Asset Management and Financial Stability

Financial Stability Oversight Council Publishes Statement on Asset Management; Focuses on Liquidity, Leverage; Creates “Interagency Working Group” on Hedge Fund Leverage

SUMMARY

On April 18, 2016, the Financial Stability Oversight Council ("FSOC") held an open meeting during which it unanimously approved a public statement on its review of potential risks to U.S. financial stability that may arise from asset management products and activities (the "Statement"). The Statement follows the 2013 report by the Office of Financial Research (the "OFR") on systemic risk in the asset management industry (the "OFR Report") and FSOC’s subsequent announcement that it would undertake a thorough review of asset management products and activities, including a request for public comments on such products and activities.

The Statement focuses on two main topics: (i) liquidity and redemption risk, especially financial stability concerns that may arise from liquidity transformation and “first-mover” advantage, particularly in mutual funds; and (ii) the use of leverage, particularly by mutual funds and hedge funds. The Statement, citing the proposition that “no single regulator has all the information necessary to evaluate the complete risk profile of hedge funds,” also announces the creation of an “interagency working group” to further study whether use of leverage by hedge funds may pose a risk to financial stability, with a report expected in the fourth quarter of 2016. In addition, the Statement addresses operational risk (including service provider risk), securities lending (including the need for enhanced data collection) and resolvability and transition planning.

The Statement received notable public support from FSOC members. Most prominently, on April 20, 2016, U.S. Treasury Secretary Jacob J. Lew, who chairs FSOC, authored an op-ed in the Wall Street Journal explaining the Statement and defending the initiative, stating: “[FSOC’s] unanimous approval of
the [Statement] issued this week is an important step toward improving the stability of our financial system. U.S. Securities and Exchange Commission (“SEC”) Chair Mary Jo White and Commodities Futures Trading Commission (“CFTC”) Chairman Timothy Massad also made public statements. These actions may be a response in part to previous criticism of the OFR Report and FSOC’s procedures, as well as to the March 30, 2016, decision by the U.S. District Court for the District of Columbia rescinding FSOC’s designation of MetLife, Inc. as a systemically important non-bank financial company.

BACKGROUND

Section 113 of the Dodd-Frank Wall Street Reform and Consumer Protection Act (the “Dodd-Frank Act”) empowers FSOC to designate non-bank financial companies for supervision by the Board of Governors of the Federal Reserve System (the “Federal Reserve”) and application of enhanced prudential standards, while Section 120 of the Dodd-Frank Act allows FSOC to regulate on an activities basis by issuing recommendations to primary financial regulators.

FSOC initially focused its review of non-bank financial companies on three insurers, American International Group, Inc., Prudential Financial, Inc. and MetLife, Inc., as well as on General Electric Capital Corporation, Inc.

The OFR Report was released on September 2, 2013 and explores the ways in which asset management activities might create, amplify or transmit stress through the financial system. This report, which was widely criticized by the asset management industry, led to increased engagement between industry participants and regulators about how various asset management products function in an effort by industry participants to demonstrate asset management’s limited systemic risk.

FSOC hosted a public conference on asset management on May 19, 2014. Participants included individuals from the asset management industry, regulatory agencies, the public sector and academia, who discussed investment risk management, risks across the broader financial system and operational issues and resolvability. After this conference, FSOC directed its staff to undertake a more focused analysis of asset management products and activities.

In December 2014, FSOC published a notice seeking public comment on whether and how certain asset management products and activities (as distinguished from specific managers or firms) could pose potential risks to U.S. financial stability. FSOC received 49 comment letters from individual companies, trade organizations and public interest groups. Since receiving these comments, FSOC has continued its evaluation of asset management products and activities.

