Dechert LLP

FSB Issues Proposed Activities-Based Financial Stability Recommendations for the Global Asset Management Industry

A legal update from Dechert's Financial Services Group

July 2016

FSB Issues Proposed Activities-Based Financial Stability Recommendations for the Global Asset Management Industry

The Financial Stability Board (FSB), an international body established by the G-20 in response to the 2008 financial crisis, on June 22, 2016 released its third Consultative Document relating to the regulation and oversight of the global asset management industry (Proposal). The Proposal follows previous Consultative Documents in 2014 and 2015, which focused on designating asset managers and investment funds as global systemically important financial institutions (G-SIFIs), and reflects, to some extent, the impact of educational efforts and formal comments by the asset management industry on the prior Consultative Documents. The Proposal represents a new focus by the FSB on activities-based policy recommendations to address perceived threats to global financial stability posed by asset managers and investment funds.

In the Proposal, the FSB identifies, and is seeking public comment on, four principal areas of perceived concern: (1) liquidity and redemption challenges for funds; (2) funds' use of leverage; (3) operational risks and issues in transferring assets under management; and (4) securities lending by asset managers and funds.[1]

The U.S. Department of the Treasury, Board of Governors of the Federal Reserve System, and Securities and Exchange Commission (SEC) represent the United States on the FSB, and the heads of those agencies are also voting members on the U.S. Financial Stability Oversight Council (FSOC). The interplay between global and U.S. regulation of asset management will be the subject of a forthcoming guide by Dechert.

Interested firms should consider participating in the comment process. Comments on this Proposal are due by September 21, 2016.

Previous FSB Proposals

As noted above, the Proposal is the third Consultative Document issued by the FSB that focuses on asset managers and investment funds and their perceived threats to financial stability. In January 2014, the FSB and the International Organization of Securities Commissions (IOSCO) jointly issued an assessment report (First G-SIFI Proposal) that looked at the possible systemic risks that might be posed by individual asset managers and investment funds, broker-dealers, and finance companies. The First G-SIFI Proposal evaluated possible systemic risks and size thresholds in seeking to establish assessment methodologies for identifying systemically important non-bank non-insurer financial entities. This proposal would have set a $100 billion threshold for investment funds to have been evaluated for G-SIFI status. The First G-SIFI Proposal was reported to have only covered 14 funds, each of which was based in the United States.[2]

---

1 The Proposal also notes a fifth area of concern – the vulnerabilities associated with pension funds and sovereign wealth funds – which the FSB will consider at a later date. The FSB indicates it will consider, in collaboration with the International Organization of Securities Commissions, whether any residual risk that may remain after implementation of the activities-based recommendations would warrant G-SIFI designations of individual funds or asset managers.

2 For further information, please refer to *Dechert OnPoint*, FSB and IOSCO to Consider Standards for Treating Investment Funds and Asset Managers as Global Systemically Important Financial Institutions.

After receiving comments on the First G-SIFI Proposal, the FSB and IOSCO issued their second report in March 2015 (Second G-SIFI Proposal) (together with the First G-SIFI Proposal, G-SIFI Proposals). Notwithstanding comments challenging the predicates and rationales for potentially treating funds and asset managers as G-SIFIs, the Second G-SIFI Proposal continued to call for such designations.[3]

In June 2015, IOSCO announced that a full review of asset management activities and products should be undertaken before further action on G-SIFI designations would be pursued. The following month, the FSB stated that it had decided to hold off on finalizing G-SIFI designation methodologies until completion of its review of potential financial stability issues related to asset management entities and activities.[4]

FSB's Concerns about the Asset Management Industry

The latest Proposal takes a new – sectoral – approach that represents a shift away from a focus on limiting risks purportedly associated with a small number of large funds or asset managers through the application of enhanced prudential standards to those firms. Under the Proposal, the FSB will instead look to impose risk reduction methods across all sizes of funds and managers and all jurisdictions.

