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Asset Management Industry Regulation Remains In Flux

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Thomas P. Vartanian   Robert H. Ledig

As U.S. and global regulators continue to evaluate the potential impact, if any, of the asset management industry and its products and activities on financial stability, the regulatory standards that will ultimately be applied remain in flux.

The Bottom Line

U.S. and international regulators have been refining their views as they have considered the asset management business, its role in the financial stability debate, and how it should be regulated in the future. The regulators' initial pronouncements and studies left many experts surprised, if for no reason other than these statements and studies appeared to lack basic supporting facts and analyses. A flood of responses and analyses were submitted by the industry in the subsequent blowback. Several years later, regulators have taken a step back — or more appropriately, a sidestep — toward a more disciplined and rigorous assemblage of facts, law and careful research.

Both U.S. and global regulators have, at least temporarily, moved away from considering designation of asset managers and asset management vehicles as systemically important financial institutions (SIFIs), and instead seemed focused on industrywide prudential regulations. At least in the United States, the dynamics of an election year will likely impact how regulators proceed with regard to these issues.

U.S. Financial Stability Oversight Council Actions

In its role as the entity that designates nonbank financial companies as SIFIs, the FSOC has moved away from potential SIFI designations of asset managers or asset management vehicles, in favor of studying the financial stability implications of the sector. The course leading to this point may tell something

about where it ends.

While the FSOC was considering potential asset management SIFI designations, it decided to engage in an activities-based initiative. In November 2012, the FSOC proposed its first prudential regulation recommendations. If finalized, these would have been directed to the U.S. Securities and Exchange Commission and would have recommended a number of options that the SEC could take to address financial stability concerns related to money market funds (MMFs).[1]

In September 2013, the U.S. Office of Financial Research, acting at the request of the FSOC, issued a Report on the Asset Management and Financial Stability (OFR report). The OFR report, which suggested that the asset management industry could pose a threat to financial stability under certain circumstances,[2] was sharply criticized by industry participants on the grounds that it failed to adequately distinguish the risk characteristics of different types of asset management vehicles, or take adequate steps to obtain public input. The SEC expressed a number of concerns regarding the OFR report — and further took the unusual step of soliciting public comment on it.

In the wake of strong critical reaction to the OFR report, the FSOC moved in the direction of seeking industry and public views on the financial stability implications of the sector. In May 2014, the FSOC held a public forum on asset management in which government officials and industry representatives presented their views. In early November 2014, representatives of the FSOC held closed door meetings at the U.S. Department of Treasury with a broad range of asset management and insurance industry representatives, concerning the transparency and processes employed by the FSOC.[3]

That was followed in December 2014 by a notice seeking comments on asset management products and activities (FSOC notice).[4] The FSOC notice indicated that the FSOC had not reached any conclusions regarding the potential financial stability threats posed by the asset management industry. The FSOC notice sought input on a broad range of questions related to: (i) liquidity and redemptions; (ii) leverage; (iii) operational risk; and (iv) resolution. In response, a substantial number of comments were submitted. At its September 2015 meeting, the FSOC indicated that it was engaged in an ongoing process of evaluating the asset management industry.

SEC Actions

The SEC — as the primary U.S. regulator of asset managers and asset management vehicles — has historically focused on investor protection and the fair, efficient and orderly operation of the markets, rather than on prudential regulation or financial stability concerns. The advent of the FSOC, and the emergence of the Financial Stability Board as a global standard-setting entity, has raised the potential of an encroachment and/or pressure on the SEC's regulatory role with regard to the asset management industry. These developments potentially could lead to FSOC designation of asset management entities as SIFIs subject to prudential regulation by the Federal Reserve Board, or pressure on the SEC to impose activities-based prudential requirements.

After the FSOC's first activities-based move — its November 2012 recommendations regarding MMFs — the SEC proposed substantial revisions to its MMF regulations in June 2013, and adopted these revisions in July 2014 (including an end to stable-value MMFs, other than government funds, being offered to non-retail investors).[5]

In December 2014, SEC Chairwoman Mary Jo White signaled that the SEC would be reviewing its regulation of asset management entities under the Investment Company Act of 1940 and the

Investment Advisers Act of 1940, presumably at least in part to demonstrate the SEC's focus on financial stability-related concerns and to potentially discourage further FSOC actions.[6] She indicated that the SEC would, among other things, be reviewing liquidity, the use of derivatives and operational risks. At the same time, she stressed that asset management regulation must strike a balance between reducing undue risks and preserving the principle of reward for risk that is at the center of the capital markets.

