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Current U.S. Regulatory Initiatives Impacting Asset Managers

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I. Current Initiatives and Related Developments

A. Current SEC Rulemaking Initiatives

The SEC's Division of Investment Management ("Division") is currently undertaking a number of significant initiatives that would apply to investment advisers and their registered investment company and other clients ("SEC Initiatives"). Among other matters, the Division is considering recommendations that the SEC propose the following rule changes and guidance under the Investment Company Act of 1940 ("1940 Act") and Investment Advisers Act of 1940 ("Advisers Act"):

- ***Enhanced Data Reporting Initiative***
  - Amendments to the forms used by open-end and closed-end registered investment companies to report information about fund operations and portfolio holdings;
  - Amendments to the form used by investment advisers to register with the SEC that will improve registration procedures and data collected from investment advisers (including data about separately managed accounts); and
  - Amendments to the books and records rule under the Advisers Act regarding the calculation of performance information.
- ***Liquidity and Derivatives Initiative***
  - A new rule requiring open-end funds to adopt and implement liquidity management programs, as well as enhanced SEC guidance relating to required liquid assets in open-end funds; and
  - New rules under the 1940 Act addressing the use of derivatives by funds and related matters, including disclosure of fund use of derivatives.

[1] The authors gratefully acknowledge the assistance of their Dechert LLP colleagues in preparing this outline – particularly Kirsten Linder and Wendy Fox, who provided substantial support to the authors.

- ***Transition Planning and Stress Testing Initiatives***
  - A new rule that would require investment advisers registered with the SEC to create and maintain transition plans; and
  - New requirements for stress testing by large asset managers and large investment companies that would implement section 165(i) of the Dodd-Frank Act.[2]

B. Chair White's Statements on the Initiatives

December 2014 DealBook Conference. On December 11, 2014, SEC Chair Mary Jo White delivered a speech to the New York Times DealBook Opportunities for Tomorrow Conference, in which she introduced each of the SEC Initiatives and described how they will address the "increasingly complex portfolio composition and operations of today's asset-management industry," serving both the SEC's traditional investor protection mission and assessing systemic risks.[3]

In these remarks, Chair White indicated that three of the most significant tools the SEC has to regulate the asset management industry are "controls on conflicts of interest; a registration, reporting and disclosure regime; and controls on fund portfolio composition risks and operational risks." Chair White stated that "[a] broader set of proactive initiatives is required to help ensure that [the SEC's] regulatory program is fully addressing" portfolio composition and operations.[4] Chair White described the SEC Initiatives as comprising three "core initiatives" for asset managers, which the SEC Staff has been developing at Chair White's direction in order to address issues relating to portfolio composition and operations, including:

- ***Improving the data from which the SEC draws its conclusions.*** Chair White indicated that "the reporting and disclosure of fund investments in derivatives, the liquidity and valuation of their holdings, and their securities lending practices should all be significantly enhanced." Additionally, she stated that the SEC intends to collect more data on separately managed accounts so that the SEC can further assess the risks in these accounts and can create better examination priorities.

- ***Increasing the controls that registered funds have in place to identify risks related to portfolio composition.*** Chair White noted that the SEC Staff "is considering whether broad risk management programs should be required for mutual funds and ETFs to address the risks related to their liquidity and derivatives use" and is evaluating specific requirements regarding liquidity standards, liquidity risk disclosures, and the leverage of funds related to derivatives.

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2 *See* Unified Agenda of Regulatory and Deregulatory Actions (Fall 2014).

3 *See* Mary Jo White, Chair, SEC, Enhancing Risk Monitoring and Regulatory Standards for the Asset Management Industry (Dec. 11, 2014) ("December 2014 Remarks"), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VPNgieGVRps.

4 Chair White also noted relatively recent rulemaking focused on conflicts of interest and the registration, reporting and disclosure regime.

- ***Ensuring that firms have plans for transitioning their clients' assets in a crisis.*** Chair White indicated that the SEC Staff is "developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business" as well as assessing proposals for the stress testing of large investment advisers and large funds.

