Testimony on "Oversight of the SEC's Division of Investment Management"

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Subcommittee on Capital Markets and Government Sponsored Enterprises

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Chairman Garrett, Ranking Member Maloney, and Members of the Subcommittee:

Thank you for inviting me to testify today on behalf of the U.S. Securities and Exchange Commission (Commission) about the Division of Investment Management's (Division) activities and responsibilities.

The tripartite mission of the Commission is to protect investors, maintain fair, orderly and efficient markets, and facilitate capital formation. The Division promotes this mission through regulating the asset management industry. A primary function of the Division is to administer the Investment Company Act of 1940 (Investment Company Act) and Investment Advisers Act of 1940 (Investment Advisers Act) and to develop regulatory policy for both investment companies – including mutual funds, closed-end funds,[1] business development companies,[2] unit investment trusts (UITs),[3] and exchange-traded funds (ETFs)[4] – and investment advisers, all of which play a major role in the lives of Americans and our national economy.

Investors, in particular retail investors, have increasingly come to rely on investments in mutual funds to reach their financial goals. At the end of 2014, more than 53 million households

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[1] Closed-end funds generally do not continuously offer their shares for sale and are not required to repurchase or redeem them. Rather, they sell a fixed number of shares at one time (in an initial public offering), after which the shares typically trade on a secondary market, such as the New York Stock Exchange or the Nasdaq Stock Market.

[2] Congress created business development companies in 1980 as a specialized type of closed-end investment company (*i.e.,* a fund that is not required to repurchase or redeem its securities) whose principal activities consist of investing in, and providing managerial assistance to, small, growing, or financially troubled domestic businesses.

[3] A UIT is a type of investment company which (a) is organized under a trust indenture contract of custodianship or agency or similar instrument; (b) does not have a board of directors; and (c) issues only redeemable securities.

[4] Like mutual funds, ETFs offer investors a way to pool their money in a fund that makes investments in stocks, bonds, or other assets and, in return, to receive an interest in that investment pool. Unlike mutual funds, however, ETF shares are traded on a national stock exchange and at market prices that may or may not be the same as the net asset value of the shares, that is, the value of the ETF's assets minus its liabilities divided by the number of shares outstanding . Some ETFs track the performance of specific U.S. equity indexes, while others track indexes of fixed-income instruments and foreign securities. In addition, many newer ETFs are actively managed – that is, they do not merely seek to passively track an index, and instead seek to achieve a specified investment objective using an active investment strategy.

– more than 43 percent of all U.S. households – owned mutual funds. Mutual funds are the largest segment of the investment company industry, accounting for 87 percent of the over $18.7 trillion in total investment company assets. Assets in mutual funds have grown from $94.5 billion at the end of 1979 to $16.3 trillion at July 31, 2015, a more than 173 fold increase. Over the same period, the number of mutual fund portfolios has increased from 526 to 8,059.

Like mutual funds, ETFs also have become increasingly popular as investment vehicles for both retail and institutional investors. ETFs have grown rapidly in recent years, with assets in ETFs increasing from $300.8 billion at the end of 2005 to $2.1 trillion at July 31, 2015, a more than 600% increase.

Protecting investors through the regulation of registered investment advisers is another of the Division's crucial roles. As of October 1, 2015, there were 11,986 investment advisers registered with the Commission reporting approximately $66.9 trillion in regulatory assets under management, which was an 8 percent increase from the beginning of fiscal year 2015. Approximately 60 percent of these advisers provide investment advice to individuals. Beyond this, approximately 37 percent of these SEC-registered investment advisers provide investment advice to approximately 29,000 private funds (e.g., hedge funds, private equity funds, and venture capital funds) with gross assets of about $10.4 trillion.

In addition to registered investment advisers, the Commission also receives reports from approximately 3,047 exempt reporting advisers. These are advisers whose only clients are private funds and are exempt from registration with the Commission. These advisers manage over 10,000 private funds accounting for $2.3 trillion.

The Division carries out the Commission's mission through its dedicated staff, which includes lawyers, accountants, quantitative analysts, economists, industry experts and other employees primarily in Washington, DC, but also located in SEC Regional Offices in New York, Philadelphia, and Chicago. The four core activities of the Division are: (1) crafting rulemaking recommendations to the Commission on matters within the Division's expertise; (2) reviewing fund filings; (3) providing interpretive and other advice to the asset management industry and the public about the securities laws and corresponding regulations; and (4) monitoring risks in the asset management industry. Below is an overview of those activities.

