Regulatory brief

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Asset managers: FSOC stands down, SEC stands up

Overview

In August, the Financial Stability Oversight Council (FSOC) announced that rather than designating individual asset managers as systemically important financial institutions (SIFIs), it would focus on examining systemic risk posed by asset managers' products and activities. This shift in focus followed a contentious public debate between FSOC and the SEC, during which the SEC strongly asserted its position as the industry's primary regulator and echoed the industry's views that large asset managers are fundamentally different from large banks and insurance firms.

Although FSOC's shift away from designating large asset managers marks a significant victory for the SEC and the industry, the move is by no means the end of increased regulatory scrutiny. FSOC and other regulators now expect the SEC to assume a prudential supervisory role, in addition to exercising its traditional mandate of investor protection.

In the short-run, enhanced supervision by the SEC is likely to be felt by firms through the SEC's existing examination process. Large firms in particular should be prepared for more probing questions from SEC examiners, e.g., around leverage, liquidity, and risk management. In the long-term, these changes will likely be supplemented by rulemakings that enhance existing requirements and introduce new ones (e.g., stress testing and perhaps resolution planning).

Parallel to the US debate, the Financial Stability Board (FSB) is also re-focusing its approach on asset managers' products and activities, signaling that the FSB is also moving away from designating individual asset managers as systemically important. However, we do not expect that the FSB's actions will have a significant impact on US firms, as US regulators seem determined to take their own path (Treasury Secretary Jack Lew has emphasized that the FSB's process is distinctly separate from FSOC's).

EU regulations, however, may impact US asset managers in a more substantial way. Specifically, the Alternative Investment Fund Managers Directive (AIFMD) may not only discourage US firms from marketing their funds in the EU (to avoid compliance complexity), the directive could also ultimately serve to inform future US rulemaking for addressing risks within the industry.

This **Regulatory Brief** (a) provides background on the ongoing debate regarding the systemic risk potentially posed by asset managers, (b) outlines our view of the next steps the SEC will likely take, and (c) assesses the impact of global regulatory efforts on US asset managers.

Background

In 2012, FSOC issued a final rule on designating nonbank SIFIs.[1] The following year, three nonbanks were designated as SIFIs, including two insurers (AIG and Prudential). A third insurer has since been proposed for designation (MetLife), and FSOC held a hearing on November 3rd to address the firm's contestation of its designation.

Despite quickly moving forward on insurer SIFI designations, FSOC has struggled with how to address systemic risks potentially posed by asset managers. In 2012, FSOC asked the Treasury Department's Office of Financial Research (OFR) to prepare a report on the topic. The OFR's report was published in September 2013, and suggested that certain asset management activities may transmit, amplify, or be a source of systemic risk.[2]

However, the OFR's report stopped short of providing FSOC with clear metrics for designating asset managers as SIFIs or even confirming that designation would be a suitable regulatory tool to address asset manager risks. The industry used the report to mount a substantial lobbying effort, utilizing comment letters on the report and industry meetings to oppose the rationale for designation.

Such vocal opposition by the industry and others substantially raised the political cost for FSOC to move forward. Asset managers also used an FSOC-sponsored conference held in May 2014 as an opportunity to push back against views that the distress of a single asset manager or fund could pose systemic risk. These views were echoed by several SEC commissioners who publically derided the exercise of designating fund complexes, and criticized FSOC for lacking capital market expertise and having an opaque designation process.

A window into FSOC's latest perspective on SEC jurisdiction over asset managers emerged when the SEC issued its long-debated final money market rule in July 2014, after some conflict with FSOC on the issue over the past few years.[3] Importantly, FSOC did not publicly challenge the SEC's approach, serving as an early indication that FSOC may also defer to the SEC on asset manager regulation more generally.[4] SEC Commissioner Kara Stein's stance is worth watching going forward in this regard, as she was the only Democratic commissioner to vote against the money market rule (favoring a floating NAV over gates) and has been more welcoming of FSOC's role in addressing systemic risk issues.