As part of the SEC's risk management initiative, in September 2015 the SEC issued proposals intended to: (i) limit the risk that open-end funds (including mutual funds and exchange-traded funds) would be unable to meet investor redemption requests; and (ii) minimize the dilutive impact of shareholder transactions.[7] The SEC referred to the FSOC's notice, and indicated that the SEC's proposed rule had taken into account comments submitted to the FSOC. Reflecting on the relation between its proposal and financial stability concerns, the SEC offered the following observations:

As the primary regulator of the U.S. securities markets, we are proposing rules today that focus on mitigating the adverse effects that liquidity risk in funds can have on investors and the fair, efficient and orderly operation of the markets. To the extent there are any potential financial stability risks from poor fund liquidity management, our proposal may mitigate those risks as well (footnote omitted).

Financial Stability Board

In January 2014, the FSB (established by the G-20 following the 2008 financial crisis to protect global financial stability), together with the International Organization of Securities Commissioners, issued a proposed methodology for designating nonbank, noninsurer entities — including asset managers and asset management vehicles — as global systemically important financial institutions (G-SIFIs).[8]

In March 2015, the FSB and IOSCO issued a revised proposal that would have established thresholds for review of public and private investment funds and asset managers for potential designation as G-SIFIs.[9] If implemented, such a process would have relied on national regulators to propose home country entities for ultimate G-SIFI designation. This, in turn, could have placed significant pressure on national regulators, such as the FSOC, to evaluate potential SIFI status for G-SIFI designated entities.

In June 2015, IOSCO announced it had concluded that a full review of asset management activities and products that may pose systemic risks should take precedence over further work on the methodologies for the identification of G-SIFI asset management entities. IOSCO indicated that work on its G-SIFI methodologies should be reassessed after the completion of its broader review.[10]

In July 2015, the FSB stated that it too had decided to wait to finalize its G-SIFI asset management designation methodologies until the FSB's review of potential financial stability issues associated with asset management entities and activities is completed.[11] The FSB expects to develop activities-based policy recommendations by spring 2016 and, together with IOSCO, will conduct further analyses and finalize the G-SIFI asset management methodology. Their focus will be on any residual entity-based sources of systemic risk from distress or disorderly failure that cannot be effectively addressed by market-wide activities-based policies.

There are many challenges associated with reaching an international consensus on appropriate activities-based policies, as well as their potential implementation in diverse national regulatory systems. Similar challenges would apply to implementation of G-SIFI designation-related prudential standards, particularly where a U.S.-based asset management entity has not been designated as a SIFI.

—By Thomas P. Vartanian and Robert H. Ledig, Dechert LLP

Thomas Vartanian is a partner in Dechert's Washington, D.C., office. He is a former general counsel of the Federal Home Loan Bank Board and the Federal Savings and Loan Insurance Corporation, and a former special assistant to the chief counsel in the Office of the Comptroller of the Currency. He has also served on the staffs of theAdministrative Conference of the United States and the Depository Institutions Deregulation Committee.

Robert Ledig, also a partner in Washington, is a former attorney in the office of the general counsel of the Federal Home Loan Bank Board, where he was responsible for regulatory policy matters.

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[1] Dechert OnPoint, U.S. Financial Stability Oversight Council Proposes Recommendations for Money Market Reform.

[2] Dechert OnPoint, U.S. Office of Financial Research Issues Report on Asset Management and Financial Stability.

[3] Dechert attended that meeting as counsel to an industry trade association.

[4] Dechert OnPoint, U.S. Financial Stability Oversight Council Requests Comments on Financial Stability Implications of Asset Management Activities.

[5] Dechert OnPoint, SEC Proposes Sweeping Amendments to Rules Governing Money Market Funds; Dechert OnPoint, U.S. SEC Approves Sweeping Amendments to Rules Governing Money Market Funds.

[6] SEC Chair Mary Jo White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Dec. 11, 2014.

[7] Dechert OnPoint, SEC Proposes New Liquidity Management Rules for Mutual Funds and ETFs.

[8] Dechert OnPoint, FSB and IOSCO to Consider Standards for Treating Investment Funds and Asset Managers as Global Systemically Important Financial Institutions.

[9] Dechert OnPoint, FSB/IOSCO Issue Second Proposal on G-SIFI Designation Methodology for Investment Funds and Asset Managers.

[10] OICU-IOSCO Media Release, IOSCO: Meeting the Challenges of a New Financial World, June 17, 2015.

[11] FSB Press Release, Next Steps on the Assessment Methodologies for Non-Bank Non-Insure Global Systemically Important Financial Institutions, July 30, 2015.

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