Contemporaneously with these domestic developments, the Financial Stability Board (“FSB”) and the International Organization of Securities Commissions (“IOSCO”) have undertaken a review of the asset management industry and issued two consultative documents proposing methodologies for designating asset managers and/or investment funds as “non-bank non-insurer global systemically important financial institutions.” Both of these consultative documents also received criticism from the asset management industry.
industry, leading both FSB and IOSCO, like FSOC, to focus on reviewing asset management activities before finalizing a joint assessment methodology for asset management under a global SIFI framework. The FSB’s review of asset managers has focused primarily on risks that may arise from liquidity mismatch, leverage, operational risk and securities lending. The FSB has stated publicly that it expects to launch a public consultation in mid-2016 on policy recommendations to address structural vulnerabilities arising from asset management activities.

**FSOC STATEMENT: LIQUIDITY AND REDEMPTION RISK**

In reviewing liquidity and redemption risk, FSOC has primarily addressed pooled investment vehicles and situations in which investor redemption rights may exceed available liquidity, with a particular (but not exclusive) focus on mutual funds. Consistent with this approach, the Statement highlights two features of pooled investment vehicles that it believes could give rise to systemic risk:

- **Liquidity Transformation**: Liquidity transformation occurs when investment vehicles allow frequent redemptions by investors while investing in less-liquid underlying assets. The Statement expresses concern that, during a stress event, the price of assets held by an investment vehicle may fall rapidly if large redemptions occur and the investment vehicle must sell its less-liquid assets, and incur significant losses, to meet redemption requests.

- **First-Mover Advantage**: The Statement expresses concern that certain redemption options and pricing methods may create a “first-mover” advantage whereby the transaction costs of redemptions are borne by the remaining investors, thus creating incentives for some investors to redeem as promptly as possible in times of (real or anticipated) market stress.

While the Statement notes that the magnitude of the effects of liquidity transformation in mutual funds is uncertain, it asserts that potential risks would appear to be more significant in funds that invest in less-liquid asset classes and at times when bid-ask spreads are widest. Although hedge funds are often less vulnerable to these risks, the Statement contends that they could still be forced to engage in large asset sales in order to meet redemption demands in times of stress or—the Statement argues more controversially—in times when investors fear that managers may invoke gates or suspensions and thus preemptively redeem. The Statement acknowledges that exchange-traded funds (“ETFs”) generally may not be vulnerable to the same types of liquidity and redemption risks.

FSOC believes that the following steps should be considered to mitigate the financial stability risks noted above:

- Robust liquidity management practices for mutual funds;
- Clear regulatory guidelines addressing limits on mutual funds’ holding of illiquid assets;
- Enhanced reporting and disclosure by mutual funds of their liquidity profiles and liquidity risk management practices;
- Facilitating use of tools to allocate redemption costs to redeeming shareholders;
- Additional disclosure and analysis of external sources of financing; and
• Measures to mitigate liquidity and redemption risks applicable to other pooled investment vehicles that offer daily redemptions.

The Statement expressly acknowledges that there are several already-pending regulatory developments related to many of these steps. Further details on existing regulatory initiatives, which the Statement mentions in passing, are included in Annex A to this Memorandum.

FSOC STATEMENT: LEVERAGE RISK

In the Statement, FSOC considers whether the use of leverage by investment vehicles increases the potential for direct and indirect losses to counterparties and other market participants. The Statement argues that, because leverage can magnify the impact of asset price fluctuations, margin calls or similar constraints triggered by significant changes in asset prices could require the disorderly sale of assets or unwinding of positions to satisfy those constraints.

Although the Statement’s discussion of leverage addresses certain major categories of investment vehicles, it devotes the greatest attention to hedge funds. Using data from SEC Form PF, FSOC found that “many hedge funds use relatively small amounts of leverage, but leverage appears to be concentrated in larger hedge funds, based on certain measures.” Further, the Statement contends that, because hedge fund counterparties are regulated by a variety of different regulatory bodies with varying jurisdictions, “no single regulator currently has all the information necessary to evaluate the complete risk profiles of hedge funds.”

The Statement discusses which, if any, metrics might be appropriate for identifying whether the use of leverage by hedge funds may present financial stability risks. Metrics formulated and considered by FSOC include:

• **Borrowing divided by net asset value (borrowing/NAV)** – indicates credit exposure relative to vehicle assets, but does not take into account synthetic leverage resulting from derivative investments.

