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US Financial Stability Oversight Council Focuses on Asset Management Products and Activities

On April 18, 2016, the US Financial Stability Oversight Council issued an update on its multi-year review of potential financial stability risks in the asset management industry. This note highlights takeaways from that report, summarizes its key sections and predicts next steps.

Here are the highlights:

- ***FSOC believes alleged liquidity mismatches (particularly for mutual funds), high leverage (particularly for hedge funds) and other industry practices present potential risks to financial stability.***
- ***FSOC believes regulators do not collect sufficient data to understand the scope or nature of these risks.***
- ***FSOC is creating an interagency working group to assess potential risks associated with leveraged hedge funds. The working group must report its findings to FSOC by the fourth quarter of 2016.***[1]

Brief Background

The creation of the Financial Stability Oversight Council (typically abbreviated to FSOC) was a centerpiece of US regulatory reform legislation that followed the 2008-2009 financial crisis. FSOC coordinates financial stability initiatives across otherwise separate financial regulators and is chaired by the Secretary of the Treasury.

FSOC voting membership, in addition to the Treasury Secretary, includes the heads of the Federal Reserve, Office of the Comptroller of the Currency, Bureau of Consumer Financial Protection, Securities and Exchange Commission, Federal Deposit Insurance Company, Commodity Futures Trading Commission, Federal Housing Finance Agency and National Credit Union Administration, plus an independent member with insurance expertise appointed by the President and confirmed by the Senate.[2]

1 The full FSOC report is available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf

2 The regulators are listed as they appear in Treasury's FSOC FAQ, which is available at https://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx. In addition to the Council's ten voting members, there are five non-voting members who serve in an advisory capacity.

Related International Focus

- The issues raised by FSOC have been vexing policy makers and regulators since the financial crisis. The UK's Turner Review,[3] published in 2009, focused on activities carried out by hedge funds and similar entities. It called for regulators to be given powers to collect extensive data on hedge fund activities and other forms of investment intermediation so as to consider their macro-economic risks. In addition, the review considered that regulators should have powers to apply prudential regulation to hedge fund activities that were bank-like in nature or of systemic importance.
- Issues identified in the Turner Review also have been considered at the international level by the Financial Stability Board (FSB), an international body that monitors and makes recommendations about the global financial system. FSB has announced its intention to consult in mid-2016 on the risks posed by funds' liquidity mismatch, leverage within funds, operational risk, challenges in transferring investment mandates in a stressed situation and securities lending activities of asset managers and funds—in other words, most of the same themes addressed in FSOC's report. FSB recommendations are expected by the end of the year.[4]
- In Europe, the European Commission's Capital Markets Union is based, in part, on expanding market-based intermediation to fuel EU economic growth. This objective is tempered through regulation to increase transparency, such as the Securities Financing Transaction Regulation (SFTR) which requires firms to report securities financing transactions, and regulatory monitoring for concentration risks, cross border exposures and regulatory arbitrage. Other initiatives aim to revive the securitization market—by providing preferential regulatory capital treatment for investors, in particular bank and investment firm investors, in simple, transparent and standardized securitizations—as well as develop a harmonized approach to the regulation of new innovations such as crowdfunding platforms. Regulation of non-bank credit intermediation remains under consideration.

What Does This Mean?

- **Regulatory focus on asset management "activities" rather than individual firms**. Asset managers appear to have fended off so-called "systemically significant" designations for individual firms (at least by US regulators). The industry did so in part by urging regulators to focus on inspecting "activities" rather than firms. This report can be understood, at least in part, as a response from FSOC to that industry position.
- **Regulatory focus on the largest hedge funds**. Regulators are likely to focus on the largest hedge funds and have already developed screens to identify these funds with data from SEC Form PF. This is implicitly phrased in the report as its most urgent area of inquiry and also is the aspect that has generated the most press coverage.
- **Intensified data collection**. Regulators have two ways to address the information gaps that concern FSOC. One approach is to do more with existing data; for example, identifying which regulators have access to which

[3] The Turner Review was a report produced by the Financial Services Authority in 2009 under the leadership of Lord Turner who chaired the FSA at the time. The FSA has since been split into the Financial Conduct Authority and the Prudential Regulation Authority.