Although the approach in the Proposal is quite different from the G-SIFI Proposals, the underlying premise of the FSB remains the same – that the asset management industry presents a serious potential threat to financial stability. Yet, in accordance with comment letters on the G-SIFI Proposals, the Proposal repeatedly concedes that, in a non-money market fund context, there is little – or no – historical empirical evidence to support the FSB's financial stability concerns in regard to the asset management sector. Indeed, the Proposal tellingly uses words like "may," "could" and "might" well over 100 times, while there are only a handful of descriptions of global risks that have *actually* occurred. Nevertheless, in the absence of historical precedent, the Proposal suggests that new levels of risk may be accumulating in the asset management sector, as the size of the sector has experienced substantial growth in recent years and as government monetary policies incentivize investors to reach for higher yields on fixed income instruments.

With this backdrop, the FSB justifies its proposed measures based on highly speculative scenarios that would purportedly threaten financial stability. For example, in the key area of liquidity and redemption risks, the Proposal acknowledges that it relies on a chain of events divorced from considerations of historical empirical evidence or evaluations of likelihood. Thus, it sets forth the following scenario of "what ifs":

- there would have to be significant redemptions from funds
- that result in significant asset sales by funds (especially of less-liquid assets)
- and those sales would need to be significant enough to lead to material price declines or increases in price volatility in particular asset sectors
- that would be serious enough to impair market access by borrowers.

---

[3] For further information, please refer to US FSOC and Global FSB Signal Continued Scrutiny of Financial Stability of the Asset Management Industry.

[4] For further information, please refer to *Dechert OnPoint*, Asset Management Industry: Financial Stability Update, Fall 2015.

The FSB's exercise in hypothesizing highly speculative risks, and then finding remedies to counter those risks, closely resembles the kind of reasoning that a U.S. district court recently rejected in *MetLife v. Financial Stability Oversight Council*.[5] In that case, the court determined that the FSOC's designation of MetLife as a systemically important financial institution under U.S. law was arbitrary and capricious because, among other things, the FSOC had relied on assumptions that were not supported by the record to establish a basis for finding that MetLife's material financial distress would materially impair MetLife's counterparties.

A similar lack of empirical foundation appears to be a hallmark of the Proposal. Unfortunately, the FSB, unlike the FSOC, does not operate within the construct of laws that would subject its actions to independent judicial review (whether on procedural or empirical grounds). While the FSB's recommendations ultimately must be implemented by national authorities whose actions are constrained by their national laws, the weight that the Proposal's recommendations creates does impact the record and could have a self-fulfilling effect. Thus, the importance of commenting on the imperfections in the FSB's analysis and approach.

The Four Areas of Focus

The Proposal discusses four principal areas of concern related to the structural systemic risks "inherent in the design of different types of investment funds and/or asset managers." For each area, the Proposal provides a very general overview of the structural and regulatory mitigators that may exist in various jurisdictions to protect against these risks, as well as the residual risks that the FSB believes remain.

1. ***"Liquidity mismatch" between fund investments and redemption terms and conditions for open-end funds.*** The Proposal suggests that open-end investment funds may not be able to meet redemptions during times of market stress because of the mismatch in the liquidity of fund investments and the ability to meet daily redemptions. Yet, the Proposal makes clear that non-money market open-end funds have created no global financial stability concerns historically. The Proposal does assert that there is some evidence that, in times of stress, "investor herding" and "momentum trading" can exacerbate the stress for open-end funds to meet redemption requests. In contrast to previous U.S. policy initiatives related to stable net asset value (NAV) money market funds (based on the theory that a move to floating NAV would mitigate against a purported first-mover advantage), the Proposal states that there may be cases where open-end funds could incentivize investors to redeem ahead of other investors (which the Proposal refers to as a first-mover advantage as well).

   The Proposal recognizes that many investment funds already use a range of liquidity management tools. It suggests, however, that: current regulatory reporting may not provide enough information for regulators to assess risks to financial stability; gaps may still exist in liquidity risk management tools; and existing risk management tools may not function properly when needed.

   The Proposal makes a series of recommendations, including that authorities should:

   - collect information on the liquidity profile of open-end funds proportionate to the risks such funds may pose from a financial stability perspective;

   - review and enhance required disclosures to investors regarding fund liquidity profiles;

---

[5] For further information, please refer to *Dechert OnPoint*, *MetLife* Opinion Turns the Tables on FSOC: Back to the Drawing Board.