Finally, the practical constraints of Dodd-Frank also played a role in FSOC's changed approach to asset manager regulation. Designating specific asset managers as systemically important would add to the burden of the Federal Reserve (Fed) to tailor its prudential framework to nonbank SIFIs, especially given the capital floors imposed by Dodd-Frank's "Collins Amendment."[5] Even if the currently stalled efforts to revise the Collins Amendment for insurers are finalized in the new Republican-controlled Congress (as we believe is under serious consideration),[6] a broader fix to also include asset managers would require more extensive legislation.

As this US debate has ensued, the FSB and the International Organization of Securities Commissions (IOSCO) issued a consultative document in January 2014 proposing methodologies for identifying globally active systemically important investment funds.[7] However, the FSB has recently signaled that it too is likely moving away from designating individual funds or fund complexes as systemically important.

SEC raises its hand

As part of FSOC's deliberations, the SEC asserted its lead role as the industry's primary regulator. Chair White emphasized in public that the SEC has the authority and expertise to address potential systemic risk posed by asset managers.

This assertion has been supported by recent changes within the SEC. The SEC's Division of Economic and Risk Analysis recently created a Risk Assessment Office (RAO) to centralize and expand its risk analysis efforts that support the agency's policy, rulemaking,

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

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

[3] See PwC's *First take: SEC's money market reform* (July 2014); *A closer look, Money market reform: The SEC's long awaited proposal* (July 2013); and *Regulatory Brief, FSOC moves swiftly on money market reform* (November 2012).

[4] We suggested in a prior brief that FSOC's reaction to the SEC's final money market rule may provide a window into whether FSOC would move forward with asset manager SIFI designations. See PwC's *Regulatory Brief, Asset manager SIFI designation: Enter SEC* (June 2014).

[5] The Collins Amendment mandates that minimum capital requirements apply across all firms designated as SIFIs, including nonbanks.

[6] See PwC's *First take: The new Republican Senate* (November 2014).

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

examination, and enforcement functions. We expect the RAO to further intensify the focus on identifying asset managers that demonstrate suspicious performance patterns and other unusual characteristics relative to key benchmarks.

In addition, the SEC's Division of Investment Management has created a Risk and Examinations Office (REO), which now manages an informal "Top 20" hedge fund program to focus monitoring efforts on the largest, most interconnected firms. In time, we expect REO's efforts to lead to more specific and substantive disclosures, including more detailed reporting to Congress on how Form PF is being utilized by FSOC to monitor systemic risk.[8]

Near-term impact of SEC's enhanced supervision

In the near-term, we expect the SEC to implement a more robust oversight agenda, primarily through its existing examination program and oversight authority. In particular, firms managing large mutual fund complexes and hedge funds should expect more probing questions from SEC examiners and REO staff on issues such as strategy, exposures, leverage, liquidity, and fat tail-risks (in addition to the SEC's usual focus on reasonable compliance procedures being in place).

Mutual fund complexes are likely to face additional questions related to how centralized shared services are delivered and managed across managed funds, rather than just questions on individual funds' investor protection. Inquiries about the potential impact of certain stresses (e.g., concurrent redemption across several funds) are also likely.

In addition, the progress by the SEC and OFR toward better utilizing Form PF data means that large hedge fund managers will likely face increasingly more sophisticated questions. We expect these questions (e.g., around risk management and macroeconomic assumptions made in portfolio stressing) to inform future SEC rulemaking and examination efforts.

SEC's long-term rulemaking agenda

In the long-term, the SEC could step up its supervision of asset managers through new rules to enhance existing requirements (e.g., around disclosures) and introduce new mandates (e.g., stress testing and resolution planning).

Enhanced requirements are likely to be proposed before any new mandates, as they can build upon existing frameworks. For example, we expect a proposal to revise Form N-SAR (the current semi-annual report for registered investment companies) within the next year. Based on statements by SEC officials, the proposal may require more detailed holdings, exposure, and risk management information. These could be reportable on a monthly or quarterly basis by mutual funds and ETFs, similar to what is already required from money market funds and large hedge funds, respectively.