• **Gross asset value divided by net asset value (GAV/NAV)** – indicates financial leverage resulting from cash borrowings, but accounts only for the mark-to-market value of derivatives and may thus understate synthetic leverage.

• **Gross notional exposure divided by net asset value (GNE/NAV)** – indicates the total absolute notional values of long and short positions. This measure accounts for both financial and synthetic leverage, but it ignores the effects of hedging and does not capture differences in risk exposure between different classes of derivatives.

The Statement reports that, for the second quarter of 2015, the weighted averages across all qualifying hedge funds for GAV/NAV, GNE/NAV, and borrowing/NAV were 1.8x, 5.5x, and 0.7x, respectively. When considering only the ten largest funds by GAV, however, the weighted averages for the three ratios were significantly higher, at 6.1x, 23.3x, and 4.6x, respectively. The Statement concludes that “larger hedge funds, as measured by GAV, tend to be more leveraged than smaller hedge funds.”
In his remarks at FSOC’s April 18, 2016 meeting, Timothy Massad, Chairman of the CFTC, agreed that it is difficult to find a proper metric for leverage, discussing, in particular, the shortcomings of “gross notional exposure,” which “does not take into account a variety of factors that affect risk, such as product type, offsetting positions, whether a transaction is cleared, or whether margin is collected.”

Massad continued that “[t]o analyze the implications of leverage, [regulators] need to take into consideration these and other critical market structure details.”

As a result of the challenges in understanding leverage risks to financial stability, the Statement announces the establishment of an interagency working group that will share and analyze data with a goal toward better assessing hedge fund activities and whether potential risks exist, although the Statement does not explain how the working group will be constituted. The working group will:

- Use available regulatory data to analyze the use of leverage in combination with other relevant factors;
- Assess the sufficiency of current data and reporting for evaluating risks; and
- Consider possible changes to and development of standards for assessing leverage risks.

The Statement indicates that the interagency working group will report its finding in the fourth quarter of 2016.

OTHER AREAS OF FSOC ANALYSIS
A. OPERATIONAL RISK

The Statement notes that FSOC has considered whether disruptions by service providers could present risks to the broader financial system, pointing to not only historical operational risks but also new and developing challenges, such as cybersecurity. To date, FSOC's review of operational risks has focused
on areas where there is a relatively high level of outsourcing by asset managers to a relatively small number of service providers. FSOC will continue to gather and analyze data on operational risks from service providers and best practices.

B. SECURITIES LENDING

The Statement also reports on FSOC’s analysis of securities lending transactions. Because securities lending can involve hedge funds or broker-dealers as borrowers, institutional investors and pension funds as lenders and banks or asset managers as lending agents, the Statement contends that understanding the potential financial stability implications of such transactions requires considering entities across the financial spectrum. The Statement notes that FSOC is particularly concerned with the risk to financial stability arising from the reinvestment of cash collateral by lenders. FSOC acknowledges that, while some data collection and data enhancement efforts are underway, there is currently little comprehensive data on securities lending. FSOC welcomes efforts by other agencies to develop data collection in this area, and, given the cross-border nature of securities lending, encourages collaboration with regulators in foreign jurisdictions in collecting and sharing data.

C. RESOLVABILITY AND TRANSITION PLANNING

FSOC’s review of asset management products and activities has also explored potential risks that may arise due to a resolution or liquidation of an asset management entity. In particular, FSOC is interested in whether resolvability challenges would amplify the liquidity/redemption and leverage risks discussed above.

OBSERVATIONS

In many respects, the Statement is a modest document, providing a promised update on FSOC’s asset management review but stopping short of recommending significant new policy initiatives besides the establishment of the interagency working group on hedge funds. As acknowledged by FSOC, regulations are already pending (or forthcoming) to address many, if not all, the risks identified in the Statement relating to mutual funds. Much of the rest of the Statement simply notes that various risks are possible but cannot currently be adequately quantified and therefore recommends further research.

