SUBMITTED ELECTRONICALLY

May 13, 2019

The Honorable Steven T. Mnuchin
Secretary, United States Department of the Treasury
Chairman, Financial Stability Oversight Council
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Re: Financial Stability Oversight Council (the "FSOC") Notification of Proposed Interpretive Guidance Regarding Nonbank Financial Company Determinations (RIN 4030-ZA00)

Dear Secretary Mnuchin:

On behalf of our members, the American Investment Council (the "AIC") is pleased to submit the following comments regarding the proposed interpretive guidance to replace the FSOC's existing interpretive guidance on nonbank financial company designations (the "Proposed Guidance").[1]

The AIC is an advocacy, communications and research organization established to advance access to capital, job creation, retirement security, innovation, and economic growth by promoting responsible long-term investment. In this effort, the AIC develops, analyzes, and distributes information about the private equity and private credit industries and their contributions to the U.S. and global economy. Established in 2007, and formerly known as the Private Equity Growth Capital Council, the AIC is based in Washington, D.C. The AIC's members are the world's leading private equity and private credit firms, united by their commitment to growing and strengthening the businesses in which they invest. For further information about the AIC and its members, please visit our website at http://www.investmentcouncil.org.

The AIC has supported and continues to support efforts to identify potential systemic risks before they arise and to address appropriately any identified risks. The AIC greatly appreciates the FSOC's effort to reconsider its existing designation procedures and to enhance the FSOC's transparency, analytical rigor, and public engagement. The AIC believes that the Proposed Guidance would achieve those goals and supports the significant changes contemplated therein, including prioritizing an activities-based approach over entity-specific determinations, performing a cost-benefit analysis before making any entity-specific determination, and

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[1] FSOC, Notification of proposed interpretive guidance; request for public comment, 84 Fed. Reg. 9028 (Mar. 13, 2019).

providing "off-ramps" for designated firms and those under consideration. As explained below, private equity and private credit[2] do not—collectively or individually—pose risk to U.S. financial stability, which the AIC believes would be more than evident under the process and analytical framework of the Proposed Guidance.

I. The activities-based approach, including its prioritization over entity-specific determinations, generally is an appropriate framework for analyzing the potential for systemic risk but would benefit from cost-benefit analysis. Application of the proposed framework to private equity and private credit demonstrates that such firms and funds do not present systemic risk concerns.

The Proposed Guidance explains that the FSOC would prioritize its efforts to identify, assess and address potential risks and thresholds to U.S. financial stability through a process that emphasizes an "activities-based approach." This approach would have two steps. The first step would consist of monitoring diverse financial markets and market developments to identify products, activities, and practices that could pose risks to financial stability ("Monitoring Markets Stage") and then evaluating, in consultation with relevant financial regulatory agencies and other experts, whether a potential risk merits further actions ("Evaluating Potential Risks Stage").

In the second step, the FSOC would work with relevant financial regulatory agencies at the federal and state level to address any such risk across all companies that engage in the identified activity. The FSOC anticipates that, typically, this second step will involve relatively informal actions, such as sharing information among regulators. Less frequently, the second step may involve more formal but non-binding recommendations to a primary regulator, a process that would involve consultations with the primary regulator and an invitation for public comments.

The FSOC has asked for comment on this activities-based approach and, in particular, whether the proposed approach is appropriate or should be modified. The proposal explains that the activities-based approach is intended to (1) reduce the potential for competitive distortions among companies and markets, as compared to the current designation procedures; and (2) allow authorities with greater information and expertise to address potential risks. The AIC notes that the prioritization of the activities-based approach is critical to achieving the first goal; the Proposed Guidance states that FSOC will pursue entity-specific determinations "only if a potential risk or threat cannot be addressed through an activities-based approach."[3] The AIC supports the FSOC pursuing entity-specific determinations only as a last resort.

The AIC also wishes to underscore that a crucial element of achieving the Proposed Guidance's second goal is the practice of making recommendations under section 120 of the Dodd-Frank Wall Street Reform and Consumer Protection Act ("Dodd-Frank Act") only to the extent that the recommendation would be consistent with the agency's statutory mandate. The

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2 As used herein, "private equity and private credit" refers to both the investing funds and the firms advising the funds.