With respect to new requirements, little is known about what exact shape they may take or to which entities they will apply. However, the SEC's rulemaking efforts are likely to be influenced by FSOC's new focus on the transmission of systemic risk at the activity or product level, and we expect FSOC to solicit public comment on its new approach in the coming months. We would expect the SEC's new requirements to address FSOC's concerns around:

- The use of leverage by hedge funds, including synthetic leverage via OTC derivatives;
- Mutual funds that utilize derivatives to enhance returns, and levered and synthetic ETFs;
- Asset managers' bank-like functions, such as the provision of implicit or explicit guarantees, or activities that involve credit intermediation outside the formal banking sector; or
- Risk management standards around counterparty concentration limits, operational planning, and key man risks for hedge funds.

Impact of international efforts on US asset managers

Parallel to the US debate, the FSB and EU are also working to address risks posed by asset managers. The EU is notably ahead of the US and FSB, with regulations for stricter supervision of alternative asset managers under AIFMD already in place.[9] AIFMD addresses industry risks by imposing capital and liquidity requirements on alternative fund managers, and fund leverage restrictions that may be implemented under the advice of the European Systemic Risk Board.

Despite this conceptually advanced framework, national implementation of AIFMD across the EU has been

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[8] Under Dodd-Frank, the SEC must provide Congress with an annual readout of how Form PF is being utilized for systemic risk monitoring by FSOC as well as to support SEC examinations of hedge funds. These more detailed disclosures could eventually be similar to the UK's semi-annual Hedge Fund Survey, which includes aggregate leverage trends amongst the firms supervised by the Financial Conduct Authority.

[9] See PwC's *Regulatory Brief*, *EU's AIFMD: Impact on US Asset Managers* (June 2013).

uneven, creating challenges especially for non-EU managers. For example, although European managers may market their funds to professional investors across the EU via AIFMD's passporting regime, this option is not yet available to non-EU managers. As a result, non-EU managers must comply with the national laws of each EU member state where the manager seeks to market its funds, which includes separate disclosures and reports in the local language. With the extension of the passporting regime to non-EU managers still uncertain, the myriad of AIFMD requirements has left few options for smaller US asset managers. Thus, US firms that seek to avoid these issues must either cease marketing in the EU entirely, or allow EU investors only through reverse solicitation.

Globally, as part of its mandate to reduce systemic risks posed by SIFIs (endorsed by G-20 leaders in 2010), the FSB has been developing methodologies for identifying systemically important asset managers, similar to existing global regimes for insurers and banks. The FSB and IOSCO issued a joint proposal earlier this year, setting out quantitative measure to assess fund-level systemic risk based on a fund's size, interconnectedness, substitutability, complexity, and cross-jurisdictional presence. However, similar to FSOC, the FSB has since changed its assessment focus from individual funds to products and activities, and will likely issue a second proposal for public comment around the end of 2014.

We believe the FSB's effort on this front is now less critical, as it is unlikely to influence the domestic debate in the US. US regulators will want to remain in the driver's seat, especially given that the world's largest mutual fund complexes are all US firms and the US and UK are home to most of the world's largest hedge funds.

In conclusion, SIFI designation of a US asset manager is off the table for at least a while. Instead, we expect heightened SEC monitoring and examination in the near-term. Of course, the possibility of an impactful market event, such as the catastrophic failure of a large, levered hedge fund, casts a constant shadow over any complete certainty that regulators won't call for more sooner than expected.

Additional information

For additional information about this Regulatory Brief or PwC's Financial Services Regulatory Practice, please contact:

Dan Ryan
Financial Services Advisory Leader
646 471 8488
daniel.ryan@us.pwc.com

Shyam Venkat
Partner, Financial Services Risk Advisory
646 471 8296
shyam.venkat@us.pwc.com

Troy Paredes
Senior Strategy & Policy Advisor
202 309 2850
troy.a.paredes@us.pwc.com

Armen Meyer
Director of Regulatory Strategy
646 531 4519
armen.meyer@us.pwc.com

Contributors: Brett Janis, Scott Weisman, and Roozbeh Alavi.

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