Nonetheless, the Statement’s focus on hedge fund leverage and its conclusion that the largest hedge funds are significantly more leveraged than smaller hedge funds may signal a likely area of prospective regulatory scrutiny. The question of leverage at the largest hedge funds—which does not correspond directly to any existing regulatory initiative—appears to have contributed to the creation of the interagency working group. The discussion in the Statement is also notable in that it identifies risks created by an activity (i.e., use of leverage) rather than by a particular firm, but also suggests that the risks of the activity are influenced by the degree to which the activity is concentrated in the largest firms.
The Statement focuses only on one type of risk—that is, risks to the financial system by asset management activities or investment products. Presumably, any policy recommendations or proposed regulations that would follow from the research described in the Statement would adopt a more holistic approach, taking into account the benefits brought to the nation’s economy and the risk that such regulation would diminish those benefits. Through pooled investment vehicles, asset managers provide investing expertise to savers, are critical participants in the nation's retirement systems and play an important role in the capital allocation process. Pooled investment vehicles are, among other things, a key tool for allowing asset management to take place on a scale and at a cost that would not otherwise be possible. Any additional regulation of asset management activities—particularly regulation that were to go meaningfully beyond the in-progress initiatives referenced throughout the Statement and this Memorandum—would need to carefully balance the risk addressed with these beneficial elements and national policy objectives.  

The full text of the Statement can be found at:  
1 See Financial Stability Oversight Council, "Update on Review of Asset Management Products and Activities," (April 18, 2016) ("Statement").

2 Id. at 20.

3 Jacob J. Lew, Why We’re Reviewing Asset Management, WALL ST. J., April 19, 2016.

4 See, Mary Jo White, “Statement on Financial Stability Oversight Council’s Review of Asset Management Products and Activities” (April 18, 2016), and Timothy Massad, "Statement of Chairman Timothy Massad on the Financial Stability Oversight Council’s Update on its Review of Asset Management Products and Activities" (April 18, 2016). While Chair White expressed support for the Statement and acknowledged that there is overlap between the topics covered in the Statement and work currently being done by the SEC, she noted that the Statement "should not be read as an indication of the direction that the SEC’s final asset management rules may take."


6 12 U.S.C. §§ 5323(a) and 5330.

7 On March 31, 2016, General Electric Capital Corporation, Inc. submitted a petition to FSOC seeking to rescind its designation in light of material changes to its operations.


9 When the OFR Report was released, the SEC took the unusual step of soliciting comments on it. See Press Release, SEC, Public Feedback on OFR Study on Asset Management Issues (September 30, 2013). It was later reported that memos and emails between SEC staff and Treasury staff, which were obtained by a U.S. House of Representatives investigative panel, demonstrated that the SEC had warned the OFR of major flaws in earlier drafts of the report and pushed Treasury officials to make changes to the report before it was published; however, it appears that not all of the SEC’s concerns were addressed before the report was released. See Sarah N. Lynch, Memos Show SEC-Treasury Dispute Over 2013 Asset Management Study, REUTERS, April 7, 2014.


13 See Letter from Mark Carney, FSB Chairman to G20 Finance Ministers and Central Bank Governors (February 22, 2016) (“Once the . . . activity-based work is complete, the FSB, jointly with IOSCO, will conduct further analysis and finalise the assessment methodology for asset management under the global systemically important financial institutions (G-SIFI) framework. This analysis will focus on any residual risks once measures to address these activities are taken into account.”); see also Greg Medcraft, IOSCO Chairman, Speech at the Nation Press Club: IOSCO and the International Reform Agenda for Financial Market (June 22, 2015) (stating that at
IOSCO’s June 2015 board meeting it had decided that a “full review of asset management activities and products should be the immediate focus of work in identifying potential systemic risks and vulnerabilities in this space” and that this review “should take precedence over further work on methodologies for the designation of systemically important asset management entities”.

See Mark Carney, supra note 13.


With respect to mutual funds, the Statement claims that, although the Investment Company Act of 1940 places limits on leverage, certain alternative investment strategies enable mutual funds to achieve higher degrees of leverage. FSOC acknowledges the SEC’s December 2015 proposed rule that would limit such practices.


Statement at 20.