[4] The FSB announcement, made in March 2016, is available here.

kinds of data and doing more to synthesize and harmonize their different pools of data. The other approach is to simply request new data from regulated asset managers, their lenders, brokers, counterparties, etc.

- Until new reporting rules are implemented (and presumably those are coming), any additional information presumably will have to be sought through some combination of mandatory, voluntary or semi-voluntary requests by regulators—who might act singly (e.g., the SEC only) or in groups (e.g., the SEC and Federal Reserve contact a firm together). That in turn suggests targeted information sweeps of large hedge funds or other asset managers and/or the banks and broker-dealers that act as lending, derivatives or trading counterparties.
- Potentially, these sweeps could expand to derivatives clearinghouses and execution facilities.
- One also should not assume that rulemaking or other activity in this area will be confined to one side of the industry (e.g., that regulators will be satisfied with hedge fund leverage data developed only from banks or only from funds). A multi-pronged effort that comes at the relevant information from different directions seems likely.

- **Application of bank regulatory themes to funds**. A subtext to the report is a generalized concern that longstanding bank roles such as the provision of liquidity to markets and extensions of credit have "migrated" to less regulated funds. Liquidity, leverage, outsourcing and resolvability, themes in the report, are areas of keen interest to bank regulators post-financial crisis, so it is no surprise that they should be extended to funds here.
- **Political dynamics remain uncertain**. FSOC speaks for a broad group of regulators with varying agendas, interests and roles as relate to the asset management industry.
  - As an illustration of potentially differing views, the SEC press release accompanying the FSOC report reads as guarded. Chair White pointedly recites the agency's mantra that the SEC is the "primary regulator" in this sphere and goes on to say that: "Today's FSOC update should not be read as an indication of the direction that the SEC's final asset management rules may take."
  - Congress, under Republican leadership, generally has been skeptical of FSOC's asset management initiatives.

Summary of the Report

FSOC's report on the asset management industry builds on a related 2014 roundtable and request for comment and is FSOC's most comprehensive statement in this area to date. Key sections from the report, which address perceived risks associated with (1) liquidity and redemption; (2) leverage; (3) operational considerations; (4) securities lending; and (5) winding down and liquidation, are summarized below.

(1) <u>Liquidity and Redemption Risk</u>

In its discussion of liquidity and redemption risk, FSOC points to pooled investment vehicles and the risk of so-called "liquidity mismatch," focusing in particular on mutual funds, which usually allow investors to redeem daily while holding (and thus potentially needing to sell to satisfy a redemption) somewhat longer-term assets. For these funds, FSOC is especially concerned that large redemptions may occur during a stress event, with the fund and its non-redeeming investors potentially bearing significant costs in selling assets.

As an example of liquidity mismatch, FSOC points to the closure of high-yield bond fund Third Avenue Focused Credit Fund, which was unable to meet redemptions in December 2015 and ultimately closed. The report suggests the fund's portfolio was somewhat anomalous (less liquid and more heavily invested in distressed assets than competitors). FSOC also acknowledges that other high-yield bond mutual funds met redemption requests despite widespread redemption and selling pressures. FSOC nonetheless suggests that had the distress spread and led to other fund closures, it could have driven broader market instability.