Chair White also discussed the SEC's role in addressing "risks that could have a systemic impact on the securities markets or the financial system as a whole" and her view that the SEC Initiatives "will necessarily have a broader impact on the financial system." In this regard, Chair White discussed the role of the Financial Stability Oversight Council ("FSOC") in regulating systemic financial institutions, noting that "tackling systemic risk in any area, obviously, demands a broader program than one agency can execute." She noted that the "FSOC's current review of the potential risks to the stability of U.S. financial system of asset managers is a complement to the work [the SEC is] now undertaking."

2015 SEC Speaks Conference. Chair White indicated in an address at SEC Speaks on February 20, 2015 that the SEC and Division staff will consider each of the SEC Initiatives over the course of this year, and will be looking to market participants for their views during the rulemaking process.[5] In her remarks, Chair White noted that "one of the most fundamental, and important, post-crisis changes for all financial regulators has been an emphasis on addressing risks that could have a systemic impact on the markets or the financial system as a whole." Chair White noted that this goal does not mean eliminating "informed investment risk," but that the SEC's post-crisis focus must include "particular attention to the activities of asset managers."

C. FSOC Request for Comment on Financial Stability Implications of Asset Management Activities

The Dodd-Frank Act established the FSOC to identify risks to the financial stability of the United States, promote market discipline, and respond to emerging threats to the stability of the U.S. financial system. The Dodd-Frank Act gives the FSOC authority to:

- Make formal recommendations to the SEC regarding enhanced measures to regulate the asset management industry, if the FSOC determines that financial activity or practice conducted by a fund or asset manager is systemically significant; and

- Designate nonbank financial companies (including participants in the asset management industry) that could pose a risk to U.S. financial stability as systemically important financial institutions ("SIFIs") for heightened regulation and supervision by the Federal Reserve Board.

Consequently, the SEC Initiatives generally will need to address any concerns the FSOC raises about potentially systemically significant activities or practices of asset managers.

On December 18, 2014, one week following Chair White's December 2014 remarks, the FSOC took a significant next step in its consideration of the asset management industry by issuing a

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5 *See* Mary Jo White, Chair, SEC, Chairman's Address at SEC Speaks 2015 (February 20, 2015), *available at* http://www.sec.gov/news/speech/2015-spch022015mjw.html#.VPNfo-GVRps.

notice requesting public comment as to whether asset management products and activities may pose potential risks to the U.S. financial system ("FSOC Notice").[6] This action followed a series of meetings that the FSOC staff initiated in November with a wide variety of industry representatives in order to gather intelligence regarding improvements that could be made to the SIFI designation process.

The FSOC Notice states that the FSOC has decided to analyze industry-wide asset management products and activities to assess potential financial stability risks. This may be viewed as a move away from the FSOC's prior focus on potential designations of individual asset managers or asset management vehicles as SIFIs and a move toward greater prudential regulation of the overall industry.[7] However, the FSOC Notice also indicates that the FSOC has not made any determinations as to the existence or nature of any potential risks to U.S. financial stability related to the asset management industry.[8]

The FSOC Notice acknowledges the initiatives being undertaken by the SEC, indicating that "[w]hile the SEC's initiatives are not specifically focused on financial stability," the FSOC "intends to consider the impact these initiatives may have in reducing any risks to U.S. financial stability associated with the asset management industry." Many of the themes raised in Chair White's December 2014 remarks and under the SEC Initiatives overlap with the themes of the FSOC Notice, which include liquidity and redemptions, leverage, operational risk, and resolution.[9]

D. Federal Reserve Governor Commentary on Risk from Asset Managers

As noted above, the FSOC has authority to designate asset managers as SIFIs and subject them to regulation and supervision by the Federal Reserve Board. Federal Reserve Board Governor Daniel K. Tarullo, Chairman of the Federal Reserve Board Committee on Bank Supervision,

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6 Notice Seeking Comment on Asset Management Products and Activities, 79 Fed. Reg. 77,488 (Dec. 24, 2014). The FSOC subsequently extended the comment period until March 25, 2015.

