Remarks of The Honorable Paul S. Atkins
2015 Investment Adviser Association Compliance Conference
Arlington, Virginia
5 March 2015

Thank you very much, Chuck [Senatore], for your kind introduction, and thanks to the Investment Adviser Association for inviting me to speak at this conference today. Not to date a young guy like Chuck, but he and I go all the way back to when I worked for Arthur Levitt and Chuck was appointed the Director of the SEC's Miami regional office. After that, he eventually went to Fidelity, trading sun and palm trees for things like the 100-inch (and counting) snowfall that Boston has had this season.

Speaking of snow, congratulations on your having braved the elements today. It is a pleasure to see you all here.

And . . . speaking of chilling subjects and cold, inhospitable climes, let us talk about the regulatory climate in Washington. This afternoon I would like to discuss the regulators' systemic risk agenda, especially the activities of the Federal Reserve and other regulators using new tools that they got from the Dodd-Frank Act. They are now focusing on your business as investment advisors, your clients, and your business model. This is regulation on top of what the SEC does. It is also driving the SEC to tighten supervision of asset managers.

As you all know, the Dodd-Frank Act is now almost five years old. It is 2,319 pages long and contains demands for more than 500 new rules and studies, which have produced so far tens of thousands of pages of regulations. Despite a once-in-a-lifetime opportunity to streamline our crazy quilt of financial services regulators, the Dodd-Frank authors blew it. They created, depending on how you count, at least 15 new offices and agencies, eliminating only one, the hapless Office of Thrift Supervision, which had no one left to regulate, anyway.

Chris Dodd famously said about his own bill: "No one will know until this is actually in place how it works." There is a good reason that was so—the bill was never subject to what legislators call "regular order." Instead, it was crafted in backrooms by congressional staffers meeting with favored interest groups, like trial lawyers, consumer activists, and labor unions. Virtually no substantive hearings were held, even on its major provisions, such as the Volcker Rule, not to mention supposedly minor provisions, which have turned out to be major headaches because of poor drafting. In the conference committee working on the final version to mesh the House and Senate bills, whole sections were written in long-hand and handed to keepers of the master draft. The members of the conference committee had no idea what they were voting on, just as the rest of Congress did not when the final votes were called. There are incomplete provisions and wrong cross-references. It was a travesty of democratic legislative process.

About the only thing well-planned about Dodd-Frank was its focus-group-tested name: The Wall Street Reform and Consumer Protection Act of 2010. Those terms poll really well, but they obscure a lot of rubbish.

This afternoon, I would like to focus on Title 1 of Dodd-Frank. It is entitled "Financial Stability," and this is the leitmotif of Dodd-Frank. I like to call it "Stability über alles." To help achieve the goal of financial stability, Dodd-Frank established the Financial Stability Oversight Council, which is a non-transparent, not-well-known group comprised of the heads of nine financial services regulatory agencies plus one insurance regulatory expert appointed specifically for this task by the president, as well as five non-voting members.

This gaggle of regulators has substantial power to drive the regulatory agenda at its member agencies like the SEC. It has little accountability to Congress or to the American people. It has broad power to gather information and then is supposed to think deep thoughts, peer into its crystal ball, identify bubbles, and then prick them before they grow. Well, just how well has that worked in the past?

The conceit of the authors of Dodd-Frank, which is carried on to this day, is that if you get enough smart people in a room and enough data, they can bring stability to the marketplace. But, just as human beings are hardly stable, those of us who are market participants know that markets are not always stable. Why? Because human beings ultimately make up markets, even if machines are also involved. At its base, a market needs a willing buyer and a willing seller. But, we all know that people from time to time are motivated by all sorts of virtues, including enlightened self-interest as Adam Smith noted, as well as vices, such as anger, greed, envy, fear, and pride – and, at times, just plain passion. To suggest that government can control human action is naïve and egotistical.

In his last book, *The Fatal Conceit: The Errors of Socialism*, Friedrich Hayek, the Austrian-born economist, labels as the "fatal conceit" the idea that "man is able to shape the world around him according to his wishes." Hayek argues: "To act on the belief that we possess the knowledge and the power which enable us to shape the processes of society entirely to our liking, knowledge which in fact we do not possess, is likely to make us do much harm."

