SYSTEMICALLY IMPORTANT ASSET MANAGERS: PERSPECTIVES ON DODD-FRANK'S SYSTEMIC DESIGNATION MECHANISM

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In the aftermath of the global financial crisis, Congress significantly broadened the reach of various regulatory entities through the Dodd-Frank Act. One particular power, found in section 113 of the Act, gives the newly formed Financial Stability Oversight Council (FSOC) the authority to designate nonbank financial institutions (NBFIs) as systemically important financial institutions (SIFIs). Once designated, these nonbank SIFIs are placed under the supervision of the Federal Reserve and subject to enhanced prudential regulation. In 2013, after designating four NBFIs—AIG, GE Capital, Prudential Financial, and MetLife—as systemically important, FSOC turned its attention to the asset management industry. This Note examines the efficacy of the legal framework underlying section 113 for regulating systemic risk when it arises in asset managers. By aligning the enhanced prudential standards mandated by systemic designations with the unique characteristics of the asset management industry, this Note identifies a mismatch created by deploying bank regulatory principles to address systemic risk in nonbank sectors. Ultimately, this Note argues that a better solution to the systemic oversight problem may be to limit FSOC's role as systemic regulator to that of an information-gathering and coordinating device, while leaving prudential regulatory authority with primary regulators.

INTRODUCTION

The global financial crisis of 2008 exposed the weaknesses of a heavily interconnected financial system and revealed systemic risk in unexpected areas.[1] While large banks and securities firms were known to pose risks to the financial system, it was largely unforeseen that nonbank financial institutions such as AIG could be equally dangerous.[2] As a result of the crisis, a new wave of prudential regulation spearheaded by the Dodd-

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1. See Fin. Crisis Inquiry Comm'n, Financial Crisis Inquiry Report, at xv–xxviii (2011), http://fcic-static.law.stanford.edu/cdn_media/fcic-reports/fcic_final_report_full.pdf [http://perma.cc/72QR-9DXN] (describing Commission's findings on causes of 2008 financial crisis).

2. See Alan Greenspan, Never Saw It Coming: Why the Financial Crisis Took Economists by Surprise, Foreign Affairs (Nov. 2013), http://www.foreignaffairs.com/articles/140161/alan-greenspan/never-saw-it-coming (on file with the *Columbia Law Review*) (explaining why financial crisis broke traditional risk models).

Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank)[3] attempted to bring about sweeping reform to the financial sector, with a strong focus on financial stability.[4] Through Dodd-Frank, Congress vastly expanded regulatory oversight, and has in many ways drastically changed the regulatory landscape for the financial industry.[5] One issue surrounding post–Dodd-Frank prudential regulation that has garnered a great deal of attention has been systemic risk regulation in nonbank financial sectors, particularly the asset management industry.[6]

Dodd-Frank significantly broadens the reach of various regulatory entities.[7] One particular power, found in section 113 of the Act, gives the newly formed Financial Stability Oversight Council (FSOC) the authority to designate nonbank financial institutions (NBFIs) as systemically important financial institutions (SIFIs).[8] This systemic designation mechanism—created by Congress—places a financial institution under the oversight of the Federal Reserve Board (Fed), which is then given broad discretion to implement enhanced prudential standards under section 165 of the Act.[9] After the first four NBFIs—AIG, GE Capital, Prudential Financial, and MetLife[10]—received this designation in 2013, FSOC turned its attention to asset managers.[11] And while the Council has

3. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 113, 124 Stat. 1376, 1398 (2010) (codified at 12 U.S.C. § 5323 (2012)).

4. See Baird Webel, Cong. Research Serv., R41350, The Dodd-Frank Wall Street Reform and Consumer Protection Act: Issues and Summary 3 (2010), http://www.llsdc.org/assets/DoddFrankdocs/crs-r41350.pdf [http://perma.cc/8VNU-ZCM5] (describing systemic risk mitigation as one of Dodd-Frank's primary policy goals).

5. See Weil, Gotshal & Manges LLP, Financial Regulatory Reform: An Overview of the Dodd-Frank Wall Street Reform and Consumer Protection Act (2010), http://financial-reform.weil.com/wp-content/uploads/2011/05/9357-FRROverview_v1.pdf [http://perma.cc/A26B-AQ6G] (summarizing regulatory reorganization provisions of Dodd-Frank).

6. See Ian Katz & Jesse Hamilton, BlackRock, Fidelity Face Initial Risk Study by Regulators, Bloomberg (Nov. 6, 2013, 12:03 PM), http://www.bloomberg.com/news/2013-11-05/blackrock-fidelity-face-initial-risk-study-by-u-s-regulators.html [http://perma.cc/CS5T-Z897] (describing Financial Stability Oversight Council's enhanced scrutiny on asset managers).

7. See Webel, supra note 4, at 4 (describing formation of FSOC and expansion of Fed powers to regulate systemically important financial institutions).

8. See § 113, 124 Stat. at 1398 (authorizing FSOC to designate nonbank SIFIs).

9. See Int'l Bar Ass'n Task Force on the Fin. Crisis, A Survey of Current Regulatory Trends 43–47 (2010) [hereinafter IBA Report], http://www.ibanet.org/Document/Default.aspx?DocumentUid=D36C2638-F82C-4AA4-97D7-4234C5FFBB7C (on file with the *Columbia Law Review*) (describing powers granted to Fed to address systemic risk); see also §§ 114–115, 124 Stat. at 1403–06 (requiring companies FSOC chooses to supervise to register with Fed and comply with more stringent supervision and regulatory standards).

10. See PwC, Nonbank SIFIs: Up Next, Asset Managers 6 (2013) [hereinafter PwC, Regulatory Brief], http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/fs-regulatory-brief-nonbank-sifi-asset-manager.pdf [http://perma.cc/6H7B-EM6V] (predicting two to four asset manager proposals in 2015).

11. See Donna Borak, FSOC Names AIG, GE Capital as Systemic Institutions, Am. Banker (July 9, 2013, 5:23 PM), http://www.americanbanker.com/issues/178_131/fsoc-

since cooled on the idea of systemic designations in the industry,[12] the debate over the issue between asset managers, regulators, and other interested parties, in hindsight, offers key insights into the effectiveness of the systemic designation mechanism in addressing systemic risk when it arises in the asset management industry.

Some have argued that Dodd-Frank expands the role of the Fed to that of "systemic regulator."[13] In fact, longstanding tensions between the Fed and other primary regulators became particularly heated in the context of regulating systemic risk.[14] Several Securities and Exchange Commission (SEC) commissioners stated that the agency's authority as the primary regulator of asset managers was being undercut by FSOC.[15] In response, Fed officials criticized the SEC for being too slow to act in addressing systemic risk, arguing that the agency only acted to limit the risk of runs on money market funds in response to heavy pressure from FSOC and global regulators.[16] Congress's new systemic designation mechanism thus aggravated existing tensions between the different regulatory entities and further led to uncertainty concerning the proper distribution of authority over issues of financial stability.

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names-aig-ge-capital-as-systemic-institutions-1060477-1.html (on file with the *Columbia Law Review*) (noting designations of AIG and GE Capital as first nonbank SIFIs). MetLife's designation continues to be challenged by the firm. See Steve Schaefer, MetLife Plans to Fight 'Systemically Important' Designation, Forbes (Aug. 4, 2014, 4:40 PM), http://www.forbes.com/sites/steveschaefer/2014/09/04/metlife-tagged-with-systemically-important-designation/ (on file with the *Columbia Law Review*).

12. See Andrew Ackerman & Ryan Tracy, Asset Managers Notch an 'Important' Win, Wall St. J. (July 31, 2014, 7:39 PM), http://www.wsj.com/articles/asset-managers-may-avoid-more-oversight-by-fsoc-1406828103 (on file with the *Columbia Law Review*) (describing temporary ceasefire between asset managers and regulators over SIFI designations).

13. See Steven J. Markovich, The Dodd-Frank Act, Council on Foreign Rel. (Dec. 10, 2013), http://www.cfr.org/united-states/dodd-frank-act/p28735 [http://perma.cc/2CF8-TJ2P] (describing Dodd-Frank's adoption of various systemic regulator proposals); see also Squam Lake Working Grp. on Fin. Regulation, A Systemic Regulator for Financial Markets 5 (May 2009) [hereinafter Squam Lake] (unpublished working paper), http://www.cfr.org/financial-regulation/systemic-regulator-financial-markets/p19256 (on file with the *Columbia Law Review*) (suggesting expanded role of Fed as systemic regulator).

14. See Andrew Ackerman, SEC Details Plan to Target Risks at Asset Managers, Wall St. J. (Dec. 11, 2014, 8:30 PM) [hereinafter Ackerman, SEC Plan], http://www.wsj.com/articles/sec-chief-calls-for-stress-testing-of-mutual-funds-other-asset-managers-1418312083 (on file with the *Columbia Law Review*) (discussing dispute between Fed and SEC officials over regulation of systemic risk in asset managers).

15. Id.

16. Id. Whether the Fed is equipped to handle this systemic regulator role is a much-debated topic. See, e.g., Andrew Crockett, Should the Federal Reserve Be a Systemic Stability Regulator?, *in* The Road Ahead for the Fed 137, 146–49 (John D. Ciorciari & John B. Taylor eds., 2009) (arguing against Fed as systemic regulator). But see Frederic Mishkin, Opinion Why All Regulatory Roads Lead to the Fed, Fin. Times (June 22, 2009, 7:45 PM), http://www.ft.com/intl/cms/s/0/0a52dc76-5f5c-11de-93d1-00144feabdc0.html#axzz3NrzpCZQT (on file with the *Columbia Law Review*) (outlining case for Fed as systemic regulator).

This Note examines the legal framework underlying the systemic designation mechanism and argues that the mechanism is an inefficient regulatory tool for addressing systemic risk in asset managers. As a threshold matter, this Note does not directly address the question of the extent to which systemic risk in asset managers exists. Indeed, there has been considerable debate among academics as well as industry experts as to whether asset managers pose threats to financial stability at all.[17] But while this issue certainly raises important questions, this Note will focus instead on the ability of financial regulators under Dodd-Frank to address *potential* risks using the new legal tools at their disposal.[18] By examining the systemic designation mechanism in the context of the specific characteristics of the asset management industry, this Note explores the costs and benefits of addressing systemic risk through expansion of Fed authority. This Note then assesses whether the Fed as centralized prudential regulator of a group of "systemically important" financial institutions is the most effective mechanism for addressing systemic risk when it arises in NBFIs. Part I provides background on sections 113 and 165 of Dodd-Frank and the mechanics of systemic designations. Part II analyzes the unique systemic risks potentially posed by asset managers and assesses the institutional competence of the Fed with respect to serving as a prudential regulator of asset manager SIFIs. Finally, Part III weighs the pros and cons of the two existing regulatory approaches and suggests that an alternative framework to address the specific systemic risks posed by the asset management industry would be the ideal approach.

I. SYSTEMIC RISK AND DODD-FRANK

In many ways, Dodd-Frank was an attempt by Congress to comprehensively address the components of the financial industry that con-

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17. See infra section II.A.4 (describing SIFI designation challenges by industry experts and academics).

18. While this Note will address some of the questions concerning the existence of systemic risk in asset managers, it will not express a view on the overarching question of whether asset managers are systemically important. Although this is indeed an important question, this Note is more interested in the proper role of the Fed in a regulatory system designed to maintain financial stability. In some areas, this Note may appear to presume the existence of certain systemic risks stemming from the asset management industry. This presumption is an analytical tool designed to test the limits of the Fed's regulatory tools. For a more specific discussion on the threshold question, see, e.g., Douglas J. Elliott, Systemic Risk and the Asset Management Industry (2014), http://www.brookings.edu/~/media/research/files/papers/2014/05/systemic%20risk%20asset%20management%20elliott/systemic_risk_asset_management_elliott.pdf [http://perma.cc/QS23-6RNA] (describing diverse activities that characterize asset management industry); see also Philip Coggan, Are Asset Managers a Source of Systemic Risk?, Economist: Buttonwood's Notebook (Apr. 4, 2014, 3:11 PM), http://www.economist.com/blogs/buttonwood/2014/04/financial-sector [http://perma.cc/G3HL-QZ7J] (distinguishing asset managers from systemically risky banks).

tributed to the global financial crisis.[19] As a result, this sweeping legislation reformed nearly all of the areas that were identified as being causally linked to the crisis: Banks, securities firms, insurance companies, asset managers, and credit rating agencies were all addressed in the Act.[20] The Act also gave the Fed a more central role in the oversight of the financial system, since a key issue during the crisis was believed to be the lack of a single entity that could oversee the extensive network of financial regulators.[21] Furthermore, the Fed's role in ultimately bailing out a number of financial institutions using hundreds of billions of dollars of taxpayer money led to a call for greater Fed oversight over institutions posing the greatest risk of failure in order to prevent the need for such drastic bailout measures in the future.[22]

It is worth noting that Dodd-Frank does not create new regulatory agencies responsible for implementing prudential regulations targeting systemic risk. FSOC, originally conceived of as a collaborative council of regulators, does not itself have the power to impose enhanced regulations on designated SIFIs.[23] Instead, this power is vested in the Fed.[24] And while the Fed has historically regulated banking institutions, it lacks the same level of experience and expertise when it comes to regulating NBFIs.[25] For the Fed to have direct oversight over asset managers would

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19. See Webel, supra note 4, at 3–21 (summarizing extensive list of reforms in Dodd-Frank).

