THE INVESTMENT LAWYER™
covering legal and regulatory issues of asset management

Vol. 20, No. 4 • April 2013

Designation of Asset Managers and Funds As Systemically Important Non-Bank Financial Institutions: Process and Industry Implications: Part 2 of 2

By Gregory S. Rowland

In the March 2013 issue of *The Investment Lawyer*, Part 1 of this article addressed the process by which investment funds or their advisers could be designated as systemically important financial institutions (SIFIs), including the factors that regulators have indicated they would consider in making a SIFI designation. Part 2 of this article further discusses this process, as well as the potential consequences of such a designation for those designated, as well as for the industry as a whole.

The Three-Stage Review Process

To determine whether, based on the six-category analytic framework described in Part 1 of this article, a nonbank financial company (NBFC) should be designated as a SIFI, the Financial Stability Oversight Council (the Council) will undertake a review of the NBFC that may progress through up to three stages.

Stage 1

Stage 1 of the Council's review is effectively a mechanical screening process whose purpose is to eliminate from review those NBFCs that are so unlikely to pose significant

The author is a partner in the Investment Management Group of Davis Polk & Wardwell LLP. The author would like to thank Angelica Grasso, an associate in the Investment Management Group of Davis Polk & Wardwell LLP, and Nathan Scott Gimpel, a summer associate at Davis Polk & Wardwell LLP, for their significant contributions to this article.

systemic risk that they do not warrant extensive individual scrutiny. In this stage, the Council will apply six quantitative thresholds to identify NBFCs that will be subject to more qualitative, company-specific evaluation in Stage 2 and, possibly, Stage 3. These quantitative thresholds, which are designed to be easily measurable proxies for the six primary designation criteria described in Part 1 of this article (other than existing regulatory oversight) are:

- $50 billion in total consolidated assets;
- $30 billion in gross notional credit default swaps outstanding for which the NBFC is the reference entity;
- $3.5 billion in derivative liabilities;[1]
- $20 billion of total debt outstanding;
- 15 to 1 leverage ratio of total consolidated assets to total equity; and
- A 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months to total consolidated assets.[2]

To pass from Stage 1 to Stage 2, an NBFC generally must satisfy the $50 billion consolidated assets threshold *and* at least one other threshold. Where the Council believes that the Stage 1 thresholds inappropriately eliminated an NBFC, however, the Council retains the discretion to advance the NBFC to Stage 2.[3] The design of these thresholds appears to have been influenced by the firms that failed in the recent financial crisis, as the thresholds would have captured firms such as Bear Stearns, Lehman Brothers, and Countrywide.[4]

Relevance of Form PF in Stage 1

In determining whether these thresholds are met, the Council will look to information already available to it about the relevant NBFC.[5] The main source of information for private funds and their advisers will be Form PF, which was implemented by the US Securities and Exchange Commission (SEC) to help it and the Council monitor systemic risk.[6] In reviewing an asset manager or fund, the Council will, of course, be likely to review the manager's Form ADV, which provides much more limited financial information about an asset manager and its funds.

Form PF, which advisers began to file for the first time in 2012, requires most SEC-registered investment advisers of private funds to report unprecedented levels of information regarding their funds' assets, liabilities, and exposures.[7] Except for the Stage 1 threshold relating to credit default swaps written on the NBFC, the Stage 1 thresholds are all either directly or indirectly addressed by questions in Form PF. Please see Appendix A to this article for examples of how certain Form PF questions address the Stage 1 thresholds, as well as the overall designation criteria.

Potential New Stage 1 Thresholds for the Asset Management Industry

The Stage 1 thresholds are not designed specifically for the asset management industry, and the Council has indicated that it may develop additional metrics and thresholds for asset managers. The Council, its member agencies, and the Office of Financial Research are in the process of analyzing the extent to which the industry could present potential threats to system-wide financial stability.[8] Depending on the results of the study, the Council may issue new thresholds tailored for asset managers and funds, or it might even determine that prudential regulation is not the appropriate framework for the asset management industry. In the same vein, the Council stated that it may use the data that is collected through Form PF to establish an additional set of metrics or thresholds tailored to evaluate private funds and their advisers.[9] Although the Council has stated that, until such additional asset-management-specific metrics and thresholds are developed, it intends to apply the current, general thresholds to the asset management industry,[10] given the slow pace at which the current designation process is progressing, it is unclear whether any asset managers or funds will actually be designated as SIFIs before the more specific metrics and thresholds are announced.[11]