7 On July 31, 2014, the U.S. Treasury Department Office of Public Affairs issued a statement relating to a meeting of the FSOC that occurred that day ("Treasury Statement"). The Treasury Statement indicated that the FSOC at that meeting had "directed staff to undertake a more focused analysis of industry-wide products and activities to assess potential risks associated with the asset management industry."

8 The FSOC Notice expresses a broad view of potential financial stability threats that could be related to the asset management industry, even where existing measures protect individual market participants. The FSOC Notice also suggests that some risks may not result from the actions of any individual entity, but rather appear collectively across market participants. While certain activities may not pose financial stability risks during normal times, the FSOC Notice suggests these activities may pose such risks during periods of financial market stress or stress at an individual firm.

9 The minutes of the December 18, 2014 meeting of the FSOC indicate that, consistent with her December 2014 remarks, Chair White stated that she supported the decision to seek comments on these issues and "that systemic risks, by definition, cannot be addressed by any single agency alone and the [FSOC] is an important forum for identifying and studying systemic risk," and that she described the FSOC Notice as "a constructive complement to the SEC's initiatives." Minutes of the Financial Stability Oversight Council (Dec. 18, 2014).

provided an indication of his views on potential risks posed by the asset management industry, in remarks at a January 30, 2015 conference held by Treasury's Office of Financial Research and the FSOC on the evaluation of macroprudential tools ("Governor Tarullo Remarks").[10]

Governor Tarullo provided his view that "safeguarding financial stability by containing systemic risk" is an aim that "rests at the center" of the concept of macroprudential policy. He continued that, while tools to regulate large financial institutions have already been developed, "there is still a need to develop, analyze, and consider tools that should be used for achieving macroprudential aims" in the asset management industry. In this regard, Governor Tarullo noted that:

- Selloffs by asset management vehicles holding less liquid assets resulting from shareholder redemptions could create "contagion effects on other holders of similar assets;"

- The use of leverage by funds, including through derivatives transactions "could create interconnectedness risks between funds and key market intermediaries and amplify the risk of such firesales;" and

- "Work is needed . . . to develop better data on assets under management, liquidity, and leverage, in order to fill the information gaps . . . ."

Governor Tarullo stated that he believes these risks "point to the broader objective for macroprudential policy of developing . . . 'prudential market regulation' – that is, a policy framework that builds on the traditional investor protection and market functioning aims of securities regulation by incorporating system-wide perspective." He cited, as an example, a framework that takes into account considerations such as "system-wide demands on liquidity during stress periods" and "correlated risks among asset managers that could exacerbate liquidity, redemption, and firesale pressures."

Governor Tarullo noted that prudential market regulation "might start by strengthening some of the firm- or fund-specific measures associated with those traditional regulatory aims, but then move forward to take into account such considerations as system-wide demands on liquidity during stress periods and correlated risks among asset managers that could exacerbate liquidity, redemption, and firesale pressures." He acknowledged that Chair White's December 2014 remarks "provided a roadmap for beginning to develop just such a regulatory approach for the asset management industry."

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[10] Governor Daniel K. Tarullo, Speech at the Office of Financial Research and Financial Stability Oversight Council's 4th Annual Conference on Evaluating Macroprudential Tools: Complementarities and Conflicts (Jan. 30, 2015) ("Governor Tarullo Remarks"), *available at* http://www.federalreserve.gov/newsevents/speech/tarullo20150130a.htm. The Chair of the Federal Reserve Board, and not Governor Tarullo himself, is the representative of the Federal Reserve Board on the FSOC. However, Governor Tarullo's views may inform the direction that the Federal Reserve Board and FSOC generally will take with respect to regulatory policy objectives of the SEC for asset managers.

E. Roles of the SEC and FSOC Going Forward

The FSOC first addressed the regulation of asset managers in November 2012 by issuing proposed recommendations pertaining to money market fund reforms under Section 120 of the Dodd-Frank Act.[11] Although the SEC subsequently acted on money market fund reforms on its own initiative, the FSOC indicated in July 2014 that it "intends to monitor the effectiveness of the SEC's reforms in addressing risks to financial stability. . . . After these measures have been implemented, [FSOC] will report on the effects of these reforms and their broader implications for financial stability."[12]

Chair White's statements appear to indicate that the SEC is working to address the potential financial stability concerns currently being discussed with respect to the asset management industry. However, as noted above, the FSOC has not yet made any determinations with respect to the existence or nature of risks to U.S. financial stability related to the asset management industry. The issuance of the FSOC Notice and Governor Tarullo's remarks appear to indicate that the FSOC may be headed toward seeking an increasing level of prudential-type regulation of the asset management industry.

