Asset Management and Financial Stability—Risks in Perspective

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Gerry Corrigan was right. Banks are special.[2] Banks serve unique functions in our financial system and, in doing so, create special risks to the stability of the financial system. But, not every financial intermediary is a bank. Treating nonbank financial intermediaries as banks by designating them as systemically important nonbank financial companies, or SIFIs, under the Dodd-Frank Act may or may not promote the stability of our financial system. It may be that financial stability would benefit from a less-is-more approach, as suggested by Andrew Haldane's dog and frisbee analogy.[3]

At a minimum, SIFI designation will impose costs on these companies that will be passed on like a tax to the broader economy. At worst, designation will impair the ability of businesses to obtain capital and funding to the detriment of the economy as a whole. To the extent the risk characteristics of nonbank financial companies look like the risk characteristics of banks, the benefits to stability may outweigh the costs to the economy. To the extent that the risk characteristics of nonbank financial companies are different than the risk characteristics of banks, designation is likely to do more harm than good to the economy.

The Great Recession that followed the bursting of the residential real estate bubble in early 2007 again focused our attention on the role of financial intermediaries and their relationship to financial stability. The latest attempt to address these issues comes from the Office of Financial Research at the Department of the Treasury ("OFR"). In September2013, the OFR issued a report on Asset Management and Financial Stability ("Report"). The Report states that the OFR produced the Report in response to a decision by the Financial Stability Oversight Council ("FSOC") to study the activities of asset management firms to better inform FSOC's

[1] The following represents the views of the author and is not intended to represent the views of Morrison & Foerster LLP.

[2] *See,* E. Gerald Corrigan, Are Banks Special?, http://www.minneapolisfed.org/publications_papers/pub_display.cfm?id=3527

[3] The Dog and the Frisbee, http://www.bankofengland.co.uk/publications/Documents/speeches/2012/speech596.pdf

analysis of whether—and how—to consider such firms for enhanced prudential standards and supervision under Section 113 of the Dodd-Frank Act.

Unfortunately, the OFR Report looks at asset management through a narrow lens and does not place its analysis in the context of: 1) the benefits to the financial system that flow from asset management; 2) the differences between the risks to financial stability posed by asset management and those posed by banking; and 3) the consequences of applying a bank supervisory model to any risks to financial stability that could be posed by asset managers of the funds that they manage. We need to do better.

I. Importance of Financial Markets

First, before embarking on a discussion of whether any particular type of financial intermediary presents systemic risks to our financial system, it is useful to step back and look at what we want the financial system to do and what we don't want it to do. At the heart of our financial system is the conversion of idle funds into loans and investments. As Walter Bagehot put it, in Lombard Street in 1873:

> a new man, with small capital of his own and a large borrowed capital, can undersell a rich man who depends on his own capital only. The rich man wants the full rate of mercantile profit on the whole of the capital employed in his trade, but the poor man wants only the interest of money (perhaps not a third of the rate of profit) on very much of what he uses, and therefore an income will be ample recompense to the poor man which would starve the rich man out of the trade.[4]

Although Bagehot's reference focused on borrowed capital, a similar analysis can be applied to equity investments as well.

From this simple observation, it follows that the more efficiently financial markets function the more efficiently they will distribute both borrowed funds and equity capital to the businesses that can use those funds most effectively and thereby generate the highest return over time. This allocation of funds will, in turn, tend to promote the most viable business and to maximize economic growth, household incomes and standards of living. Although the idea is simple, the implementation of that idea is more difficult and requires the balancing of financial market efficiency against financial market risk.

[4] Lombard Street is available at http://socserv2.socsci.mcmaster.ca/econ/ugcm/3ll3/bagehot/lombard.html, among other places.

Financial intermediaries are catalysts for liquidity in the financial markets. They create this liquidity, among other ways, by taking deposits or issuing securities. The ability of Individuals to create this liquidity by themselves is limited because they lack the economies of scale available to create large liquid pools of funds. Moreover, the financial intermediaries have considerable resources to help investors evaluate creditworthiness of borrowers and the risks of investing in particular issuers and sectors. As the go-between connecting quiet savers and active employers, financial intermediaries are responsible for supplying funds that are the lifeblood of the economy.

