***Via e-mail: fsb@bis.org***

May 29, 2015

Secretariat of the Financial Stability Board
c/o Bank for International Settlements
CH-4002, Basel
Switzerland

**Re: FINANCIAL STABILITY BOARD AND INTERNATIONAL ORGANIZATION OF SECURITIES COMMISSIONS, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions" (Mar. 4, 2015)**

Dear Gentlemen and Ladies:

The Financial Services Roundtable ("FSR")[1] extends its appreciation to the Financial Stability Board ("FSB") and the International Organization of Securities Commissions ("IOSCO") for providing an opportunity for us to comment on the second, revised consultative document, "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies" (the "Proposed Framework").[2]

1 The Financial Services Roundtable represents the largest integrated financial services companies providing banking, insurance, payment and investment products and services to the American consumer. Member companies participate through the Chief Executive Officer and other senior executives nominated by the CEO. Roundtable member companies provide fuel for America's economic engine, accounting directly for $92.7 trillion in managed assets, $1.2 trillion in revenue, and 2.3 million jobs. Learn more at FSRoundtable.org.

2 FSB, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Mar. 4, 2015), *available at* http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf.

FSR recognizes the challenging task undertaken by the FSB to meet the request by the G20 Leaders to prepare methodologies to identify systemically important non-bank, non-insurer ("NBNI") financial entities.[3] In reviewing the revisions to the Proposed Framework, we commend the FSB and IOSCO for considering the comments received on the first consultative document,[4] and we appreciate that several of the concerns we raised in our comments on that document are reflected in the revised Proposed Framework. However, we urge the FSB and IOSCO to consider again our comments[5] for further revisions to the Proposed Framework in order to ensure that the assessment methodologies effectively and accurately identify NBNI entities that present a systemic risk to the global financial system and economic activity across jurisdictions.

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[3] G20 Cannes Declaration (Nov. 2011).

[4] FSB, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/publications/r_140108.pdf.

[5] See, FSR's comments on FSB, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions (Jan. 8, 2014), *available at* http://www.financialstabilityboard.org/wp-content/uploads/r_140423v.pdf. The Comment File is *available at* http://www.financialstabilityboard.org/2014/04/r_140423/.

## Table of Contents

## I. Executive Summary

- The Proposed Framework should be further revised to utilize a transparent, risk-based approach and focus the assessment methodologies on only those transmission channels and indicators clearly relevant, as supported by empirical evidence and academic research, to a determination of systemic importance.

- The revised assessment process continues to exhibit over-reliance on the supervisory judgment of national authorities and may, consequently, result in an inconsistent application of the methodologies across jurisdictions.

- NBNI entities assessed under the revised Proposed Framework continue to be denied meaningful opportunities to participate in the designation process and should be allowed, as relevant, to receive notice of their potential designation and an opportunity to respond.

- The assessment methodologies still do not account explicitly for existing laws and regulations that already mitigate the potential risks captured by the proposed indicators, even in cases where the revised discussion of the relevant transmission channels now notes the potential mitigating effects of such laws and regulations.

- The Proposed Framework continues to require the consolidation of an assessed entity's balance sheet, even where such consolidation would inappropriately capture assets and liabilities held by subsidiaries and affiliates not engaged in financial activities.

- The FSB and IOSCO were correct in their initial determination that asset managers are not an appropriate focus for the Proposed Framework, and the new discussion of the potential impact of a distressed or failed asset manager dramatically overemphasizes potential disruption to the global financial system.

- If the FSB and IOSCO propose to expand the types of NBNI subject to assessment, specific methodologies and indicators for each type of NBNI entity proposed for assessment should be developed and submitted for public consultation.

## II. The Proposed Framework Should Utilize a Transparent, Risk-Based Approach in a Manner that Promotes the Consistent Application of the Assessment Methodologies.

FSR understands the objective of the assessment methodologies remains the identification of those NBNI entities "whose distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity at the global level."[6] In undertaking this task, FSR believes that the assessment methodologies should be designed to result in the designation of only those NBNIs that present a real risk of disruption to the global financial system. We continue to urge the FSB and IOSCO not to presume that NBNI globally systemically important financial institutions ("G-SIFIs") presently exist. Rather, we believe the FSB and IOSCO should consider the possibility that when they apply an objective, risk-based assessment that evaluates finance companies, market intermediaries, investment funds, and other types of NBNI financial institutions through the lens of the three transmission channels, an NBNI entity would not present global systemic risks.

### A. *The Proposed Methodologies Should Utilize a Transparent, Risk-Based Assessment Process that Ensures the Designation of Only Those Entities that Are Truly Systemically Important.*

As we stated in our first comment letter, FSR believes that the most effective means of properly identifying NBNI financial institutions that have high potential to cause a disruption to the global financial system is to focus the assessment methodology on factors that clearly strengthen the three transmission channels identified in the Proposed Framework. In reviewing the revised Proposed Framework, we note that limited efforts have been made to adjust the assessment methodologies; however, we believe that these efforts are insufficient in moving the assessment process towards a fully risk-based approach.

Thus, FSR continues to believe that the assessment methodologies should be revised to incorporate a risk-based approach, which should include:

(i) financial activities that are "systemically important" as the sole focus, rather than a wide assessment of metrics that have no clear relationship to global financial stability;

(ii) an understanding that an assessment of size, complexity and systemic interconnectedness is relevant only to the extent that it relates to the global financial system and economic activity across jurisdictions; and

(iii) definitions of individual financial markets, as applicable, that are as broadly defined as possible such that a disruption of the defined market has a clear correlation to disruption of the global financial system.

[6] Proposed Framework at 1.

B. *The Assessment Process Should Include Consideration of Existing Laws and Regulations.*

FSR believes that the factors comprising the assessment methodologies should explicitly include consideration of current and proposed legal and regulatory structures that are applicable to finance companies, market intermediaries and investment funds. We believe that regulation of NBNI G-SIFI entities should occur only to the extent that an international backstop is necessary to protect the stability of the global financial system. Thus, when reviewing specific indicators in the assessment process, indicators assessing activities already covered by laws and regulations should not be considered, as a risk-based methodology would recognize that national regulators have already acted to counter any potentially destabilizing effects captured by these indicators.

C. *The Assessment Process Continues to Contain Procedural Shortcomings and Does Not Sufficiently Address Concerns About Consistency in the Application of the Proposed Methodologies.*

The assessment process laid out in the first Proposed Framework was severely flawed because there is no notice or comment period regarding designation determinations or any apparent means for an entity to dispute a designation by the FSB as an NBNI G-SIFI. Unfortunately, the FSB and IOSCO have not addressed these flaws in the revised Proposed Framework.

In contrast to the assessment methodologies for bank and insurer G-SIFIs,[7] the Proposed Framework relies heavily on qualitative assessments and the judgment of local regulators as an explicit substitute for consistent quantitative assessment across jurisdictions. This subjective process is therefore much more at risk for inconsistent application by national regulators and, therefore, incorrect designations.

It is crucial that the assessment methodologies are wholly consistent and, by extension, transparent in their application. FSR is concerned that the FSB and IOSCO have chosen to address the complexity and data collection issues relating to NBNIs through over-reliance on "supervisory judgment" in the designation process. Our primary concern is that such reliance on various national regulators to apply a general framework (along with the differing data available in each jurisdiction) will result in an assessment process that is highly subjective, and therefore variable, in its application.[8]

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[7] *See* Basel Committee on Banking Supervision, Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement (Jul. 3, 2013); International Association of Insurance Supervisors, Global Systemically Important Insurers: Initial Assessment Methodology (Jul. 18, 2013).

[8] The FSB and IOSCO state that "The NBNI G-SIFI methodologies will rely on detailed analysis conducted primarily by national authorities . . . [and] the assessment by the home regulator will tend

Although the FSB and IOSCO recognize this concern in their decision to establish the international oversight group on NBNI G-SIFI assessment (the "IOG"), FSR believes that the Proposed Framework does not sufficiently detail how the IOG will ensure the consistent application of the assessment methodologies across jurisdictions or how it will resolve disagreements between different regulators. Nor does the Proposed Framework detail how disagreements between the FSB and national regulators—or the IOG and national regulators—will be resolved.