3 Proposed Guidance at 9039.

AIC agrees that section 120 of the Dodd-Frank Act should not be used to expand the statutory mandate of an agency or to require an agency to regulate an activity or market in which it does not have sufficient existing expertise.

The AIC also supports the FSOC's determination to take actions informally in most cases, provided of course that such actions do not impose obligations on market participants or other entities. The AIC believes that the informal processes, which may include data and information sharing, followed by a resort to more formal recommendations only in those situations in which informal methods have proven to be insufficient, is an appropriate and sound manner of proceeding.

The FSOC also has asked whether there are specific categories of risks to U.S. financial stability that the FSOC should examine under the activities-based approach. The AIC believes that the appropriate categories of risks that the FSOC should consider under the activities-based approach are the same as those set forth in section 113 of the Dodd-Frank Act for evaluating individual nonbank financial companies. As described below, these statutory factors, as well as the proposed activities-based approach, evidence that private equity and private credit do not present risks to U.S. financial stability.

A. The Monitoring Market Stage should evidence that private equity and private credit do not pose a potential risk to U.S. financial stability.

The AIC believes that the activities-based approach would clearly evidence that private equity and private credit, even if viewed collectively, do not pose a risk to U.S. financial stability. This should be evident from the Monitoring Markets Stage of the activities-based approach.

The Proposed Guidance provides examples of financial markets and market developments that could pose risks to financial stability (e.g., public debt and equity, short-term funding markets, and derivatives or structured products) and asks whether those examples are appropriate.[4] The AIC believes those examples are appropriate. By their nature, private equity and private credit are not significant participants in the markets and activities that are likely to pose financial stability concerns, including the examples listed in the Proposed Guidance. Rather, these funds invest in highly-illiquid equity or debt of financial and non-financial companies ("portfolio companies") across a wide-range of industries.

The Proposed Guidance explains that, during the Monitoring Markets Stage, the FSOC also would consider the linkages across products, activities, and practices, and their interconnectedness across firms and markets. Private equity and private credit do not significantly increase linkages across markets or firms. These firms and funds generally do not rely on prime brokers and are not otherwise operationally linked to other financial companies. They do not hold derivative positions (aside from limited hedges); have counterparty exposure

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[4] See id. at 9032, 9040.

arising from swaps or securities lending activities; rely on short-term[5] credit; or provide short-term liquidity to financial system participants. In addition, private equity funds generally do not engage in long-term borrowing, and the borrowing of credit funds is limited and backed by higher quality collateral in the form of legally-binding capital commitments. Moreover, investors in funds are large, sophisticated, often regulated, and generally make investments that are only a small percentage of the investor's total assets. In all, the structures and operations of private equity and private credit are such that their failure could not have "spillover" or "ripple" effects on other financial system participants.

In addition, private equity and private credit firms and funds are not interconnected with each other. Even within a large private equity or credit business, the firm and the funds that it manages are not interconnected because such a firm and its funds neither pledge their assets as security for, nor do they guarantee, each other's obligations.

Private equity and private credit funds also do not increase interconnections between portfolio companies of a fund. The fund does not pledge the equity or debt of the fund to secure indebtedness or other obligations of another portfolio company, and no portfolio company pledges assets in favor of, or guarantees the indebtedness or obligations of, another portfolio company or the fund. Likewise, private equity and private credit funds are highly diversified across markets, including significant investments in nonfinancial sectors.

B. The Evaluating Potential Risks Stage should provide further evidence that private equity and private credit do not pose a potential risk to U.S. financial stability.

If the FSOC were to determine that private equity or private credit poses a potential risk to U.S. financial stability during the Monitoring Markets Stage, which, as explained above, we do not believe to be the case, the FSOC's consideration of that risk during the Evaluating Potential Risks Stage should confirm that no such risk exists. During this stage, the FSOC would consult with the relevant financial regulatory agencies. The AIC notes that the primary regulator of private equity and private credit firms is the Securities and Exchange Commission ("SEC"); private equity and private credit firms, subject to very limited exceptions, are registered with the SEC as investment advisers and therefore subject to regulation, reporting and examination by that agency. The AIC believes that initial consultations with the SEC, leveraging the agency's significant insight into the business, would confirm that private equity and private credit do not present a risk to U.S. financial stability.