II. Credit Risk and Panic

Although lending and investment play crucial roles in a market economy, there is no escaping the fact that lending and investing money entails financial risks. A borrower may be unwilling, or unable, to repay a loan for reasons that may be specific to that borrower or due to factors that affect the economy more broadly. Just as borrowers may not be able to repay their loans, businesses may fail and their investors may lose their investments. Imperfect information about current market conditions, "irrational exuberance" at the prospect of unbounded increased wealth, fear of a loss of wealth, and the reality that no one can predict the future, make it difficult for financial markets to allocate funds optimally. The emotional influences on investment decisions of exuberance and fear can be reduced, and information about the current condition of prospective borrowers and investments can be improved. But, in practice, these factors cannot be eliminated.

When lending or investment risks turn into losses, lenders and investors, in turn, may be unable to meet their own obligations. This domino chain of events may ripple through the economy until the losses fall on parties that are able to absorb them. On a large scale, a domino chain of interconnected failures may be characterized as systemic risk.

However, a more pernicious form of systemic risk may result—a loss in confidence in loans and investments generally. Such a loss in confidence may dry up the availability of loans and investment capital. As a result, asset prices plummet as intermediaries in need of liquidity must dispose of assets at fire sale prices. The decline in asset prices in turn puts more intermediaries in jeopardy, thus creating a downward spiral that can lead to the collapse of markets or, potentially, a market economy as a whole. In the 19th century, and at least until 1907 in the United States, these events were associated with what were referred to as banking panics.[5]

[5]Charles W. Calomiris and Gary Gorton have identified thirteen banking panics from 1814 through 1914. The Origins of Banking Panics: Models, Facts and Bank Regulation, Table 4.1, http://www.nber.org/chapters/c11484.pdf.

III. Addressing Systemic Risk

While we can limit the spread of direct credit losses by introducing regulations that set standards for prudent lending and investment, financial panic, once ignited, is much more difficult to control. The process of restoring confidence in financial markets requires financial support for the liquidity, and value, of assets that are yet to be compromised. In describing how the Bank of England could restore confidence to troubled markets, Walter Bagehot noted that:

> . . . advances should be made on all good banking securities, and as largely as the public ask for them. The reason is plain. The object is to stay alarm, and nothing therefore should be done to cause alarm. But the way to cause alarm is to refuse someone who has good security to offer. The news of this will spread in an instant through all the money market at a moment of terror; no one can say exactly who carries it, but in half an hour it will be carried on all sides, and will intensify the terror everywhere. … If it is known that the Bank of England is freely advancing on what in ordinary times is reckoned a good security on what is then commonly pledged and easily convertible the alarm of the solvent merchants and bankers will be stayed. But if securities, really good and usually convertible, are refused by the Bank, the alarm will not abate, the other loans made will fail in obtaining their end, and the panic will become worse and worse.[6]

In the United States, the Currency panic of 1907 led to the establishment of the Federal Reserve System as the central bank for the United States. The Federal Reserve System's powers make it uniquely qualified to undertake and address panics as described by Bagehot by intervening in financial markets and by providing direct credit to banks[7] experiencing liquidity pressures but that retain good assets that can be pledged to secure advances.

However, the Federal Reserve Act did not eliminate all future panics, as demonstrated by the Great Depression of the 1930s and the Great Recession that the National Bureau of Economic Research dates from December of 2007. In both of these cases, the Federal government was compelled to step in to stabilize and recapitalize large portions of the private sector. For example, starting in the Great Depression and continuing into World War II, the Reconstruction Finance Corporation provided billions of dollars in loans and other assistance to state and local governments, banks and other business. Similarly, in 2008, the Troubled Asset

[6] See note 4.

[7] For purposes of this comment, the term banks includes saving associations and credit unions but does not include nonbank affiliates.

Relief Program provided hundreds of billions of dollars that was used to support banking institutions, an insurance company and automobile manufacturers. Nor did the enactment of the Federal Reserve Act and other banking legislation eliminate widespread bank failures such as the Savings and Loan Crisis in the late 1980s and early 1990s. This crisis also required government intervention.

In addition, in response to the Great Depression, the Great Recession, and the Savings and Loan Crisis, Congress enacted legislation designed to prevent future crises.[8] In some cases, this legislation was focused on restoring confidence in the financial system. Deposit Insurance is a clear example. In other cases, legislation has focused on strengthening financial intermediaries and the avoidance of creation of unsound assets to begin with. For example, in response to the Great Depression, the Securities Act of 1933, the Securities and Exchange Act of 1934, and the Banking Acts of 1933 and 1935 focused on reducing the likelihood of a panic by regulating the issuance and trading of securities and, in addition to creating the deposit insurance system, by strengthening the regulation of banking institutions, including creating barriers between the business of banking and commercial activities and certain securities activities.