Finally, FSR believes that providing notice and comment before designation is important since the FSB and IOSCO will not be proposing policies to apply to NBNI G-SIFIs until after the Proposed Framework has been finalized. As acknowledged by the FSB and IOSCO, NBNIs engage in a wide range of businesses and follow a variety of business models; therefore, any policies that are applied to an NBNI G-SIFI should be adapted to reflect this variation. Furthermore, an NBNI should have an opportunity to engage with the FSB and IOSCO (including in-person meetings) and present information and other data related to its possible designation.

In order to begin addressing these important transparency and due process issues, FSR believes that it is extremely important for a proposed NBNI SIFI to have notice and opportunity to dispute the designation prior to any public notice, and that the FSB and IOSCO should describe in detail how the various indicators should be weighted in the application of the methodologies of the Proposed Framework.[9]

D. *The Assessment Process Should Not Consolidate Non-Financial Assets.*

FSR noted in our comments on the first Proposed Framework that the methodologies called for consolidated financial data, which could include the non-financial affiliates of an asset manager, a finance company, or market intermediary. We note that this concern has not been addressed in the revised Proposed Framework.

FSR remains concerned with the failure to include in the Proposed Framework guidance on the use of consolidated data in the indicators for NBNI entities, such as asset managers, finance companies and market intermediaries. Asset managers, finance companies and market intermediaries may have subsidiaries and other affiliates that

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to use indicators more as guidance than as inputs to a common scale (i.e. rank-ordering)." Proposed Framework at 7. The FSB and IOSCO also state that "national supervisory judgment could also be used to add entities to the assessment pool even when they fall below the materiality threshold but are considered potentially globally systemic." Proposed Framework at 10-11.

[9] *See*, *e.g.*, Basel Committee on Banking Supervision, Global Systemically Important Banks: Updated Assessment Methodology and the Higher Loss Absorbency Requirement (Jul. 3, 2013); International Association of Insurance Supervisors, Global Systemically Important Insurers: Initial Assessment Methodology (Jul. 18, 2013).

engage in non-financial activities. We do not believe that an assessment of a financial entity's assets, liabilities or other characteristics, when considered for the materiality threshold or as an indicator of systemic risk, should include assets or liabilities not linked to that entity's financial activities. For that reason, we recommend that the FSB and IOSCO provide guidance that, in circumstances where the Proposed Framework calls for consolidated balance sheets, assets held by non-financial subsidiaries and other affiliates shall be excluded.

## III. Although The Investment Funds Assessment Methodology Has Been Significantly Improved, It Should Be Revised to Focus More on the Risks Actually Posed by Investment Funds.

FSR believes that any assessment of investment funds should be tailored to the risks posed by investment funds. Accordingly, in our comments on the first consultative document, FSR strongly recommended that the FSB and IOSCO focus the assessment methodology on leverage. We believe that the proposed assessment methodology is greatly improved as a result of the FSB and IOSCO incorporating our recommendations into the revised Proposed Framework. FSR appreciates your favorable consideration of our recommendation.

FSR also appreciates that, as recommended in our comments on the original Proposed Framework, the FSB and IOSCO are now proposing to exclude pension funds from the definition of NBNI financial entities.[10] We agree that the exclusion of pension funds from the Proposed Framework is justified by the low risk they pose to global financial stability due to their long-term investment perspective.

As an initial matter, FSR recommends that the FSB and IOSCO should consider the possibility that when they apply an objective, risk-based assessment to most large, passively-managed investment funds (*e.g.*, a large index mutual fund), the funds would not be globally systemically significant.

### A. *Investment Funds Are Unlikely To Be Systemically Important.*

Despite the FSB and IOSCO's significant revisions to their discussion of the systemic importance of investment funds, the FSR continues to question the premise that investment funds, particularly open-ended, highly regulated funds, pose significant risks to the global financial system.

We commended the FSB and IOSCO on their recognition in the first consultative document that investment funds present very different risk profiles compared to other types of financial entities. We believe it is critical in conducting an effective risk-based

[10] Proposed Framework at 5.

assessment of investment funds that the methodology acknowledges and takes into account that fund investors decide, based on full disclosures, to take on certain risks. To that purpose, the assessment methodology for investment funds should recognize that, from a systemic perspective, investment funds, unlike banks, have an inherent "shock absorber" because fund investors absorb losses as well as gains. Furthermore, unlike persons who deposit funds in an insured bank savings account expecting the return of principal plus interest, investors in investment funds do not seek shelter from risk. Rather, investors make investments in investment funds because they seek a certain level of risk and the opportunity to obtain the corresponding financial rewards of their risk-taking. FSR believes that this important distinction between banking institutions and investment funds does not adequately inform the proposed assessment methodology.

1. *Exposures / Counterparty Channel.*

FSR previously recommended that a risk-based assessment should focus on indicators involving leverage and the resulting exposures to counterparties. The FSB and IOSCO have made improvements on both counts. The revised discussion of the Exposure / Counterparty Channel now notes that many commenters pointed to leverage as a potential source of risk to counterparties and that many jurisdictions place limits, particularly on public funds, from taking on significant leverage. However, FSR believes that the FSB and IOSCO could more clearly address how mitigating regulation already seeks to address the potential destabilizing effects of the exposure being assessed. Accordingly, FSR again recommends that the FSB and IOSCO should recognize that the application of mitigating regulation weighs heavily against a determination of systemic importance.

2. *Asset Liquidation / Market Channel.*

We recognize that investment funds, just as with all financial entities, may have the capacity under certain circumstances to exert downward pressure on the market prices of assets the funds may be forced to sell off. However, we note that, given the frequency of fund liquidations,[11] there is no data to suggest that this downward pressure would impact global financial stability or economic activity across jurisdictions. Thus, a risk-sensitive assessment methodology should capture only those factors that accurately describe the systemic risk posed by investment funds individually and should not place undue emphasis on factors that assess more general effects and activities. As the FSB and IOSCO acknowledge in the revised Proposed Framework, there is no clear market

[11] *See* Investment Company Institute, 2015 Investment Company Fact Book at 14-15 (55th Edition) (noting that in the United States, 362 funds liquidated or merged in 2014, and 25 fund sponsors left the market).

evidence or academic research supporting a hypothesis that individual investment funds may, through contagion effects in the capital markets, impact global financial stability.[12]

FSR remains concerned that the FSB and IOSCO still "wish to explore particular situations where certain individual funds may play a significant role," even after several years to prepare the assessment methodology and review all available information.[13] FSR encourages the FSB and IOSCO to acknowledge clearly that individual investment funds are a likely cause of global financial stability through asset sales.

3. *Critical Function / Substitutability Channel.*

In our original comments, FSR supported the FSB and IOSCO's recognition that investment funds are sufficiently substitutable and do not provide critical functions or services. Therefore, we believed, the FSB and IOSCO had determined that an effective risk-based assessment methodology would not attempt to capture indicators that assess issues related to substitutability and the provision of critical functions or services. Thus, we are surprised that a new discussion of this channel has been included in the revised Proposed Framework, particularly because it appears that the FSB and IOSCO are merely "interested in exploring" whether this channel may be relevant. We believe that the FSB and IOSCO were correct in their original assessment, and urge the FSB and IOSCO to adopt their original assessment.

B. *Materiality Threshold.*

FSR strongly argued that a simple assessment of a fund's net asset value is not an effective indication of systemic importance, even for the limited purpose of establishing the materiality threshold. Rather, the materiality threshold for investment funds should incorporate an indicator of the most critical assessment factor for investment funds—leverage. FSR is pleased that the FSB and IOSCO recognized the importance of leverage and have re-proposed materiality thresholds that account for an investment fund's leverage.

Although the inclusion of leverage is a significant improvement, FSR believes the revised materiality thresholds for traditional investment funds (including open-ended mutual funds) remains too low, in the case of Option 1. For example, we note Option 1 may still capture several large, passively-managed index mutual funds that utilize very little or no leverage. As these types of funds are clearly outside the scope of the FSB and IOSCO's discussion of the systemic importance of investment funds, we believe they should not be captured by the materiality threshold. Furthermore, this materiality

[12] Proposed Framework at 34.

[13] Proposed Framework at 34.

threshold introduces two ratios (the "substitutability ratio" and "fire sale ratio") that are set at arbitrary numbers without any support, whether from a survey of such ratios or from any peer-reviewed academic research.