But, the Financial Stability Oversight Council, or FSOC, is embarking on just this mission. It has the authority to designate entities within the financial services industry as "systemically important financial institutions," abbreviated S-I-F-I.[1] Former Congressman Barney Frank once quipped that "SIFFY," as some pronounce it, sounds like a disease. He is right—but there is more. First, I would argue with the pronunciation.

How does one pronounce H-I-F-I?
And, how does one pronounce W-I-F-I?
So, how should one pronounce S-I-F-I?
By no coincidence, SIFI has a homonym: "Sci-fi"

SIFI designation is the statutory gateway to a new level—and for asset managers, a whole new world—of regulation by the Federal Reserve.[2] Those are the reasons why I insist that my pronunciation of "SIFI" is necessary and correct. FSOC's SIFIs take us way out there to a world of unreality that exists only in the fertile imaginations of an unaccountable few.

---

[1] *See* 12 U.S.C. § 5323 (2010) (Dodd-Frank Act § 113).
[2] *See* 12 U.S.C. § 5365 (2010) (Dodd-Frank Act § 165).

But that is not all. The FSOC may also recommend regulatory action to other federal agencies for "activities and practices" that the FSOC deems to be potentially risky to financial stability.[3] "Activities and practices" includes each of you in this room with respect to asset management. Should the federal agency decide not to follow the FSOC's recommendation, it must submit its reasons in writing to the FSOC. In one example, starting about two years ago, the FSOC, the Fed, Treasury, and foreign regulatory groups have focused on asset management, beginning with money market mutual funds and now implicating activities beyond that. Even though the SEC possesses the subject-matter expertise to address asset management, the FSOC has stepped in to try to force the SEC's hand.

What is the consequence of this determination that entities, activities, or practices are systemically risky? The FSOC is authorized to subject the designated firms to enhanced prudential supervision by the Federal Reserve and to recommend additional regulation for systemically important activities and practices, in the interest of promoting the safety and soundness of the U.S. financial system.

Once under the Fed's regulatory umbrella, systemically important firms can expect to be subjected to bank-like capital requirements. What if the FSOC designates asset management as a systemically important activity? These scenarios indicate that the science fiction aspect of SIFI is really appropriate. Where in the asset management industry would one impose capital requirements? To a fund or separate account? To the advisor? If the activity is the issue, rather than an institution, then size of the advisor is no matter. There is no limiting factor. Moreover, in what form would this capital requirement or other regulation take shape? Withdrawal fees? Gates? "Minimum value at risk"?

Therein lies the problem: One cannot simply assume that an enhanced supervisory structure designed to stabilize very large banks is equally well suited to other areas of the financial services industry with radically different structures and risk profiles. Indeed, given the considerable differences in how these other businesses are structured and operate, one should expect that applying the same regulatory standards would yield at least some unexpected and perhaps undesirable outcomes. I want to stress that that is just as true if you are a proponent of the various initiatives taken in the Dodd-Frank Act as if—like me—you are not. Let me explain.

To date, the FSOC has designated four non-bank financial companies and eight financial market utilities as SIFIs, subjecting them to the Fed's prudential supervision. Implicit in these designations, as well as in the statutory authority from which they stem, is a theory that large financial companies share characteristics that would make the Fed's prudential supervision and capital adequacy requirements a helpful and effective regulatory approach. The trouble with that theory is that insurance companies and banks are, in fact, fundamentally different from each other. Then, of course, asset managers are even more different.

Start with this: banks take deposits; the resulting obligations are bank indebtedness. Investment managers are agents—whether they manage money in separate accounts or on behalf of public or private funds, the ultimate ownership of the assets and the risk of gains and losses

[3] *See* 15 U.S.C. § 5330 (2010) (Dodd-Frank Act § 120).

reside with the investor. Bank depositors look to the government for security of their investment; clients of asset managers and shareholders of funds have no such guarantee. [They look to plaintiffs' lawyers—just kidding.] Investment managers have a fiduciary obligation to their clients and funds—with the corollary that their judgment as fiduciaries could be at odds with what an outside prudential regulator might require. Banks, unburdened by fiduciary obligations to their depositors (they act as principals) face no such potential conflict of interest.