IV. The Dodd-Frank Act

In response to the Great Recession, Congress enacted sweeping financial services reform legislation in the form of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010. Dodd-Frank touches virtually every financial regulatory agency and virtually every type of financial service. Among its reforms are a number of provisions designed expressly to address systemic risk. Although the Great Recession was caused by a residential real estate bubble and poor mortgage underwriting practices, as the bubble deflated and mortgage defaults grew, the resulting effects created problems at financial intermediaries, including a number of failures or near-failures of large depository institutions. These effects also included the failure of two large investment banks, the rescue of a large insurance company, and a money market mutual fund "breaking the buck" before regulators and Congress undertook large scale interventions to stabilize the markets and financial institutions generally.

One of Dodd-Frank's approaches to reduce the potential that the failure of a single financial institution will trigger domino failures or a financial panic was to establish a process by which a council of regulators in the form of FSOC may impose bank-like supervision on designated nonbank financial companies that the council deems to be systemically important. Implicit in this designation is that: 1) these entities have risk characteristics that are similar to the risk

[8] The Ohio and Maryland thrift crises in 1985 involved runs on state-chartered thrifts that were insured by state insurance funds rather than the federal deposit insurance funds.

characteristics of banks, both in terms of the risks of the assets created by banks as financial intermediaries and the risks presented to creditors of banks; 2) the magnitude of these risks raises the potential that these institutions will create or transmit material systemic risks; and 3) bank-like supervision and regulation is the most appropriate regulatory response to address the systemic risks related to these institutions.

Although the United States system for regulating financial intermediaries has often been criticized as fragmented and inefficient, Dodd-Frank did not choose to consolidate the federal financial regulators, let alone to put all financial intermediaries under a single supervisory and regulatory regime. Rather, under Dodd-Frank all but one federal banking regulator and their supervisory and regulatory regimes survived intact. Dodd-Frank sought to strengthen those regimes, achieve better coordination of their activities through the creation of FSOC, and to address uneven supervision and regulation by authorizing FSOC to recommend new or heightened standards or safeguards for particular financial activities.

When existing functional regulation, as enhanced by coordination through FSOC and heightened standards or safeguards for particular activities, does not adequately address the risks posed by particular financial companies, FSOC can determine, or designate, that a U.S. nonbank financial company is "systemically important" and, thus, subject to the jurisdiction of and supervision by the Board of Governors of the Federal Reserve System ("Board"). As a practical matter, and by statute, Board supervision will be based on the Board's experience with, and approaches to, bank holding companies. By statute, it includes requirements for capital, liquidity and risk management, as well as resolution planning and concentration limits.

Although Dodd-Frank gives the Board a broad array of regulatory tools to address systemic risks of nonbank financial companies, the structure of Dodd-Frank, as well as practical considerations, strongly argue that FSOC should use its power to designate SIFIs sparingly. To apply a bank-like supervisory and regulatory regime more broadly would unnecessarily impair the operations and benefits to the financial markets that the designated intermediaries provide. Indeed, as discussed further below, designation may put some asset managers out of business and/or artificially create a ceiling on the size of asset managers or pooled investment vehicles, thereby losing the economies of scale in research and trade execution that can flow from size.

V. Banks and Bank Risk

Recognition of the unique role of banks in the United States financial systems dates to at least the early 19th century, and banks have been a focus of federal legislation to promote their operation and to protect their stability since the enactment of the National Bank Act 150 years ago. Since the enactment of the National Bank Act, successive financial crises have seen successive additional efforts to protect the stability of banks and the financial system, including, as noted above, the enactment of the Federal Reserve Act after the Currency Panic of 1907 and the creation of the Federal Deposit Insurance fund in the Great Depression, as well as the enactment of FIRREA in 1989 and FDICIA in 1991 in response to the Savings and Loan Crisis.

Historically, banks have often been the first and, in some cases the only, sources of credit for businesses and, more recently, for many consumers. These loans are often made based on unique knowledge of local business conditions and individual borrowers and, therefore, are difficult for third parties to evaluate and value. Even today, although some loans may be traded among banks and other investors, bank loans represent individual assets that are not fungible and are not easily valued by reference to market prices for identical assets. Consequently, bank assets typically are relatively illiquid, and often banks cannot quickly sell these assets at par to meet demands for withdrawals.