20. Id. Surprisingly, Dodd-Frank did not include government sponsored entity (GSE) reform, despite the fact that two GSEs, Fannie Mae and Freddie Mac, were at the core of the housing bubble that triggered the crisis. Id.

21. Am. Bar Ass'n Banking Law Comm. Task Force on Regulatory Reform, The Financial Crisis of 2007–2009: Causes and Contributing Circumstances 31 (2009) [hereinafter ABA Report], http://apps.americanbar.org/buslaw/committees/CL130055 pub/materials/201001/causes-report.pdf [http://perma.cc/W75E-ZGFS] (finding lack of comprehensive and integrated oversight among regulators to be one cause of financial crisis).

22. See Wall Street Reform: The Dodd-Frank Act, White House Briefing Room, http://www.whitehouse.gov/economy/middle-class/dodd-frank-wall-street-reform [http:// perma.cc/S5AX-YPT3] (last visited Jan. 14, 2016) (discussing preventing future bailouts as major goal of Dodd-Frank Act); see also Michael Cooper & Patrick Healy, McCain, More Critical of Bailout Plan, Faults Oversight, N.Y. Times (Sept. 22, 2008), http://www.nytimes.com/2008/09/23/us/politics/23campaign.html (on file with the *Columbia Law Review*) (reporting congressional calls for greater regulatory oversight in aftermath of bailouts).

23. See IBA Report, supra note 9, at 43 (describing Fed supervision of FSOC-designated nonbank SIFIs).

24. See id. ("The Federal Reserve is required to establish enhanced risk-based capital, leverage and liquidity requirements, overall risk management requirements, resolution plans, credit exposure reporting, concentration limits and prompt corrective action to apply to systemically important companies.").

25. Many arguments have been made in the insurance context that the Fed does not have the experience and expertise to regulate NBFIs. See Jim Sivon & Greg Wilson, Insurance Needs a Federal Regulator—But Not the Fed, Am. Banker (Oct. 25, 2013), http://www.americanbanker.com/bankthink/insurance-needs-a-federal-regulator-but-not-

be an extraordinary situation, and would mark a sea change in systemic risk regulation.[26] Therefore it is of critical importance that legislators understand and acknowledge the limits of the Fed as a regulator of non-bank SIFIs before significantly expanding the Fed's powers through Dodd-Frank's systemic designation mechanism.

This Part will provide an overview of Dodd-Frank's treatment of systemic risk in NBFIs. Section I.A describes systemic risk, Dodd-Frank's response to systemic risk, and the mechanics of SIFI designations under section 113. Section I.B addresses the Fed's broad regulatory powers that are triggered under section 165 once such designations have been made. This background will illustrate how Congress's SIFI mechanism has applied bank regulatory principles to NBFIs and will inform Part II's discussion of the appropriateness of extending such a regime beyond insurance SIFIs and into the asset management industry.

A. *Overview of Section 113: SIFI Designations*

Spearheading the regulatory response to the global financial crisis, Dodd-Frank attempted to affect a sweeping overhaul of the financial regulatory landscape.[27] Title I of Dodd-Frank, entitled "Financial Stability," was created specifically to address the systemic risk that was integral in causing the financial crisis.[28] Title I established the Financial Stability Oversight Council to monitor and respond to systemic risks that have the potential to destabilize the U.S. financial system.[29] FSOC is a collaborative body chaired by the Secretary of the Treasury and composed of federal financial regulators, an independent insurance expert appointed by the President, and state regulators.[30] Congress charged

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the-fed-1063140-1.html (on file with the *Columbia Law Review*) (identifying problems with dual Fed/state insurance regulation schemes); Emily Stephenson, Exclusive: Fed Hires Official To Oversee AIG, Prudential, Reuters (June 2, 2014, 3:44 PM), http://www.reuters.com/article/2014/06/02/us-financial-regulations-insurance-idUSKBN0ED1QD20140602 [http://perma.cc/74Y3-5RGA] (describing Fed hiring of former state insurance commissioner to oversee AIG and Prudential).

26. For a more detailed description of the Fed as centralized systemic regulator, see Squam Lake, supra note 13, at 4–5.

27. See supra notes 19–22 and accompanying text (noting comprehensiveness of Dodd-Frank).

28. See Webel, supra note 4, at 3–4 (describing systemic risk mitigation as one of Dodd-Frank's primary policy goals).

29. See U.S. Dep't of the Treasury, Financial Stability Oversight Council Created Under the Dodd-Frank Wall Street Reform and Consumer Protection Act: Frequently Asked Questions (2010), http://www.treasury.gov/initiatives/Documents/FAQ%20-%20FinancialStabilityOversightCouncilOctober2010FINALv2.pdf [http://perma.cc/HV57-N2HJ] (describing role and responsibilities of newly created FSOC).

30. The voting members of FSOC consist of the Secretary of the Treasury, who serves as the Chairperson of the Council, Chairman of the Board of Governors of the Federal Reserve System, Comptroller of the Currency, Director of the Consumer Financial Protection Bureau (CFPB), Chairman of the Securities and Exchange Commission, Chairperson of the Federal Deposit Insurance Corporation (FDIC), Chairperson of the Commodity Futures Trading

FSOC with making systemic designations under section 113.[31] Section 113 gave FSOC the authority to identify individual nonbank financial institutions posing the greatest systemic risk, place them under the supervision of the Fed, and subject them to enhanced prudential regulations promulgated by the Fed.[32] And because banking institutions with over $50 billion in assets are automatically designated as SIFIs under Title I,[33] the most debated questions surrounding the SIFI mechanism revolve around designations of NBFIs.

Previous discussions regarding FSOC's authority to designate SIFIs have largely involved insurance companies and money market funds, both of which played critical roles in the financial crisis.[34] After the initial round of designations, however, FSOC turned its attention to the asset management industry.[35] In September 2013, the Office of Financial Research (OFR)—an independent agency charged with providing research support to FSOC[36]—published a report (OFR Report) analyzing

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Commission (CFTC), Director of the Federal Housing Finance Agency (FHFA), Chairman of the National Credit Union Administration (NCUA), and an independent member with insurance expertise who is appointed by the President and confirmed by the Senate for a six-year term. The nonvoting members consist of the Director of the Office of Financial Research, Director of the Federal Insurance Office, a state insurance commissioner designated by the state insurance commissioners, a state banking supervisor designated by the state banking supervisors, and a state securities commissioner (or officer performing like functions) designated by the state securities commissioners. About FSOC, U.S. Dep't of the Treasury, http://www.treasury.gov/initiatives/fsoc/about/Pages/default.aspx [http://perma.cc/9Y57-ZKTZ] (detailing composition of FSOC).

31. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 113, 124 Stat. 1376, 1398 (2010) (codified at 12 U.S.C. § 5323 (2012)) ("[FSOC] . . . may determine that a U.S. nonbank financial company shall be supervised . . . and shall be subject to prudential standards . . . if [FSOC] determines that [the company] . . . could pose a threat to the financial stability of the United States.").

32. Id.; 12 C.F.R. § 1310.10 (2012).

33. See IBA Report, supra note 9, at 43 (describing automatic SIFI designation for bank holding companies with global assets in excess of $50 billion).

34. See, e.g., Inv. Co. Inst., Comment Letter on Authority to Require Supervision and Regulation of Certain Nonbank Financial Companies (Feb. 25, 2011), http://www.ici.org/pdf/24994.pdf [http://perma.cc/TY5M-R6MG] (discussing merits of designating money market funds as SIFIs); see also Jonathan Macey, Reducing Systemic Risk: The Role of Money Market Mutual Funds as Substitutes for Federally Insured Bank Deposits 18–28 (Yale Law Sch. Faculty Scholarship Series, Paper No. 2020, 2011), http://digitalcommons.law.yale.edu/cgi/viewcontent.cgi?article=3100&context=fss_papers [http://perma.cc/B2ND-ADJH] (describing role of money market funds in financial crisis).

35. See PwC, Regulatory Brief, supra note 10, at 6 (predicting asset management industry will be next in line for systemic designations).

36. The Annual Report of the Office of Financial Research: Hearing Before the H. Fin. Servs. Subcomm. on Oversight & Investigations, 113th Cong. 9 (2014) (statement of Richard Berner, Director, Office of Fin. Research, U.S. Dep't of the Treasury) ("The OFR provides data and analysis to the Council, and our missions to assess and monitor threats to financial stability are complementary.").

the possible systemic risks posed by the asset management industry.[37] The SEC then solicited comment letters on the OFR Report,[38] opening up a dialogue with the industry concerning the systemic risk of asset managers. Some have viewed FSOC's position as aggressively pursuing systemic designations in order to expand the regulatory reach of the Fed[39]—a position that has prompted calls from Congress to scale back systemic designations.[40] In late 2013, industry experts predicted that FSOC would next target asset managers,[41] which would have resulted in the largest asset management firms, such as Blackrock, PIMCO, and Vanguard—with trillions of dollars of assets under management[42]—being placed under the direct supervision of the Fed.[43]

FSOC's approach to the asset management industry later took a sharp turn in July 2014, with the Council announcing that it would change its focus to risky products and activities rather than individual asset managers, after facing stark opposition from the industry and lawmakers.[44] The SEC—the primary regulator of asset managers—has since taken up the mantle of regulating systemic risk in the asset management industry.[45] Large asset managers have also declared victory in the

37. See Office of Fin. Research, Asset Management and Financial Stability 9–20 (2013) [hereinafter OFR Report], http://financialresearch.gov/reports/files/ofr_asset_management_and_financial_stability.pdf [http://perma.cc/TK9X-JE9N] (presenting findings of research study by OFR into systemic risks posed by asset management industry).

38. See Comments on OFR Study on Asset Management Issues, U.S. Sec. & Exch. Comm'n [hereinafter SEC Comment Letters], http://www.sec.gov/comments/am-1/am-1.shtml [http://perma.cc/BA6K-9HXT] (last modified Sept. 14, 2015) (listing all comment letters received).

39. See, e.g., Daniel M. Gallagher, Comment Letter on OFR Study on Asset Management Issues 2 (May 15, 2014), http://www.sec.gov/comments/am-1/am1-52.pdf [http://perma.cc/3T23-3DAA] (arguing FSOC SIFI mechanism is "power grab" by Fed and FSOC).

40. See Ryan Tracy, Regulators Promise Changes for Applying 'Systemic' Label, Wall St. J. (Jan. 21, 2015, 7:37 PM), http://www.wsj.com/articles/regulators-promise-changes-for-applying-systemic-label-1421876026 (on file with the *Columbia Law Review*) (describing calls from Congress to make changes to SIFI designation process).

41. See PwC, Regulatory Brief, supra note 10, at 6 (predicting two to four asset managers would be proposed for systemic designation process in 2015).

42. See Jonathan Williams, AUM Growth at 10 Largest Fund Managers Outstrips Sector—Top 400, Inv. & Pensions Eur. (June 10, 2013), http://www.ipe.com/aum-growth-at-10-largest-fund-managers-outstrips-sector-top-400/53219.fullarticle [http://perma.cc/U8ZQ-RH9Q] (sizing asset manager market).

43. See IBA Report, supra note 9, at 43–44 (describing Fed supervision of FSOC-designated nonbank SIFIs).

44. See Gina Chon & Stephen Foley, Asset Managers May Escape Systemic Label, Fin. Times (July 31, 2014, 10:39 PM), http://www.ft.com/intl/cms/s/0/d2739c66-182c-11e4-a6e4-00144feabdc0.html (on file with the *Columbia Law Review*) (announcing FSOC's temporary change in focus from systemic designations to activity-based regulation).

45. See Andrew Ackerman, SEC Preps Mutual Fund Rules, Wall St. J. (Sept. 7, 2014, 8:45 PM), http://www.wsj.com/articles/sec-preps-mutual-fund-rules-1410137113 (on file with the *Columbia Law Review*) (announcing SEC's plans to create heightened regulations for asset managers).

international arena after mounting an aggressive lobbying effort against global systemically important financial institution (G-SIFI) designations by the Financial Stability Board (FSB).[46] Although FSOC and the FSB have directed their attention away from individual firm designations, it is important to note that Dodd-Frank's SIFI mechanism was a knee-jerk reaction to catastrophic market events. The stability of the postcrisis bull market has provided the climate for policymakers to shift their focus to more targeted interventions. Yet so long as the authority remains vested with FSOC, the threat of systemic designations will emerge again during the inevitable next recession. The following subsection describes the general process by which nonbank SIFIs are designated.