Stage 2

In Stage 2, the Council will perform a comprehensive analysis, using the six-criteria

analytic framework described above, to determine whether an NBFC that passes Stage 1 poses a threat to US financial stability. During this stage, the Council will analyze public or regulatory information about the relevant NBFC, including industry- and company-specific metrics beyond those analyzed in Stage 1.[12] To the extent data are available, the Council also intends to consider the impact that resolving a particular NBFC could have on U.S. financial stability during this stage.[13]

Because Stage 2 is intended to be the Council's initial company-specific analysis, based primarily on information already available to the Council, the Council has indicated that it will not notify an NBFC that it has entered Stage 2 review.[14] Instead, an NBFC will receive a notice only if it becomes subject to Stage 3 review, at which point the Council will likely request significant amounts of additional, non-public information. As a result of Form PF, a private fund manager and its funds may spend a longer time in Stage 2 than other NBFCs, because the Council will not need to initiate a Stage 3 review in order to obtain detailed information about the manager's private funds.

After a thorough qualitative analysis in Stage 2, the Council will advance to Stage 3 those NBFCs that it still believes may require designation as SIFIs in order to protect the US financial system.[15]

Relevance of Form PF in Stage 2

In Stage 2, the Council intends to evaluate in great detail the risk profile and characteristics of each NBFC based on the six-criteria analytic framework. In Stage 2, the Council will certainly consider the thresholds applied in Stage 1 (and in that regard the Form PF data relevant to Stage 1 will also be relevant here), but Stage 2 will also allow the Council to move beyond the simple Stage 1 metrics to dig more deeply into some of the designation factors not fully addressed by the Stage 1 review. Form PF data will be useful to the Council in this more comprehensive review as well. Please see Appendix A for examples of how Form PF data may be used by the Council during Stage 2.

Stage 3

If an NBFC moves to Stage 3 – the final review before formal designation as a SIFI – the Council will notify the NBFC that it is under review for designation as systemically important. While Stage 3 will, like Stage 2, be a quantitative and qualitative review of an NBFC within the designation criteria framework, in Stage 3, unlike in Stage 2, the Council will likely require the NBFC under consideration to produce a significant amount of non-public data for use in the Council's review.[16] As such, the Stage 3 review is likely to be even more detailed and company-specific than Stage 2 and may focus on aspects of an NBFC that are not readily apparent from information already available to the Council, such as the NBFC's resolvability and the opacity and complexity of its operations.[17] Thus, although Form PF data will undoubtedly continue to be relevant in Stage 3, the Council may be more likely to focus on the new information it obtains directly from the NBFC under review.

After completing its Stage 3 review of an NBFC, the Council may vote on whether to "subject [the NBFC] to a proposed determination" that it is a SIFI.[18] If there is an affirmative vote,[19] the Council will serve the NBFC with a notice of proposed determination.[20] The NBFC will then have an opportunity to request an evidentiary hearing, at which it can contest the proposed determination.[21] Following the hearing, the Council will again vote on the designation, and, if the designation is affirmed, it will issue a notice of final determination to the NBFC.[22] The Council will not announce the name of any NBFC that is under evaluation prior to this final determination.[23] Once a final determination has been made, the Council will endeavor to provide that NBFC with at least one business day's prior notice before publicly announcing the designation.[24]

After an NBFC has been finally designated as a SIFI, the NBFC may invoke a statutory appeal mechanism. No later than 30 days after receiving notice of a final determination, the NBFC may bring an action in a US district court for an order requiring that the determination be rescinded.[25] The court may

order the rescission of the Council's designation only if it determines that the Council was arbitrary and capricious in making its decision.[26] This standard of review will make the Council's determinations very difficult to overturn.

The Consequences of Being Designated

An asset manager or fund designated as a SIFI would become subject to regulation by the Board of Governors of the Federal Reserve System (FRB) pursuant to Section 113 of the Dodd-Frank Act, which requires that the FRB subject all SIFIs to "enhanced prudential standards."[27] The FRB has authority to craft the prudential regulatory requirements for non-bank SIFIs on an industry-by-industry or even firm-by-firm basis,[28] and senior officials have indicated that the FRB is likely to tailor its prudential standards to fit the industry or firm in question.[29]

