Managed Funds Association
The Voice of the Global Alternative Investment Industry
Washington, D.C. | New York

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Eric Froman
Assistant General Counsel, U.S. Department of Treasury
1500 Pennsylvania Avenue, NW
Room 2308
Washington, D.C. 20220

Re: Analytic Framework for Financial Stability Risk Identification, Assessment and Response, Docket No. FSOC-2023-0001; Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, FSOC-2023-0002

Dear Mr. Froman:

Managed Funds Association[1] ("**MFA**") appreciates the opportunity to respond to the Financial Stability Oversight Council's (the "**Council**") above-captioned proposals: the Analytic Framework for Financial Stability Risk Identification, Assessment and Response (the "**Proposed Risk Analytic Framework**") and the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (the "**Nonbank Designation Guidance Proposal**," and, together with the Proposed Risk Analytic Framework, the "**Proposed Guidance**").[2]

Although MFA supports the Council having the necessary tools to achieve its statutory goals, the Administrative Procedure Act and existing, valid caselaw require revision of the Proposed Guidance to include strong and transparent procedural and analytical safeguards. Designating an entity would have severe consequences—

[1] MFA, based in Washington, DC, New York, Brussels, and London, represents the global alternative asset management industry. MFA's mission is to advance the ability of alternative asset managers to raise capital, invest, and generate returns for their beneficiaries. MFA advocates on behalf of its membership and convenes stakeholders to address global regulatory, operational, and business issues. MFA has more than 170 member firms, including traditional hedge funds, credit funds, and crossover funds, that collectively manage nearly $2.2 trillion across a diverse group of investment strategies. Member firms help pension plans, university endowments, charitable foundations, and other institutional investors to diversify their investments, manage risk, and generate attractive returns over time.

[2] Financial Oversight Stability Council, Proposed Interpretive Guidance on the Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 82 Fed. Reg. 26234 (Apr. 28, 2023); Financial Oversight Stability Council, Analytic Framework for Financial Stability Risk Identification, Assessment and Response, 82 Fed. Reg. 26305 (Apr. 28, 2023).

potentially firm-altering—and as such it is imperative that the Council use any such authority judiciously.

MFA disagrees with the proposed elimination of key aspects of the existing interpretive guidance regarding nonbank financial company designation finalized by the Council in December 2019 (the "**2019 Nonbank Designation Guidance**").[3] In particular, proposing to eliminate both the existing prioritization of an activities-based approach and the requirement to conduct a cost-benefit analysis prior to entity-specific designation, would undermine the credibility, predictability and prudence of the use of the Council's authorities. In place of these approaches would be the Proposed Guidance, from which Council makes clear it can deviate if it so decides.[4]

The Proposed Guidance also fails to give appropriate deference to *MetLife v. Financial Stability Oversight Council* ("***MetLife***")[5] and related Supreme Court precedent, all of which remain good law to this day. The Proposed Guidance further fails to provide commensurate analytical or procedural safeguards consistent with *MetLife* and related Supreme Court precedent. MFA encourages the Council to retain the procedural backstops of the 2019 Nonbank Designation Guidance, which would help avoid further litigation while enhancing the legitimacy of its actions.

We also recommend that the Council enhance the Proposed Guidance to provide an appropriate level of transparency with respect to its approach to identifying or assessing risks to financial stability and to its use of the designation authority. This could include more publicly available information on precisely which risks the Council may consider systemically important, as well as greater mandatory dialogue before and during pre-designation stages.

Further strengthening of procedural safeguards, greater transparency and additional dialogue with the industry and firms that are potentially in scope would encourage self-corrective behavior, as appropriate. MFA believes this would be a faster, more effective, and fairer way to achieve the Council's financial stability goals. For example, a longer notice period would provide clear opportunities for discussion with potential designees and would better permit firms to be responsive to the Council's perspectives on purported sources of systemic risk and provide realistic opportunities for firms to reduce their alleged systemic footprint if needed. Such an approach is more likely to allow the Council to achieve its financial stability-related goals while also reducing the risk of litigation and uncertainty in the designation process.

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[3] Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 84 Fed. Reg. 71740 (December 30, 2019) (the "**2019 Nonbank Designation Guidance**").

[4] Nonbank Designation Guidance Proposal, *supra* note 2, at n.15 and accompanying text.

[5] 177 F. Supp. 3d 219 (D.D.C. 2016).

