CLIENT MEMORANDUM

FSOC Releases Update Statement on Review of Asset Management Products and Activities

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On April 18, 2016, the Financial Stability Oversight Council ("FSOC") released a statement (the "FSOC Statement") providing an update on its review of asset management products and activities and their potential risks to U.S. financial stability.[1] The FSOC Statement builds upon FSOC's ongoing review of the asset management industry[2] and summarizes FSOC's collective views on key areas of focus and responses to potential risks.[3] The FSOC Statement outlines FSOC's recent analysis of risks related to (1) liquidity and redemption; (2) leverage; (3) operational functions; (4) securities lending; and (5) resolvability and transition planning. For each of these categories, FSOC provided its thoughts on steps to mitigate potential financial instability, with a focus on further study of factors affecting the asset management sector.

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1 "Financial Stability Oversight Council Update on Review of Asset Management Products and Activities," available here.

2 *See*, *e.g.*, Financial Stability Oversight Council Conference on Asset Management, May 19, 2014, agenda available here; FSOC Press Release, "Financial Stability Oversight Council Meeting July 31, 2014," available here; "Notice Seeking Comment on Asset Management Products and Activities," available here.

3 U.S. Department of the Treasury Press Release, "Remarks by Treasury Secretary Jacob J. Lew at a Meeting of the Financial Stability and Oversight Council," April 18, 2016, available here.

The FSOC Statement suggests that individual asset management firms will not be the primary subject of FSOC's near-term focus. FSOC instead reiterated its focus on individual products and activities more broadly. In his remarks at FSOC's meeting providing the update, Treasury Secretary and Council Chair Jacob Lew noted the Securities and Exchange Commission ("SEC")'s recent rulemaking proposals related to data reporting, liquidity risk management, and derivatives investment limitations for investment companies, but clarified that the SEC's work should be seen as complementary to FSOC's initiatives.[4] The FSOC Statement makes clear that FSOC will be monitoring the SEC proposals and, if the rules are implemented, FSOC will evaluate their efficacy to determine whether additional regulatory oversight is warranted.[5] In a separate statement, SEC Chair Mary Jo White expressed her support, but noted that the FSOC Statement should not be interpreted as an indication of the direction that the SEC's final rules may take.[6] Of note, Chair White also mentioned other issues she viewed as outside of the SEC's jurisdiction that FSOC and other regulators should carefully examine, including the interaction of asset managers with other financial institutions (*e.g.*, banks and broker-dealers), the use of economic substitutes across the industry, and the behavior of market participants both before and after the financial crisis.[7]

In our view, the FSOC Statement and the remarks by Secretary Lew suggest that hedge funds and other pooled vehicles not covered by the SEC's proposed rules will continue to be subject to FSOC scrutiny, but the FSOC Statement leaves open the possibility of future regulatory action focused on both registered and unregistered funds. Such action could be undertaken by FSOC or any of its member regulators and could supplement or supersede rulemaking efforts already underway at the SEC. Of note is FSOC's decision to create an interagency working group to analyze regulatory information about, and evaluate the use of leverage in, the hedge fund industry. Because the FSOC Statement outlines no formal procedures that will govern the operation of this group or its deliberations, we anticipate that any recommendations that come out of it will be subject to significant scrutiny by industry participants.

Following is a summary of FSOC's views on major topics covered in the FSOC Statement.

Liquidity and Redemption Risk

FSOC's analysis of liquidity and redemption highlighted two features of pooled investment vehicles that raise potential financial stability concerns: liquidity transformation and first-mover advantage.[8] To mitigate these and other concerns related to liquidity and redemption risks, FSOC recommended a series of policy initiatives including (i) robust liquidity risk

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4 *Id.*

5 FSOC Statement, 4.

6 SEC Public Statement, "Statement on Financial Stability Oversight Council's Review of Asset Management Products and Activities," available here.

7 *Id.*

8 FSOC Statement, 3-4.

management practices for mutual funds; (ii) the establishment of clear regulatory guidelines addressing limits on the ability of mutual funds to hold assets with limited liquidity; (iii) enhanced reporting and disclosures by mutual funds of their liquidity profiles and liquidity risk management practices; (iv) steps to allow and facilitate mutual funds' use of tools to allocate redemption costs more directly to investors who redeem shares; (v) additional public disclosure and analysis of external sources of financing; and (vi) measures to mitigate liquidity and redemption risks that are applicable to collective investment funds and similar pooled investment vehicles offering daily redemptions.[9] FSOC noted that the SEC is currently reviewing public comments on proposed rules regarding liquidity and redemption risk. Should they be implemented, FSOC stated its intention to review these and any other measures implemented by the SEC and other regulators to assess whether risks to financial stability remain.[10]