Bank loans are also almost all term loans, although they vary in maturity. Historically, banks funded these loans by issuing circulating demand notes. The mismatch between the maturity of the bank's loan portfolio, the nature of which are mostly opaque to note holders, and the demand nature of the notes they issue led to unpredictable demand for redemption of notes by note holders. In order to meet these demands and remain in business, a number of states required banks to collateralize their notes with government bonds. Nevertheless, in the first half of the 19th century, banks often carried capital equal to 40% of their assets, or more, to meet redemption demands. The enactment of the National Bank Acts of 1863 and 1864 marked a shift to a national currency backed by government bonds, but also spurred the growth of deposits in order to be able to fund loans. The continued mismatch between the maturity of bank assets and liabilities and the relative illiquidity and uncertain value of bank-assets led to capital ratios in excess of 15% until after the passage of the Federal Reserve Act in 1913.

In response to panic withdrawals from banks and a nationwide bank holiday in March of 1933, Federal deposit insurance was added to the then-existing framework of bank supervision, regulation and central bank support as an additional tool to stabilize bank balance sheets. Since that time, Federal legislation and bank supervisors have continued to expand and refine the supervisory and regulatory regime for banking institutions. This regime has been characterized by capital requirements, individual on-site examinations, and a wide array of requirements to limit the risks of the loans made by the bank on an individual, and on a portfolio, basis. Nor is this regime limited to bank regulation in the United States. Although details vary, almost all market economies have developed similar bank supervisory and regulatory systems to promote the vital functions that banks serve as providers of credit while limiting the risks that they pose to depositors and to financial stability that stem from highly liquid liabilities and far more illiquid assets.

Despite this extensive regime, rapid withdrawals from banks, which have come to be known as banks runs, have continued to threaten the solvency of banks in times of stress for individual institutions or the banking system more broadly unless bank obligations are guaranteed by the Federal government.[9] The wholesale run on Continental Illinois National Bank and Trust Company in 1984 and the events that led to the Federal Deposit Insurance Corporation's ("FDIC") Transaction Account Guarantee Program in 2008 are but two examples. Bank depositors expect to have their deposits returned at par. To the extent that depositors can be viewed as investors, they should be viewed as investors with minimal, if any, appetite for risk with respect to the deposited funds.

The challenge of the bank supervisory and regulatory system has been to balance this low appetite for risk combined with short maturities on the liability side of a bank's balance sheet with the creation of unique hard-to-value assets in the form of commercial loans with longer maturities on the asset side of the balance sheet. This balancing act has led to a unique regulatory structure that FSOC must consider whether or not to apply to a nonbank financial company when it believes that the company threatens U.S. financial stability.

VI. FSOC Designation of Systemically Important Nonbank Financial Institutions

Based on their long history at the center of our financial system, and at the center of banking panics, it has generally been supposed that banks are the primary creators and transmitters of systemic risk in the financial system.[10] One of the difficulties confronting the process for designating systemically important nonbank financial institutions is that it asks which nonbank financial institutions might pose systemic risks to the financial system and then proposes to apply bank-like supervision and regulation to those institutions. Under this approach, there is no necessary relationship between the risks and the remedy. Given the remedy, a more appropriate approach would be to ask which large entities engaged in financial activities present bank-like risks and then to extend a bank-like supervisory and regulatory regime to those institutions.

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[9] The portrayal of a crowd of people clamoring for their money in a bank run in the movie *It's a Wonderful Life* reflects historical experience. In recent times in the U.S., to the extent that retail banks runs have occurred, police presence has ensured more orderly crowds. During the Ohio Thrift Crisis one uninsured, state-chartered thrift was able to avoid the runs on state-insured thrifts by placing a sign in its window that it was not insured, demonstrating the irrationality that is the hallmark of banking panics.

[10] This is true even though from time to time the government has felt the need to bail out nonbank commercial companies such as automobile manufacturers, railroads, aircraft manufacturers, airlines and at least one city.

Nevertheless, to date, FSOC has followed the approach of attempting to analyze risks to financial stability and then applying the designation process, even if the result may be to apply a supervisory and regulatory regime that is not appropriate for the designated institution. To this end, FSOC has developed a six-category framework of interconnectedness, substitutability, size, leverage, liquidity risk and maturity mismatch.

Even though the OFR Report states that it was prepared to inform FSOC's consideration of asset management entities with respect to the designation of nonbank financial companies for bank-like supervision, it adopts a third approach of identifying risks in the form of vulnerabilities of the asset management industry itself to financial shocks that differ from the FSOC categories and suggesting how those vulnerabilities could transmit risks to markets, creditors, counterparties and investors. Although this analysis is sprinkled with references to the financial crisis, the Report makes no serious effort to quantify these risks in terms of likelihood of occurring or likely effect. The federal bank regulatory agencies have generated innumerable guidance to banks on the potential for risks of activities ranging from specific types of lending to outsourcing of back office functions. The identification of risks in the Report generally is a far cry from the identification and quantification of risks as threats to U.S. financial stability.

