC to the potential advantageous and disadvantageous implications of company designation for the sector, the financial markets, and the real economy. More specifically, we recommend that the FSOC be permitted to consider a company under the EBA only after the primary regulator has made an attestation to the FSOC stating that it is unable to address systemic risk through an ABA. An affirmative vote of two-thirds of the FSOC members, including the Chairperson, should be required to conclude that an ABA is insufficient to address systemic risk and that the company should be considered under the EBA.

We appreciate that one of the FSOC's considerations in making a determination is the degree to which the nonbank financial company is already regulated by one or more primary financial regulatory agencies. We recommend that FSOC add to this consideration an explicit deference to the primary financial regulatory agency, absent a finding that the scrutiny applied by that agency to the company is inadequate. We would also appreciate an explicit recognition that, in the case of some nonbank financial companies, the primary financial regulatory agency is not a federal agency but is an agency of a U.S. state or territory.

8. **The process of moving from Stage 1 to Stage 2 in the EBA should be better articulated in the guidance and the company should be advised in Stage 1 which aspects of its operations raise systemic risk concerns. Clear guidelines should be provided for the re-initiation of a Stage 1 review.**

The proposed guidance does not make clear who bears the responsibility for moving from Stage 1 to Stage 2 in the EBA. In particular, it is not clear that the primary regulator, which is best suited to making a determination of systemic importance, has the primary role in moving the company from Stage 1 to Stage 2. We strongly encourage the FSOC to give this critical role to the primary regulator, as the regulator with the greatest experience with the company in question, the sector, and the market, and to make clear in the guidance that the primary regulator serves the primary and key role in the designation process and that the FSOC supports, rather than supplants, the primary regulator in that role.

It is not clear whether a vote is required to move a company from Stage 1 to Stage 2 and, if so, the required threshold for moving to Stage 2. We would recommend that an affirmative vote of two-thirds of the FSOC members, including the Chairperson, be required to move the designation process from Stage 1 to Stage

2. This voting requirement would be consistent with the threshold for designation and would reflect that a high threshold is appropriate in order to justify subjecting a company to the significant burden of a Stage 2 proceeding.

While still in Stage 1, the company should be advised as to which aspects of its operations raise systemic risk concerns. This advice could allow the company to restructure its operations or take other actions to avoid moving to Stage 2 and would be consistent with fundamental principles of due process. Allowing the company to take mitigating actions would also save company and FSOC (and, thus, taxpayer) resources.

The proposed guidance notes that a Stage 1 review could be terminated and re-initiated at a later time. The FSOC should establish clear guidelines for the re-initiation of Stage 1, including a waiting period before Stage 1 could be re-initiated. Otherwise, one could envision a situation in which a company could be in Stage 1 indefinitely without resolution of its status. This set of circumstances would create substantial uncertainty for the company and its stakeholders and could lead to ratings downgrades, loss of investment opportunities, and loss of shareholder support, and could stymie innovation and product expansion out of fear that those initiatives could result in the firm being moved to Stage 2.

9. **Prior to designating a company as systemically important, the FSOC should obtain from the Federal Reserve a written plan as to how the company would be supervised and how that supervision would effectively and efficiently mitigate the systemic risk posed by the company.**

Prior to voting to designate a company as systemically important, the FSOC should obtain from the Federal Reserve a detailed, company-specific supervisory plan. The FSOC should review the plan and determine whether and to what extent the plan would reduce the systemic risk posed by the company, whether the plan would reduce systemic risk in an effective and efficient manner, and whether other, less costly or burdensome alternatives could mitigate systemic risk as effectively. Importantly, a company should not be designated and subjected to Federal Reserve supervision without a clear plan. The experience of the previously designated insurance companies, which were designated without a clear supervisory plan in place and waited years for final rules to be adopted[9], highlights the inefficiencies and lack of clarity to the companies and the markets of a 'cart before the horse' approach. Moreover, the FSOC cannot determine that designation would effectively mitigate systemic risk without a clear understanding of the supervisory plan to mitigate that risk.

Moreover, the plan should be shared with the company potentially subject to designation and the company should be afforded the opportunity to share its views on the effectiveness and efficiency of the plan and to recommend alternatives to the plan.

