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How SIFI Designation Could Undermine Fund Governance: Parsing the Fed's Proposal for GE Capital

By Paul Schott Stevens

Fund boards and independent directors have a long history of serving shareholder interests, yet today they face an alarming prospect that could threaten their ability to continue doing so. I refer to the possibility that funds or fund advisers might be designated as "systemically important financial institutions" (SIFIs) and thus subject to "enhanced prudential supervision" by the Federal Reserve Board.

SIFI designation and prudential supervision by the Fed could fundamentally alter the governance of regulated funds in the United States. Consider, for example, the implications of SIFI designation for governance of General Electric Capital Corporation.

Proposed Restrictions on GE Capital's Board

We have written a number of *ICI Viewpoints* pieces about efforts by the U.S. Financial Stability Oversight Council (FSOC) to determine whether financial firms other than banks pose outsized risks to the financial system. Firms that the FSOC considers to pose systemic risk are designated as SIFIs under the Dodd-Frank Act and regulated by the Federal Reserve.

One of the firms that the FSOC has already designated is GE Capital. To provide specificity for its new oversight role, the Federal Reserve Board has proposed an extensive set of enhanced prudential standards for GE Capital, including unprecedented, highly prescriptive requirements for its board of directors. The Fed is still working through comments on its proposal—including comments from GE Capital itself—and we can't be certain how its final rule will turn out. But we do know that what the Fed has proposed constitutes a remarkable intrusion on the existing governance arrangements of GE Capital as well as its parent, the General Electric Corporation.

What Might Fund Boards Face?

The Fed's approach to governance derives from its experience with the largest global banks, and it seems intent on applying that governance template elsewhere. Its approach consists, first, of *reshaping the composition of boards and effectively changing the loyalties of directors* consistent with the Fed's interests in prudential supervision; and second, of *imposing on boards detailed new responsibilities and requirements* that ultimately will need to be carried out to the Fed's satisfaction.

More specifically, the Fed would require GE Capital to add two new outside directors who are not only independent of GE and GE Capital, but who also are independent of GE's board and its outside directors. In practice, they also will need to meet the approval of the Fed. In effect, these directors would be loyal to the Fed and to its interests and objectives as a prudential regulator, not to the interests of GE's shareholders or other stakeholders.

Similar mandates on fund boards could result in the seating of a wholly new class of independent directors—ones who are independent both of the fund's adviser and of the fund's current independent directors. This new class of independent directors would be hand-picked by the Fed, and would owe primary loyalties not to the fund or its investors but to the "prudential" objectives of the Fed. This conflicted model of fund governance would mirror the conflicted model of regulation that produced it. The "prudential market regulation" model envisioned by the Fed's leadership for the fund industry would place the "demands" of the banking system above the interests of fund investors, and the regulatory objectives of the Fed above the fiduciary obligations of fund advisers and directors.

The Fed's proposal goes even further, to add many duties for GE Capital's directors. It envisions an independent board committee responsible for GE Capital's risk-management policies—a new structure mandated by the Fed wholly outside the risk-management structures established by the management of GE and GE Capital. Other new duties include analyzing and approving risk-management policies; annually approving GE Capital's liquidity-risk tolerance and ensuring that it operates within that tolerance; and reviewing the process for assessing capital adequacy in capital plans submitted to the Fed each year.

The upshot of all these new requirements is to place on the board responsibilities that arguably are better suited to management. This tension over the proper role for, and expectations of, a board is one with which the fund industry already wrestles under Securities and Exchange Commission regulation. It likely would become far greater under the "enhanced prudential supervision" of the Federal Reserve.

Ominous Implications for Fund Boards and Independent Directors

The Fed's governance designs do not stop with its GE Capital proposal. As has been widely reported, the Fed's supervisors have become a frequent presence at the board meetings of some of the largest U.S. financial institutions. And these supervisors are calling increasingly for boards to become involved in management duties that reach beyond the scope of—or are too granular for—directors' traditional oversight role. According to the *Wall Street Journal,* the Fed's approach has led some otherwise-qualified directors to question whether to serve on a board, so great are the concerns about second-guessing and personal liability.

Federal Reserve Board Governor Daniel K. Tarullo, the de facto head of regulatory policy at the central bank, advocates going much further. In a speech last year, he asked how corporate governance might be modified to align with "macroprudential" regulatory objectives. One way to accomplish this goal, Tarullo suggested, would be to "broaden the fiduciary duties" of boards—broaden them, that is, beyond the duties of loyalty and care traditionally owed to shareholders to include new loyalties to the banking system and, effectively, to the Fed.

For fund boards and independent directors, all this has an ominous quality—and raises serious questions. What happens when these differing interests collide? How would independent fund directors respond if the Fed were to direct that a fund's portfolio investments be managed in a way that the directors or the fund's adviser believed was not in the best interests of the fund's shareholders?

These questions ought to concern us all. If the Fed succeeds in inserting itself into fund boardrooms, the long-term impact likely would extend well beyond any funds or advisers initially designated as SIFIs. The number of such SIFIs could well grow over time to encompass more and more complexes. And as new regulatory expectations of funds or asset managers emerge that are centered on banking "system demands," they likely will not be satisfied until applied more broadly.

According to press reports, the board and management of GE have elected to exit the business and sell off most of its GE Capital subsidiary, thus possibly disentangling the parent company from the intrusive and burdensome Fed supervision that has come along with GE Capital's SIFI designation. The answer for a fund or adviser may not be so simple, but one thing seems certain: designation would put the Fed in the driver's seat, and put independent directors—and with them fund shareholders—in the back seat. It would upend a governance structure that has evolved over the past 75 years and today serves the interests of our shareholders very successfully.

As noted above, the GE Capital proposal is not yet final. But with funds and their advisers still at risk of SIFI designation, the Fed's stated intentions have important implications—and high stakes—for all independent fund directors. ICI will continue to engage vigorously on this issue, and do everything we can to ensure that the Fed's intentions don't become reality. Fund boards—and fund shareholders—deserve nothing less.

Paul Schott Stevens was President and CEO of ICI.
