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Financial Stability Oversight Council
Attn: Eric Froman
1500 Pennsylvania Avenue NW, Room 2308
Washington, DC 20220

July 27, 2023

Dear Mr. Froman,

Re: Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies and Analytic Framework for Financial Stability Risk Identification, Assessment, and Response

The Alternative Investment Management Association ("AIMA")[1] welcomes this opportunity to respond to the Financial Stability Oversight Council's ("FSOC") request for public comment on its proposals to revise existing interpretive guidance on nonbank financial company designations ("Nonbank Guidance")[2] and to adopt an analytic framework to potentially designate individual companies as posing a systemic risk to U.S. financial stability ("Analytic Framework").[3] We support the FSOC's goal of preserving financial stability but have the following high-level concerns about the Nonbank Guidance and Analytic Framework:

- The proposed ability for FSOC to designate a nonbank financial institution ("NBFI") without first allowing the primary regulator to address identified concerns effectively removes the ability of the primary sectoral regulators to use their existing regulatory tools to address potential issues and bring to bear their better understanding of the relevant sector and the products and practices in question.

- Removing the preference for an activities-based approach ("ABA") would be a departure from the growing consensus at the Financial Stability Board ("FSB") in favor of an ABA, which has so far proven to be the only effective mechanism for addressing potential systemic risk in nonbank financial sectors. For instance, the G20 used an ABA to completely reform global derivatives markets after the 2008 crisis,[4] and, in 2022, the FSB discontinued individual systemic risk designations for globally active

1 The Alternative Investment Management Association (AIMA) is the global representative of the alternative investment industry, with around 2,100 corporate members in over 60 countries. AIMA's fund manager members collectively manage more than $2.5 trillion in hedge fund and private credit assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. The ACC currently represents over 250 members that manage $800 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. AIMA is governed by its Council (Board of Directors). For further information, please visit AIMA's website, www.aima.org.

2 FSOC, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies" 88 FR 26234 (Apr. 28, 2023).

3 FSOC, "Analytic Framework for Financial Stability Risk Identification, Assessment, and Response" 88 FR 26305 (Apr. 28, 2023).

4 FSB, "Implementation and Effects of the G20 Financial Regulatory Reforms" (July 3, 2017).

insurance companies and is currently advancing activities-based proposals to manage risks related to digital assets[5] and open-ended funds.[6]

- The removal of the requirement to carry out a cost-benefit analysis will result in less effective regulation and is not consistent with the requirements of Section 113 of the Wall Street Reform and Consumer Protection Act of 2010 ("Dodd-Frank Act")[7] and the ruling in MetLife vs. FSOC[8].

- The proposed elimination of the definition of what constitutes a sufficient "threat to financial stability" to warrant designation and replacing that with the extremely broad, numerous categories of vulnerabilities and transmission channels in the proposed analytic framework is so vague that it fails to provide meaningful guidance for companies seeking to address perceived vulnerabilities that could lead to designation or to have their designation rescinded.

- The enhanced prudential standards required by Section 165 of the Dodd-Frank Act[9] are not appropriate for a wide range of NBFIs that could be subject to potential designation under the Nonbank Guidance and Analytic Framework. For instance, imposing heightened capital requirements or forcing designated NBFIs to dispose of or to retain assets against their judgment would force them to override asset managers' fiduciary responsibility, would not be fair to investors, would create legal uncertainty and could subject them to litigation.

For these reasons, and as further explained in the Annex below, we recommend that FSOC retain an initial preference for an ABA utilizing the existing authorities of the relevant primary regulator. Rather than imposing unnecessary hurdles, an ABA would be both more tailored to the relevant sector and more effective than going through the two stages of the designation process, imposing the Federal Reserve Board ("Federal Reserve") as the macroprudential regulator and then waiting for the Federal Reserve to develop and finalize enhanced prudential standards. Our concern about the effectiveness and presumed benefits of designation and enhanced prudential standards is highlighted by the recent failure to identify and prevent the build-up of systemic risk in a number of banks that were already subject to heightened standards and macroprudential supervision by the Federal Reserve.

For further information, please contact James Hopegood, Director of Asset Management Regulation, at jhopegood@aima.org or Joseph Engelhard, Senior Counsel, at jengelhard@aima.org.

