MEMO# 30930

October 30, 2017

Treasury Issues Report on Asset Management and Insurance, the Third Report in a Series on Financial Regulatory Reform

[30930]

October 30, 2017 TO: ICI Members
Investment Company Directors
ICI Global Members SUBJECTS: Closed-End Funds
Compliance
Cybersecurity
Derivatives
Disclosure
Distribution
Exchange-Traded Funds (ETFs)
Fund Accounting & Financial Reporting
Fund Governance
International/Global
Investment Advisers
Money Market Funds
Operations
Pension
Portfolio Oversight
Recordkeeping
Risk Oversight
State Issues
Systemic Risk
Transfer Agency RE: Treasury Issues Report on Asset Management and Insurance, the Third Report in a Series on Financial Regulatory Reform

The Treasury Department recently issued a report entitled *A Financial System That Creates Economic Opportunities: Asset Management and Insurance* (Report).[1] This is the third of four reports in response to Executive Order 13772, which identifies several "Core Principles" intended to guide financial regulation by the Trump Administration.[2] ICI and many members provided input to Treasury on issues of concern for the asset management industry during the engagement process for the Report. This memorandum focuses on the

Report’s discussion and recommendations relating to asset management.

The Report begins with an overview of the US asset management industry that includes a description of industry trends and the outlook for the industry. It highlights: a shift by investors from actively managed funds to passively managed funds;[3] the growth of exchange-traded funds (ETFs); declines in the average expense ratios for stock and bond funds over the past 20 years;[4] and the continued pressure on margins from implementing compliance regimes under the current regulatory framework (with a disproportionate effect on smaller managers). In describing the industry’s regulatory structure, the Report makes several important statements (and includes supporting data) in line with ICI’s views and research findings, including:

- The performance of the asset management industry during periods of financial stress demonstrates that the types of industry-wide “runs” that occur in the banking industry during a systemic crisis have not materialized in the asset management industry outside of money market mutual funds.[5]
- One feature that distinguishes the asset management industry is the ease by which funds are formed and terminated, without any disruption to the financial markets.
- When disruptive events occur in the asset management industry, significant redemption at individual funds or fund complexes have not led to material market dislocations or longer term systemic consequences to the economy.
- Although total assets under management continue to rise across the industry, so do costs—and one of the most important drivers of these rising costs is the cost of complying with an increased regulatory burden since the financial crisis.[6]

The Report identifies “significant opportunities for reform consistent with the Core Principles.” Recommendations for reforms relating to asset management are presented in the following 11 categories: (1) systemic risk and stress testing; (2) liquidity risk management; (3) derivatives; (4) exchange traded funds; (5) business continuity and transition planning; (6) dual CFTC and SEC registration; (7) modernizing the delivery of fund disclosures; (8) asset management reporting and disclosure requirements; (9) Volcker Rule; (10) international engagement; and (11) economic growth and informed choices.[7] Most of the recommendations are for regulatory, rather than legislative, action.

Systemic Risk and Stress Testing

The Report provides background information on the evaluation of systemic risk as it pertains to the asset management industry in the wake of the financial crisis. It mentions the September 2013 Office of Financial Research report, *Asset Management and Financial Stability*, and the Financial Stability Oversight Council (FSOC) review of the asset management industry—which it notes led to a focus on products and activities, rather than entity-specific evaluation. The Report highlights the “fundamental differences” between asset managers and prudentially regulated institutions such as banks. It states that to the extent systemic risks arise from the asset management industry, prudential regulation is unlikely to be the most effective regulatory approach for mitigating those risks. The Report describes several of the “long-established [mutual fund] regulations that reduce the risks that individual funds present to the broader financial system,” and points to new rules adopted since the financial crisis to further address risks in the asset management sector. Treasury makes the following recommendations:

- Treasury’s position is that entity-based systemic risk evaluations of asset managers or their funds are generally not the best approach for mitigating risks arising from asset management. Instead, primary federal regulators should focus on potential risks

arising from asset management products and activities, and on implementing regulations that strengthen the asset management industry as a whole.
- FSOC should maintain primary responsibility for identifying, evaluating, and addressing systemic risks in the US financial system, and the SEC should remain the primary federal regulator of the asset management industry in the United States.

