Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry

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Thank you for the invitation to join you today. On a personal note, it is particularly meaningful to me to be speaking for the first time in this building.

The SEC, which I have now chaired for 18 months, has many important priorities for the upcoming year. These include addressing structural questions about our complex, dispersed securities marketplace; reviewing our public company disclosure regime to make it more effective for investors; and completing the rulemakings mandated by Congress under the Dodd-Frank and JOBS Acts, to name just a few. What I have chosen to focus on here is our regulation of the asset management industry, which is one of the agency's most important responsibilities.

The SEC has regulated asset management since the passage of the Investment Advisers Act and the Investment Company Act in 1940 – nearly 75 years ago. Our objective in discharging this responsibility is guided by our overarching mission to protect investors, to maintain fair, orderly and efficient markets, and to facilitate capital formation. Over the years, our regulatory program for asset management has grown and adapted, guided by our mission, to address ever-evolving markets and the challenges that evolution presents. We are now embarking on a new period of regulatory change, driven by long-term trends in the industry and the lessons of the financial crisis.

This morning, I will talk about the SEC's perspective on the asset management industry today through a review of some of its most important features, highlighting the regulatory issues that the industry presents, and setting out how we plan to enhance and strengthen our response to those issues.

Evolving Regulatory Tools for an Evolving Industry

Currently, there are more than $63 trillion of assets under management[1] in what has become a vital part of our economy, with over 11,000 investment advisers and almost 10,000 mutual funds registered with the SEC.[2] This industry has grown exponentially from the $4 billion in assets and 51 firms Congress identified in 1940 that "managed, supervised and [gave] investment advice with respect to funds."[3]And the industry continues to grow, with the assets under management for most of the largest firms doubling since 2004.[4]

Investors, and retail investors in particular, have increasingly come to rely on advice from investment advisers and investments in mutual funds to meet their financial needs. In 2013, 57 million households, or 46 percent of all U.S. households, owned mutual funds.[5] American households invest in mutual funds, and hope their investments will grow, for many important reasons, including making a down payment on a house, saving for a college education, and ultimately providing income for retirement.

The industry has also created new products and implemented new investment strategies to meet a range of new demands from an increasingly diverse population of investors. Exchange-traded funds, for example, emerged in the early 1990s and have grown significantly since then.[6] In October 2014, trading in U.S.-listed ETFs and other exchange-traded products made up about a quarter of U.S. equity trading by dollar volume.[7] Private funds have also grown significantly in number and size,[8] and many mutual funds are now engaging in alternative investment strategies and using derivatives.[9]

Evolution of the asset management industry with new risks and challenges is not a surprising phenomenon. Over the years, the Commission and the staff have taken important steps to recalibrate its program to better match the current "facts on the ground."

Understanding the tools that the Investment Company Act and Investment Advisers Act give us to regulate asset management helps to illustrate this ongoing process. These statutes establish a comprehensive federal regulatory framework that addresses a wide range of activities and focuses on many complex areas of regulation. Three of the most significant tools provided are: controls on conflicts of interest; a registration, reporting and disclosure regime; and controls on fund portfolio composition risks and operational risks. I recognize that I am drawing general lines to organize very complex issues, but looking at these tools is important to understand the approach the SEC is taking to respond to the evolution of the asset management industry.

Let me take these tools in turn, starting with controls on conflicts of interest. The statutory framework establishes regulatory safeguards and incentives to address risks to investors emerging from the conflicts of interest existing in the organization, operation and management of investment advisers and funds.[10] Even reviewing just the last 15 years of Commission regulation demonstrates our careful focus on revising the approach to conflicts of interest to address modern market practices. For example, in 2003, the Commission required advisers and funds to implement written compliance programs and appoint chief compliance officers to address, among other things, abusive "market timing" practices that benefitted some investors at the expense of others.[11] And in 2010, the Commission amended advisers' disclosure brochures to more clearly explain conflicts of interest to their clients.[12]

The second set of tools is our registration, reporting and disclosure regime. Registration is the core regulatory foundation that enables the Commission to identify, monitor, and regulate funds and advisers. The periodic reporting and public disclosure of their key business arrangements, related conflicts, and compliance practices is critical for oversight. Here, too, the Commission has taken significant steps. Most recently, using authority granted under the Dodd-Frank Act, we implemented a comprehensive registration regime for investment advisers to certain private funds.[13] These rules use the framework laid out 75 years ago to address the much larger role that private fund advisers have come to play. The Commission also created a summary prospectus to better focus mutual fund investors on the fees and risks of a fund.[14]