VII. Do Asset Managers Increase Risk or Decrease Risk in our Financial System?

a. Professional Advice

The business model and risk profile of asset management are very different from the business model and risk profile of banking. Rather than lending money to another person with the expectation of repayment, asset management provides recommendations on the advisability of investing in individual financial assets. The creation of these assets is regulated under the regulatory regimes designed to address their particular risk characteristics. The investor invests its own money directly in those financial assets and bears the gain or loss on that investment. The asset manager is a fiduciary that recommends investments that are in the best interests of its client. It provides advice in selecting and monitoring these investments and has a duty to seek the best execution of the transactions that it recommends.

Direct markets for assets, whether they are financial assets or physical commodities, have been subject to panic selling just as there have been panic withdrawals at banks. These events are often preceded by a run up, or bubble, in the asset prices. The Dutch Tulip Bubble is often cited as an early example of such extreme market volatility. The availability of better information about assets and market behavior along with better trade execution facilitated by an asset manager should not increase this type of market volatility. Rather, it should improve market efficiency and reduce volatility, as should the judgments of a skilled professional who is investing a pool of assets across a more diversified portfolio than an individual investor could typically create and manage. In addition, a professional investment adviser is not subject to the exuberance of anticipated wealth or the fear of impending loss that can accelerate price movements to the same degree as individual investors and can help isolate both investors and markets from those emotions.

b. Pooled Investment Vehicles

Frequently, asset management includes the formation of pooled investment vehicles in addition to investment advice and trade execution services. A single asset manager or family of asset managers may advise any number of pooled investment vehicles. The aggregation of large blocks of capital raises additional issues. Large positions could be created that could be used to manipulate markets. In some circumstances, these large positions could become a threat to the stability of markets. These issues, however, are already addressed extensively by robust regulation by the Securities and Exchange Commission ("SEC") and the Commodity Futures Trading Commission.[11] Further, these large positions should benefit from the more dispassionate judgments of the asset manager, thereby likely contributing to market stability rather than exacerbating market volatility, when compared to individual investors.

Pooled investment vehicles do not, by themselves, raise the issue of maturity mismatch that plague the bank model of financial intermediation. Investors in collectively managed funds own an undivided interest in all of the underlying assets; when they redeem their interests, they receive their proportionate share of those underlying assets at their current value. While liquidation may take place at a rapid pace, this pace should be no different than the pace of liquidation if the assets were managed by the individual investors.

c. Separate Obligations

Open-end investment companies (mutual funds) issue redeemable securities that represent undivided interests in the underlying portfolio. This structure, formalized by the Investment Company Act of 1940, contemplates that that the funds may pay redemption proceeds on any given day that exceed the cash available to meet those redemptions. To meet such liquidity demands, investment companies are required to maintain a large percentage of their assets in liquid securities. In addition, many investment companies maintain liquidity facilities to draw upon in order to meet redemptions that exceed available cash.

[11] Individual large positions may also threaten markets. Silver Thursday and the Hunt brothers' effort to corner the silver market in 1980 comes to mind.

Other types of pooled investment vehicles, including closed-end funds, private funds such as hedge funds, private equity funds, venture capital funds and real estate investment trusts, do not typically allow for daily redemption by shareholders and may hold less liquid securities in their portfolios. But the structure essentially is the same: shareholders hold an undivided interest in all of the collective fund's underlying interests, and participate in the profits and losses as equity holders.

It may be tempting to view the bank model (of issuing debt instruments with an expectation of immediate liquidity while investing in illiquid term loans) as sitting at one end of the spectrum of asset management, both in terms of the liquidity and the maturity mismatch. But, this would be wrong. Unlike investors in a collective investment fund, bank depositors do not think of themselves as, and as a legal matter are not, investing in the bank's individual assets; rather, they view themselves as, and they are in fact, lenders to a conservative business, the bank, that provides instant liquidity coupled with transaction processing. Their deposit accounts are merely a claim on the general assets of the bank. Further, unlike a bank where the inability to liquidate assets to meet depositor demands at par can lead to insolvency, pooled investment vehicles are typically invested in financial market instruments and they can readily sell at market prices and the proceeds are passed on to investors. (The daily net asset value of those funds reflects the current market value of the underlying portfolio securities.)

