Client Update

FSOC Gets Curious: Are Asset Managers' Products and Activities Creating Systemic Risk?

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In connection with its ongoing evaluation of the asset management industry, the U.S. Financial Stability Oversight Council (the "FSOC") recently issued a notice seeking public comment (the "Notice") on whether asset management products and activities may pose potential risks to U.S. financial stability.[1] Specifically, the FSOC seeks comment on the systemic risks posed by: (1) liquidity and redemption practices; (2) use of leverage; (3) operational functions; and (4) resolution, *i.e.*, the extent to which the failure or closure of an asset manager, investment vehicle or an affiliate could have an adverse impact on financial markets or the economy. Comments on the Notice must be submitted by February 23, 2015; and we are working with several clients to prepare and submit such comments. This client update summarizes some of the FSOC's key concerns and questions outlined in the Notice.

BACKGROUND

The FSOC has long been considering the potential systemic risks presented by asset managers. Most notably, in 2013, at the request of the FSOC, the U.S. Treasury Department's Office of Financial Research (the "OFR") published a report, "Asset Management and Financial Stability," citing several potential vulnerabilities: (1) "reaching for yield" and herding behaviors; (2) redemption risk in pooled investment vehicles; (3) leverage; and (4) firm-level (or fund complex-level) risk management and operations (including management of reputational risks and correlated risks in different asset management products). The OFR theorized that these vulnerabilities could lead to disruptions in markets caused by fire sales; adversely affect counterparties, creditors, service providers

[1] The Notice is available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.

and investors; and affect other business lines of the asset manager that are interconnected with the asset management business.

The OFR report was met with substantial criticism from the public, the asset management industry and others.[2] Apparently in response to these comments, in July 2014 the FSOC announced that it would shift its focus to evaluating activities and products of the asset management industry rather than particular asset management firms. In particular, the FSOC directed its staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry.

The Notice reflects the FSOC's desire to "understand whether and how certain asset management products and activities could pose potential risks to the U.S. financial stability" and whether "asset management products or activities could create, amplify, or transmit risk more broadly in the financial system in ways that could affect U.S. financial stability." Perhaps in response to some of the criticisms leveled at the OFR report, the Notice raises questions with respect to these activities and notes that the FSOC "has not made any determination regarding the existence or nature of any potential risks to U.S. financial stability discussed in" the Notice.[3]

The questions raised by the Notice are worth considering in light of a recent speech by SEC Chair Mary Jo White, which outlines three regulatory initiatives that also appear to be aimed at some of these concerns.[4] Proposals to implement these initiatives will likely be considered by the SEC in the coming year.[5]

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2 The U.S. Securities and Exchange Commission ("SEC") requested public feedback on the OFR report, which is *available at* http://www.sec.gov/comments/am-1/am-1.shtml.

3 In parallel to the FSOC's and SEC's efforts, the Financial Stability Board (the "FSB") announced in September 2014 that it will issue a second public consultation to follow its January 2014 consultation on proposed methodologies for identifying systemically important non-bank non-insurer financial institutions, which includes asset managers. See Press Release, FSB Plenary Meets in Cairns, Australia (Sept. 18, 2014), *available at* http://www.financialstabilityboard.org/2014/09/pr_140918/. We understand that, like the FSOC's Notice, the FSB's forthcoming consultation reportedly will focus on asset management activities and ask about particular risks that certain asset management activities may present to financial stability. It is not yet clear how the FSOC's, SEC's and FSB's efforts will overlap or be coordinated.

4 *See* our Client Update: "Planning for the Worst": The SEC Plans New Regulations for the Asset Management Industry, *available at* http://www.debevoise.com/insights/publications/2014/12/planning-for-the-worst.

5 *See* Unified Agenda of Regulatory and Deregulatory Actions (Fall 2014) (initiatives relating to the use of derivatives by investment companies, fund liquidity management

THE FSOC NOTICE

The Notice focuses on the asset management activities of registered investment advisers, banks and thrifts, insurance companies, commodity trading advisors and commodity pool operators and their "investment vehicle" products, including separately managed accounts and pooled investment vehicles (*e.g.*, registered investment companies, private equity funds, hedge funds, other private funds, bank collective investment trusts and commodity pools). In a number of instances, the Notice specifically focuses on potential risks presented by practices in the securities lending market, as discussed in more detail below.