Based on the prior FSOC actions under Section 120, the FSOC could issue proposed formal recommendations with respect to prudential market regulation of asset managers after it reviews the industry responses to the FSOC Notice. It appears that the FSOC would be more likely to do so if the SEC rule changes that result from the SEC Initiatives do not address all of the systemic risk concerns the FSOC identifies. Whether or not FSOC initiates such formal action, it appears likely the FSOC will focus on the SEC's regulation of the asset management industry going forward.

II. Enhanced Data Reporting Initiative

The first SEC Initiative Chair White discussed in her December 2014 remarks was enhanced data gathering on asset management activities. She noted that data gathering has risen on the SEC's agenda in response to a perception that, while "funds and advisers currently report significant information about their portfolios and operations to the Commission, these reporting obligations have not, in my view, adequately kept pace with emerging products and strategies being used in the asset management industry." Chair White noted that the information gathered under this SEC Initiative would enable the SEC to better assess risks relating to the asset management industry and develop appropriate regulation to target those risks.

Chair White indicated that the SEC will expand data collection by:

- Updating the basic reported general census data about asset managers to allow the SEC to "better monitor industry developments and potential compliance issues."

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[11] *See* Financial Stability Oversight Council, Proposed Recommendations Regarding Money Market Mutual Fund Reform, 77 Fed. Reg. 69455 (Nov. 19, 2012).

[12] *See* Treasury Statement, *supra* note 7.

- Gathering more detailed information on portfolio holdings, particularly with respect to derivatives, liquidity and valuation, as well as information on securities lending practices.

- Gathering information on separately managed accounts, a major component of many asset managers' businesses.

It appears that this SEC Initiative may be proposed in at least two separate components. The SEC's Fall 2014 regulatory agenda includes potential rulemakings to update and expand reporting on Form N-SAR and N-Q. The regulatory agenda also notes that updates to Form ADV are being considered to collect additional information on investment advisers relating to separately managed accounts. Disclosure regarding fund use of derivatives likely will be covered under the leverage and derivatives-related SEC Initiative.

It is expected that any information about the asset management industry obtained though these new data gathering initiatives would be analyzed and used to inform ongoing rulemakings and identify new risk areas in the asset management industry. This would be consistent with the collection and use of data by the SEC's Risk and Examinations Office ("REO").[13] The REO analysis has been used by the SEC Staff "to inform policy and rulemaking initiatives with regard to private funds."[14] As an example, the REO has been instrumental in analyzing the data reported on Form PF, including the production of reports on general census data and market segments.[15]

To the extent that new reporting requirements are introduced for asset managers, the question remains whether these requirements will be harmonized with other global reporting requirements. For example, the SEC's Form PF has a significant overlap with the information gathered under the European Union Alternative Investment Fund Managers Directive.[16] Although both forms are aimed at assessing systemic risk posed by private funds, the prompts and information required to be reported have not been harmonized.

The FSOC has also highlighted the importance of the "availability of high-quality data and information" in assessing the potential impact of the asset management industry on widespread

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[13] Division of Investment Management Homepage, *available at* http://www.sec.gov/divisions/investment/investment_about.shtml#.VPNJH60tAUQ. Created under the Dodd-Frank requirement to build a Staff of examiners in the Division, REO's mission includes quantitative analysis of investment management industry data. The REO's primary mission has been performing this analysis for use in examinations; however, the REO's data analysis expertise may also be leveraged to form the basis of future rulemaking. Part of the REO's mandate is "gathering and analyzing operational information directly from participants in the asset management industry, including in particular the risk-taking activities of investment advisers and investment companies."