1. *Mechanics of Section 113.* — Section 113 of Dodd-Frank gives FSOC the authority, by two-thirds vote, to designate an NBFI as a SIFI if the company's "material financial distress" or activities could pose a

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46. See Barney Jopson & Stephen Foley, Big US Fund Managers Fight Off 'Systemic' Label, Fin. Times (July 14, 2015, 6:56 PM), http://www.ft.com/intl/cms/s/0/4cd1e06a-2a44-11e5-acfb-cbd2e1c81cca.html (on file with the *Columbia Law Review*) (describing FSB's "change in course" following June 29, 2015, meeting between regulators and industry representatives in Basel). Although not treated in this Note, the FSB's approach to global systemic risk played a major role in shaping the response in the United States. The FSB was formed to coordinate regulatory and supervisory policy in the financial sectors of the G-20 member countries. Int'l Monetary Fund, IMF Membership in the Financial Stability Board 2–7 (2010), http://www.imf.org/external/np/pp/eng/2010/081010.pdf [http://perma.cc/G5JG-WDYQ] (introducing institutional framework and function of FSB); What We Do, Fin. Stability Board, http://www.fsb.org/what-we-do/ [http://perma.cc/WG7L-F83D] (last visited Jan. 29, 2016) ("The FSB promotes global financial stability by coordinating the development of regulatory, supervisory and other financial sector policies and conducts outreach to nonmember countries. It achieves cooperation and consistency through a three-stage process, including monitoring implementation of agreed policies."). In 2014 and 2015, the FSB and the International Organization of Securities Commissions (IOSCO) proposed a series of assessment methodologies to identify investment funds that could be G-SIFIs, which would be regulated differently from other financial institutions. See Int'l Monetary Fund, Global Financial Stability Report (GFSR): Navigating Monetary Policy Challenges and Managing Risks 96 (2015), http://www.imf.org/External/Pubs/FT/GFSR/2015/01/pdf/c3.pdf [http://perma.cc/TF4W-FJH6] (summarizing FSB and IOSCO's approach to systemic risk in asset management industry). For a discussion of the FSB's proposed framework for identifying nonbank SIFIs, see Fin. Stability Bd., Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions 5–13 (2014), http://www.financialstabilityboard.org/wp-content/uploads/r_140108.pdf [http://perma.cc/Z3DY-JPJD] (detailing FSB framework for designating G-SIFIs); Fin. Stability Bd., Second Consultative Document: Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions 30–55 (2015), http://www.financialstabilityboard.org/wp-content/uploads/2nd-Con-Doc-on-NBNI-G-SIFI-methodologies.pdf [http://perma.cc/ZLD8-UWK5] (revising 2014 framework by proposing approaches for identifying both investment funds and asset managers as G-SIFIs). The threat of systemic designations by the FSB has not completely dissipated, however, as the Board has indicated that it is still exploring its options with respect to systemic risk regulation in the asset management industry. See infra note 197 and accompanying text.

threat to U.S. financial stability.[47] In making this determination, section 113 lists ten criteria for analysis, but also allows FSOC to consider "any other risk-related factors that the Council deems appropriate."[48] FSOC is thus given very broad statutory authority to designate SIFIs. Due to this expansive statutory authority to determine the SIFI designation factors, FSOC's operational procedures have largely been set through the regulatory rulemaking process.[49]

On April 3, 2012, FSOC voted to approve its final rule implementing section 113.[50] The final rule outlines a detailed three-stage evaluation process for the designation of SIFIs.[51] Stage 1 narrows the pool of companies potentially subject to a SIFI designation through a quantitative screening process.[52] To pass Stage 1, an NBFI must meet a size threshold of $50 billion in global assets as well as at least one other quantitative threshold.[53] Stage 2 entails a detailed quantitative and qualitative analysis of six categories derived from the ten statutory criteria.[54] The factors considered at this stage are: (1) size, (2) interconnectedness, (3) leverage, (4) substitutability, (5) liquidity risk and maturity mismatch, and (6) existing regulatory scrutiny.[55] FSOC evaluates the risk profile and characteristics of each NBFI using industry- and company-specific factors with information gathered from regulators and voluntarily submitted by companies under review.[56] Finally, a company shortlisted for Stage 3 is subjected to a detailed review based on the above six-factor framework to determine whether it would pose a threat to financial stability if placed in

47. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 113, 124 Stat. 1376, 1398 (2010) (codified at 12 U.S.C. § 5323 (2012)).

48. Id.

49. See Andy Winkler, Primer: FSOC's SIFI Designation Process for Nonbank Financial Companies, Am. Action F. (Sept. 3, 2014), http://americanactionforum.org/research/primer-fsocs-sifi-designation-process-for-nonbank-financial-companies [http://perma.cc/AU3P-WT4L] (describing importance of regulatory rulemaking process in systemic designation mechanism).

50. See Heath P. Tarbert, Sylvia A. Mayer & Derrick D. Cephas, A SIFI in Three Easy Steps? FSOC Approves Final Rule for Nonbank SIFI Designations, 129 Banking L.J. 419, 419 (2012) (describing nonbank SIFI designation process in FSOC final rule).

51. Id. at 420.

52. Id. at 423–24.

53. These additional thresholds include: a total of $30 billion in gross notional credit default swaps (CDSs) in which the NBFI is the reference entity, a total of $3.5 billion in derivative liabilities, a total of $20 billion in outstanding debt, a leverage ratio of 15:1 or higher measured by total consolidated assets, and a short-term debt ratio to consolidated assets of 10%. PwC, The FSOC SIFI Designation Proposal for Nonbank Financial Companies 5–6 (2011), http://www.pwc.com/en_US/us/financial-services/regulatory-services/publications/assets/closer-look-fsoc-sifi-proposal-for-nonbank-financial-companies.pdf [http://perma.cc/YLV7-V866].

54. Id.

55. Id.

56. Id.

a stressed scenario.[57] An additional analysis of the company's resolvability may also be conducted.[58] At this final stage, FSOC works with OFR, which may request nonpublic information from the company.[59]

It is clear that the SIFI designation process under section 113 focuses primarily on size and scale, which can indeed be proxies for systemic importance, but are by no means correlated with such risk for *all* nonbank financial industries.[60] Size and scale have often been emphasized in the context of banking regulation, but less so with respect to asset managers.[61] Furthermore, the additional oversight authority given to the Fed exists only at the institutional level rather than at the industry level. And to the extent that systemic risk exists beyond a group of large firms, the nonbank SIFI framework would fail to capture such risk.

2. *Ramifications for SIFIs Designated Under Section 113.* — Once designated by a two-thirds majority of FSOC (including a mandatory affirmative vote by the Treasury Secretary), each nonbank SIFI would be placed under the authority of the Fed and become subject to a number of enhanced prudential requirements as determined by the Fed through regulatory rulemakings.[62] It is unclear at this point what these enhanced requirements will entail. Although the Fed issued its final rule on enhanced prudential standards for bank holding companies (BHCs) and foreign banking organizations, Regulation YY[63] specifically left open the question of prudential standards for nonbank SIFIs placed under the supervision of the Fed, instead providing that such standards will be applied on a case-by-case basis.[64]

Enhanced standards, however, will likely include "capital, liquidity, leverage, stress testing, resolution planning, and risk management re-

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57. Id. at 6.

58. Id.

59. Id.

60. See Luc Laeven, Lev Ratnovski & Hui Tong, Bank Size and Systemic Risk 14–18 (2014), http://www.imf.org/external/pubs/ft/sdn/2014/sdn1404.pdf [http://perma.cc/98KV-AGXX] (finding "large market-oriented banks are more likely to fail together . . . [because] they are jointly exposed to the boom-bust cycles in financial markets and more interconnected through asset and short-term funding markets").

61. See Theirry Roncallli & Guillaume Wising, Asset Management and Systemic Risk 8–9 (May 26, 2015) (unpublished manuscript), http://ssrn.com/abstract=2610174 (on file with the *Columbia Law Review*) (explaining lack of homogeneity in liquidity among asset classes complicates relationship between size and systemic risk).

62. 12 C.F.R. § 1310.10 (2014).

63. 12 C.F.R. §§ 252.1–4 (2015).

64. Id. § 252.1; see also Morrison & Foerster, LLP, Client Alert: Summary of Final Rule Imposing Enhanced Prudential Standards on FBOs (2014), http://media.mofo.com/files/Uploads/Images/140224-Final-Rule-FBO-Standards.pdf [http://perma.cc/9UHX-2MRN] (summarizing impact of Regulation YY on bank holding companies and foreign banking organizations).

quirements."[65] The Fed has stated that "following designation of a[n] [NBFI] for supervision by the Board, the Board intends thoroughly to assess the business model, capital structure, and risk profile of the designated company to determine how the proposed enhanced prudential standards should apply, and . . . would tailor application of the standards by order or regulation."[66] This highly fact-specific and firm-specific determination of prudential standards has contributed to the high degree of uncertainty surrounding the exact regulatory burden faced by nonbank SIFIs.[67] Some commentators have speculated that to meet new requirements, SIFIs may be required to hire additional compliance staff, reinforce IT infrastructure, and set aside additional capital reserves.[68]

B. *Mechanics of Section 165*

While precise regulations have yet to be issued, Dodd-Frank establishes a framework under section 165 for enhanced prudential standards following a SIFI designation. In order to better understand the appropriateness of the systemic designation mechanism for addressing systemic risk in asset managers, this Note will first examine the procedures underlying Fed oversight of nonbank SIFIs. This subsection will summarize the mechanics behind the authority given to the Fed to set enhanced prudential standards for nonbank SIFIs under section 165 of Dodd-Frank.

A final determination by FSOC under section 113 allows the Fed to apply various enhanced prudential regulations to nonbank SIFIs, as enumerated under section 165.[69] Section 165(b) details the authorized prudential standards and is divided into two subsections. Section 165(b)(1)(A) lists mandatory standards: (1) risk-based capital requirements and a leverage limit of no greater than 15:1, unless the Fed in consultation with FSOC determines that such requirements are not appropriate for a specific company because of the company's activities; (2) liquidity requirements; (3) a risk committee and overall risk-management requirements; (4) a resolution plan providing for its rapid and orderly resolution in the event of material financial distress or failure; (5) a credit exposure report detailing the nonbank SIFI's credit exposure

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65. Tarbert et al., supra note 50, at 419; see also 12 C.F.R. § 1310–1310.11 (outlining SIFI designation process).

66. Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,245 (Mar. 27, 2014) (to be codified at 12 C.F.R. pt. 252).

67. See Winkler, supra note 49 ("This decision to assess the appropriate standards on a firm-specific basis means there is still a high degree of uncertainty around the exact regulatory burden facing designated [NBFIs].").

68. Id.

69. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1423 (2010) (codified at 12 U.S.C. § 5365 (2012)) (authorizing Fed to impose enhanced prudential standards on nonbank SIFIs and certain BHCs).

with other systemically important banks and financial companies; (6) concentration limits (including a credit exposure limit of 25% of the capital stock and surplus of the company); and (7) annual stress tests to determine whether such companies hold adequate capital, "on a total consolidated basis, necessary to absorb losses as a result of adverse economic [and financial] conditions."[70]

In addition to these required standards, section 165 also *permits* the Fed to impose a number of additional standards: (1) a minimum amount of contingent capital that is convertible to equity in times of financial stress;[71] (2) enhanced public disclosures;[72] (3) short-term debt limits, including off balance sheet exposures;[73] and (4) a catchall provision allowing "such other prudential standards as the Board of Governors, on its own or pursuant to a recommendation made by the Council in accordance with section 115, determines are appropriate."[74]

The drafting of section 165 therefore creates the potential for difficulty and inconsistency in the regulation of nonbank entities. Although the mandatory and permitted enumerated standards in section 165 primarily draw from BHC principles, the catchall provision in 165(g) gives the Fed a broad mandate to regulate nonbank SIFIs placed under its supervision by FSOC. As will be discussed in Part II, the potential inconsistencies between BHC-centric standards and nonbank prudential regulations may prove to be problematic as regulators apply this regime to sectors outside the scope of traditional bank regulation such as insurance and asset management.

II. THE UNIQUENESS OF ASSET MANAGERS

The financial crisis revealed weaknesses in sectors not traditionally thought of as posing systemic risk.[75] While the impact in the asset management industry fell primarily on money market mutual funds,[76] the traditional asset management industry has also since received a great deal of attention as a potential source of risk. By one estimate, the U.S. asset management industry oversees the allocation of approximately $53 trillion in financial assets.[77] The industry plays a key role in facilitating capital formation and credit intermediation, while spreading losses across

70. Id. §§ 165(b)(1)(A), 165(i).

71. Id. § 165(c).

72. Id. § 165(b)(1)(B).

73. Id. § 165(g).

74. Id. § 165(b)(1)(B)(iv).

75. See Greenspan, supra note 2 (explaining why financial crisis broke traditional risk models).

76. See Melanie L. Fein, Money Market Funds, Systemic Risk and the Dodd-Frank Act 1 (2012), http://www.sec.gov/comments/4-619/4619-209.pdf [http://perma.cc/JTZ4-76RA] (arguing money market funds do not pose systemic risk to financial system).

77. See OFR Report, supra note 37, at 1 (sizing U.S. asset management industry).

a diverse spectrum of individual and institutional investors.[78] This Part will first examine the nature of the asset management industry before turning to the regulation of the industry.

This Part will also examine the ability of the Fed to regulate asset managers, specifically in the context of systemic risk. In its capacity as a financial regulator, the Fed has historically overseen BHCs.[79] But during the financial crisis, the Fed was forced to play a role in bailing out AIG in what was generally accepted as an unprecedented move.[80] The bailout therefore placed the Fed in control of an insurance company, expanding the Fed's regulatory power beyond its traditional market and into an unfamiliar industry.[81] Determining whether the systemic designation mechanism is appropriate for the asset management industry begins with an examination of the extent to which bank regulatory principles historically employed by the Fed can be exported to nonbank financial institutions. In many ways, the insurance industry is analogous to the banking industry in terms of risks,[82] and as a result, expanding Fed oversight to insurance companies is conceivable[83] Yet, asset managers are

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78. See id. (describing various activities engaged in by U.S. asset management industry).

