Regulatory Cooperation and Conflict: Regulating Systemic Risk in the Asset Management Industry

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This brief reviews the legal powers allocated to designated authorities to regulate the asset management industry in three 'jurisdictions'. It focuses on the powers of different government bodies to designate and regulate potential systemic risk posed by systematically important financial institutions; and in particular, by nonbank non-insurer asset management companies. By explaining the different regulatory structures, this brief outlines the institutional architecture entrusted to maintain national and international financial stability.

Systematically Important Financial Institutions: the International Framework

The Financial Stability Board (FSB) was formed in 2009 out of a prior group, the Financial Stability Forum. It is a group composed of the G20 financial regulators and finance ministers; the global regulatory committees (the Bank of International Settlements (BIS) and its three subcommittees (BCBS, CGFS and CPSS)[1], the International Organization of Securities Commissioners (IOSCO), and the International Association of Insurance Supervisors (IAIS)[2]); the International Accounting Standards Board (IASB)[3]; and additional members such as the IMF, World Bank, European Central Bank, European Commission and the OECD.[4]

In November 2011 the FSB published an integrated set of policy measures to address the systemic and moral hazard risks associated with systemically important financial institutions (SIFIs), and identified an initial group of 29 global systemically important banks (G-SIBs) based on a methodology developed by the BCBS.[5] On July 2013 the FBS proceeded to identify, in consultation with the IAIS and national authorities, an initial list of 9 global systematically important insurers (G-SIIs) to which a prudential set of policy measures was subsequently applied.[6]

In the summit of November 2011, however, the G20 Leaders have also asked the FSB, in consultation with the IOSCO, to prepare a set of methodologies for identifying systemically important non-bank non-insurer systematically important financial institutions (NBNI SIFIs). The proposed methodologies for NBNI G-SIFIs were then published for public consultation in January 2014 (the January 2014 Consultative Document), and introduced a framework of detailed NBNI sector-specific methodologies for

[1] The Bank of International Settlements (BIS) includes three subcommittees: Basle Committee on Banking Supervision, Committee on the Global

Financial System, and Committee on Payments and Settlement Systems; and is comprised of the G20 central banks and banking supervisors.
[2] Both IOSCO and IAIS are international committees of national regulators.
[3] A non-State body of accounting professionals.
[4] OECD (2013), *International Regulatory Co-operation: Case Studies, Vol. 2: Canada-US Co-operation, EU Energy Regulation, Risk Assessment and Banking Supervision*, OECD Publishing, p. 72. http://dx.doi.org/10.1787/9789264200500-en
[5] The list was subsequently updated. http://www.fsb.org/wp-content/uploads/r_121031ac.pdf
[6] http://www.fsb.org/wp-content/uploads/r_130718.pdf

identifying systematically important (i) finance companies; (ii) market intermediaries (securities broker-dealers); and (iii) investment funds (including hedge funds).[7]

The January 2014 Consultative Document aimed to identify NBNI financial institutions whose "distress or disorderly failure, because of their size, complexity and systemic interconnectedness, would cause significant disruption to the wider financial system and economic activity at the global level".[8] Consultative responses asked for a more thorough analysis of the systemic risks associated particularly with asset management entities; and on 4 March 2015, the FSB published the revised second consultative document on the assessment methodologies (March 2015 Consultative Document), which included sector-specific methodologies for (i) finance companies, (ii) market intermediaries, (iii) investment funds (including hedge funds), and (iv) asset managers (as a separate subsector).[9]

The separation of the two categories of asset management entities (i.e. investment funds and asset managers) in the March 2015 Consultative Document, indicated a dual approach to analyzing asset management associated systemic risk: (i) a **refined** methodology for investment funds with an increased focus on leverage, and (ii) a **separate** methodology focused on *activities* that *if* conducted by *a particular asset manager* may have the potential to generate systemic risk.[10]

The process of designating NBNI G-SIFIs, as set in the January 2014 Consultative Document, shows a strong reliance on inter-agency power sharing, where assessments are conducted by national authorities in coordination with an international oversight mechanism.[11] The FSB and IOSCO form an international oversight group (IOG) in order to coordinate the assessment process. The group is comprised of representatives from the FSB and IOSCO member jurisdictions, and other relevant standard setting bodies (SSBs). The process envisions a cumulative step-based designation in which:

- The IOG first compiles reference lists – **Stage 0 lists** - of NBNI financial entities in FSB and IOSCO member jurisdictions that equal or exceed the set *materiality thresholds*, broken down by their sector-specific type. NBNI entities around the threshold may also be included in order to prevent potential arbitrage or to capture errors that may occur around the thresholds. Each financial entity is reviewed by its home jurisdiction (in addition to NBNI financial entities that home jurisdictions independently add to the lists – **Stage 1 lists**).[12]

- National authorities then collect data/information on the indicators specified in the NBNI G-SIFI sector-specific methodologies using all available sources (including public information, supervisory information, or, if possible, information obtained directly from the relevant NBNI financial entity), and conduct an analysis of the impact of failure or distress of the entity on the global financial system, in order to develop a n**arrative**

[7] *Consultative Document (2nd), Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions: Proposed High-Level Framework and Specific Methodologies*, FSB and IOSCO, 4 March 2015, pp. 1-3 (*FSB Assessment Methodologies*).
[8] *Ibid*, p. 1.
[9] *Ibid*, pp. 1-3.
[10] *Ibid*, p. 30.
[11] For a more detailed description of the proposed process: *FSB Assessment Methodologies*, pp. 12-15.
[12] If the jurisdiction is not an FSB member or a member of IOSCO or other relevant standard-setting bodies, the relevant authorities in that jurisdiction will be asked to participate in the designation process as if they were a member of these bodies.

assessment (discussing the indicators and transmission mechanisms) and an initial recommendation.