Enhanced Prudential Standards

The FRB has yet to finalize the enhanced prudential regulatory framework for NBFC SIFIs generally, let alone for asset managers specifically, so it is as of now unclear what prudential regulation of an asset manager or investment fund would look like. The FRB has, however, proposed Regulation YY,[30] which outlines the proposed enhanced prudential standards applicable to large bank holding companies and NBFCs designated as SIFIs.[31] If adopted, Regulation YY would apply to a SIFI-manager or SIFI-fund unless more tailored requirements for the asset management industry were implemented. These proposed standards include capital requirements,[32] leverage limits,[33] liquidity requirements,[34] single-counterparty credit limits,[35] establishment of risk-management committees,[36] and establishment of an early remediation framework.[37] The FRB has also already adopted regular stress testing standards for large bank holding companies and NBFCs designated as SIFIs.[38] Although many of these standards are merely enhanced versions of regulations already in place for bank holding companies, if they, or something similar, were applied to asset managers and investment funds, they would represent an entirely new form of regulation for managers of private funds, which generally are not subject to substantive operational requirements (as opposed to anti-fraud and disclosure requirements). Further, even though some of these prudential standards would be familiar to the manager of a registered fund, such as leverage limits and liquidity requirements,[39] imposition of the proposed Regulation YY standards on a registered fund would, at a minimum, add additional substantive restrictions to the operation of the fund and might also lead to conflicts with the fund's regulation under the Investment Company Act of 1940.

While many of these prudential standards do not make much sense as applied to an asset manager itself (for example, capital requirements would be pointless for most asset managers, as they generally do not borrow significantly), it is certainly conceivable that the FRB could apply some form of many of these standards to a SIFI-fund. Indeed, the paralysis at the SEC over money market fund reform[40] has increased the chances that the Council might seek to regulate that subset of the asset management industry as SIFIs. Any fund or manager designated as a SIFI would face higher compliance and operating costs and might even need fundamentally to change the manner in which it operates.

Implications for the Asset Management Industry

The designation of even one asset manager or investment fund as a SIFI could affect the entire industry. While it cannot be known exactly how such a designation would impact the broader industry, several possibilities seem clear. First, the imposition of SIFI-prudential standards on one firm could cause that firm to be seen in the market as "too big to fail" and, therefore, as operating with an implicit government guarantee. This market perception could, of course, give the firm a significant competitive advantage over other managers in raising and retaining assets from fund investors (particularly if the firm were able to maintain its performance while operating under the

prudential standards). It might even give the firm more subtle advantages for its funds, such as lower financing costs and better terms from counterparties.

Second, if a few of the largest asset managers begin operating their funds under SIFI-prudential standards – such as capital requirements – those standards may eventually become seen as "best practices" and spread throughout the rest of the industry. Smaller firms could feel compelled to adopt such standards, even if not legally required, either because investors had come to expect adherence to the standards or because the smaller firms felt exposed to liability if they did not follow perceived "best practices."

Third, the regulation of money market funds as SIFIs could affect non–money market funds and their managers as well. In particular, many investment advisers use money market funds as a way to manage their investment funds' cash positions (both temporary positions and defensive allocations), and the imposition of SIFI standards on money market funds could affect the utility and convenience they offer. While it is impossible to know at this stage exactly what sort of effects the SIFI-regulation of money market funds could have (and it also seems likely that some manner of money market fund reform will occur whether or not effected through the SIFI process), any proposal to designate money market funds as SIFIs could be relevant to asset managers that do not themselves manage money market funds.

Thus, although it is very unlikely that more than a handful of asset managers or non–money market funds will be designated as SIFIs, given the potentially broad implications if even a few asset managers or investment funds were designated as SIFIs, the asset management industry as a whole should be closely monitoring developments in this area. Since the FRB is still in the process of crafting the enhanced prudential regulatory framework for NBFC SIFIs, and more industry-specific SIFI-designation criteria for asset managers have yet to be announced, the asset management industry, through lobbyists and trade groups, may still be able to seek to influence the development of the SIFI regime as it relates to the industry.

Conclusion

The Dodd-Frank Act has dramatically altered the US financial regulatory landscape, not least through the creation of the Council and the NBFC SIFI prudential regulatory framework. It remains to be seen to what extent the Council will seek to designate asset managers and investment funds as SIFIs and to impose the FRB's prudential regulatory authority on them. Given the potentially sweeping implications for the asset management industry if the Council were to do so, asset managers should be closely following this area and seeking to influence the process to ensure that the industry receives fair and thoughtful treatment.

Appendix A

Relevance of Form PF to the SIFI Designation Process	
Stage 1 Threshold	**Certain Relevant Form PF Questions**
$50 billion in total consolidated assets	Question 8 (private fund's gross asset value).
$3.5 billion in derivative liabilities	Questions 13 and 44 (gross notional value of derivative positions of a private fund and hedge fund, respectively). Given that Form PF asks for the gross notional value of a reporting fund's derivative positions and the Council intends to assess this factor on a fair value basis,[41] the Council may also look to Question 23 which requires disclosure of the exposures a hedge fund's top five counterparties have to the fund.

continued...