In contrast to banks, shareholders of pooled investment vehicles hold equity participations in the entire fund. There is no central counterparty—like a bank—to become insolvent or to liquidate. Rather, investors redeeming their investments receive an amount equal to their proportionate share of the underlying assets. (In the case of open-end funds, the value of their investment is determined at the close of business on the day that they request the redemption.) In a market when investors see assets' values as declining, even where the asset values are perceived as declining rapidly, this gradual loss of return on investment is vastly different than the "all or nothing," or "if you are lucky, something at some point in the future," that confronts uninsured bank depositors. Investor expectations reflect these differing results.

This potential for a significant, if not complete return on investment, coupled with the differing expectations and risk appetites, has historically resulted in pooled investment vehicles being far less susceptible to panic redemptions, or runs, than banks. While, in some cases, fund managers have found it desirable to contribute additional assets, generally in the form of cash, to maintain longer-term confidence in individual funds and, thus, to maintain the assets manager's reputation in the market, this fact alone does not suggest that failure to make these contributions would have led to broader instability in the economy, or even in other funds.

Finally, the issuance and redemption of separate obligations relating to pooled investments does not raise the same types of interconnections and exposures that tie large banks together in myriad ways. The fact that banks are not only the channels for converting savings into loans but also the primary vehicles for payments, places them in a central role between counterparties in all types of transactions, including transactions cleared through independent payment and settlement systems that nevertheless must use the banking system to receive and disburse funds. There is simply no comparison in practical terms between the complexity of unwinding a bank and the process of unwinding or liquidating a pooled investment vehicle.

d. Leverage

Potential problems from the wind-down of a pooled investment vehicle, including losses to customers as well as the effects on the markets in which the fund is invested, can be magnified by the use of leverage by the fund, just as these same problems can be magnified for individual investors by the use of leverage. Although the difficulties at Long Term Capital Management might be cited as an example of the risks posed by pooled funds, those difficulties are more properly viewed as the result of the use of a high degree of leverage. The need to repay lenders who are not, and do not view themselves as, equity participants, created risk to both the investors in the fund and the individual markets in which the fund invested, as margin calls on the fund's large positions accelerated the liquidation of, or attempts to liquidate, fund investments. However, investment company use of leverage is highly regulated, and use of leverage by private funds generally is monitored by the federal securities and commodity regulators, as well as investors themselves who have choice among the investment strategies of differing pooled investment vehicles. The resort to the full panoply of bank-like supervision and regulation is far from necessary to achieve such a limit and any attendant reduction in risk.

e. Transparency

To the extent that a collective investment fund invests in securities or other assets that are regularly traded in financial markets, including the securities and the commodities markets, the nature and valuation of those assets is apparent and relatively readily verifiable. The ability to identify and assess the value of the assets in the fund provides confidence to fund investors that they at least understand the risks of their investment at any point in time. This ability also avoids the uncertainty as to condition that confronts bank depositors who must rely on the practices of bank examiners and their diligence in valuing loan assets, which are practices and diligence whose historical track record cannot inspire any real confidence.

VIII. A Word About Money Market Mutual Funds

Much of the sentiment regarding potential threats to U.S. financial stability arising from asset management may come from the experience with money market mutual funds in September of 2008, when the failure of Lehman Brothers caused The Reserve Primary Fund to mark its holding of Lehman commercial paper to zero and ultimately to "break the buck" and cease redemptions.[12] The announcement that the fund would break the buck occurred in the midst of a time of the severest market stress. The announcement triggered concerns that other money market mutual funds would also break the buck and would not be able to redeem their shares at the stable net asset value of $1.00. The United States Treasury stepped in to provide a program of insurance for money market mutual funds in order to stabilize these funds. This Treasury program was one of a number of extraordinary measures taken to stabilize financial institutions and markets, as well as some commercial companies.

Since that time, the SEC has taken steps to improve the liquidity of money market mutual funds and there has been a continual dialogue about whether additional measures are needed to prevent a recurrence of the 2008 events. A significant issue in the money market mutual fund debate is the use of a stable net asset value and the potential that customers may tend to view a fund that offers a stable net asset value as offering the equivalent of bank deposit, thereby raising the specter that a mismatch between the maturity and liquidity of the fund's shares and the maturity and liquidity of the fund's assets and increasing the potential for runs on the fund. Although existing regulatory requirements require money fund assets to be highly liquid so that there is little resemblance between a money market mutual fund balance sheet and a bank balance sheet, additional requirements are under consideration. However this debate is resolved, it emphasizes the differences between other collective investment funds and banks rather than the similarities. It also emphasizes the differences between the supervision and regulation of activities and the supervision and regulation of individual institutions. To the extent that the additional supervision and regulation of money market mutual funds, or a class of money market mutual funds, is warranted, it is warranted for all of those funds through the existing structure of functional regulation, rather than by designation of select funds as SIFIs.

