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Financial Stability Oversight Council and Asset Management Firms

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The 2010 Dodd–Frank Act greatly expanded the federal government's reach into financial markets. In particular, the creation of the Financial Stability Oversight Council (FSOC) leaves the Federal Reserve poised to regulate nonbank sectors of financial markets more extensively than ever before. The FSOC is supposed to increase U.S. financial stability, but in practice it will lower competition, increase concentration risks, and cost consumers money.

These regulations also increase the likelihood of future taxpayer bailouts for even more nonbanking financial firms. The FSOC's existence has enshrined and expanded—not eliminated—the too-big-to-fail doctrine. The FSOC has already targeted insurance companies, and it now appears ready to single out asset management firms for special regulations under the Federal Reserve.

Asset Management Firms: Money Movers

An asset management firm is essentially any company that manages investments for people. Mutual fund companies, for example, pool investors' money to buy stocks, bonds, and various other investments. Companies such as Fidelity are *dedicated* asset management firms, while insurance companies and banks also operate asset management divisions. The key commonality, though, is that all asset management firms act on their clients' behalf and do not bear their clients' losses.

This arrangement is in stark contrast to the relationship between a bank and its depositors. Typically, a bank owes its customers their deposits on demand at all times even though it uses those funds to make commercial loans. This relationship is one of the main justifications for requiring capital standards and imposing regulations on banks. It does not apply to asset managers.[1]

Nonetheless, certain features of Dodd–Frank are set to impose new regulations and fees on asset management firms thus increasing costs on both small and large investors. In certain cases, these new regulations would extend the too-big-to-fail stigma to yet another sector of the economy.

FSOC Expands Too Big to Fail

One of the main ways that Dodd–Frank worsens the too-big-to-fail problem is through the FSOC.[2] The FSOC is tasked with identifying risks to the financial stability of the United States. Under this broad, ill-defined mandate, the FSOC designates certain financial companies for special regulations under the Federal Reserve, but its authority goes well beyond these designations. Ultimately, the FSOC can require new regulations for any financial company for virtually any stability-related reason.[3]

In addition to singling out firms for special supervision, Section 112 of Dodd–Frank even authorizes the FSOC to identify specific financial *activities* that justify heightened regulations. The FSOC has not yet identified specific activities that pose a systemic threat,

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but it has designated three nonbank financial firms—the American International Group, General Electric Capital Corporation, and Prudential Financial—for heightened regulation under the Fed.[4] The insurance company Met Life is in the final stages of the FSOC's determination process.[5] It now appears that asset management firms are one of the FSOC's next targets.

FSOC's Controversial Report

In September 2013, the FSOC's official research agency, the Office of Financial Research, released a report titled "Asset Management and Financial Stability."[6] The stated goal of this study was to assist the FSOC in deciding whether—and how—to apply heightened regulations and supervision to asset management firms under the Fed. Strangely, the report fails to identify specific risks that these companies actually pose to the U.S. economy. The report also neglects to describe how heightened regulations under Section 113 of Dodd–Frank might reduce systemic risk caused by the asset management industry.

The report was so vague and controversial that the Securities and Exchange Commission (SEC)—whose chairman sits on the FSOC—publicly criticized it and separately (from the FSOC) requested public comments *on the study*.[7] Further, a group of five U.S. Senators—three of whom sit on the Banking Committee—pointedly criticized the report, stating that it "mischaracterizes the asset management industry and the risk asset managers pose, makes speculative assertions with little or no empirical evidence, and in some places, predicates claims on misused or faulty information."[8]

In the House, more than 40 Representatives signed a letter urging the FSOC to provide more specifics before designating any asset managers for heightened regulations.[9] Regardless of its stated purpose, the report does not justify imposing new regulations on the asset management industry. Moreover, the Federal Reserve should not be in charge of regulating the asset management industry.

