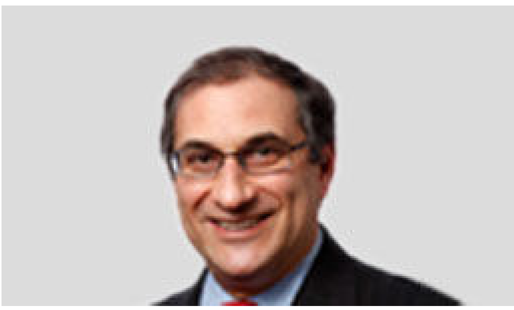
IGNITES

A Financial Times Service

Opinion

FSOC Oversight Could Be Catastrophic for Funds

May 31, 2012



Jay Baris is a partner and the chair of the Investment Management practice at Morrison & Foerster. Oliver Ireland, a banking and financial services partner in the firm's Washington, D.C. office, co-authored this article.

The Dodd-Frank Act provides for enhanced prudential standards not just for banks and bank holding companies, but also for other large financial institutions that the government perceives pose a grave threat to U.S. financial stability. And your mutual fund may be one of them, even if it seems like a stretch for your fund to be classified as a systemic risk.

The law created the Financial Stability Oversight Council (FSOC) to sniff out these grave threats to America's financial stability. FSOC is authorized to bestow status as a systemically important financial institution, or SIFI. These enhanced SIFI requirements include risk-based capital requirements and leverage limits; liquidity requirements; single-counterparty credit limits; risk management; stress tests; debt-to-equity ceiling; and early remediation in the event of a bankruptcy.

While these requirements may make sense for retail banks, investment banks, their holding companies and other large operating financial institutions, it is more complicated when applied to the fund industry. Although the focus has recently been on money market funds, the SIFI issue affects all investment companies, even some unregistered funds.

Some of the concepts that apply to SIFIs that are operating companies do not translate well to mutual funds. For example, FSOC may limit short-term debt of SIFIs and may require a higher percentage of capital and surplus. Mutual funds don't issue short-term debt, or any debt for that matter. Rather, 100% of a mutual fund is equity, owned by its shareholders.

Moreover, mutual funds are already subject to enhanced prudential regulation by the Securities and Exchange Commission. They must comply with significant operating, structural, governance, disclosure and reporting requirements, not to mention limits on leverage and borrowing.

Mutual funds are subject to oversight by a board of directors consisting, in most cases, of at least a majority of independent directors. They must establish compliance programs, anti–money laundering programs and know-your-customer programs, and hire a chief compliance officer. SEC rules require money market funds to conduct stress testing. And if something goes wrong, the SEC has broad discretion to intervene through injunction, enforcement, cease-and-desist and other emergency powers.

In other words, the extra levels of regulation provided by the Dodd-Frank Act, which are designed to protect against operating companies' taking excessive risks, are sweeping in mutual funds, and amount to overkill.

The results for adding more layers of regulation to mutual funds could be catastrophic. Adding more layers of prudential standards and reporting requirements likely will add significant costs, to be borne by fund shareholders in the form of increased expense ratios. SIFI funds would be subject to examination by the Fed, adding additional costs.

Who would want to invest in a mutual fund that has been designated as a “grave threat” to the financial stability of the U.S.?

That is, SIFI designation of a mutual fund may create more harm to the U.S. financial system than good. Investors in funds with SIFI designation may run for the exits, instead choosing to invest with other funds that do not pose a “grave threat.” SIFI funds faced with massive redemptions may be forced to liquidate positions quickly, thereby accelerating their demise and creating additional pressures on the financial markets as portfolio managers dump portfolio securities.

Also at play is the law of unintended consequences. This law provides that if you take a square peg and try to force it into a round hole, then you are likely to create significant damage that you did not anticipate or plan for, and may even destroy the very thing you are trying to protect. Regulating mutual funds like banks does not make a whole lot of sense, especially since the existing laws and regulations that apply to mutual funds, as they have evolved over the past 72 years, are working adequately.