- Next the IOG provides feedback, and national authorities conduct follow-up analyses to reach a **preliminary determination** on designation. The preliminary determination and the final narrative assessments are compiled by the IOG for discussion and review by the relevant competent subsections of the FSB and the IOSCO.

- The FSB and the national authorities then together determine the **final list** of G-SIFIs, and the FSB releases a combined list of all NBNI G-SIFIs and a summary of narrative assessments for each identified G-SIFI. The process is repeated annually and an updated NBNI G-SIFI list - along with the G-SIB and G-SII lists – is published on the FSB website.

On March 2015, the FSB had additionally started working on structural vulnerabilities associated with asset management activities (in parallel to its work on the assessment methodologies). The purpose was to better understand and address potential risks to the global financial stability resulting from various asset management activities.[13] On July 2015, the FSB decided to wait with finalizing the assessment methodologies for NBNI G-SIFIs until the work on structural vulnerabilities was completed.[14] The final *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* report was ultimately published on 12 January 2017.[15] The report presents four main activities-based vulnerabilities: liquidity mismatch between fund investments and redemption terms and conditions for open-ended fund units; leverage within investment funds; operational risk and challenges at asset managers in stressed conditions; and securities lending and indemnification activities of asset managers and funds. It then provides 15 final policy recommendations.[16]

As for the development of specific instruments for regulating NBNI SIFIs, the March 2015 Consultative Document does not propose any specific entities for designation nor any prudential policy measures. Instead it notes that once the assessment methodologies are finalized, the FSB and IOSCO (and other SSBs where relevant) will develop policy measures to address the systemic and moral hazard risks posed by NBNI G-SIFIs.[17]

The emerging global regulatory framework for NBNI SIFIs therefore presents a structure of power sharing: a thematically-based division of authority in combination with mechanisms for inter-agency cooperation. Next this brief will examine the regulatory frameworks for preventing or mitigating NBNI-associated systemic risk in two separate jurisdictions: the US and the EU.

[13] http://www.fsb.org/wp-content/uploads/Press-Release-FSB-Plenary-Frankfurt-final-26Mar15.pdf
[14] http://www.fsb.org/wp-content/uploads/NBNI-G-SIFI-Next-Steps-Press-Release.pdf
[15] http://www.fsb.org/wp-content/uploads/Asset-Management-Press-Release.pdf
[16] http://www.fsb.org/wp-content/uploads/FSB-Policy-Recommendations-on-Asset-Management-Structural-Vulnerabilities.pdf
[17] FSB (2017), *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities*, p. 2 (*FSB Policy Recommendations on Asset Management Activities*), p. 2.

NBNI SIFIs in the US System

The Dodd–Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) was enacted on July 2010, aiming to solve some of the problems that contributed to the financial crisis of 2008 and to end implicit guarantees and federal intervention for bailing out large, complex, interconnected firms.[18] The Dodd-Frank Act created the Financial Stability Oversight Council (FSOC),[19] to provide a comprehensive monitoring body for ensuring the stability of the US financial system. The FSOC was charged with identifying risks to financial stability, promoting market discipline by eliminating expectations on the part of shareholders, creditors and counterparties of systematically important companies that the government will shield them in the event of failure, and with responding to emerging risks. It consists of ten voting members and five non-voting members, chaired by the Secretary of the Treasury, and it brings together the expertise of federal financial regulators, state regulators, and an independent insurance expert appointed by the President.[20]

The legal authority to designate NBNI systematically important financial institutions:

To address potential risks to U.S. financial stability posed by large, complex, interconnected firms beyond the traditional banking sector, the Dodd- Frank Act authorizes the FSOC to designate certain nonbank financial companies and place them under the authority and supervision of the Fed (§ 113), thus to subject them to an enhanced set of prudential standards as set forth in the Act and further developed by the Fed (§ 165) (i.e., the designation process). The FSOC makes a determination:

> "[…] on a nondelegable basis and by a vote of not fewer than 2⁄3 of the voting members then serving, including an affirmative vote by the Chairperson, […] that a U.S. nonbank financial company shall be supervised by the Board of Governors [of the Fed. Res. System] and shall be subject to prudential standards, in accordance with this title, if the Council determines that material financial distress at the U.S. nonbank financial company, or the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the U.S. nonbank financial company, could pose a threat to the financial stability of the United States".[21]

Dodd-Frank § 165 provides that prudential standards for SIFIs will include risk based capital requirements and leverage limits, liquidity requirements, overall risk management requirements, resolution plans, credit exposure report and concentration limits. Section 113, by empowering the FSOC to designate **nonbank** financial institutions, essentially extends this *lex specialis* to nonbank financial firms that are systemically significant.