Lastly, and most importantly, it would be inappropriate to impose bank-centric prudential regulatory standards on the asset management industry. Designation would result in the application of enhanced prudential standards and supervision by the Board of Governors of the Federal Reserve System (the "**Federal Reserve**") to investment management firms. With respect, the Federal Reserve has no track record of successfully applying these types of standards to asset management firms or funds. When the Council is considering a designation, the paramount consideration must be whether designation resolves or mitigates the identified risks. In the case of private funds, any systemic benefits of designation would be severely undercut by the Federal Reserve's modest institutional experience with nonbanks, particularly when considered relative to the strength of the nonbank's primary regulatory authorities.

The costs of applying another regulatory regime, including capital requirements and supervisory fees, most assuredly would outweigh any benefit to financial stability—particularly considering that any costs to the entity of designation ultimately would be borne by investors and other financial market participants. MFA therefore encourages the Council to focus on activities-based oversight, coordinating with the Securities and Exchange Commission ("**SEC**") and other appropriate functional regulators to address conduct that the Council has determined to present risks to financial stability that would justify the consideration of a designation. MFA would note that multi-agency cooperation efforts represent high points in regulatory oversight, such as the collective, coordinated multi-agency adoption of the OTC derivatives market reforms, including with respect to central clearing and margining, and the cessation of the use of the London Interbank Offered Rate throughout the financial markets and their participants.

Following an executive summary, Sections II and III set out our specific comments to the Proposed Guidance and Section IV discusses why applying the Council's designation authority to the private fund industry is an inappropriate and ultimately ineffective tool to reduce systemic risk.

I. Executive Summary

A. The Proposed Risk Analytic Framework Should Be Revised to Provide Greater Transparency, Public Input, and Greater Deference to the Holdings of the *MetLife* Case

- The Administrative Procedure Act requires revision of the Proposed Risk Analytic Framework to provide more detail on how the Council would evaluate factors set out in the framework. This would allow market participants to consider proactive steps to reduce any purported systemic footprint, consistent with the Council's goals.

- Any future revisions to the Proposed Risk Analytic Framework must be subject to public notice and comment. Without public input, the Council cannot credibly claim to identify and consider all relevant financial stability risks and mitigants.

- The *MetLife* case, the statutory requirements and the Supreme Court case law that decision relied upon all remain good law and as such the Proposed Risk Analytic Framework should be revised to consider costs and benefits prior to designation.[6]

- The Proposed Risk Analytic Framework should be revised to make clear that the Council will consider the vulnerability of the nonbank financial company to material financial distress, in addition to whether a distressed situation would pose a threat to financial stability, prior to using the designation authority.

B. The Nonbank Designation Guidance Proposal Should Be Revised to Prioritize the Use of an Activities-Based Approach and Provide Greater Procedural Safeguards Before and During Any Designation Consideration

- The Proposed Guidance should be revised to require the Council to consider the viability of an activities-based approach, prior to designation, given the consequences to the entity that would be so designated. The Council should be required to coordinate with the entity's functional regulators (*e.g.*, the SEC) to first seek to address any identified risks to financial stability through agency action.

- Procedural safeguards are critical to the legitimacy and efficacy of the Council's goals. Accordingly, the Council should be obligated under any designation regime to provide additional insight into the work of staff-level committees, extend the notice period prior to escalation in pre-designation stages and require extensive dialogue between the Council, potential designees and primary regulatory authorities to collectively determine how to best mitigate each identified financial stability risk.

C. The Nature of Private Funds Make Application of Entity-Specific Designation Authority Inappropriate

- Private funds historically have contributed to the efficiency and resilience of U.S. financial markets, oftentimes during otherwise stressed market conditions.

- Private funds are unlikely to create risks to U.S. financial stability due to their relatively small proprietary balance sheets; and private funds have a long history of orderly wind-downs and low industry concentration.

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[6] The Council baldly asserts that the benefits of designation as "potentially enormous and, in many respects, incalculable" compared to the costs. Nonbank Designation Guidance Proposal, *supra* note 2, at 26238. As discussed further below, this statement is unlikely to be true for private funds, and it is unclear that this statement considers the exponential effects over time of diminished market functioning.

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II. Proposed Risk Analytic Framework

MFA recommends that the Council revise the Proposed Risk Analytic Framework to provide additional clarity on how the Council would evaluate and respond to potential risks to financial stability, and to provide for notice and comment for any future changes to the Proposed Analytic Guidance.