Recent Investment Management Rulemaking Initiatives

Money Market Fund Reform

In July 2014, the Commission adopted significant reforms to the rules governing money market mutual funds. The amendments were intended to reduce the risk of runs in money market funds, provide important tools to help further protect investors and the financial system in a crisis, and enhance the transparency and fairness of these products for America's investors.

Under the new rules, "institutional prime" money market funds[5] will be required to maintain a floating net asset value (NAV) based on the current market value of the securities in

[5] These funds include all money market funds except retail and government money market funds.

their portfolios. The rules also provide new tools for boards of directors of money market funds to directly address heightened redemptions in a fund. Specifically, fund boards will be able to impose liquidity fees or to suspend redemptions temporarily, also known as "gates," if a fund's level of weekly liquid assets falls below certain thresholds. The Commission provided for approximately a two-year transition period for these new provisions, with the rules becoming effective in October 2016, to enable both funds and investors time to fully adapt their systems, operations, and investing practices.

The new rules also enhance money market fund disclosure requirements. Specifically, money market funds will be required to promptly disclose certain significant events, including the imposition or removal of fees or gates, portfolio security defaults, and instances of sponsor support. In addition, money market funds will be required to disclose additional key information on their website on a daily basis, including funds' liquidity levels, net shareholder flows, and market-based net asset values per share.

In September 2015, the Commission also adopted amendments related to the removal of credit ratings references in rule 2a-7, the primary rule that governs money market funds under the Investment Company Act and in Form N-MFP, the money market fund portfolio disclosure form. The amendments give effect to section 939A of the Dodd Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank Act).

Investment Company Reporting Modernization & Amendments to Form ADV and Investment Advisers Act Rules

The Commission's rules should evolve with developments in the asset management industry. To that end, on May 20, 2015, the Commission proposed new rules and forms as well as amendments to its rules and forms to modernize the reporting and disclosure of information by registered investment companies.

If the proposed rules are adopted, a new monthly portfolio reporting form, Form N-PORT, would require registered funds other than money market funds to provide portfolio-wide and position-level holdings data to the Commission on a monthly basis. Information contained on reports for the last month of each fund's fiscal quarter would be available to the public. In light of the proposed Form N-PORT, the Commission proposed rescinding Form N-Q, on which funds currently report certain portfolio holdings for the first and third fiscal quarters.

A new annual reporting form, Form N-CEN, would be established if the proposed rules are adopted. It would require registered funds to annually report certain census-type information to the Commission and would replace the form currently used to report fund census information (Form N-SAR). The form would streamline and update information reported to the Commission to reflect current information needs, such as requiring more information on ETFs and securities lending. Reports would be filed annually within 60 days of the end of the fund's fiscal year, rather than semi-annually as is currently required by Form N-SAR for most funds.

If adopted, funds would report portfolio and census information in a structured data format, which would improve the ability of the Commission and the public both to aggregate and

analyze information across all funds and to link the reported information with information from other sources. The Commission currently receives this type of reporting for: (1) money market funds through the publicly available Form N-MFP; and (2) certain private funds through Form PF, which is reported to the Commission.

The proposed amendments also would require enhanced and standardized financial statement disclosures. For example, the proposed amendments would include requirements to provide: derivatives-related information in financial statements similar to what would be required in the proposed monthly portfolio holdings reports;[6] and information in the notes to the financial statements relating to a fund's securities lending activities.

The proposed amendments also would permit mutual funds and other registered investment companies to provide shareholder reports and the funds' quarterly portfolio holdings for the past year by making them accessible on their website, unless shareholders specifically request paper copies. Funds currently satisfy delivery requirements by printing and mailing shareholder reports unless investors have affirmatively requested electronic delivery.[7]

Also on May 20, 2015, the Commission proposed amendments to Form ADV, the primary investment adviser reporting and disclosure form. The amendments are designed to: (1) provide additional information regarding advisers, including information about their separately managed account business; and (2) address issues that staff has identified since the Commission made significant changes to Form ADV in 2011.[8] The amendments also would incorporate a method for private fund adviser entities operating a single advisory business to register using a single Form ADV.

In addition, the proposed amendments would, if adopted, require advisers to maintain records of the calculation of performance information that is distributed to any person. Currently, advisers are required to maintain performance information that is distributed to 10 or more persons. The proposed amendments also would require advisers to maintain communications related to performance or rate of return of accounts and securities recommendations.