[14] Securities and Exchange Commission, "Private Fund Annual Report" (Aug. 18, 2014), *available at* http://www.sec.gov/reportspubs/special-studies/im-private-fund-annual-report-081514.pdf.

[15] *Id.*

[16] *See generally* Dechert LLP, "The AIFM Directive Regulatory Reporting Template, and its Comparison to SEC Form PF," (March 2013), *available at* http://sites.edechert.com/10/1102/uploads/fs-aifmd-final.pdf.

financial stability. In this regard, the FSOC Notice states that a core component of the FSOC review of the asset management industry "is an evaluation of the extent to which sufficient data are available to monitor and assess potential risks in the asset management industry and whether there are areas where additional data and information would be helpful to [the FSOC], as well as to market participants."

III. Liquidity and Derivatives Initiative

The second SEC Initiative Chair White discussed in her December 2014 remarks would require funds to have controls in place to more effectively identify and manage the risks related to the composition of their portfolios, including liquidity management and the use of derivatives by funds and ETFs, which represent "two key areas of focus by the staff." Chair White noted that inadequate controls in those areas can:

- Create significant risks for funds and investors; and
- Raise "questions about whether there could be a potential impact on the financial system as a whole."

Chair White stated that the SEC staff is considering "whether broad risk management programs should be required for mutual funds and ETFs to address the risks related to their liquidity and derivatives use," and measures to provide for SEC oversight of those programs. In addition, she indicated that the staff is considering specific requirements, including updated liquidity standards, disclosures of liquidity risks, and measures to appropriately limit the leverage created by a fund's use of derivatives. She noted that these types of changes would protect investors, provide better transparency about liquidity risks, and "mitigate any broader market implications were funds forced to sell assets precipitously to meet redemptions."

A. Liquidity

Currently, the SEC takes the position that mutual funds may not invest more than 15% of net assets in illiquid securities (5% for money market funds).[17] An illiquid security is defined under SEC guidance as one that cannot be disposed of within seven days at approximately the same value at which the fund valued the instrument.

In discussing this SEC Initiative's focus on liquidity in her December 2014 remarks, Chair White noted that a fund that does not manage liquidity risk "could have difficulty meeting redemptions if it came under stress." She noted this is a particularly important issue for open-end investment companies. She also acknowledged that stress caused by increased redemptions during such periods could "potentially have spillover effects in the markets in which those funds invest."

It is notable that this SEC Initiative will be crafted in the context of the SEC's review of the results of a "sweep" examination that reviewed "liquid alternative funds" (i.e., retail funds that are managed using alternative or non-traditional strategies), an exam initiative that the SEC began

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[17] Section 22(e) of the 1940 Act requires that open-end registered funds provide proceeds to shareholders within seven days of redemption.

in August 2014.[18] The SEC staff is closely reviewing matters related to liquidity and leverage in the context of the sweep exam.[19]

In addition, the FSOC Notice highlighted a number of potential questions the FSOC is exploring with respect to liquidity risk that are relevant to open-end registered funds, including:

- ***The Impact of Fund Liquidity and Shareholder Incentives to Redeem.*** The FSOC is exploring "whether investments through pooled investment vehicles that provide redemption rights, and their management of liquidity risks and redemptions, could potentially influence investor behavior in a way that could affect financial stability differently than direct investment." The FSOC Notice indicates that the FSOC is particularly interested in the way liquidity management could magnify shareholders' incentives to redeem during periods of market stress, and "whether such redemption incentives could make fire sales more likely in asset markets in which funds invest, as well as in correlated or broader asset markets."

- ***The Impact of Redemptions Triggered by Termination of Securities Loans.*** The FSOC is exploring whether redemption incentives associated with pooled investment vehicles in which lenders invest securities lending cash collateral could increase during times of market stress and result in potential broader market impacts.

- ***Investor and Competitive Pressure to Invest in Less Liquid Assets; Risk Management Practices.*** The FSOC Notice suggests that "pressures to increase returns and outperform benchmarks may provide disincentives to holding cash or highly-liquid assets," and requests input on whether risk management practices of asset managers "sufficiently account for the possibility of simultaneous asset sales by multiple investors or the likelihood of significantly larger price effects in times of stress."