Yours sincerely,

Jiří Król
Deputy CEO, Global Head of Government Affairs

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5 FSB, "The Financial Stability Risks of Decentralised Finance" (Feb. 16, 2023) ("DeFi Risks").

6 FSB, "Assessment of the Effectiveness of the FSB's 2017 Recommendations on Liquidity Mismatch in Open-Ended Funds" (Dec. 14, 2022) ("2022 Assessment").

7 12 U.S.C. 5322 at Section 113.

8 MetLife Inc. v. FSOC, 177 F. Supp. 3d 219 (D.D.C. 2016).

9 *Id.*, at Section 165.

ANNEX

The Nonbank Guidance and Analytic Framework advance five problematic propositions, which are the following:

- Elimination of the preference to use an activities-based assessment of risk before invoking its designation powers;
- Removal of the preference for FSOC to first work with the primary regulator to address identified potential financial stability concerns before designating individual firms;
- Abolition of FSOC's current requirement to carry out a cost-benefit analysis and to determine the likelihood of material financial distress before deciding that the firm poses a financial stability risk;
- Replacement of the "threat to financial stability" definition with a generic list of vulnerabilities and risk transmission channels that are too vague to provide meaningful guidance to companies seeking to address perceived vulnerabilities that could lead to designation or to be de-designated; and
- Imposition of enhanced prudential standards for designated NBFIs, as required by the Dodd-Frank Act, that are too bank-centric, inappropriate for the wide variety of institutions lumped together as "nonbanks" and inconsistent with investment advisers' fiduciary duties.

The Nonbank Guidance and Analytic Framework, as proposed, have the potential to disrupt NBFIs via an opaque process that runs counter to global standards regarding the most effective supervisory practices. We address these points in turn.

Elimination of the preference to use an activities-based assessment of risk before invoking its designation powers.

We share the FSOC's goal of safeguarding the financial system from potential shocks and events that could undermine its stability and integrity. Since the Financial Crisis of 2007 and 2008, there has been an intense regulatory focus on identifying and mitigating threats to financial stability. The FSB has in recent years been very active in its attempts to locate risks that NBFIs may present to the stability of the financial system.

In recent years, the FSB has moved away from the designation of NBFIs and instead focused on specific activities that warrant cross-sectoral regulation from a macroprudential perspective to avoid any negative externalities to the broader economy. The FSB, in December of 2022, decided to discontinue the designation of globally active insurance companies as systemically important.[10] Instead, they replaced designations with a broad framework developed by the primary regulators of insurance companies that monitors trends across the industry, identifies potential risks and recommends standards implemented by national regulators on a cross-sectoral basis.[11] Similarly, the FSB is currently actively engaged in the

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[10] FSB, Press Release, "The FSB endorses an improved framework for the assessment and mitigation of systemic risk in the insurance sector and discontinues annual identification of global systemically important insurers (G-SIIs)" (Dec. 9, 2022).

[11] FSB Statement, "Finalisation of IAIS holistic framework for the assessment and mitigation of systemic risk in the insurance sector" (Nov. 14, 2019).

discussion of risks posed by digital assets[12] and open-ended funds[13] and considering appropriate measures that would apply to all participants in those activities. For NBFIs in general, but in particular, for asset managers, the FSB has increasingly recognized that targeting a handful of the largest market participants for "enhanced regulation" would merely shift risk into less regulated firms.

The Nonbank Guidance's reasoning that it is necessary to remove the preference for an ABA because it represents a "hurdle" that would make the FSOC wait too long to address a potential systemic threat ignores the reality that an ABA has proven to be the most effective means of addressing potential systemic risk in nonbank financial sectors. The primary regulators for NBFIs in the U.S., including the SEC and other market regulators, have uniformly adopted an ABA to effectively address potential threats to financial stability covering a wide variety of activities and industry sectors, including money market funds, open-ended funds, private funds, and registered investment advisors.[14]

Perhaps the best example of addressing potential systemic risk using an ABA can be found in the derivatives regulatory reforms mandated by Title VII of the Dodd-Frank Act.[15] That chapter completely reformed the over-the-counter derivatives market by imposing minimum clearing, margin, collateral and transparency requirements for all relevant market participants. These reforms successfully reduced systemic risk and increased market resiliency, but that would not have been possible if those reforms were merely imposed on a handful of the largest swap market participants. Similarly, the National Association of Insurance Companies ("NAIC"), which represents the primary regulators of the insurance sector, adopted an effective ABA to address potential systemic risks.[16] These regulations were effective because the primary regulators have a deep understanding of the markets that they regulate, the existing regulatory framework, and how to develop policy changes on a sectoral basis to address the underlying cause of the identified risk.