With respect to all of the proposed amendments, the Commission has received substantial public comment. These comments will be analyzed in connection with the staff's development of recommendations to the Commission on final rules.

Liquidity Management Programs for Funds

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[6] Current requirements do not include specific information for many types of derivatives, such as swaps, futures, and forwards.

[7] Under the proposed rule, funds would be required to send notices to investors regarding the change to electronic delivery and online availability of shareholder reports on a regular basis, and the notices would need to inform investors how to receive free of charge paper copies of shareholder reports.

[8] For example, the proposals would, if adopted, require aggregate information related to assets held and use of borrowings and derivatives in separately managed accounts and provide additional information about an adviser's advisory business, including branch office operations and the use of social media.

In addition to these proposals, to further address developments in the asset management industry, on September 22, 2015, the Commission proposed a new rule that if adopted would require open-end funds to adopt and implement liquidity management programs. The proposed amendments also, if adopted, would permit mutual funds to use "swing pricing," and would enhance disclosure regarding fund liquidity and redemption practices.

Specifically, the proposed rule would require mutual funds and other open-end management investment companies, including ETFs, to have a liquidity risk management program. The proposed rule would exclude money market funds from the requirements because they are already subject to liquidity requirements tailored to their particular structure and operations.

The Commission also proposed amendments that if adopted would permit, but not require, open-end funds (except money market funds or ETFs) to use "swing pricing." Swing pricing is the process of reflecting in a fund's net asset value the costs associated with the trading activity of the fund occasioned by shareholders' redemptions and purchases in order to pass those costs on to the purchasing and redeeming shareholders. Additionally, proposed amendments to the registration form used by open-end investment companies (Form N-1A) would, if adopted, require funds to disclose swing pricing, if applicable, and the methods used by funds to meet redemptions.

Proposed amendments to the census reporting form the Commission proposed in May 2015 also would require funds to disclose information regarding committed lines of credit, interfund borrowing and lending, and swing pricing.

The comment period for the proposed rules will be open through January 13, 2016.

Other Potential Rules to Enhance Risk Monitoring and Regulatory Safeguards

At the direction of the Chair, the Division also is working on initiatives aimed at helping to ensure the Commission's regulatory program is fully addressing the increasingly complex portfolio composition and operations of the asset management industry. These initiatives include potential new rules concerning the following:

- *Use of Derivatives by Investment Companies* – The Division, in close consultation with staff in the SEC's Division of Economic and Risk Analysis, is considering recommending that the Commission propose new requirements related to the use of derivatives by funds, including measures to appropriately limit the leverage these instruments may create, and measures to enhance risk management programs for such activities.

- *Transition Plans for Investment Advisers* – The Division also is considering recommending that the Commission propose a new requirement that investment advisers registered with the Commission create and maintain transition plans to prepare for a major disruption in their business.

- *Stress Testing for Large Investment Advisers and Large Investment Companies* – In addition, the Division is considering recommending that the Commission propose new requirements for stress testing by large investment advisers and large investment companies. Such rules would implement section 165(i) of the Dodd Frank Act.

- *Third-Party Compliance Reviews* – Division staff, working in conjunction with the staff from the SEC's Office of Compliance Inspections and Examinations (OCIE), is developing a recommendation for the Commission's consideration that, if proposed and adopted, would establish a program of third-party compliance reviews for registered investment advisers. The reviews would not replace examinations conducted by OCIE, but would supplement them in order to improve compliance by registered investment advisers.

Personalized Investment Advice Standard of Conduct

Section 913 of the Dodd Frank Act grants the Commission authority under the Exchange Act and Advisers Act to adopt rules establishing a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers. The Commission issued a public request for information to obtain further data and other information to assist it in determining whether or not to use the authority provided under section 913 of the Dodd Frank Act.

In March of this year, Chair White expressed her view that the SEC should act to implement a uniform fiduciary standard of conduct for broker-dealers and investment advisers when providing personalized investment advice about securities to retail customers, and directed staff to prepare such a recommendation for the Commission's consideration. The issue is a complicated one that has been contemplated in prior years without a rule being proposed, and whether a rule is ultimately proposed and adopted depends on further analysis and action by the full Commission.