10. **Prior to designating a company as systemically important, the FSOC should follow the recommendation of the U.S. General Accountability Office to design a framework for evaluating the impacts of systemic risk designations.**

In a September 2012 report, the U.S. General Accountability Office (GAO) recommended that FSOC design a framework for evaluating the impacts of systemic risk designations.[10] The GAO report noted that, while FSOC must periodically re-evaluate the nonbank financial company designations, it is not required to

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[9] For example, Prudential was designated on September 19, 2013 (https://www.treasury.gov/initiatives/fsoc/designations/Documents/Prudential%20Financial%20Inc.pdf), but the Federal Reserve did not publish Enhanced Prudential Standards for Systemically Important Insurance Companies until June 14, 2016 (81 Fed. Reg. 38610).

[10] New Council and Research Office Should Strengthen the Accountability and Transparency of Their Decisions, U.S. Government Accountability Office, September 2012. See https://www.gao.gov/assets/650/648064.pdf.

conduct a comprehensive assessment to determine whether the designations are having their intended impact of improved financial stability as well as other consequences. As a result, Congress, the affected institutions, the public, and FSOC cannot determine whether the designations and associated oversight are actually helping to improve financial stability.

We agree with the observations and recommendation of the GAO and encourage the FSOC to commit to publish for public comment a proposed framework for evaluating the impact of systemic risk designations and adopt a final framework prior to designating any nonbank financial company.

11. **The FSOC should adopt basic adjudicatory procedures designed to improve transparency and due process.**

Initially, the FSOC should separate the responsibility for investigating whether a particular activity or company warrants review or designation from the responsibility for making a final determination that the activity or company is systemically important. This separation of duties at the outset would facilitate an objective and impartial view of the activity or company and provide the needed checks and balances before an activity is subject to increased scrutiny or additional policy or regulatory measures and before a company is subject to enhanced prudential measures.

If the FSOC believes that the designation of an activity or company is necessary to mitigate a threat to U.S. financial stability, it should issue a provisional determination that is subject to challenge prior to finalizing that determination.

As noted above, the guidance should make it clear that the FSOC bears the burden of establishing that the activity or company warrants additional scrutiny or advanced prudential measures. The FSOC should provide a written record clearly elaborating the basis for any provisional determination in order to establish that the burden of proof has been met. The written record should provide sufficient detail on any empirical analyses that support the determination such that interested parties (in the case of the ABA) or the company (in the case of the EBA) can effectively challenge the provisional determination and bring additional or conflicting information to light prior to a final determination.

Interested parties or the company should be afforded the opportunity to review the written record provided by the FSOC and raise challenges to the analyses contained therein. If the analyses are sound, they will withstand scrutiny. If they are not, FSOC, the company, the primary regulator and all stakeholders have an interest in correcting them.

The proposed guidance notes that the FSOC Deputies Committee would make itself available to meet with the company during Stage 2 of an EBA designation proceeding. We urge the FSOC to make both FSOC principals and their deputies available to a company in both Stages 1 and 2 of an EBA designation proceeding.

12. **The guidance should elaborate on the confidentiality of any consideration of a company under an EBA in order to confirm the protection of privileged, confidential and trade secret information.**

The guidance should contain a confirmation that the FSOC will pursue all legal and procedural steps necessary to ensure that privileged, confidential and trade secret information shared with the FSOC by the company or its regulators would be treated as strictly confidential and not shared with third parties or the public. This duty of confidentiality should be interpreted broadly and extended to all work product of the company as well as to any responses to requests for information, written responses to inquiries from the FSOC or regulators, or challenges to FSOC proposed or final determinations.

13. **The proposed guidance expands the ABA to include products and practices without a clear justification for this expanded scope.**

The FSOC does not explain why it would expand the ABA focus on activities to products and practices and we believe that this expansion would be inappropriate and unnecessary. At a minimum, the FSOC should conduct and publish an empirical analysis of the impact on consumers and markets of targeting specific products and practices. This analysis should consider whether targeting specific products could result in socially desirable products becoming unavailable or available only at prohibitive prices.