There is a large difference between the bank regulatory model, led by the Federal Reserve and which focuses on safety and soundness of the banking system, and the SEC's statutorily mandated focus on the protection of investors, capital formation, and competition—which is one important reason why asset managers' regulation should remain with the SEC.

Now, I would not be the first to acknowledge from long and sometimes painful experience that not everything the SEC does is wise. Nor am I here to defend the SEC's jurisdiction. Even so, there can be no question about whether the SEC is expert at regulating capital markets—risk markets. It is expert, and it has no close competition—certainly not the Fed. That is simply not what the Fed does—much less the FSOC.

The Fed, as our central bank and the nation's lender of last resort, is concerned with overall maintenance of a stable banking system. It is a prudential regulator concerned with the safety and soundness of the banking system and, by extension, our larger financial system. Accordingly, the Fed's core concern is with capital adequacy—whether the banking system, in which leverage is inherent, is adequately capitalized and sufficiently liquid to meet its obligations as they come due.

The SEC, by contrast, has a professed goal of using both its rulemaking and enforcement authority to keep those markets free and fair. The Fed, then, is in the capital assurance business, while the SEC is overwhelmingly focused on the actions and activities of participants in U.S. capital markets. For the SEC, the liquidity of risk-taking entities is generally the issue, rather than their capitalization.

The point is simple: Not only is there a big difference between the Fed's objectives and expertise and that of the SEC, but the implications stemming from that difference are enormous when it comes to regulating non-bank financial entities, particularly investment funds.

When you or I invest in an investment fund, we buy shares in that fund; as a result, we participate in the fund's gains and losses. We can redeem our shares for whatever they happen to be worth when we elect to redeem them. But we are not assured of making a profit—or even of getting our money back. We made an investment and to that extent have put our invested funds at risk. We may—and certainly hope to—do far better than we would by putting that money into, say, a savings account. Our investment risk, in other words, correlates to our desired returns.

There is nothing in the Fed's 100-year history that even begins to suggest that applying prudential standards to capital market participants would be a benefit—or that the Fed would in any sense be an effective capital markets regulator. It is just not what the Fed does.

And what could the individual investor saving for retirement reap from this situation? First, higher costs and lower returns. Were the Fed to impose capital requirements on SIFI-designated funds or advisors, or were the FSOC to recommend such action for investment activities that have been designated systemically risky, investors—ordinary individual investors who are saving for retirement through their 401(k) plan or for a down payment—would have to pony up. The same would be true as to any fees imposed, just as it would if funds were to seek to raise capital some other way. Likewise, if capital requirements were imposed on investment advisors, investors would ultimately pay in the form of higher fees or decreased choice. The higher fees could cause investors to withdraw their money from funds managed by SIFI-designated advisors, which could lead to the advisors dropping below the threshold that caused them to be designated in the first place. Talk about circularity.

Most worrisome to me is that the Federal Reserve could constrain investors' ability to dispose of assets on demand. For example, the Fed could impose a delay on the effectiveness of an investor's redemption decision or elect to require fund managers to remain in positions they would otherwise have elected to exit. It could advise asset managers that they should not dispose of a particular kind of security, despite the judgment of the advisor that it is its fiduciary duty to sell, or despite the wishes of the client to sell.

The basic message is: Take one for the team. When I mention this scenario at cocktail parties (with investment professionals, of course, not necessarily with my neighbors who want to talk sports), some think that this is too far-fetched. All I have to do is remind them of the TARP program—sound banks were told to take TARP bailouts so as not to make weak banks look bad, all while the Treasury was claiming that all banks were okay. Predictably, the result tainted the entire financial services industry.

Moreover, regardless of fund or investor interests, SIFI-fund managers could be forced to finance banks or other counterparties, to remain exposed to particular markets, to avoid exposure to specified issuers, and to hold cash or cash equivalents. What would this do to risk management or even to liquidity in the market? How would market participants price in this uncertainty regarding the potential disposition of securities? If anything, this uncertainty would make markets more unstable and much more unfair for the average investor in troublesome times. All of this would be novel and none of it would provide any advantage to the fund's investors. To the Fed's end game, however, it might at least stabilize the banking system.