Addressing Portfolio Composition Risks and Operational Risks

The importance and impact of conflicts of interest controls and the registration and reporting requirements are indisputable. But my main focus today is on the third set of tools: controls on portfolio composition risks and operational risks. By "portfolio composition risk," I mean the risk related to the mix of a fund's investments and the impact that mix, including the interaction of particular financial instruments, can have on a fund. Portfolio composition risks can include risks associated with the liquidity and leverage of a fund's holdings. And by "operational risk," I generally mean risk from inadequate or failed internal processes and systems.

Just as they do for conflicts of interest and registration, our governing statutes set forth a framework for addressing these issues. That is why mutual funds and investment advisers have limits on where to custody their assets and on what terms.[15] Capital structure restrictions limit leverage and protect a registered investment company's assets and investors from the risks associated with excessive borrowing or overexposure to indebtedness.[16] There are requirements for certain funds to diversify holdings.[17] And, of course, mutual funds must pay shareholders their redemption proceeds within seven days of any request.[18]

The Commission has regularly sought to evaluate and enhance its regulations to address portfolio composition and operational risks. Most recently, the Commission approved major reforms to money market funds that demand significant new controls to address the risks those funds present to investors and, potentially, the larger financial system.[19] Working with our fellow regulators, the Commission has also established reporting requirements for advisers to private funds that includes important information about certain private fund activities.[20] With respect to operational risk, the Commission has implemented a number of rules to protect customer information, including, most recently in 2013, rules to address the risk of identity theft.[21]

While these actions are all important, there is still work to be done. The financial crisis only underscored the importance of the careful management of risk by funds and their advisers, including portfolio composition and operational risks in particular. The Commission staff has been focused on such risks for some time, and has expanded and deepened its oversight of the industry, which enables us to better identify, monitor, and evaluate these risks in order to facilitate appropriate Commission responses.

It is not enough, however, to simply identify, monitor and evaluate. A broader set of proactive initiatives is required to help ensure that our regulatory program is fully addressing the increasingly complex portfolio composition and operations of today's asset management industry. And the staff, at my direction, has been developing recommendations for three core initiatives. This is the right set of initiatives for this stage of the development of the modern asset management industry.

First, we must improve the data and other information we use to draw conclusions about the risks of the asset management industry and develop appropriate regulatory responses. Existing data requirements need to be expanded and updated.

Second, we must take steps to ensure that registered funds enhance their fund-level controls so that they are able to identify and address risks related to the composition of modern portfolios, whether those spring from the overall financial profile of a fund, such as its liquidity levels, or the nature of specific instruments, such as derivatives.

And third, we must take steps to ensure that firms have a plan for transitioning their clients' assets when circumstances warrant. If we have learned nothing else from the financial crisis, it is that we must test and plan for the worst.

Enhancing Data Reporting

Let me begin with data. The SEC's ability to effectively identify and address risks in the asset management industry is diminished without the ability to monitor for those risks at the fund level and across the entire industry. 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. For example, our rules do not require standardized reporting for many types of derivatives used by funds today. This is a clear gap, particularly given the growth in the volume and complexity of derivatives used by funds.[22] Similarly, we do not today receive the most complete information about securities lending by funds, which is done by approximately a quarter of funds.[23]

The staff is developing recommendations for the Commission to modernize and enhance data reporting for both funds and advisers. Even the reporting of basic census information should be updated so that we are better able to monitor industry developments and potential compliance issues. Beyond 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. Collecting more data on separately managed accounts, where the adviser manages assets owned by a particular client, will also better inform examination priorities and the assessment of the risks associated with those accounts, which are a significant portion of the business of many investment advisers.

Enhancing Controls on Risks Related to Portfolio Composition

We also need to ensure that registered funds have controls in place that effectively identify and manage the risks of their current portfolio composition. Liquidity management and the use of derivatives in mutual funds and ETFs are two key areas of focus by the staff. Inadequate 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.