14. **The proposed guidance should modify the scope of a nonbank financial company to limit the inclusion of successors of the company to those that succeed to substantially all of the assets and liabilities of the designated company.**

The proposed guidance states that the FSOC intends to interpret the term "nonbank financial company" as including any successor of a company that is subject to a final determination of FSOC. We would encourage the FSOC to consider limiting this interpretation to successors that succeed to substantially all of the assets and liabilities of the designated company. We believe that a narrower interpretation would facilitate a company's ability to restructure or spin off a portion of its operations in order to avoid or "cure" designation. Including a successor as a designated company could also act as a form of "poison pill" that would render substantially more difficult any effort to sell a portion of the designated company's operations.

15. **The FSOC should look beyond the private sector to identify threats to the financial stability of the United States that can arise from sovereigns and other state actors and even from the post-crisis reform agenda.**

An expansive view of systemic risk requires a holistic approach that looks beyond the private sector for potential sources of systemic risk. The FSOC should not overlook the potential for sovereigns and state actors to be a threat to U.S. financial stability, through monetary policy or the use or manipulation of currency reserves, imprudent debt issuances, interference in capital markets, investments or actions of sovereign wealth funds, or malicious actions (e.g. cyber events). Moreover, the FSOC should consider the potential for systemic risk to arise from overbroad or miscalibrated responses to the financial crisis.

We appreciate that the Treasury and the FSOC have reflected our prior recommendations in their guidance and proposed guidance; however, we have some further recommendations for enhancements to more fully reflect our prior recommendations.

The IIF has commented on the Treasury's and the FSOC's prior pronouncements on issues concerning the appropriate regulation of financial services and the FSOC's process for addressing nonbank financial services companies. Among these submissions were comments by IIF President and CEO Timothy Adams on September 14, 2017[11] on the April 2017 Presidential Memorandum on the FSOC and IIF Managing Director for Regulatory Affairs Andres Portilla's comments on March 25, 2015[12] on the FSOC's Note Seeking Comment on Asset Management Products and Activities published on December 24, 2014. We appreciate the careful attention of Treasury and FSOC to public comments and the reflection of these

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[11] IIF Letter to Secretary of the Treasury Steven Mnuchin regarding the Presidential Memorandum for the Secretary of the Treasury – April 21, 2017 – Financial Stability Oversight Council, September 14, 2017.

[12] IIF Response on Financial Oversight Council's Notice: Asset Management Products and Activities, March 25, 2015.

comments in guidance and subsequent proposals; however, we have some further recommendations that are consistent with these prior observations.

16. **The FSOC should expand the information it shares with a company that has been selected for potential designation.**

We appreciate the FSOC's statement that it would share information with a company that has been selected for potential designation, but we encourage the FSOC to expand that information beyond public information to any information that is relevant to the FSOC's review. Consistent with fundamental principles of due process, a company that is potentially subject to designation (and the attendant costs and burdens) should have the opportunity to challenge or correct the full portfolio of information on which that designation could be based, before that information is used in decision making.

17. **The FSOC should provide additional specificity and detail regarding how it would conduct a cost-benefit analysis, as well as provide a clear statement to the effect that the analyses should be based on quantifiable and empirically based data that is capable of independent verification and validation.**

We appreciate the inclusion in the proposed guidance of a cost-benefit analysis of a potential company designation under the EBA and would welcome greater specificity on how those analyses would be conducted and by whom and a clear statement to the effect that the analyses should be based on quantifiable and empirically based data that is capable of independent verification and validation (as opposed to estimates or projections). Importantly, the cost-benefit analysis should be extended to policy measures contemplated under the ABA. The substantial costs and burdens of both an ABA and an EBA call for a robust cost-benefit analysis that is open to review and challenge.

