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April 21, 2016

FSOC Issues Statement on its Review of Asset Management Products and Activities

[29847]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 7-16
CHIEF RISK OFFICER COMMITTEE No. 9-16
CLOSED-END INVESTMENT COMPANY COMMITTEE No. 5-16
COMPLIANCE MEMBERS No. 9-16
ETF (EXCHANGE-TRADED FUNDS) COMMITTEE No. 9-16
ETF ADVISORY COMMITTEE No. 9-16
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SEC RULES MEMBERS No. 16-16
UNIT INVESTMENT TRUST MEMBERS No. 2-16
VARIABLE INSURANCE PRODUCTS ADVISORY COMMITTEE No. 8-16 RE: FSOC ISSUES STATEMENT ON ITS REVIEW OF ASSET MANAGEMENT PRODUCTS AND ACTIVITIES

At an open session on April 18, the Financial Stability Oversight Council (FSOC or Council) discussed its ongoing review of the asset management industry and a 27-page statement (Statement) detailing the Council's views regarding potential financial stability risks in asset management and next steps to respond to these potential risks. The Council's review of potential risks focuses on: (1) liquidity and redemption; (2) leverage; (3) operational functions; (4) securities lending; and (5) resolvability and transition planning. This memorandum briefly highlights some of the commentary at the meeting and views reflected in the Statement. [1]

In his opening remarks, FSOC Chairman and Treasury Secretary Jacob Lew noted that the Council "did not begin [its] work with pre-conceived notions or pre-determined outcomes, but with a recognition that the asset management industry is a significant and growing segment of the U.S. financial system." He explained that FSOC has "focused on the issues and questions that are being studied by market participants, academic experts and other market observers as they seek to understand and manage risk in a changing world." Secretary Lew remarked that the Council "benefitted greatly from the expertise of many of its member agencies in [its] analysis, particularly the insights of Chair White and the [Securities and Exchange Commission] staff." He stated that the Council welcomes the

SEC's rulemaking initiatives in several of the same areas under FSOC review, stressing that it is important for the work of the SEC and the Council to be "complementary." [2]

SEC Chair Mary Jo White likewise stated that she believes FSOC's work in this area is complementary to the SEC's current reform agenda with respect to the asset management industry. She went on to say:

Although there is overlap in the topics covered in FSOC's update and the SEC's proposed reforms, it should be understood that the SEC's analysis of foundational asset management issues, including liquidity management and use of leverage, is set forth in the Commission's proposals and accompanying white papers of the SEC's Division of Economic and Risk Analysis. In developing the SEC's final regulations, we will consider and rely on our analysis of the input we receive from the public through the notice and comment process. Today's FSOC update thus should not be read as an indication of the direction that the SEC's final asset management rules may take. [3]

FSOC members voted unanimously to issue the Statement. The readout from the Council's meeting [4] sets forth "a selection of key Council views described in the [Statement]," as reproduced below.

Liquidity and Redemption Risk

The Council believes financial stability concerns may arise from liquidity and redemption risks in pooled investment vehicles, particularly where investor redemption rights and underlying asset liquidity may not match. To help mitigate these potential financial stability risks, the Council believes that the following steps should be considered:

- Adoption of robust liquidity risk management practices for mutual funds, particularly with regard to preparations for stressed conditions by funds that invest in less-liquid assets;
- Establishment of clear regulatory guidelines addressing limits on the ability of mutual funds to hold assets with very limited liquidity, such that holdings of potentially illiquid assets do not interfere with a fund's ability to make orderly redemptions;
- Enhanced reporting and disclosures by mutual funds of their liquidity profiles and liquidity risk management practices;
- Steps to allow and facilitate the use of tools by mutual funds to allocate redemption costs more directly to investors who redeem shares; and
- Additional public disclosure and analysis of external sources of financing for mutual funds.

The Council also believes that regulators should consider whether these or other measures may be appropriate for reducing potential liquidity risks in collective investment funds and similar pooled investment vehicles subject to their respective jurisdictions.

Leverage Risk

The Council's analysis of data from the SEC's Form PF showed that many hedge funds use relatively small amounts of leverage, but leverage appears to be concentrated in larger hedge funds, based on certain measures. The Council acknowledges that the relationship between a hedge fund’s level of leverage and risk, and whether that risk may have financial stability implications, is highly complex. While reporting on Form PF has increased transparency, it does not provide complete information on the economics and corresponding risk exposures of hedge fund leverage or potential mitigants associated with reported leverage levels. In addition, hedge funds’ major counterparties are regulated by various regulators with different jurisdictions. Therefore, no single regulator currently has all the information necessary to evaluate the complete risk profiles of hedge funds.

Accordingly, the Council believes further analysis is needed, and therefore is creating an interagency working group that will share and analyze relevant regulatory information in order to better understand hedge fund activities and further assess whether there are potential risks to financial stability. The working group will:

- Use regulatory and supervisory data to evaluate the use of leverage in combination with other factors – such as counterparty exposures, margining requirements, underlying assets, and trading strategies – for purposes of assessing potential risks to financial stability;
- Assess the sufficiency and accuracy of existing data and information, including data reported on Form PF, for evaluating risks to financial stability, and consider how the existing data might be augmented to improve the ability to make such evaluation; and
- Consider potential enhancements to and the establishment of standards governing the current measurements of leverage, including risk-based measures of synthetic leverage.

This group will seek to report its consolidated findings to the Council by the fourth quarter of 2016.

Other Areas of Council Analysis

With regard to operational risks, the Council focused on potential risks that may be associated with the use of service providers and believes that continued analysis is called for in light of the growing reliance on service providers, the concentration of some service provider markets, and the continuously evolving nature of their services. This analysis will include continued engagement with industry participants and other stakeholders and will seek to develop a greater understanding of service providers, their operating infrastructure, and the measures used by asset managers and other financial institutions to mitigate potential risks from service providers.

With regard to securities lending, the Council believes that more comprehensive information on securities lending activities across the financial system is necessary to fully assess the materiality of potential risks. A number of data collection and data enhancement efforts are already underway, and the Council encourages improved and regular data collection and reporting, interagency data sharing, and additional engagement with international counterparts.

With respect to resolvability and transition planning, the Council has identified potential risks associated with stress scenarios affecting asset management entities. Steps to address those risks are described in the context of the Council’s consideration of liquidity and redemption risks and leverage risks.

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endnotes

[1] The Statement is available at https://www.treasury.gov/initiatives/fsoc/news/Documents/FSOC%20Update%20on%20Review%20of%20Asset%20Management%20Products%20and%20Activities.pdf.

[2] Secretary Lew further stated: "I want to underscore the importance that by addressing these issues, the Council continues to lead the international regulatory conversation in this area. The Council's work represents a domestic consensus on potential risks to financial stability from asset management products and activities. Given that many of these same issues are being discussed globally, it is important that the United States clearly establish its views on potential risks and the appropriate regulatory approach to those risks based on the collective insight of member agencies and relevant stakeholders through the Council's process."
A copy of Secretary Lew's statement is available at https://www.treasury.gov/press-center/press-releases/Pages/jl0430.aspx.

[3] Chair White's statement is available at http://www.sec.gov/news/statement/white-statement-041816.html.

[4] The readout is available at https://www.treasury.gov/initiatives/fsoc/council-meetings/Documents/Financial%20Stability%20Oversight%20Council%20Releases%20Statement041816.pdf.