ICI Mutual Funds Conference Outlines the SEC's 2016 Agenda

Overview

The Investment Company Institute's annual Mutual Funds and Investment Management Conference heralded springtime and a fresh approach to the regulation of registered funds. During the panel sessions held on March 14-16, 2016, staff of the Securities and Exchange Commission (SEC), outside counsel and industry participants discussed a variety of topics, focusing on three recent regulatory developments and several initiatives to come. The overarching theme was whether, and how, those interlinked topics might be addressed holistically.

- Key regulatory developments for registered funds include proposed rules governing liquidity risk management, derivatives and reporting.
- Forthcoming initiatives include distribution matters, stress testing and broadened fiduciary standards.

These topics are discussed, in turn, below. Any remarks from SEC personnel reflect their own views and not the views of the SEC, its commissioners or other staff members.

LIQUIDITY

A registered open-end investment company, including any exchange-traded fund (ETF), is ordinarily required to limit its illiquid assets to 15% of its portfolio. In light of recent growth in the size of the fund industry and the increasing complexity of fund strategies, the SEC has proposed[1] to codify and supplement this restriction with an additional regulatory regime for open-end funds, including ETFs, that would call for the following:

- Public fund disclosures that classify, in six categories, the liquidity of portfolio assets based on the amount of time an asset would be able to be converted to cash without a market impact;
- The adoption of fund-level programs for the assessment, periodic review and management of liquidity risk;
- The establishment of three-day liquid asset minimums for each fund;
- The optional adoption of policies for "swing pricing," which is a process of adjusting the net asset value of a fund's shares in order to pass on to purchasing or redeeming shareholders more of the costs associated with their trading activity; and
- Board approval and review.

During his keynote remarks,[2] David W. Grim, the Director of the SEC's Division of Investment Management (the IM Division), began by discussing the liquidity risk management proposal. He noted that there were almost 80 comment letters; many commenters supported the proposal because liquidity risk management is a foundation of sound risk management, while other commenters suggested modifications. Of particular note, Mr. Grim suggested that some investment strategies currently in use by mutual funds (that is, open-end investment companies) may be inappropriate for those funds and instead may be better suited for closed-end investment companies or private funds that do not entitle investors to daily redemptions of their investments. (During her keynote speech at a Mutual Fund Directors Forum policy conference shortly thereafter, SEC Chair Mary Jo White emphasized the same point.[3])

In a later panel discussion, Diane C. Blizzard, the IM Division's Associate Director for Rulemaking, described the industry's current liquidity guidance as outdated and inadequate, and characterized the proposed liquidity risk management rulemaking as part of a general modernization that also includes some of the topics noted below. Some panelists expressed concern at the significant role of a fund board under the proposal, including in making technical decisions about the implementation of swing pricing. Others, during this panel and at a separate panel dedicated to the proposal, urged the SEC to consider alternatives to the six categories of liquidity. SEC staff panelists seemed to signal a willingness to consider such alternatives for the final rule but did not commit to a particular outcome.

In response to a panelist's urging that this liquidity rulemaking and some of the rules described below be consolidated into a single cohesive whole, Ms. Blizzard remarked on the challenges to that approach but also highlighted the overlap among certain drafters of the rules as evidence of such coordination.[4]

DERIVATIVES

The SEC has proposed rulemaking[5] that would amend, and in some instances upend, the requirements applicable to registered funds' use of derivatives. Unlike the liquidity proposal, the derivatives proposal would affect not just open-end funds but also registered closed-end funds and business development companies. The proposed rule would do the following:

- Limit a fund's use of derivatives by requiring compliance with one of two alternative portfolio limitations designed to limit the amount of leverage the fund may obtain through derivatives and certain other transactions; and
- Require a fund to put risk management measures in place, including:
  - To segregate certain assets in an amount designed to enable the fund to meet its obligations, including under stressed conditions;
  - To cover obligations under certain transactions, such as reverse repurchase agreements and short sales, by segregating certain assets; and
  - For a fund with more than 50% of its net assets exposed to derivatives transactions or that uses complex derivatives, to:
    - Establish a formalized derivatives risk management program;

- Designate a derivatives risk manager; and
- Submit the program and risk manager for fund board approval and ongoing review.