- develop requirements or guidance so that funds' assets and investment strategies are consistent with the terms and conditions governing redemptions; and
- provide guidance on stress testing and other liquidity management tools.

The Proposal also suggests that IOSCO should consider whether certain asset classes and investment strategies may not be suitable for open-end funds.

2. ***Use of leverage by investment funds.*** Leverage is identified as a structural vulnerability that could cause or amplify risks throughout the global financial system. The main sources of concern cited are that the use of leverage through derivatives can magnify a fund's losses and ripple through the financial system by harming the fund's counterparties. The FSB acknowledges that many funds are required to have limits on leverage but still identifies perceived risks through the use of leverage – mainly, in that regulators do not have access to enough data to appropriately monitor, evaluate and identify potential risks arising from leverage. The Proposal includes recommendations for the collection of more data on the use of leverage and recommends that jurisdictions adopt consistent measures of leverage.

3. ***Operational risk and challenges in transferring investment mandates in stressed conditions.*** The Proposal identifies operational risks in the transfer of investment mandates or client accounts – these risks include reputational harm and related investor behavior. The Proposal acknowledges that such challenges have been infrequent and have not raised financial stability issues, but identifies three areas where this operational risk could occur: (i) termination of derivative contracts; (ii) replacement of ancillary services; and (iii) legal and regulatory difficulties associated with transferring client accounts. The Proposal recommends that formal requirements be adopted (and/or guidance issued) for asset managers that are large, complex, and/or provide critical services – for example, regulations to require such managers to implement comprehensive and robust risk management frameworks and practices (including business continuity and transition plans) to enable orderly transfer of client accounts and investment mandates in stressed conditions.[6]

4. ***Securities lending activities of asset managers and funds.*** The last area of structural vulnerability discussed in the Proposal relates to asset managers' securities lending activities and attendant indemnification arrangements. Although the benefits of securities lending are acknowledged, the Proposal recommends that authorities monitor indemnification provided by asset managers. In this regard, the Proposal indicates that should any particular asset manager's indemnification arrangements pose a material risk, the relevant authority should ensure that such asset manager adequately covers any potential credit losses.

---

[6] The Proposal states that in some jurisdictions, some asset managers are required to set aside capital or hold indemnity insurance for certain risks, including business disruptions and process management failures. The Proposal states that further assessment is needed to understand whether such requirements are common across jurisdictions or calibrated to sufficiently cover potential losses from operational issues arising in stressed market conditions.

The Proposal Mirrors Recent SEC and FSOC Initiatives

SEC Rule Proposals

The FSB published the Proposal shortly after the SEC issued rule proposals that address two of the FSB's areas of concern – liquidity risk management[7] and funds' use of derivatives.[8] The SEC's proposed rules previewed much of the FSB's discussion and many of its policy recommendations, including the potential use of swing pricing and enhanced disclosures about a fund's liquidity characteristics and use of derivatives. The SEC is currently considering comments on its proposals.[9]

Further, after the FSB published the Proposal, the SEC issued rule proposals that would require registered investment advisers to adopt and implement business continuity and transition plans – the FSB's third area of concern noted above.[10]

A chart comparing the policy recommendations in the Proposal with SEC current requirements and actions the SEC has proposed in its liquidity management, derivatives and investment adviser business continuity and transition plan proposals appears in the Appendix.

FSOC Statement on Risks Posed by the Asset Management Industry

The FSOC in April 2016 issued an update on its review of the risks posed by the asset management industry (Statement). The Statement sets forth the FSOC's views regarding potential asset management financial stability concerns arising from: (i) liquidity and redemption risk; (ii) leverage risk; (iii) operational risk; (iv) securities lending risk; and (v) resolvability and transition planning. The Statement identifies certain actions that the FSOC indicates it believes should be considered in regard to the five areas of financial stability concern. The Statement does not, however, involve any proposed exercise of the FSOC's authority to make activities-based enhanced standards recommendations to federal regulatory agencies under section 120 of the Dodd-Frank Act. FSOC representatives have indicated that the FSOC is principally focused on liquidity, redemption and leverage risks. U.S. Treasury Secretary Jacob Lew has stated that it is important for U.S. regulators, including the FSOC and SEC, to work in a complementary manner. Secretary Lew has also expressed the importance of the FSOC continuing to lead the international conversation in the asset management area, a reference to the role that the United States plays on the FSB.