Appendix A *(continued)*

Relevance of Form PF to the SIFI Designation Process	
Stage 1 Threshold	**Certain Relevant Form PF Questions**
$20 billion of total debt outstanding	Question 46 (aggregate amount of borrowing by a hedge fund plus undrawn available cash financing); Question 58 (similar information for liquidity funds). There is no corresponding question for reporting private equity funds, but a private equity fund's outstanding debt could be estimated by comparing its gross asset value (Question 8) to its net asset value (Question 9).
15 to 1 leverage ratio of total consolidated assets to total equity	A private fund's leverage ratio can be estimated by comparing its gross asset value (Question 8) to its net asset value (Question 9), which is a proxy for the amount of equity investors have in the fund.
A 10 percent short-term debt ratio of total debt outstanding with a maturity of less than 12 months to total consolidated assets	A hedge fund's or liquidity fund's short-term debt ratio could be estimated by comparing the amount of its short-term debt reported in Question 46 or Question 58 to its gross asset value in Question 8. Private equity funds are not required to report the maturity of their outstanding debt.
Council Criteria Considered in Stage 2 and Beyond	**Certain Relevant Form PF Questions**
Interconnectedness	Questions 22, 23, 36, and 37 report a hedge fund's five counterparties that have the largest exposures to the fund (and the five to which the fund has the greatest exposure) and the extent such exposures have been collateralized. There are no similar questions for liquidity funds or private equity funds. Questions 15 and 16 report the nature and extent of a private fund's investors and it may be notable to the Council if a large portion of the fund is owned by financial institutions.
Size	Question 8 (private fund's gross asset value).
Substitutability	To assess a private fund manager's substitutability, the Council might consider the types of assets its funds invest in as shown by Questions 30 (for hedge funds) and 56 (for liquidity funds). A fund investing heavily in debt issued by financial institutions, for example, might be considered less substitutable than a fund investing in liquid equities.
Liquidity and maturity mismatch risk	To understand better a hedge fund's or liquidity fund's liquidity and maturity mismatch risk arising from investor redemptions or its debt maturation, the Council could compare the liquidity of the fund's portfolio (Questions 32 and 55(d)-(i)) with the liquidity that the fund's investors enjoy (Questions 50 and 64) or with the expected maturity of the fund's debt obligations (Questions 46 and 58).

Relevance of Form PF to the SIFI Designation Process	
Council Criteria Considered in Stage 2 and Beyond	**Certain Relevant Form PF Questions**
Leverage	The following questions are examples of those that provide information about a fund's leverage: • Questions 8 and 9 (gross and net asset value of a private fund); • Question 43 (amount and type of borrowings by a hedge fund); • Question 44 (aggregate gross notional value of a hedge fund's derivative positions); • Question 46 (amount and maturity terms of a hedge fund's borrowing); • Question 58 (amount, type and maturity terms of borrowings by a liquidity fund); and • Question 66 (amount of portfolio company debt guaranteed by a private equity fund).
Existing regulatory scrutiny	N/A
Other Possible Consideration	**Certain Relevant Form PF Questions**
Riskiness	The Council may also consider the riskiness of an investment manager's investment activities. Relevant to that analysis will be Questions 40 and 42 that require information about hedge fund VaR statistics and stress test results.

Notes

1. The Council intends to measure derivatives liability for this purpose as the "fair value of derivatives contracts in a negative position." Financial Stability Oversight Council (FSOC), Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies, 77 Fed. Reg. 21,637, 21,661 (Apr. 11, 2012) (to be codified at 12 C.F.R. pt. 1310).

2. *Id.* at 21,643.

3. *Id.*

4. *See id.* at 21,661.

5. *See id.* at 21,643-44.

6. *See Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF,* SEC Release No. IA-3308 (Oct. 31, 2011), available at *http://www.sec.gov/rules/final/2011/ia-3308.pdf.* For more information about Form PF, *see generally* United States Securities and Exchange Commission, Form PF: Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors (hereinafter, SEC, Form PF), available at *http://www.sec.gov/about/forms/formpf.pdf* and Davis Polk Client Newsletter "Investment Management Regulatory Update" (Nov. 18, 2011). In the case of registered funds, the financial statements and portfolio holdings reports publicly filed by the funds will be available to the Council. Further, registered money market funds also file on a monthly basis Form MFP, which provides detailed information about the funds' portfolios. This information, however, is not as extensive as the information about private funds reported on Form PF.