Regardless of where the final material threshold is set, FSR believes that the proposed materiality threshold should not be a static designation but rather should be pegged to the growth in global "investable assets"—a common measurement for the asset management industry in determining assets available for investment in reference to market share.

C. *Specific Assessment Factors.*

1. *Size.*

FSR continues to believe that net asset value is an appropriate measure for the size of investment funds. Although the FSB and IOSCO have now noted that "size is only one of five factors" that national authorities should consider under the assessment methodology, FSR recommends that the FSB and IOSCO stress further that fund size should not be a significant assessment factor of systemic importance.

2. *Interconnectedness.*

We believe that interconnectedness is an important assessment factor in properly assessing the potential systemic risk of an investment fund, provided that interconnectedness is properly defined. However, the assessment process should reflect recent, risk-mitigating regulatory changes designed to reduce potential systemic risks arising from financial connections between investment funds and their counterparties.

We agree that the leverage ratio of a fund is an important risk-based assessment factor. FSR supports the new inclusion of balance sheet leverage of an investment fund as a relevant consideration (Indicator 2-1). With regard to the revised leverage ratio (Indicator 2-2), we still believe that the FSB and IOSCO should provide greater guidance on when a leverage ratio should be considered significant. We note, for example, that leverage incurred by investment funds is significantly less than the leverage incurred by financial institutions with different business models (*e.g.*, banks).[14] This difference in leverage is especially true for U.S. registered investment companies that are subject to regulatory limits on leverage, but it is also true for hedge funds (see Indicator 2-3).

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[14] *See* Paul Schott Stevens, President and CEO of the Investment Company Institute, *Financial Stability and U.S. Mutual Funds* (Speech given at the Mutual Fund and Investment Management Conference) (March 17, 2014), *available at* http://www.ici.org/pressroom/speeches/14_pss_mfimc (citing data showing that the average leverage for U.S. commercial banks is 9:1 and the average leverage for the 15 largest U.S. funds is 1.04:1).

Similarly, the ratio of collateral posted by the investment fund to its net asset value (Indicator 2-4) and the counterparty exposure ratio (2-5) are also adequate risk-based factors to assess a fund's interconnectedness. However, FSR maintains that, to the extent the assessment of intra-financial system liabilities assesses exposures to global systemically important banks ("G-SIBs") and global systemically important insurers ("G-SIIs") that are already subject to regulatory controls (Indicator 2-6), such exposures should not be assessed. Moreover, the newly added assessment of the nature of investors in an investment fund should take into account whether such investors are themselves already subject to prudential regulations, such as in the case of G-SIBs and G-SIIs (Indicator 2-7).

3. *Substitutability.*

As we discussed in our previous comments, every year funds are closing or merging with other funds in an orderly manner with no systemic impact and no government intervention. Thus, we do not believe that substitutability factors are relevant to a risk-focused assessment methodology. Indeed, the high level of substitutability among investment funds, in many ways, highlights the challenges of the entire NBNI SIFI designation process. To the extent designation of funds as G-SIFIs is accompanied by policy measures that increase the costs borne by the investors of such funds, investments may shift out of such funds and into less regulated (*i.e.*, non-designated) funds, resulting in a larger number of funds just below the materiality threshold. It is not clear whether a change in the fund market structure along these lines would actually reduce systemic risk or, conversely, better promote financial stability.

To this end, FSR does not believe that any of the revised indicators, which now target trading in market segments and asset classes, are appropriate criteria. The new indicators provide no context for determining whether the assessed market segments or asset classes are themselves relevant to a determination of the investment fund's systemic importance. FSR believes an assessment using the revised indicators may lead to an inappropriate conclusion as to the investment fund's systemic importance, unless clearly supported by a finding that the investment fund is engaged in the provision of critical services in specific market segments or asset classes.

4. *Complexity.*

FSR agrees that complexity is a relevant assessment factor; however, even considering the revisions to the suggested indicators, several of these do not appear to be the type of complexity that could increase the systemic risks of investment funds. Complexity of the strategy engaged in by the fund does not make the fund more difficult to resolve. For example, a fund pursuing a complex strategy involving liquid securities would not be difficult to resolve, since, at the end of the trading day, the fund is holding liquid securities. In fact, these indicators strongly suggest that the systemic risk regulation process should focus more on activities instead of entities.

However, to the extent that the revised indicators now focus on the difficulty of winding up a fund (which FSR recommended in our earlier comments) assessment of these factors may be appropriate. If one focuses on the ease of winding up the fund, one would quickly come to the conclusion that most investment funds are easily resolved, as shown through the repeated liquidations of investment funds without government intervention.[15] We further note that the investors in liquidated funds receive a full distribution of their respective *pro rata* share of the fund at the current value; and the fund's assets are not subject to any claims by the asset manager or its creditors prior to distribution to investors.[16]

In addition, FSR reiterates that some of the suggested indicators in the complexity factor appear to be focused on interconnectedness with counterparties (*e.g.*, OTC derivatives and ratio of collateral that has been re-hypothecated). In our view, these indicators properly belong in the "interconnectedness" category since they only secondarily impact the complexity of resolution.

5. *Cross-Jurisdictional Activities.*

FSR continues to maintain that a simple count of jurisdictions in which a fund invests, offers interests, or has counterparties is not an accurate measure of cross-jurisdictional importance. In fact, FSR does not believe that it is appropriate to focus on fund investors (Indicator 5-2) or fund investments (Indicator 5-1) with respect to cross-jurisdictional activities at all. As noted above, an investor in a capital markets transaction is seeking risk when making an investment in a fund. Moreover, neither the sale of securities nor the ultimate liquidation of a fund will have an impact on the companies in which the fund invests. Finally, FSR notes that there are also significant diversification benefits from investing in multiple jurisdictions, which would significantly reduce the risks faced by an investment fund.

With respect to cross-jurisdictional counterparty exposure (Indicator 5-3), this indicator should be revised to capture the level of risk that the investment fund's activities in that jurisdiction actually pose and, in particular, the exposure amount to counterparties in other jurisdictions. The proposed indicator of a simple count of jurisdictions in which the fund has counterparties does not provide a meaningful measure

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[15] *See*, *e.g.,* Investment Company Institute, 2015 Investment Company Fact Book at 15-19 (55th Edition) (discussing liquidation of registered investment funds).

[16] *See*, *e.g.*, Kirsten Grind, What to Do if a Fund Closes, The Wall Street Journal (Jul. 5, 2012) (noting that "[i]nvestor assets, though subject to market fluctuations, are protected from seizure, and on the day of closure, investors get the full value of their fund shares, just as if they had decided to sell on their own").

of the potential for a global impact, particularly where the fund has only *de minimis* exposure to the other jurisdictions.

## IV. Asset Managers Are Not An Appropriate Focus of the NBNI Methodology.

The original Proposed Framework solicited input on whether the FSB and IOSCO should focus the assessment methodology solely on investment funds, or whether the Proposed Framework should have a broader focus. FSR and many other commenters strongly supported limiting the focus of the assessment methodologies solely to investment funds.[17] FSR continues to believe that asset managers are not an appropriate focus of the NBNI methodology, and urges the FSB and IOSCO to remove asset managers from further consideration.

### A. *Asset Managers Are Unlikely To Be Systemically Important.*

As the FSB and IOSCO accurately describe in the revised Proposed Framework, asset managers are agents that manage investment assets on behalf of individuals and/or institutions in accordance with a specified investment mandate.[18] Because asset managers are entrusted to act as agents of their respective clients' assets, they are bound not only by fiduciary duties to their clients but also by extensive legal, regulatory and contractual requirements. FSR believes that the FSB and IOSCO's discussion of the potential systemic effects arising from the distress or failure of an asset manager dramatically overemphasizes the potential disruption to the global financial system.

#### 1. *Exposures / Counterparty Channel.*

Asset managers' direct exposures to counterparties are generally limited when considered on the scale necessary to potentially cause disruption to the global financial system. For example, in many jurisdictions banks are, or soon will be, required to prudently manage their credit exposures to counterparties, including asset managers, to ensure the failure of any counterparty would not present a risk to the bank.[19]

Furthermore, as the FSB and IOSCO acknowledge, the balance sheets of asset managers are generally small,[20] and are unlikely to ever have a single exposure to any

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[17] *See* Proposed Framework at 30.

[18] *See* Proposed Framework at 47.

[19] *See*, *e.g.*, BCBS, Supervisory Framework for Measuring and Controlling Large Exposures – Final Standard (April 2014).