We would recommend that the primary regulator conduct an independently verifiable cost-benefit analysis of any proposed policy or regulatory measure designed to address the systemic risk of an activity in the sector for which the regulator has responsibility. That analysis should include a consideration of other potentially less costly and less burdensome alternatives that could achieve the same objectives. This analysis should include an explicit reflection of the full range of risk mitigants that are being or could be applied to reduce the risk profile of the activity. Importantly, the impact of the prohibition or curtailment of an activity should be carefully assessed to avoid negative unintended consequences. For example, could a regulatory measure impact the ability of consumers to access socially beneficial investment or insurance products, such as retirement or long-term savings products? The impact of the regulatory measure on economic growth and the ability of the sector to contribute to a well-functioning financial system should likewise be measured. The impact analyses should be grounded in robust data and capable of independent empirical analysis.

Importantly, a cost-benefit analysis should be data- and fact-based, subject to empirical analysis, and open to peer review. By their nature, cost-benefit analyses include assumptions and projections. Only by exposing those assumptions and projections to critical analysis and challenge can they be refined and made more precise.

18. **The FSOC should provide to firms subject to designation under the EBA additional information on the consequences of designation and a clear "off-ramp" from a systemic risk determination.**

While we appreciate the FSOC's commitment to greater transparency, this transparency should extend to a clear regulatory and supervisory plan, on which the company has the opportunity to comment, in advance of designation. As noted above, all of the information on which a decision to make a determination has been based should be available to the company and the company should have the

opportunity to dispute or amend that information prior to its use in decision making. We urge the FSOC to make the full evidentiary record available to the company at least 30 days in advance of an FSOC vote on a proposed determination.

As noted in Mr. Adams' September 14, 2017 letter to Secretary of the Treasury Steven Mnuchin regarding the Presidential Memorandum on the FSOC[13], before deciding on a potential designation, FSOC should provide full transparency to the company, including the full set of designation criteria, the extent to which the company fulfills the criteria, and policy measures that would be applied upon designation. This information should outline a clear "off-ramp" from designation if the company elects to pursue this option.

This comprehensive information would enable the company to conduct a reasonable analysis as to how to address the underlying reasons for its potential designation and properly weigh the decision to accept the designation or to adjust its activities to avoid designation. The company should be given a reasonable amount of time to make adjustments to its activities or operations if it decides to pursue an "off ramp" from designation.

As a more general matter, the FSOC should err on the side of greater transparency and disclosure in its guidance and future activities. The post-crisis regulatory and supervisory agenda has suffered from a general lack of transparency that has, in some cases, de-legitimized regulations, supervisory actions, and even some regulators and supervisors. Exposing the FSOC's guidance, basis for actions, and deliberations would allow for meaningful critical analysis and input and would help to ensure that the FSOC's actions are the most effective and efficient actions in the pursuit of financial stability.

19. **The language of the proposed guidance regarding when the FSOC will pursue an EBA should better align with the objective of using the EBA only in very limited circumstances when an ABA would prove ineffective.**

Specifically, the language in Section II, Part C (page 9032) and in Section III (page 9041) of the proposed guidance should be amended as follows:

> *"The Council expects to advance beyond the activities-based approach, and evaluate a nonbank financial company for a potential determination under section 113 of the Dodd-Frank Act, only in a limited set of circumstances—namely, if (1) the Council's collaboration and engagement with the relevant financial regulatory agencies does not adequately address the potential risk identified by the Council, or if the potential threat to U.S. financial stability is outside the jurisdiction or authority of financial regulatory agencies, and (2) the potential threat identified by the Council is one that ~~could~~ can only be adequately addressed by a Council determination regarding one or more companies. Following is a description of the substantive analysis the Council would undertake regarding any nonbank financial company under review for a potential determination." (page 9032)*

> *"If the Council's collaboration and engagement with the relevant financial regulatory agencies does not adequately address a potential threat identified by the Council – or if a potential threat to U.S. financial stability is outside the jurisdiction or authority of financial regulatory agencies – and if the potential threat identified by the Council is one that ~~could~~ can only be adequately addressed by a Council determination regarding one or more companies, the Council may evaluate one or more nonbank financial*

[13] See Footnote 11.

companies for an entity-specific determination under section 113 of the Dodd-Frank Act, applying the analytic framework described below." (page 9041)

We appreciate the opportunity to comment on this important proposal and we would be pleased to discuss these views in greater detail with you and your staff.

Very truly yours,