See Statement at 16. Although the SEC has previously released reports summarizing private fund industry statistics and trends, reflecting data collected through Form PF, the specific data points regarding leverage included in the Statement, which FSOC derived from Form PF, do not appear to have been previously available publicly. See SEC, Division of Investment Management, “Private Funds Statistics: Fourth Calendar Quarter 2014” (December 30, 2015) at 40. To date there has been little transparency with regard to how the SEC uses and analyzes Form PF data. Furthermore, although FSOC used Form PF as a starting point to analyze financial stability risk, the Statement notes a number of shortcomings of available data and metrics for assessing leverage. A “qualifying hedge fund” is “[a] hedge fund advised by a Large Hedge Fund Adviser that has a net asset value (individually or in combination with any feeder funds, parallel funds, and/or dependent parallel managed accounts) of at least $500 million as of the last day of any month in the fiscal quarter immediately preceding the adviser’s most recently completed fiscal quarter. Id. A “Large Hedge Fund Adviser” is “[a]n adviser that has at least $1 billion in combined liquidity fund and money market fund assets under management.” Id.

Statement at 16.

Massad, supra note 4.

Id.

In its 2015 Annual Report to Congress, the OFR stated that it is developing a “Hedge Fund Monitor” that will provide information on potential risks that could arise out of the hedge fund industry. The basis for the monitor would be commercially acquired data and SEC supervisory information. Office of Financial Research, “2015 Annual Report to Congress.”

See Statement at 21.

In her opinion rescinding FSOC’s designation of MetLife, Inc. as a systemically important non-bank financial company, Judge Rosemary M. Collyer suggested that FSOC was required to conduct a cost-benefit analysis before subjecting non-bank financial companies to designation. See decision in MetLife, Inc. (stating that FSOC’s refusal “to consider cost as part of its calculus” made it “impossible to know whether its designation ‘does significantly more harm than good’ and in itself rendered FSOC’s designation of MetLife, Inc. arbitrary and capricious).
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The Statement makes several general references to ongoing work being done by regulators, in particular the SEC, to address certain risks identified in the Statement. The following chart provides a high-level summary of the regulatory initiatives mentioned in the Statement; please refer to S&C’s previous Memoranda to Clients and relevant proposed rules (cited in the endnotes to this Annex) for full details.