[20] Proposed Framework at 48.

counterparty or counterparties of significant size. Thus, asset managers are highly unlikely to present a risk to their counterparties through financing and trading activities conducted for their own account. The fact that asset managers may have certain limited counterparty exposures (whether through securities lending indemnification or investment of seed capital) is not important if the asset manager's balance sheet is not of sufficient size to have a material impact on the stability of the global financial system.

2. *Asset Liquidation / Market Channel.*

FSR agrees with the FSB and IOSCO that "asset managers tend to have small balance sheets and the forced liquidation of their own assets would not generally create market disruptions" and that "the core function of an asset manager is managing assets as an agent on behalf of others."[21]

However, FSR does not agree that there are material risks either from the asset managers' off-balance sheet activities (such as indemnifications), reputational risks (such as a result of litigation or the departure of key individuals) or operational risks (such as inadequate or failed internal processes and systems), and the FSB and IOSCO provide no evidence to support the materiality of any of these risks.

As a practical matter (and in part because they have small balance sheets), asset managers engage in only limited off-balance sheet activities, which are extremely unlikely to be of a sufficient size to be systemically important. The existence of reputational risks seems disconnected from the long history of asset managers that have withstood the departure of a large number of "key persons" (for a wide range of reasons) and litigation without creating any market instability, even if it ended with the liquidation of the asset manager.

3. *Critical Function / Substitutability Channel.*

Again, FSR agrees that asset managers are generally substitutable[22] and that there is strong competition among asset managers in the marketplace.[23] Furthermore, as the FSB and IOSCO note, asset managers' use of third-party custody arrangements for client assets facilitates substitutability among asset managers. As FSR noted in our earlier comments, investors regularly move assets between managers, and such transfers are

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[21] Proposed Framework at 48.

[22] *See, e.g.,* Investment Adviser Association and National Regulatory Services, 2014 Evolution Revolution: A Profile of the Investment Adviser Profession at 9 (Oct. 24, 2014) (noting that in the United States, there were 10,895 asset managers registered with the U.S. Securities and Exchange Commission as of April 2014).

[23] Proposed Framework at 49.

accommodated not only by asset managers but also by third-party custodians. Accordingly, the core function of asset managers does not raise concerns under the Substitutability Channel. Regarding the FSB and IOSCO's inquiry about specific activities conducted by asset managers, FSR is not aware of any activities that an asset manager may provide that are both significant enough to impact global financial stability and for which ready substitutes are not available.

B. *Materiality Threshold.*

Just as with our comments on investment funds, FSR believes that a simple consideration of the size of an asset manager's balance sheet is not an effective indication of systemic importance. Rather, as the FSB and IOSCO acknowledged for investment funds, it is the combination of a significant balance sheet combined with leverage that begins to capture potentially systemically risky asset managers. Accordingly, FSR recommends that the materiality threshold for asset managers reflect a consideration of leverage in addition to overall balance sheet size.

FSR also believes that the FSB and IOSCO's proposal to adopt a materiality threshold that looks at assets under management is wholly inappropriate to capturing the potential systemic risk posed by an asset manager. Asset managers pose very little risk to the financial system through their asset management activities.[24] Therefore, it is unclear why providing investment advice (discretionary or non-discretionary) would increase the systemic importance of a client portfolio if that client portfolio were appropriately segregated from the asset manager's proprietary assets or otherwise safeguarded.

C. *Specific Assessment Factors.*

1. *Size.*

FSR concurs with the FSB and IOSCO in their determination that the measurement of net assets under management (Indicator 1-1) is unlikely to be an effective measure of the impact resulting from the failure or distress of an asset manager through the Counterparty and Substitutability Channels.[25] In addition, FSR believes that it is unlikely to be relevant to the Market Channel as well.

The scenario presented by the FSB and IOSCO that a reputational event at an asset manager may lead to substantial redemptions from managed funds and transfers of separately managed accounts it advises, ignores fundamental market dynamics in which asset managers operate. Liquidation of investment funds occurs regularly, and without

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[24] *See supra* notes 21, 22 and 24 and accompanying text.

[25] *See* Proposed Framework at 52.

government intervention or significant impact on the global financial system.[26] Moreover, asset managers operate in highly substitutable markets, which reduces the impact of any potential reputational risk.[27]

FSR does not believe that the hypothetical scenario of an asset manager that has a "certain bespoke position" that could not be transferred without being unwound would justify inclusion of this factor. In fact, the position would be held by the client—not the manager itself—and this scenario inappropriately conflates the manager with the client. Nor are we aware of any asset manager that has a non-substitutable skill with respect to a significant segment of the global financial market.

2. *Interconnectedness.*

FSR believes that interconnectedness is a relevant assessment factor; however, the Proposed Framework fails to provide a persuasive argument "whether and how this factor would be relevant" to an asset manager.[28] For example, the FSB and IOSCO fail to present a complete argument of when an asset manager would take on such a significant indemnification obligation that a failure to make a payment would have a material impact on global financial stability. Even where an asset manager may itself take on leverage (Indicator 2-1) or maintain other off-balance sheet exposures (Indicator 2-2), its limited balance sheet and limited direct relationship with counterparties are unlikely to be sufficient to warrant serious consideration under the Proposed Framework.

3. *Substitutability.*

While the FSB and IOSCO have acknowledged the competitiveness of the market for asset managers, the analysis of the substitutability factors appears to be based principally on hypotheticals without any real world examples. The Proposed Framework theorizes that an asset manager could be a "dominant pricing source for a particular type of asset or a prominent expert in a given market segment," but it fails to acknowledge that any such asset or market segment is not likely to be significant to global financial stability.

FSR notes that, even if an asset manager did provide services that market participants could not easily obtain from other sources, whether that is a pricing service or expertise in a given market segment, it does not directly follow under a risk-based framework that such services should indicate that the asset manager's distress or failure would potentially cause global financial instability. Rather, the services provided by the

[26] *See supra* note 11 and accompanying text.

[27] *See supra* note 23 and accompanying text.

[28] Proposed Framework at 53.

asset manager would themselves need to be systemically important, which is an argument in favor of focusing potential regulation and the proposed assessment methodology on specific activities that pose a material threat to global financial stability rather than individual entities.

4. *Complexity.*

The FSB and IOSCO themselves acknowledge the generally high substitutability of asset managers and the role that third-party custodians play in facilitating that substitutability. Accordingly, FSR believes that little weight should be placed on this factor under a risk-based framework.

5. *Cross-Jurisdictional Activities.*

As we have said in the context of the other assessment methodologies, FSR does not believe that a simple count of jurisdictions in which an asset manager is licensed, registered or supervised is an accurate measure of cross-jurisdictional significance. Further, to the degree that an asset manager has significant clients and counterparties in jurisdictions other than where the asset manager is headquartered, the potential risk to the global financial system is significantly offset by the diversification benefits of spreading its exposure across jurisdictions.

## V. THE FINANCE COMPANY ASSESSMENT METHODOLOGY SHOULD BE FURTHER REVISED TO BE MORE RISK-SENSITIVE.

The revised methodology proposed for finance companies better reflects the widely-varying business models, funding sources, and affiliate relationships of finance companies. However, FSR believes the assessment methodology should better reflect the varying types of risk posed by the different business models of finance companies.

A. *Finance Companies Are Unlikely To Be Systemically Important*

FSR continues to disagree with the FSB's assertion that finance companies could be systemically important either because they provide certain types of finance that are potentially difficult to substitute or because of their interconnections with other financial institutions or their issuances in funding markets.

1. *Critical Function / Substitutability Channel.*

As we discussed above and in our previous comments, it is critical that the assessment methodology focus on activities and markets the disruption of which has a clear relationship to the disruption of the global financial system. The FSB's discussion of finance companies' systemic importance through the "critical function/substitutability" channel fails to demonstrate how the activities of and markets in which finance companies operate are themselves systemically important such that a disruption could cause a disruption of the global financial system.

We support the FSB's revisions to the Proposed Framework to acknowledge that finance companies operate in highly competitive markets and often command limited market share, as well as the FSB's focus on finance companies that operate in relatively concentrated market structures. However, these revisions to the discussion of the Critical Function / Substitutability Channel were not incorporated into the assessment methodology for finance companies, and it remains unclear what impact, if any, these revisions will have on national authorities' assessments under the FSB's methodology.