1. The Securities and Exchange Commission's (SEC) net capital rule (Rule 15c3-1) does apply to all securities brokers and dealers registered with the SEC under Section 15(b) of the Securities Exchange Act of 1934. This rule requires all registered broker-dealers to adhere to minimum liquidity standards. See Financial Industry Regulatory Authority, "Net Capital Requirements for Brokers or Dealers," Rule 15c3-1, http://www.finra.org/web/groups/industry/@ip/@reg/@rules/documents/interpretationsfor/p037763.pdf (accessed May 2, 2014).
2. See Norbert J. Michel, "The Financial Stability Oversight Council: Helping to Enshrine 'Too Big to Fail,'" Heritage Foundation *Backgrounder* No. 2900, April 1, 2014, http://www.heritage.org/research/reports/2014/04/the-financial-stability-oversight-council-helping-to-enshrine-too-big-to-fail.
3. These regulations would mainly be imposed through whichever regulator has primary jurisdiction. Large companies designated for special Fed-supervised regulations are commonly referred to as systemically important financial institutions (SIFIs). Presumably, companies that fall under the separate regulations would not be referred to as SIFIs, but the Dodd–Frank Act does not require any formal term for either group of companies. See ibid.
4. The council's designation for Fed supervision can be challenged in federal court, but Section 113(h) of Dodd–Frank limits this legal challenge to "whether the final determination made under this section was arbitrary and capricious." In practice, companies will have virtually no way to challenge (or remove) the special designation. See ibid.
5. The insurance industry is currently arguing against bank-style capital requirements being imposed on insurance firms. Some Members of Congress (and the Fed) currently disagree over whether Dodd–Frank requires these capital rules to be applied to insurance companies. See Elizabeth Festa, "Bernanke Comments on Collins Amendment: Fed Is Scratching Its Brow over How to Remedy Sec. 171 of Dodd–Frank So That Basel III Capital Rules Don't Hobble Insurers with Thrifts, SIFIs," LifeHealthPro, July 17, 2013, http://www.lifehealthpro.com/2013/07/17/bernanke-comments-on-collins-amendment (accessed April 28, 2014), and Diane Katz, "Clumsy Regulation Puts Insurance at Risk," Heritage Foundation *Issue Brief* No. 4174, March 19, 2014, http://www.heritage.org/research/reports/2014/03/clumsy-regulation-puts-insurance-at-risk.
6. FSOC, Office of Financial Research, "Asset Management and Financial Responsibility," September 2013, http://www.treasury.gov/initiatives/ofr/research/Pages/AssetManagementFinancialStability.aspx (accessed April 28, 2014.)
7. See Sarah Lynch, "Memos Show SEC-Treasury Dispute over 2013 Asset Management Study," Reuters, April 7, 2014, http://www.reuters.com/article/2014/04/07/sec-documents-assetmanagers-idUSL2N0MZ0UL20140407 (accessed April 28, 2014).
8. See Emily Stephenson and Sarah N. Lynch, "U.S. Senators Slam Study on Systemic Risks Posed by Asset Managers," Reuters, January 24, 2014, http://www.reuters.com/article/2014/01/24/us-financial-regulation-asset-idUSBREA0N1LG20140124 (accessed April 28, 2014). See Investor Company Institute, letter to Jacob Lew, Chairman of the FSOC, January 23, 2014, http://www.ici.org/pdf/14_ofr_lew.pdf (accessed April 29, 2014).
9. Press release, "Ross, Delaney Caution Lew Against Hastily Adopting New Designations for Asset Managers," Office of Representative Dennis Ross (R–FL), April 10, 2014, http://dennisross.house.gov/news/documentsingle.aspx?DocumentID=376320 (accessed April 28, 2014).

Fed's Authority Should Be Limited

Traditional lending by banks has accounted for an increasingly smaller share of commercial financing since the 1970s, thus reducing the Fed's customary role. Rather than allowing nonbank financing to evolve unencumbered, Dodd–Frank has extended the Fed's reach into this sector of financial markets. This expansion is the wrong approach because it increases the likelihood of future bailouts and makes it more likely that monetary policy will become entangled with fiscal policies.

What Congress Can Do

Congress should fix the most glaring weaknesses in the process the FSOC uses to designate firms for heightened supervision under the Fed. In particular, Congress should force the FSOC to be more transparent and should lift Dodd–Frank's restrictions on legal challenges to the FSOC's designations. However, Congress should be wary of improvements that might lead to the impression that Title I of Dodd–Frank should remain in the U.S. code.

The mere existence of the FSOC is wholly incompatible with the functioning of a dynamic private capital market. Going forward, Congress's best course of action remains repealing the Dodd–Frank Act. Until a full repeal is politically possible, Congress should focus on repealing Title I and Title II of Dodd–Frank or, at the very least, eliminating the FSOC. Any other reforms to Titles I and II should be viewed as temporary fixes.

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