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December 12, 2014

SEC Chair White Speech on Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry

[28576]

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TO: ACCOUNTING/TREASURERS MEMBERS No. 18-14
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SEC RULES MEMBERS No. 48-14
SMALL FUNDS MEMBERS No. 26-14
UNIT INVESTMENT TRUST MEMBERS No. 9-14 RE: SEC CHAIR WHITE SPEECH ON ENHANCING RISK MONITORING AND REGULATORY SAFEGUARDS FOR THE ASSET MANAGEMENT INDUSTRY

In a December 11 speech, Securities and Exchange Commission Chair Mary Jo White discussed the SEC's regulation of the asset management industry and how the SEC plans to enhance and strengthen its response to the regulatory issues the industry presents. [1] In addition to describing current and upcoming SEC asset management initiatives, Chair White commented on the SEC's role in addressing systemic risk and on the important balance the Commission seeks to strike in regulating the asset management industry.

Chair White began with a brief overview of the asset management industry and its evolution since 1940. She commented that the Investment Company Act and Investment Advisers Act "establish a comprehensive federal regulatory framework that addresses a wide range of activities and focuses on many complex areas of regulation." Chair White next described the three "most significant tools" these statutes provide: (1) controls on conflicts of interest; (2) a registration, reporting and disclosure regime; and (3) controls on fund portfolio composition risks and operational risks. [2] The bulk of her speech focused primarily on the third category.

Chair White discussed how the governing statutes and recent regulatory actions address portfolio composition risks and operational risks but acknowledged that “there is still work to be done.” She described three core initiatives the staff is working on for this purpose: first, enhancing data reporting; second, enhancing controls on risks related to portfolio composition; and third, improving transition planning and stress testing.

Regarding data reporting, Chair White expressed her view that while funds and advisers currently report significant information to the Commission, reporting obligations have not kept pace with emerging asset management products and strategies. She said that the staff is developing recommendations to enhance and modernize data reporting, including “basic census information.” Other specific areas of attention include the reporting and disclosure of fund investments in derivatives, the liquidity and valuation of fund holdings, and funds’ securities lending practices. Chair White also mentioned that collecting more data on separately managed accounts would help inform the SEC’s examination priorities and the assessment of the risks associated with those accounts.

Turning to controls on risks related to portfolio composition, Chair White highlighted liquidity management and the use of derivatives in mutual funds and exchange-traded funds as two key areas of staff focus. She observed that “[i]nadequate controls in those areas can create significant risks for funds themselves and their investors, as well as raising questions about whether there could be a potential impact on the financial system as a whole.” Chair White indicated that the staff is considering whether mutual funds and ETFs should be required to have broad risk management programs to address the risks related to their liquidity and derivatives use. Also under consideration are “updated liquidity standards, disclosures of liquidity risks, or measures to appropriately limit the leverage created by a fund’s use of derivatives.”

With regard to transition planning and stress testing, Chair White stated that the SEC is focusing on the impact on investors of a market stress event or when an investment adviser is no longer able to serve its clients. She pointed out that “the risks associated with winding down an investment adviser are different than those associated with other kinds of financial firms,” noting that client assets do not belong to the adviser and that advisers routinely exit the market without significant market impact. She added that these exits nevertheless do involve challenges and said that the staff is developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their businesses. In addition, the staff is considering ways to implement the Dodd-Frank Act requirements for annual stress testing by large investment advisers and large funds. Commenting that stress testing is an important tool routinely used by bank regulators, Chair White said that the staff, building on lessons learned through money market fund reform, is evaluating what protocols would be appropriate for investment advisers and investment companies. She emphasized that “[a]s with transition planning, the staff is considering how to tailor these requirements for asset management, as well as for different types of firms.”

Chair White then took the opportunity to reflect on the SEC’s role in addressing systemic risk. She observed that one of the most fundamental post-crisis changes for all financial regulators has been “an emphasis on addressing risks that could have a systemic impact on the securities markets or the financial system as a whole.” She expressed the view that this renewed emphasis complements the SEC’s historic three-part mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation. She said that the SEC initiatives described above will necessarily have a broader impact on the financial system. She also commented that “[t]ruly tackling systemic risk . . . demands a broader program than one agency can execute.” She described the Financial Stability Oversight Council as “an important forum for studying and identifying systemic risks across different markets and market participants,” while underscoring that the SEC’s market perspective is an essential component of FSOC’s efforts. In Chair White’s view, FSOC’s current review of the potential risks asset managers pose to the stability of the U.S. financial system is “a complement” to the work the SEC is now undertaking.

In closing, Chair White spoke of the need for the SEC to “continue to focus on assessing the activities of the asset management industry as it evolves, ensuring that we are addressing the risks of modern portfolio composition and operations, and anticipating and planning for the worst.” She stressed that the SEC’s objective is not to eliminate all risk—calling the investment risk inherent in capital markets “the engine that gives life to new companies and provides opportunities for investors.” Instead, she said, “just as our regulatory program evolves, so too must our understanding of the balance that program strikes between reducing undue risks and preserving the principle of ‘reward for risk’ that is at the center of our capital markets.”

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endnotes

[1] Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry, Speech by SEC Chair Mary Jo White at The New York Times Dealbook Opportunities for Tomorrow Conference, New York, NY (Dec. 11, 2014), available at http://www.sec.gov/News/Speech/Detail/Speech/1370543677722#.VIoGhTHF884.

[2] Chair White defined “portfolio composition risk” as “the risk related to the mix of a funds’ investments and the impact that mix, including the interaction of particular financial instruments, can have on a fund,” including the risks associated with the liquidity and leverage of a fund’s holdings. She used the term “operational risk” generally to mean “risk from inadequate or failed internal processes and systems.”