---

7 80 Fed. Reg. 62,274 (October 15, 2015).

8 80 Fed. Reg. 80,884 (December 28, 2015).

9 There are significant administrative law issues associated with both of the SEC proposals. For further information, see Letter from Dechert LLP to SEC re: Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, January 13, 2016 and Letter from Dechert LLP to SEC re: Use of Derivatives by Registered Investments Companies and Business Development Companies, March 28, 2016.

10 *See* Adviser Business Continuity and Transition Plans, Release No. IA-4439 (June 28, 2016).

Appendix: Comparative Summary of FSB Proposals, Current SEC Requirements and SEC Rulemaking Initiatives for Open-End Investment Companies (Mutual Funds[11])

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
FSB recommendations to address liquidity mismatch between fund investments and redemption terms and conditions for fund units		
Perceived lack of information and transparency		
▪ Authorities should collect information on the liquidity profile of mutual funds in their jurisdiction proportionate to the risks they may pose from a financial stability perspective. They should review existing reporting requirements and enhance them as appropriate to ensure that they are adequate, and that required reporting is sufficiently granular and frequent.	▪ Mutual funds are not currently subject to reporting requirements with respect to the liquidity of fund assets.	▪ On proposed Form N-PORT,[12] a mutual fund would be required to: (1) identify the liquidity classification category of each portfolio asset based on the number of days the fund anticipates it would take to convert the asset to cash; (2) report whether each portfolio asset is a "15% standard asset;"[13] and (3) disclose its three-day liquid asset minimum (TDLA Minimum).[14] ▪ On proposed Form N-CEN, a mutual fund would be required to report on the use of: (1) lines of credit; (2) interfund lending; (3) borrowing; and (4) swing pricing.[15]

11 Most of the current SEC requirements and pending initiatives apply to exchange-traded funds (ETFs) as well. Note, however, that the comparisons included in this Appendix do not cover money market mutual funds.

12 In May 2015, the SEC proposed a series of rules that would expand the reporting and disclosure requirements of registered investment companies, including a new requirement to file monthly portfolio investment information on Form N-PORT. Although Form N-PORT would be filed monthly, only the information reported for the third month of a fund's fiscal quarter would be made publicly available (subject to a 60-day delay). The proposed rules also included Form N-CEN, which would require all registered investment companies to report certain census-type information on an annual basis.

13 Under the proposal, a "15% standard asset" would be any asset that may not be sold or disposed of in the ordinary course of business within seven calendar days at approximately the value ascribed to it by a fund.

14 Under the proposal, the TDLA Minimum is the percentage of a fund's net assets that must be invested in three-day liquid assets (TDLAs), defined as any cash held by a fund together with any fund position (or portion thereof) in an asset that the fund believes is convertible to cash within three business days at a price that does not materially affect the value of that asset immediately prior to sale.

15 ETFs and exchange-traded managed funds (ETMFs) would be required to disclose whether they required "authorized participants" to post collateral to the fund or any of its designated service providers in connection with the purchase or redemption of fund shares.