The Report describes a provision of the Dodd-Frank Act requiring that "financial companies" with $10 billion or more in total consolidated assets conduct annual stress tests.[8] The Report notes that the SEC has not yet proposed a rule to implement this requirement for investment companies and investment advisers, and states that "[p]rudential stress testing for asset management raises significant implementation challenges." The Report also indicates that, where appropriate, the SEC has imposed regulations on mutual funds to address potential risks that funds might face as a result of stressed market conditions, and provides examples. The Report states that Treasury endorses the principle of appropriate risk management in the asset management industry, but does not support the Dodd-Frank Act's requirements for prudential stress testing of investment advisers and investment companies. Treasury's recommendations are as follows:

- Treasury supports legislative action to amend Dodd-Frank to eliminate the stress testing requirement for investment advisers and investment companies.
- In the alternative, Treasury supports the view that the stress testing provisions of Rule 2a-7 for money market mutual funds and Rule 22e-4 on liquidity risk management programs (discussed in the next section) satisfy the spirit of Dodd-Frank's stress testing requirements.[9]

Liquidity Risk Management

The Report describes the importance of liquidity risk management within the financial system generally, and policymakers' and regulators' focus on liquidity risk following the 2008 financial crisis. It then discusses current liquidity-related provisions that open-end funds follow (including a 15% limitation on investments in illiquid assets held by funds) and Investment Company Act Rule 22e-4, adopted by the SEC in 2016.[10] It opines that robust liquidity risk management programs are "imperative to effective fund management and the health of the financial markets," but also expresses concern that the new liquidity rule's bucketing methodology is "overly prescriptive" and "may not help funds improve their current liquidity risk management programs." Specifically, Treasury's recommendations are:

- Treasury supports the 15% limitation on illiquid assets.
- Treasury supports the SEC adopting a principles-based approach to liquidity risk management rulemaking and any associated bucketing requirements.
- The SEC should take appropriate action to postpone the currently scheduled December 2018 implementation of Rule 22e-4's bucketing requirement.[11]

Derivatives

The Report recognizes the importance of derivatives for funds (*e.g.*, as financial tools that can mitigate risk). It then briefly summarizes the current regulation of registered funds' use of derivatives under Section 18 of the Investment Company Act, related guidance, and SEC staff no-action letters, and proposed Rule 18f-4 under the Investment Company Act.[12] The Report characterizes the proposed rule as an "improvement from the current piecemeal approach," but expresses concerns about its portfolio limits (which could unnecessarily restrict funds' beneficial use of derivatives), reliance on gross notional exposure (which is problematic as a measure of risk), and restrictions on qualifying coverage assets (cash and cash equivalents only, which could lead to increased cash holdings potentially reducing returns or increasing tracking error). Accordingly, the Report makes the following recommendations:

- The SEC should consider a fund derivatives rule that would include a derivatives risk management program and an asset segregation requirement, but reconsider (i) what, if any, portfolio limits should be part of the rule,[13] and (ii) the scope of assets that would be considered qualifying coverage assets for purposes of the asset segregation requirement.
- The SEC should examine the derivatives data that funds will report starting next year and publish analysis based on empirical data regarding their use of derivatives.

Exchange Traded Funds

The Report acknowledges the growing market share of ETFs and the expanding diversity of product offerings. It observes that each ETF currently must obtain exemptive relief under a process that is "unpredictable, lengthy, and expensive." The Report discusses at some length the rule proposed by the SEC in 2008, which would have permitted new ETFs to operate without obtaining exemptive relief under specified conditions. That proposal was not finalized. The Report's recommendations are as follows:

- The SEC should move forward with a "plain vanilla" ETF rule that allows entrants to access the market without the cost and delay of obtaining exemptive relief orders, subject to conditions the SEC determines appropriate and in the public interest.[14]
- The SEC should consider establishing a single process for ETF and related approvals, rather than allowing SEC divisions to set multiple and sometimes conflicting requirements.