A. The Proposed Risk Analytic Framework Must Be Revised to Provide More Guidance on How the Council Will Evaluate the Proposed Factors

The Administrative Procedure Act requires the Proposed Risk Analytic Framework to provide greater direction to potential designees of how the Council might consider and apply its factors. This lack of transparency disallows market participants from organizing their activities to avoid such risks. The Proposed Risk Analytic Framework provides two key steps in evaluating potential risks to financial stability that the Council identifies. First, it considers factors which "commonly contribute" to financial stability risks: including but not limited to leverage, liquidity risk and maturity mismatch, operational risks, complexity or opacity, inadequate risk management, concentration, and destabilizing activities. If the Council in the future identifies other factors it deems important, MFA strongly encourages the Council to publish them. Second, it considers how the adverse effects of potential risks may be transmitted to the financial system, including through exposures, asset liquidation, critical functions, or contagion. The Proposed Analytic Framework, however, makes clear that the Council can consider other factors if it so chooses.

MFA recommends revisions to the Proposed Risk Analytic Framework to provide greater transparency, specificity, and guidance to market participants. First, the Council must make market participants aware of when the enumerated risks or transmission factors become serious enough to, in the Council's view, pose a potential threat to financial stability. Second, the Proposed Risk Analytic Framework should be revised to require the Council to provide meaningful insight into how the Council evaluates the potential systemic risks posed by a specific nonbank financial company. Market participants, and the designation process itself, would benefit from such transparency.

Market participants generally deserve greater clarity, particularly when considering the considerable consequences of designation. The Proposed Guidance is ambiguous in how the Council would consider the enumerated factors, which could deter firms from engaging in particular businesses or practices, despite the fact that the activity would not pose a risk to financial stability. These potential effects of the Proposed Guidance, while unintentional, would undermine the strength and flexibility of U.S. financial markets and market participants. At the same time, also unintentionally, the lack of details may allow risks to grow and amplify where they may be avoided with greater transparency.

Additional guidance in key areas would mitigate the risk of an arbitrary and capricious rulemaking with respect to the Proposed Guidance. For instance, the Council stated that concentration is a potential source of financial stability risk, emphasizing market share as one relevant metric. The Council however fails to identify, even at the highest level of generality, a threshold where it believes concentration could adversely affect financial stability, either generally or in specific markets. MFA would recommend that Council acknowledge, for starters, that concentration is relevant insofar as a concentrated entity's failure creates substitutability problems and, therefore, potential financial stability risks. MFA would note as an aside that such concerns are unlikely to be present in the case of private funds. The subjectivity and ambiguity highlighted in this paragraph is but one example that exists in each of the enumerated risk and transmission factors. The subjectivity and ambiguity is magnified and amplified in the context of any non-enumerated factors that the Council may decide to consider in its analysis.[7]

The Proposed Risk Analytic Framework at the same time fails to discuss any considerations which would mitigate these risk and transmission factors. Our recommendations are therefore twofold: MFA encourages the Council to further develop publicly how it would intend to implement the Proposed Risk Analytic Framework with specific examples, and to disclose mitigating factors that it would consider in its designation analysis. These changes would improve the ability of the market, market participants, and financial regulators to address potential risks to financial stability in a more efficient and less disruptive manner.

B. The Council Should Ensure That Any Future Revisions to the Proposed Risk Analytic Framework Are Subject to Public Notice and Comment

The notice and comment requirements are essential to the development of a credible designation process. MFA thus does not support the proposal to remove the Proposed Risk Analytic Framework from Appendix A of 12 C.F.R. § 1310. Separating the Council's substantive framework for identifying, assessing, and responding to risks to financial stability from the procedural elements of a nonbank financial company designation effectively removes the public notice and comment requirement for the Council's substantive review standards.

MFA recommends restoring the notice and comment process for any future revisions to the Proposed Risk Analytic Framework, consistent with the Administrative Procedure Act. The Council's proposed approach to eliminate the Proposed Risk Analytic Framework from the notice and comment requirements would make the Council's work unnecessarily opaque and undermine its ability to fully achieve its goals. Like the primary financial regulatory agencies, the Council benefits greatly from discussions with market participants. The high stakes associated with the designation process and its nearness to the political process demand acute consideration of issues that could

[7] Proposed Risk Analytic Framework, *supra* note 2, at 26307.

undermine the legitimacy of the process, including consideration of the impact on stakeholders. Seeking public comment also would greatly improve the input to the Council by market participants and other interested parties into financial stability risks, as market participants are more likely to have direct insights into new or evolving risks. Arriving at the correct determination, response, and subsequent course of action is well worth the additional time and process to both the Council and market participants. For these reasons, MFA recommends that the Council explicitly commit to soliciting public notice and comment on future revisions to the Proposed Risk Analytic Framework.