7. *See generally* SEC, Form PF*, supra* n.6.

8. FSOC, 77 Fed. Reg. at 21,644.

9. *Id.*

10. *Id.*

11. Notably, at a Senate Banking Committee hearing on financial regulatory reform in February 2013, Treasury Undersecretary Mary Miller stated that the final nonbank SIFI designation criteria had not been developed with the asset management industry in mind, because the Council and the Office of Financial Research were still studying the systemic implications of the industry. *See* Hearing on Wall Street Reform, Senate Committee on Banking, Housing and Urban Affairs, 113th Cong. 35-36 (2013). Ms. Miller noted that the Council would likely create additional criteria that it would apply in considering asset managers for SIFI designation and that these criteria

would likely be published for public comment. *Id.* at 36. This further supports the conclusion that asset managers and funds will likely not be under serious consideration for designation until such criteria have been established.

12. *Id.* at 21,642.

13. *Id.* at 21,645.

14. *Id.*

15. *See id.* at 21,642.

16. *See id.* at 21,662 (stating that the Council will likely "request that the [NBFC that the Council is moving to Stage 3] provide information that the Council deems relevant to the Council's evaluation").

17. *Id.*

18. *Id.* at 21,646.

19. An affirmative vote requires two-thirds of the voting members of the Council then serving, including the vote of the Council Chairperson. *Id.* at 21,662.

20. *Id.* If either before or after a proposed determination, an NBFC that has advanced to Stage 3 ceases to be considered for determination, the Council expects to notify the NBFC of this. *Id.*

21. *Id.*

22. *Id.* As with a proposed determination, the affirmative vote of two-thirds of the voting members of the Council then serving, including the affirmative vote of the Council Chairperson, is required for the Council to approve a final determination. *Id.*

23. *Id.*

24. *Id.*

25. Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act), Pub. L. No. 111-203, § 113(h), 124 Stat. 1376, 1402 (2010) (codified as amended in scattered sections of the US Code).

26. *See id.*

27. *See generally id.* at § 113, 124 Stat. at 1398–1402.

28. *Id.* at § 165 (a)(2)(A), 124 Stat. at 1423-24.

29. *See* Hearing Before the House Financial Services Financial Institutions Subcommittee on The Impact of the Dodd-Frank Act: What It Means to be a Systemically Important Financial Institution, 112th Cong. 3 (2012), at 4 (statement of Michael S. Gibson, Dir. of Div. of Banking Supervision and Reg. of the Bd. of Governors of the Fed. Res. Sys.).

30. *Enhanced Prudential Standards and Early Remediation Requirements for Covered Companies*, 77 Fed. Reg. 594 (proposed Jan. 5, 2012) (to be codified at 12 C.F.R. pt. 252). The only Regulation YY standards that have been finalized to date are the stress test requirements. *See Supervisory and Company-Run Stress Test Requirements for Covered Companies*, 77 Fed. Reg. 62,378 (Oct. 12, 2012).

31. Enhanced Prudential Standards, *supra* n.30.

32. *Id.* at 602–04.

33. *Id.* at 633–34.

34. *Id.* at 604–12.

35. *Id.* at 612–22.

36. *Id.* at 622–25.

37. *Id.* at 634–42.

38. *See* Supervisory and Company-Run Stress Test Requirements for Covered Companies, *supra* n.30.

39. *See* Investment Company Act of 1940, 15 U.S.C. §§ 80a-18(a)-(h) (2006) and 15 U.S.C.§ 80a-22(e) (2006).

40. *See, e.g.*, U.S. Securities and Exchange Commission, Statement of SEC Chairman Mary L. Schapiro on Money Market Fund Reform (Aug. 22, 2012), available at *http://www.sec.gov/news/press/2012/2012-166.htm*; *see also* U.S. Securities and Exchange Commission, Statement on the Regulation of Money Market Funds by Commissioner Daniel M. Gallagher; Commissioner Troy A. Paredes (Aug. 28, 2012), available at *http://www.sec.gov/news/speech/2012/spch082812dmgtap.htm*.

41. *See* FSOC, 77 Fed. Reg. at 21,661.

Copyright © 2013 CCH Incorporated. All Rights Reserved
Reprinted from *The Investment Lawyer* April 2013, Volume 20, Number 4, pages, 24–31, with permission from Aspen Publishers, Wolters Kluwer Law & Business, New York, NY, 1-800-638-8437, www.aspenpublishers.com

Wolters Kluwer
Law & Business