[18] Balasubramnian and Cyree (2014), p. 156.
[19] Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act) § 111, 12 U.S.C. 5321 (Financial Stability Oversight Council).
[20] "The voting members, who shall each have 1 vote on the Council shall be the Secretary of the Treasury, who shall serve as Chairperson of the Council; the Chairman of the Board of Governors; the Comptroller of the Currency; the Director of the Bureau; the Chairman of the Commission; the Chairperson of the Corporation; the Chairperson of the Commodity Futures Trading Commission; the Director of the Federal Housing Finance Agency; the Chairman of the National Credit Union Administration Board; and an independent member appointed by the President, by and with the advice and consent of the Senate, having insurance expertise […]The nonvoting members, who shall serve in an advisory capacity as a nonvoting member of the Council, shall be the Director of the Office of Financial Research; the Director of the Federal Insurance Office; a State insurance commissioner, to be designated by a selection process determined by the State insurance commissioners; a State banking supervisor, to be designated by a selection process determined by the State banking supervisors; and a State securities commissioner (or an officer performing like functions), to be designated by a selection process determined by such State securities commissioners."
The Dodd-Frank Act § 111(b)(1)-(2) [12 U.S.C. 5321] Financial Stability Oversight Council Established.
[21] Dodd-Frank Act, § 113 (a)(1), 12 U.S.C. 5323 (Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies).

On 3 April 2012, the FSOC voted to approve its Final Rule implementing section 113 (*Final Rule*), thereby allowing the federal government, for the first time, to identify systemically important financial institutions outside the traditional banking sector. The Final Rule develops a detailed three-stage evaluation process which includes both quantitative and qualitative measures. Under the Final Rule, a particular nonbank financial company (that meets the quantitative threshold) will be subject to Fed supervision and prudential standards under two scenarios: (i) if material financial distress at the nonbank financial company could pose a threat to the financial stability of the U.S. (the "First Determination Standard"); *or* (ii) if the nature, scope, size, scale, concentration, interconnectedness, or mix of the activities of the nonbank financial company could pose a threat to the financial stability of the U.S. (the "Second Determination Standard"). [22] The term *or* indicates an alternative, not cumulative, structure.

In deciding whether a particular nonbank financial company meets either of the determination standards, the FSOC must evaluate 10 statutory considerations as required in § 113. The FSOC has consolidated these 10 statutory considerations into a six-category analytical framework that includes: size, interconnectedness, lack of substitutes, leverage, liquidity risk and maturity mismatch, and existing regulatory scrutiny. The Final Rule envisions a three-step designation process.[23]

- In **Stage 1** the FSOC identifies nonbank financial companies that should be subject to further evaluation in subsequent stages of review, by applying the *quantitative thresholds* set by the analytical categories of size, interconnectedness, leverage, and liquidity risk and maturity mismatch. Stage 1 is not a final determination, however, but merely an initial review to narrow the scope of potential companies.

- **Stage 2** then introduces an in-depth analysis of each nonbank financial company to determine the potential threat that each could pose to the financial stability of the US. This stage relies on publicly available information, including information possessed by the company's primary financial regulatory agency or home-country supervisor. The FSOC evaluates the information, using the six-category analytical framework. Additionally, qualitative factors are used in order to evaluate whether the resolution of the specific nonbank financial company could pose a threat and the degree to which a nonbank financial company is already subject to regulatory scrutiny.

- After the completion of Stage 2, the FSOC notifies the nonbank financial companies identified as requiring further review by a formal **Notice of Consideration** that the nonbank financial company is under consideration for a **Proposed Determination**. The Notice will likely contain a request that the company provides certain additional financial information relevant to the analysis, some of which may involve confidential business information. The company is allowed to submit written materials contesting the consideration for a proposed determination.[24]

[22] *Appendix A to Part 1310—Financial Stability Oversight Council Guidance for Nonbank Financial Company Determinations*, 12 C.F.R Part 1310 [Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies], 77 Federal Register 70, April 11, 2012 (Rules and Regulations), p. 21657. (*FSOC Final Rule*)
[23] Tarbert et al. (2012), pp. 421-426; FSOC Final Rule, pp. 21656-21660.
[24] Tarbert et al. (2012), pp. 423-426.

The legal authority to regulate systematically important financial institutions:

Dodd-Frank Act § 165 provides a framework for enhanced prudential standards following a SIFI designation. A determination by the FSOC under § 113 provides the Fed with the legal authority to regulate nonbank SIFIs. Section 165(b)(1)(A) sets several **mandatory prudential standards**, including risk-based capital requirements and leverage limits; liquidity requirements; risk management requirements; a resolution plan in the event of financial distress or failure; credit exposure reports requirements, and concentration limits (including a credit exposure limit).[25] With regard to *risk-based capital* and *leverage limits*, however, the Fed (in consultation with the FSOC) can decided that such requirements will not apply if the company is subject to more stringent prudential standards because of its activities (such as investment company activities or assets under management) or structure; and, in this case, to apply other standards that result in similarly stringent risk controls.[26]

The Act then **permits the Fed** to impose **additional standards** (as opposed to the mandatory ones); in particular, to apply a contingent capital requirement that is convertible to equity in times of financial stress; enhanced public disclosures; short-term debt limits, including off balance sheet exposures,[27] and

> "such other prudential standards as the [Fed], on its own or pursuant to a recommendation made by the [FSOC] in accordance with section 115, determines are appropriate."[28]

An open-ended provision to indicate that the list of prudential standards is non-exhaustive and may include other measures not mentioned in the Act. Whether such additional standards will or will not be required, is at the discretion of the Fed.