Given its concerns, FSOC proposes the following steps:[5]

- *Adopt liquidity risk management practices*. Mutual funds, especially those in less-liquid assets, should adopt risk management practices to reduce the risk of not being able to meet redemptions during stress events;
- *Establish regulatory guidelines on liquidity*. FSOC suggests the establishment of regulatory guidelines addressing limits on mutual funds' ability to hold assets with very limited liquidity;
- *Enhance reporting and disclosures on liquidity*. FSOC proposes enhanced reporting and disclosures by mutual funds of their liquidity profiles and risk management practices;
- *Allocate redemption costs to redeeming investors*. Regulators should assess how mutual funds could allocate redemption costs to investors who redeem shares. FSOC believes allocating redemption costs in this way could reduce redemptions and the potential for widespread sales of less-liquid assets during stress events;
- *Disclose external sources of financing to the public*. FSOC supports public disclosure and analysis of external sources of financing (e.g., lines of credit and interfund lending), including events that trigger use of external financing. FSOC is concerned that draws on financing could create liquidity stress for broader markets; and
- *Consider other pooled investment vehicles*. Regulators should consider whether the above suggestions or other measures should be implemented for similar vehicles with daily redemptions (e.g., bank collective funds).

(2) Leverage Risk

After focusing on mutual funds in its liquidity discussion, FSOC turns to hedge funds in reviewing perceived leverage risks.[6] The report's headline finding regarding leverage merits a full quote, as follows:

> The relationship between a hedge fund's level of leverage and risk, and whether that risk may have financial stability implications, is highly complex. Leverage is not a perfect proxy for risk, but there is ample evidence that the use of leverage, in combination with other factors, can contribute to risks to financial stability. These risks are likely to be greater if an elevated level of leverage is employed; borrowing counterparties are large, highly interconnected financial institutions; counterparty margining requirements are limited or lax and positions are infrequently marked to market; the underlying assets are less liquid and price discovery is

[5] These proposals will be familiar to the mutual fund industry as they track pending SEC liquidity rules for mutual funds. Shearman & Sterling's summary of those proposals is available at http://www.shearman.com/en/newsinsights/publications/2015/10/liquidity-of-mutual-fund-portfolios.

[6] Mutual funds are not excused in full from the discussion of leverage. FSOC lends a few sentences to support pending SEC rulemaking that would reduce the ability of mutual funds to use derivatives as a source of leveraged exposure. Shearman & Sterling's summary of those rule proposals is available at http://www.shearman.com/en/newsinsights/publications/2016/01/sec-new-rules-for-registered-funds-and-bdcs.

poor; or other financial institutions with large positions are involved in similar trading strategies.

FSOC also concludes that:

- No single regulator has all the information necessary to assess the complete risk profiles of hedge funds.
  - FSOC stated as an example, that on SEC Form PF, hedge funds report the five counterparties with the greatest mark-to-market net counterparty credit exposure to the fund. Counterparties are regulated by various regulators and jurisdictions, so this exposure information is spread among different regulators.
- Leverage is concentrated among a subset of funds.
  - For example, the top ten funds in FSOC's data set sorted by net asset value (NAV) represent less than 10% of the NAV of all "qualifying hedge funds" (SEC Form PF refers to funds with at least $500 million in net assets as "qualifying hedge funds" or QHFs). However, when sorted by gross notional exposure (GNE), borrowings and notional value of derivatives, the top ten funds represent 28%, 35% and 49%, respectively, of such funds. When sorted by NAV, the top 100 funds account for 39% of the NAV of all qualifying hedge funds, but when sorted by GNE, borrowings and notional value of derivatives, the top 100 funds represent 66%, 73% and 83% of GNE, borrowings and notional value of derivatives, respectively, of such funds.
  - Based on gross assets, relative value, fixed-income arbitrage funds are some of the largest and most leveraged funds. FSOC notes that these funds' leveraged positions generally appear to be hedged, but the data is not sufficient for FSOC to assess the potential for liquidation of leveraged assets in a stress event.
- FSOC should have an interagency working group to assess potential risks with leveraged hedge funds.
  - The new working group is charged with using regulatory and supervisory data to evaluate the use of leverage in combination with other factors—such as counterparty exposures, margining requirements, underlying assets and trading strategies—for purposes of assessing potential risks to financial stability.
  - The working group also is charged with considering how and whether existing regulatory data might be augmented.
  - The working group is directed to report its findings to FSOC by the fourth quarter of 2016.