C. The Proposed Risk Analytic Framework Should Be Revised to Include a Cost-Benefit Analysis, as Required by *MetLife v. Financial Stability Oversight Council*, Which Remains Good Law

1. *MetLife* Remains Good Law

MetLife has not been abrogated or otherwise overruled, and the Council ultimately abandoned its appeal of the decision. When it invalidated the Council's designation of MetLife,[8] the U.S. District Court for the District of Columbia held that the designation:[9] (1) failed to consider the costs associated with designation as compared to the benefits; and (2) did not include an adequately reasoned finding that MetLife's material financial distress "would impair financial intermediation or market functioning [in a sufficiently severe manner so as] to inflict significant damage on the broader economy."[10] The Council incorporated these holdings into its 2019 Nonbank Designation Guidance.[11]

In addition to the fact that *MetLife* remains good law, the decision was based on the text of the Wall Street Reform and Consumer Protection Act (the "**Dodd-Frank Act**")[12] and on Supreme Court decisions regarding the requirements of reasoned agency decision-making. Nevertheless, the Proposed Guidance would remove both above-noted aspects of the 2019 Nonbank Designation Guidance without explanation or justification – just a passing footnote reference.[13] The standards set out in the 2019 Nonbank Designation Guidance, which were based on the decision in *MetLife*, accordingly should be reincorporated as part of the Proposed Risk Analytic Framework.

[8] *MetLife Inc. v. Fin. Stability Oversight Council*, 177 F. Supp. 3d 219 (D.D.C. 2016).

[9] Financial Stability Oversight Council, Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21637 (Apr. 11, 2012).

[10] *MetLife*, 177 F. Supp. 3d at 227, 239.

[11] 2019 Nonbank Designation Guidance, *supra* note 3, at 71753, 71761.

[12] 12 U.S.C. §5321.

[13] Proposed Risk Analytic Framework, *supra* note 2, at n.16.

2. *MetLife* Requires the Proposed Risk Analytic Framework to Consider Costs and Benefits

The Proposed Analytic Framework must be revised according to *MetLife* and the Supreme Court precedent as applied to the Dodd-Frank Act.[14] First, the *MetLife* court held that that Supreme Court precedent required the Council to consider both costs and benefits of applying enhanced prudential standards to a designated company. MFA agrees with the *MetLife* court's statement that a cost-benefit analysis is "a central part of the administrative process" and "essential to reasoned rulemaking."[15] The Proposed Guidance, while not proposed as a formal rulemaking, would have the effect of formal rulemaking on the affected parties, and as such *MetLife* and its underpinning logic should remain at the forefront of the Council's processes.

The Dodd-Frank Act requires the Council to determine that a company's material financial stress could pose systemic risk as a condition of a nonbank designation, and therefore MFA encourages the Council to reintroduce this type of evaluation of costs to the company into the Proposed Guidance. Section 113 of the Dodd-Frank Act in effect requires an evaluation of cost by the Council, insofar as the threat to financial stability must be of a sufficient degree to merit a designation.[16] *MetLife* similarly found that the Dodd-Frank Act required the Council to consider "appropriate," "risk-related factors" such as cost.[17] Failing to do so risks at a minimum appearing arbitrary—a slippery slope that would invariably lead to a challenge that a designation, as the *MetLife* court held, in fact is arbitrary and capricious. Either way, the effect would be to undermine public confidence in the Council and to fail to balance the Council's sweeping powers against the magnitude of the consequences of entity-specific designation. The Council's decision-making process would be enhanced, not restricted, by the requirement that the Council conduct an analysis of the costs of designation before moving forward with one.

D. *MetLife* Requires the Consideration of Material Financial Distress

MFA further encourages the Council to consider a definition of "threats to financial stability" that requires evaluation of the likelihood of a nonbank financial company posing a threat to financial stability prior to using the designation authority. Under the 2019 Nonbank Designation Guidance, the Council specifically defines "threat to financial stability" to mean "impairment of financial intermediation or of financial market functioning that *would* be sufficient to inflict severe damage on the broader

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[14] *MetLife*, 177 F. Supp. 3d at 239 (citing *Michigan v. Environmental Protection Agency*, 576 U.S. 743 (2015)).