Target Date Funds

On April 3, 2014, the Commission issued a release reopening the period for public comment on proposed rule amendments concerning target date fund names and marketing. The release requested additional comment on a 2010 Commission proposal to require that certain marketing materials for target date retirement funds provide better information to investors and reduce the potential for investors to be confused or misled. The Division is continuing to evaluate the comment letters submitted to the Commission and is considering what further actions may be appropriate.

Reviewing Fund Filings and Disclosures

In addition to rulemaking, Division staff helps fulfill the Commission's mission by reviewing and commenting on the numerous prospectuses, proxy statements, and other

disclosure documents filed by mutual funds, ETFs, closed-end funds, business development companies, variable insurance products issuers, and UITs each year.

The staff reviews new portfolios of open-end funds, closed-end funds and UITs, and new insurance contracts.[9] The staff also examines certain post-effective amendments that contain material changes in disclosure or in fund operations, as well as certain preliminary proxy statements. Additionally, the staff continues to fulfill the Sarbanes-Oxley Act requirement to review investment company issuer accounting statements at least once every three years.

In the course of a filing review, Division staff will conduct an evaluation of a fund's disclosure and will, as appropriate, issue comments to elicit better compliance with applicable disclosure requirements, as well as other applicable statutory and rule requirements under the federal securities laws. In response to Division staff comments, a fund may amend its disclosures to provide additional or enhanced information in the filing that is under review. A fund may also provide Division staff with information that supplements what is contained in the filing so staff can better understand the fund's disclosure decisions.

Division staff coordinates with other offices and divisions within the Commission on complex or interconnected issues that arise within these reviews. Division staff also identifies new and recurring issues that may need new policy guidance. Where appropriate, Division staff refers matters to the SEC's Office of Compliance Inspections and Examinations or the Division of Enforcement. Division staff also continues to seek to improve the quality and consistency of our comments, as well as the overall effectiveness of our filing review process.

To increase the transparency of the filing review process, after Division staff completes its review of a filing, its comments and fund responses to those comments are made public on the Commission's website.

As part of the filing review process, Division staff also is responsible for: (1) providing advice to help ensure the full and fair disclosure of financial information by investment companies and issuers of variable insurance products; (2) rendering interpretations as to the meaning and application of rules relating to the form and content of financial statements required to be filed by investment companies, issuers of variable insurance products, and investment advisers; and (3) recommending the establishment, in collaboration with the other divisions and offices of the Commission, of sound and uniform standards of auditing and accounting procedures and practices with respect to investment companies, variable insurance products, and investment advisers.

Guidance & Exemptive Relief

The Division also is responsible for issuing no-action letters, interpretive letters, and other guidance under both the Investment Company Act and the Investment Advisers Act (and their related rules), as well as under other federal securities laws that affect the asset management industry. In addition, the Division provides counsel to the Commission, SEC staff, and non-SEC

[9] Division staff reviews all new fund and UIT portfolios except those for which the disclosure is substantially identical to disclosures previously reviewed by the staff.

persons on matters involving the interplay of the Investment Company Act and Investment Advisers Act (and their related rules) with other federal and state laws.

Division staff also reviews all enforcement matters that concern investment companies and investment advisers. In carrying out this function, Division staff has extensive contact with other divisions and offices, including the Commission's regional offices and enforcement and examination staff.

In addition, Division staff reviews applications from entities that request exemptions from provisions of the Investment Company Act or the Investment Advisers Act. By granting exemptive relief, the Commission can encourage innovation in financial products and services while assuring that appropriate investor protections remain in place. Exemptive relief also affords the Commission a means to adapt the application of the Acts to current markets and practices

Risk Monitoring

Pursuant to Section 965 of the Dodd-Frank Act, the Division established a new risk and examinations office. Division staff assigned to this office monitors trends in the asset management industry and carries out the Division's limited inspection and examination program. In addition, Division staff periodicallymeet with the senior management of large asset management firms and fund boards as part of the staff's ongoing outreach efforts.

Financial Stability Oversight Council

On December 18, 2014, the Financial Stability Oversight Council (FSOC) voted unanimously to release a notice seeking public comment regarding potential risks to U.S. financial stability from asset management products and activities. Division staff has reviewed the comments received on this notice and are working with the staffs of other FSOC members to analyze potential risks, if any, to U.S. financial stability from asset management products and activities.

Conclusion

Thank you again for inviting me to discuss the Division's activities and responsibilities. I am happy to answer your questions.