Removal of the preference for FSOC to first work with the primary Federal regulators to address identified potential financial stability concerns before designating individual firms.

FSOC's 2019 Interpretive Guidance reflects the supervisory "ladder of intervention," whereby a risk or potential risk should best be initially addressed by early intervention by a supervisory authority.[17] The degree of supervisory intervention increases in line with both the size of the potential or actual risk and where the earlier interventions are insufficient to mitigate them. Another benefit of this approach is that the primary regulator will be better positioned to address the identified risks with its existing authority and to tailor any new regulation given their deeper understanding of the relevant industry's market dynamics, practices and range of financial products.

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12 DeFi Risks, *supra* note 4.

13 *See e.g.,* 2022 Assessment, *supra* note 5 and FSB, "Addressing Structural Vulnerabilities from Liquidity Mismatch in Open-Ended Funds" (July 5, 2023).

14 See, e.g., SEC Chair Mary Jo White Speech, "The SEC after the Financial Crisis: Protecting Investors, Preserving Markets" (January 17, 2017); SEC Commissioner Caroline Crenshaw, Statement on the Adoption of Money Market Fund Reforms," (July 12, 2023); and BlackRock, "The Decade of Financial Regulatory Reform: 2009 to 2019" (January, 2020) ("Decade of Financial Reform").

15 Dodd-Frank Act, *supra* note 7.

16 National Association of Insurance Commissioners, "Macroprudential Supervision" (February 1, 2023).

17 FSOC, "Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies", 84 FR 71740 (Dec. 30, 2019).

The Bank for International Settlements ("BIS") March 2018 paper on early supervisory intervention makes this point powerfully:

> "Based on practices observed, early supervisory intervention therefore involves supervisors taking actions to correct an identified weakness or potential issue before rules or buffers are materially breached. In the context of prudential supervision, early intervention programmes are aimed at minimizing the impact of material distress and the probability of failure of an individual bank or group of banks on the broader financial system. Early supervisory intervention is firmly entrenched within a risk-based approach to supervision, where the intensity of supervisory attention escalates as the risks and impact that an institution poses to financial stability increases."[18]

The Nonbank Guidance's intention to potentially cut the primary regulator out of the process undermines the internationally respected approach outlined by BIS. Recent issues relating to U.S. banks indicate that problems were building up as a result of poor management practices. Done properly, early intervention by the primary regulator using their better understanding of the relevant sector and their existing authorities could have required the banks to improve their interest rate risk management frameworks. Removing this rung from the ladder of intervention for NBFIs will rob the process of a key stage that can allow problems to be resolved before they crystallize. It can also be done without the attendant publicity, distortionary competitive impact and potential to push risks to non-designated competitors that would come with a SIFI designation as well as the inevitable investor disruption that would cause.

As noted above, it also runs counter to the established and internationally recognized ladder of intervention with no compelling evidence as to why this would necessarily lead to superior outcomes.

Abolition of FSOC's current requirement to carry out a cost-benefit analysis and to determine the likelihood of material financial distress before deciding that the firm poses a financial stability risk.

The Nonbank Guidance's reversal of the FSOC's 2019 Interpretive Guidance is contrary to established and well-documented federal agency rulemaking policy. This was restated as recently as 2022:

> "Since the 1970s, federal agencies have been required to consider the costs and benefits of certain regulations that are expected to have large economic effects. Under current requirements, most agencies are to design regulations in a cost-effective manner and ensure that the benefits of their regulations justify the costs."[19]

Understanding the impact, both negative and positive, of a regulatory proposal is a vital part of the policy process. A thorough, effective cost-benefit analysis ("CBA") ensures that any change is proportionate to the risk it seeks to mitigate as regulators evaluate both the perceived benefits of a proposed regulation and compare that with the implementation costs and the potential negative impact on the efficiency of the relevant market sector. Such an analysis also makes it more apparent what unintended effects might occur that would either mitigate the effectiveness of the proposed reform or simply shift the risk

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18 BIS, "Frameworks for early supervisory intervention" (March 2018).

