Financial Stability Board Issues Policy Recommendations to Address “Structural Vulnerabilities” in Asset Management Industry

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On June 22, 2016, the Financial Stability Board (FSB) issued proposed policy recommendations to “address risks to global financial stability associated with the relevant structural vulnerabilities from asset management activities,” with a request for public comment by September 21, 2016. The recommendations are the product of an initiative launched by the FSB in March 2015.

The proposed policy recommendations seek to address financial stability risks associated with: (1) the mismatch between liquidity of fund investments and redemption terms and conditions for fund units; (2) leverage within investment funds; (3) operational risk and challenges in transferring investment mandates in stressed conditions; and (4) securities lending activities of asset managers and funds. Following receipt and review of public comments, the FSB intends to finalize the recommendations by the end of 2016, “some of which will then be operationalised by [the International Organizational of Securities Commissions (IOSCO)]14 and the relevant FSB working groups.”

Notably, several of the policy recommendations appear to have been addressed, at least in part, by recent SEC rule proposals, including liquidity risk management.

The FSB’s proposed policy recommendations are categorized by the four areas noted above and include the following:

(1) Recommendations to address liquidity mismatch between fund investment assets and redemption terms and conditions for fund units

Lack of information and transparency:

- Authorities should: (a) collect information on the liquidity profile of open-ended funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective; (b) review existing reporting requirements; and (c) enhance reporting requirements as appropriate to ensure that they are adequate, sufficiently granular and frequent.

- Authorities should: (a) review existing investor disclosure requirements; and (b) determine the degree to which additional disclosures should be provided regarding fund liquidity profiles.

Gaps in liquidity risk management tools both at the design phase and on an ongoing basis:

- In order to reduce the likelihood of “material liquidity mismatches arising from an open-ended fund’s structure,” authorities should have requirements or guidance stating that funds’ assets and investment strategies should be consistent with the terms and conditions governing fund unit (share) redemptions both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected portfolio liquidity and investor behavior during normal and stressed market conditions.

- When appropriate, authorities should widen the availability of liquidity risk management tools (such as swing pricing, redemptions fees and other anti-dilution methods) to open-ended funds, and reduce

The FSB was established in April 2009 as the successor to the Financial Stability Forum (FSF) by the G20 and is an international body that monitors and makes recommendations about the global financial system. 14 IOSCO is an international body of securities regulators founded in April 1983 and includes the SEC among its 211 members. SEC Chair Mary Jo White is a member of IOSCO’s Board barriers to the use of those tools to: (a) increase the likelihood that redemptions are met even under stressed market conditions; and (b) reduce first-mover advantage, where it may exist.

Adequacy of liquidity risk management tools to deal with exceptional circumstances:

- Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for open-ended funds’ use of “extraordinary liquidity risk management tools” (e.g., suspensions of redemptions, gates), and the processes should be made transparent to investors and the relevant authorities.

(2) Recommendations to address leverage within funds

- IOSCO should develop simple and consistent measure(s) of leverage in funds with due consideration of appropriate netting and hedging assumptions, which would “enhance authorities’ understanding of risks that leverage in funds may create, facilitate more meaningful monitoring of leverage, and help enable direct comparisons across funds and at a global level.”

(3) Recommendations to address operational risk and challenges in transferring investment mandates or client accounts

- Authorities should have requirements or guidance for asset managers that are “large, complex, and/or provide critical services” to have comprehensive and robust risk management frameworks and practices, particularly with respect to business continuity and transition plans, “to enable orderly transfer of their clients’ accounts and investment mandates in stressed conditions.”

(4) Recommendation to address securities lending activities of asset managers and funds

- Authorities should monitor indemnifications provided by securities lending agents and asset managers to clients in relation to their securities lending activities, i.e., authorities should verify and confirm asset managers adequately cover potential credit losses from the indemnification provided to their clients.

The FSB's policy recommendations are available at: http://www.fsb.org/2016/06/proposed-policy-recommendations-toaddress-structural-vulnerabilities-from-asset-management-activities/.

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