Lastly, under its powers to adopt Rules, the Fed eventually issued a Rule on enhanced prudential standards, Regulation YY.[29] Wan (2016) notes, however, that while the Rule implements certain provisions of §165 establishing enhanced prudential standards for bank holding companies and foreign banking organizations; it currently left open the question of prudential standards for nonbank systematically important financial companies, and instead noted that such standards will be applied on a case-by-case basis.[30]

Additional considerations:

The authority to designate SIFIs has been allocated to the FSOC, a combination of the Treasury and Federal-level and State-level regulators. However, the FSOC does not hold any regulating powers in relation to SIFIs, and instead has only been legally authorized to designate and place them under the supervision of the Fed (with the exception of making *recommendations* on prudential standards). The Fed is the regulatory body with the legal mandate to develop specific prudential standards. Applying this *lex specialis* beyond the banking sector, therefore, means that a designated financial institution that has not been traditionally under the supervision of the Fed will be subject to the scrutiny of the Fed from the

[25] Dodd-Frank Act, § 165(b)(1)(A) [12 U.S.C. 5365].
[26] Dodd-Frank Act, § 165(b)(1)(A)(i) [12 U.S.C. 5365].
[27] Dodd-Frank Act, § 165(b)(1)(B)(i)-(iii) [12 U.S.C. 5365].
[28] Dodd-Frank Act, §165(b)(1)(B)(iv) [12 U.S.C. 5365].
[29] 12 C.F.R. pt. 252 (Enhanced Prudential Standards, Regulation YY): http://www.ecfr.gov/cgi-bin/text-idx?SID=b7d3909ccf5433ce72ecd126aaf55bb6&mc=true&node=pt12.4.252&rgn=div5#_top
[30] Wan (2016), p. 815.; see also 12 C.F.R. pt. 252.4 (a) (U.S. Nonbank Financial Companies Supervised by the Board): http://www.ecfr.gov/cgi-bin/text-idx?SID=b7d3909ccf5433ce72ecd126aaf55bb6&mc=true&node=pt12.4.252&rgn=div5#_top

moment of designation. However, while the Fed is the regulatory body with a *de jure* mandate to establish prudential standards for both banks and nonbank companies; a *de facto* structure had evolved in relation to nonbank entities.

- The Second Determination Standard - which takes into account the "nature, scope, size, scale, concentration, interconnectedness, or mix of the activities"[31] of nonbank financial companies - provides a legal basis for the FSOC to designate companies in cases where the potential for systemic risk is not directly linked to their insolvency, but can also result from a mix of their activities .[32] Dodd-Frank Act § 115 mandates the FSOC to make recommendations to the Fed on additional prudential standards and/or on reporting and disclosure requirements in relation to nonbank financial companies in order:

  > "[T]o prevent or mitigate risks to the financial stability of the United States that could arise from the material financial distress, failure, or ongoing activities of large, interconnected financial institutions […]".[33]

  The use of the term *ongoing* in § 115 – while referring more specifically to recommendations of prudential standards following designation, and not the designation process itself – nonetheless suggests that systemic risk can result from the ongoing operations and practices of financial companies.[34] Therefore, while the language of Dodd-Frank might limit the FSOC's powers of designation to *companies* by setting the threshold at a *mix of activities* (at the firm-level); the language chosen to define its powers to recommend prudential standards for designated nonbank financial companies (i.e. *ongoing activities*) implies that **individual activities** may well be the source of such systemic risk if carried out by large interconnected financial institutions, and it is within the prerogative of the FSOC to look into such activities.

- Nonbank non-insurer asset management companies are generally not regulated by the Fed.[35] Most such companies are registered with the SEC as investment advisers and regulated by the Investment Advisers Act of 1940.[36] Unbounded by the restrictions on investment concentration or leverage under the Investment Company Act 1940, investment advisors are only restricted by the terms specified in their contractually-based agreements with their clients when it comes to taking on leverage or to investing in various asset classes or concentrated positions.[37] According to the Office of Financial Research[38], the regulation of investment advisors is more focused on limiting conflict of interests between asset managers and their clients.[39] Existing data gaps in relation to

[31] *FSOC Final Rule*, p. 21657.
[32] As suggested by the term or that separates the two standards.
[33] Under § 115, the FSOC may recommend risk-based capital requirements; leverage limits; liquidity requirements; resolution plan and credit exposure report requirements; concentration limits; a contingent capital requirement; enhanced public disclosures; short-term debt limits, and overall risk management requirements. Dodd-Frank Act, § 115 (a)(1) and (b)(1) 12 U.S.C. 5325 (Enhanced Supervision and Prudential Standards for Nonbank Financial Companies Supervised by the Board of Governors and Certain Bank Holding Companies).
[34] In comparison with the FSB, the Dodd-Frank review framework is broader in scope, as the FSB reviews only financial institutions whose distress or disorderly failure would cause significant disruption to the wider financial system.
[35] Although many of them maintain a trust bank, regulated by the Office of the Comptroller of the Currency or a state bank regulatory agency, to offer collective investment funds to eligible clients or certain individual retirement account products.
[36] Office of Financial Research (2013), *Asset Management and Financial Stability*, p. 27.
https://www.financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf (*OFR report 2013*)
[37] OFR report 2013, p. 24.
[38] The agency providing research support to the FSOC.
[39] By focusing primarily on ensuring that asset managers adhere to their clients' desired risk-return profiles, these regulations do not address collective action problems relating to herding behavior, for example. OFR report 2013, p. 12.