79. See A History of Central Banking in the United States, Fed. Reserve Bank of Minn., http://www.minneapolisfed.org/community/student-resources/central-bank-history/history-of-central-banking [http://perma.cc/7SZE-BT92] (last visited Jan. 30, 2016) ("In this way, [the Second Bank of the United States] functioned as an early bank regulator, a crucial function of the modern Fed.").

80. See Andrew Zajac, Fed Didn't Want to Make AIG Bailout Loan, Lawyer Says, Bloomberg (Sept. 30, 2014, 9:33 PM), http://www.bloomberg.com/news/2014-09-30/fed-s-e-mails-reveal-worry-about-bailout-transaction.html [http://perma.cc/G4V6-D34E] (describing lawsuit challenging unprecedented assumption of eighty percent of AIG's equity by government during AIG bailout). Large-scale Fed interventions were generally viewed as violating economic principles, notably Bagehot's rule that central banks should follow to avoid time-inconsistency problems and creating moral hazard. See Frederic S. Mishkin & Eugene N. White, Unprecedented Actions: The Federal Reserve's Response to the Global Financial Crisis in Historical Perspective 7–11 (Globalization & Monetary Policy Inst., Working Paper No. 209, 2014), http://www.dallasfed.org/assets/documents/institute/wpapers/2014/0209.pdf [http://perma.cc/M7NK-43G4] (identifying bailouts of financial institutions as one of seven actions by Fed generally accepted as "unprecedented" during financial crisis).

81. For a detailed discussion of issues that arise in government bailouts, see Richard W. Painter, Bailouts: An Essay on Conflicts of Interest and Ethics When Government Pays the Tab, 41 McGeorge L. Rev. 131, 154 (2009) ("For bailouts, however, outsourcing is probably unavoidable, because the government is venturing into unfamiliar areas that require specialized private-sector expertise.").

82. See infra section II.B.2 (comparing insurance industry risks to banking industry risks).

83. This position is certainly controversial and by no means established. The insurance industry would undoubtedly push back strongly against these claims of similarity. For the purposes of this Note, however, it is enough to show that such connections are possible as a basis for an analytical framework. For more on the similarities and differences between risks posed by the banking and insurance industries, see George Alexander Walker, International Banking Regulation: Law, Policy, and Practice

an even greater step removed, as section II.B will illustrate. Exploring these similarities and differences between industries will help to determine at what point it no longer makes sense to employ a BHC regulatory framework to create prudential standards for nonbanks.

This Part proceeds as follows. Section II.A will summarize the unique systemic risks posed by the asset management industry, comparing regulatory and industry perspectives. Section II.B will examine the institutional competence of the Fed with respect to regulating the specific risks identified in section II.A. This analysis will focus on two key questions: (1) whether the Fed has the legal tools to address systemic risk when it arises in asset managers; and (2) whether the Fed has the intellectual tools to address such risks.

A. *Systemic Risks of Asset Managers*

Asset managers differ in many ways from the banks and insurance companies that the Fed has had experience regulating in the past.[84] And while Dodd-Frank has in effect precluded a first-principles approach to regulating systemic risk in the industry, this Note argues that there may still be an effective method of operating within the existing regulatory framework to address the risks specific to asset managers. This, however, first requires an understanding of the nature of the business and the unique risks asset managers pose to the financial system. Section II.A.1 gives a broad overview of systemic risk. Section II.A.2 then summarizes the debate between regulators and the industry concerning the unique systemic risks created by asset managers.

1. *Systemic Risk.* — Title I of Dodd-Frank—"Financial Stability"—expressly targets systemic risk.[85] According to former Fed Chairman Bernanke, the goal of Dodd-Frank and postcrisis regulatory reform "is to produce a well-integrated set of rules that meaningfully reduces the probability of failure of our largest, most complex financial firms, and that minimizes the losses to the financial system and the economy if such a firm should fail."[86] Of course, this is not the first time that concerns were

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182 (2001) (describing similarities between banking and insurance industries); Nat'l Ass'n of Ins. Comm'rs & the Fed. Reserve Sys. Joint Troubled Co. Subgroup, A Comparison of the Insurance and Banking Regulatory Frameworks for Identifying and Supervising Companies in Weakened Financial Condition (2005), http://www.federalreserve.gov/boarddocs/staffreports/naicfrs/naicfrs.pdf [http://perma.cc/9HTF-BK7C] (comparing insurance and bank regulatory frameworks).

84. See infra section II.B.2 (comparing risks faced by asset management firms to those faced by insurance companies and banks).

85. See Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1572 (2010) (codified at 12 U.S.C. § 5323 (2012)) (outlining reporting requirements "as necessary and appropriate in the public interest and for the protection of investors, or for the assessment of systemic risk").

86. Dodd-Frank Implementation: Monitoring Systemic Risk and Promoting Financial Stability: Hearing Before the S. Comm. on Banking, Hous. & Urban Affairs, 112th Cong. 43 (2011), https://www.gpo.gov/fdsys/pkg/CHRG-112shrg71127/pdf/

expressed about the overall stability of the financial system. These concerns echo sentiments in the 1920s that the practices of banks and their securities subsidiaries had jeopardized the soundness of banks and were partly responsible for the stock market crash of 1929 and subsequent Great Depression.[87]

Despite efforts to mitigate it, there has not been a clearly established definition of systemic risk.[88] According to some, "systemic risk" is a term of art that describes "[t]he possibility that an event at the company level could trigger severe instability or collapse an entire industry or economy."[89] The key is that systemic risk involves the cascading effect of failures due to linkages between parts of a system.[90] An implicit assumption in Dodd-Frank is that enhanced prudential regulation imposed on some companies but not others is justified on the grounds of reducing overall systemic risk.[91] But when systemic risk is targeted at a firm-specific rather than industry-wide level, it is critical to question whether the bank regulatory principles potentially imposed on asset managers is actually furthering the underlying goal of systemic risk mitigation or simply unfairly burdening a small number of firms.

2. *Asset Management Industry.* — The asset management industry is difficult to characterize.[92] Unlike banks and insurance companies, the asset management industry is unique in the sense that different firms can have drastically different business models.[93] Some managers focus their strategies on a particular asset class, such as equities or fixed income.[94]

CHRG-112shrg71127.pdf (on file with the *Columbia Law Review*) (statement of Ben Bernanke, Chairman, Bd. of Governors of the Fed. Reserve Sys.).

87. See Eugene Nelson White, Before the Glass-Steagall Act: An Analysis of the Investment Banking Activities of National Banks, 23 Explorations Econ. Hist. 33, 33 (1986) (exploring causes of stock market crash of 1929).

88. See Iman Anabtawi & Steven L. Schwarcz, Regulating Systemic Risk: Towards an Analytical Framework, 86 Notre Dame L. Rev. 1349, 1353 (2011) (recognizing that "term 'systemic risk' has been used in various ways, sometimes inconsistently"). For an overview of systemic risk, see generally Steven L. Schwarcz, Systemic Risk, 97 Geo. L.J. 193 (2008) (defining systemic risk and describing role of law in reducing it).

89. Systemic Risk, Investopedia, http://www.investopedia.com/terms/s/systemic-risk.asp [http://perma.cc/DNU6-YL26] (last visited Nov. 14, 2015).

90. Regulatory Restructuring: Balancing the Independence of the Federal Reserve in Monetary Policy with Systemic Risk Regulation: Hearing Before the Subcomm. on Domestic Monetary Policy & Tech. of the H. Comm. on Fin. Servs., 111th Cong. 88 (2009) (statement of John B. Taylor, Professor of Economics, Stanford Univ.) ("[S]ystemic risk in the financial sector [is] a risk that impacts the entire financial system and real economy, through cascading, contagion, and chain-reaction effects.").

91. Cf. Enhanced Prudential Standards for Bank Holding Companies and Foreign Banking Organizations, 79 Fed. Reg. 17,240, 17,244–45 (Mar. 27, 2014) (to be codified at 12 C.F.R. pt. 252) (applying enhanced prudential standards to NBFIs despite differences in business models, activities, and risks).

92. Cf. Elliott, supra note 18, at 2–3 (describing diverse activities that characterize asset management industry).

93. OFR Report, supra note 37, at 3.

94. See id. at 4 fig.1 (providing breakdown of investments in various strategies).

Others tailor their strategies to a particular style of investing, for example international regional equities or municipal bonds.[95] Many of these individual funds can be thought of as products that are ultimately consumed by large institutional investors attempting to diversify their portfolio risk.[96]

This diversity makes it difficult even to determine the *size* of the industry.[97] But to properly regulate an industry requires a deep and thorough understanding of it, and OFR acknowledges its own data limitations.[98] Furthermore, if the Fed is to regulate systemic risk within the asset management industry, it must also first be able to demarcate the boundaries of its regulatory reach because the U.S. regulatory system is based on a network of primary regulators, sometimes with overlapping authority.[99] Broad exercise of the SIFI designation authority threatens to radically redraw these boundaries. As section II.B will show, giving the Fed the responsibility of regulating systemic risk in the asset management industry is an inefficient allocation of regulatory authority.

3. *OFR Report.* — In September 2013, OFR issued a report entitled "Asset Management and Financial Stability,"[100] which was prepared in response to a request from FSOC to assess whether certain asset managers pose systemic risk such that they should be designated nonbank SIFIs.[101] The report therefore attempted to identify whether certain asset management-specific activities could create vulnerabilities in the financial system and whether those vulnerabilities could pose threats to financial stability in the event of a financial shock.[102]

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95. See id. at 4 figs.1 & 11 (noting different strategies).

96. Cf. id. (providing detailed breakdown of various investment vehicles and describing rise of exchange-traded funds as popular investment product).

97. Of course, the size of the industry alone may only be a rough proxy for systemic risk. OFR estimates that "[t]he U.S. asset management industry oversees the allocation of approximately $53 trillion in financial assets" as of December 2012. Id. at 1. Industry experts estimate that global investable assets will surpass $100 trillion by 2020. See PwC, Asset Management 2020: A Brave New World 9 (2014), http://www.pwc.com/gx/en/asset-management/publications/pdfs/pwc-asset-management-2020-a-brave-new-world-final.pdf [http://perma.cc/FJM7-UCA9] (forecasting future size of global asset management industry).

98. See OFR Report, supra note 37, at 2 (discussing limitations caused by data availability).

99. See Lee Hudson Teslik, The U.S. Financial Regulatory System, Council on Foreign Relations (2008), http://www.cfr.org/financial-regulation/us-financial-regulatory-system/p17417 [http://perma.cc/5EXK-ZC8R] (summarizing structure of U.S. financial regulatory system).

100. OFR Report, supra note 37.

101. See Press Release, Dep't of the Treasury, Office of Financial Research (OFR) Delivers Report on Asset Management Industry (Sept. 30, 2013), http://www.treasury.gov/press-center/press-releases/Pages/jl2177.aspx [http://perma.cc/A3XJ-6U7Q] (describing goals of OFR study).

102. Richard Berner, Dir., Office of Fin. Research, Remarks at Brookings Institute Panel (Dec. 16, 2013), http://www.brookings.edu/~/media/events/2013/12/16%20

The OFR Report concluded that certain asset management activities could indeed lead to vulnerabilities that create systemic risk.[103] Such activities include "risk-taking in separate accounts and reinvestment of cash collateral from securities lending transactions."[104] Specific factors identified as being vulnerable to shocks include: "(1) reaching for yield and herding behaviors; (2) redemption risk in collective investment vehicles; (3) leverage, which can amplify asset price movements and increase the potential for fire sales; and (4) [individual] firms as sources of risk."[105] The report further identifies two channels through which asset managers could transmit risks across the financial system: industry linkages and fire sales.[106] Commenters have used this report to justify greater FSOC regulatory authority over asset managers, but the report has also generated a great deal of controversy, both within the industry and within regulatory entities.[107]

This Note will examine the vulnerabilities associated with the asset management industry in the context of the bank regulatory principles identified in section 165 of Dodd-Frank.[108] While there is disagreement over whether any of these supposed "risks" actually exists,[109] this Note will presume their existence as the basis for an analytical framework designed to test the limits of traditionally employed enhanced prudential standards.

a. *Reaching for Yield.* — The first factor deemed to create systemic risk is "reaching for yield" and herding behavior.[110] According to OFR, "reaching for yield" is defined as "seek[ing] higher returns by purchasing relatively riskier assets than [asset managers] would otherwise for a particular investment strategy."[111] In a low-interest-rate climate, competitive forces may force investment managers to take on greater risk, in spite of strong regulatory restrictions and disclosure requirements.[112]

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systemic%20risk/20131216_systemic_risk_asset_management_transcript.pdf [http://perma.cc/7EBU-9QSA] (describing goals and findings of OFR Report).

103. See OFR Report, supra note 37, at 1 (discussing types of activities that could create vulnerabilities).

104. Id.

105. Id. at 2 (internal quotation marks omitted).

106. Id. at 21.

107. For a compilation of all public comments to OFR Report, see Comments on OFR Study on Asset Management Issues, SEC, http://www.sec.gov/comments/am-1/am-1.shtml [http://perma.cc/KM7B-RE9N] (last visited Nov. 12, 2015).

