Regulatory brief

June 2014

A publication of PwC's financial services regulatory practice

Asset manager SIFI designation: Enter SEC

Overview

Asset managers who tuned in to last month's Financial Stability Oversight Council's ("Council") conference regarding the industry's potential systemic importance heard no surprises. The US Treasury Department and regulators did not defend the September 2013 report by the Office of Financial Research ("OFR Report") which had suggested that the industry's activities as a whole were systemically important.[1] Rather, officials continued to emphasize that they hold no predisposition toward designation. It was left to academics at the conference to argue that asset managers could pose systemic risk.

Although asset managers may take some comfort in the strength of the arguments put forth by industry panelists against the academics' hypothetical possibilities of systemic risk, the conference itself will have modest impact on whether any asset managers are ultimately designated as systemically important financial institutions ("SIFIs"). The conference is better viewed as an effort at public transparency by the Council which has lately been subject to bipartisan criticism for its holding private meetings, and which has received widespread criticism of the OFR Report (partly fueled by the Securities & Exchange Commission ("SEC") soliciting public comment on it).

In the near term the focus is on the SEC, whose regulatory actions are the industry's best chance at sidestepping SIFI designation for a few of its largest members. SEC Chair Mary Jo White has signaled a shift toward more prudential supervision by suggesting stress tests and calling for more oversight and disclosure obligations. Norm Champ, the SEC's Director of Investment Management, recently added that the SEC will propose a rule to obtain more data from mutual funds and ETFs (somewhat similar to what the SEC has been receiving from money market funds and private funds).

The SEC commissioners' advocacy (and industry's) has also been proactive. A majority of SEC commissioners have criticized the OFR Report, while legislators from both parties have urged the Council not to use the OFR Report as the basis for designation. Furthermore, Chair White recently publicly disagreed with US Treasury Under Secretary Mary Miller's statement that the industry was "overreact[ing]" to the possibility of SIFI designation. Chair White stressed that the Council needs "requisite expertise" before moving forward and that asset managers are different from banks.

This **Regulatory Brief** provides our view that (a) asset manager SIFI designations will not occur this year, (b) the SEC's upcoming money market reform rule will play an important role in the debate, and (c) the Council is facing increased political scrutiny as a result of the designation process.

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Background

In 2012, the Council issued its final rule on designating nonbank financial companies as systemically important.[2] The following year, three nonbanks were designated as SIFIs (GE Capital, AIG, and Prudential),[3] and a fourth (MetLife) was placed in the final stage ("stage 3")[4] of review last July where it has since remained.[5]

The Council has long asserted that it would consider whether certain asset managers pose systemic risk. The Council asked for the OFR Report as part of that effort. However, the OFR Report garnered few supporters after being extensively criticized by industry, lawmakers, and SEC commissioners.

Criticisms of the OFR Report have included that it fails to demonstrate an understanding of how asset managers differ from other financial institutions and that it lacks an appreciation of the extent to which asset managers are already effectively regulated. In an unusual move, the names of two large asset managers were leaked to the press last month after allegedly entering stage 2,[6] which may have been intended to pressure the SEC towards regulatory action sooner rather than later.

As the US debate has unfolded, the Financial Stability Board and the International Organization of Securities Commissions issued a consultative document in January 2014 proposing methodologies for identifying globally active systemically important investment funds.[7] Like the OFR Report, the consultative document explains why designation may be necessary, but it does not address which firms may be designated or what additional regulations would apply.

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[1] See PwC's *Regulatory Brief, Nonbanks SIFIs: Up next, asset managers* (October 2013).

[2] See PwC's *Regulatory Brief, The FSOC finalizes rules and guidance for designating nonbank financial companies as SIFIs* (April 2012).

[3] See PwC's *Regulatory Brief, Nonbank SIFIs: FSOC proposes initial designations – more names to follow* (June 2013).

[4] During stage 3 the OFR normally gathers privately held information from the nonbank under consideration, unlike stage 2 which relies on an analysis of public information.

[5] See PwC's *Regulatory Brief, Systemically important insurers: Global follows US lead* (July 2013).

[6] In the case of insurers, the firms' names remained private through the end of stage 2.

[7] See PwC's *Regulatory Brief, Nonbank SIFIs: No solace for US asset managers* (February 2014).

Hurdles before SIFI designation

No asset manager will be proposed for designation this year, considering the Council's many obligations including reviewing the status of MetLife. Furthermore, recalling the historical timeline, the Council took about nine months to advance the insurers from stage 3 of the process to designation.