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<th>FSOC Reference to Regulatory Initiative</th>
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<td>Amendments to modernize and enhance reporting and disclosure by registered investment companies and registered investment advisers</td>
<td>An SEC proposed rule, released on May 20, 2015, would replace Form N-Q under the Investment Company Act of 1940 (the “Investment Company Act”), currently used for reporting by most management investment companies, with a new Form N-PORT, to be filed by all registered management investment companies and unit investment trusts that operate as ETFs. The new form would include reporting on several risk metrics not currently included, as well on specific types of investment activity, including derivatives, securities lending and repurchase and reverse repurchase agreements. The rule would also implement related amendments to Regulation S-X, which control shareholder reports and registration statements, as well as widen data collection via a new Form N-CEN. The proposed rule would also implement changes to Form ADV, filed by registered investment advisers, including reporting information on separately managed accounts (“SMAs”) and wrap fee programs (discussed further below). The SEC has not indicated when it expects to issue a final rule.</td>
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<td>Disclosure by registered investment advisers of annual data on SMAs</td>
<td>Under the same proposed rule described above, advisers would be required to report aggregate information on SMAs, including regulatory assets under management (“RAUM”), the percentage of SMA RAUM in each of 10 asset classes and the percentage of SMA RAUM invested in derivatives. Moreover, advisers with at least $150 million in SMA RAUM would be required to report certain information on the use of derivatives and borrowings, while advisers with at least $10 billion in SMA RAUM would be required to report the weighted average gross notional value of derivatives across six different categories. The SEC has not indicated when it expects to issue a final rule.</td>
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<td>Liquidity risk management by mutual funds and ETFs and “swing pricing”</td>
<td>An SEC proposed rule, released on September 22, 2015, would require registered open-end management investment companies to implement liquidity risk management programs and categorize the liquidity of each portfolio position. As part of such a program, each fund would be required to establish a minimum percentage of net assets that could be converted to cash within three business days at a price that does not materially affect the value of the asset. Additionally, no more than 15% of total assets of such funds could be assets that could not be converted to cash within seven business days. The SEC has not indicated when it expects to issue a final rule.</td>
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<td>Use of derivatives by registered investment companies</td>
<td>An SEC proposed rule, released on December 11, 2015, would re-classify derivatives as “senior securities” for purposes of restrictions under the Investment Company Act and require registered investment companies, including mutual funds and ETFs, to comply with one of two alternative portfolio limitations imposing a total amount of leverage obtained through derivatives. Additionally, funds would be required to maintain “qualifying coverage assets” with respect to each derivative so as to be able to meet commitments under such transactions. A fund engaging in derivative transactions with a combined notional value of at least 50% of the fund’s net assets would be required to establish a formal derivatives risk management program. The proposed rule also includes further amendments to proposed Forms N-PORT and N-CEN (which, as described above, the SEC initially proposed in May 2015, but which have yet to be adopted) that would add disclosure requirements relating to use of derivatives and risk calculations. The SEC has not indicated when it expects to issue a final rule.</td>
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<td>SEC review of ETFs</td>
<td>In response to unusual price volatility on August 24, 2015, the SEC published a research note in December 2015, analyzing data relating to ETFs and exchange-traded products (“ETPs”), observing that ETPs “as a class experienced more substantial increases in volume and more severe volatility” and that “extreme volatility seemed to occur idiosyncratically among otherwise seemingly similar ETPs.” The note was primarily an attempt to explain a historical anomaly, and did not contain any policy recommendations.</td>
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<td>Joint securities lending data collection pilot of Office of Financial Research, Federal Reserve and SEC</td>
<td>On January 13, 2016, the OFR released a brief analyzing new data about the bilateral repo market. The data was collected from U.S. dealer affiliates of nine bank holding companies who agreed to share the data through a voluntary pilot program run by the OFR, the Federal Reserve and the SEC. The same agencies are currently conducting a second pilot program focusing on collecting data regarding securities lending. This second pilot program includes participants other than dealers. The Statement encourages efforts to propose and adopt a rule for permanent collection of securities lending data, and suggests that collection of securities lending data and bilateral repo data could be combined into one proposed rule.</td>
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<td>SEC work on proposed rule for transition planning</td>
<td>The SEC has announced intent to propose rules requiring all fund managers to create transition plans in the event of an asset manager’s dissolution or the departure of key personnel. Testifying before the House Financial Services Committee on November 18, 2015, Chair White predicted that an SEC proposal on transition planning would be issued “relatively early [in 2016].” However, as the Statement acknowledges, the SEC has not issued any specific proposals or recommendations to date, and the SEC’s Fall 2015 Agency Rule List indicates that a proposed rule may not be issued until October 2016.</td>
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<td>SEC work on stress testing for large registered investment advisers and registered investment companies</td>
<td>The SEC has also announced plans to implement annual stress tests for large investment advisers and large funds pursuant to the Dodd-Frank Act. In her November 18, 2015 testimony before the House Financial Services Committee, Chair White did not give an indication of when such a proposal would be issued, noting that the SEC, in developing stress tests for investment advisers and investment companies, must account for “different kinds” of assets and stresses than banks. The SEC’s Fall 2015 Agency Rule List indicates that a proposal may be issued in October 2016.</td>
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ENDNOTES


6. See Key Burne, Nine Banks Tapped to Provide Regulators With Repo Data, WALL ST. J., March 1, 2016.

7. See Statement at 25.

8. See Mary Jo White, Chair, SEC, Enhancing Risk Monitoring and Regulatory Safeguards for the Asset Management Industry (Dec. 11, 2014); Dave Grim, Acting Dir., Div. of Inv. Mgmt., SEC, Remarks to 2014 IAA Compliance Conference (Mar. 6, 2015).


10. See SEC Agency Rule List – Fall 2015 (RIN 3235-AL62).

11. See White, supra note 8.