One especially invidious provision of Dodd-Frank is Section 210,[4] under which investors could find their SIFI-designated funds or advisors subject to demands to support failing banks—an entirely new and unnecessary phenomenon—think of it as an investor-funded "TARPs-are-us." So sure, one could argue that U.S. taxpayers are off the hook for bailouts, but it would be the unfortunate investors in SIFI funds—taxpayers all—whose returns would be subjected to the risk of supporting too-big-to-fail financial institutions.

[4] *See* 12 U.S.C. § 5390 (2010) (Dodd-Frank Act § 210).

That would be more tolerable were it not for the fact that investment funds are wound up and leave the business regularly, with no systemic consequences and no FDIC resolution process. Because of the nature of the investor's agreement with his or her fund, there is simply no need for a "bail out," nor are such funds "interconnected" with other financial institutions in any way that would impose an unsustainable burden on them. Once again, we see new costs without corresponding benefits.

Much the same objections could be made to FSOC designation of large insurance companies as SIFIs. In case you missed them, I note with great concern the pointed comments that FSOC's two insurance experts made in dissenting from the FSOC's latest designation of MetLife as a SIFI.

The voting insurance expert, Roy Woodall, slammed the FSOC's basis for designating MetLife a SIFI, stating that the FSOC "relies on implausible, contrived scenarios as well as failures to appreciate fundamental aspects of insurance and annuity products," and, ultimately, "concludes that the origin of the company's systemic risk would stem from a sudden and unforeseen insolvency of unprecedented scale, of unexplained causation, and without effective regulatory responses or safeguards."[5]

The non-voting insurance expert, Adam Hamm, similarly criticized the FSOC's basis for designation. He said: "Identifying outer boundaries of exposures and claiming they could impact a nebulously defined market is not robust analysis; it simply means the [FSOC] has identified a very large company."[6] All in all, the two insurance experts call out the speculation and feeble analysis conducted by the FSOC in its designation process. It certainly seems as though the FSOC had a predetermined outcome in mind, before the matter was brought to a vote. As Mr. Hamm stated in his dissent: "Saying it does not make it so."

Indeed, MetLife has sued the FSOC to contest its designation—the first SIFI to do so. If FSOC's cavalier treatment of the insurance industry is any precedent, we should all be extremely concerned that equally misguided and uninformed treatment of the asset management industry is soon to follow.

The fix seems already to be in. In September 2013, the FSOC's research arm, the newly created Office of Financial Research (one of the 15 new offices created by Dodd-Frank) released a self-serving report that reflected, first, a flawed analysis of asset managers, and second, fundamental misconceptions about how securities markets function.[7] The report lacked meaningful analysis, and its conclusions rested on inaccurate data and unsupported assumptions. Remarkably, the report expressed concern about asset managers' "reaching for yield." What else does the Fed expect with its irresponsible beggar-thy-neighbor, zero percent interest rate policy, which destroys savers and retirees but helps the Fed's regulated entities? Investors of all kinds, including asset managers who invest their customers' money, necessarily seek to "buy low and

---

[5] Roy Woodall, Views of the Council's Independent Member Having Insurance Expertise (Dec. 18, 2014), http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.
[6] Adam Hamm, View of Adam Hamm, the State Insurance Commissioner Representative (Dec. 18, 2014), http://www.treasury.gov/initiatives/fsoc/designations/Documents/Dissenting%20and%20Minority%20Views.pdf.
[7] *See* Office of Financial Research, *Asset Management and Financial Stability* (2013).

sell high." That is how markets work. The federal government cannot—and should not—attempt to influence investors' inclinations whether, when, and why to buy or sell securities.

Unsurprisingly, the OFR's report did not articulate solutions tailored to the concerns it expressed. Instead, it seemed intended to lead to the imposition of capital controls and liquidity restraints.

To its credit, the SEC requested public comments on the OFR's report. Putting out for comment another agency's report certainly was unusual, but it was necessary because the OFR did not seek public comment, and the OFR did not accept many SEC staff comments on the report, either.