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
▪ Authorities should review existing investor disclosure requirements and determine the degree to which additional disclosures should be provided by mutual funds to investors regarding fund liquidity profiles proportionate to the liquidity risks funds may pose from a financial stability perspective. Authorities should enhance existing investor disclosure requirements as appropriate to ensure that the required disclosures are of sufficient quality and frequency. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.	▪ Mutual funds are not currently subject to specific disclosure requirements with respect to liquidity.[16] However, funds are required to disclose the principal risks of investing, including the risks to which the fund's particular portfolio as a whole is expected to be subject. See Form N-IA, Item 9(c).	▪ Form N-1A, the registration form used by mutual funds, would be amended to require mutual funds to: (1) disclose the number of days in which they will pay redemption requests to redeeming shareholders (including the number of days for each distribution channel, if the number differs by channel); (2) disclose the methods they will use to meet redemption requests (*e.g.,* sale of portfolio securities, cash reserves, lines of credit, interfund lending, redemptions in kind), including whether such methods will be used regularly or only in stressed market conditions; (3) file as exhibits to their registration statements agreements relating to lines of credit; and (4) disclose the circumstances in which they will use swing pricing as well as the effects of initiating swing pricing (if applicable).

16 Mutual funds are required to disclose their "principal investment risks," which could include investments in securities that are illiquid.

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
Perceived 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 a mutual fund's structure, authorities should have requirements or guidance stating that the funds' assets and investment strategies should be consistent with the terms and conditions governing fund unit redemptions, both at fund inception and on an ongoing basis (for new and existing funds), taking into account the expected liquidity of the assets and investor behavior during normal and stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.	▪ Under Section 22(e) of the Investment Company Act of 1940 (1940 Act), redemption proceeds must be made within seven days,[17] and the right of redemption may not be suspended, except in very limited circumstances (*e.g.,* for any period during which the New York Stock Exchange is closed). In addition, under Rule 22c-1 under the 1940 Act, shares of mutual funds must be priced and be redeemable on a daily basis at their current NAV per share. ▪ Under SEC guidance, mutual funds may not invest more than 15% of their net assets in illiquid securities (*i.e.,* securities that generally cannot be sold or disposed of in the ordinary course of business within seven days at approximately the value at which the fund has valued the security).[18]	▪ Under proposed Rule 22e-4, a mutual fund would be required to adopt and implement a written liquidity risk management program, which would be required to provide for the: (1) classification and ongoing review of the liquidity of the fund's portfolio positions;[19] (2) assessment and periodic review of the fund's liquidity risk;[20] and (3) management of the fund's liquidity risk, including the requirement to determine the TDLA Minimum and the prohibition from acquiring any 15% standard asset if, immediately after the acquisition, the fund would have invested more than 15% of its net assets in 15% standard assets.[21]

---

17 Furthermore, mutual funds that are redeemed through broker-dealers must meet redemption requests within three business days, because broker-dealers are subject to Rule 15c6-1 under the Securities Exchange Act of 1934, which establishes a three-day (T+3) settlement period for security trades effected by a broker or a dealer.

18 Money market funds are limited by Rule 2a-7(c)(4)(i) to investing no more than 5% of total assets in illiquid securities.

19 The SEC's proposal would require each fund to classify each of the fund's portfolio positions (or portions of a position) into one of six liquidity categories. Under the proposal, a fund would also be required to engage in an ongoing review of each such classification. The liquidity categories would describe the number of days in which a fund's position (or portion thereof) would be convertible to cash at a price that does not materially affect the value of the asset immediately prior to sale. The determination to place an asset in a particular liquidity category would be made "using information obtained after reasonable inquiry" and would have to take into account, to the extent applicable, nine specified factors.

20 The SEC's proposal would require each fund to assess and periodically review its "liquidity risk," taking into account certain specified factors. "Liquidity risk" would be defined as "the risk that the fund could not meet requests to redeem shares issued by the fund that are expected under normal conditions, or are reasonably foreseeable under stressed conditions, without materially affecting the fund's net asset value."