2. *Exposures / Counterparty Channel.*

The FSB still has not sufficiently demonstrated that a finance company's reliance on wholesale markets is an indication of its systemic importance. The issue of national regulators extending solvency and liquidity support to finance companies in order to support such finance companies' ability to lend to the real economy is an issue of national economic policy, and unless and until the FSB better demonstrates how reliance on wholesale funding by an individual finance company impacts the global financial system, the use of wholesale funding should not, in itself, be an indication of systemic importance.

As we noted in our first comment letter, finance companies rely on wholesale funding from a variety of diverse sources, including bank loans, corporate bonds and securitizations. This diversity of funding further reduces a finance company's systemic importance because an individual finance company lacks concentrated exposures to other financial institutions. Additionally, many of the counterparties in these transactions are themselves already subject to regulations that reduce the potential systemic impact of the funding activity. For example, with regard to bank loans, banks are subject to lending limits, and as the FSB is well aware, the Basel Committee on Banking Supervision is currently working on regulatory guidance for controlling large exposures.[29] Similarly, other providers of funding, such as money market funds that may purchase the commercial paper issued by a finance company, operate under regulatory restrictions that limit their exposure to any single issuer.[30]

[29] BCBS, Supervisory Framework for Measuring and Controlling Large Exposures – Final Standard (April 2014).

[30] *See*, *e.g.*, Rule 2a-7 under the U.S. Investment Company Act of 1940 [17 C.F.R. § 270.2a-7] (setting diversification requirements for money market funds).

B. *The Materiality Threshold Is Too Low.*

FSR continues to believe the proposed materiality threshold for finance companies is too low in light of the G-SIFIs already designated. For example, the smallest G-SIB has total assets greater than $200 billion. We urge the FSB to bring the NBNI assessment methodology for finance companies into alignment with the G-SIB and G-SII methodologies.

In addition, given the lower riskiness of finance companies, FSR believes that the materiality threshold should be set higher than $200 billion. To this end, the FSB should calculate the materiality threshold with reference solely to "at risk" assets, which would be defined to capture only unsecured assets. This risk-weighted calculation is broadly in line with the Basel framework applicable to banking entities, which recognizes that different categories of assets have different risk profiles. Similarly, FSR urges the FSB to clarify that the materiality threshold does not include assets of a finance company that may be held by a non-financial subsidiary or affiliate.

Regardless, the materiality threshold should not be a static designation but rather pegged to some appropriate measurement of the growth of the global financial system.

C. *The Specific Assessment Factors Should Be Revised To Be More Risk Sensitive.*

FSR agrees that factors such as size, interconnectedness, complexity and substitutability are generally relevant in assessing a finance company's systemic importance, but we have strong concerns that the proposed assessment methodology fails to be properly risk-focused and account for the relative riskiness of different activities and factors, even considering the revisions to individual indicators. We continue to believe that the assessment methodology for finance companies should be revised to develop assessment factors that properly identify and capture those factors that contribute to systemic risk through the transmission channels discussed above.

1. *Size.*

While we agree that size may contribute to an entity's systemic importance, the size of a finance company, as an independent measurement of systemic risk, is a poor assessment factor. Rather, size may amplify the importance of other assessment factors, such as complexity and interconnectedness. Therefore, FSR reiterates its prior recommendation that the assessment methodology place significantly less weight on size.

There are two proposed indicators of size, a finance company's total globally consolidated balance sheet assets (Indicator 1-1) and its total globally consolidated off-balance sheet exposures (Indicator 1-2). The Proposed Framework states that the "assessment methodologies should apply at the highest level of the firm that is a financial entity and on a globally-consolidated basis."[31] The FSB should clarify the scope of such consolidation. For example, FSR believes that consolidation should not include assets held by non-financial subsidiaries and affiliates of a financial company, as an appropriate risk-based assessment should not assess assets that are not related to the financial activities of the finance companies. Furthermore, FSR is concerned about variation in the measurement of off-balance sheet assets, as this could lead to greater inconsistency in calculations across jurisdictions.

2. *Interconnectedness.*

FSR agrees that interconnectedness is an important assessment factor. However, FSR believes that the degree of risk posed by a finance company varies depending on the mix of assets and liabilities held by that entity. Therefore, a simple quantitative aggregation of the notional amount of various assets and liabilities does not provide an effective risk-based assessment.

A risk-sensitive analysis would better identify those interconnections that present the greatest potential material threat to financial stability, which analysis could be accomplished by providing guidance on the assessment and weighting of the relevant indicators. Additionally, in weighing these indicators, the FSB should take into account, as we noted above, that many jurisdictions have implemented or proposed regulatory requirements that prevent financial entities from developing large exposures to individual counterparties. To the degree that such regulations apply to an asset or liability assessed under this factor, the FSB should reduce the weight placed on that factor in its assessment.

As to Indicator 2-1 (intra-financial system assets), we commend the FSB's acknowledgement that the various asset classes in this indicator may not all be relevant to finance companies and that national authorities should consider if a finance company has concentrated exposures in any asset class. However, given these revisions to the proposed methodology, it is unclear why this indicator remains a sum of the various asset classes. A finance company that holds low amounts of each category in equal amounts would be assessed the same as a finance company that is highly exposed to one particular category. FSR believes it would be more appropriate to assess whether a finance company is especially interconnected with respect to a particular asset class, as this would be more indicative of systemic importance. We recommend that the FSB revisit this indicator and better tailor it to the circumstances of finance companies' business practices.

In assessing a finance company's intra-financial system liabilities (Indicator 2-2), FSR does not believe it is appropriate to include all marketable securities issued by the

[31] Proposed Framework at 10.

finance company because a substantial portion of these securities may be held by non-financial entities. Again, we recommend that the FSB better adapt this indicator to the operations of finance companies.

FSR supports a granular assessment of a finance company's borrowings identified by type and maturity (Indicator 2-3). FSR notes that the FSB revised this indicator to better account for the maturity and terms of the liabilities and the netting of derivatives. However, these revisions focus only on considering whether short-term liabilities are matched by short-term assets. FSR notes that finance companies are not engaging in proprietary trading or maturity transformation and, therefore, the maturity of the liabilities are highly correlated with the maturity of the assets. Thus, expanding consideration of maturity matching to include all liabilities would be more likely to identify actual risks that may arise from exposures to financial counterparties (*i.e.*, maturity mismatches). FSR believes, however, that the FSB should only focus on those categories of borrowings that are potentially critical to the global financial system.

In noting the revisions to this indicator, it is not clear what the FSB means when it encourages national authorities to "consider the extent to which the finance company's borrowings represent a material exposure to counterparties in each of its key funding markets."[32] Is the FSB referring to a material exposure from the perspective of the finance company, in which case it is not apparent why this consideration is relevant to an assessment of the finance company's systemic importance? Conversely, if the finance company's borrowings are a material exposure from the perspective of the lender, the FSR believes that the more appropriate approach would be to address the issue at the lender, not the borrower.

With regard to the revisions that direct national authorities to consider parent financial support when assessing captive finance companies, the FSB appears to be encouraging national authorities make a guess as to whether "the captive can actually rely on parent funding," even where there is an explicit guarantee from the parent in place.[33] FSR believes that such a process is problematic for two reasons. First, given the large amount of subjectivity involved in such an assessment, it is not clear from the assessment methodology how the FSB intends to ensure that this indicator is consistently applied among national regulators. Second, such an assessment may require a disruptive analysis of the parent's balance sheet and financing activities, which is outside the scope of the FSB's assessment methodology for finance companies.

Finally, FSR recognizes that high levels of leverage may amplify disruptions arising from a finance company's failure (Indicator 2-4); however, FSR notes that the

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[32] Proposed Framework at 20.

[33] Proposed Framework at 20.

FSB still has not provided the additional guidance for national authorities to determine what constitutes a particularly high leverage ratio for a finance company, as we recommended in our first comment letter.

The FSR also recommends that the new guidance in Indicator 2-3 directing national authorities "to consider the size and claims of the captive relative to the parent" should apply equally to an assessment of leverage under Indicator 2-4. Finance companies often have support agreements with their parents (*e.g.*, keepwell agreements), and a risk-sensitive assessment of a finance company's leverage should take such agreements into account.