It is also important not to underestimate the burden imposed on the Federal Reserve ("Fed") to develop more tailored prudential frameworks for different industry sectors. For example, the Fed in establishing initial capital rules for Savings and Loan Holding Companies (SLHCs) has decided to treat separately those SLHCs that are insurers or commercial firms. Further complicating these technical and policy matters, Dodd-Frank's "Collins Amendment" may be interpreted to mandate that minimum capital requirements apply across all covered holding companies, including those of the designated nonbanks.[8] These implementation difficulties suggest a gradualist approach which is consonant with the Council's desire to be a permanent part of the US regulatory framework.

The money market tell

In addition to the SEC's efforts to enhance oversight of asset managers overall, a particular telltale worth watching is the outcome of money market reform. The Council has long expressed its desire that the SEC further enhance regulation in this area.[9] However, the SEC has yet to act on a final rule.[10] Among those who favor designation of asset managers, the potential systemic risks associated with money market funds are often pointed to first, as was the case at the Council's conference.

We believe that the SEC will finalize its money market reform rule this summer or fall. In doing so, the SEC and industry can point to an ability to regulate the asset management industry in the absence of SIFI designations. Chair White indicated the importance of this reform by announcing shortly after the Council's conference that the SEC is focused on producing robust, workable money market rules "in the very near term."

The key question is whether the Council will view the final money market rule as going far enough.

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[8] The US Senate has recently passed a bill to alleviate these complications, but the House of Representatives has yet to do so.

[9] See PwC's *A Closer Look, Money market reform in flux* (October 2012).

[10] See PwC's *A Closer Look, Money market funds: The SEC's long awaited proposal* (July 2013).

The Council under scrutiny

While the SEC has been under pressure to act on money market reform, the Council has been under pressure of its own because the OFR Report and asset manager designation process have invited more political scrutiny.

In the past few months, lawmakers from both parties have criticized the Council for lack of transparency, requesting that the Council reveal the models, data, and analysis used to evaluate systemic risk, and explain in detail how identified risks would be better mitigated by subjecting an asset manager to Fed supervision instead of stricter SEC oversight. Democratic and Republican SEC Commissioners, beyond Chair White, have also been seeking to attend Council meetings, while Republican lawmakers introduced legislation addressing a range of concerns with the Council.

The Council has so far responded with some transparency improvements, including providing seven days of advanced notice of all meetings and publishing redacted meeting minutes. These modest changes are unlikely to satisfy those legislators and those in industry concerned with the highly discretionary process and impact of designation.

What to look for next

Pressure on both the Council and the SEC – along with the policy and political difficulties in actually making designations and then following up with effective regulation – appears to create an opportunity for a de facto compromise that results only in heightened asset manager supervision by the SEC.

However, we would be surprised if the Council did not propose two to four for large asset managers for designation. There is too strong a desire by the Council to have a regulatory and supervisory window into all major financial industry sectors to better understand the dynamics of size, interconnectedness, and complexity across financial markets in times of stress or full-blown crisis.

This has been described as a Noah's Ark approach to designation which is not unreasonable from the Council's perspective given the wide range of players in the markets, including those in the unregulated or less regulated "shadows." The burden on the Fed will be substantial to tailor requirements across these players, but the Council will likely proceed in bringing them under the regulatory tent.

If designated by the Council as a SIFI, a firm will be subjected to Fed supervision that may include risk-based capital or leverage requirements, liquidity requirements and liquidity risk management, annual supervisory-run stress testing, and resolution planning. We expect that any such requirements would ultimately be tailored to asset managers' business model, especially given that final enhanced prudential standards rule ("EPS") for banks issued in February explicitly stated the regime did not apply to nonbank SIFIs.[11] The EPS final rule states that the Fed will apply EPS to such companies by rule or order, so we would expect case-by-case orders by the Fed. The Fed will provide designated nonbanks with notice and opportunity to comment prior to determining exact standards.

For designated asset managers, the outcome will be a learning curve that is long, costly, and disruptive. Firms should keep the following events in view as they watch the designation debate unfold:

- The results of money market reform by this summer or fall
- Whether MetLife is ultimately designated in the coming months
- If any asset managers move to stage 3 within the next year
- Whether any US asset managers are implicated by the global designation process

[11] See PwC's *First Take: Enhanced Prudential Standards* (February 2014).

Additional information

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