21 This proposal essentially codifies the SEC's current guidance on mutual funds' investments in illiquid assets.

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
▪ Where appropriate, authorities should widen the availability of liquidity risk management tools to mutual funds, and reduce barriers to the use of those tools to increase the likelihood that redemptions are met even under stressed market conditions. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.	▪ Mutual funds may use a variety of tools to manage liquidity risk, including: (1) reserving the right to redeem shares in kind instead of in cash; (2) establishing lines of credit (or other funding sources, including interfund lending and repurchase agreements) in order to borrow money to meet shareholder redemptions; (3) investing in ETFs; and (4) imposing redemption fees under Rule 22c-2.[22]	▪ Under proposed Rule 22e-4, to the extent mutual funds engage in, or reserve the right to engage in, redemptions in kind, mutual funds would be required to establish written policies and procedures regarding redemptions in kind.[23] ▪ Under proposed Rule 22e-4, mutual funds would be required to consider their borrowing arrangements and other funding sources in assessing liquidity risk.
▪ Authorities should make liquidity risk management tools available to mutual funds to reduce first-mover advantage, where it may exist. Such tools may include swing pricing, redemption fees and other anti-dilution methods. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.	▪ See above.	▪ Rule 22c-1 would be amended to permit (but not require) mutual funds (but not ETFs) to use swing pricing to mitigate the risk that shareholder purchase and redemption activities could dilute the value of fund shares.[24]
▪ Authorities should require and/or provide guidance on stress testing at the level of individual mutual funds to support liquidity risk management to mitigate financial stability risk. The requirements and/or guidance should address the need for stress testing and how it could be performed. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.	▪ Mutual funds are not currently subject to requirements with respect to stress testing.[25]	▪ The Dodd-Frank Act requires the SEC to establish stress testing methodologies for large investment advisers and registered investment companies and to design a reporting regime for this stress testing. ▪ The SEC is expected to propose stress testing requirements later this year.

22 Money market mutual funds are also permitted to impose "liquidity fees" and "redemption gates" that temporarily suspend the right of redemption under certain circumstances. Money market mutual funds are outside the scope of this Appendix.

23 These policies and procedures would be required to address the process for redemptions and the circumstances under which funds would consider redeeming in kind.

24 Swing pricing generally refers to a mechanism that would adjust the NAV of a fund's shares to effectively pass on the trading and other costs associated with purchases or redemptions of fund shares to the purchasing or redeeming shareholder. Before a fund could employ swing pricing, it would be required to establish policies and procedures that designate an amount (swing factor) by which the fund will adjust its NAV if the level of net purchases into or net redemptions from the fund has exceeded a specified percentage of the fund's NAV (swing threshold).

25 Money market mutual funds are required to stress test their portfolios. Money market mutual funds are outside the scope of this Appendix.

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
Adequacy of liquidity risk management tools to deal with exceptional circumstances		
▪ Authorities should promote (through regulatory requirements or guidance) clear decision-making processes for mutual funds' use of extraordinary liquidity risk management tools, and the processes should be made transparent to investors and the relevant authorities. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.	▪ See above regarding mutual funds' current liquidity risk management tools.	▪ Under proposed Rule 22e-4, a mutual fund's board, including a majority of the independent board members, would be required to approve and oversee the fund's liquidity risk management program. ▪ Rule 22c-1 would be amended to condition a mutual fund's use of swing pricing on the establishment of policies and procedures that designate how the fund's Swing Pricing Administrator (the investment adviser or officers designated by the fund board as responsible for administering the swing pricing policies and procedures) will determine the swing factor and swing threshold, and whether the swing factor will be subject to any upper limit. A fund's board, including a majority of its independent board members, would be required to approve and oversee the fund's swing pricing policies and procedures.
▪ Authorities should provide guidance and, where appropriate and necessary, direction regarding mutual funds' use of extraordinary liquidity risk management tools. In this regard, IOSCO should review its existing guidance and, as appropriate, enhance it.	▪ See above regarding mutual funds' current liquidity risk management tools.	▪ See above regarding the processes proposed under Rules 22e-4 and 22c-1.
Additional market liquidity considerations		
▪ Where relevant, authorities should give consideration to system-wide stress testing that could potentially capture effects of collective selling by funds and other institutional investors, on the resilience of financial markets and the financial system more generally.	▪ See above regarding the lack of current requirements for stress testing.	▪ See above regarding the expected stress testing proposal.
FSB recommendations to address use of leverage by funds		
▪ IOSCO should develop simple and consistent measure(s) of leverage in funds with due	▪ Section 18(f) of the 1940 Act provides that it is unlawful for any registered open-end funds to	▪ Under proposed Rule 18f-4, mutual funds would be permitted to enter into derivatives and