IX. Section 113 of Dodd-Frank

To the extent that managed assets present risks to the stability of the financial system, designation of these funds under Section 113 of Dodd-Frank is not the appropriate way to

[12] Apparently because of the regulatory issues involved in ceasing redemption, the Reserve Primary Fund went through a lengthy wind down process.

address any risks presented. Although FSOC and the Board have some discretion as to how they might go about supervising and regulating asset managers as designated nonbank financial companies, two points are significant. First, asset management, including investments in collective investment funds, is a discrete service and is not part of the cluster of loan deposit, payment and trust services that banks typically offer their customers. Asset management is far less sticky than banking relationships. In addition, asset managers are generally compensated through a fee that is often relatively small based on assets managed that are highly transparent.

The introduction of an entirely new supervisory and regulatory regime to a subset of asset managers would inevitably result in sharply higher costs, and therefore fees, and would likely result in capital flight to other asset managers that were not subject to the new regime. For example, a criterion for designating asset managers under Section 113 of Dodd-Frank that is based on the amount of the assets under management would likely have the effect of creating a ceiling on the amount of assets in individual funds or in a class of funds. It is not clear how this result would reduce systemic risk as investors seeking to invest in a particular asset, or seeking a particular investment strategy, will simply move their investments into a larger number of smaller funds, or into less-regulated entities or jurisdictions. The experience with the Thrift Crisis suggests that it may not be easier to deal with a problem that affects a large number of smaller entities than a problem that affects a small number of larger entities.

Second, the cornerstone of the mandatory requirements that flow from designation under Section 113, and the cornerstone of bank safety and soundness supervision and regulation, is capital requirements. Designation under Section 113 triggers the imposition of risk-based capital and leverage requirements that would require specific amounts of capital to be carried against on- and off-balance sheet assets. Although the Board and FSOC can determine that capital requirements are not appropriate for investment companies and assets under management, the primacy of capital in the list of regulatory tools for designated nonbank financial companies suggests that the need for capital is an important factor in identifying companies that are appropriate for designation under Section 113.

In banks, capital acts as a shock absorber. It absorbs losses on the asset side of the balance sheet so that they are not passed through to the bank depositors on the liability side of the balance sheet. Capital protects against losses due to bad loans as well as losses that may be incurred in selling off assets, whether they are loans or securities, to meet withdrawals of deposits. In insured banks, capital also serves as a buffer to protect the interests of the FDIC as insurer when it succeeds to the rights of insured depositors. Most importantly, history, including the most recent financial crisis, has shown that capital is critical to public confidence in banks and, therefore, to the stability of banks.

But, as a shock absorber, capital has no established function in managed assets. Indeed, managed assets consist entirely of capital except to the extent that the asset manager leverages that capital in a fund's investment strategy. Because asset management differs fundamentally from banking, the history of the regulation of asset management has had a different focus than the history of bank regulation. Bank regulation has historically, and necessarily, focused on maintaining the stability and, therefore, the safety and soundness of banks, while the history of asset management has focused on protecting the investor from unscrupulous or negligent asset managers and ensuring market integrity.

For example, the regulation of investment companies originated in the 1920s when legal restrictions that prevented one corporation from owning shares of another had been removed. Investors who could not otherwise diversify their portfolios rushed to pooled investment vehicles to take advantage of rising stock prices. Broker-dealers, investment bankers and financial institutions sponsored investment companies to fill this need. During this period, pooled investment vehicles grew in popularity.[13]

This rapid growth resulted in perceived abuses by unscrupulous sponsors who used the fund assets to further their own business interests. The main abuses that developed during the 1920s and 1930s related to the fact that the liquid, mobile and readily negotiable assets that investment companies held could be, and were easily, misappropriated and diverted by management affiliates who fostered their personal interests, rather than the interests of the public securities holders.[14] The Investment Company Act, as originally written, established the regulatory framework that has endured to this day to address these abuses. It is designed to protect investors from mismanagement of investment companies including: the issuance of securities having inequitable or discriminatory provisions; the use of unsound or misleading methods of computing earnings and asset value; changes in the character of investment companies without the consent of investors; and excessive leverage; and to provide for full and accurate information about the companies and their sponsors.