B. Derivatives and Leverage

Section 18(f) of the 1940 Act limits the ability of a registered fund to borrow or engage in "senior securities" transactions that leverage its portfolio. While a "senior security" is defined as "any bond, debenture, note, or similar obligation or investment constituting a security and evidencing indebtedness" as well as "any stock of a class having priority over any other class as to the distribution of assets and payments of dividends," the SEC has broadly interpreted Section 18(f) to apply to any transaction that exposes a fund's shareholders to "leverage," such as short sales,

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18 "SEC Launches Examination of Alternative Mutual Funds," WALL ST. J., Aug. 12, 2014. In connection with the launch of the sweep exam, the SEC staff member leading the SEC's investment adviser and investment company exam program stated that the exam staff would initially review around 30 firms by April 2015 and may cover more firms thereafter if necessary.

19 The SEC staff has stated that it would review these funds with a "particular focus" on: (i) leverage, liquidity and valuation policies and practices; (ii) factors relevant to the adequacy of the funds' internal controls, including staffing, funding and empowerment of boards, compliance personnel and back-offices; and (iii) the manner in which such funds are marketed to investors. "Examination Priorities for 2015," National Exam Program, Office of Compliance Inspections and Examinations, SEC (Jan. 13, 2015).

reverse repurchase agreements and derivative transactions (e.g., swaps, futures and written security and commodity options).

The SEC and its staff have provided guidance that a fund can avoid the issuance of senior securities when engaging in transactions involving leverage by:

- Segregating on the books of its custodian or designating on the fund's records certain amounts of liquid assets; or
- Entering into an offsetting transaction.

The "cover" amount must at all times be sufficient to meet the fund's potential obligations under the transaction (i.e., by "covering" the leverage exposure created by the transaction). This practice is meant to ensure that the fund always has liquid assets sufficient to meet its future obligations as well as to place a practical limit on the ability to leverage fund assets. Alternatively, a fund may treat the leveraged transaction as a borrowing. The amount of cover required will depend on the particular derivative instrument used.

In addition, a host of other compliance issues arising under the 1940 Act and the rules thereunder must be considered when funds engage in derivatives transactions. For example:

- Whether to treat over-the-counter ("OTC") derivative instruments, such as swaps, as illiquid; and
- The appropriate methods to calculate derivative counterparty exposure for purposes of Section 12(d)(3) of the 1940 Act and exposure to reference assets underlying derivative contracts for purposes of the concentration and diversification limitations in Section 8 of the 1940 Act.[20]

Chair White stated in her December 2014 remarks that derivatives "can pose a separate set of risks" and noted that funds are using derivatives in "increasingly complex ways." She acknowledged that funds often use derivatives for risk management or to efficiently adjust investment exposure, but stated that derivatives "also frequently result in leveraged investment exposures and potential future obligations that can create risks for the funds." Chair White also noted that "a more comprehensive approach is required to address the risks associated with the increasingly diverse nature of fund holdings and the use of derivatives," which appears to indicate that the derivatives rulemaking will go far beyond the subject of leverage.

At the same time, Chair White highlighted the fact that the SEC staff's work in respect of the derivatives-related rulemaking will be informed by the results of the prior work of the Division staff and the National Exam Program. In this regard, this rulemaking revives a 2011 SEC request for comments relating to the use of derivatives by registered investment companies ("Derivatives Concept Release").[21] The Derivatives Concept Release highlighted questions for industry

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[20] Section 12(d)(3) and related SEC rules govern funds' exposure to securities-related issuers, while Section 8 contains disclosure requirements related to portfolio concentration and diversification.

[21] Use of Derivatives by Investment Companies under the Investment Company Act of 1940, Investment Company Act Release No. 29776, 76 Fed. Reg. 55,237 (Aug. 31, 2011).

consideration and input relating to leverage, diversification, concentration, exposure to securities-related issues, and valuation of derivatives, in addition to requesting general comments on any related issues.