108. See supra section I.B (summarizing mechanics of section 165).

109. See infra section II.A.4 (describing industry criticisms of OFR Report).

110. OFR Report, supra note 37, at 9–12.

111. Id. at 9.

112. Id. In an environment where interest rates approach zero ("zero-bound policy"), asset managers' gross profit margins collapse as returns on many securities decrease, causing investors to receive negative returns after fees. Faced with the threat of outflows of funds, managers may shift their risk into securities with higher interest rates. For a more detailed discussion on both the mechanics and the effects of zero-bound policy, see

Such behavior could in theory trigger a "flight to quality" during a market shock that would create redemption risk.[113] Furthermore, the asset management industry is susceptible to "herding" behavior—crowding into the same or similar assets.[114] Herding into illiquid investments is particularly risky.[115]

b. *Redemption Risk.* — Asset managers are susceptible to increased redemption risk in a stressed market if investors believe that redeeming early will give them an economic advantage.[116] For example, if there is a liquidity crunch, investors could race to redeem their shares if they think that "slower-to-redeem investors [will hold] shares of an increasingly less liquid portfolio whose net asset value (NAV) may fall . . . as market liquidity premiums rise."[117] Reputational risk could also cause increased redemption risk, as investors lose faith in a particular asset manager because of poor risk management or the collapse of a flagship fund.[118] Furthermore, "[i]nvestors who expect[ed] their investments to be protected by explicit or implicit backstops" provided by fund sponsors may redeem if such protections are taken away.[119] And finally, securities lending transactions in which asset managers invest cash collateral in

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Jaewon Choi & Mathias Kronlund, Reaching for Yield by Corporate Bond Mutual Funds 14–22 (Nov. 13, 2015) (unpublished manuscript), http://ssrn.com/abstract=2527682 [http://perma.cc/7TPX-K7YR] (investigating phenomenon in bond mutual funds); Marco Di Maggio & Marcin Kacperczyk, The Unintended Consequences of the Zero Lower Bound Policy 3 (Feb. 2015) (unpublished manuscript), http://www0.gsb.columbia.edu/mygsb/faculty/research/pubfiles/6475/zerobound_dk.pdf [http://perma.cc/T6WY-7E4E] (observing reaching for yield in money market mutual funds).

113. OFR Report, supra note 37, at 10. For a more extensive definition of "flight to quality," see Alessandro Beber, Michael W. Brandt & Kenneth A. Kavajecz, Flight-to-Quality or Flight-to-Liquidity? Evidence from the Euro-Area Bond Market, 22 Rev. Fin. Stud. 925, 926 (2009).

114. OFR Report, supra note 37, at 10. For a description on herding behavior in investments, see David S. Scharfstein & Jeremy C. Stein, Herd Behavior and Investment, 80 Am. Econ. Rev. 465, 467 (1990); Albert Phung, Behavioral Finance: Key Concepts—Herd Behavior, Investopedia, http://www.investopedia.com/university/behavioral_finance/behavioral8.asp [http://perma.cc/59YV-HDRQ] (last visited Nov. 12, 2015).

115. See OFR Report, supra note 37, at 11 ("Another way that these risks could surface is by investors herding into certain new products, particularly if the products are relatively illiquid and investors fail to fully appreciate their risks under different market conditions.").

116. Id. at 12–16. For an analysis of redemption risk in hedge funds, see Benjamin Klaus & Bronka Rzepkowski, Risk Spillover Among Hedge Funds: The Role of Redemptions and Fund Failures (European Cent. Bank, Working Paper No. 1112, 2009), http://www.ecb.europa.eu/pub/pdf/scpwps/ecbwp1112.pdf?b5b11344280d386fab9b7a53835e7c2f [http://perma.cc/U2H2-NNRE]; see also Sophia Grene, Big Tickets Mean Big Redemption Risks, Fin. Times (Aug. 3, 2014, 6:56 AM), http://www.ft.com/cms/s/0/9916d120-17d4-11e4-a82d-00144feabdc0.html#axzz3Hvkm2dTj (on file with the *Columbia Law Review*) (illustrating effects of large redemption on asset manager).

117. OFR Report, supra note 37, at 12.

118. Id. at 13–14.

119. Id. at 14.

assets can exacerbate a liquidity crunch in situations where illiquid assets are sold at a loss in order to meet cash collateral demands.[120]

c. *Leverage.* — The financial crisis illustrated that firms that employ leverage can be subject to margin calls and liquidity constraints that increase the risk of fire sales in times of market stress.[121] Leverage can also magnify losses on bad investments the same way it can magnify gains on good investments.[122] In one instance, AIG's credit downgrade resulted in a margin call on its credit default swaps that caused an acute liquidity crunch.[123] Asset managers can face similar risks from leverage[124] at the fund level by borrowing on behalf of the fund, or at the portfolio level by acquiring structured products and trading in derivatives.[125] Investors can further obtain leverage through products such as derivative-based exchange-traded products.[126] Despite fairly strict leverage requirements for registered funds under the Investment Company Act of 1940,[127] registered funds obtained large amounts of leverage as well as exposure to credit risk in the lead up to the crisis through the use of credit default swaps (CDSs).[128] By 2008, sixty percent of the 100 largest U.S. corporate bond funds sold CDS, up from twenty percent in 2004.[129] During the crisis, the use of derivatives to increase leverage led to substantial losses

120. Id. at 15.

121. Id. at 17. See generally Markus K. Brunnermeier & Lasse Heje Pedersen, Market Liquidity and Funding Liquidity, 22 Rev. Fin. Stud. 2201 (2009) (analyzing causes and effects of liquidity spirals due to liquidity freezes).

122. See Elliott, supra note 18, at 6 (explaining consequences of asset managers using leverage).

123. See ABA Report, supra note 21, at 16 (explaining circumstances surrounding AIG's liquidity crisis); Int'l Swaps & Derivatives Ass'n, AIG and Credit Default Swaps (2009), http://www.isda.org/c_and_a/pdf/ISDA-AIGandCDS.pdf [http://perma.cc/22FV-TYJU] (same).

124. OFR Report, supra note 37, at 17.

125. Id.

126. Id.

127. Investment Company Act of 1940, Pub. L. No. 768, § 18, 54 Stat. 789, 817–21 (1940). For a detailed discussion of the rationale behind and leverage limits imposed by the Investment Company Act of 1940, see Andrew J. Donohue, Dir., Div. of Inv. Mgmt., U.S. Sec. and Exch. Comm'n, Investment Company Act of 1940: Regulatory Gap Between Paradigm and Reality? (Apr. 17, 2009), http://www.sec.gov/news/speech/2009/spch041709ajd.htm [http://perma.cc/9S6B-USX5].

128. See Sean Campbell & Josh Gallin, Risk Transfer Across Economic Sectors Using Credit Default Swaps, FEDS Notes (Sept. 3, 2014), http://www.federalreserve.gov/econresdata/notes/feds-notes/2014/risk-transfer-across-economic-sectors-using-credit-default-swaps-20140903.html [http://perma.cc/Y8TH-P7WH] (describing mechanisms of risk transfers through use of CDSs).

129. Tim Adam & Andre Guettler, The Use of Credit Default Swaps by U.S. Fixed-Income Mutual Funds 2 (FDIC Ctr. for Fin. Research, Working Paper No. 2011-01, 2010), http://www.fdic.gov/bank/analytical/cfr/2011/wp2011/CFR_WP_2011_01.pdf [http://perma.cc/3QJS-ECF4].

for some registered funds.[130] Other funds paid significant fines in connection with fraudulent misrepresentations about credit risk exposure and leverage.[131]

d. *Firms as Sources of Risk.* — Finally, the OFR Report also suggests that individual firms can be a source of systemic risk, although this risk factor poses more questions than solutions.[132] In theory, firms could have strategies that are correlated in unanticipated ways.[133] Essentially, this factor assumes that the size, complexity, and unpredictability of the asset management industry all combine to generate systemic risk.[134] And it is this unquantified degree of interconnectedness, exerting its invisible force on the market, that calls for contingencies such as capital reserves—not currently required for stand-alone asset managers but required for asset management divisions of BHCs.[135]

4. *Industry Response.* — The FSOC final rule on systemic designations for NBFIs and the OFR Report have generated enormous controversy.[136] In fact, internal memos showed that the SEC raised serious concerns about the report during its drafting, but that these suggestions were largely ignored.[137] The SEC solicited public comment after the report was published, allowing industry stakeholders to voice their concerns.[138] Among the fifty-four public comments on the report was a pointed critique by then SEC Commissioner Daniel Gallagher, who stated that "[a]pplying bank regulatory principles to capital markets regulation is a fatally misguided approach, the regulatory equivalent of trying to jam a square peg into a round hole."[139]

Comment letters further included a number of criticisms challenging the underlying assumptions made by OFR in its study. First, commenters

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130. "For example, the Oppenheimer Champion Income Fund and Oppenheimer Core Bond Fund—two large fixed-income mutual funds—lost roughly 80 and 36 percent of their net asset value in 2008, respectively." OFR Report, supra note 37, at 18.

131. "The SEC . . . fined OppenheimerFunds $35 million for inadequately disclosing the risks associated with [its use of] leverage." Id. State Street Corporation paid "significant settlements" related to its noncompliance with state disclosure requirements. Id.

132. Id.

133. Id. at 19.

134. Id. at 18.

135. Id. at 19.

136. See Sarah N. Lynch, Memos Show SEC–Treasury Dispute over 2013 Asset Management Study, Reuters (Apr. 7, 2014, 5:00 PM), http://www.reuters.com/article/2014/04/07/sec-documents-assetmanagers-idUSL2N0MZ0UL20140407 [http://perma.cc/8SSL-SMSU] (highlighting dispute between SEC and OFR over contents of OFR Asset Management Report).

137. Id.

138. Comments on OFR Study on Asset Management Issues, U.S. Sec. & Exch. Comm'n, http://www.sec.gov/comments/am-1/am-1.shtml [http://perma.cc/USW9-5775] (last modified Sept. 14, 2015) (listing all comment letters received).

139. Gallagher, supra note 39, at 2.

argued that asset management is fundamentally an agency business, and therefore these institutions do not have the same kind of balance sheet obligations that would complicate the unwinding process.[140] If an asset manager goes out of business, client accounts can simply be moved to a new custodian, thus obviating the need for a bailout.[141] Asset managers also do not participate directly in capital markets.[142] Unlike banks and insurance companies, asset managers do not lend money or act as counterparties and therefore are not exposed to the same kinds of underwriting risk on their smaller balance sheets.[143] Finally, asset managers are not susceptible to runs like those of institutional prime money market funds that contributed to the financial crisis.[144] While the idiosyncratic failure of a single fund or manager could trigger a run on that *specific* fund or manager's assets, it is argued that there is simply no evidence suggesting that such an event would spill over into the broader market.[145]

The OFR Report also triggered a strong reaction from the industry concerning the possible immediate ramifications of SIFI designations. First, the underlying assumption that systemic designations could mitigate risk was challenged as a fundamental misunderstanding of the asset

140. Id. at 7–8 ("[U]nlike banks, asset managers do not have balance sheet obligations that complicate the unwinding process."); see also Blackrock, Who Owns the Assets? Developing a Better Understanding of the Flow of Assets and the Implications for Financial Regulation 1 (2014) [hereinafter Blackrock Viewpoint], http://www.blackrock.com/corporate/en-us/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf (on file with the *Columbia Law Review*) (explaining respective roles of asset owners, asset managers, and intermediaries to show agency relationship).

141. See Gallagher, supra note 39, at 7–8 (explaining asset manager liquidation process).

142. See id. (identifying unique characteristics of asset managers).

143. Id. at 8 ("Unlike banks (and some insurance companies), asset managers do not lend money or act as counterparties.").

144. R. Glenn Hubbard, John L. Thorton & Hal S. Scott, Comment Letter on OFR Study on Asset Management Issues 3 (Nov. 1, 2013), http://www.sec.gov/comments/am-1/am1-9.pdf [http://perma.cc/VMR5-UUAB] (distinguishing money market mutual funds from traditional asset managers).

145. Id. at 2 (arguing OFR Report "does not provide any empirical evidence that such runs or fire sales pose systemic risk"). The theory is that the failure of a single fund has no impact on the viability of other funds because when an asset manager goes out of business, customer accounts and assets simply shift to another manager. Gallagher, supra note 39, at 7–8 (stating "accounts and the assets within them simply relocate to a new custodian" when asset manager goes out of business). Furthermore, asset managers do not participate directly in the capital markets by lending money or acting as counterparties. Id. at 8. Empirical support for spillover effects is limited, as few academic studies have examined the specific issue of systemic risk in asset managers. See Roncalli & Weisang, supra note 61, at 9 ("While the interconnection between the banking system and financial crises is well documented . . . the same cannot be said for the asset management industry[,] . . . [and] existing studies generally focus on hedge funds and do not address the role of the entire asset management industry.").

management industry.[146] Applying SIFI designations to large asset managers may cause money to move between different managers and different funds but would not address the core issue of asset flows into and out of a specific asset class or type of fund.[147] Such decisions are made by investors (asset owners) rather than asset managers. Asset owners may use banks or insurance companies to mitigate risk, but they invest in funds to *assume* risk in order to seek higher returns on their investments. Second, it is argued that a SIFI designation that does not meaningfully target or reduce systemic risk serves only to increase costs for a select group of investors and funds.[148] And so far, neither FSOC nor OFR has suggested any specific prudential regulations that could feasibly be placed on asset managers.