risk-taking, leverage, and liquidity transformation, thus impede the ability of regulators to review their activities.[40]

- On May 2014, the FSOC held a public conference on asset management. Following this conference, in July 2014, it directed its staff to undertake a more focused analysis of **industry-wide products and activities to assess potential risks across the asset management sector**. On December 2014, the FSOC published a notice seeking public comment on whether and how certain asset management products and activities could pose potential risks to U.S. financial stability, and in April 2016 published an update on the review of asset management products and activities – underlying a focus on liquidity and redemption; leverage; operational functions, in particular service provider concentration; securities lending, and resolvability and transition planning.[41]

- The FSOC's statement explicitly mentions some of the recent activities taken by the SEC, and specifically points to a set of Rules it has issued since May 2015 with the objectives of (1) enhancing data reporting for registered investment companies and registered investment advisers of separately managed accounts; (2) strengthening liquidity risk management programs and disclosure for registered funds; and (3) limiting the amount of leverage that registered investment companies may obtain through derivatives transactions.[42] Among other things, the SEC has apparently adopted rules that will enhance the reporting of information by investment advisors and will include (starting October 2017) aggregate data on types of assets held by separately managed accounts and the use of borrowing and derivatives.[43]

While the question of whether the Fed is the appropriate authority to regulate nonbank financial companies; it seems that, at least for now, the FSOC is refraining from exercising its jurisdictional authority to designate specific asset managers; and instead is focusing on reviewing activities and products in the asset management industry as a whole. Such authority (as argued above) is well within the prerogative of the FSOC. By refraining from designating specific asset managers, the FSOC essentially shifts the power balance back to the SEC, the traditional regulator of asset managers, and in fact relies on the SEC to address systemic risk in the asset management industry.

NBNI SIFIs in the EU System

The European System of Financial Supervision (ESFS) was created in late 2010 and came into operation on 1 January 2011. It consists of a *macro-prudential pillar* – the European Systemic Risk Board (ESRB) - responsible for the macroprudential oversight of the financial system in the EU as a whole, and a *micro-*

[40] OFR report 2013, p. 24.
[41] *Financial Stability Oversight Council Releases Statement on Review of Asset Management Products and Activities*, public statement from 4/18/2016 (https://www.treasury.gov/press-center/press-releases/Pages/jl0431.aspx) (*FSOC Statement, April 2016*).
[42] FSOC Statement, April 2016.
[43] https://www.sec.gov/news/pressrelease/2016-168.html

prudential pillar composed of the three European Supervisory Authorities (ESAs)[44], a Joint Committee of the ESAs, and the supervisory or competent authorities of Member States (NCAs).[45]

Regulation 1092/2010 of the European Parliament and of the Council of November 2010 on the EU macro-prudential oversight of the financial system and establishing a European Systemic Risk Board (ESRB Regulation) entered into force on December 2010.[46] Further codification of the ESRB practices was subsequently adopted in its decision on Rules of Procedures[47] and the ESRB Code of Conduct[48]. Article 3(1) of the ESRB Regulation sets out the objective of the ESRB to be responsible:

> "[…] for the macro-prudential oversight of the financial system within the Union in order to contribute to the prevention or mitigation of systemic risks to financial stability in the Union that arise from developments within the financial system and taking into account macroeconomic developments, so as to avoid periods of widespread financial distress. It shall contribute to the smooth functioning of the internal market and thereby ensure a sustainable contribution of the financial sector to economic growth".[49]

The General Board of the ESRB has a large and broad membership composed of 38 voting members (including the President and Vice-President of the ECB, the governor of the central bank of each Member State, the chairpersons of each of the three ESAs, a member of the European Commission, the Chair and two Vice-Chairs of the Advisory Scientific Committee, and the Chair of the Advisory Technical Committee), and 29 non-voting members (including one high-level representative per Member State of the competent national supervisory authorities - rotating depending on the item discussed - and the President of the Economic and Financial Committee (EFC) of the Council).[50]

The legal authority to designate systemically important financial institutions:

The ESRB Regulation mandates the Board with the legal authority to carry out 10 specific tasks for the purpose of contributing to the prevention or mitigation of systemic risks in the EU. This mandate includes tasks in such areas as risk identification and mitigation, cooperation with other ESFS institutions, and additional related tasks as specified in EU law.[51] Unlike the Dodd-Frank Act or the FSB Consultative Documents, the language of the ESRB Regulation does not explicitly point to systemic risk posed by financial *companies* or *institutions*. Instead, it only refers to risks *that arise from developments within the financial system.* Thus, while such risks can be connected with specific financial institutions; the mandate for the ESRB to identify systemic risk is broader in scope than the one given to the FSOC. The designation process, however, mostly depends on the quality of the analyses provided by the member bodies of the ESRB.