The Proposed Guidance also states that the FSOC efforts during this stage may include consultations with "other experts."[6] Should FSOC ever reach this stage with respect to private

[5] Private equity funds generally are permitted to borrow for the very specific purpose of efficient cash flow management, i.e., to bridge the period from when an investment is made by the fund to when money is received from investors following the issue of a draw down notice on already committed capital. These shorter-term loans typically are capped and secured for their duration against the undrawn (but legally binding) commitments of investors and, therefore, do not increase the aggregate amount available for investments at the fund level.

[6] Proposed Guidance at 9040.

equity or private credit, the AIC would encourage, and would be happy to facilitate, the FSOC's consultation with industry experts. The AIC believes such experts also would confirm that private equity and private credit do not pose a potential risk to U.S. financial stability.

During the Evaluating Potential Risks Stage, the Proposed Guidance also states that the FSOC would analyze whether certain characteristics may amplify potential risks to U.S. financial stability arising from identified products, activities, or practices, and requests comment on the proposed characteristics that may amplify potential risks. The AIC believes that the proposed characteristics are generally appropriate and that, in any event, private equity and private credit do not have characteristics that would amplify potential risks to U.S. financial stability. As noted, these funds have limited leverage, limited counterparty risk to, and interconnections with, financial market participants, and do not trade in financial markets or instruments that are significant to financial stability concerns. The firms and funds, by their nature, also pose limited operational risk.

Moreover, private equity and private credit funds have limited liquidity risk or maturity mismatches. They invest in highly illiquid assets and rely on long-term, stable financing in the form of capital commitments from their investors. Furthermore, investors generally do not have redemption or withdrawal rights that would enable the investors to force the rapid unwind, and corresponding asset-sale, of a fund.

Private equity and private credit also provide high levels of transparency to regulators and investors. Funds report a substantial amount of information to the SEC and the FSOC on Form PF. Moreover, most fund managers are regulated and examined by the SEC and file Form ADVs. Institutional investors also carefully diligence the funds in which they invest (as well as the firm that manages the fund) and heavily negotiate the reporting, governance, and other duties of the fund and firm.

In short, under the proposed framing questions discussed in the Evaluating Potential Risks Stage, it is clear that private equity and private credit do not pose potential risk to U.S. financial stability; no adverse effects on such firms and funds would be transmitted to financial markets or market participants; and the financial system and non-financial sectors of the U.S. economy would not suffer adverse effects.

C. Cost-benefit analysis should be applied to the activities-based approach.

Under the Proposed Guidance, the FSOC would preform a cost-benefit analysis before making any designation under section 113 of the Dodd-Frank Act and would only make a designation if the expected benefits justify the expected costs that the determination would impose. The proposal explains that this analysis is consistent with thoughtful decision making and cites supportive caselaw, including *Michigan v. Environmental Protection Agency*.[7] The AIC strongly supports this aspect of the proposal and believes that cost-benefit analysis should also be applied to any FSOC action under the activities-based approach, including actions under section 120 of the Dodd-Frank Act and recommendations for legislation. Cost-benefit analysis is an essential part of reasoned decision making and significant agency actions, such as those

[7] Id. at 9044.

contemplated in the activities-based approach, should be undertaken only if the expected costs to the industry justify the benefits to U.S. financial stability.

II. The identified transmission channels framework for nonbank financial company determinations is appropriate for analyzing the potential systemic risk of a specific company. Application of this framework to a private equity or private credit firm or fund would demonstrate that such a firm or fund does not present systemic risk concerns.

The Proposed Guidance also would amend the framework for evaluating one or more companies for an entity-specific determination under section 113 of the Dodd-Frank Act. The new framework sets forth three transmission channels as those that are most likely to facilitate the transmission of the negative effects of a nonbank financial company's material financial distress, or of the nature, scope, size, scale, concentration, interconnectedness, or mix of the company's activities, to other financial firms and markets: exposure, asset liquidation, and critical function or service. Under the proposal, the FSOC would take into account the 10 statutory considerations as part of its evaluation of a nonbank financial company under the three transactions channels.

The FSOC has asked whether the three transmission channels are appropriate for evaluating whether a nonbank financial company meets one of the determination standards under section 113 of the Dodd-Frank Act. The AIC believes that the three transmission channels provide an appropriate framework for analyzing systemic risk of a nonbank financial company and use of these channels highlights that no private equity or credit firm or fund would be deemed to present systemic risk under the proposed framework. We discuss each of the three transmission channels below.