B. *Application of BHC Principles to Asset Management Risks*

Thus far, this Note has discussed: (1) the Fed's powers under Dodd-Frank to oversee and reduce systemic risk in the financial system and (2) the unique business model and risks posed by the asset management industry. With the goal of better understanding the relative suitability of the systemic designation mechanism, this section will analyze how far existing prudential regulations for BHCs can be stretched to apply to NBFIs by testing them against purported asset manager risks. Section II.B.1 will examine whether the Fed has the legal tools to adequately regulate systemic risk in asset managers through the SIFI mechanism. Section II.B.2 will examine whether the Fed has the intellectual tools—knowledge, expertise, and experience—to target such systemic risk.

1. *Legal Tools.* — In determining whether the Fed is capable of addressing systemic risk in the asset management industry, it is important to first consider the threshold question of whether the Fed has statutory authority under Dodd-Frank to impose the necessary regulations. The relevant provisions of the Act are found in sections 115 and 165.[149] Section 115 covers permissible recommendations for enhanced prudential regulation by FSOC,[150] and section 165 describes in greater detail the characteristics of the enhanced prudential standards required of and

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146. Hubbard et al., supra note 144, at 3 ("In the absence of any clear evidence that asset managers contribute to systemic risk, we remain of the belief that FSOC should refrain from designating asset managers as non-bank SIFIs . . . .").

147. See Blackrock Viewpoint, supra note 140, at 1 (predicting industry response to SIFI designations).

148. Douglas M. Hodge, Comment Letter Regarding Consultative Document, Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions 10–11 (Apr. 7, 2014), http://www.sec.gov/comments/am-1/am1-40.pdf [http://perma.cc/Z2ZQ-HREW] (outlining PIMCO CEO's predictions of increased compliance costs resulting from SIFI designations).

149. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, §§ 115, 165, 124 Stat. 1376, 1403, 1423 (2010) (codified at 12 U.S.C. § 5365 (2012)).

150. Id. § 115.

permitted to be used by the Fed.[151] These enhanced regulations—including capital and leverage ratios, resolution plans, and enhanced public disclosures[152]—are primarily based on bank regulatory principles.[153] While the BHC-centric language may appear to constrict the Fed's ability to regulate NBFIs, section 165 further includes a catchall provision granting the authority to impose "such other prudential standards as the Board of Governors, on its own or pursuant to a recommendation made by the Council in accordance with section 115, determines are appropriate."[154] Given the broad mandate of these two sections, the Fed most likely has the legal power to address systemic risk in the institutions placed under its supervision. It is, however, worth noting that the Fed has no power to regulate whole industries, and to the extent that there are risks posed by the entire asset management industry, the power of the systemic designation mechanism is limited.

2. *Intellectual Tools.* — While Dodd-Frank's broad mandate may indeed give the Fed the legal authority to impose controls on asset managers, it is less clear that the Fed has the expertise and experience to regulate an industry that differs drastically from BHCs. This subsection will test the BHC-oriented prudential framework outlined in section 165 against the risks identified in the OFR Report.[155] This analysis will help assess the Fed's ability to regulate systemic risk in asset managers and ultimately shed light on the appropriateness of applying the systemic designation mechanism to the asset management industry. By establishing the limits of the Fed's intellectual regulatory capacity, this Note serves as a warning to legislators that broad exercise of the systemic designation mechanism such that the Fed effectively becomes the "systemic regulator" may be an inefficient way to target systemic risk.[156] This subsection will analyze five traditional BHC regulatory tools: (1) risk-based capital requirements, (2) leverage ratios, (3) liquidity coverage ratios, (4) living wills, and (5) stress testing.

a. *Regulatory Capital Requirements.* — Capital adequacy has long been a central tenet of prudential banking regulation.[157] Although there

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151. Id. § 165; see supra section I.B.1 (discussing section 165 provisions authorizing Fed to impose enhanced prudential standards).

152. § 165; see supra section I.B.1 (describing Fed's power to impose additional requirements on SIFIs).

153. Many of the enumerated prudential standards are widely accepted bank regulatory tools found in both the Bank Holding Company Act as well as the Basel Accords. See Basel Comm. on Banking Supervision, Core Principles for Effective Banking Supervision 9–13 (2012), http://www.bis.org/publ/bcbs230.pdf [http://perma.cc/FXP7-UWWT] (describing core principles of banking regulation).

154. § 165(b)(1)(B)(iv).

155. See supra section I.B.1 for a list of enumerated prudential standards in section 165.

156. See infra section III.A (analyzing efficacy of SIFI mechanism).

157. Maintaining regulatory capital has historically been a core tenet of both domestic and international banking regulation, from the Bank Holding Company Act to the Basel

are a number of specific capital ratios, the most basic is the total risk-based capital ratio, which is calculated by dividing total capital by risk-weighted assets.[158] Capital ratios have historically been the centerpiece of banking regulation because of the basic assumption that a bank will be safer to the extent the value of its assets exceeds the value of its liabilities, with the excess serving as a buffer during troubled times.[159] In some ways, the risks posed by insurance companies are analogous to risks posed by banks. For example, non-life insurers face underwriting risk (including premium and reserve risks), credit risk, asset risk, and interest rate risk.[160] As a result, these general insurers hold relatively large amounts of capital compared to life insurers and commercial banks.[161] But while an increase in capital may mitigate these risks, holding capital also involves costs. In addition to tax and agency costs associated with holding capital, holding too much regulatory capital could affect an institution's bottom line or the products it is able to offer.[162]

The analogy, however, breaks down when extended to asset managers, which operate on a completely different business model. Although asset managers face credit, market, and operational risk, the nature of asset management is fundamentally an agency business, and assets are owned

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Accords. See Richard S. Grossman, Unsettled Account: The Evolution of Banking in the Industrialized World Since 1800, at 145–56 (2010) (defining and exploring history of regulatory capital).

158. For a more detailed explanation of capital ratios, see Risk-Based Capital Requirement, Investopedia, http://www.investopedia.com/terms/r/risk-based-capital-requirement.asp [http://perma.cc/UM3K-XAYJ] (last visited Jan. 30, 2016).

159. See Fed. Deposit Ins. Corp., Financial Institution Letters: Regulatory Capital Rules (July 21, 2014), http://www.fdic.gov/news/news/financial/2014/fil14040.html [http://perma.cc/FM9U-T9B6] (describing buffer effect of Basel III capital requirements).

160. Scott E. Harrington, Capital Adequacy in Insurance and Reinsurance, *in* Capital Adequacy Beyond Basel: Banking, Securities, and Insurance 87, 88–89 (Hal S. Scott ed., 2005) (examining capital regulation in insurers and reinsurers).

161. Id. at 89.

162. Dwight M. Jaffee & Thomas Russell, Catastrophe Insurance, Capital Markets, and Uninsurable Risk, 64 J. Risk & Ins. 205, 212–13 (1997) (discussing tax and agency costs of capital). An increase in regulatory capital requirements reduces the return on equity by spreading out profits over a larger capital base. These requirements can also affect the products an institution is able to offer. J.P. Morgan, Leveraging the Leverage Ratio 3 (2014), http://www.jpmorgan.com/cm/BlobServer/is_leveragingtheleverage.pdf?blobkey=id&blobwhere=1320634324649&blobheader=application/pdf&blobheadername1=Cache-Control&blobheadervalue1=private&blobcol=urldata&blobtable=MungoBlobs [http://perma.cc/Q7PD-BP2T] (warning that "hedge fund managers should expect banks to become more discerning in their allocation of equity to support new and existing business—redirecting resources away from businesses that are expected to earn low returns on equity"). Furthermore, because the denominator of the capital ratio is risk-weighted assets, financial institutions may increase their capital ratios by reducing loans or by shifting to less risky assets. Juliusz Jablecki, The Impact of Basel I Capital Requirements on Bank Behavior and the Efficacy of Monetary Policy, 2 Int'l J. Econ. Sci. & Applied Res. 16, 22 (2009) (identifying ways in which banks can increase capital ratios).

by individual or institutional investors.[163] Viewed through the lens of the OFR Report's systemic vulnerabilities, herding behavior and reaching for yield actually occurred *because of* regulatory capital requirements under Basel II.[164] Furthermore, redemption risk would presumably not be reduced unless capital was used to backstop losses, which runs counter to the asset manager business model.[165] It appears that the drafters of Dodd-Frank anticipated this mismatch, explicitly allowing an exception for the otherwise mandatory capital and leverage requirements if FSOC and the Fed determine "that such requirements are not appropriate for a company subject to more stringent prudential standards because of the activities of such company (such as investment company activities or assets under management) or structure."[166] Therefore, while applying enhanced capital requirements may make sense for insurance companies, the utility of the tool goes away with asset managers.

b. *Leverage Ratio.* — Leverage ratios are another traditional bank regulatory tool. While leverage can be a valuable tool for increasing returns, excess leverage poses the danger of magnifying losses and causing devastating results.[167] Generally, financial leverage is calculated as a firm's debt-to-equity ratio.[168] Regulatory leverage ratio, however, under Basel II—the Minimum Tier 1 Leverage Ratio—is calculated as Tier 1

163. See Blackrock Viewpoint, supra note 140, at 7 (arguing systemic risk designation will raise costs of offering certain products).

164. Peter J. Wallison, How Regulators Herded Banks into Trouble, Wall St. J. (Dec. 3, 2011), http://www.wsj.com/articles/SB10001424052970203833104577069911633739768 (on file with the *Columbia Law Review*) (arguing Basel rules encouraged financial institutions to hold mortgage-backed securities during housing crisis and to hold sovereign European debt during Greek crisis); see also OFR Report, supra note 37, at 9–12 (describing herding behavior and risks from reaching for yield). Basel II, put forth by the Basel Committee on Bank Supervision, is a set of international banking regulations that focuses on setting capital requirements. Basel II, Investopedia, http://www.investopedia.com/terms/b/baselii.asp#ixzz3newhtSry [http://perma.cc/DU74-X479] (last visited Jan. 30, 2016).

165. See Timothy W. Cameron, Asset Managers Do Not Pose Systemic Risk, SIFMA: Pa. + Wall (May 7, 2014), http://www.sifma.org/blog/asset-managers-do-not-pose-systemic-risk/ [http://perma.cc/H9D9-F5U7] ("Additionally, asset managers do not guarantee positive investment returns, and do not back-stop investment losses."); see also Capital Adequacy of Investment Firms and Credit Institutions, EUR-Lex, http://europa.eu/legislation_summaries/internal_market/single_market_services/financial_services_banking/l24037_en.htm [http://perma.cc/GNA4-TXGH] (last updated Mar. 18, 2011) (explaining unique role of capital adequacy in investment firms).

166. Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, § 165, 124 Stat. 1376, 1423 (2010) (codified at 12 U.S.C. § 5365 (2012)).

167. For a more detailed explanation of leverage ratio, see Leverage Ratio, Investopedia, http://www.investopedia.com/terms/l/leverageratio.asp [http://perma.cc/AJ6M-8H9Y] (last visited Jan. 30, 2016).

168. U.S. Gov't Accountability Office, GAO-09-739, Financial Crisis Highlights Need to Improve Oversight of Leverage at Financial Institutions and Across System 1 (2009), http://www.gao.gov/assets/300/292757.pdf [http://perma.cc/JH3E-LZUW] (describing limitations of regulatory approaches used to restrict leverage revealed by financial crisis).

capital divided by total assets,[169] meaning that the Basel Accords build regulatory capital into the definition of leverage. Just as leverage is inherent to the nature of a bank as a deposit-taking institution engaged in maturity transformation, the insurance industry similarly relies on leverage.[170] Insurance companies are able to take extremely leveraged positions because they are able to sell insurance many multiples the amount of its capital.[171] Therefore, proper regulatory controls on leverage can be as important for insurance companies as they are for banks.

The role leverage plays in the asset management industry differs significantly from the role it plays in banks and insurance companies. While asset managers can generate leverage at the firm or fund level, the SEC and CFTC both use net capital rules to limit broker-dealer leverage by directly regulating the ability of firms to meet their obligations to clients and creditors.[172] According to the OFR Report, firms create systemic vulnerability by investing in levered products such as CDSs or leveraged exchange-traded funds.[173] Therefore, leverage in asset managers is created primarily at the product level. This characteristic means that a traditional leverage ratio imposed on individual firms cannot address the unique risk posed by leverage in the asset management industry. Finally, as

169. Basel Comm. on Banking Supervision, Bank for Int'l Settlements, International Convergence of Capital Measurement and Capital Standards 12–14 (2004), http://www.bis.org/publ/bcbs107.pdf (on file with the *Columbia Law Review*).

170. See Soc'y of Actuaries, U.S. Insurance Company Investment Strategies in an Economic Downturn 8 (2011), http://www.soa.org/Files/Research/Projects/research-2012-us-insurance.pdf [http://perma.cc/LHX7-E4DM] ("Insurers utilize low amounts of true borrowing although their basic business model utilizes float, where cash is collected today with promises to pay it back to claimants at a later time.").

171. See J. Robert Ferrari, The Relationship to Underwriting, Investment, Leverage, and Exposure to Total Return on Owners' Equity, Actuarial Outpost, http://www.actuarialoutpost.com/actuarial_discussion_forum/attachment.php?attachmentid=11453&d=1216838345 [http://perma.cc/G7FL-CDFC] (last visited Nov. 11, 2015) (explaining significance of leverage in insurance companies); see also Leverage, Int'l Risk Mgmt. Inst., http://www.irmi.com/online/insurance-glossary/terms/l/leverage.aspx [http://perma.cc/97SU-ZHM6] (last visited Nov. 11, 2015) (defining leverage in insurance context).