As a final note to the report's discussion of leverage, FSOC highlights data collected by the SEC under hedge fund Form PF filings—a form that was implemented just a few years ago and whose data has not yet seen much public discussion.[7] While that data underlies nearly all of FSOC's conclusions here, FSOC ultimately characterizes SEC Form PF as an imperfect starting point and encourages the development of better data.[8]

7 The SEC has been collecting these filings for several years and recently released its first analysis of Form PF data, which is available at https://www.sec.gov/news/pressrelease/2015-240.html.

8 That Form PF data is imperfect is widely known, with regulators privately acknowledging various complaints about the form, among them that filings are completed differently and under different assumptions by different firms, that leverage and notional exposure data is not effectively linked to or otherwise adjusted for risk measures, and that the form does not adequately address the diversity of hedge fund strategies.

(3) Operational Considerations

FSOC opens its discussion of operational risk with an observation that "the use of service providers and reliance on technology within the asset management industry calls for greater understanding of potential risks." The report reviews cybersecurity risks and then the broader question of whether disruption or failure of a service provider for cyber or other reasons could spread risk to broader markets.

As with other risk areas in the report, FSOC says that regulators do not have sufficient information to assess potential risks related to service providers. FSOC plans to engage with industry and market participants to better understand these risks and identifies the following as items it expects to look at in the future:

- Key functions performed by service providers;
- A review of the concentration of service providers;
- The level of outsourcing for particular services;
- The complexity of the infrastructure and activities supported by service providers;
- Whether operational disruptions among service providers could cause significant losses and disrupt markets; and
- Industry practices for managing these operational disruptions.

(4) Securities Lending Risk

FSOC observes that securities lending transactions present the potential for market risk as a result of a version of liquidity mismatch, this time associated with securities lending collateral pools. As a brief overview, securities lending transactions involve the temporary transfer of a security by one party (the lender) to another (the borrower) in exchange for collateral, which may be cash or other instruments. Per the report, the primary borrowers are hedge funds and broker-dealers, as well as their clients, while the primary lenders are large institutional investors, such as pension plans, insurance companies, sovereign wealth funds and endowments, as well as mutual funds and other pooled investment vehicles.

Collateral received by the lenders is often invested in collateral pools, and FSOC is concerned that lenders may not be able to redeem from those pools in time to return collateral on demand, with ripple effects to the borrowers and then broader markets. Again, FSOC observes that regulators have insufficient data, with information currently collected on a fragmentary basis by a variety of regulators and across multiple jurisdictions.

- The report thus encourages the expansion of a pilot program that collected data from major securities lending agents and recommends that rulemaking provide for permanent and standardized collection of data in this area.
- The report also encourages cross-border cooperative efforts given the risk that securities lending programs outside the United States could impact US markets.

(5) Wind-down and Liquidation Risk

FSOC says it continues to examine potential challenges and risks to financial stability that may arise in liquidation of an entity in the asset management industry, "particularly in circumstances of market stress, or involving an entity with a high degree of complexity and multi-jurisdictional operations." The report adds that, while there are limited precedents, a disorderly or abrupt liquidation of a significant, global asset manager can be expected to "amplify" other industry risks, notably those associated with liquidity, redemption or leverage in client accounts. The report cites specific potential triggering issues: "Challenges [associated with the disorderly liquidition of a manager] include the disruption or termination of critical service provider relationships, complications arising from affiliate insolvencies, the liquidation and re-establishment of over-the-counter derivative positions, and obstacles associated with the transfer of foreign assets." Looking ahead, FSOC supports planned (but not yet public) SEC rulemaking that would provide for structure and planning around the liquidation of asset managers.

We will continue to monitor and report on these developments.

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