A. Exposure transmission channel: The exposure that private equity and private credit firms and funds have to other market participants is limited and does not pose a risk to U.S. financial stability.

Under the exposure transmission channel, the FSOC would evaluate whether a nonbank financial company's creditors, counterparties, investors, and other market participants have direct or indirect exposure to the nonbank financial company that is significant enough to materially and adversely affect those or other creditors, counterparties, investors, or other market participants and thereby pose a threat to U.S. financial stability. Among other factors, the FSOC would evaluate the amounts of the exposures, the degree of the protection for the counterparty under the terms of the transactions, whether the largest counterparties include large financial institutions, and the company's leverage and size. The Proposed Guidance also confirms that the FSOC, as required by statute, will 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. The Proposed Guidance adds that this statutory requirement recognizes the distinct nature of exposure risk when the company is acting as an agent rather than as a principal.

Private equity and private credit are quite small in size relative to large banks, insurance companies, broker-dealers, and advisers to registered investment companies. The AIC continues to believe that, for purposes of analyzing potential systemic risk, the proper metric for measuring size of a private equity or credit firm is risk assets, which refers to the total amount that a firm would lose in the extraordinarily unlikely (indeed, unprecedented) event that the firm and all of the funds it advises were to fail.

Although private equity and private credit firms are also relatively small when measured by assets under management, the AIC does not believe that it is appropriate for systemic risk analysis purposes to calculate the size of such a firm based on its assets under management. As noted, private equity and private credit firms and their sponsored funds are not cross-collateralized, and portfolio investments of private equity firms are indirectly managed, and not owned, by the private equity firm. The risk of loss of a particular portfolio investment made by a particular fund is a risk borne by that fund and its investors, and not by the firm (except to the extent of its investment through the general partner of that fund). The firm cannot use the assets of a fund to gain access to liquidity (except to a limited extent for credit funds) or to settle the firm's debt.

The liabilities of private equity and private credit also are relatively small because, as discussed above, they do not have significant counterparty exposure. Moreover, private equity funds are typically not leveraged. Similarly, private credit funds may have revolving lines of credit or other borrowings to fund investments but are only modestly leveraged.

Also as noted above, the transaction volume of firms is relatively low because firms do not actively trade their portfolios. Similarly, these firms do not significantly engage in derivatives or securities financing transactions and do not serve as reference entities for credit-default swaps.

The Proposed Guidance also states that FSOC will seek evidence regarding the potential for contagion when considering the exposure transmission channel. However, as explained above, private equity and private credit are not deeply interconnected with non-affiliated banks and other nonbank financial companies.

B. Asset liquidation transmission channel: Private equity and private credit are not subject to rapid liquidation and cannot cause asset fire sales when liquidated.

Under the asset liquidation transmission channel, the FSOC would consider whether a nonbank financial company holds assets that, if liquidated quickly, could cause a fall in asset prices and thereby significantly disrupt trading or funding in key markets or cause significant losses or funding problems for other firms with similar holdings. The Proposed Guidance notes that this channel would likely be most relevant for a nonbank financial company that could be forced to liquidate assets quickly due to its funding and liquid asset profile.

Private equity and private credit do not pose risk under this transmission channel. As explained above, private equity and private credit funds rely on long-term, stable financing in the form of capital commitments from their investors. Private equity funds are not typically levered, and the modest leverage of credit funds likewise does not make those funds subject to unsustainable debt or creditor margin calls (and the adverse effects thereof). Private equity funds generally are not permitted to reinvest the proceeds of a sale of a portfolio investment and such "recycling" is limited for credit funds. Furthermore, investors generally do not have redemption or withdrawal rights that would enable investors to force the rapid unwind, and corresponding asset-sale, of a fund. In addition, fund assets are not typically widely-held such that any liquidation would have a significant impact on other market participants.

C. Critical function or service transmission channel: Private equity and private credit do not present "substitutability" concerns.

Under the critical function or service transmission channel, the FSOC would consider the potential for a nonbank financial company to become unable or unwilling to provide a critical function or service that is relied upon by market participants and for which there are no ready substitutes. This factor is commonly referred to as "substitutability."