[15] *MetLife*, 177 F. Supp. 3d at 240, 242.

[16] 12 U.S.C. § 5323(a)(1).

[17] *MetLife*, 177 F. Supp. 3d at 240 (citing 12 U.S.C. 5323).

economy."[18] This standard has been removed from the Proposed Guidance. In addition, the Council indicates that it "would not assess the likelihood of a company's material financial distress" in conducting an analysis under the Nonbank Designation Guidance Proposal.[19] The Council should, consistent with the *MetLife* holding, explicitly acknowledge that it will evaluate the "vulnerability" factors enumerated in the Proposed Risk Analytic Framework with appropriate consideration of the likelihood of failure of a specific nonbank financial company.

A comparison of the designation authority language of Title I for nonbank financial companies with that of Title VIII, which is applicable to financial market utilities and payment, clearing or settlement activities, further supports a requirement that the Council assess the potential financial distress of an entity it is considering for designation. Title VIII provides the Council with authority to designate those utilities or activities if it determines that they "are or are *likely to become* systemically important."[20] Title I, on the other hand, provides that the Council may designate a nonbank financial company if "*material financial distress* at [a particular company], or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of [such company], could *pose a threat to U.S. financial stability*."[21] The Title I standard thus imposes a higher standard for designation than the Title VIII equivalent, suggesting that such additional steps as a cost-benefit analysis and evaluation of the likelihood of a threat to financial stability should be part of the Council's nonbank financial company designation process. A failure to conduct both a cost-benefit analysis and an evaluation of the likelihood of failure would be inconsistent with the designation requirements of Titles I and VIII.

III. Nonbank Designation Guidance Proposal

MFA recommends revision to the Nonbank Designation Guidance Proposal to prioritize an activities-based approach to minimize disruption to the financial system through the designation process. We also recommend the Council revise the Nonbank Designation Guidance Proposal to further enhance its procedural safeguards. The Council should, as part of the consideration of any designation, deepen collaboration with primary financial regulators, ensure opportunities for dialogue with entities under review and further bolster the transparency of its screening process.

[18] 2019 Nonbank Designation Guidance, *supra* note 3, at 71761 (emphasis added).

[19] Nonbank Designation Guidance Proposal, *supra* note 2, at 26238.

[20] 12 U.S.C. § 5463(a)(1) (emphasis added).

[21] 12 U.S.C. § 5323(a)(1) (emphasis added).

A. The Council Should Consider Collaboration with Primary Financial Regulators Prior to Designating an Entity

MFA recommends the Council restore the requirement of the 2019 Nonbank Designation Guidance to re-emphasize collaboration with member agencies or other financial regulators to develop an appropriate "activities-based approach" to addressing identified financial stability risks.[22] The Council therefore would first give consideration of activities-based approaches in addressing identified risks to financial stability. The Council should revise the proposal so it is clear the Council would move to consideration of an entity designation only after it determined that activities-based tools would not address identified risks. An activities-based approach can address identified risks comprehensively and fairly, best reducing identified risks to financial stability while limiting opportunities for regulatory arbitrage.

The Council should only use entity designation authority as a last resort. If the designation authority is exercised, the designated firm is immediately placed at a significant market disadvantage. Designation also increases the likelihood that identified risks shift elsewhere in financial markets where enhanced standards do not apply. Indeed, Treasury Secretary Yellen has previously recognized the benefits of pursuing an activities-based approach as compared to entity-specific designation, noting in an exchange with Senator Warren that "rather than focus[ing] on the designation of [nonbank financial] companies," it is "important to focus on an activity [. . .] and what the appropriate restrictions are" to address the risks posed by such activity.[23] MFA agrees. Moreover, as with consideration of the likelihood of material financial distress at a firm and of the costs of designating the firm, the alternative of an activities-based approach arises from well-established requirements of agency decision-making. Even if the *MetLife* decision is ignored, existing case law requires agencies to consider reasonable alternatives to the regulatory approaches they propose, and an activities-based approach would be considerably more reasonable than an entity designation.

For these reasons, the Proposed Guidance should be revised to require the Council to explicitly continue to ensure a primary role for an activities-based approach, particularly in consultation with primary financial regulators. If an entity is designated, the Council should be required to publish its rationale against pursuing an activities-based approach. Agencies like the SEC and the CFTC have deep knowledge of the markets they regulate and are best positioned, in consultation with the Council, to evaluate the potential systemic risk posed by a given activity. Explicitly emphasizing this collaborative function would help ensure an appropriately tailored, transparent and well-administered designation process that is used only in necessary circumstances.