3. *Substitutability.*

FSR believes substitutability is an appropriate factor, but as we discussed above, finance companies operate in highly competitive markets and compete with a wide range of providers of credit, both banks and non-banks. Further, the barrier to entry into these markets is very low. Thus, even where a finance company may fail, other market participants will quickly and smoothly fill any void left by that finance company.

Regarding Indicator 3-1 (qualitative assessment of substitutability), FSR continues to have concerns that a qualitative approach to determining the substitutability of a finance company may not produce an objective and consistent assessment across jurisdictions. Specifically, we are concerned that the FSB and national regulators do not have sufficient data to understand the full competitive landscape for market participants. We believe that, to the extent that the FSB and national regulators are themselves defining the relevant market in which a finance company operates, they should be cautious about narrowing the scope of the market such that the assessment no longer captures a market that is significant to the global financial system. In addition, while certain entities may not engage in certain sub-markets of the financing market, FSR believes that many of these entities (including banks) could easily adapt to new sub-markets should opportunities arise. To prevent inconsistent market definitions across jurisdictions, FSR believes that the FSB should provide national regulators with more guidance on how to appropriately define the market for finance companies.

Our concern of inconsistent application across jurisdictions has been compounded by the addition to Indicator 3-1 of a recommendation to "consider substitutability in both benign and stressed credit environments."[34] There is no further guidance on how national authorities should define "benign and stressed credit environments" for this purpose, and each jurisdiction may adopt its own unique approach to implement this assessment. FSR

[34] Proposed Framework at 21.

recommends that the FSB provide additional details on how national authorities should conduct such an assessment.

4. *Complexity.*

FSR believes that complexity is an important factor in a risk-based assessment methodology. However, because finance companies operate pursuant to business plans that focus on a very limited set of activities, and given the existing resolution régimes applicable to finance companies, and the nature of their assets and liabilities, FSR believes that any risk-based assessment under this factor may not produce any findings that weigh in favor of designating the finance company a G-SIFI.

In conducting an assessment under this factor, FSR recommended in our earlier comments that Indicator 4-1 (OTC derivatives notional amount) be substantially revised. The inclusion of this indicator appeared to ignore the significant changes in regulations with respect to OTC derivatives since the financial crisis in 2008.[35] A risk-based assessment of a finance company's OTC derivatives transactions should make quantitative adjustments for applicable netting and place greater weight on an assessment of the finance company's exposure amount, which accounts for the degree to which the transaction is collateralized, rather than the notional amount. Additionally, derivatives transactions should also be evaluated by the purposes for which they are used, with less weight placed on transactions used for hedging purposes. FSR reiterates its recommendation that the FSB take these considerations into account in the revised Proposed Framework.

FSR also recommended that Indicator 4-2 (Difficulty in resolving a firm) be better tailored for application to finance companies. We continue to note that the FSB's *Key Attributes of Effective Resolution Regimes for Financial Institutions* were designed primarily for application on highly complex, internationally active financial holding companies and universal banks.[36] Therefore, the application of these key attributes to finance companies may show that most finance companies would not pose any significant challenges in resolution, as they are significantly less complex than large banking entities, hold assets with highly stable market values and have no large exposures. Consequently, an appropriate risk-based assessment of this indicator may show that

[35] *See*, *e.g.*, FSB, OTC Derivatives Reforms Progress – Report from the FSB Chairman for the G20 Leaders' Summit (Sept. 2, 2013) (noting that at least half of FSB member jurisdictions have fully implemented the G20 Leaders' comprehensive reform agenda for OTC derivatives); *See also* Dodd-Frank Wall Street Reform and Consumer Protection Act Title VII, Pub. L. 111-203, 1124 Stat. 1376 at 1641 (July 10, 2010).

[36] FSB, Key Attributes of Effective Resolution Regimes for Financial Institutions (Oct. 2011).

finance companies are not so complex that their distress or failure may be disruptive to the global financial system.

FSR notes that a new Indicator 4-3 (Amount of less liquid assets) has been added to the proposed methodology for finance companies that calls for an assessment of a finance company's holdings of Level 2 and 3 assets, which is based on an indicator for G-SIBs that takes into account their inventory of complex financial assets that have no observable price inputs. FSR does not believe that this indicator would be appropriate for finance companies, which typically do not hold these types of assets. Accordingly, FSR urges the FSB to remove this indicator from further consideration in the proposed assessment framework.

5. *Cross-Jurisdictional Activities.*

A G-SIFI is, by definition, an institution whose distress or failure may potentially disrupt the global financial system. Therefore, an assessment of global activities is appropriate, but only to the extent that such an assessment appropriately captures cross-border risks. FSR previously recommended that the FSB revise this assessment factor so that, rather than merely counting the number of jurisdictions in which a finance company operates and the size of its operations in such jurisdictions, the assessment focuses on those activities that have the potential to spread risks across jurisdictions. For example, a finance company with self-funded and independent subsidiaries poses very little risk to the global financial system, even if it has a large presence in several jurisdictions. In determining which activities have the potential to spread risks across jurisdictions, the assessment methodology should focus on the provision of critical services or functions that, in operation, span multiple jurisdictions. Because the FSB did not make substantive revisions to this section of the assessment methodology, FSR continues to believe that none of the indicators in this factor truly provide a risk-based assessment.

We further note that the FSB revised Indicator 5-4 to incorporate our earlier recommendation that this assessment factor consider a finance company's relative market share in each jurisdiction as a means to risk-weight the factor. FSR appreciates the FSB's favorable consideration of our recommendation.

## VI. THE MARKET INTERMEDIARIES ASSESSMENT METHODOLOGY IS STILL NOT SUFFICIENTLY RISK-BASED.

FSR believes that the definition of "market intermediary" remains overly broad, even with the welcome elimination of investment advisers from the definition in the revised assessment methodology. FSR urges the FSB to revise the Proposed Framework to focus solely on NBNI entities that deal in securities or provide funding to their clients.

The Proposed Framework defines "market intermediaries" to include entities that engage in any of the following activities: (i) receiving and transmitting orders (*i.e.*, brokers); (ii) proprietary trading/dealing on own account (*i.e.*, dealers); (iii) securities underwriting (*i.e.*, underwriters); (iv) providing funding to clients (*e.g.*, margin loans, reverse repos) (*i.e.*, prime brokers); and (v) placing of financial instruments without a firm commitment basis (*i.e.*, placement agents). The FSB and IOSCO do not analyze why each of these activities would raise systemic risks and we believe that, in fact, most of these activities would not. Brokers, underwriters[37] and placement agents act as agents for their clients, do not present systemic risks (as discussed below) and, therefore, should be excluded from the definition of "market intermediaries." Furthermore, we believe that the FSB and IOSCO (or the IOG) should exclude these entities from consideration in all jurisdictions so that the exclusions are not inconsistently applied across jurisdictions.

A. *Market Intermediaries Are Unlikely To Be Systemically Important.*

We commended the FSB in our original comments for acknowledging that market intermediaries generally would not present systemic risks to the global financial system. We agreed that market intermediaries present different risk profiles than banks and insurers, the only types of financial entities currently designated as G-SIFIs. However, FSR notes that the FSB and IOSCO have not revised the assessment methodology to consider existing laws and regulations, including customer asset segregation, capital and liquidity requirements, and resolution régimes. Therefore, we reiterate our recommendation that FSB and IOSCO consider these existing regulatory régimes and revise the assessment methodology accordingly.

1. *Exposures / Counterparty Channel.*

The FSB and IOSCO hypothesize that a market intermediary could be systemically important if it has "extensive exposures and liabilities in the financial system" with other systemically important counterparties or multiple counterparties. As a primary matter, this channel would eliminate agents (including brokers, investment advisers, underwriters and placement agents) who do not have any significant counterparties. Second, the FSB and IOSCO continue to fail to account for the significant regulatory limitations placed on such systemically important institutions precisely to prohibit significant exposure that may lead to destabilizing impacts. Third, the FSB and IOSCO still do not consider that counterparty exposures supported with collateral or other risk-mitigating measures greatly reduces counterparty risks. For these reasons, FSR believes that the FSB and IOSCO should focus only on those activities

[37] We note that underwriters would not be traditionally categorized as agents. However, we believe that, for purposes of this analysis, they would be appropriately categorized with the other agent market intermediaries. Although underwriters are exposed to certain risks associated with the inability to place securities for which they have been engaged on a firm commitment basis, these are not the types of risks that would create systemic risk. Putting aside the placement risk, the activities of an underwriter are very similar to those of an agent. Furthermore, we note that there are likely only a small number of market intermediaries who are only engaged in underwriting.

where the market intermediary is acting as principal, there is not existing applicable regulation, and the activity is not subject to risk mitigation.