Liquidity risks affect investors in open-end investment companies and ETFs through the underlying assets in which those funds invest. A fund that does not manage liquidity risk in its portfolio could have difficulty meeting redemptions if it came under stress, particularly an open-end investment company, which has to provide shareholders with redemption proceeds within seven days of any redemption request.[24] And stress at funds facing increased redemptions could, in turn, potentially have spillover effects in the markets in which those funds invest. If a distressed fund, for example, has to sell securities at below-market prices to meet redemptions, it could drive down asset prices for funds and other investors holding those securities or similar assets.

Derivatives can pose a separate set of risks. The use of derivatives by registered funds has grown significantly in recent years, and many funds are using derivatives in increasingly complex ways.[25] While funds often use derivatives to manage risks or to more efficiently adjust exposure to a market, sector or security, these instruments also frequently result in leveraged investment exposures and potential future obligations that can create risks for the funds.

A more comprehensive approach is required to address the risks associated with the increasingly diverse nature of fund holdings and the use of derivatives. The Commission staff, both in Investment Management and our National Exam Program, have been focused on these issues for some time, and the results of these efforts are informing recommendations for the rulemaking in these areas.

At the most basic level, the 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, as well as measures to ensure the Commission's comprehensive oversight of those programs. The staff is also reviewing options for specific requirements, such as updated liquidity standards, disclosures of liquidity risks, or measures to appropriately limit the leverage created by a fund's use of derivatives. Such changes could better protect investors, provide better transparency about the liquidity risks associated with various funds, and mitigate any broader market implications were funds forced to sell assets precipitously to meet redemptions.

Improving Transition Planning and Stress Testing

A third focus of our regulatory enhancements is on the impact on investors of a market stress event or when an investment adviser is no longer able to serve its clients. There are several risks associated with such events. For example, during an adviser's dissolution or following the departure of key personnel, an adviser may face challenges in serving its clients' needs while also swiftly transferring its asset management services to another firm.

To better understand this risk, it is important to recognize that the risks associated with winding down an investment adviser are different than those associated with other kinds of financial firms. Client assets are not the assets of an adviser,[26] and advisers routinely exit the market without significant market impact; those exits, however, are not without challenges, and those challenges may differ depending on the adviser's clients. For example, if there are restrictions on investors' ability to access or move assets away from an adviser – or, more generally, *de facto* limitations imposed by illiquid assets or market conditions – a clear transition plan for that adviser could benefit investors and the market.

The staff is therefore developing a recommendation to require investment advisers to create transition plans to prepare for a major disruption in their business. The process of creating such a plan in advance of an actual severe disruption in the adviser's operations could better prepare advisers and their clients to deal with a transition and its attendant risks if one were required.

The staff is also considering ways to implement the new requirements for annual stress testing by large investment advisers and large funds, as required by the Dodd-Frank Act.[27] Stress testing is an important tool routinely used by banking regulators. Implementing this new mandate in asset management, while relatively novel, will help market participants and the Commission better understand the potential impact of stress events. Building on what we have learned about stress testing through money market reform, the staff is evaluating what protocols would be appropriate for investment advisers and investment companies. As with transition planning, the staff is considering how to tailor these requirements for asset management, as well as for different types of firms.

A Word on Systemic Risk

Taken together, the recommendations I have just outlined will lay the foundation for a renewed focus on regulating the risks arising from the portfolio composition and operations of investment advisers and funds. Before closing, I want to change my lens a bit and reflect very briefly on the Commission's role in addressing systemic risk, which has become part of the public dialogue about the regulation of asset management.

The term "systemic risk" can mean different things to different speakers, and addressing the range of meanings is well beyond the scope of my remarks today. But, clearly, one of the most fundamental post-crisis changes for all of the financial regulators, including the Commission, has been an emphasis on addressing risks that could have a systemic impact on the securities markets or the financial system as a whole. This renewed emphasis, in my view, complements our long-standing mission to protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation.

The program that I have just outlined is designed to serve our historic three-part mission. But, at the same time, the measures we take will necessarily have a broader impact on the financial system. Asset management is a significant segment of our financial system – and, as we all know, the nature of finance means that changes to *any* significant segment has consequences for the others.

Truly tackling systemic risk in any area, obviously, demands a broader program than one agency can execute. Systemic risks cannot be addressed alone – they are, after all, "systemic." Risks that could cascade through our financial system could have an impact on a range of market participants, many of which we do not oversee. The Financial Stability Oversight Council (FSOC) is an important forum for studying and identifying systemic risks across different markets and market participants. The market perspective that the SEC brings is an essential component of FSOC's efforts. And 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 we are now undertaking.