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[22] 2019 Nonbank Designation Guidance, *supra* note 3, at 71755; Nonbank Designation Guidance Proposal, *supra* note 2, at 26237.

[23] The Quarterly CARES Act Report to Congress, Hearing Before the Committee on Banking, Housing, and Urban Affairs, 117 Cong. 215 (Mar. 24, 2021) (Statement of Secretary Yellen).

B. The Procedural Safeguards Should Be Enhanced to Bolster the Legitimacy and Efficacy of Designation Process

MFA does not oppose of the procedural safeguards to entity-specific designation retained from the 2019 Nonbank Designation Guidance, including a two-stage designation evaluation, engagement with the Council, annual review of designation and an opportunity to "off-ramp" and thereby avoid continued supervision and regulation by the Federal Reserve.[24]

We further recognize that in some cases, the Nonbank Designation Guidance Proposal enhances procedural processes. This includes the Council's commitment to providing 60-days' notice to a nonbank financial company before escalation from stage 1 to stage 2. Advanced notice of this key Council vote provides nonbank financial companies under preliminary review the crucial ability to prepare for dialogue with the Council and address any financial stability risks the Council may perceive. Indeed, given the complexity of issues often involved, we believe the Council should consider extending such advanced notice to more than 60 days. Such notice is particularly important if the Council declines to offer greater transparency into how it intends to apply the factors set out in the Proposed Risk Analytic Framework.

1. It Is Important that the Proposed Guidance Be Revised to Reinstate the Requirement to Consider Risk Mitigation

MFA urges the Council to reinstate the reference from the 2019 Nonbank Designation Guidance to a nonbank financial company's ability to "mitigate any risks to financial stability and thereby potentially avoid becoming subject to [the Council's designation authority]." If the purpose of the designation process is to remove systemic risk from the financial ecosystem, allowing a firm to do so voluntarily would be considerably more efficient and less disruptive than going through the designation process. It furthermore is far from certain that Federal Reserve oversight would fully address whatever systemic risk the Council identified and determined was problematic. A more effective approach would be to engage in early and fulsome dialogue with entities throughout the Council's review regarding mitigation. Risk mitigation is the most efficient and effective way to achieve the Council's financial stability goals and should be encouraged. MFA urges that Council to reinstate risk mitigation into the Council's process, consistent with the 2019 Nonbank Designation Guidance.

MFA further notes that a consideration of alternatives to designation would likely have the effect of mitigating identified systemic risks, not only more efficiently, but also in a considerably shorter time frame. Modest improvements in discussion with entities under review could facilitate de-escalation of financial stability risks consistent with the Council's goals. A designation process that fails to provide ample time and space for discussion increases the likelihood of designation being incorrectly viewed as the only

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[24] Nonbank Designation Guidance Proposal, *supra* note 2, at 26241-44.

answer, while in fact it may not be necessary. The Council and nonbank financial companies should be required to collaborate to mitigate risks. Such an approach would streamline and enhance, rather than diminish, the Council's ability to reduce risks to U.S. financial stability. As a practical matter, the Federal Reserve would require months or longer to craft, draft, publish and revise appropriate enhanced prudential standards for a designated nonbank financial company. There is also the considerable matter of hiring and training examination and regulatory staff to perform such ongoing oversight. The Federal Reserve's "ramp up" process would be further extended if the designated nonbank financial company was poorly suited to bank-like regulation, such as a private fund adviser. We therefore urge the Council to reintroduce the missing procedural language from the 2019 Nonbank Designation Guidance into the final version of the Nonbank Designation Guidance Proposal to recognize and encourage risk mitigation as an alternative.

Finally, the MFA recommends the Nonbank Designation Guidance Proposal provide a greater notice period than the proposed one business day notice prior to publicly announcing a designation.[25] Entities that are successful candidates for designation will require additional time to get their affairs in order, and provide notice to counterparties, custodians and other affected parties and stakeholders to help prevent market disruptions while leaving the Council's authority unaffected.

2. The Council Should Provide More Insight into the Work of Staff-Level Committees

MFA recommends that the Nonbank Designation Guidance Proposal be revised to provide transparency into the Deputies Committee and staff-level committees that apply the Proposed Risk Analytic Guidance.[26] The Proposed Guidance fails to provide any material transparency into the activities of these bodies. This lack of transparency would further erode confidence in the Council's processes and would fail to provide the market information on the attributes the Council perceives to present risks to financial stability. To address this issue, MFA recommends the Council enhance the transparency of these committees' work.