172. A net capital rule requires firms to value their securities at market and to apply a haircut based on each security's risk characteristics. The haircut values of securities are used to compute the liquidation value of a broker-dealer's assets to determine whether the broker-dealer holds enough liquid assets to pay all of its nonsubordinated liabilities and to still retain a cushion of required liquid assets ("net capital") to ensure payment of all obligations owed to customers if there is a delay in liquidating the assets. See U.S. Gen. Accounting Office, GAO/GGD-98-153, Regulatory and Industry Approaches to Capital and Risk 9 (1998), http://www.gao.gov/archive/1998/gg98153.pdf [http://perma.cc/CCK2-RDVY] (defining net capital rules).

173. See supra section II.A.3 (describing OFR conclusion that systemic vulnerabilities are created by asset manager investments in leveraged products). Swaps are derivatives that are often used to generate returns many multiples over the daily performance of a referenced index. These products can be highly profitable but also generate enormous risk, as both gains *and* losses are magnified. Ari I. Weinberg, 'Swaps' Add a New Risk, Wall St. J. (Feb. 7, 2011, 12:01 AM), http://www.wsj.com/articles/SB10001424052748704590704576091963688787104 (on file with the *Columbia Law Review*).

explained in the context of regulatory capital, section 165 has a built-in exception for the otherwise mandatory enhanced leverage requirement.[174]

c. *Liquidity Coverage.* — During the recent financial crisis, liquidity risk emerged as the predominant threat to the financial system such that even well-capitalized institutions faced serious liquidity problems.[175] Banks that relied on short-term wholesale funding while simultaneously failing to hold adequate liquid assets on their balance sheets were hard hit by the credit crunch when financing in the overnight markets dried up.[176] Insurance companies, on the other hand, historically had viewed liquidity risk as being a consequence of major catastrophes, and thus contained liquidity risk within insurance, investment, and credit risk because of the rarity of catastrophic events.[177] But during the financial crisis, AIG—facing a liquidity crunch due to $18 billion in losses over three quarters on mortgage guarantees it had underwritten—was forced to request bailout funds when faced with up to $14.5 billion in collateral calls due to an impending credit downgrade.[178] Partially as a result, much attention has been given recently to the Liquidity Coverage Ratio, a key component of the Basel Accords, which ensures that a financial institution maintains the necessary assets to survive short-term liquidity crunches.[179]

Liquidity risk in asset managers, however, poses a different set of concerns. In the context of the asset management industry, the relevant types of liquidity are funding liquidity (i.e., redemption risk in the manner described in the OFR Report) and market/asset liquidity (i.e., the ability of the institution to convert its investments to cash).[180] Critical

174. See supra section I.B (explaining section 165's built-in exception for inapplicable prudential standards).

175. See Derek Newton, David Sanders & Gary Wells, Liquidity Risk in an Insurance Operation 2 (2009), http://www.milliman.com/insight/Research/perspective/research/pdfs/Liquidity-risk-in-an-insurance-operation/ [http://perma.cc/D529-XPEN] (describing new post-financial crisis attitudes toward liquidity risk in insurance companies).

176. See KPMG, Liquidity: A Bigger Challenge than Capital 3 (2012), http://www.kpmg.com/Global/en/IssuesAndInsights/ArticlesPublications/Documents/liquidity-challenges.pdf [http://perma.cc/GJT6-UV5B] (assessing liquidity problems faced during financial crisis by large banks relying on short-term wholesale funding).

177. See Newton, Sanders & Wells, supra note 175, at 1 (illustrating treatment of liquidity risk in insurance industry).

178. See Lilla Zuill, AIG Facing Liquidity Crisis, Seeks $40 Billion Loan from Federal Reserve, Ins. J. (Sept. 14, 2008), http://www.insurancejournal.com/news/national/2008/09/14/93672.htm [http://perma.cc/GHR7-DJUP] (detailing AIG liquidity crisis).

179. See Liquidity Coverage Ratio, Investopedia, http://www.investopedia.com/terms/l/liquidity-coverage-ratio.asp [http://perma.cc/E6DW-FT2K] (last visited Nov. 13, 2015) ("Banks are required to hold an amount of highly-liquid assets, such as cash or Treasury bonds, equal to or greater than their net cash over a 30 day period.").

180. See Roderick Fisher, New Challenges in Liquidity Management for Investment Funds 3–10 (2012), http://www.garp.org/media/934707/garp%20presentation%20-%20june%2014%202012_roderick%20fisher_061812.pdf [http://perma.cc/CR83-9UJL] (describing new issues for asset management firms with respect to liquidity after financial crisis).

scenarios unique to asset managers would include: (1) scenarios in which investors wish to redeem shares, but the cash amount in the fund is insufficient and assets cannot be sold on short notice (or only at fire sale prices); and (2) situations where "[i]nvestment decisions cannot be executed due to asset illiquidity (violation of limits, unwanted fund structure, bad fund performance)."[181] One method of addressing the liquidity risks associated with the asset management industry would be to employ the Basel Accord's liquidity coverage ratio. But the agency nature of the business may present complications as the asset manager does not actually own the assets, and therefore requiring a set amount of liquid assets may lead to inefficient capital allocation. Perhaps a better approach would be to create more stringent reporting requirements combined with robust stress testing that would encourage firms to tailor their liquidity management regimes to the specific behavioral characteristics of their investors.[182] Alternatively, liquidity controls could be imposed at the product level, limiting concentration in illiquid assets.

d. *Resolution Planning.* — Dodd-Frank mandates that certain BHCs and nonbank SIFIs submit resolution plans (living wills) that describe the institution's "strategy for rapid and orderly resolution in the event of material financial distress or failure of the company."[183] The financial crisis demonstrated the need for large BHCs and insurance companies to plan out their liquidation process due to the large-scale failures and bailouts.[184] And yet, industry groups including the Investment Company Institute (ICI) have been strongly critical of living wills on the grounds that they are unnecessary, primarily because funds do not fail in the same way banks do.[185] Funds do not promise investors any returns or even the return of their principal, and therefore investment gains and losses are borne by shareholders in funds on a pro rata basis rather than by the fund

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181. Stephan Schruff, Liquidity Risk from the Perspective of Asset Managers, Inv. Data Servs. 10 (2012), http://investmentdataservices.info/fileadmin/media/PDF/Insights/Publikationen/2012-08-30_PRMIA_Liquidity_Reporting_final.pdf [http://perma.cc/UK8K-Q8GP] (analyzing liquidity risk in asset managers and proposing liquidity risk control processes).

182. Id. at 9.

183. See Resolution Plans, Bd. of Governors of the Fed. Reserve Sys., http://www.federalreserve.gov/bankinforeg/resolution-plans.htm [http://perma.cc/3A68-GG5W] (last updated Nov. 10, 2015) (describing living wills).

184. See Gregg L. Rozansky, Ned S. Schodek & Shriram Bhashyam, Living Will Requirements for Financial Institutions 3–4 (2012), http://www.shearman.com/~/media/Files/NewsInsights/Publications/2012/05/Living-Will-Requirements-for-Financial-Instituti__/Files/View-full-article-Living-Will-Requirements-for-F__/FileAttachment/LivingWillRequirementsforFinancialInstitutionsFI__.pdf [http://perma.cc/HLC9-VA2N] (describing purposes of Dodd-Frank orderly resolution requirements).

185. See Inv. Co. Inst., "Orderly Resolution" of Mutual Funds and Their Managers 1 (2014), http://www.ici.org/pdf/14_ici_orderly_resolution.pdf [http://perma.cc/48DA-VQ8F] (arguing against "orderly resolution" of mutual funds).

managers.[186] Furthermore, funds and fund managers routinely exit the industry without creating spillover effects in the markets, as 424 funds were merged or liquidated in 2013 and forty-eight fund managers exited in 2013.[187] Therefore, imposing living will requirements on asset managers may be unduly burdensome in a market that already contains adequate mechanisms for orderly resolution.

e. *Stress Tests.* — Stress tests have been an integral part of financial regulation, identified by one Fed official as "one of the Federal Reserve's most important tools to gauge the resiliency of the financial sector and to help ensure that the largest firms have strong capital positions."[188] For example, in the context of national banks regulated by the Office of the Comptroller of the Currency (OCC), results of company-run stress tests provide the OCC with forward-looking information that the regulator uses to assess the bank's risk profile and capital adequacy.[189] Each year, the OCC releases a set of hypothetical scenarios, which include baseline, adverse, and severely adverse scenarios, each of which includes twenty-eight variables (i.e., economic activity, unemployment, exchange rates, prices, incomes, and interest rates).[190] Despite differences between the banking, insurance, and asset management industries, stress tests can be tailored to each sector to provide valuable information to regulators on the ability of firms to withstand times of economic and financial stress.

An analysis of the bank regulatory tools enumerated in section 165 of Dodd-Frank in the context of asset managers reveals that although arguments can be made that these prudential standards can be applied to insurance companies, it is often difficult to extend the analogy beyond insurance companies to asset managers. With the exception of stress testing, the four remaining core enhanced prudential regulations are either inapplicable to asset management firms or would result in unwanted distortions. Furthermore, the specific risks that these regulatory tools are intended to curtail in banks and insurance companies are not addressed using an approach that applies the same standards to asset managers on an institutional level. The current statutory framework,

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186. Id. ("All investment results—gains and losses, no matter how big or small—belong to the fund's investors on a *pro rata* basis.").

187. See Frances Stadler & Rachel Graham, Living Wills and an Orderly Resolution Mechanism? A Poor Fit for Mutual Funds and Their Managers, ICI Viewpoints (Aug. 12, 2014), http://www.ici.org/viewpoints/view_14_orderly_resolution (on file with the *Columbia Law Review*) (describing reasons why funds and fund managers routinely exit market).

188. Victoria Finkle, Fed's Dodd-Frank Stress Test Results a Mixed Bag for Banks, Am. Banker (Mar. 20, 2014), http://www.americanbanker.com/issues/179_55/feds-dodd-frank-stress-test-results-a-mixed-bag-for-banks-1066414-1.html [http://perma.cc/7YBF-E9B5].

189. Dodd-Frank Act Stress Test (Company-Run), Office of the Comptroller of the Currency, http://www.occ.gov/tools-forms/forms/bank-operations/stress-test-reporting.html [http://perma.cc/6F2J-3RZS] (last visited Mar. 9, 2016) (providing detailed requirements of stress tests).

190. Id.

therefore, poses serious problems when applied to NBFIs. The above analysis calls for alternative approaches that would more efficiently achieve the goal of systemic regulation across the financial sector.

III. Alternative Approaches

Critics of Dodd-Frank have called for the legislation to be reformed.[191] Whether such broad criticisms have merit is beyond the scope of this Note. It is, however, almost certainly unrealistic that sweeping changes will be applied to Dodd-Frank in the near future, especially since the Act itself is relatively new and many of the regulations have yet to be drafted. It also remains uncertain how far FSOC will go in terms of exercising its discretionary authority to expand the role of the Fed as systemic regulator through the systemic designation mechanism, and as a result, whether bank regulatory principles will be carried beyond banks and insurance companies to other NBFIs. But working within the existing bank regulatory framework, this Note examines the pros and cons of two existing approaches to regulating systemic risk in asset managers. This Note also examines some of the key structural issues that arise when designing systemic risk regulation regimes and, in doing so, advocates a simple alternative framework.

Starting with the baseline assumption that there is some systemic risk that is created by asset managers, this Note has thus far identified two different paths for future regulation of systemic risk in the asset management industry. Section III.A will consider the "Insurance SIFI Model." Under this approach, FSOC could move forward with systemic designations of asset managers and tailor enhanced prudential regulations to address the unique problems of asset manager systemic risk.[192] Section III.B analyzes the "Activity-Based Approach" recently proposed by the SEC. Originally suggested by ICI, this model eschews specific firm designations and instead regulates the entire asset management industry for systemic risk by targeting risky activity.[193] Finally, in section III.C, this Note advocates an alternative approach, the "Systemic Regulator Model," which entails comprehensive oversight under which FSOC serves as systemic watchdog, promoting interagency cooperation and information

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191. Brady Dennis, Congress Passes Financial Reform Bill, Wash. Post (July 16, 2010), http://www.washingtonpost.com/wp-dyn/content/article/2010/07/15/AR2010071500464_pf.html [http://perma.cc/D3H3-C3NP] (describing Republican opposition to Dodd-Frank, including Senate Minority Leader's predictions that bill will ultimately result in unintended consequences).

192. See supra section I.B (describing SIFI mechanism and resulting enhanced prudential standards).

193. ICI Responds to the FSB Consultation on Systemic Risk and Investment Funds, Inv. Company Inst. Viewpoints (Apr. 8, 2014) [hereinafter ICI Viewpoints, Response to FSB], http://www.ici.org/viewpoints/view_14_fsb_comment [http://perma.cc/Z6TB-9V7T] (responding to FSB consultation paper on systemic risk and investment funds).

sharing, while regulatory authority remains in the hands of the primary regulators.

A. *"Insurance SIFI Model"—Tailored Application of Enhanced Prudential Standards to Asset Manager SIFIs*

The "Insurance SIFI Model" is essentially Congress's current approach with respect to insurance SIFIs. Rather than provide recommendations to the Fed, as it is entitled to do under section 115, FSOC deferred the creation of new prudential standards entirely to the Fed's regulatory rulemaking discretion.[194] Although FSOC had previously suggested that it was backing away from individual systemic designations of asset managers,[195] and the SEC recently unveiled a sweeping set of initiatives to stem risk in the asset management industry,[196] the possibility of systemic designations continues to exist in the shadow of the FSB's G-SIFI framework.[197] Whether FSOC reignites this debate depends on the FSB's plan for global systemic designations as well as the Council's assessment of the SEC's latest round of regulations.