19 *See* Congressional Research Service, In Focus, "Cost-Benefit Analysis in Federal Agency Rulemaking", IF12058 Version 2 (March 8, 2022).

elsewhere. Monetary and opportunity costs, as well as other relevant factors, should always be taken into account in regulatory and supervisory policy and decision-making.

While the Dodd-Frank Act does not explicitly require a cost-benefit analysis for implementing regulations, U.S. courts have increasingly required at least some form of cost-benefit analysis in recent cases.[20] For instance, a recent federal District Court case rescinded an FSOC nonbank designation due to its lack of a sound economic analysis to support its forecasts of potential systemic risk or the financial effects of designation, which it found to be arbitrary and capricious.[21]

The proposed Nonbank Guidance claims that eliminating the need to determine financial distress is sufficient to overcome this court ruling. However, failing to follow FSOC's own stated policy of determining vulnerability to financial distress was only the first ground for the court's ruling. The second ground, failing to consider the cost of designation, still imposes a duty on FSOC to at least consider the cost of being designated. The court relied on the language of Section 113 of the Dodd-Frank Act, which requires FSOC to consider "other risk-related factors as appropriate."[22] Citing the Supreme Court in *Michigan vs. EPA*[23] as precedent, the court concluded that the cost of designation must be considered since "no regulation is appropriate if it does more harm than good."[24]

The Nonbank Guidance loosely and without any real analysis estimates that the benefits of individual nonbanks being designated could "*be measured in the trillions of dollars,"*[25]but this implicitly assumes that once designated as systemically important, nonbank firms will not fail. Presumably, that is because they would be under the macroprudential supervision of the Federal Reserve and subject to the enhanced prudential standards required by the Dodd-Frank Act. However, recent history has proven that assumption to be incorrect. Silicon Valley, First Republic and Signature banks were already subject to Federal Reserve macroprudential supervision and enhanced prudential standards because they exceeded the $50 billion threshold for systemic banks.[26]

The proposed elimination of the need to determine the likelihood of material financial distress does not seem advisable in light of the Federal Reserve's admission that it failed to anticipate or at least address the likelihood of material financial distress at those recently failed banks. The Federal Reserve's review found that the San Francisco Federal Reserve Branch "supervisors identified some of the material issues, but also underappreciated important ones."[27] These underappreciated consequences forced the FDIC Board to utilize its own systemically important risk exception and to bail out the banks' uninsured depositors. Given that these banks were already subject to enhanced supervision by the Federal Reserve, but that failed to prevent the build-up of systemic risk in a timely manner, why should FSOC expect the Federal Reserve bank supervisors to be able to detect and address in a timely manner the build-up of systemic risk in NBFIs that they are not familiar with supervising?

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[20] Jonathan Masur & Eric Posner, "Cost-Benefit Analysis and the Judicial Role", Coase-Sandor Working Paper Series in Law and Economics, No. 794 (2017).

[21] MetLife vs. FSOC, *supra* note 7.

[22] Dodd-Frank Act, *supra* note 7.

[23] 135 S. Ct. 2699 (2015).

[24] MetLife vs. FSOC, *supra* note 7.

[25] Nonbank Guidance, *supra* note 2, at 26238.

[26] Dodd-Frank Act, *supra* note 6.

[27] Federal Reserve Board, "Review of the Federal Reserve's Supervision and Regulation of Silicon Valley Bank" (Apr. 28, 2023).

Replacement of the "threat to financial stability" definition with a generic list of vulnerabilities and risk transmission channels more applicable to banks does not provide meaningful transparency or guidance to asset managers seeking to avoid designation or to be de-designated.

