

ICI VIEWPOINTS

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Errors of the Times: Getting the FSOC Debate All Wrong

By Mike McNamee

New York Times columnist Floyd Norris makes a number of fundamental errors in his [Friday column](#) about the House Financial Services Committee hearing and the broader debate about the Financial Stability Oversight Council (FSOC) and its review of asset management.

First, no one in the fund industry or on Capitol Hill has told FSOC that it should not study the asset management industry. FSOC has an obligation to look at all parts of the financial system for threats to financial stability.

What's troubling—and frightening—is the quality of the study that we've seen so far, and the vast consequences if the FSOC proceeds on the basis of the limited knowledge it's displayed. Discussing the [report on asset management](#) by FSOC's research arm, the Office of Financial Research (OFR), at the hearing even former Treasury official Michael Barr said: "The report was not something I would hang my hat on."

He's being polite. The consensus of dozens of comments on the OFR study was that its work was, as the pro-regulation advocacy group [Better Markets](#) said, "inexplicably and indefensibly poor quality." FSOC's May 19 conference on asset management, which was able only to skim the surface of the asset management business, highlighted the need for regulators not to rush to judgment, but to spend the time and resources to understand this important and diverse area of our financial system.

Distinctions Matter

Norris's second error is in charging that FSOC's critics have "studiously ignored" hedge funds and presented "plain-vanilla mutual fund companies" as the face of asset management. It was the OFR study that lumped together mutual funds, hedge funds, separately managed accounts, and other forms of asset management—ignoring sharp differences in regulation, business models, investor bases, and practices.

The FSOC could have corrected that error at its conference; it didn't. Instead, FSOC organized the meeting to treat all forms of asset management as identical, without making important distinctions. The Investment Company Institute, the trade association for mutual funds, has never limited its analysis on this issue to "plain-vanilla mutual funds."

(By the way, that phrase originated with former House Financial Services Chairman Barney Frank (D-MA), who said that his signature law—the Dodd-Frank Act—was never intended to subject asset managers to FSOC's designation.)

Those distinctions matter and reflect a nuanced understanding that neither the OFR study nor Norris have displayed. His third error lies in invoking Long Term Capital Management (LTCM)—a hedge fund that exceeded even its peers in leverage and risky trading—as typical of asset management and its risks.

As the [President's Working Group on Financial Markets noted](#), "Assessed against the trading practices of hedge funds and other trading institutions...the LTCM Fund stood out with respect to its opaqueness and low degree of external monitoring, and its high degree of leverage." The mutual fund industry—highly regulated, transparent, using little to no leverage—bears no relationship to LTCM.

The FSOC's global sister agency, the Financial Stability Board, has set forward criteria that focus on 14 large U.S. regulated funds as candidates for further regulation. The [FSB 14](#) include six index funds and the CREF teacher's retirement fund. Collectively, they

carry 4 cents of debt for every \$1 of shareholder equity—compared to, say, banks, where \$10 of debt for every \$1 of equity is a common leverage ratio. It's clear from the FSB 14 list that regulators are not solely targeting the LTCMs of the world.

Overlooking the Facts

Fourth, the Securities and Exchange Commission (SEC) *has* acted to reform money market funds. Its [2010 rule changes](#) were the first concrete post-crisis reforms of any part of the financial system. They were tested in the U.S. debt-ceiling crisis and the European debt crisis of 2011, which money market funds passed with flying colors. Norris knows this—in fact, ICI's Chief Economist Brian Reid [pointed these facts out to him](#) during a segment on CNBC's *Nightly Business Report*. And, as [SEC Chair Mary Jo White told ICI](#) at its annual conference just this week, additional money market fund reforms are forthcoming from the agency “in the very near term.”

Finally, Norris overlooks the basic structure of our government: Congress created the FSOC and has a responsibility to examine and question the job that the FSOC is doing. Even Norris's star witness, former Treasury official Barr, told the House committee that “I am 100 percent in favor of the oversight you're exercising on the FSOC and on the other financial regulatory agencies.”

As ICI President and CEO Paul Schott Stevens said [earlier this week](#): “This is not a debate about ‘regulation’ versus ‘no regulation’... [t]his is instead a debate over *where* and *how* risks to the financial system at large may occur—and *what* the most effective tools are to address such risks, out of the many tools that regulators have at hand.”

Those risks do not lie in the regulated fund industry—and when it reaches for designation of large asset managers, the FSOC is going for the wrong tool.

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