It may be argued that if the Fed indeed intends to become the "systemic regulator," it must have oversight over the largest financial firms that are deemed to pose systemic risk in the "Too Big to Fail" sense. If this is the goal, then perhaps the benefits of the SIFI-oriented approach outweigh the costs of having the Fed develop the expertise to regulate NBFIs. Furthermore, as seen in the insurance case, FSOC has expressed a willingness to grant the Fed enormous latitude in designing a regulatory scheme for nonbank SIFIs designated under section 113.[198] This approach would require the difficult task of examining what makes

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194. See Winkler, supra note 49 (describing Fed's broad discretion over enhanced prudential standards through regulatory rulemakings).

195. See Ackerman & Tracy, supra note 12 (describing temporary shift in FSOC direction from systemic designations to activity-based regulation).

196. See Ackerman, SEC Plan, supra note 14 (describing latest SEC initiatives to target systemic risk in asset managers).

197. On the international front, asset managers are still under scrutiny. In the face of diverging consultative responses, the FSB delayed further G-SIFI designation in August 2015. See Ashley Lee, FSB Delays Asset Manager G-SIFI Designations, Int'l Fin. L. Rev. (Aug. 4, 2015), http://www.iflr.com/Article/3476821/FSB-delays-asset-manager-G-Sifi-designations.html (on file with the *Columbia Law Review*) (explaining delay in FSB timeline on G-SIFI designations). In its September 2015 plenary meeting, the FSB indicated that it was engaged in an ongoing evaluation of the asset management industry. Press Release, Fin. Stability Bd., Meeting of the Financial Stability Board in London on 25 September, at 1 (Sept. 25, 2015), http://www.financialstabilityboard.org/wp-content/uploads/September-Plenary-press-release.pdf [http://perma.cc/A583-23VV] ("[FSB] will evaluate . . . the role that existing or additional activity-based policy measures could play in mitigating potential risks . . . .").

198. Paul H. Kupiec, The Fed's Blueprint for Financial Control, Wall St. J. (May 21, 2014, 6:51 PM), http://www.wsj.com/articles/SB10001424052702304198504579570433761599064 (on file with the *Columbia Law Review*) ("There is little in Dodd-Frank to constrain the Fed's options for imposing heightened prudential standards on nonbank SIFIs.").

asset managers systemically risky (incorporating empirical data through OFR) and then tailoring a regulatory approach to these specific factors. But the benefit of this approach would be to customize the solution to the problem—to have a unique standard for systemically important asset managers.

On the other hand, the analysis in section II.B applying the standards enumerated in section 165 to asset managers reveals the difficulties of overextending the traditional BHC prudential framework.[199] While some traditional bank regulatory principles can be applied to the insurance industry, analogies to banking begin to break down when these principles are stretched to asset managers, and may actually create unwanted distortions without targeting risk.[200] Another cost that is difficult to predict under this approach is that the Fed would only have oversight over a small number of the largest asset managers. The collateral impact on the rest of the asset management industry could be quite substantial, with some firms forced to scale down.[201] Although Dodd-Frank's systemic designation mechanism as illustrated through the Insurance SIFI Model may be appropriate in certain cases, it is not the most effective mechanism to address systemic risk in peripheral NBFIs such as asset managers.

B. *"Activity-Based Approach"—More Aggressive SEC Regulation*

Recently, the SEC unveiled a sweeping set of reforms for the asset management industry.[202] This approach follows the framework of an activity-based approach originally endorsed by ICI.[203] While precise regulations have yet to be promulgated, they may force funds to cut down on the use of complex derivatives or may target some of the popular but controversial investments offered to the public, including "alternative mutual funds," which mimic hedge funds but cater to retail investors.[204] Finally, the new rules could also affect "leveraged" exchange-traded funds, which use derivatives to magnify daily performances of indexes.[205]

199. See supra section II.B (analyzing inadequacy of applying BHC framework to asset management industry).

200. A number of comment letters discuss the impact of such distortions in the asset management industry. See, e.g., Scott C. Goebel, Comment Letter on OFR Study on Asset Management Issues (Nov. 1, 2013), http://www.sec.gov/comments/am-1/am1-19.pdf [http://perma.cc/P2E4-L2J6] (arguing systemic designations would likely result in liquidations and smaller funds).

201. See id. (predicting shrinking of asset managers as result of systemic designations). This impact is beyond the scope of this Note and some of these effects are described in the comment letters to the SEC regarding the OFR Report. See SEC Comment Letters, supra note 38 (listing all comment letters).

202. See Ackerman, SEC Plan, supra note 14 (describing SEC announcement of new series of regulations for asset managers).

203. See ICI Viewpoints, Response to FSB, supra note 193 (proposing activity-based approach to regulating systemic risk in asset managers).

204. See Ackerman, SEC Plan, supra note 14 (listing possible new SEC regulations).

205. Id.

This approach has the advantage of targeting systemic risk arising out of the collective activities of the whole industry rather than individual participants.

Although the impacts of this approach will not be apparent for many years, this method poses a number of potential complications. First, the SEC's mandate is to ensure "fair and honest markets"; given this language, it is questionable that the agency has a statutory mandate for systemic risk reduction at all.[206] Second, the SEC's staff is neither trained nor equipped to perform detailed systemic risk analysis.[207] The SEC's already limited resources are spent on enforcement of securities laws and disclosure rules, and such resources do not include crucial macroeconomic data required for adequate monitoring of systemic risk.[208] Finally, this approach lacks a central systemic regulator, since the enhanced prudential regulations are designed and implemented by primary regulators. This approach, however, does have an advantage over the Insurance SIFI Model in that it addresses risk at the product level—an approach that is gaining traction in both the industry and with regulators as being more suitable for asset managers—while maintaining regulatory authority within the primary regulators. Nevertheless, it is still not the best method because of: (1) overlapping jurisdiction among primary regulators and (2) the lack of a strong central systemic regulator with the ability to coordinate cooperation and information sharing between regulatory agencies.

C. *"Systemic Regulator Model"—Alternative Approach*

The collective shortcomings of the previous two approaches support a simple alternative solution that FSOC attempted with money market funds in 2012 that entailed more aggressive recommendations by the Council to primary regulators. In November 2012, FSOC voted unanimously to release for public comment "Proposed Recommendations Regarding Money Market Mutual Fund Reform,"[209] and the SEC adopted

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206. See Robert G. Eccles & Jean Rogers, The SEC and Capital Markets in the 21st Century: Evolving Accounting Infrastructure for Today's World 2 (2014), http://www.brookings.edu/~/media/research/files/papers/2014/09/23%20sustainable%20accounting%20capital%20markets/eccles%20paper_v08.pdf [http://perma.cc/WTX5-69YM] (describing Congress's goal to "assure fair and honest markets" in creation of the SEC).

207. See Michael J. Halloran, Systemic Risks and the Bear Stearns Crisis, *in* The Road Ahead for the Fed 151, 159 (John D. Ciorciari & John B. Taylor eds., 2009) (arguing inability of SEC to adequately monitor and regulate systemic risk).

208. See id. ("Staff expertise is concentrated in securities law and disclosure rules, not macroeconomics or systematic financial risk modeling.").

209. Fin. Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform (2012), http://www.treasury.gov/initiatives/fsoc/Documents/Proposed%20Recommendations%20Regarding%20Money%20Market%20Mutual%20Fund%20Reform%20-%20November%2013,%202012.pdf [http://perma.cc/2EVM-HCUM].

its final rules on Money Market Fund Reform in July 2014.[210] One new rule requires certain funds to maintain a floating net asset value that would cause daily fund share prices to fluctuate according to the market value of their investments.[211] The rules also give funds new tools to prevent runs—including fees and gates—which would allow funds to impose liquidity fees or to suspend redemptions temporarily if weekly liquid assets fall below a certain threshold.[212] This general approach would be an effective compromise position that preserves the existing balance between the Fed and primary regulators while empowering FSOC to take a more active role in overseeing systemic risk in the overall financial system.

This approach incorporates the benefits from the approaches in sections III.A and III.B by shifting the focus of regulation from the institutional level to the product level. Like the activity-based approach, this "Systemic Regulator Approach" is better suited to address systemic risk concerns because of the incompatibility of traditional prudential bank regulatory rules to asset manager risks. The Systemic Regulator Approach also has the added benefit of allowing FSOC to assume the oversight role of systemic regulator without radically distorting the existing allocation of authority between the agencies. Regulations are still promulgated by the SEC, but with active participation and input from FSOC and its information-gathering arm, OFR.

Of course, to call FSOC a "systemic regulator" would be misleading. FSOC is a council composed of members of independent regulatory agencies but does not itself have the power to promulgate prudential regulation.[213] Yet a more active FSOC would provide the key missing link in the current systemic risk regulation regime, which is cooperation and information sharing among the disaggregated regulatory bodies that compose the system. Because OFR has broad authority to gather information from nonpublic sources, the office has the unique ability of filling in information gaps where other agencies lack capacity and access. Indeed, pilot programs have already been launched in which OFR has taken on this gap-filling role.[214] In a 2014 statement, OFR Director Richard Berner stated, "At the OFR, our job is to look across the financial system and shine

210. Press Release, U.S. Sec. & Exch. Comm'n, SEC Adopts Money Market Fund Reform Rules (July 23, 2014), http://www.sec.gov/News/PressRelease/Detail/1370542347679 [http://perma.cc/SRG9-NGK3] (announcing adoption of final rules on money market fund reform).

211. Id.

212. Id.

213. See supra notes 23–24 and accompanying text (describing organization and authority of FSOC).

214. See Richard Berner, OFR Teams with Fed to Fill Key Gap in Financial Data, Office of Fin. Res. (Oct. 8, 2014), http://financialresearch.gov/from-the-director/2014/10/08/ofr-teams-with-fed-to-fill-key-gap-in-financial-data/ [http://perma.cc/K9KM-W2M6] (introducing OFR initiative partnering with Fed and SEC to provide information on repo market).

a light into its dark corners."[215] While these pilot programs are a step in the right direction, FSOC should continue to explore the enormous potential of OFR as an information gathering and sharing tool for systemic risk regulation in NBFIs.

This approach, however, raises a number of complications. The first question is one of distribution of power. It would naturally make sense for regulatory authority to be vested in the SEC, which is the primary regulator of asset managers. But the SEC is not a prudential regulator,[216] and therefore the agency faces some of the same institutional competence challenges as the Fed. Although FSOC's active oversight could allay some of these concerns, implementing prudential regulation would still entail a step outside of the SEC's traditional role. Furthermore, FSOC has no authority to impose its will on any agency, so the adoption of any proposed regulation is solely within the discretion of the SEC.[217] Broad use of the recommendation mechanism could also foster resentment by regulators who are wary of Council members without industry expertise second-guessing agency decisions.[218] Whether or not this approach becomes the norm remains to be seen. But given the existing menu of options for systemic risk regulation, more extensive exercise of FSOC's recommendation authority is a far superior approach to broad use of its systemic designation mechanism for asset managers.

CONCLUSION

Dodd-Frank drastically expanded regulatory authority within the financial sector. The precise allocation of this authority, however, remains unclear since there has yet been no established delineation of systemic risk regulatory authority between the Fed and primary regulators. One key area in which this tension has played out has been in the asset management industry. The debate over systemic designations in asset managers provides a unique case study into the ability and suitability of the Fed to extend its regulatory reach to NBFIs through Dodd-Frank's systemic designation mechanism. Applying the bank-centric prudential framework auth-

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215. Id.

216. See Annette L. Nazareth, Comm'r, U.S. Securities and Exchange Comm'n, Remarks Before the SIFMA Compliance and Legal Conference (Mar. 26, 2007), http://www.sec.gov/news/speech/2007/spch032607aln.htm [http://perma.cc/6N4F-9AF4] (noting view that SEC should move toward "prudential approach to regulation," and describing various applications of "prudential regulation" by SEC).

217. See Donald N. Lamson & Sylvia Favretto, FSOC's Risky Push for Money-Market Fund Reform, Am. Banker (Feb. 20, 2013, 12:00 PM), http://www.americanbanker.com/bankthink/fsocs-risky-push-for-money-market-fund-reform-1056877-1.html [http://perma.cc/BWZ3-M92Y] (explaining FSOC use of "extraordinary tool" of Dodd-Frank recommendation mechanism in context of money market mutual funds).

218. See id. ("The FSOC is engaged in a risky business, as intervention will inevitably carry a price: potential resentment by regulators who are jealous of their independence and possible divisions among regulators who need to cooperate with their peers.").

orized in section 165 to asset managers and their specific risks, this Note finds that many of the traditional bank regulatory tools used by the Fed are either inapplicable to asset managers or would create unwanted market distortions. While the systemic designation mechanism may be here to stay, this Note highlights some of the problems with deploying such a cumbersome legal framework to address a series of intricate problems. Instead of placing prudential regulation of NBFIs in the hands of the Fed, perhaps a better approach would be to limit FSOC's role as a systemic regulator to that of an information-gathering and coordinating device, with regulatory authority remaining with the primary regulators.