The Analytic Framework purports to provide greater public transparency by providing a laundry list of activities, products, practices, markets and specific entities to identify risks and a similarly lengthy list of vulnerabilities and transmission channels to assess the identified risks. The central problem is that these lists do not provide the promised transparency as there is no meaningful explanation of how FSOC proposes to analyze the identified risks, vulnerabilities and transmission channels in the context of asset managers, let alone all NBFIs. The Analytic Framework lacks a sufficient description of how the identified risks will be measured for asset managers and does not indicate how the risks will be connected to the vulnerabilities. Most problematically, the Analytic Framework provides no concrete guidance on how the FSOC will determine that the identified threats and vulnerabilities will result in a sufficient level of transmission risk to be considered systemic. That is because the FSOC has proposed to remove the definitional threshold in the 2019 FSOC guidance that, before an NBFI can be designated, the FSOC must find that the threat to financial stability is so great that "the economy would be severely damaged."[28]

As a result, the Analytic Framework is so high level that it does not provide meaningful transparency. Without the level of detail and analysis required of a proper analytical framework, potentially affected firms will not be able to understand what the FSOC's concerns are, how to mitigate those concerns, or even how to to address perceived vulnerabilities that could lead to designation or to have their designation removed. This approach varies considerably from the global frameworks used for assessing globally active banks and insurers, which, for all of their drawbacks, at least contain a series of quantitative measurements of risk, attempt to explain their connection to the transmission of systemic risk, and are more tailored to the risks and functions relevant to their respective industries.

The Analytical Framework's section on "identifying potential risks"[29] puts forth an undifferentiated amalgam of asset classes, institutions and activities, including:

- markets for debt, loans, short-term funds, equity securities, commodities, digital assets, derivatives and other institutional and consumer financial products and services;
- central counterparties and payment, clearing and settlement activities;
- financial entities, including banking organizations, broker-dealers, asset managers, investment companies, insurance companies, mortgage originators and servicers and specialty finance companies;
- new or evolving financial products and practices; and
- developments affecting the resiliency of the financial system, such as cybersecurity and climate-related financial risks.[30]

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28 FSOC, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 88 FR 71, 7140 (Dec. 30, 2019).

29 Analytic Framework, *supra* note 3, at 26307.

30 *Id.*

Nowhere in the Analytic Framework does it explain in any level of meaningful detail why or how these various categories relate to the identification of risk in the asset management industry. Instead, it simply indicates that the FSOC reviews "historical data, research … and new developments that arise in evolving marketplaces."[31] Thus, the Analytic Framework fails to give any indication of how the mix of asset classes, types of financial institutions and activities will be measured or analyzed to identify potential systemic risk.

In its assessing potential risks section, the Analytic Framework briefly describes the enumerated vulnerabilities: leverage, liquidity risk, interconnections, operational risks, complexity or opacity, inadequate risk management, concentration and destabilizing activities. Again, what is lacking is any concrete understanding of how these vulnerabilities are measured or how they have a sufficient connection to the undue transmission of systemic risk rather than normal market changes. Below are some additional comments or concerns about several of these vulnerabilities.

Leverage

There is no discussion in the Analytic Framework on the proper measurement of leverage for an individual asset manager. Nor is there sufficient recognition of how leverage for an asset manager is different than a bank. Unlike banks, an asset manager's assets under management are owned by their clients, are segregated and held by a custodian. As a result, an individual asset manager's use of leverage does not generate the same kind of balance sheet risk as bank leverage. Nor do asset managers provide critical functions like banks' payment and clearing services. Furthermore, the use of leverage by the asset management industry is already being appropriately measured and analyzed at a sectoral level. For instance, the SEC in 2020 adopted new limitations on the use of derivatives by registered investment companies and business development companies in 2020 that are tailored to the specific nature of those markets.[32] Additionally, when financial companies use leverage, extensive safeguards are generally already in place, including collateral, margining and reporting requirements. In the U.S., the SEC has a thorough set of reporting requirements reflecting global standards developed by the FSB and IOSCO.[33]

In our view, the proper analysis and regulation of leverage can best be achieved via the relevant Federal regulators that understand their companies' funding sources, products and industry practices to understand and, if appropriate, regulate the use of leverage. These regulatory agencies recognize that leverage is a legitimate and widely used method for optimizing portfolio exposure and hedging risks. Within the established regulations, how much leverage a fund or manager chooses to employ will vary over time, but the amount that can be used and the restrictions on its form will generally be set out in the fund's offering document.

Liquidity risk and maturity mismatch

The Analytic Framework does not sufficiently reflect that liquidity and maturity mismatch risk is significantly different for asset managers than for banks. First, banks' demand deposit structure results in an inherent maturity mismatch. In contrast, asset managers have extensive rules and requirements surrounding how investment funds operate to manage any potential mismatch between the managed

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31 *Id.*

32 SEC, "Use of Derivatives by Registered Investment Companies and Business Development Companies," SEC Release No. IC-34084, 85 FR 83162 (Dec. 21, 2020).