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
consideration of appropriate netting and hedging assumptions. This 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. IOSCO should also consider developing more risk-based measure(s) to complement the initial measure(s) and enhance the monitoring of leverage across funds at a global level.	issue "senior securities," including any instrument evidencing indebtedness. ▪ Section 18(f)(1) permits a mutual fund to borrow money from a bank provided that immediately after such borrowing there is "asset coverage" of at least 300% for all borrowings of the fund (*i.e.,* there is a 3-to-1 assets-to-debt ratio). "Asset coverage" of a "senior security representing an indebtedness" of a fund is the ratio which (1) the value of a fund's total assets less all liabilities and indebtedness not represented by senior securities bears to (2) the aggregate amount of senior securities representing the fund's indebtedness.[26] ▪ If at any time a fund does not have 300% asset coverage for all borrowings, the fund is expected, within three days (not including Sundays and holidays), to reduce the amount of borrowings until it has at least 300% asset coverage. ▪ The SEC and its staff have taken positions that a mutual fund's investments in certain transactions may involve the issuance of senior securities subject to the prohibitions of Section 18 of the 1940 Act when the transactions have the potential to create leverage (*i.e.,* enable the fund to participate in gains and losses on an amount that exceeds its initial investment or enable the fund to obtain	certain financial commitment transactions[28] provided that certain conditions are met. Among the conditions are alternative 150% and 300% leverage-based portfolio limitations. Specifically, a fund's "aggregate exposure"[29] could not exceed 150% of the value of a fund's net assets (Exposure-Based Portfolio Limit) or, alternatively, 300% of the value of the fund's net assets if the use of derivatives by the fund reduces the fund's market risk (as determined using a VaR methodology) (Risk-Based Portfolio Limit).

[26] For example, a fund with $50M in total assets could borrow $25M because the fund would have total assets of $75M immediately after the borrowing (*i.e.,* 300% asset coverage). Section 18(g) of the 1940 Act also provides an exception from the term "senior security" for a note evidencing a temporary loan that does not exceed 5% of the fund's total assets as of the time it was made.

[28] A "financial commitment transaction" would include any reverse repurchase agreement, short sale borrowing, or any firm or standby commitment agreement or similar agreement, including certain conditional and unconditional unfunded commitments often entered into by closed-end funds and business development companies.

[29] "Aggregate exposure" would include: (1) the aggregate notional amounts of the fund's derivatives transactions (netting certain directly offsetting derivatives transactions); (2) the aggregate obligations under the fund's financial commitment transactions; and (3) the fund's aggregate indebtedness with respect to any other senior securities transaction.

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
	investment exposure without a concurrent delivery of cash). ▪ However, under SEC and staff guidance, these transactions would not be subject to the prohibitions of Section 18 if the transactions are "covered" by establishing and maintaining segregated accounts or earmarking unencumbered liquid assets on the fund's records. Funds have developed different cover tests for different categories of transactions based on SEC and staff guidance.[27]	
▪ Authorities should collect data on leverage in funds, monitor the use of leverage by funds not subject to leverage limits or which pose significant leverage-related risks to the financial system, and take action when appropriate.	▪ Mutual funds are not currently subject to separate SEC reporting requirements with respect to leverage and derivatives. ▪ However, in certain cases, reporting may be required on the CFTC's Form CPO-PQR and the NFA's Form PQR.	▪ Under proposed Rule 18f-4, mutual funds that are required to adopt a derivatives risk management program (*i.e.,* those funds that enter into so-called complex derivatives transactions and those funds that do not adhere to a limit of 50% on aggregate exposure associated with the fund's derivatives transactions) would be required to report certain risk metrics on proposed Form N-PORT. Funds would also be required to report on proposed Form N-CEN whether they relied on the Exposure-Based Portfolio Limit or the Risk-Based Portfolio Limit during the reporting period.
▪ IOSCO should collect national/regional aggregated data on leverage across its member jurisdictions based on the simple and consistent measures(s) it develops.	▪ See above.	▪ See above.