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[44] The European Banking Authority (EBA), the European Securities and Markets Authority (ESMA), and the European Insurance and Occupational Pensions Authority (EIOPA).
[45] Review of the New European System of Financial Supervision (ESFS), Part 2: the Work of the European Systemic Risk Board – the ESFS's Macro-Prudential Pillar, IP/A/ECON/ST/2012, October 2013, pp. 13-14 (*Review of the new ESFS 2013*).
[46] OJ L 331, 15.12.2010, p. 1.
[47] Decision of the European Systemic Risk Board of 20 January 2011 adopting the Rules of Procedure of the European Systemic Risk Board, (ESRB/2011/1), OJ C 58, 24.2.2011, p. 4.
[48] Decision of the European Systemic Risk Board of 25 March 2011 adopting the Code of Conduct of the European Systemic Risk Board, (ESRB/2011/3), OJ C 140, 11.5.2011, p. 19.
[49] Article 3(1), ESRB Regulation.
[50] Review of the new ESFS 2013, p. 22.
[51] Article 3(2), ESRB Regulation.

- The ESRB receives information from the ESAs, the European System of Central Banks (ESCB), the Commission, the national supervisory authorities and the national statistics authorities; who are required to cooperate and to provide all the information necessary for the ESRB to fulfill its tasks.[52]

- When the ESRB requests information from the ESAs, such information will be provided in summary or aggregate form so that individual financial institutions cannot be identified.[53]

- The ESRB may request information from ESAs in a non-aggregated form on individual financial institutions; but such a request is subject to the condition that the ESRB can explain why data on the respective individual financial institution is deemed to be systemically relevant and necessary considering the prevailing market situation. Before each request for non-aggregated information, the ESRB is required to consult the relevant ESA in order to ensure that the request is *justified* and *proportionate*. If the relevant ESA does not consider the request to be justified and proportionate, it sends the request back to the ESRB and asks for additional justification. After the ESRB has provided such additional justification, the requested information is sent to the ESRB by the addressees of the request, provided that they have legal access to the relevant information.[54]

- Analyses of emerging trends and vulnerabilities are produced 'in house' by the ESRB Secretariat and are provided through regular analytical contributions from its member institutions.[55] In addition, the ESRB, with the collaboration of the ECB and the ESAs, produces a quarterly *Risk Dashboard*, a "common set of quantitative and qualitative indicators […] to identify and measure systemic risk".[56] The Risk Dashboard includes various indicators grouped in six categories of risk: interlinkages and imbalances, macro risk, credit risk, funding and liquidity risk, market risk, and profitability and solvency.[57]

- Following identification, the ESRB then prioritizes amongst the risks and forms ad hoc expert groups and specific workstreams to conduct in-depth risk analysis and investigate potential mitigating actions.[58]

- Since June 2011, the ESRB has used the press releases following meetings of its General Board and prepared statements given by the Chair and Vice Chairs to the Economic and Monetary Affairs Committee of the European Parliament to communicate publicly the risks it has identified.[59]

[52] Article 15(2), ESRB Regulation.
[53] Article 15(3), ESRB Regulation.
[54] Article 15(6)-(7), ESRB Regulation.
[55] The ESRB Secretariat produces an 'Issues Note' on risks and vulnerabilities in the EU financial system which highlights specific topics that could be taken forward by one of its constituent bodies. The ECB, the ESAs, the European Commission and the Bank of England each provide their own independent contributions and inputs. Review of the new ESFS 2013, pp. 33-34.
[56] Article 3(2)(g), ESRB Regulation.
[57] Review of the new ESFS 2013, pp. 34-35.
[58] *Ibid*, p. 38.
[59] *Ibid*, p. 36.

In its first few years of its work, the ESRB has generally been more focused on the banking sector.[60]

The legal authority to regulate systemically important financial institutions:

While providing the ESRB with the powers to designate; the ESRB Regulation does not provide it with powers to issue legally binding instructions to firms or other financial institutions. Instead, the ESRB is expected to achieve its objectives by asserting influence on other EU and national-level entities and encourage them to take action focused on addressing risks to financial stability. The legal structure therefore allocates only non-binding powers to the ESRB, on the one hand; while it formulates mechanisms that allow the ESRB to rely on the binding powers of the other components of the ESFS, on the other hand. Particularly, the ESAs constituent documents (i.e. their founding Regulations) created their binding powers to address competent national authorities and individual financial market participants and require them to act in accordance with their obligations in EU law;[61] and the framework of cooperation between the ESAs and the ESRB, as explicitly defined in their respective Regulations, established a set of structural mechanisms to encourage such inter-agency collaboration.[62]

1. When the ESRB identifies significant risks to the achievement of the objective specified in article 3(1), it may issue **warnings and recommendations** for remedial action.[63] Warnings and recommendations can be addressed to the EU or any of the Member States; any of the ESAs, and/or any of the national supervisory authorities.[64] While not being legally binding, these recommendations install a mechanism of *comply or explain*: where recipients are required to communicate to the ESRB and to the Council the actions undertaken in response to the recommendation and to provide adequate justification for any inaction.[65] If the ESRB decides that its recommendation has not been followed or that the addressees have failed to provide adequate justification for their inaction, it informs the addressees, the Council and, where relevant, the ESA concerned,[66] which may then follow up with their own legal powers.

