December 31, 2014

FSOC, At It Again, Places Asset Managers in Its Crosshairs

By Jay G. Baris and Oliver I. Ireland

In seeking comment on potential risks to the U.S. financial system created by asset managers, the Financial Stability Oversight Council (FSOC) again places asset managers in its crosshairs. This crusade potentially can lead to unnecessary, costly and counterproductive regulation of asset managers. Comments are due February 23, 2015.

The FSOC request for comments casts a broad net, capturing financial institutions under a number of different regulatory regimes including registered investment advisers, banks and thrifts, insurance companies, commodity trading advisors, and commodity pool operators, through their management of separately managed accounts (SMAs) and "pooled investment vehicles" including registered investment companies, private funds (including hedge funds), bank collective investment trusts, and commodity pools. The focus of the request is the degree to which new products and activities may pose potential risks to the U.S. financial system.

FSOC acknowledges that the Securities and Exchange Commission (SEC), which is the primary regulator of investment advisers and investment companies, may address some of the risks identified in the request but notes that the SEC does not specifically focus on financial stability.

FSOC maintains that it has not prejudged the level of potential risks to financial stability posed by asset managers. Nonetheless, FSOC asks a lot of questions concerning liquidity and redemptions; leverage; operational risk; and "resolution" (that is, when an asset manager goes out of business) to identify potential risks to financial stability, and to consider potential responses.

- *Liquidity and redemptions.* FSOC wants to know whether pooled investment vehicles that provide for liquidity (think "mutual funds") have a "greater incentive to redeem" in times of market stress than if investors held the underlying securities directly. In other words, would redemptions by shareholders of pooled investment vehicles make "fire sales" of portfolio securities more likely than if the shareholders held the underlying securities directly?

Similarly, FSOC asks whether securities lending programs may increase fund redemptions when loans terminate and funds must repay cash collateral. FSOC acknowledges that pooled investment funds feature liquidity controls (e.g., lock-ups, redemption restrictions for private funds, and liquidity management techniques for mutual funds and ETFs), but it asks the questions nonetheless.

- *Leverage.* FSOC wants to know whether leverage by pooled investment vehicles (especially private funds) could increase the potential for forced asset sales, or expose lenders or other counterparties to losses or unanticipated market risks, and the extent to which these risks may have implications for U.S. financial stability.

- *Operational risks.* FSOC is seeking to assess potential risks to the U.S. financial system resulting from "operational risks," loosely defined as inadequate or failed processes or systems, human errors or misconduct, or adverse external events. In particular, FSOC is interested in:
    - risks that may be associated with the transfer of significant levels of client accounts or assets from one asset manager to another; and
    - risks that may arise when multiple asset managers rely on one or a limited number of third parties to provide important services, including, for example, asset pricing and valuation or portfolio risk management.
- *Resolution.* FSOC is interested in the extent to which the failure or closure of an asset manager, fund, counterparty or financial intermediary could have an adverse impact on financial markets or the economy.

In a December 11, 2014 speech, SEC Chair Mary Jo White announced regulatory initiatives for the asset management industry. (You can find our summary of White's speech here.) White reminded us that SEC has a three-fold mission: to protect investors; maintain fair, orderly, and efficient markets; and facilitate capital formation. The SEC's asset management initiatives, read together with FSOC's request for comment, effectively add a fourth mission: protecting against systemic risks to the securities markets and the U.S. financial markets as a whole. White politely stated that FSOC's efforts "complement" the SEC's oversight of asset managers.

Our take: Dodd-Frank has resulted in a dramatic shift in the way that new regulatory requirements can arise. The regulatory agencies have far more power to initiate new requirements so that policy debates are now focused more on the regulatory agencies than the halls of Congress. For example, with its sweeping power to designate "systemically important financial institutions" (SIFIs), FSOC can subject nonbank financial institutions to bank-like regulation by the Federal Reserve Board.

But SIFI designation is only one arrow in FSOC's quiver. FSOC can also recommend to the primary regulators new or heightened standards for and safeguards related to activities, regardless of whether or not those activities are conducted by SIFIs, that FSOC believes create or incur risks of significant liquidity, credit, or other problems spreading through the U.S. financial companies and markets. In recommending new or heightened standards for activities, FSOC is not required to find that the financial institution poses a threat to U.S. financial stability. Although the primary regulators are not required to accept them, FSOC's recommendations trigger a requirement for the primary regulators to respond to the recommendations in reports to Congress. FSOC recommendations also can be expected to trigger other initiatives by the primary regulators to show that they are addressing the issues identified by FSOC, even if the primary regulator does not follow the FSOC recommendations.

The issue of the potential risk posed by asset managers has persisted since the days of the global financial crisis. FSOC's latest effort to explore the issue through crowd sourcing should not be ignored. Potentially affected industries should take the opportunity to educate FSOC on the issues in order to avoid recommendations for unnecessary or inappropriate standards or safeguards. Affected industries and market participants should not limit themselves to responding to the specific questions posed; rather, they should proactively address potential regulatory concerns whether or not specifically identified by FSOC. Similarly, affected industries and market participants should not limit themselves to formal comments. The potential costs to assets managers of dealing with new bank-like regulatory requirements are too high.

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