Although Mr. Grim in his keynote speech did not discuss the derivatives proposal in detail, other than to discuss the IM Division's receipt of public comments, Ms. Blizzard during her panel discussion explained that the derivatives proposal is not aimed at de-risking funds but, rather, is intended to ensure that risk is understood, managed and controlled in a manner consistent with the regulations. In response to a comment from another panelist on the additional burdens placed on a fund board, such as the board's proposed new duty to approve a derivatives risk officer and changes to a fund's derivatives risk management program, she noted that boards would be authorized to delegate many of their new responsibilities to the derivatives risk officer that they would designate.

During a separate panel dedicated to the topic of derivatives, Danforth Townley, Attorney Fellow at the SEC, noted that the policy considerations that almost four decades ago resulted in Investment Company Act Release No. 10666[6] remain the foundation for the current derivatives proposal. He described the proposal as limiting certain conduct that the SEC staff views as being at odds with the guidance in Release No. 10666 and the line of no-action letters that followed it, while liberalizing some other aspects.

The industry's focus on existing and new derivatives regulation was further demonstrated by the scheduling of a roundtable hosted by Timothy G. Massad, Chairman of the Commodity Futures Trading Commission, a chief federal regulator of derivatives.[7]

REPORTING

A third effort toward modernizing investment company regulation is a proposal[8] to enhance the reporting and disclosure of information by investment companies and investment advisers. Form N-PORT would be a new monthly portfolio reporting form that would require new disclosures including pricing data, terms of derivatives contracts, and discrete portfolio level and position level risk measures, among other data. Form N-CEN would replace the outdated Form N-SAR and call for certain census-type information. Additional disclosures would be required in fund financial statements and shareholder reports, including information about securities lending and derivatives.

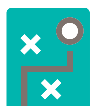
A much-discussed topic was how shareholder reports might be provided on fund websites without incurring unforeseen fees while continuing to entitle shareholders to opt to receive hard copies by mail.

Despite acknowledging the benefits of modernizing reporting by registered funds, several panelists noted the administrative burdens and costs of compiling and submitting the voluminous data contemplated by the reporting proposal. Several panelists also expressed fears that industry-wide confidential portfolio and trading data housed at the SEC might be accessed by computer hackers. During the conference's final session, SEC Chief of Staff Andrew J. "Buddy" Donohue acknowledged the importance of maintaining data securely and expressed confidence that the SEC would not begin accepting new industry data unless its security was ensured to the greatest extent possible.

DISTRIBUTION MATTERS

The use of fund assets to pay for the distribution of shares to investors is subject to considerable regulation, particularly under Rule 12b-1 under the Investment Company Act.[9] The SEC staff has long been watchful of the potential for fund relationships with financial intermediaries to result in fund assets being indirectly used outside of a board-adopted Rule 12b-1 plan to cover distribution costs. In this regard, a number of conference panels discussed recent guidance[10] from the staff of the IM Division and the SEC's "distribution in guise" examination initiatives. The guidance was adopted without the benefit of public comment or other administrative procedure, and it is generally couched as staff recommendations and considerations that a fund board may wish to take into account. Nevertheless, some industry participants noted that the SEC exam staff seems to view the guidance as establishing mandatory requirements. During a panel on examinations and enforcement, Marc Wyatt, Director of the SEC's Office of Compliance Inspections and Examinations, confirmed that the exam staff is indeed scrutinizing compliance with the guidance.

During a separate panel discussion, Ms. Blizzard emphasized that a board's consideration of distribution matters should include a 360-degree view of all distribution and nondistribution payments to intermediaries and service providers, and remarked that, despite the potential for grey areas, a robust process can eliminate second-guessing from the SEC. Ms. Blizzard considered a complaint that broker-dealers often do not provide funds with transparency into their omnibus relationships and the nature and quality of their interactions with customers. Such barriers to information can prevent a fund from being certain about the extent to which the intermediaries provide distribution or nondistribution services and whether those services must be paid for by Rule 12b-1 fees or may be paid for with sub-accounting fees paid outside of a Rule 12b-1 plan. In response, Ms. Blizzard expressed her understanding that some broker-dealers would offer the information but that some funds do not request it.