Conclusion

President Roosevelt rightly heralded the Investment Company Act and Investment Advisers Act as milestones in the "vigorous program…to protect the investor."[28] To continue this vigorous program, the SEC must 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.

Our objective, however, is not to eliminate all risk. Far from it. Investment risk is inherent in our capital markets – it is the engine that gives life to new companies and provides opportunities for investors. 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.

In all of these efforts, the details will matter a great deal and there is significant work to do before we have final rules in place. We will be looking to investors and market participants to provide us their views, and I will be working closely with my fellow Commissioners to translate staff recommendations into Commission action. While the SEC's regulation of asset management is strong and comprehensive, the source of that strength has been our willingness to take stock of our rules with a clear vision and implement the necessary changes to make effective regulation that fits current market realities. We have done that many times since 1940, and it is essential that we do so again in 2015.

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[1] This number reflects regulatory assets under management self-reported on Form ADV, and is based on Investment Adviser Registration Depository ("IARD") data as of Dec. 1, 2014. Features of the data result in the double counting of some assets.

[2] U.S. Securities and Exchange Commission: FY 2014 Congressional Budget Justification, at 4 (2014), *available at* http://www.sec.gov/about/reports/secfy14congbudgjust.pdf. These numbers are based on self-reported information from Form ADV, and features of the data result in certain entities being included in both sets of figures.

[3] Investment Company Act of 1940 and Investment Advisers Act of 1940, H.R. Rep. No. 76-2639, at 26 (1940) ("Although it is difficult to determine with precision the amount of public funds administered by investment advisers, some idea of the size of such funds may be deduced from the fact that only 51 firms for which information was available to the Securities and Exchange Commission, managed, supervised, and give investment advice with respect to funds aggregating approximately $4,000,000,000, a sum roughly equivalent to the entire assets of all investment trusts and investment companies now operating.").

[4] IARD Data as of Dec. 1, 2014. 84% of the largest 50 investment advisers based on regulatory assets under management have at least doubled their assets since 2004.

[5] *See* 2014 Investment Company Fact Book, Investment Company Institute, Figure 3.2 ("2014 ICI Fact Book"), *available at* http://www.ici.org/pdf/2014_factbook.pdf.

[6] *See* SPDR Trust Series I, Investment Company Act Release Nos. 18959 (Sept. 17, 1992) (notice) and 19055 (Oct. 26, 1992) (order). *See also* 2014 ICI Fact Book. Due to their characteristics, ETFs are only permitted to operate subject to Commission orders that provide exemptive relief from certain provisions of the Investment Company Act and rules thereunder.

[7] *See Volume, Value Traded, Market Share & Fragmentation Data*, Rosenblatt's Monthly ETP Review: October (Rosenblatt Securities Inc., New York, NY), Nov. 12, 2014, at 2-3 (ETP share of U.S. equity volume by dollar volume was 31.17% and ETP share of U.S. equity volume by shares was 20.01%).

[8] *See e.g.*, Annual Staff Report Relating to the Use of Data Collected from Private Fund Systemic Risk Reports, U.S. Securities and Exchange Commission (Aug. 15, 2014) (reporting more than 21,000 private funds with $8.8 trillion in regulatory assets under management), *available at* http://www.sec.gov/reportspubs/special-studies/im-private-fund-annual-report-081514.pdf. *See also* 2014 Preqin Global Private Equity Report, at 6, *available at* https://www.preqin.com/item/2014-preqin-global-private-equity-report/1/8194; Managed Funds Association: Hedge Fund Industry Seen to Continue Growth in 2014 (Jan. 9, 2014), *available at* https://www.managedfunds.org/2014/01/hedge-fund-industry-seen-continue-growth-2014/.

[9] Report of the Mutual Fund Directors Forum: Board Oversight of Alternative Investment (Jan. 2014) *available at* http://www.mfdf.org/images/uploads/newsroom/Board_Oversight_of_Alternative_Investments_-_January_2014.pdf.

[10] For example, our regulatory scheme encourages independence in fund governance and prohibits many affiliated transactions with funds. *See* Section 1(b)(3)-(4), 10 and 17 of the Investment Company Act. The system also recognizes the fiduciary nature of the advisory relationship, and attempts to eliminate or expose conflicts that may cause an investment adviser to render advice that is not disinterested. *See* SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 194 (1963).