After the uproar following the release of the OFR's report, the FSOC on its own released an information collection notice on the asset management industry.[8] It asked whether asset management products and activities might pose a threat to U.S. financial stability, highlighting the following areas of interest: liquidity, redemptions, leverage, operational functions, and resolution. Presumably, the FSOC may be looking to assert its Section 120 power to make recommendations for further regulation to the SEC as asset managers' primary regulator.

In any event, in an effort perhaps to respond to some of the FSOC's concerns, SEC Chairman Mary Jo White recently articulated a plan to tighten supervision of asset managers, which is meant to be "a complement" to the FSOC's review.[9]

Chairman White called for a three-pronged approach to regulatory reform. First, she said, the SEC must modernize and enhance data reporting for both funds and advisors because reporting obligations have not kept pace with emerging products and strategies. In particular, she called for enhanced reporting and disclosure related to derivatives, liquidity and valuation of holdings, securities lending, and separately managed accounts.

It is true that the newly imposed datasets on money market mutual funds and private funds may have the potential to revolutionize trend-tracking in the industry. But, it is not at all clear that the SEC has had any actual success so far in gleaning information or divining trends from the data collected. It also is not clear that the SEC can digest and use the large amounts of data that it receives. As it is, government agencies do a poor job of utilizing information that is available to them. For example, the FSOC's recent information collection on asset managers seems to replicate requests for several data sets that should be available to it from its own OFR (as well as from the SEC) through Form PF—so why is there such overlap?

As it reviews its data gathering efforts, I hope that the SEC will first ask whether some of its current data collection obligations are superfluous, inefficient, or out-dated—are there any regulatory barnacles that need to be removed? If the SEC then decides that it should add to its already onerous reporting requirements, it should try to work with the industry to ensure that it

---

[8] *See* 80 Fed. Reg. 7595 (2015).

[9] *See* SEC Chairman Mary Jo White, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014), http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VQeTjEKek3g.

does not create more work than necessary to fulfill its requirements. Understandably, many have raised concerns regarding the timing of disclosures and whether they are public; the SEC staff is aware of this issue.

The second prong of Chairman White's approach is to enhance controls on risks related to portfolio composition—and in particular, liquidity management and the use of derivatives in mutual funds and ETFs. SEC guidance on liquidity risks has not changed significantly in decades. The SEC staff reportedly is considering broad risk management programs to address risks related to funds' liquidity and use of derivatives, as well as specific requirements for updated liquidity standards, disclosure of liquidity risks, or measures to limit the leverage created by a fund's use of derivatives. This effort seems to be responsive to the general concerns raised by FSOC regarding leverage.

The third piece of SEC efforts focuses on improved transition planning and stress testing. Business continuity and disaster recovery plans already exist, of course, but the SEC is focused on making sure investment advisors are thinking about more strategic transition planning to prepare for disruptions in business, such as a key advisor's exit. Think Bill Gross at PIMCO. This piece overlaps with the FSOC's efforts to require banks to create living wills—although I have sincere doubts that those living wills will ever actually be effective resolution tools, simply because organizations are so dynamic.

The Dodd-Frank Act requires the SEC to promulgate rules requiring funds and advisors with at least $10 billion in assets to conduct annual stress testing.[10] The SEC is to put these stress test rules in place in co-ordination with the Fed and consistent with the Fed's rules. The stress tests must be submitted to the Fed as well. The SEC has some discretion as to stress testing scenarios and is considering how to tailor these requirements for asset managers. Unfortunately, the SEC seems to take the position that it cannot deviate from the Dodd-Frank statutory language.

I would urge the SEC to think more broadly. How about taking a page from the Administration's arguments yesterday before the Supreme Court regarding the Affordable Care Act? If statutory words do not mean what they seem to mean in that poorly drafted statute, then the same logic should apply to Dodd-Frank. For example, Dodd-Frank buries the requirement for mandatory stress testing of all large financial companies in a section that is dedicated to enhanced prudential standards for SIFIs. Asset managers are not–yet, at least–SIFIs. In addition, it is difficult to conceive of how one would stress test funds, much less advisors. Moreover, what would be the consequences for a fund that has a poor performance on the test? The SEC cannot very well prevent the fund from paying fund shareholders their dividends or redeem their shares as the Federal Reserve can do with a bank's shareholders.