TRANSITION PLANS, STRESS TESTING AND OTHER TOPICS

In addition to the foregoing, Mr. Grim identified the following as important parts of the IM Division's current agenda:

- Developing proposed rules that would require registered investment advisers to create and implement transition plans;
- Developing new requirements for stress testing by large investment advisers and investment companies;
- Reviewing risk disclosures in light of market developments that may be material to investors' investment decisions;[11] and
- Urging the industry to consider appropriate initial and ongoing due diligence of third-party service providers, including by focusing on business continuity and disaster recovery protocols of those service providers as well as fund firms themselves.

Mr. Grim, Mr. Wyatt and others emphasized the need for fund firms to vigilantly monitor cybersecurity issues pertaining to their systems as well as the systems of service providers.

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Andrew Ceresney, the SEC's Director of Enforcement, devoted part of the examination and enforcement panel discussion to the following topics of:

- *Whistleblowing.* Mr. Ceresney emphasized that a firm's personnel must not be prevented (such as by their employment contract, confidentiality agreements or severance arrangements) from whistleblowing or otherwise discussing regulatory issues with the SEC staff.
- *Cooperation.* The panelists noted that the SEC staff may provide credit for cooperating with enforcement inquiries, but that credit is not guaranteed.
- *Self-Reporting.* Mr. Ceresney remarked that the Division of Enforcement views self-reporting as valuable, and the failure to self-report a known issue may have consequences.
- *Remediation.* Panelists discussed whether a comprehensive plan for remediation should be in place before a firm self-reports to the SEC.

Finally, the SEC's development of a uniform fiduciary standard was not a centerpiece of SEC staff presentations during the conference. However, U.S. Department of Labor (DOL) regulations reforming the fiduciary duty and related standards applicable to many asset managers were a subject of discussion among some panelists. The long-awaited final DOL regulations were issued on April 8, 2016, shortly after the conference ended.[12] The industry's response to the new rules will be forthcoming and is anticipated to be a topic of interest at next year's conference.

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ENDNOTES

[1] Open-End Fund Liquidity Risk Management Programs; Swing Pricing; Re-Opening of Comment Period for Investment Company Reporting Modernization Release, Investment Company Act Release No. 31835 (Sept. 22, 2015), https://www.sec.gov/rules/proposed/2015/33-9922.pdf.

[2] David W. Grim, Director, Division of Investment Management, SEC, Remarks to the Investment Company Institute's 2016 Mutual Funds and Investment Management Conference (Mar. 14, 2016), https://www.sec.gov/news/speech/david-grim-remarks-to-ici-2016-mutual-funds-and-invest-mgmt-conf.html.

[3] Mary Jo White, Chair, SEC, The Fund Director in 2016: Keynote Address at the Mutual Fund Directors Forum 2016 Policy Conference (Mar. 29, 2016), https://www.sec.gov/news/speech/chair-white-mutual-fund-directors-forum-3-29-16.html ("advisers and fund boards should carefully consider whether an open-end fund's investments and investment strategy are appropriate for a fund offering daily redemptions").

[4] For information about other developments concerning fund liquidity, please see our blog postings at: https://www.assetmanagementadvocate.com/?s=liquid.

[5] Use of Derivatives by Registered Investment Companies and Business Development Companies, Investment Company Act Release No. 31933 (Dec. 11, 2015), https://www.sec.gov/rules/proposed/2015/ic-31933.pdf.

[6] Securities Trading Practices of Registered Investment Companies, Investment Company Act Release No. 10666 (Apr. 18, 1979) ("Release No. 10666"), https://www.sec.gov/divisions/investment/imseniorsecurities/ic-10666.pdf.

[7] For information about other derivatives-related developments, please see our blog postings at: https://www.derivativesandreporeport.com.

[8] Investment Company Reporting Modernization, Investment Company Act Release No. 31610 (May 20, 2015), https://www.sec.gov/rules/proposed/2015/33-9776.pdf.

[9] Please also see our blog postings concerning distribution-related matters at: https://www.assetmanagementadvocate.com/category/distribution/.

[10] *See* Mutual Fund Distribution and Sub-Accounting Fees, IM Guidance Update No. 2016-01 (Jan. 2016), https://www.sec.gov/investment/im-guidance-2016-01.pdf.

[11] *See* Fund Disclosure Reflecting Risks Related to Current Market Conditions, IM Guidance Update No. 2016-02 (Mar. 2016), https://www.sec.gov/investment/im-guidance-2016-02.pdf.

[12] *See* https://www.federalregister.gov/agencies/employee-benefits-security-administration (seven April 2016 publications).

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