33 *See, e.g.,* Form PF, 17 CFR 279.9.

assets and their redemption terms. These requirements apply at the design stage of a fund and on an ongoing basis to ensure all investors in a fund are treated fairly.

There has been and continues to be a great deal of international and U.S. domestic regulation on liquidity management, which the SEC has recently revisited. The SEC is currently consulting on widening the use of liquidity risk management tools by mutual funds.[34] There is no indication of how FSOC would weigh or assess such regulatory measures, and any decision to apply enhanced liquidity requirements on a handful of designated nonbanks would have significant negative competitive consequences while at the same time ignoring that liquidity risk would simply shift to other firms that are not designated. As a result, any decision to designate an asset manager based on the liquidity criterion would both be subjective, as there is no clear dividing line, and self-defeating, as investors would simply shift their funds to non-designated firms.

Interconnections and concentrations

The Analytic Framework does not indicate how the normal interconnections between financial firms should be assessed or determined to rise to a level of systemic risk. Nonbanks use an extensive network of counterparties and service providers in a way similar to all other financial and non-financial companies. The extensive federal and state rules that apply to private fund managers require that these relationships are recorded and reported to the relevant regulator. This includes reporting on derivative exposures, securities financing transactions, margin or collateral requirements, largest counterparties and the types and amounts of assets they hold.[35] As a double measure, the systemic banks have their own concentration limits, including a single counterparty credit limit to prevent the transmission of systemic risk.[36] Rather than designating a nonbank as systemic, any concerns in this area can best be addressed by making adjustments on a sectoral basis or by updating the counterparty limits for systemic banks or designated financial market utilities.

Operational risks and Inadequate risk management

All financial market firms face operational risks such as trading, execution and cyber security, as well as reliance on critical infrastructure provided by prime brokers, financial market utilities, and other service providers. The extensive rules and regulations applying to nonbank financial companies require an assessment of such risks and plans to mitigate them.[37] The Analytic Framework references the existence of such risks but provides scant information about how such risks should be assessed for potential systemic risk. Any identified risks in these two areas are best resolved using an activities-based approach in combination with strong regulation of payment and clearing systems.

Complexity, opacity and destabilizing activities

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[34] SEC, "Open-End Fund Liquidity Risk Management Programs and Swing Pricing; Form N-PORT Reporting," ("SEC Open-End Fund Proposal") SEC Rel. No. 33-11130, 87 FR 77172 (Dec. 16, 2022) and AIMA's response available at https://www.sec.gov/comments/s7-26-22/s72622-20157188-325522.pdf.

[35] Form PF, 17 CFR 279.9.

[36] Office of the Comptroller of the Currency, et al, "Interagency Supervisory Guidance on Counterparty Credit Risk Management" (June 29, 2011).

[37] *See e.g.,* Speech by SEC Chair Mary Jo White, "Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry" (Dec. 11, 2014) and Guide to Sound Practices for Operational Risk Management, AIMA, 2016, https://www.aima.org/static/uploaded/57e23b6e-632c-4ed7-8a7944045d7f58b8.pdf.

The Analytic Framework notes that if a market, activity, or firm is complex or opaque, then "a risk may be exacerbated."[38] However, there is no context provided that allows for companies to discern what types of proprietary trading information or strategies are permitted or will be deemed sufficiently opaque as to be systemic. Nor are there any clear insights provided on what activities will be determined to be "destabilizing." Since the great financial crisis, the SEC has implemented over 67 Dodd-Frank implementing regulations, including transparency improvements via additional reporting, disclosure, and risk management requirements for the asset management industry.[39] Unless the framework provides greater clarity, the inevitable result will be regulation by fiat, and financial companies will only learn after designation—and possibly not even then—what the FSOC decided was too complex, opaque or destabilizing.