[25] Nonbank Designation Guidance Proposal, *supra* note 2, at 26243.

[26] Under the Proposed Guidance, a nonbank financial company would be recommended for review under the two-stage designation process by one of the Council's various staff-level committees, which include the Deputies Committee, the Nonbank Financial Companies Designations Committee, and the Systemic Risk Committee. These staff-level committees "are responsible for monitoring and analyzing financial markets, financial companies, the financial system, and issues related to financial stability" across "a broad range of asset classes, institutions, and activities" generally in accordance with the Risk Analytic Framework. Nonbank Designation Guidance Proposal, *supra* note 2, at 26241. Those committees would "consider the vulnerabilities and types of metrics" from the Risk Analytic Framework and report to the Deputies Committee, which is composed of senior representatives of Council members. *Id.*

IV. The Council's Entity-Specific Designation Authority Should Not Be Used with Respect to the Private Fund Industry

The activities of private funds are unlikely to create risks to U.S. financial stability,[27] and as such the Council's designation authority is an ill-suited tool to apply. The activities of private funds are best suited to market and investor protection regulation by the SEC and the Commodity Futures Trading Commission ("**CFTC**") rather than bank-like supervision and regulation by the Federal Reserve. Private funds historically have provided resilience to U.S. financial markets, often times during otherwise stressed market conditions. MFA remains committed to collaborating with the primary financial regulators of private funds and their advisers to mitigate emerging risks to U.S. financial stability. As discussed further below, the Council should work primarily through these market regulators to craft activity-specific recommendations to be applied to all market participants.[28]

A. Private Funds Provide Resiliency to U.S. Financial Markets

The risk management practices of private funds, prevailing market structure, and the existing regulatory framework all significantly limit the potential that private funds to act as a source of systemic risk. The private fund industry is characterized by low concentration, historically low contagion risk, and robust risk management practices. These characteristics alongside existing regulatory structures make private funds better suited to activities-based oversight.

The private fund industry is further characterized by diversity which historically has enhanced resiliency for U.S. financial stability. While U.S. banking is intensely concentrated among the largest firms,[29] private funds demonstrate much greater competitiveness.[30] This diversity means that Council concerns, such as interconnectedness and concentration, are of diminished relevance to the private fund industry.

Relatedly, private funds wind down with relative frequency and do not cause financial stability problems when doing so. No private fund closure during the 2008

[27] FEDERAL RESERVE, FINANCIAL STABILITY REPORT 47 (2023) ("Overall, the financial stability vulnerabilities posed by private credit funds appear limited. Most private credit funds use little leverage and have low redemption risks, making it unlikely that these funds would amplify market stress through asset sales.")

[28] 12 U.S.C. § 5330(a).

[29] *See, e.g.*, Office of Financial Research, Bank Systemic Risk Monitor, https://www.financialresearch.gov/bank-systemic-risk-monitor/ (presenting the asset footprint of the largest U.S. banks).

[30] *See* COMMITTEE ON CAPITAL MARKETS REGULATION, A COMPETITIVE ANALYSIS OF THE U.S. HEDGE FUND MARKET 3 (2023) (concluding that the hedge fund industry is within the lowest decile of industry concentrations for public companies in the United States).

financial crisis or since has threatened market functioning or financial stability. Regulations implemented as a result of the Dodd-Frank Act, including derivatives clearing, margining and reporting, further have bolstered the resiliency of the private fund industry and minimize the risk a private fund failure would spread to its counterparties or more broadly. Counterparty risk management practices also have strengthened, further reducing the likelihood that counterparty exposures, even in periods of market stress, would have widespread impact on financial markets.

Critically, private funds differ from other financial market participants because they are ultimately vehicles for the management of others' assets. Private funds therefore do not maintain a large balance sheet of their own assets. Private funds facilitate access to particular financial instruments or strategies by sophisticated investors that understand the liquidity limitations of the fund and are capable of bearing investment risks. The Dodd-Frank Act already acknowledges this reality in section 113, which requires the Council in exercising its designation authority to consider "the extent to which assets are managed rather than owned by the company, and the extent to which ownership of assets under management is diffuse."[31]

Considering the above characteristics of the private fund industry, MFA recommends that the Council should continue to focus on systemic risk monitoring activities, not designations. Private funds report extensive risk metrics to the SEC and CFTC, including stress tests, portfolio information including collateral, margin and cash reserves, counterparty exposures and myriad other details, all of which are available to the Council. MFA notes that the Council reestablished its staff-level Hedge Fund Working Group in 2021, which has developed an interagency risk-monitoring framework to assess hedge fund-related risks to U.S. financial stability.[32] We recommend that the Council continue to focus on these efforts and increase its dialogue with market participants and other stakeholders to best foster efficient, transparent and effective policy. We also believe the Council should remain flexible, creating or disbanding working groups or ad hoc task forces as evolving market conditions warrant.