2. The ESRB can decide, subject to certain restrictions and procedural guarantees, that a warning or a recommendation will be made public.[67]

3. The ESRB Regulation authorizes it, additionally, to make **recommendations in respect of EU legislation**.[68] In practice, however, the ESRB has also made contributions on its own initiative; most significantly in relation to banking legislation[69] and primary legislation in the securities

[60] *Ibid*, pp. 36-37.
[61] Articles 17(6), 18(3),(4), and 19(3),(4), Regulations 1093/2010; 1094/2010 and 1095/2010. These articles establish the legal basis for each ESA's decision-making on its powers to act within the scope of their relevant EU legislation (set forth in Article 1(2) of each of the ESAs Regulations, to the extent that these relevant legislative acts apply to market players within the thematic areas of each ESA). Article 19(3), moreover, explicitly notes that decisions on specific actions according to the small paragraph will have "binding effects for the competent authorities concerned".
[62] Such structural mechanism includes cross-membership in their respective governing bodies, information sharing requirements, collaborations in specific systemic risk analyses and cross-fertilization of ideas, statutory requirements to consult the ESRB in developing EU-wide stress testing regime, etc. Review of the new ESFS 2013, pp. 46-49.
[63] Article 16(1), ESRB Regulation.
[64] Article 16(2), ESRB Regulation.
[65] Where relevant, the ESRB informs the ESAs of the answers received, subject to strict rules of confidentiality. Article 17(1), ESRB Regulation.
[66] Article 17(2), ESRB Regulation.
[67] Article 18, ESRB Regulation.
[68] Article 16(1)-(2), ESRB Regulation.
[69] The ESRB highlighted the desirability of allowing Member States to exercise 'constrained discretion' in setting macro-prudential capital requirements and expressed strong support for a 'systemic risk buffer' in addition to a counter-cyclical capital buffer. The resulting legislation contained provisions enabling national competent authorities to adjust macro-prudential levers at the national level. Review of the new ESFS 2013, pp. 51, 53.

sector (both for the European Markets and Infrastructure Regulation, and in respect of Money Market Funds).[70]

4. When the ESRB determines that an **emergency situation** may arise[71], it can issue a **confidential warning** addressed to the Council and providing the Council with an assessment of the situation, in order for the Council to assess the need to adopt a decision determining the existence of such an emergency situation.[72] If the Council adopt a decision determining the existence of an emergency situation, and in "exceptional circumstances where coordinated action by national authorities is necessary" to respond to the emergency situation; "the [relevant ESA] may adopt individual decisions requiring competent authorities to take the necessary action in accordance with the legislation [relevant to the respective ESA Regulation] to address any such [emergency situations] by ensuring that **financial market participants** and **competent authorities** satisfy the requirements laid down in that legislation".[73]

5. In some instances the ESRB also communicated its views on certain risks through other tools, including by providing Occasional Papers or Macro-prudential Commentaries.[74]

Additional considerations:

Overall, the legal framework of the ESRB has created a regulatory mechanism which favors a general market overview approach to systemic risk over individual firm-level designation.

- First, the mechanism for sharing information is formulated in such a way that the transfer of information to the ESRB is done in aggregated/summary form, as a rule; and requires a higher threshold (*justified* and *proportional*) for information in a non-aggregated form. It therefore makes the non-aggregated form the exception to the rule.

- Second, as mentioned above, the ESRB's objective as set in its founding Regulation is not limited to risks posed by financial institutions. It is, in fact, much broader in scope. This is quite different from the direct reference to *companies* in the Dodd-Frank Act. In comparison with the US system, therefore, an ESRB policy focus on risky practices and activities in the general market is directly linked to the language of its founding document and does not require any further justification.

- Lastly, the lack of legally binding powers to directly address individual market participants by the ESRB means that if it does so, it acts *ultra vires* and the decision is invalid. Although it is empowered to evaluate the actions of individual market participants (subject to the required procedural guarantees); the lack of authority to issue direct binding instructions to market participants suggests that the mechanism was designed in such a form to prioritize an ESRB focus on the market as a whole.

[70] In particular it recommended that the Commission legislate to ensure that all MMFs have a fluctuating net asset value, maintain adequate liquidity and are subject to robust public disclosure and reporting requirements. The Commission's proposed new rule includes some of the ESRB's recommendations, particularly the requirements for minimum levels of daily and weekly liquid assets. *Ibid*.
[71] Defined as cases of "adverse developments which may seriously jeopardize the orderly functioning and integrity of financial markets or the stability of the whole or part of the financial system in the Union", article 18(1), ESA regulations [1093/2010; 1094/2010 and 1095/2010].
[72] Article 3(2)(e), ESRB Regulation.
[73] Article 18(3), ESA regulations [1093/2010; 1094/2010 and 1095/2010].
[74] Review of the new ESFS 2013, pp. 40-42.

On July 2016, the ESRB published a strategy paper discussing systemic risk beyond the traditional banking sector.[75] The strategy paper shows this broad market focus, noting that the ESRB is targeting risks with instruments "across the whole financial system, commensurate with the contributions of **entities** and **activities** to systemic risk".[76] Recent legislative developments also imply a focus on activities; as specific tools have been devised predominantly in relation to practices and non-firm entities such as undertakings for collective investment in transferable securities (UCITS), alternative investment funds (AIF), insurance undertakings, and derivatives and securities financing transactions.[77] However, individual designations of firm-level financial institutions, including possibly asset managers, have been put on hold for now, as the ESRB is waiting for the FSB and the IOSCO to complete their work on a framework to identify NBNI SIFIs. Whether such framework will be developed at the EU level depends on whether the FSB identifies residual risks that cannot be addressed by measures targeting activities in the asset management sector.[78]

