Client Update
"Planning for the Worst": The SEC Plans New Regulations for the Asset Management Industry

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In a speech last week, Mary Jo White, Chair of the Securities and Exchange Commission (the "SEC"), outlined three initiatives aimed at the investment management industry: (i) expanded data reporting for registered investment companies and investment advisers, (ii) enhanced controls on risks related to portfolio composition and (iii) improved transition planning and stress testing.[1] The initiatives reflect the SEC's goal of a "vigorous program" aimed at assessing and addressing the activities and risks of the asset management industry and its efforts to "plan for the worst." The rules that will implement these initiatives likely will be proposed for public comment in the coming year. This client update summarizes key aspects of Chair White's speech.

The speech appears to be a response to the decision of the Financial Stability Oversight Council ("FSOC") to focus on product offerings and activities of asset managers, rather than to designate individual asset managers as systemically important.[2] FSOC's altered focus does not mean, however, that the asset management industry will be immune from prudential regulation analogous to that applicable to other financial institutions. Indeed, the initiatives described by Chair White appear to be designed to address the concerns raised by FSOC and others concerning the asset management industry.

EXPANDING AND UPDATING DATA REPORTING

Echoing concerns raised by FSOC and the Department of the Treasury's Office of Financial Research, Chair White expressed concern that the SEC's "ability to

[1] Available at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VJNGF6J2I_I.
[2] On December 18, 2014 FSOC released a notice seeking public comment regarding potential risks to U.S. financial stability from asset management products and activities, specifically seeking input about potential risks associated with liquidity and redemptions, leverage, operational functions and resolution in the asset management industry. The notice is available at http://www.treasury.gov/initiatives/fsoc/rulemaking/Documents/Notice%20Seeking%20Comment%20on%20Asset%20Management%20Products%20and%20Activities.pdf.

effectively identify and address risks in the asset management industry is diminished without the ability to monitor for those risks at the fund level and across the entire industry." To that end, the SEC Staff is developing recommendations to modernize and enhance data reporting for both registered funds and advisers, including updates with respect to reporting:

- basic census information, which the SEC Staff believes will allow it to monitor industry developments and potential compliance issues;
- fund investments in derivatives, the liquidity and valuation of fund holdings and fund securities lending practices; and
- data on separately managed accounts.

Importantly, this appears to mark the first significant SEC effort to collect data on separately managed accounts.

ENHANCING CONTROLS ON RISKS RELATED TO PORTFOLIO COMPOSITION

The second initiative is aimed at ensuring that registered funds enhance their fund-level controls so that they are able to identify and address risks related to their portfolios arising from fund liquidity levels and the use of derivatives. The SEC Staff is considering whether broad risk management programs should be required for mutual funds and exchange traded funds to address these portfolio risks. In addition, the SEC Staff is reviewing options for specific requirements, such as updated liquidity standards, disclosures of liquidity risks or measures to appropriately limit the leverage employed by a fund through its use of derivatives.

IMPROVING TRANSITION PLANNING AND STRESS TESTING

The third initiative is aimed at mitigating the "impact on investors of a market stress event or when an investment adviser is no longer able to serve its clients" and a client needs to transfer its asset management services to another firm. The SEC Staff is developing a recommendation to require advisers to create transition plans to prepare for a major disruption in their business.

This initiative appears to be analogous to the "living will" requirements for large bank holding companies ("BHCs"), which are designed to require BHCs to provide regulators with a detailed analysis of how a BHC that faces material financial distress or failure could be resolved in an orderly manner. In practice, the development of "living wills" has proven to be a substantial undertaking for BHCs and has been used by regulators as a new tool for seeking modifications to BHC operations, structures, business models and practices. It remains to be seen whether the SEC will propose an approach that will have a significant impact on investment adviser operations.

The SEC Staff is also considering ways to implement the new requirements for annual stress testing by large advisers and funds, as required by the Dodd-Frank Act.[3] Currently, the SEC requires money market mutual funds to periodically test their ability to maintain weekly liquid assets of at least 10% and to minimize principal volatility in response to specified hypothetical events and requires advisers to report the results of such stress testing to the board of the directors of the fund. The results of these stress tests are reviewed by fund boards. Notably, the Dodd-Frank Act mandates some form of public disclosures of stress test results, as well as reporting of results to the Federal Reserve (in addition to the SEC). These additional requirements could lead to a significant change in stress test practices for advisers and funds.

CONCLUSION

The initiatives reflect the SEC's increasing focus on the asset management industry and the SEC's efforts to assess and address the activities and risks of the industry as it evolves. In part these initiatives are intended to address the concerns raised by FSOC and others regarding the asset management regulatory framework, and to demonstrate that FSOC appears to be adopting a more secondary role. Chair White noted that these initiatives are not intended to eliminate all risk and are aimed at balancing the reduction of undue risks and the preservation of the principle of "reward for risk." Market participants are likely to wonder whether the SEC's "planning for the worst" will affect the final rules' balancing of risk and reward. We will keep you apprised of future SEC actions on these initiatives.

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Please do not hesitate to contact us with any questions.

[3] Dodd-Frank Wall Street Reform and Consumer Protection Act § 165(i)(2).