In a related oversight push, the SEC frequently has had to respond to inquiries about its process for investment advisor examinations. Congress correctly has expressed frustration at the SEC's examination function. I think that Drew Bowden, the head of the SEC's Office of Compliance Inspections and Examinations, is trying to do a good job, given the working

---

[10] *See* 12 U.S.C. § 5365(i) (2010) (Dodd-Frank Act §165(i)).

environment. For example, he has a largely unionized workforce that, by union rules, cannot travel outside of business hours without extra compensation. What if your salaried employees had that deal?

In 2014, the SEC examined only about nine percent of all registered investment advisors—in stark contrast to the Financial Industry Regulatory Authority, which examined 48 percent of broker-dealers under its purview. Several proposals have been floated to help ensure that more advisors are examined more frequently. Some options include imposing "user fees" on investment advisors to fund their exams, "outsourcing" exam functions or forming a self-regulatory organization, or increasing budget requests to plump up the SEC's inspection and examination resources.

I must raise serious concerns about expanding FINRA's reach without a fundamental re-examination of its statutory functions and organization. Today's FINRA has evolved from the worthwhile goals of a self-regulatory membership organisation envisaged in the 1930s; namely, the balance of efficient and effective regulation with the need to be accountable and transparent. Its budget has reached $887 million—not far from that of the SEC itself. FINRA, of course, has a virtual monopoly on oversight of broker-dealers. And, while most of the blame over the Madoff and Stanford schemes has been placed on the SEC, both firms were registered with and examined by FINRA for years.

What about just giving more money to the SEC? I would argue that the SEC could be much more efficient with the huge budget that it already has. The SEC's budget has grown to $1.35 billion in 2014. Its new budget request for fiscal 2016 is $400 million on top of that. In 2002, when I became a commissioner, that was the size of the entire SEC budget—around $400 million. More than half of the SEC's budget request for 2016 relates to examinations ($349 million) and enforcement ($528 million).

The SEC's organizational inefficiencies need to be remedied before we throw more money at the problem. For example, besides work rules that I mentioned earlier, examiners should be in closer contact with the staff who are considering and formulating regulations, and vice versa. This organizational change—the need for which is not satisfied merely by placing examiner liaisons in the Division of Investment Management—would make the examination function more coherent and possibly more effective. After all, not just in its final form, but in its legislative history as well, Dodd-Frank clearly invited the SEC to rethink its examination program.[11] The SEC must remedy these shortcomings and address its own inefficiencies before its budget continues to grow at such a high rate.

I have painted a rather bleak picture—sorry to ruin your lunch. But, hope is not lost. There is a new Congress, and Jeb Hensarling, Chairman of the House Financial Services Committee, and Richard Shelby, Chairman of the Senate Banking Committee, lead bipartisan majorities on their committees that realize the basic issues regarding the application of bank-style regulation to the asset management industry, asset managers, and investors. They realize that it is a threat to the functioning, vibrancy, and ultimate liquidity of our capital markets.

[11] *See* 15 U.S.C. §78d (2010) (Dodd-Frank Act §965).

Democrats and Republicans came together last year to fire repeated shots across Treasury's and FSOC's bow regarding designation of asset management as "systemically important."

You all must be active. Let us call the regulatory threat posed by the FSOC and the Federal Reserve for what it is—fundamentally antithetical to free markets and capital markets in general and a terrible idea for investors. It is not just a threat to the "big boys" in the business, but to each of you – and, most importantly, to your clients.

Karen Barr and her colleagues at IAA are well aware and are active in this area. Please support them with your brains and most importantly your mouths. Let your members of Congress know where you stand. Do not be afraid to speak out.

So, on that note, I would like to say that this is a time for prudence and caution. There should be, at the least, further study and robust analysis—quantitative analysis—before hasty action that could seriously harm the process of capital formation. Thank you, and I would be happy to take any questions in the time remaining.