Business Continuity and Transition Planning

The Report discusses the importance of business continuity planning to funds and advisers, describes how it has evolved and improved over time, and outlines how the SEC and its staff have regulated (through guidance under Advisers Act Rule 206(4)-7 and Investment Company Act Rule 38a-1) and examined business continuity planning over the past fifteen years. With respect to transition planning, it notes that "transitioning accounts from one adviser to another is largely a streamlined process that may not even involve the legal transfer or sale of assets." The Report then describes the SEC's proposed Rule 206(4)-4 under the Advisers Act,[15] which would require registered investment advisers to adopt and implement written business continuity and transition plans. It notes the proposed rule's prescriptive requirements and anticipated costs, and makes the following recommendations:

- The SEC should withdraw its proposal on business continuity and transition planning because there is no compelling need for additional rulemaking in this area.
- The SEC and its staff should continue to work with investment companies, investment advisers, and other relevant parties to recommend improvements to business continuity plans (to the extent that such plans are determined not to be sufficiently robust), and to address new issues as they arise.

Dual CFTC and SEC Registration[16]

The Report discusses the CFTC's 2012 adoption of amendments that "narrowed the universe of SEC-registered investment companies and their advisers that could be exempt" from registration and regulation as commodity pool operators (CPOs). It explains that the CFTC acted in response to a petition filed by the National Futures Association (NFA), expressing concern that three SEC-registered investment companies were being marketed as "de facto" commodity pools, while at the same time claiming an exemption from CFTC regulation. The Report notes that although the CFTC cited the "de facto commodity pool" issue as a principal reason for its action, its expanded jurisdiction "now captures many funds that do not resemble, or compete with, traditional commodity pools." It then briefly describes the additional regulatory obligations applicable to "investment companies subject to dual registration and regulation by the SEC and CFTC." The Report recommends the following:

- The CFTC should amend its rules so that an investment company registered with the SEC and its adviser are exempt from dual registration and regulation by the CFTC as a CPO. To address concerns of de facto commodity pools operating without sufficient oversight, the CFTC and the SEC should work together to identify a single regulator for these entities, with the goal that oversight of these entities will either remain with the SEC or be transferred to the CFTC and NFA.
- The CFTC and the SEC should cooperate to share information provided by their respective regulated entities so that disclosures made to one agency can address the information needs of the other agency to monitor the markets for securities and derivatives transactions.

Modernizing the Delivery of Fund Disclosures

The Report discusses current fund disclosure requirements, including the regulatory default to provide disclosures in paper by mail absent consent for electronic delivery. It notes the significant expense of paper disclosures, which is paid out of fund assets, and states that these disclosures often are discarded by fund shareholders. The Report cites data indicating that Americans generally (and mutual fund-owning households in particular) have very high levels of Internet access. The Report describes the SEC's May 2015 proposal to permit mutual funds to transmit shareholder reports through a website (proposed Rule 30e-3 under the Investment Company Act), and highlights the potential benefits to investors of delivering fund information through electronic means. Treasury's recommendations are as follows:

- The SEC should finalize its proposed rule to modernize its shareholder report disclosure requirements and permit the use of implied consent for electronic disclosures.
- The SEC should explore other areas for which the delivery [of] information to investors through an electronic medium using implied consent is appropriate and consistent with investor protection; however, investors should retain the choice to continue to receive paper disclosures.

Asset Management Reporting and Disclosure Requirements

The Report notes that the asset management industry is subject to a significant number of reporting obligations (imposed at both the adviser level and the fund level), that these obligations come from a variety of sources, and that "immense data reporting requirements" have been added over the past few years. It observes that the efficient and effective collection of data is critical to the ability of financial regulators to oversee the financial markets, and that "[t]horough reporting of fund holdings and other key financial data is essential to a well-functioning financial system." At the same time, duplicative requirements "can add considerable burden and costs to funds that are passed on to investors" and can "artificially inflate costs." While acknowledging efforts by the SEC, CFTC and NFA to harmonize reporting obligations, the Report notes that industry participants are concerned about remaining differences in reporting with respect to definitional terms, methodologies and timing. The Report's recommendations are as follows:

- The SEC, the CFTC, SROs and other regulators should work together to rationalize and harmonize the reporting regimes. Where possible, duplicative forms should be combined and any unnecessary or inconsistent data collection should be eliminated.
- Regulators should continue to update reporting requirements to utilize structured data where appropriate.