Finally, the FSOC Notice also identifies potential risks posed by asset managers' use of derivatives and other leverage transactions, stating that "high degrees of leverage can present risks to investment vehicles by magnifying the impact of asset price or rate movements," although the use of derivatives and related risks can "vary significantly" depending on the type of vehicle and type of investment strategy. The FSOC Notice highlights a number of potential questions the FSOC is exploring with respect to leverage risk that are relevant to open-end registered funds, including requesting, among other information:

- A description of how derivatives are used to obtain leveraged exposure (as opposed to how derivatives are used to hedge risks related to other investment positions);

- Information on stress testing of appropriate leverage amounts for an investment strategy and assessment of "potential interconnectedness of counterparties;"

- Typical risk management practices, such as tools and models or hedging strategies, evaluation of risk of margin call, and whether any risk management practices concerning the use of leverage could amplify risks; and

- A discussion of the best metrics that can be used to assess the degree and risks of leverage in investment vehicles and what data or information would be useful to help regulators and market participants better monitor risks arising from the use of leverage.

C. Potential SEC Liquidity and Derivatives Rulemaking

As noted above, the SEC's regulatory agenda states that the proposals would entail:

- "A new rule requiring open-end funds to adopt and implement liquidity management programs and that the Commission provide enhanced guidance relating to required liquid assets in open-end funds;" and

- New rules under the 1940 Act addressing the use of derivatives by funds and related matters, including disclosure of fund use of derivatives.

There has been no further public indication of what the substantive changes to the SEC's liquidity and derivatives regimes will entail. However, it is likely that the SEC's rulemaking process will be informed by the issues identified by the SEC exam staff relating to liquidity and leverage in the context of the sweep exam of liquid alternative funds. The SEC likely will also consider the concerns raised by, and feedback provided to, the FSOC with respect to the FSOC Notice.

For the derivatives-related rulemaking, it appears that the SEC staff will also build on the work that has already been done by the SEC and SEC staff relating to the Derivatives Concept Release and likely will revisit the public comments the SEC received in response to the Derivatives Concept Release. However, it remains to be seen what parts of the rulemaking relating to

derivatives will be proposed as part of a principles- and risk management-based regime rather than as new and different substantive limits for funds that engage in derivatives and other complex transactions.

IV. Transition Planning and Stress Testing Initiative

The final priority enumerated in the December 2014 remarks was transition planning and stress testing for asset managers. Chair White noted that these measures are key to assessing the potential impact of "market stress events" or when asset managers fail.

As Chair White noted, "advisers routinely exit the market without significant market impact." However, she noted that transition planning will bolster advisers' ability to effect a smooth transition during times of market stress or other severe disruptions to an adviser's business. Much of the focus for transition planning relates to liquidity (as discussed in Section III.A), namely, how advisers would handle large redemptions during periods of market stress.[22]

In addition to transition planning, the SEC expects to implement annual stress testing by "large investment advisers and large funds." Chair White indicated that the SEC will draw on lessons learned through its review of money market funds. Once implemented, the results of stress tests would be publicly disclosed.[23]

As with data gathering and risk assessment, these systemic risk initiatives come amid pressure from the FSOC and the Fed to implement "macroprudential" regulation.[24] While transition planning and stress testing are clearly the current SEC Initiatives that are most analogous to bank-style prudential regulation, Chair White emphasized that both of the initiatives would be tailored to fit the investment management industry.[25] In addition she noted that any requirements would have to be keyed to "different types of firms" in the industry.[26]

As with the other SEC Initiatives, there are very few public details on how the SEC will implement the stress testing and transition planning SEC Initiative, including the consequences for failing a stress test.[27]

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[22] "Gauging Funds' Emergency Preparedness," NEW YORK TIMES, Jan. 9, 2015.

[23] "SEC Chief Calls for Stress Testing of Mutual Funds and Other Asset Managers," WALL ST. J., Dec. 11, 2014.

[24] Governor Tarullo Remarks, *supra* note 10.

[25] December 2014 Remarks, *supra* note 3.

[26] *Id.*

[27] "SEC Chief Calls for Stress Testing of Mutual Funds and Other Asset Managers," WALL ST. J., Dec. 11, 2014.