[27] Alternatively, earmarking or segregation of assets is not required in certain circumstances if a fund "covers" a transaction by entering into an offsetting transaction or if the fund owns the instrument or instruments underlying a transaction.

FSB Proposal	Current SEC Requirement(s) for Mutual Funds	SEC Rulemaking Initiatives for Mutual Funds
FSB recommendation 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, (including business continuity and transition plans) to enable orderly transfer of client accounts and investment mandates in stressed conditions.	▪ Rule 38a-1 under the 1940 Act and Rule 204-2 under the Investment Advisers Act of 1940 (Advisers Act) require mutual funds and their advisers to adopt and implement written compliance policies and procedures.[30]	▪ Under a recent SEC proposal, Rule 204-2 under the Advisers Act would be amended to require all investment advisers registered or required to be registered with the SEC to adopt and implement a written business continuity and transition plan, and to review the adequacy and implementation of such plan no less frequently than annually. The plan would involve policies and procedures reasonably designed to address operational and other risks related to a significant disruption in the adviser's operations, including policies and procedures addressing business continuity following a significant business disruption and business transition in the event the adviser is unable to continue providing advisory services to clients.
FSB recommendation to address securities lending activities of asset managers and funds		
▪ Authorities should monitor indemnification provided by agent lenders/asset managers to clients in relation to their securities lending activities. Where these monitoring efforts detect the development of material risks or regulatory arbitrage that may adversely affect financial stability, authorities should verify and confirm that asset managers adequately cover potential credit losses from the indemnification provided to their clients.	▪ Mutual funds are currently permitted to engage in securities lending, subject to a number of requirements.[31]	▪ No applicable proposals.

[30] According to the SEC Staff, mutual funds should consider their respective compliance obligations under the federal securities laws when assessing their ability to continue operations during a business continuity event. *See* IM Guidance Update, Business Continuity Planning for Registered Investment Companies (June 2016).

[31] *See* Securities Lending by U.S. Open-End and Closed-End Investment Companies, U.S. Securities and Exchange Commission, *available at* https://www.sec.gov/divisions/investment/securities-lending-open-closed-end-investment-companies.htm.

This update was authored by:

Richard Frase
Partner
London
+44 20 7184 7692
Send email

Robert H. Ledig
Partner
Washington, D.C.
+1 202 261 3454
Send email

Jack W. Murphy
Partner
Washington, D.C.
+1 202 261 3303
Send email

Jeremy I. Senderowicz
Partner
New York
+1 212 641 5669
Send email

Thomas P. Vartanian
Partner
Washington, D.C.
+1 202 261 3439
Send email

David A. Vaughan
Partner
New York / Washington, D.C.
+1 212 698 3540
+1 202 261 3355
Send email

Brenden P. Carroll
Associate
Washington, D.C.
+1 202 261 3458
Send email

Robert J. Rhatigan
Associate
Washington, D.C.
+1 202 261 3329
Send email

Aaron D. Withrow
Associate
Washington, D.C.
+1 202 261 3442
Send email

Shayna Gilmore
Associate
Washington, D.C.
+1 202 261 3362
Send email

© 2016 Dechert LLP. All rights reserved. This publication should not be considered as legal opinions on specific facts or as a substitute for legal counsel. It is provided by Dechert LLP as a general informational service and may be considered attorney advertising in some jurisdictions. Prior results do not guarantee a similar outcome. We can be reached at the following postal addresses: in the US: 1095 Avenue of the Americas, New York, NY 10036-6797 (+1 212 698 3500); in Hong Kong: 27/F Henley Building, 5 Queen's Road Central, Hong Kong (+852 3518 4700); and in the UK: 160 Queen Victoria Street, London EC4V 4QQ (+44 20 7184 7000). Dechert internationally is a combination of separate limited liability partnerships and other entities registered in different jurisdictions. Dechert has more than 900 qualified lawyers and 700 staff members in its offices in Belgium, China, France, Germany, Georgia, Hong Kong, Ireland, Kazakhstan, Luxembourg, Russia, Singapore, the United Arab Emirates, the UK and the US. Further details of these partnerships and entities can be found at dechert.com on our Legal Notices page.