[11] *See* Compliance Programs of Investment Companies and Investment Advisers, Investment Company Act Release No. 26299 (Dec. 17, 2003) [68 FR 74714 (Dec. 24, 2003)].

[12] *See* Amendments to Form ADV, Investment Advisers Act Release No. 3060 (July 28, 2010) [75 FR 49234 (Aug. 12, 2010)].

[13] *See* Rules Implementing Amendments to the Investment Advisers Act of 1940, Investment Advisers Act Release No. 3221 (June 22, 2011) [76 FR 42950 (July 19, 2011)]. *See also* Exemptions for Advisers to Venture Capital Funds, Private Fund Advisers With Less Than $150 Million in Assets Under Management, and Foreign Private Advisers, Investment Advisers Act Release No. 3222 (June 22, 2011) [76 FR 39645, 39680 (July 6, 2011)].

[14] *See* Enhanced Disclosure and New Prospectus Delivery Option for Registered Open-End Management Investment Companies, Investment Company Act Release No. 28584 (Jan. 13, 2009) [74 FR 4546 (Jan. 26, 2009)].

[15] *See* Section 17(f) of the Investment Company Act; 17 CFR 270.17f-1 to 17 CFR 270.17f-7; 17 CFR 275.206(4)-2.

[16] *See* Section 18 of the Investment Company Act. *See also* section 1(b)(7) of the Investment Company Act.

[17] *See* Sections 5(b)(1) and 13(a)(1) of the Investment Company Act.

[18] *See* Section 22(e) of the Investment Company Act.

[19] *See* Money Market Fund Reform; Amendments to Form PF, Investment Company Act Release No. 31166 (July 23, 2014) [79 FR 47735, (August 14, 2014)].

[20] *See* Reporting by Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors on Form PF, Investment Advisers Act Release No. 3308 (Oct. 31, 2011) [76 FR 711287 (Nov. 16, 2011)]. This information includes assets under management, use of leverage, counterparty credit risk exposure and trading practices. *See* Form PF, Reporting Form for Investment Advisers to Private Funds and Certain Commodity Pool Operators and Commodity Trading Advisors, *available at* http://www.sec.gov/about/forms/formpf.pdf.

[21] *See* Privacy of Consumer Financial Information, Investment Company Act Release No. 24543 (June 22, 2000) [65 FR 40334 (June 29, 2000)]; Limitations on Affiliate Marketing, Investment Company Act Release

No. 28842 (Nov. 5, 2009) [74 FR 58204 (Nov, 12, 2009)]; Identity Theft Red Flags Rules, Investment Company Act Release No. 3582 (Apr. 10, 2013) [78 FR 23637 (Apr. 19, 2013)].

[22] *See, e.g.*, Use of Derivatives by Registered Investment Companies Under the Investment Company Act of 1940, Investment Company Act Release No. 29776, at section I (Aug. 31, 2011) ("2011 Derivatives Concept Release"), *available at* http://www.sec.gov/rules/concept/2011/ic-29776.pdf.

[23] Based on staff analysis of public reports filed on Form N-SAR with the SEC by registered investment companies.

[24] *See* Section 22(e) of the Investment Company Act. *See, also*, In the Matter of Heartland Advisors, Inc., et al., Investment Company Release Act No. 28136 (Jan. 25, 2008).

[25] *See, e.g.*, 2011 Derivatives Concept Release, *supra* n. 22, at section I.

[26] Client assets are generally held at a third-party custodian and the creditors of the investment adviser have no claim to the client assets. *See* Section 17(f) of the Investment Company Act; 17 CFR 270.17f-1 to 17 CFR 270.17f-7; 17 CFR 275.206(4)-2.

[27] The Dodd-Frank Act requires the Commission to establish methodologies for this stress testing of financial companies such as broker-dealers, registered investment companies and registered investment advisers with $10B or more in total consolidated assets—including baseline, adverse, and severely adverse scenarios—and to design a reporting regime for this stress testing, which must be reported to the Commission and the Federal Reserve Board. *See*Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, section 165(i)(2), 124 Stat. 1423 (2010) (codified at 12 USC 5365).

[28] Franklin D. Roosevelt, Statement on Signing Two Statutes to Protect Investors (Aug. 23, 1940), *available at* http://www.presidency.ucsb.edu/ws/?pid=15993.