Liquidity and Redemption

- The FSOC is "focused on exploring whether investments through pooled investment vehicles that provide redemption rights, as well as their management of liquidity risks and redemptions, could potentially influence investor behavior in a way that could affect U.S. financial stability differently than direct investment."
- Specifically, the FSOC is interested in exploring the ways in which investors in some pooled investment vehicles may have incentives to redeem earlier than other investors as a result of redemption costs being borne partially by remaining investors (because, for example, relatively less liquid assets would be available to be sold to meet redemption requests of such remaining investors). Along these lines, the FSOC appears to be interested in exploring ways to reduce investors' incentive to redeem early through the asset manager's management of liquidity.
- In addition, the FSOC asks whether the potential for terminations of securities loans that would trigger redemptions from cash collateral reinvestment vehicles poses any distinct financial stability concerns. The specific activity-based nature of this query suggests that securities lending is a particular area of focus for the FSOC.[6]

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programs, transition plans for investment advisers, stress testing for large asset managers and large investment companies and information reporting by SEC-regulated entities).

6 Securities lending appears to be an increasing focus of the FSOC. For example, the FSOC's 2011 annual report included only passing references to securities lending, while its 2014 annual report raised a number of issues related to securities lending and emphasized the importance of gathering data on the securities lending market. *See* FSOC 2014 Annual Report, at 5, 8, 13, 123-124, *available at* http://www.treasury.gov/initiatives/fsoc/studies-reports/Pages/2014-Annual-Report.aspx. To that point, the OFR is working on a reference guide on U.S. repo and securities lending markets, which will identify data gaps. OFR 2014 Annual Report, at 15, 107, *available at* http://www.treasury.gov/initiatives/ofr/research/Pages/default.aspx. The

Leverage

- The FSOC is "interested in exploring the ways in which the use of leverage by investment vehicles 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."
- In addition, the FSOC is focused on the extent and variety of ways in which private funds, separately managed accounts and registered investment companies obtain leverage, including through the use of derivatives. To this end, the Notice asks for information on how leverage is used, the types of leveraged used and how asset managers manage risks associated with leverage.
- Securities lending is also implicated in the FSOC's focus on leverage. The Notice asks to what extent the termination of securities borrowing transactions in stressed market conditions could force securities lenders to unwind cash collateral reinvestment positions and to what extent securities lenders are exposed to significant risk of loss.

Operational Risk

The FSOC is particularly interested in two areas of operational risk: (1) risks that may be associated with the transfer of significant levels of client accounts or assets from one asset manager to another; and (2) risks that may arise when multiple asset managers rely on one or a limited number of third parties to provide important services, including asset pricing and valuation or portfolio risk management.

Specifically, the Notice seeks comments on:

- The risks associated with transferring client accounts or assets from one manager to another and how these risks vary depending on the nature of the client, the asset types owned by the client or how the asset type is traded or cleared.
- Market practices, processes and systems that must be in place to smoothly effect transfers of client accounts or assets by asset managers and/or custodians.

FSOC's 2014 Annual Report also discussed the vulnerability of securities lenders to same-day calls for liquidity (consistent with themes raised in the Notice).

- The extent to which asset managers rely on affiliated or unaffiliated service providers in a concentrated or exclusive manner for key functions.

Resolution

The FSOC is "interested in the extent to which the failure or closure of an entity could have an adverse impact on financial markets or the economy" and "whether there are any financial interconnections, such as transactions, investments, or loans across affiliated investment vehicles, between investment vehicles and an asset manager, or with third parties, that could complicate resolution in the asset management industry, particularly during a period of financial market stress." On this topic, the Notice seeks comment on:

- The financial interconnections that exist between an asset manager and the investment vehicles it manages, between an asset manager and its affiliates and among investment vehicles managed by the same or affiliated asset managers, and the extent to which such interconnections could pose obstacles to an orderly resolution.
- The ability of a counterparty to accelerate, terminate or net derivative or other types of contracts with a solvent affiliate or investment vehicle of a failed asset manager or affiliate thereof.
- The extent to which asset managers undertake contingency planning to help mitigate risks to clients associated with firm-specific or market-wide stress.

CONCLUSION

The Notice is the latest step in the FSOC's multi-year effort to better understand the asset management industry. The underlying focus of the FSOC's efforts has remained relatively consistent, although the authorities and regulatory tools that the FSOC is employing have changed. In particular, after considering whether to use its most direct authority – designation of certain asset managers as nonbank systemically important financial institutions – the FSOC appears to be taking a more open-ended approach and deferring, at least for now, to the SEC's developing agenda to adopt new regulations for the asset management industry. In any event, the views the FSOC forms based on the public's response to the Notice likely will be critical to how the FSOC develops its future agenda with respect to the asset management industry and how the FSOC determines which regulatory authorities to use.

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Please do not hesitate to contact us with any questions.