B. Bank-like Regulation of Private Funds Could Reduce U.S. Financial Stability

As discussed above, the Council's evaluations of potential designations must consider costs and benefits. On this score, MFA remains deeply skeptical of the benefits of designating a hedge fund or private credit fund for regulation and supervision by the Federal Reserve. Risk management is a cornerstone of the private fund industry, and firms have taken steps to mitigate the risks identified in the Proposed Risk Analytical Framework to the extent they are present. For example, as evidenced in the quarterly Form PF reports, financing for private funds is overwhelmingly obtained through

[31] 12 U.S.C. § 5323(a)(2)(F).

[32] *See* U.S. Department of Treasury, *Financial Stability Oversight Council*, https://home.treasury.gov/policy-issues/financial-markets-financial-institutions-and-fiscal-service/fsoc.

collateralized arrangements from sophisticated counterparties with robust risk monitoring. The Government Accountability Office moreover concluded in a December 2020 report that banks could absorb losses associated with exposure to leveraged borrowers, which include hedge funds and private credit funds, suggesting interconnectedness between banks and private funds would not pose meaningful financial stability risks.[33]

Private funds also manage liquidity risk by contractually controlling the timing and amount of redemptions given the investment strategy of the fund. Being able to control redemptions greatly mitigates fire sale concerns.[34] Form PF reports provide detailed analyses of asset and liability liquidity, including redemption provisions.

While any determinative conclusions would require formal cost-benefit analysis on an entity-by-entity basis, the costs imposed by the capital requirements, supervision and resolution planning requirements that result from designation would be significant and potentially fatal to the private fund. Elimination of private funds reduces the availability of capital for American businesses and would adversely affect innovation and increase financing costs, reducing the resiliency of both U.S. financial markets and the real economy. For investors such as pension funds, foundations, insurance companies and endowments, a reduced market for private funds associated with markedly higher compliance costs would remove a critical source of uncorrelated returns and harm the beneficiaries of these institutional investors.

Hedge funds and private credit funds are fundamentally different from banks. Private funds are not funded by liabilities, like deposits, which are redeemable at par and on demand, and do not benefit from deposit insurance or typical Federal Reserve liquidity. Instead, private funds investors commit long-term capital, take investment risk and accordingly agree to redemption limits established and enforced by fund managers to manage liquidity. Private funds fundamentally are investment products limited to sophisticated parties that do not require daily or "on demand" liquidity, are typically advised by professionals, and understand the investment and related risks. Private funds should be regulated accordingly, and are so regulated by the SEC, CFTC, and others.

In closing, MFA reiterates our longstanding belief that the Council's designation authority is not "fit for use" as applied to the private funds industry. Particularly given the scope of market structure reforms and additional monitoring tools that followed the 2008 financial crisis, the activities of private funds are sufficiently regulated and supervised by

[33] GOV'T ACCOUNTABILITY OFFICE, FINANCIAL STABILITY: AGENCIES HAVE NOT FOUND LEVERAGED LENDING TO SIGNIFICANTLY THREATEN STABILITY BUT REMAIN CAUTIOUS AMID PANDEMIC 33-34 (2020).

[34] *See* MANAGED FUNDS ASS'N, THE ROLE OF PRIVATE CREDIT IN U.S. CAPITAL MARKETS 10 (2020).

the SEC and other regulators: no private fund adviser poses a financial stability risk sufficient to justify the use of designation authority.

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MFA thanks the Council for the opportunity to provide these comments on the Proposed Guidance, and we would be happy to discuss our comments with Council staff if it would be helpful. We welcome the opportunity to continue to work with the Council and its member agencies and provide any additional information that may be required. Please do not hesitate to contact Jeff Himstreet or the undersigned at (202) 730-2600 should you have any questions.

Respectfully submitted,

\s\ Jennifer W. Han

Jennifer W. Han
Executive Vice President
Chief Counsel & Head of Global Regulatory Affairs