Conclusion

A SIFI designation in the asset management industry has not yet occurred. Presently it is unclear if such designation will take place at all and in what form - whether it will be asset managers, investment funds or both. Among the various issues currently under consideration, one is the structural difference between traditional banks and asset management firms. Particularly, while the structure of banking and asset management is not entirely dissimilar; the systemic risk they potentially pose is quite different, both in terms of its effects and its source. In contrast to banks, asset managers act as agents on behalf of their clients. They generally do not bear credit, market or liquidity risks; and fluctuations in asset values do not threaten their insolvency the same way as they would a bank.[79]

Asset managers are appointed by investors to manage their money in accordance with pre-defined investment strategies; and it is the investors, not the managers, that own the assets and bear the risks. Given that the balance sheets of asset managers are generally very small relative to the size of their AUM, distress at the asset manager level should generally pose less risk to the financial system than distress across its funds. This may not be the case, however, if asset managers also engage in securities lending or indemnification activities, thus expanding their activities beyond the capacity of pure asset management.[80]

The FSB has identified four structural vulnerabilities associated with the asset management industry (see above on page 3 the final *Policy Recommendations to Address Structural Vulnerabilities from Asset Management Activities* report). While *liquidity mismatch* and *leverage* concerns generally focus on the fund-level (and are associated with specific asset management strategies), *operational risks* and *securities lending* apply more directly to the firm-level (and are associated with asset manager firm strategies). Nevertheless, the latter two vulnerabilities often relate to strategies at the firm-level that the firm **may** or

[75] ESRB, *Macroprudential policy beyond banking: an ESRB strategy paper*, July 2016 (see: http://www.esrb.europa.eu/pub/pdf/reports/20160718_strategy_paper_beyond_banking.en.pdf?d163240bf1a6ad9dad5de6c408da6362) (*ESRB Strategy Paper*).
[76] ESRB Strategy Paper, p. 16.
[77] *Ibid*, pp. 20-23. Recent EU legislative reforms beyond banking include the AIFMD, Solvency II, EMIR, etc.; which, among other things, provide more access to new data for alternative investment funds, insurers, derivatives markets and soon for securities financing as well. *Ibid*, pp. 26-27.
[78] ESRB Strategy Paper, p. 13.
[79] Haldane, 2014.
[80] FSB Policy Recommendations on Asset Management Activities, pp. 8-9.

may not pursue: the proprietary activities which asset managers undertake in a separate capacity, which then may – or may not - affect the funds they manage in times of distress. In other words, the FSB's identified risks that are associated with the activities of *asset managers* (as opposed to *asset management*) are not activities that are inherent in their *agent* capacity.

For example, a defaulted indemnification commitment[81] from a distressed asset manager will lead lenders of securities to withdraw suddenly, forcing securities borrowers to exit their positions, thus affecting asset prices and market liquidity.[82] This would be a risk posed by asset managers; but one that is independent of their agent capacity, even if their failure subsequently affects their managed funds. On the other hand, portfolio adjustments by asset managers that aggregate pro-cyclical swings in asset prices and investor flows[83], would be a vulnerability associated with asset management strategies at the fund-level and well within the agent capacity. Accepting this separation between risks associated with distressed asset managers (*entities*) and risks associated with asset management (*activities*), opens the door to adopting a more flexible approach to designation and supervision.

Considering the unique liabilities structure in the asset management industry – a structure that affects both the sources and transmission channels of systemic risk – it may not be so clear whether the traditional regulators of the banking and insurance sectors are the appropriate ones for asset managers as well. The regulatory frameworks that were designed in response to the financial crisis established new legal powers and mandates to specific old and new government bodies. As this brief has shown, the new jurisdictional tools are applicable to asset managers as well. Thus, if the authorized agencies choose to act in their new/adjusted capacity, they are not acting *ultra vires*; it is well within their powers to scrutinize individual asset managers. Yet they currently refrain from exercising their jurisdictional powers.

An interesting situation presently exists: this brief clarified the formal (*de jure*) allocation of legal powers and the scope of delegated authority given to various regulatory bodies, as they are defined in their founding documents in each of the reviewed jurisdictions. The legislative acts created specialized bodies and assigned specific mandates to each. However, this brief also suggests that, at the same time, a less formal (*de facto*) allocation of powers is evolving, whereby different regulatory authorities are coordinating a response in a relatively unknown turf, relying on each other's independent mandates and expertise, and affording each other sufficient margin of appreciation.

At present time there is not much historical evidence of systemic risk resulting from the asset management industry. However, the industry is growing. More than ever, investment flows are being allocated to less liquid assets and indexed strategies, and the associated risks are increasingly being borne by easily-triggered end-investors.[84] Against this background, concerns about systemic risk have understandingly grown. Considering that not much is yet known, the current solution - which *de facto* allows the asset management industry's traditional regulating bodies to continue exercising their specialized powers in each of the reviewed 'jurisdictions' (IOSCO, SEC and ESMA respectively) - may be sufficient for now. However, the question is whether this interim solution would persist, and more importantly, whether it should. What would be the outcome of a prolonged lacuna this time?

[81] Borrower or counterparty indemnifications are insurance-like commitments offered to investors, to insure against potential losses when a counterparty defaults or does not return borrowed securities and the pledged collateral is not sufficient to cover the replacement cost of the loaned securities.
[82] FSB Policy Recommendations on Asset Management Activities, p. 35.
[83] Haldane, 2014.
[84] *Ibid*.

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