2. *Asset Liquidation / Market Channel.*

The Proposed Framework indicates that the financial distress of a market intermediary may create "potential for increased margin calls and/or fire sales in the broader market" because market intermediaries may be significant lenders or borrowers in the financial system.[38]

As we noted in our previous comments, many of the entities that fall within the definition of "market intermediary" (*e.g.*, brokers, underwriters, and placement agents) are not significant lenders or borrowers because they act as agents on behalf of clients. By the nature of the agency relationship, the failure of an agent does not require the client to liquidate the assets for which the agent was providing services. In fact, this analysis is not even applicable when the services the agent provides are execution services (such as a broker or placement agent), since an investor or issuer could simply find another agent to execute a particular transaction.

3. *Critical Function / Substitutability Channel.*

Market intermediaries operate in the highly competitive capital markets in which the products and services offered by any one market intermediary are often similarly offered into the same market by other market intermediaries.[39] In particular, the agency relationships that many market intermediaries have (whether as brokers, underwriters, or placement agents) are by their nature highly substitutable.

Furthermore, not all of the activities identified as characterizing market intermediaries are critical functions. For example, acting as a placement agent for private companies who engage in limited offerings on only an intermittent basis is not a critical function or service, the failure of which would cause material disruption to the global financial system or economic activity across jurisdictions.

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[38] Proposed Framework at 25. We note that the FSB and IOSCO conspicuously do not directly attribute increased margin calls and fire sales in the broader market to the distress of a market intermediary.

[39] *See*, *e.g.*, Financial Industry Regulatory Authority, Annual Report 2012 at 8 (noting that in the United States, there are nearly 4,300 brokerage firms and nearly 630,000 registered securities representatives); Investment Company Institute, 2013 Investment Company Fact Book at 13-14 (53rd Edition) (noting that in 2012, 776 financial firms competed in the U.S. market to provide investment management services, with a net growth over the last three years of 95 new firms entering the market).

Thus, most market intermediaries are highly substitutable, and to the extent that any failed market intermediary offered a critical service or provided a critical function, a competitor could quickly fill the void. For this reason, FSR recommended that the FSB and IOSCO narrow the definition of activities that characterize market intermediaries by specifying only those critical functions or services for which there is limited substitutability. We note that our recommended revisions were not incorporated into the proposed methodology. FSR reiterates this recommendation to the FSB and IOSCO.

B. *Materiality Threshold.*

As with respect to finance companies, FSR recommended that the FSB and IOSCO should evaluate potential NBNI G-SIFIs in relation to the G-SIFIs already designated, the smallest of which, as we noted earlier, had total assets of greater than $200 billion. However, as discussed above, because the risk profile of market intermediaries is also significantly different than banks and insurance companies, FSR believes that the materiality threshold should be set even higher and, similar to finance companies, should only include "at risk" assets. Finally, FSR believes that the materiality threshold should be calculated based on the total assets of the market intermediary itself and should not include any assets held by non-financial subsidiaries and affiliates; otherwise, the materiality threshold may be based on assets that are completely unrelated to the market intermediary's activities.

FSR continues to recommend that the FSB and IOSCO revise the threshold to make clear that no client assets should count toward the threshold, even if the market intermediary is required under national accounting standards to consolidate the assets on its balance sheet.

Regardless of where the final materiality threshold is set, FSR believes that the proposed materiality threshold should not be a static designation but rather should be pegged to some appropriate measurement of the growth of the global financial system.

C. *The Specific Assessment Factors Are Still Not Sufficiently Risk Sensitive.*

As we have consistently discussed in our comments, factors such as size, interconnectedness, complexity and substitutability are generally appropriate to assess an entity's systemic risk. However, a sector-specific methodology requires that these general factors be calibrated to the specific risks raised by entities in that sector. FSR continues to recommend that such a risk-based assessment of market intermediaries focus on indicators of interconnectedness and place less weight on other factors.

1. *Size.*

Although a market intermediary's size may contribute to its systemic importance, it is a poor standalone indicator of systemic importance. The original indicators proposed by the FSB and IOSCO remain untouched in the revised Proposed Framework and continue to capture many assets that are outside the market intermediary's control. As a result, the revised Proposed Framework continues to assess information that should be outside the scope of a risk-based assessment methodology.

In assessing the market intermediary's total global consolidated balance sheet assets (Indicator 1-1), FSR believes there are significant issues with relying solely on the consolidated balance sheet assets in determining systemic importance. As noted above, it is misleading to rely on consolidated balance sheet assets where the assets relate to non-market intermediary businesses or where the assets are included as a technical accounting matter (such as the consolidation of certain private fund assets on the balance sheet of their adviser under GAAP). FSR further believes that, unlike with the determination of the materiality threshold, the practical issues that may make access to consolidated assets easier are not applicable to the more detailed determination, since the FSB and IOSCO may request additional information from the market intermediary. Therefore, FSR believes that the FSB and IOSCO will be capable of making a more appropriate calculation of size that goes beyond consolidated balance sheet assets.

Regarding the assessment of total globally consolidated off-balance sheet exposures (Indicator 1-2), FSR remains concerned that the FSB's instruction that "national authorities should consider off-balance sheet assets to the extent possible" may lead to two issues—the attribution of assets to the market intermediary that would not be affected in any significant manner by the entity's failure, and inconsistent application of this indicator across jurisdictions.

Finally, despite the inclusion of a new footnote indicating that "some jurisdictions allow an entity to use client funds for approved purposes," FSR does not believe that an assessment of client assets outstanding is an appropriate indicator (Indicator 1-3).[40] As noted above, we do not believe that market intermediaries who act as agents on behalf of clients are systemically risky, since, among other things, they are in a highly competitive industry and are readily replaceable. Furthermore, this indicator ignores the fact that, as the FSB and IOSCO acknowledge, market intermediaries are generally subject to regulation for the purpose of protecting client assets, which often requires that client assets are segregated from the market intermediary's assets. Therefore, at a minimum, FSR again recommends that this indicator be narrowed to only those client assets that are not segregated from the assets of the market intermediary or subject to equivalent safeguards under the applicable laws and regulation.

Furthermore, the FSB's instructions that the assessment of this indicator should focus on "the potential for generalised market panic" lacks clarity and substance. The FSB and IOSCO still have not provided any guidance for national authorities to

[40] *See* Proposed Framework at 26.

determine how to assess whether the failure of the market intermediary, rather than broader market forces, may be causing a "generalised market panic." We also note that "generalised market panic" is not one of the transmission channels identified by the FSB and IOSCO, and as such, we do not believe that it should inform the assessment of market intermediaries.

2. *Interconnectedness.*

FSR believes that interconnectedness should be given significant weight in a risk-focused assessment of market intermediaries. However, FSR continues to recommend that the assessment focus solely on activities that the market intermediary conducts for its own accounts and utilizing its own assets. Any activities that are conducted at the direction of or on behalf of customers, utilizing customer assets, should not be attributed to the market intermediary. This is particularly relevant to the indicators that address intra-financial system assets and liabilities.

It is unclear to us why the FSB and IOSCO continue to suggest that intra-financial system assets and liabilities should be a sum of a range of very different financial activities (Indicators 2-1 and 2-2). FSR again urges the FSB and IOSCO to revise these indicators to better capture the risks that arise from a market intermediary's exposures. A risk-sensitive analysis would assess each sub-indicator individually because a distressed market intermediary whose intra-financial system assets and liabilities are concentrated in a single sub-indicator would be more likely to cause disruptions. With respect to the intra-financial liabilities, we do not believe it is appropriate to include all marketable securities issued by the market intermediary, since a substantial portion of these securities may be held by non-financial entities. Of course, as discussed previously, we do not think it is appropriate for the assessment to include factors that are addressed by regulations that limit large exposures between counterparties.

In reviewing the proposed assessment factors that capture the market intermediary's leverage ratio and short-term debt ratio (Indicators 2-3 and 2-4), we supported the suggestion that these ratios should be evaluated in light of the quality of the underlying assets and the sources of funding. However, FSR continues to believe that the FSB and IOSCO should provide greater guidance on how the underlying assets and sources of funding should be assessed.