In a text box following this section, the Report notes the harm that can come from inadequate protection of data by federal agencies and regulators. It further observes that the SEC has not fully implemented recommendations from the General Accountability Office (GAO) on protecting fund information and the systems/networks in which that data is administered. The Report makes the following recommendation:

- All regulatory agencies that collect any form of data from registered firms in the asset management industry should redouble efforts to ensure the information security measures are meeting and exceeding standards set by Congress and the recommendations of other federal oversight bodies such as the GAO.[17]

Volcker Rule

In its June 2017 report on banks and credit unions, Treasury discussed the Volcker Rule at length and recommended that it be substantially amended, including by modifying the covered fund provisions of the rule to decrease regulatory burden.[18] The Report briefly summarizes regulatory developments since June, including FSOC's consideration of potential improvements to the Volcker Rule and the OCC's request for public comment on potential changes to the Rule. It urges regulators to "take further action to reduce the burden of the Volcker Rule on asset managers and investors" and offers three recommendations. Of relevance to registered funds is the following recommendation:

- Congress should revise the definition of "banking entity" to encompass only insured depositary institutions, their holding companies, foreign banking organizations, and affiliates and subsidiaries of such entities that are at least 25% owned or otherwise controlled by such entities.

International Engagement

The Report states that US engagement in the Financial Stability Board (FSB) and international financial regulatory standard-setting bodies (SSBs) such as the International Organization of Securities Commissions (IOSCO) "remains important to promote financial stability, level the playing field for US financial institutions, and prevent unnecessary and overly burdensome regulatory standard-setting that could stifle financial innovation." Observing that the FSB has a wide mandate and at times "has gone beyond its core mission," the Report states that "Treasury's position is that the FSB's activities should be limited to its purpose of monitoring and enhancing global financial stability." The Report then chronicles the multilateral work on asset management over the last several years, including the two consultations on proposed methodologies to identify non-bank, non-insurer "global SIFIs" (G-SIFIs) and the FSB's recommendations to address perceived structural vulnerabilities from asset management activities, and comments on the international standard-setting process. It recommends the following:

- Further improvements should be made to FSB and SSB processes to better promote transparency, accountability, and appropriate representation with respect to policymaking.

- US representatives to FSB and IOSCO should review the processes used by each international SSB and work to ensure that they utilize a collaborative process that includes, where appropriate, economic analysis and subject matter expertise at the relevant SSB.
- The FSB should transition away from using the term “shadow banking” to describe registered investment companies and their investment advisers.
- The US members of the FSB should work to revise the G-SIFI framework so that it appropriately takes into account the differentiated ways that sectors are structured and manage risks.

Economic Growth and Informed Choices

This section of the Report begins by noting the sources from which standards of conduct for financial professionals are derived—SEC, Department of Labor (DOL), Financial Industry Regulatory Authority (FINRA), and state securities and insurance regulators. It describes the concept of “fiduciary” under the Employee Retirement Income Security Act and the DOL’s new fiduciary rule (Fiduciary Rule), and provides a procedural history of this rule. It also describes the regulation of investment advisers and broker-dealers under the federal securities laws (and for broker-dealers, FINRA requirements) and insurance agents under state law, and mentions SEC Chairman Clayton’s request for comments on the standard of care under the federal securities laws that should apply to investment advisers and broker-dealers serving retail investors (including retirement investors). The Report then offers Treasury’s perspective on these developments, and makes the following recommendations:

- Treasury supports the current efforts at the DOL to re-examine the implications of the Fiduciary Rule. Treasury believes it is appropriate to delay full implementation of the rule until the relevant issues (including costs of the rule and exemptions) are evaluated and addressed to best serve investors, and believes that such assessment and resolution of standard of conduct issues should include participation by the SEC and other regulators.
- Treasury believes that conflicts of interest should be addressed in a manner that preserves, to the extent possible, access to a wide range of asset classes, investment products, business models, distribution channels, and other relevant features of financial services that benefit American workers and their families.
- Within the federal regulatory framework, Treasury believes that the SEC and DOL should work together to address standards of conduct for financial professionals who provide investment advice to IRA and non-IRA accounts.
- Treasury recommends that the DOL and the SEC engage with state insurance regulators regarding the impact of the standards of care on the annuities market.
- Treasury encourages the SEC, the DOL, and the states to work together to implement a regulatory framework appropriately tailored to both preserve investor choice and protect retirement investors in an efficient and effective manner.