Private equity and private credit firms and funds over the years have made, and continue to make, important positive contributions to job growth, innovation, economic growth, and productivity by improving the operations of the businesses in which they invest. However, the firms and funds do not present substitutability concerns because they do not provide the kinds of products, services or infrastructure (a) that are necessary for the functioning of the financial system and (b) that could not quickly be replaced by other firms. There is intense competition in the marketplace to raise funds from sophisticated investors. If a private equity or credit firm decides not to raise or is unable to raise a new fund, there are large numbers of investment professionals and new and existing investment firms and lenders ready and able to step in and compete for that capital and the available investment opportunities. Indeed, many large firms have ceased operations, including within the past few years, with no negative impact on the functioning of the U.S. financial system.

We also note that private equity and private credit are not a source of credit to households, governments or (except to a limited extent) businesses, nor do they act as a material source of liquidity for the financial system.[8] Therefore the failure of such firms and funds would not deprive the financial system, or consumers of credit, of an important source of credit.

III. Private equity and private credit are relatively non-complex, transparent and easily resolvable.

The Proposed Guidance also notes that the FSOC may consider whether the potential threat that a nonbank financial company could pose to U.S. financial stability may be mitigated or aggravated by the company's opacity, complexity, or resolvability. The proposal states that evaluation of these issues entails an assessment of the complexity of the nonbank financial company's legal, funding, or operational structure, and any obstacles to the rapid and orderly resolution of the nonbank company.

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[8] While private credit is an important provider of loans to businesses, it represents less than 2% of U.S. capital markets.

As noted elsewhere, private equity and private credit are well-understood by their investors and Federal financial regulators. Moreover, compared to large financial institutions, insurance companies, broker-dealers, and advisers to registered investment companies, private equity and private credit have relatively simple structures. In general, funds are closed-end pooled investment vehicles, most frequently organized as limited partnerships ("LPs") and controlled by a general partner ("GP") that is affiliated with the private equity or private credit firm that advises the fund. The funds receive most or all of their funding for investment through the capital contributions of the LPs and GPs; as noted above, private equity funds generally are not leveraged and private credit funds are only modestly leveraged. Funds generally do not trade in public securities and may only purchase derivatives to a limited extent and only for hedging purposes. Also as noted above, private equity and private credit funds have limited interconnections with other financial market participants and with each other; there are no cross-collateralizations or cross-guarantees among the funds.

As a result, the failure of a fund would merely result in its winddown. The fund's failure should have no impact on the other funds advised by the firm and the impact on investors should be limited to their committed capital. If, however, one or more funds advised by a firm fail to generate satisfactory returns for LPs, the firm may be unable to raise new funds. In that case, the firm would continue to advise its existing funds, wind the funds down at the end of their term, and then quietly go out of business.

IV. Private equity and private credit are subject to significant regulatory scrutiny.

One of the statutorily required considerations the FSOC must take into account in making a determination under section 113 of the Dodd-Frank Act is the degree to which the nonbank financial company is already regulated by one or more primary financial regulatory agencies. The Proposed Guidance states that the FSOC will focus on the extent to which existing regulation of the company has mitigated the potential risks to financial stability identified by the FSOC. The FSOC also says it would most likely consider designation of a nonbanking financial firm under section 113 "only in rare instances such as … if a [firm] is outside the jurisdiction or authority of a financial regulatory authority."[9]

The AIC agrees with this approach and notes that, subject to limited exceptions, private equity and private credit firms are registered with the SEC as investment advisers and therefore subject to robust regulation, reporting and examination by that agency. Furthermore, the FSOC monitors information related to systemic risk through Form PF filings.

In addition, interests in funds are offered to sophisticated investors in private placement transactions subject to the antifraud provisions of U.S. federal and state and non-U.S. securities laws. Similarly, most funds are organized as LPs with a GP that owes common law and statutory duties to the limited partners under state law. The AIC believes that these requirements are more

[9] Proposed Guidance at 9045.

than sufficient to protect investors and U.S. financial stability, especially considering the lack of systemic risk that private equity and private credit poses to U.S. financial stability, as explained above.

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The AIC appreciates the opportunity to comment on the Proposed Guidance and would be pleased to answer any questions that you might have concerning our comments.

Respectfully submitted,

Jason Mulvihill

Jason Mulvihill
Chief Operating Officer & General Counsel
American Investment Council