In assessing a market intermediary's OTC derivatives assets and liabilities (Indicator 2-5), FSR again emphasizes that it is imperative that the assessment focus solely on the activities the market intermediary conducts for its own accounts and utilizing its own assets. Furthermore, as discussed above, a risk-based assessment of a market intermediary's OTC derivatives transactions should make quantitative adjustments for applicable netting and place greater weight on an assessment of the market intermediary's exposure amount, which accounts for the degree to which the transaction is collateralized, rather than the notional amount. Additionally, derivatives transactions should also be evaluated by the purposes for which they are used, with less weight placed on transactions used for hedging purposes. We note that our recommended revisions were not incorporated into the proposed methodology. FSR reiterates this recommendation to the FSB and IOSCO.

In considering the assessment of the amount of margin a market intermediary is required to post at clearing houses or central counterparties (Indicator 2-6), FSR reiterates the need to ensure that the assessment is properly calibrated to focus on the actual risks posed by the activities of market intermediaries by limiting the scope of the assessment to margin which supports those activities the market intermediary conducts for its own accounts and utilizing its own assets. It is still not clear how margin posted by a market intermediary in support of customer positions is a useful proxy of either the overall size of risk being taken by the market intermediary or that entity's market interconnectedness. In fact, as FSR noted in our original comments, this indicator appears to actually be a counter-indicator, since the margin is being posted for the purpose of reducing the riskiness of the associated transaction.

3. *Substitutability.*

FSR notes again that market intermediaries operate in the highly competitive capital markets, and the products and services offered by any one market intermediary are often similarly offered into the same market by other market intermediaries. Thus, there should be a very high hurdle for an assessment under this factor to weigh in favor of designating a market intermediary a G-SIFI.

FSR believes that Indicator 3-1 (qualitative assessment of substitutability) continues to lack meaningful instruction or guidance on how to conduct a qualitative assessment of whether "the market" relies on a critical function or service provided by the market intermediary. In particular, the FSB and IOSCO should provide guidance to assess when a market intermediary has assumed a "key role" or is "essential." Any assessment of whether an intermediary is "essential" should include an evaluation of the competitiveness of the larger market of market intermediaries and the ability of other market intermediaries to assume a similar "key role" without causing systemic disruption.

As with previous indicators, FSR recommends that the assessment of a market intermediary's total trading and transaction volumes (Indicator 3-2) be calibrated to measure the actual risks posed by the market intermediary by assessing only those activities the market intermediary conducts for its own accounts and utilizing its own assets. All trading and transactions on behalf of customers should be excluded from the assessment because activities undertaken as an agent are not indicative of a market intermediaries' systemic importance.

4. *Complexity.*

Although complexity is generally an important indicator of potential systemic risk posed by a financial institution, it is not as relevant in assessments of market intermediaries because their business models typically do not involve complex operations or opaque transactions. FSR believes that the indicators identified by the FSB to assess market intermediaries are not appropriate.

The indicator for "structural complexity" is a severely flawed measure in that it fails to assess the actual risk that the complexity of a market intermediary may pose to the global financial system (Indicator 4-1). We believe that attempting to measure such "structural complexity" by counting the number of legal entities consolidated into a market intermediary is a particularly ineffective process. In fact, counter to the suggestion in the Proposed Framework, a large number of legal entities may decrease the likelihood of market disruption upon the failure of a market intermediary, since the separate legal entities are often more insulated and separated for purposes of bankruptcies or other liquidation purposes. Furthermore, as noted above, certain pooled investment vehicles may be consolidated on the balance sheet, but a large number of such pooled investment vehicles (which are insulated from the other entities in the structure for liability purposes) clearly does not indicate greater complexity that could make liquidation more difficult.

FSR does not believe that the simple measurement of "less liquid" Level 2 and Level 3 assets is an appropriate risk-sensitive assessment of the potential risk arising from a market intermediary's complexity. FSR believes that the FSB should also consider (i) which such assets are complex to evaluate and (ii) in what situations the complexity to value such assets has a material impact on a market intermediary. Furthermore, as discussed above, the measurement should exclude assets held in client accounts.

5. *Cross-Jurisdictional Activities.*

FSR commented previously and continues to believe that a simple count of jurisdictions in which a market intermediary conducts operations, as measured by the number of jurisdictions in which it and/or its affiliates are licensed, registered, or recognized by or reportable to the market regulator, is not an appropriate measurement of cross-jurisdictional activities (Indicator 5-1). As the FSB notes, market intermediaries may be subject to local regulatory jurisdiction but engage in *de minimis* business in that jurisdiction. We also note that the licensing or reporting of market intermediaries is fundamentally different than opening or operating a branch of a bank. Additionally, the FSB and IOSCO should take into consideration the risk reducing effects of such licensing or registration.

In assessing a market intermediary's cross-jurisdictional claims and liabilities (Indicator 5-2), FSR again stresses that the assessment should focus on the market intermediary's claims and liabilities and not its customers. In addition, the indicator is unclear whether the FSB and IOSCO are focusing on market intermediaries that are diversified across a large number of jurisdictions, or market intermediaries that are concentrated in a single geographic region.

## VII. Assessment Methodologies for Other NBNI Financial Entities.

FSR reiterates its prior comment that the proposed "backstop" framework is severely flawed and should be removed. First, it is unclear why the methodology for assessing other NBNI financial entities should be any less rigorous or informed than that applicable to finance companies, market intermediaries or investment funds as defined in the Proposed Framework. Therefore, the FSB and IOSCO should propose for comment specific methodologies and indicators that apply to specific categories of other NBNI financial entities, rather than rely on an undeveloped generalized methodology. FSR believes that the FSB, IOSCO and the national regulators would benefit from receiving comment from the public, given the range of financial activities in which other entities engage, some of which may be significantly different than those conducted by more "traditional" financial institutions, such as banks, insurance companies, broker-dealers, finance companies and investment funds. Furthermore, a specific, customized methodology would ensure that other NBNI financial entities are treated consistently across the jurisdictions. Finally, FSR is concerned that this "backstop" methodology, which lacks transparency and does not afford due process rights to NBNI financial companies, could be used to designate finance companies, market intermediaries or investment funds (or their affiliates) that would not otherwise qualify for designation under the specific framework prescribed for each of these categories of NBNI financial entities.

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FSR appreciates the opportunity to submit comments on the FSB and IOSCO's proposed assessment methodologies for NBNI G-SIFIs. We would welcome additional opportunities to assist the FSB and IOSCO in their effort to develop an assessment methodology that effectively and accurately identifies NBNI entities that present a systemic risk to the global financial system and economic activity across jurisdictions. If it would be helpful to discuss FSR's specific comments or general views on this issue, please contact Richard.Foster@FSRoundtable.org, or Felicia Smith, Vice President and Senior Counsel for Regulatory Affairs, at Felicia.Smith@FSRoundtable.org.

Sincerely yours,

Rich Foster

Richard Foster
Senior Vice President and Senior Counsel
for Regulatory and Legal Affairs
**Financial Services Roundtable**

*With a copy to*:

The Honorable Jacob J. Lew, Secretary of the Treasury and Chairperson of the Financial Stability Oversight Council
The Honorable Mary Jo White, Chair, United States Securities and Exchange Commission
The Honorable Timothy Massad, Chairman, United States Commodity Futures Trading Commission
The Honorable Janet Yellen, Chair, Board of Governors of the Federal Reserve System
The Honorable Thomas J. Curry, Comptroller of the Currency
The Honorable Richard Cordray, Director of the Bureau of Consumer Financial Protection
The Honorable Martin J. Gruenberg, Chairperson, Federal Deposit Insurance Corporation
The Honorable Melvin Watt, Director, Federal Housing Finance Agency
The Honorable Debbie Matz, Chairman, National Credit Union Administration
The Honorable S. Roy Woodall, Jr., Independent Member with Insurance Expertise
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The Honorable Luis A. Aguilar, Member
The Honorable Daniel M. Gallagher, Member
The Honorable Kara M. Stein, Member
The Honorable Michael S. Piwowar, Member
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The Honorable Mark P. Wetjen, Member
The Honorable Sharon Y. Bowen, Member
The Honorable J. Christopher Giancarlo, Member
**United States Commodity Futures Trading Commission**