Matthew Thornton
Assistant General Counsel

Frances M. Stadler
Associate General Counsel & Corporate Secretary

Rachel H. Graham

Associate General Counsel

endnotes

[1] The Report is *available at* https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

[2] The executive order is *available at* https://www.whitehouse.gov/the-press-office/2017/02/03/presidential-executive-order-core-principles-regulating-united-states. For more information about the context in which the Report is issued, *see* ICI Memorandum 30748 (June 20, 2017), *available at* https://www.ici.org/my_ici/memorandum/memo30748.

[3] The Report states that "[t]ogether, the option to invest in actively or passively managed funds, or a combination of both, provides investors customization options to meet investment objectives."

[4] As support for this statement, the Report cites an ICI publication, *Trends in the Expenses and Fees of Funds, 2016* (May 2017).

[5] A text box on pages 44-45 of the Report discusses the experience of money market funds during the financial crisis and related regulatory actions. It also describes the Securities and Exchange Commission's 2010 and 2014 money market fund reforms. A footnote later in the Report (footnote 174) states that "[money market funds] are distinctly different in operation than other types of funds, and the SEC's recent structural reforms of [money market funds] significantly addressed the risks they could pose."

[6] The Report cites an ICI member survey finding a median increase in compliance costs of an estimated 20% over the past five years.

[7] For a list of the recommendations, *see* Appendix B of the Report.

[8] Among other things, each federal primary financial regulatory agency, in coordination with the Federal Reserve Board and the Federal Insurance Office, must issue "consistent and comparable" regulations to implement the stress tests.

[9] This recommendation appears on page 33 of the Report but is not listed in Appendix B.

[10] *See* Institute Memorandum No. 30334, dated October 21, 2016, for a detailed summary of the liquidity rule and related reporting requirements applicable to open-end funds (except for money market funds).

[11] The Report includes a brief discussion of swing pricing, a voluntary method of pricing mutual fund shares that will be permitted pursuant to Rule 22c-1 amendments adopted by the SEC in 2016. See Institute Memorandum No. 30333, dated October 21, 2016, for a detailed summary of swing pricing, the rule amendments, and related requirements. After casting doubt on the "first mover advantage" policy rationale for swing pricing, the Report states that "given current distribution practices of U.S. mutual funds, there may be practical difficulties with implementing swing pricing." Moreover, "Treasury encourages further analysis of whether, and to what extent, swing pricing is implemented by funds.

Particular concern should be focused on investor protection and whether funds are appropriately setting the amount of the swing as justified by relevant trading costs."

[12] *See* Institute Memorandum No. 29566, dated December 17, 2015, for a detailed summary of the proposed rule.

[13] The Report further indicates that "[a]ny portfolio limits, if adopted, should be based on significantly more risk-adjusted measures of a fund's derivatives than the current proposal."

[14] The Report states that the SEC should either re-propose its 2008 rule or propose a new rule on ETFs for public comment.

[15] *See* Institute Memorandum No. 30010, dated July 5, 2016, for a detailed summary of the proposed rule.

[16] The Report's recommendations applicable to private funds and their advisers are beyond the scope of this memorandum.

[17] This recommendation appears on page 53 of the Report but is not listed in Appendix B.

[18] For a brief summary of that report, including Treasury's recommendations to improve the Volcker Rule, *see* ICI Memorandum No. 30748, dated June 20, 2017.

Copyright © by the Investment Company Institute. All rights reserved. Information may be abridged and therefore incomplete. Communications from the Institute do not constitute, and should not be considered a substitute for, legal advice.