Leverage

FSOC used data reported on the SEC's Form PF as a starting point to assess hedge funds' leverage and found that, while many hedge funds use relatively small amounts of leverage, larger hedge funds tend to be more leveraged than smaller hedge funds.[11] Data cited by FSOC suggested that the use of leverage is concentrated among a small number of hedge funds.[12] However, FSOC also stated that the leverage metrics and broad strategy classifications available in Form PF do not provide sufficient insight into relevant risks, which limits FSOC's ability to fully assess leverage risk and possible mitigants to this risk.[13] FSOC therefore believes that no regulator currently has information sufficient to fully evaluate leverage risk for hedge funds.[14] To develop a better understanding of hedge fund activities and their potential risks to financial stability, FSOC is creating an interagency working group comprised of experts from member agencies to analyze regulator information and evaluate the use of leverage in the hedge fund industry. According to FSOC, the working group will (i) use regulatory and supervisory data to evaluate the use of leverage in combination with other factors to assess potential risks to financial stability; (ii) assess the sufficiency and accuracy of existing data and information, including data reported on Form PF, to evaluate risks to financial security and consider how existing data could be modified to improve the ability to make this evaluation; and (iii) consider potential enhancements to and the establishment of standards governing the current measurements of leverage.[15] The group will report its findings by the fourth quarter of

[9] *Id.* at 12-13.

[10] *Id.* at 13.

[11] *Id.* at 16.

[12] *Id.* at 17.

[13] *Id.* at 18.

[14] *Id.* at 20.

[15] *Id.* at 20-21.

2016.[16] It is not evident from the FSOC Statement itself who will spearhead this group or whether its findings and/or methodologies of analysis will be subject to further formal evaluation or oversight, and these procedural deficiencies will doubtless be challenged if the group recommends that any formal action be undertaken.

Operational Functions

FSOC stated that there is limited information available for regulators to evaluate operational risk across the asset management industry, including service provider[17] risk, and as a result there is a need for a greater understanding of potential risk in this area.[18] FSOC will continue to analyze potential service provider risk and engage with relevant industry participants and other stakeholders to better understand both these risks and industry practices for risk management and mitigation.[19] FSOC also stated that it will continue to work to improve planning, response and recovery from cyber incidents.[20]

Securities Lending

While the FSOC Statement noted efforts by the Office of Financial Research, the Federal Reserve and the SEC on their recent joint securities lending data collection pilot survey of major securities lending agents,[21] FSOC believes that more comprehensive information on securities lending across the financial system is needed for regulators to fully assess securities lending risk. According to FSOC, current estimates of the total size of the securities lending market differ widely, and there is a need for greater transparency.[22] The FSOC Statement encouraged improved data collection and reporting efforts both domestically and in foreign jurisdictions,[23] while acknowledging the SEC's proposed rule requiring registered funds to report monthly on their securities lending activities.[24]

16 *Id.* at 21.

17 Asset managers may use affiliated or third-party service providers for functions including portfolio decision making, trading, marketing, trade processing, asset pricing, fund valuation, services performed by prime brokers, portfolio risk management, custody services, fund administration, fund accounting, transfer agency and shareholder recordkeeping, and facilitation of securities lending. *Id.* at 22, fn. 84.

18 *Id.* at 23.

19 *Id.* at 24.

20 *Id.*

21 *See* "Securities Lending Data Collection Pilot Project," available here.

22 FSOC Statement, 25.

23 *Id*.

24 *Id.* at 26.

Resolvability and Transition Planning

FSOC identified risks associated with the resolution or liquidation of an entity in the asset management industry, including stress scenarios affecting the asset management industry and steps to address such risks.[25] Although the SEC has not yet proposed regulations addressing these issues, FSOC acknowledged that such efforts are underway and promised to monitor the rulemaking process as it develops.

Observations

Although the FSOC Statement might suggest that traditional fund managers are not the primary focus of FSOC's immediate agenda, all asset management industry participants, not just managers of hedge funds and other non-registered vehicles and their service providers, should continue to monitor FSOC's developments going forward. Of special concern—and reminiscent of the procedural deficiencies that characterized other FSOC studies and actions—the FSOC Statement offers few specifics on the methodologies by which FSOC intends to carry out its review or the formal feedback mechanisms or other means of assuring the quality of the evaluation to be performed. As a result, industry participants must keep a vigilant eye on how these initiatives are carried out and whether FSOC or other member agencies take steps to encroach on areas that are subject to the primary jurisdiction of the SEC.

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25 *Id.* at 26-27.