Transmission channels

The Analytic Framework specifies four transmission channels: (i) exposures, (ii) asset liquidation, (iii) critical function or service, and (iv) contagion.[40] The exposure section discusses in very general terms the well-accepted understanding that the larger the direct or indirect exposures, the greater the potential for losses. However, this begs the question of what types or extent of losses would result in the transmission of risk sufficient to be deemed systemic. The Analytic Framework does not attempt to draw any line between acceptable levels of losses that occur daily in markets versus those that the FSOC would deem to be systemic. Nor does the Analytic Framework attempt to make any causal connection between the identified risks and vulnerabilities and how these might lead to the transmission of systemic risk. Again, this leaves potentially designated firms with little or no guidance on how to address perceived vulnerabilities that could lead to designation. Similarly, the Analytic Framework's discussion of asset liquidation is so high-level that there is no principled way for a nonbank to distinguish between an acceptable level of asset sales and those that might be assessed as posing a threat to financial stability.

In summary, the activities, products and practices listed in the Analytic Framework are ill-defined, overly broad and overlap with each other. The assessment of risks section provides insufficient context and does not explain in objective terms how the FSOC would measure or assess their interaction or connection with the transmission channels. Given how much is missing or not properly defined, what has been proposed is more a series of lists than a transparent analytical framework. Potentially designated companies would be left without any meaningful guidance and would have no visibility as to whether or why they are being designated.

Imposition of enhanced prudential standards for designated NBFIs, as required by the Dodd-Frank Act, that are too bank-centric, inappropriate for the wide variety of institutions classified as nonbanks, and inconsistent with investment advisers' fiduciary duties.

The fiduciary duty of investment advisers to act in the best interests of investors in a fund is a cornerstone of fund regulation at the federal and state levels in the U.S. as well as internationally. It ensures that investment advisers fully consider the effect of their actions on all investors before acting. Designation as a SIFI will allow the Federal Reserve to require investment advisers to take actions, for example,

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[38] Analytic Framework, *supra* note 3, at 26308.

[39] *See e.g.,* SEC, Implementing the Dodd-Frank Wall Street Reform and Consumer Protection Act, https://www.sec.gov/securities-topics/dodd-frank-act; BlackRock, *supra* note 14, Decade of Financial Reform.

[40] Analytic Framework, *supra* note 3, at 26308-26309.

suspending funds or buying or selling assets, that may go against the best interests of the fund or its investors. Such action may cause investment losses or prevent investors from redeeming, causing them potential financial harm. This will both undermine investor confidence that the investment adviser will always act in the best interests of the fund and its investors and create legal uncertainty as to who is responsible for investor losses.

More information about what the designation of an individual asset manager would mean and how the Federal Reserve would apply the enhanced prudential standards required for designated asset managers would help inform the behavior of asset managers seeking to avoid being viewed as presenting systemic risk. As noted earlier, this process would likely take years and, if limited to a small number of asset managers, would merely result in the shifting of risk to other, non-designated asset management firms.

The increased reliance in the Nonbank Guidance on individual designations ignores the problem that the enhanced prudential standards required in Section 165 of the Dodd-Frank Act for designated companies, such as enhanced risk-based capital requirements, liquidity requirements, resolution plans, living wills and concentration limits, are unlikely to be appropriate for most NBFIs or even effective in addressing potential systemic risk. As noted earlier, unless the identified risk is addressed using an ABA, the enhanced rules will simply shift the risk to other non-designated firms. Another indication of the ineffectiveness of the enhanced prudential requirements for designated nonbanks is that it would take the Federal Reserve years to adopt these requirements for designated NBFIs, which would likely have a significant negative impact on their ability to compete with other firms and meet their fiduciary duties to investors. Again, in the absence of more specific, clearer requirements, the inevitable result will be regulation by fiat. This is what happened in the insurance sector, where the handful of designated insurers were handicapped for years by the extensive cost, additional regulatory burden and anti-competitive effect of the rules that it took many years for the Federal Reserve to formulate and impose on the designated insurers.

For any newly designated asset managers, it would likely take even longer for the Federal Reserve to develop the enhanced prudential requirements in Section 165 of the Dodd-Frank Act given how inappropriate they are for funds and investment advisers. Paradoxically, skipping over the ABA would therefore very likely take longer to address the identified financial threat and allow it to spread to non-designated firms.

Concluding Recommendation

Given the above concerns, we would recommend that FSOC retain an initial preference for an ABA utilizing the existing authorities of the nonbank's relevant primary regulator and the requirement for a cost-benefit analysis. Doing so would not prevent the FSOC from using its emergency exception allowing it to rapidly designate a nonbank should exigent circumstances arise.