Similarly, the Investment Advisers Act reflects the concern that investment advisers had large potential influence on the integrity of securities markets and the "dangerous potentialities of stock market tipsters imposing upon unsophisticated investors."[15] To protect against these

[13] Protecting Investors: A Half Century of Investment Company Regulation, Division of Investment Management, Securities and Exchange Commission, at xvii ("Protecting Investors Report").

[14] Investment Company Act of 1940 and Investment Advisers Act of 1940, Senate Report No. 1775, 76th Congress, 3rd Session at 6 ("Senate Report"). *See also* Jaretzki, *The Investment Company Act of 1940*, XXVI Washington University Law Quarterly 303 (April 1941).

[15] Senate Report at 21.

potential abuses, Congress saw the need to protect investors through federal regulation of investment advisers on a national scale. The Investment Advisers Act is designed to: identify investment advisers through registration with the SEC; limit incentive compensation and assignment of contracts; prohibit or limit certain transactions with affiliates; regulate representations, including advertising and publicity; and to preserve the confidentiality of the adviser-client relationship.

In practice, both of these regulatory regimes also promote stability in the financial system, even though they were designed to promote investor protection and market integrity. As discussed above, the severest form of systemic risk is a financial panic. Investor protection gives investors confidence that they understand the risks that they are taking and in the integrity of their advisers and the managers of their funds. This confidence, in turn, supports the stability of the financial system. In other words, regulation of asset management as administered by the SEC already promotes financial stability, although its intent and structure are very different from the bank regulatory model contemplated by Section 113 of Dodd-Frank.

X. A Practical Perspective

As a practical matter, it is impossible to assess fully the likely consequences of extending the supervisory and regulatory regime for the largest banks to asset management firms whose business is so different from the business of banking, before the supervisory and regulatory regime for the largest banks, let alone designated nonbanks, is itself established and there is some experience with its effects, including any potential adverse effects on the financial intermediation that we are trying to promote. The Board has yet to 1) finalize the enhanced supervision and prudential standards for bank holding companies with consolidated assets of great than $50 billion; 2) establish an intermediate holding company structure to separate financial from nonfinancial activities; 3) implement, and in some cases establish, capital ratios applicable to large bank holding companies; 4) finalize a liquidity coverage ratio or propose a net stable funding ratio as contemplated by Basel III; or 5) finalize the Volcker rule. This environment of uncertainty for the bank supervisory and regulatory regime argues for proceeding cautiously rather than forging ahead to designate different business models to be subject to the same type of regime. A more orderly process would be to gain experience with a fully developed bank model first and then see whether, and under what circumstances, it might be applied to nonbank financial companies.

The uncertainties, including the number and magnitude of potential adverse consequences that could result from selectively imposing a new regulatory regime as comprehensive and intrusive as the bank model on a subset of a key financial services industry, are difficult to overstate. For example, it is possible that applying the bank model too rigidly to nonbanks could exacerbate systemic risk, rather than mitigate it, by increasing homogeneity in asset classes due to the incentive created by capital and liquidity rules. This homogeneity could create bubbles and then spread the effects of the ensuing collapse of such bubbles across more financial intermediaries[16] and increase the risk of multiple failures. At the same time, these incentives could starve other markets for investment and credit that might otherwise be provided by nonbank financial companies or increase assets' flight to less-regulated intermediaries or jurisdictions.

XI. Conclusion

The history of the regulation of asset management, as well as the fundamental differences between asset management and banking, confirms that these are different businesses with different risks both to investors and to the economy as a whole. But, the Report fails to focus on these differences and their significance for U.S. financial stability. Nor does the Report focus on the alternative approaches to addressing such risks and how the Section 113 designation process does, or does not, fit into those alternatives. While it may contain observations on how risk can arise relating to asset management, it does not address the probability that those risks will arise or how those risks threaten economic stability in a practical sense or how the Section 113 designation would reduce that threat.

In order to respond to FSOC's request in a meaningful way, more work needs to be done. As a practical matter, it appears that additional work would be best led by the SEC, which is already engaged in assessing money market mutual funds and the advisability of additional regulation. The SEC has a long history of regulating asset management and has responsibility for regulating a substantial portion of the industry. On some issues, collaboration with other regulators of asset managers or capital markets will be appropriate in order to gain a better understanding of the potential risks that asset management may present, whether or not they might threaten U.S. financial stability, and, if such a threat exists, the most efficient way to address that threat.

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[16] Residential home mortgages played a large part in both the Great Recession and in the savings and loan crisis two decades before.